Attracting and retaining talent

Corporate Update

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Attracting and retaining talent is a top concern for a company at any stage of growth, especially early in development when cash may be scarce. Founders often want to "cut in" key employees to allow them to participate in future growth through issuing shares. However, there is more than one way to accomplish this goal. This article provides a spectrum of alternatives that companies can utilize to attract and retain talent.

Issuing shares

Most common, companies can issue shares to incentivize the participation and performance of employees in the company. Under Canadian corporate law, any shares issued for this purpose would need to be issued at fair market value, which may pose problems for the company, most significantly relating to taxes (unless the company undergoes an estate freeze and locks the value of the company).

All recipients of shares would be required to sign a shareholder agreement to address issues including transferability and mandatory sale or buy-out mechanisms in the event the employee leaves the company. Companies should be mindful of the reality that entering a shareholder relationship creates various entitlements (for example, the right not to be treated oppressively by majority shareholders). Additionally, while not impossible, it is much more difficult to "get shares back" once issued, if the relationship between the company and the employee does not work out.

If providing votes to employees is problematic, a company can issue non-voting shares. While this solves certain problems regarding the employee's participation in the company (i.e., not being involved in day-to-day corporate law matters, including selecting the board of directors), non-voting shareholders still have rights under Canadian corporate law to approve financials and fundamental transactions such as amalgamations.

Granting options

Company grants options directly to employee

Companies can grant options to purchase shares directly to employees under their respective employment agreement. The employee would receive options that could vest over time or upon reaching certain pre-defined milestones. Once exercised, the option holder would typically become a shareholder and would benefit from the performance of the company on a go forward basis, since the exercise price is almost always equal to the fair market value of the shares.

In addition to various tax benefits, the company has the ability to decide when the employee becomes a shareholder. For example, this can be triggered during the life of the business as the options vest or only upon a liquidity event (e.g., sale of the company). If the company intends on scaling its option pool and granting options to a number of employees, it is more prudent to create a formal employee stock option plan as it ensures there is consistency around the terms and conditions.

Company grants options indirectly to employee via a trust

In lieu of issuing options directly to an employee (via individual agreements or a stock option plan), companies can issue options to a trust. Under this arrangement, there is a central decision-maker that controls the block of shares, rather than numerous small shareholders. The trust would become party to the shareholder agreement. This type of arrangement is typically used where the employee is not required to pay a fair market value exercise price for the shares held by the trust. As a result, it is common to do a freeze before putting the trust arrangement in place.

Granting participation in the proceeds of sale

Companies can grant employees the right to participate in the proceeds upon a sale of the company. Under this alternative, employees do not become "shareholders", with all the rights and responsibilities granted therewith, which alleviates some of the risks outlined above. Employees would derive value from the ability to financially capitalize upon the sale of the company on the basis of some pre-set formula. Notably, this option is not as tax effective for companies as holding shares or options directly and the employee would not accrue financial benefit from the annual performance of the company.

Offering profit or revenue sharing

Companies can offer profit or revenue sharing. Under this alternative, employees realize a benefit from the positive performance of the company (or a division), with the company's obligation to pay triggered when the company hits a certain profit or revenue threshold. This option is not as tax effective for companies as holding shares or options directly, but can be combined with granting employees participation in proceeds of a sale to truly mimic a shareholder relationship.

Talent is a key contributor to business performance. Providing talent with value, which often translates to 'skin in the game', can serve as a valuable tool to ensure your company is not constrained by a drain on talent or by the resources deployed to re-hire after an inability to retain.

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