

# EMPLOYEE SHARE OWNERSHIP IN AUSTRALIA: THEORY, EVIDENCE, CURRENT PRACTICE AND REGULATION

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## ABSTRACT

*Since at least the 1970s, employee share ownership has enjoyed bipartisan support in Australia. Despite broad and sustained public policy interest in employee share ownership, Australian literature on the subject remains scarce. There has also been very little in the way of comprehensive analysis of the regulatory framework. This paper provides an overview of employee share ownership from an Australian perspective. It begins by reviewing the literature on broad-based employee share ownership before turning to examine available data on Australian practice. It then considers how employee share ownership plans are currently provided for in public policy and law. Companies in Australia proposing to offer securities to employees must comply with a myriad of regulatory requirements. This paper examines these requirements. It also examines features of the current regulatory framework which have been identified as problematic.*

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## 1. INTRODUCTION

In Australia, interest in broad-based employee share ownership (ESO) is reflected in the inquiry held by the Commonwealth House of Representatives Standing Committee on Employment, Education and Workplace Relations into ESO in 2000;<sup>1</sup> the establishment in 2003 of a promotional Employee Share Ownership Development Unit (ESODU) within the Commonwealth Government's Department of Employment and Workplace Relations; and, in February 2004, the announcement by the Minister for Employment and Workplace Relations of a target of doubling employee share ownership plans (ESOPs) in workplaces from 5 to 11 percent of employees by 2009.<sup>2</sup> In addition, there are several organisations and networks within Australia devoted to promoting employee ownership.<sup>3</sup> Nonetheless, despite the breadth of interest in the subject, scholarship on broad-based employee share ownership in Australia remains scarce.

This paper is intended to provide a foundation for further inquiry into employee share ownership in Australia. It is produced under the auspices of the Employee Share Ownership Project, a joint initiative of the Centre for Corporate Law and Securities Regulation, the Centre for Employment and Labour Relations Law and The Tax Group, The University of Melbourne. Funded by the Australian Research Council, this three year project will subject the existing regulatory regime for employee share ownership plans in Australia—in tax, corporate and labour law—to technical and empirical scrutiny. The project examines the current incidence and forms of ESOPs in Australia, the diversity of objectives that such schemes serve, the extent to which current corporate, tax and labour law inhibits ESOPs, and the case for reform of the regulatory framework. Produced in the early stages of this project, this paper surveys the existing research on employee share ownership and the current regulatory regime.

This paper is structured as follows. Part 2 of this paper reviews the literature on employee share ownership. As literature on the practice in Australia is limited, the review draws heavily upon studies conducted in Europe and the United States. Part 3

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1. Parliament of Austl., H.R., Standing Comm. on Employment, Educ. and Workplace Relations, *Shared Endeavours: An Inquiry Into Employee Share Ownership In Australia* (2000), available at <http://www.aph.gov.au/house/committee/ewr/eso/Report/Index.htm> (last visited Oct. 18, 2007) [hereinafter *Shared Endeavours*].

2. Press Release, Kevin Andrews, Minister for Employment and Workplace Relations, *Promoting Employee Share Ownership* (Feb. 25, 2004), available at <http://www.remstrategy.com/downloads/DEWR.pdf> (last visited Nov. 29, 2007).

3. See, e.g., Australian Employee Ownership Association, <http://www.aeo.org.au>, and Employee Ownership Group, <http://www.eogroup.org>.

of this paper provides an overview of existing data on employee share ownership in Australia. Parts 4 and 5 of the paper examine the regulatory framework for employee share ownership in Australia. There is no singular piece of legislation regulating the establishment or administration of ESOPs. Companies proposing to offer securities to employees must ensure they comply with a myriad of regulatory requirements. These regulatory considerations emanate principally from corporate law and taxation law. Part 4 analyses how the corporate law framework in Australia regulates employee share plans. Part 5 analyses the taxation law framework. In analysing the current framework, the authors also identify areas of the current regime which have been recognized as being problematic.

## 2. A REVIEW OF THE LITERATURE

Employee share ownership is a form of employee financial participation that confers on employees the right to share in the wealth of the company and, in theory at least, the right to exercise some degree of control over company affairs. Despite sustained and bipartisan interest in employee share ownership in Australia over the last three decades or so, literature on the subject remains scarce. What literature exists tends to be written from a practitioner's perspective,<sup>4</sup> limited to brief magazine articles, or preliminary and tentative in nature.<sup>5</sup>

The majority of the literature on employee share ownership comes from the U.K. and the US. An increasing amount also comes from Europe—generally as a result of increased promotion of financial participation, including ESO, by the European Commission since the early 1990s.<sup>6</sup> There is also some, but very

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4. See, e.g., John Sartori, *Employee Share Ownership Plans – Issues Confronting ASX Listed Companies*, 23 COMPANY & SEC. L.J. 71 (2005).

5. See, e.g., DAVID PEETZ, DEP'T OF INDUS. RELATIONS, FINANCIAL PARTICIPATION BY EMPLOYEES: A REVIEW OF THEORETICAL AND PRACTICAL ISSUES (1988); Michael J. Aitken & Robert E. Wood, *Employee Stock Ownership Plans: Issues and Evidence*, 31 J. INDUS. REL. 147 (1989); Rayna Brown & Cheung Wah Lau, *The Extent and Industrial Pattern of Employee Share Ownership Plans in Australia: Preliminary Evidence*, 10 ACCT. RES. J. 34 (1997); Jarrod Lenne, Richard Mitchell and Ian Ramsay, *Employee Share Ownership Schemes in Australia: A Survey of Key Issues and Themes*, 14 INT'L J. EMP. STUD. 1 (2006).

6. In 1992, the European Commission issued its Recommendation Concerning the Promotion of Employee Participation in Profits and Enterprise Results, Council Recommendation 92/443, 1992 O.J. (L 245) 53 (known as the PEPPER recommendation). Since this time, the issue of financial participation has been explored and affirmed by the Commission in numerous reports and recommendations. See Erik Poutsma & Willem de Nijs, *Broad-Based Employee Financial Participation in the European Union*, 14 INT'L. J. HUM. RESOURCE MGMT. 863 (2003).

limited, attention paid to ESO in Africa,<sup>7</sup> Asia<sup>8</sup> and the transitional countries in Eastern Europe.<sup>9</sup>

The diversity of the literature on employee share ownership makes compiling a literature review a challenging task. Literature on employee share ownership is found in a range of disciplines: Finance, Financial Economics, Labour Economics, Corporate Finance, Human Resource Management, and Industrial Relations.<sup>10</sup> The various disciplines are interested in different issues posed by employee share ownership and tend to use different data.<sup>11</sup> In particular, a distinction can be drawn between research and analysis that focuses on the *control potential* of financial participation and that which focuses on the *productivity potential*. Those who adopt the former view are concerned with the potential for employee share ownership to enhance employee control over the organisations in which they work, that is, to contribute to some form of industrial democratisation. Those who focus on the latter emphasise the effect that ESO may have on organisational performance.<sup>12</sup>

This literature review organises the material as follows. Part 2.2 looks at the rationales provided for employee share ownership, focusing in particular on the Australian perspective. Part 2.3 identifies the key criticisms of employee share ownership. Part 2.4 provides an overview of the principle streams of research conducted into employee share ownership. In Part 2.5, the authors consider the interaction between employee share owner-

7. M. Wright et al., *Employee Ownership in Enterprises in Africa and Asia*, 11 INT'L J. HUM. RESOURCE MGMT. 90 (2000).

8. See, e.g., T. Holland, *A Piece of the Pie*, FAR E. ECON. REV., Aug. 3, 2000, at 40; Warren Chi-kwan et al., *When Marx Borrows from Smith: The ESOP in China*, 14 J. CONTEMP. CHINA 761 (2005); Beom-cheol Cin et al., *A Tale of Two Tigers: Employee Financial Participation in Korea and Taiwan*, 14 INT'L J. HUM. RESOURCE MGMT. 920 (2003); Beom-cheol Cin & Stephen C. Smith, *Employee Stock Ownership and Participation in South Korea: Incidence, Productivity Effects, and Prospects*, 6 REV. DEV. ECON. 263 (2002); Derek C. Jones & Takao Kato, *Employee Stock Ownership Plans and Productivity in Japanese Manufacturing Firms*, 31 BRIT. J. INDUS. REL. 31 (1993); Derek C. Jones & Takao Kato, *The Scope, Nature and Effects of Employee Stock Ownership Plans in Japan*, 46 INDUS. & LAB. REL. REV. 352 (1993).

9. See, e.g., Panu Kalmi, *The Rise and Fall of Employee Ownership in Estonia: 1987 – 2001*, 55 EUR.-ASIA STUD. 1213 (2003); BELA GALGOCZI & JANOS HOVORKA, INT'L LABOR ORG., EMPLOYEE OWNERSHIP IN HUNGARY: THE ROLE OF EMPLOYERS AND WORKERS ORGANISATIONS (1998).

10. Andrew Pendleton et al., *Theoretical Study on Stock Options in Small and Medium Enterprises*, Final Report to the Enterprise-Directorate General, Commission of the European Communities, 2002, at 5, available at [http://ec.europa.eu/enterprise/entrepreneurship/support\\_measures/stock\\_options/theoretical\\_study.pdf](http://ec.europa.eu/enterprise/entrepreneurship/support_measures/stock_options/theoretical_study.pdf) (last visited Nov. 29, 2007).

11. *Id.* at 10.

12. See Erik Poutsma & Willem de Nijs, *Financial Participation in the 1990s – Dissemination and Challenges*, 20 ECON. & INDUS. DEMOCRACY 163, 166 (1999).

ship and corporate governance. Finally, the review identifies the strand of literature that has taken a comparative approach to employee share ownership in different countries.

## 2.1 SCOPE AND METHODOLOGY

This literature review explores the law and policy issues arising in the context of employee share ownership. It focuses on broad-based employee share schemes: that is, schemes in which a majority of employees are eligible to take up shares. More specifically, it focuses on 'conventional' employee share schemes, which are generally introduced by management and confer only a small proportion of equity on employees.<sup>13</sup> However, the article also addresses schemes which transfer a substantial portion of equity to employees. Executive-based share plans are not discussed, as they raise different issues and public policy considerations.<sup>14</sup>

This review takes a broad approach. It does not examine the 'mechanics' of ESOPs in any detail, such as how the shares should be funded, the limitations on the issue of shares, restrictions on the disposal of shares by employees, or whether the shares are placed under the control of the individual workers concerned or under the control of a collective agency (trustee) on their behalf. Finally, this review has attempted to draw upon the international literature relevant to the Australian context.

## 2.2 RATIONALES FOR EMPLOYEE SHARE OWNERSHIP

There are many rationales offered to support employee share ownership, 'informed by a variety of ideologies and intentions.'<sup>15</sup> Some justifications are focused on the enterprise level, whereas others see ESOP as part of a broader social or macro-economic project. Since at least the 1970s, broad-based employee share ownership has enjoyed bipartisan support in Australia. The promotion of employee share ownership continues to be an objective of both the Liberal Party of Australia and the Australian Labour Party (ALP).<sup>16</sup> The current federal Coalition Government has committed to doubling the incidence of em-

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13. For a discussion of the various types of employee ownership and of classificatory criteria that can be employed to distinguish between the various types, see David J. Toscano, *Toward a Typology of Employee Ownership*, 36 HUM. REL. 581 (1983) and Aitken & Wood, *supra* note 5.

14. See *Shared Endeavours*, *supra* note 1, for a discussion of the regulatory framework and potential reforms.

15. *Id.* at 30.

16. See AUSTL. LABOR PARTY, 2007 NATIONAL PLATFORM AND CONSTITUTION 130, available at <http://www.alp.org.au/platform/index.php> (last visited Oct. 18, 2007).

ployee share schemes in the workplace from 5.5 percent to 11 percent of employees by 2009.<sup>17</sup> The ALP has recently foreshadowed an examination of measures to facilitate employee share ownership.<sup>18</sup>

In 1999, the Minister for Employment, Workplace Relations and Small Business, Peter Reith, directed a joint Parliamentary Committee to 'inquire into and report on the extent to which employee share ownership schemes have been established in Australian enterprises and the resultant effects on: workplace relations and productivity in enterprises; and the economy.' The Committee's report, *Shared Endeavours*, was tabled in Parliament in September 2000.

*Shared Endeavours* was overwhelmingly in favour of the promotion of broad-based employee share ownership plans in Australia.<sup>19</sup> The Dissenting Report by the Labor members of the Committee concurred with the Majority Report that broad-based employee share ownership schemes should be encouraged. Moreover, the Labor members supported a number of the Majority Report's recommendations for the promotion of these sorts of plans. They were cautious to note, however, that there was no clear and objective evidence to support the conclusion, however intuitive it might seem, that broad-based employee share plans better aligned employer and employee interests and fostered increased productivity and workplace harmony.<sup>20</sup> The Dissenting Report focused largely on their concerns with the capacity of employee share plans, as currently regulated, to facilitate tax avoidance by company executives.

Over the years, public policy makers in Australia have identified a number of key benefits arising from broad-based participation in employee share schemes. Some justifications are focused on the enterprise level, whereas others see ESOPs as part of a broader social or macro-economic project. The principal rationales that have featured in public policy discourse in Australia are outlined briefly below.

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17. Andrews, *supra* note 2.

18. See Wayne Swan, Shadow Treasurer, Keynote Address to the Labor Business Forum: Australia's Economic Future (Sept. 19, 2006).

19. The Shared Endeavours Majority Report identified a range of legislative and institutional reforms that would facilitate the public policy objectives identified. Of the forty-five policy recommendations, however, the Australian Government rejected close to thirty. The Government appears to have rejected further calls for legislative reform in favour of a 'lighter touch' approach, embodied in the establishment in 2003 of the Employee Share Ownership Unit (ESODU) within the Department of Workplace Relations.

20. Shared Endeavours, *supra* note 1, at 290.

### 2.2.1 *Improving enterprise performance*

Employee share ownership is identified as a means of enhancing enterprise performance through promoting worker productivity. The theoretical basis for this rationale is generally located in agency theory.<sup>21</sup> Agency theory proceeds from the basis that the fact that the interests of employees are not congruent with those of the company imposes considerable costs on the company. There are two commonly identified ways in which ESOPs reduce agency costs: through increased productivity as a result of employees feeling they have a direct interest in the performance of the enterprise (thus enhancing commitment to the objectives of the company); and through lowering monitoring costs by aligning employee interests with those of the company.<sup>22</sup> Former Prime Minister John Howard's policy statement in 2000, *Employee Share Ownership Plan Initiatives*, emphasised the importance of ESOPs in providing incentives for employees to achieve high levels of productivity.<sup>23</sup>

The ALP has proved more circumspect in relation to the capacity of employee share ownership to improve enterprise productivity. In 2004, for example, in response to a motion in the House of Representatives for reforms to the employee share ownership framework, the Shadow Minister for Workplace Relations, Craig Emerson, observed that as a member of the Nelson Committee, he had discovered that the links between employee share ownership and productivity were elusive.<sup>24</sup> In mid-2006, the Shadow Treasurer Wayne Swan observed the link in empirical research between employee share ownership and productivity, though he noted that this benefit only appeared to eventuate when ESOPs were coupled with participative management practices.<sup>25</sup>

Other commentators have doubted the effectiveness of ESOPs in improving enterprise performance. For example, Mong notes that not all employees will work harder as a result of share ownership, as they will choose to 'free-ride' off the efforts of

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21. Andrew Pendleton, *Incentives, Monitoring, and Employee Stock Ownership Plans: New Evidence and Interpretations*, 45 *INDUS. REL.* 753 (2006).

22. *Id.* See also ESOPs: Their Role in Corporate Finance and Performance 24–26 (NICK WILSON ED., 1992).

23. Peter Reith, Minister for Employment, Workplace Relations and Small Business, The Role of Employee Share Ownership in the New Workplace (Address to the Australian Employee Ownership Association Breakfast Briefing: Future Directions in Employee Ownership, Canberra, Jun. 29, 2000). See also John Howard, *Employee Share Plans Initiatives*, cited by Peter Reith, *supra* note 24.

24. COMMONWEALTH OF AUSTR., PARLIAMENTARY DEBATES, H.R., Official Hansard, Mar. 1, 2004, at 25375, available at <http://www.aph.gov.au/Hansard/reps/dailys/dr010304.pdf>.

25. Swan, *supra* note 18.

other employee shareholders and that rewards for increased productivity will be diluted by the number of shares held by non-employees. She also notes that incentive efforts may be offset by employees (usually executives) using financial products, such as options, to reduce their risk exposure, and who therefore may not be concerned with increased productivity.<sup>26</sup>

### 2.2.2 Industrial relations objectives

There is a range of industrial relations or human resource management ('HRM') rationales for employee share ownership. Employee share ownership is viewed by some as a potential means of enhancing industrial democracy or of bringing the employee into corporate governance.<sup>27</sup> For some, ESO is a means of increasing employee understanding of how the company for which they work operates and, more broadly, of 'absorbing the principles on which the economy of the country is run.'<sup>28</sup> For others, ESO is seen as a means of facilitating labour-management cooperation through breaking down the 'them' and 'us' mentality. Some identify ESOPs as a substitute for salary or wages when business is not performing well. More recently, employee share ownership, as a means of financial participation, is identified by HRM scholars as one practice within a 'bundle' of HR practices that together constitute a high performance work system.<sup>29</sup> Employee share ownership also intersects with the discourse on labour-management 'partnerships.'<sup>30</sup>

The capacity of employee share ownership to promote cooperative workplace relations has been repeatedly emphasised by the Liberal/National Party Coalition Government. Employee share ownership featured in the Coalition's 1996 Industrial Relations Policy, *Better Pay for Better Work*.<sup>31</sup> John Howard's policy statement in 2000, *Employee Share Ownership Plan Initiatives*, also emphasised the importance of employee share ownership plans in building a sense of participation in Australian business through giving employees a direct stake in the enterprise in

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26. Sheila Mong, *Employee Share Ownership Plans – Reform or Rethink*, 15 AUSTL. TAX FORUM 413, 416 (1999/2000).

27. Gorm Winther & Richard Marens, *Participative Democracy May Go a Long Way: Comparative Growth Performance of Employee Ownership Firms in New York and Washington States*, 18 ECON. & INDUS. DEMOCRACY 393, 394 (1997).

28. See Lenne et al., *supra* note 5, at 7–8.

29. Paul Gollan et al., *New Roads in Organizational Participation?*, 45 INDUS. RELATIONS 499, 507–8 (2006); Stephen Wood, *High Commitment Management and Payment Systems*, 33 J. MGMT. ST. 1 (1996).

30. See, e.g., Poutsma & de Nijs, *supra* note 12, at 167. In Australia, see Klaas Woldring, *Employee Share Ownership Should Be Part of the HRM Repertoire*, 39 HUM. RESOURCE MGMT. BULL., Feb. 27, 2006.

31. See Reith, *supra* note 23.

which they work.<sup>32</sup> Since this time, the capacity of employee share ownership to promote the 'mutuality of interests' in the workplace has been repeatedly identified by successive workplace relations ministers.<sup>33</sup> Tony Abbot, in particular, proved to be a passionate supporter of employee share ownership during his time as Federal Minister for Employment Services, Workplace Relations and Small Businesses from 2001 to 2003. In his words:

... if we are ever going to have workplaces which are more like partnerships and less like battlefields, we need to have a situation where workers and managers have a better perspective on each others' situation. And I think the best way to do that is through greater employee share ownership.<sup>34</sup>

For others, employee share ownership is a means of enhancing industrial democracy or of bringing the employee into corporate governance.<sup>35</sup> The ALP's 2004 platform (now superseded) identified the promotion of employee share ownership as a key principle to be pursued, as a means of 'Promoting Industrial Democracy and Cooperative Workplaces.'<sup>36</sup>

### 2.2.3 *Contributing to national savings*

The potential contribution of ESOPs to national savings was identified as a rationale for employee share schemes at least as early as the mid-1990s.<sup>37</sup> In 1996, the Federal Treasurer Peter Costello observed that giving 'blue-collar Australians' a 'stake in the business' will provide them with 'the opportunity to secure for themselves the kind of financial independence this government would like to see.'<sup>38</sup> The Prime Minister has emphasised the importance of employee share ownership plans in increasing the voluntary savings of Australian households and in 'fostering a more balanced approach to retirement planning.'<sup>39</sup> In 2000,

32. Howard, *supra* note 23.

33. See, e.g., Reith, *supra* note 23.

34. Tony Abbott, Address to the CEDA/Telstra Political and Economic Overview Conference, (Feb. 2, 2001), available at <http://www.tonyabbott.com.au/news/default.asp?action=article&ID=233> (last visited Oct. 18, 2007).

35. Winther & Marens, *supra* note 27, at 394.

36. AUSTRALIAN LABOR PARTY, 2004 NATIONAL PLATFORM AND CONSTITUTION, Ch. 3, ¶112, available at [http://www.alp.org.au/download/now/platform\\_2004.pdf](http://www.alp.org.au/download/now/platform_2004.pdf).

37. See, e.g., the numerous second reading speeches delivered in relation to the Taxation Law Amendment Bill, No. 2 (1995) (Austl.), COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, H.R., Official Hansard, Jun. 22, 1995.

38. Questions without Notice: Employee Share Ownership, COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, H.R., Official Hansard, Nov. 6, 1996, at 6665. See also Howard, *supra* note 23.

39. See Howard, *supra* note 23; John Howard, Competence, Philosophy and Future Challenges, Address to the National Press Club (2001), available at <http://www.australianpolitics.com/news/2001/01-08-01a.shtml> (last accessed Jan. 28, 2007).

however, *Shared Endeavours* observed that the place of employee share ownership in 'a national savings program has not been fully considered by Parliament nor been the subject of clear policy.'<sup>40</sup>

#### 2.2.4 Promoting innovation

Since 2001, employee share ownership has been featured within the Government's initiative to promote science and innovation. The initial strategy document—*Backing Australia's Ability: An Innovation Action Plan for the Future*—published in 2001,<sup>41</sup> noted that a high-level Ministerial Committee responsible for overseeing the implementation of *Backing Australia's Ability* would examine a number of areas in order to ensure that relevant policies provide the most effective support for R&D, its commercial application and skills development. The document identified as one of these specific areas the potential extension of employee share ownership schemes in small and medium unlisted companies, as well as in companies in sunrise and new industries.<sup>42</sup>

#### 2.2.5 Remuneration objectives

Although employee share ownership has never been highlighted as a policy objective in its own right, a number of comments related it to the desirability of giving employers and employees greater flexibility in determining the nature and mix of remuneration packages. For example, in a submission to the Nelson Committee, the Treasurer stated that ESOPs were 'consistent with Government policy of allowing employers and employees greater flexibility and choice in their working arrangements.'<sup>43</sup>

#### 2.2.6 Other objectives

The Nelson Committee identified a further objective, namely that the promotion of ESOPs could facilitate 'employee buyouts and succession planning.'<sup>44</sup> Although there was no real discussion of the issues, they had been raised in submissions to

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40. *Shared Endeavours*, *supra* note 1, at 47.

41. The initial 2001 package, *Backing Australia's Ability*, which comprised AUS\$3 billion over five years to 2005–2006, was extended on May 6, 2004. Together, the two packages constitute a ten-year, AUS\$8.3 billion funding commitment, stretching from 2001–2002 to 2010–2011. See <http://backingaus.innovation.gov.au> (last visited Nov. 29, 2007).

42. Available at <http://backingaus.innovation.gov.au/docs/statement/backing.rtf> (last visited Oct. 18, 2007).

43. *Shared Endeavours*, *supra* note 1, §2.78.

44. See *id.* Recommendation 5.

the Committee and the Majority Report noted that using ESOPs in this way would greatly expand the level of share ownership in Australia.<sup>45</sup>

The *Shared Endeavours* Majority Report identified three inter-related objectives: 1) 'ownership objectives,' whereby plans are used to transfer all or part ownership of a company; 2) 'remuneration objectives,' whereby shares are used as an incentive for employees; and 3) 'workplace change objectives,' whereby shares are used to 'change the culture' of a company.<sup>46</sup> The importance of these objectives may vary according to the company and the country context. According to the Australian Employee Ownership Association (AEOA), for example, ownership considerations are predominant in the U.S., whereas remuneration and cultural change motives appear dominant in Australia.<sup>47</sup>

The *Shared Endeavours* Majority Report concluded that public policy should be formulated so as to promote ESOPs for four purposes: 1) to better align the interests of employees and employers; 2) to develop national savings; 3) to facilitate the development of sunrise enterprises; and 4) to facilitate employee buyouts and succession planning.<sup>48</sup>

### 2.3 THE COSTS OF EMPLOYEE SHARE OWNERSHIP

The most widely identified cost arising from employee share ownership is the financial risk it imposes on employees. In general, employees have less discretionary income and a lower ability to diversify their risks than conventional investors. The wage system allocates the greater proportion of risk upon shareholders who are more capable of bearing the risk. Employee share ownership shifts some of this risk back on employees.<sup>49</sup> Through broad-based ESOPs, an 'employee is asked to make an equity investment in the same company in which his or her labour is invested. Should the company fail, the employee loses on both investments.'<sup>50</sup> The extent to which ESOPs expose employees to risk will, of course, vary significantly depending on the way the ESOP is structured and the regulatory framework. In the U.S., for example, ESOPs have been criticised for exposing employees

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45. *Shared Endeavours*, *supra* note 1, at 53-54.

46. *Id.* at 30.

47. AEOA submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations' Inquiry into Employee Share Ownership in Australian Enterprises 4 (April 1999).

48. *Shared Endeavours*, *supra* note 1, at 54.

49. PEETZ, *supra* note 5, at 16-17.

50. Aitken & Wood, *supra* note 5, at 159.

to high levels of risk as employees' pensions, personal wealth and wages may all be tied to the same company.<sup>51</sup>

Trade unions have historically taken a cautious approach to employee share ownership.<sup>52</sup> Pendleton identifies three principal issues that trade unions in the U.K. have had with ESOPs. First, ESOPs in the U.K. have generally fallen outside the scope of collective bargaining, meaning that they are often not subject to negotiation. Second, concerns have been raised that ESOPs may diminish the employee's need for trade union representation. Finally, ESOPs are seen as potentially confusing and undermining the representative role of trade unions through placing them in a position where they are representing both employees and owners.<sup>53</sup> Wariness towards the impact of ESOPs on trade unions is strongly associated with Harvie Ramsay's Marxist critique of employee participation. Ramsay's 'cycles of control' thesis contends that employers have introduced mechanisms for financial participation by employees, including share ownership schemes, at times when the power of labour has been strong, as a means of gaining workers' compliance.<sup>54</sup> Through promoting employee identification with the company, employers have sought to undermine or avoid trade union representation.<sup>55</sup>

Pendleton has argued that financial participation by employees is a much more complex phenomenon than Ramsay described. First, Pendleton notes that Ramsay's 'cycles of control' thesis fails to account for the sustained interest in ESOPs in the U.K. since the late 1970s. Second, a number of studies suggest that employers' reasons for introducing ESOPs are much more complex than a simple desire to undermine trade unionism.<sup>56</sup> While employers may be attracted by ESOPs for their potential to increase employee commitment, industrial relations considera-

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51. See, e.g., William R. Levin, *The False Promise of Worker Capitalism: Congress and the Leveraged Employee Stock Ownership Plan*, 95 YALE L.J. 148, 168 (1985). Levin argues that this level of risk is sufficient to justify the elimination of ESOP subsidies in the US. See also Amy J. Maggs, *Enron, ESOPs and Fiduciary Duty*, 16 BENEFITS L. REV. 42 (2003), Jennifer O'Hare, *Misleading Employer Communications and the Securities Fraud Implications of the Employee as Investor*, 48 VILL. L. REV. 1217 (2003), and Sharon Epperson, *Don't Bet It All on Your Employer: The Plunge of Enron Stock Serves as a Warning That Workers Should Not Invest Too Much in Their Company*, TIME, Dec. 3, 2001, at 79.

52. In the Australian context, see, e.g., AUSTRALIAN COUNCIL OF TRADE UNIONS, *EMPLOYEE SHARE OWNERSHIP PLANS – HANDLE WITH CARE* (1993).

53. See generally Andrew Pendleton, *Employee Ownership, Participation and Governance: A Study of ESOPs in the UK* (2001).

54. See Andrew Pendleton, *Employee Share Ownership, Employment Relationships and Corporate Governance*, in *Participation and Democracy at Work: Essays in Honour of Harvie Ramsay 75* (Bill Harley et al. eds., 2005).

55. *Id.* at 77–78.

56. *Id.*

tions are rarely at the forefront of employers' considerations. Adopting an institutional perspective, Pendleton argues that the character, practices and outcomes of financial participation arise from the interaction between actor interests and behaviours in specific institutional contexts.<sup>57</sup>

Employee share ownership may also impose costs on non-employee shareholders. While generally not a concern for large companies, employee share ownership has the potential to dilute a company's capital base, thus disadvantaging non-employee shareholders. It may also lead to a loss of control of the company where it is small or where the shares are closely held. Some managers may be wary of the potential for ESOPs to lead to greater control of the company by employees through employees voting as a block. There are many ways around this problem, including restrictions on voting or the use of 'shadow' shares.<sup>58</sup> Stradwick, writing on ESO in Australia in 1996, dismisses this fear as 'so remote as to be almost nil.'<sup>59</sup> Finally, concerns are raised over the potential for ESOPs to be used as a means of avoiding tax.<sup>60</sup>

#### 2.4 RESEARCH INTO EMPLOYEE SHARE OWNERSHIP

Research into employee share ownership can be grouped into two broad categories.<sup>61</sup> The first perspective, located largely within the field of labour economics, seeks to establish whether employee share ownership has an impact on company performance. The second broad perspective focuses on the industrial relations and human resource management issues posed by employee share ownership. Authors within these disciplines have explored a range of issues. These include the relationship between employee share ownership and participation by employees, both at the workplace level and in corporate governance; how participation in an ESOP affects employee attitudes and levels of commitment to the company; the relationship between employee share ownership and trade unions; employer and employee perceptions of ESOPs; the characteristics of companies adopting ESOPs; and particular issues arising out of majority em-

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57. *Id.*

58. Richard Stradwick, *Employee Share Plans: Equity Participation for Employee Commitment* 32 (1996).

59. *Id.*

60. *See, e.g.*, Shared Endeavours, *supra* note 1, Dissenting Report.

61. For similar attempts to categorise the research on employee share ownership, *see* Erik Poutsma, Willem de Nijs & Michael Poole, *The Global Phenomenon of Employee Financial Participation*, 14 INT'L J. HUM. RESOURCE MGMT. 855, 858-59 (2003); PENDLETON, *supra* note 54, at 10-12.

ployee-owned enterprises. Each of these areas of inquiry is summarised briefly below.

#### 2.4.1 *The labour economics literature*

##### *Do ESOP companies perform better than those without ESOPs?*

There is a considerable amount of empirical research that attempts to assess whether the implementation of employee share ownership leads to enhanced organisational performance. As noted above, the theoretical departure point for much of this research is the principal-agent problem.<sup>62</sup> There are two commonly identified ways in which ESO schemes reduce agency costs: through increased productivity as a result of employees' feeling they have a direct interest in the performance of the enterprise (thus enhancing commitment to the objectives of the company); and through lowering monitoring costs through aligning employee interests with those of the company.<sup>63</sup>

A number of theoretical explanations have been proffered for the precise way in which ESOPs lead to increased organisational performance.<sup>64</sup> First is the 'pure incentive effect of financial involvement' by employees as they receive some income (deferred or cash) which is directly linked to the performance of the enterprise. Second, ESOPs cause the employee to identify with the company, thus leading to reduced employee turnover and absenteeism. Finally, ESOPs may provide incentives for employee owners to share information at all levels, resulting in increased organisational efficiency. All the above, however, are predicated on the finding of some 'psychology of ownership' arising from ESOPs.<sup>65</sup>

Australian research into the link between employee share ownership and productivity is very limited. There are no extensive studies on the existence of, or reasons for, any link between the ESOPs and increased productivity.<sup>66</sup> In 1997, Brown and Wah Lau argued that, for employees, the perceived link between increasing their own effort and improved value of their equity holding was so tenuous as to be non-existent, so there is no real

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62. Pendleton, *supra* note 21.

63. *Id.* See also ESOPs: Their Role in Corporate Finance and Performance, *supra* note 22, at 24–26.

64. Conte and Svejnar identify six potential linkages between employee ownership and improved organisational performance. Michael A. Conte & Jan Svejnar, *The Performance Effects of Employee Ownership Plans*, in *PAYING FOR PRODUCTIVITY: A LOOK AT THE EVIDENCE* 143 (Alan Blinder ed., 1990).

65. *Id.* at 26.

66. *SHARED ENDEAVOURS*, *supra* note 1, at 41.

incentive to improve performance.<sup>67</sup> However, data drawn from the AWIRS 1995 indicated a positive correlation between companies with ESOPs (particularly those with broad based participation practices) and lower rates of absenteeism and higher productivity.<sup>68</sup> In contrast, based on a survey conducted among delegates in 1999, the Australian Manufacturers Workers' Union argued that the presence of a share scheme did not have an observable impact on productivity.<sup>69</sup> The *Shared Endeavours* majority report noted a correlation between ESO and higher rates of industrial action. This finding contrasts with the supposed 'industrial harmony' benefits of ESO. The report, however, dismissed this correlation, arguing that it merely reflected the fact that workplaces with ESOPs tended to be large, unionised ones.

While the findings of the international literature are mixed, the majority of evidence suggests that ESOPs alone do not improve company productivity.<sup>70</sup> Corporate performance is only improved where ESOPs are accompanied by increased employee participation in decision-making.<sup>71</sup>

Several studies have argued that ESOPs may negatively impact productivity. In 2005, Hadi Elhayek and Sonja Petrovic-Lazarevic, from Monash University, conducted a study on the relationship between ESO schemes and organisational performance.<sup>72</sup> The negative findings in this study were reported in *The Age*.<sup>73</sup> This study sought to resolve whether Australian companies with higher ESO plan participation rates exhibit improved financial performance as measured by common accounting ra-

67. Brown & Lau, *supra* note 5.

68. *Id.* at 40–41.

69. Austl. Manufacturers' Workers Union, Employee Share Ownership in Australian Enterprises (Submission 12, Standing Comm. on Employment, Educ. and Workplace Relations' Inquiry into Employee Share Ownership, May 3, 1999) 3, available at <http://www.aph.gov.au/house/committee/ewr/eso/subs/sub12.pdf> (last visited Oct. 18, 2007).

70. See Aitken & Wood, *supra* note 5, at 166, and Lenne et al., *supra* note 5. This is also the conclusion drawn by Sesil, Kruse and Blasi from their review of over fifty large-scale empirical studies on ESO. James C. Sesil et al., *Sharing Ownership via Employee Stock Options*, World Institute for Development Economics Research Discussion Paper No. 2001/25, at 2, available at [http://www.wider.unu.edu/publications/working-papers/discussion-papers/2001/en\\_GB/dp2001-25/](http://www.wider.unu.edu/publications/working-papers/discussion-papers/2001/en_GB/dp2001-25/) (last visited Nov. 29, 2007).

71. See the discussion of literature in PENDLETON, *supra* note 54, at 10–11; Brown & Lau, *supra* note 5, at 35 and sources cited therein; PEETZ, *supra* note 5, at iv; and Robert McNabb & Keith Whitfield, *The Impact of Financial Participation and Employee Involvement on Financial Performance*, 45 SCOT. J. POL. ECON. 171 (1998).

72. Hadi Elhayek & Sonja Petrovic-Lazarevic, *Are Employee Share Ownership Programs Really Improving Organisational Performance?* (Monash University Department of Management Working Paper 12/05, Mar. 2005).

73. Paul Robinson, *Workers Not Won Over By Shares*, THE AGE, Apr. 5, 2005, at 5.

tios. This quantitative study involved statistical analysis of the correlation between financial performance indicators and levels of ESO participation in Australian companies. The authors conclude that their research suggests that large employee shareholdings are not of themselves instrumental in improving company performance. Other human resource policies are much more important. They found that companies with lower ESO participation rates have better organisational performance across many financial areas. The authors argue that their findings contradict existing studies by suggesting that high ESO scheme participation may not be effective at motivating employees because ESOs do not align organisational and employee objectives, thus resulting in little to no improvement in performance.<sup>74</sup> Unsurprisingly, the Elhayek and Petrovic-Lazarevic study attracted criticism from the Australian Employee Ownership Association (AEOA). The President of the AEOA has argued that the study is unconvincing and based on a flawed methodology.<sup>75</sup>

There are a number of limitations inherent in the literature that seeks to measure whether employee ownership has a positive effect on productivity.<sup>76</sup> Attempts to establish a direct relationship between ESOPs and higher organisational productivity inevitably encounter difficulties in causal uncertainty.<sup>77</sup> It may be, for example, that it is the most productive enterprises that are choosing to introduce ESO schemes. Secondly, the small number of shares held by employees may mean that the financial entitlement from participation in an ESOP is 'marginal, uncertain and disconnected from day-to-day working life,' rendering tenuous any perceived link between ESOPs and higher productivity.<sup>78</sup> Thirdly, researchers often fail to consider why particular companies initially adopt ESO plans. Companies may implement ESO plans for a range of reasons that are not necessarily linked to a desire to improve productivity: they may be motivated by a desire to resist a take-over or to take advantage of tax concessions. The structure and performance effects of ESOPs are likely to be strongly influenced by the circumstances in which employee ownership is introduced and the motives involved.<sup>79</sup> Finally, the heterogeneity of ESOPs—in their structure, objec-

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74. Elhayek & Petrovic-Lazarevic, *supra* note 72, at 5–6.

75. See Klaas Woldring, Employee Share Ownership should be part of the HRM repertoire, available at <http://www.aeoa.org.au/docs/0024/CCH%20HR%20art.%20v.2.1.pdf> (last visited Nov. 29, 2007).

76. PENDLETON, *supra* note 54, at 11–12.

77. Lenne et al., *supra* note 5, at 19; Sesil et al., *supra* note 70, at 11.

78. Lenne et al., *supra* note 5.

79. See PENDLETON, *supra* note 54, at 11; ESOPs: Their Role in Corporate Finance and Performance, *supra* note 22, at 23.

tives and the divergent workplace cultures in which the schemes are introduced—renders problematic any attempt to establish a link between productivity and ESOPs.<sup>80</sup>

McHugh, Cutcher-Gershenfeld and Bridge adopt a more nuanced approach to the question of the relationship between ESOPs and company productivity.<sup>81</sup> The authors move beyond the literature that tends to contrast ESOP and non-ESOP companies or ESOP companies pre-adoption and post-adoption. They note that there is great variation among ESOPs in relation to the degree of employee input and influence and that most studies fail to take this diversity into account.<sup>82</sup> Through comparing companies with ESOPs against each other, McHugh et al. have sought to examine how variations in ESOP structures impact upon company performance. The authors hypothesise that three ownership attributes (the level of employee influence in decision making; the amount of ESOP information given to employee shareholders; and the extent to which ESOP design provides employee shareholders with equity) are positively related to ESOP company performance. The authors concluded from their empirical study, based on survey responses from management at sixty-one companies with ESOPs, that employee influence in operational related decisions and employee ESOP information is positively correlated to managerial perceptions of enhanced company performance. Employee influence in strategic level decisions, however, is not related to perceptions of enhanced company performance. While the authors conceded the limitations of their study, including their reliance on subjective rather than objective indicators of company performance, they argue that the findings do have implications for management, policy makers and researchers. In particular, those interested in improving company performance should increase opportunities for employee influence in the company.<sup>83</sup>

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80. ANDREW ROBINSON & NICK WILSON, *ESOPs and Corporate Performance*, IN *ESOPs: Their Role in Corporate Finance and Performance* 243 (Nick Wilson ed., 1992).

81. Patrick P. McHugh et al., *Examining Structure and Process in ESOP Firms*, 34 *PERSONNEL REV.* 277 (2005).

82. *Id.* at 278.

83. See also Aditi Bagchi, *Varieties of Employee Ownership: The Unintended Consequences of Corporate Law and Labor Law* (U. Penn. Law School, Working Paper No. 147, Mar. 8, 2005, at 19) (noting that union-negotiated ESOPs tend to have more expanded voting rights).

## 2.4.2 *The industrial relations/human resource management literature*

### *Employee share ownership and employee participation*

A number of authors have explored the relationship between employee share ownership and participation.<sup>84</sup> There appear to be two broad strands of this literature. The first is concerned with the question of whether employee share ownership leads to greater levels of employee participation in workplace-level and board-level decision making. The second strand focuses more broadly on the relationship between employee participation and financial participation. This second strand is examined below, in 'Characteristics of companies adopting ESOPs.' In relation to the former, there is little evidence to support the view that ESOPs automatically lead to increased employee participation, either at the workplace or board level.<sup>85</sup> Writing on ESOPs in the U.K., Pendleton has repeatedly observed that there is little evidence to suggest that companies with conventional share schemes develop mechanisms for employee participation in decision-making. In an article published in 1995, Pendleton et al. emphasise that the extent to which an ESOP will facilitate employee participation within a specific company depends to a large extent on the goals of those who implemented it.<sup>86</sup> The authors distinguish between three different 'constellations' of ESOPs: 1) the 'technical ESOP' (conventional ESOPs introduced by management as a technical measure and generally driven by corporate finance issues); 2) the 'paternalistic ESOP' (where an owner seeks to give employees an opportunity to share in the well-being of the company but the ESOP is established with minimal involvement by employees or their representatives); and 3) the 'representative ESOP' (where employee representatives are involved extensively in the creation of ESOPs). Significant innovations in representative forms of employee participation are only present in the latter form.

In a 1996 article, the same authors argued that, while conventional companies with ESO do not generally confer rights upon employees to participate, there is evidence to suggest that share schemes tend to form part of a broader package of workplace initiatives to develop individualistic forms of employee in-

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84. See, e.g., PENDLETON, *supra* note 54; Panu Kalmi et al., *The Relationship Between Financial Participation and Other Forms of Employee Participation: New Survey Evidence from Europe*, Helsinki Centre of Economic Research Discussion Paper No. 3, Apr. 2004.

85. See PENDLETON, *supra* note 54, 119.

86. Andrew Pendleton et al., *The Impact of Employee Share Ownership Plans on Employee Participation and Industrial Democracy*, 5 HUMAN RESOURCES MGMT. J. 44, 45 (1995).

volvement.<sup>87</sup> The authors observe that, in companies with conventional share schemes, the evidence suggests that 'employee participation focuses on direct employee involvement in task-related rather than strategic decisions, and that it is generally individualistic rather than collectivist in form.'<sup>88</sup> They attribute this tendency largely to the fact that in such companies employee share ownership tends to be a management-driven initiative. In contrast, where other actors are involved in the initial design and implementation of ESO, employee participation may be more collectivist in nature.<sup>89</sup>

Evidence from the U.S. suggests that, although there is significant variation in ESOP companies with respect to employee participation, most companies with ESOPs do not display significant innovation in employment participation.<sup>90</sup>

*Does participation in an ESOP influence employee attitudes and levels of commitment to the organisation?*

A number of studies, located largely within the human resource management field, have focused on the capacity of ESOPs to lead to improved employee attitudes and levels of commitment. More recently, employee share ownership has been identified as a means through which to facilitate employee commitment in an era where 'shareholder value' is predominant and companies no longer provide 'traditional' returns such as long-term employment.<sup>91</sup>

Authors have sought to explain how ownership translates into improved employee attitudes. Particularly influential on both the subsequent U.S. and the U.K. literature has been Klein's formulation of three models.<sup>92</sup> The first (the intrinsic model) posits that the simple fact of ownership will increase employee commitment to the company. The second (the instrumental satisfaction model) suggest that ownership will only translate into improved employee attitudes and levels of commitment where ownership allows for greater employee participation in company decision-making. The third model (the extrinsic model) posits that employee ownership will increase employee

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87. Andrew Pendleton et al., *Employee Participation and Corporate Governance in Employee-Owned Firms*, 10 *WORK, EMP. & SOC'Y.* 205, 211 (1996).

88. *Id.* at 212.

89. *Id.* at 212-13.

90. Pendleton, U.K. *supra* note 54, at 118-19.

91. See *Corporate Governance and Labor Management: an International Comparison 1* (Howard Gospel & Andrew Pendleton eds., 2005); and PENDLETON, *supra* note 55, 75.

92. Katherine J. Klein, *Employee Stock Ownership and Employee Attitudes: A Test of Three Models*, 72 *J. APPLIED PSYCHOL.* 319 (1987).

commitment and satisfaction where it is financially rewarding to employees.

A range of strategies has been used in an effort to test the proposition that employee share ownership generates increased employee commitment to the company. These include examination of the relation between employee attitudes and the number of shares held by an employee; comparison of the attitudes of employee owners and non-owners; longitudinal comparisons of employee shareholder attitudes; and interviews asking respondents for their perceptions on whether and how share ownership has changed their attitudes towards the company.

The findings in the literature are mixed, both as to whether and how ESOPs have an impact on employee attitudes. Studies range from those that find extensive attitudinal change to those that find no differences. A considerable number of studies in both the U.K. and U.S. offer strong support for Klein's 'instrumental' model and considerable support for the 'extrinsic' model. Most of the studies from the U.K. and the U.S. have emphasised that share ownership *per se* is unlikely to significantly influence employee attitudes or levels of commitment. This is particularly the case where the proportion of equity transferred is small. Other variables, such as participation in decision-making and financial reward, are necessary for ownership to be associated with increased satisfaction and commitment.

Efforts to assess the impact of employee share ownership on employee attitudes inevitably encounter obstacles. There are methodological difficulties in evaluating employee responses to the specific effects of employee share ownership and to causally relating any changes to participation in a share ownership scheme.<sup>93</sup> A number of authors have criticised studies that focus on the manipulation of large, publicly available data sets, for failing to account for other factors that may have influenced employee perceptions. Blasi, for example, has suggested that researchers should focus more on detailed studies of individual companies with ESOPs.<sup>94</sup> Finally, as Pendleton has argued, some studies are limited by their failure to take into consideration employee perceptions of what the ESOP was intended to achieve: the capacity of ESOPs to engender positive attitudes among participating employees towards their employer is a function of em-

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93. See Andrew Pendleton, Nick Wilson, & Mike Wright, *The Perception and Effects of Share Ownership: Empirical Evidence from Employee Buy-Outs*, 36 BRIT. J. INDUS. REL. 99, 100 (1998). See also *id.* at 101–03, for the authors' critique of the U.K. studies to date.

94. See *id.* at 103 and discussion in Daniel Hallock, Ronald Salazar & Sandy Venneman, *Demographic and Attitudinal Correlates of Employee Satisfaction with an ESOP*, 15 BRIT. J. MGMT. 321, 331 (2004).

ployee perceptions of the purpose of the plan and the extent to which these purposes are seen to be consistent with, and meet, employees' objectives and interests.<sup>95</sup>

### *Employee share ownership and trade unions*

A strand of the industrial relations literature has empirically examined the relationship between trade union representation and employee ownership. This literature can be divided into two broad areas of inquiry. The first examines the impact of employee share ownership on trade unions. The second looks at how trade union involvement influences the structure and nature of ESOPs.

There is little empirical evidence from the U.K. or U.S. to suggest that ESOPs result in a decreased desire among employees for trade union representation.<sup>96</sup> From their research in Europe, Pendleton et al note that the wide range of workplace and employment issues tends to create sufficient employee demand for collective industrial relations structures and organisations.<sup>97</sup> Lenne, Mitchell and Ramsay have observed that ESO schemes may in fact increase trade union voice through share holder activism, by highlighting particular employee issues.<sup>98</sup>

Writing from the U.S., Cramton, Mehran and Tracy in a recent paper explore the impact of ESOPs on the collective bargaining role of trade unions.<sup>99</sup> The authors focus on enterprises in which union members have a non-controlling ownership interest. They suggest that ESOPs create incentives for trade unions to become weaker bargainers. The authors examined data on union contract negotiations for the period 1970–1995, as collected by the Bureau of Labor Statistics. According to the authors, the data indicated a decline in both the incidence of labour disputes and strikes following the adoption of an ESOP. The authors suggest that ESOPs increase the efficiency of labour negotiations by reducing the incidence of labor disputes and shifting

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95. Pendleton, *supra* note 54, at 84–85.

96. *Research Evidence on Prevalence and Effects of Employee Ownership; Hearings Before the House Subcomm. on Employer-Employee Relations, House Comm. on Educ. and the Workforce*, 107th Cong. 5, Feb. 13, 2002, (testimony of Douglas Kruse, Professor, Rutgers University); Andrew Pendleton et al., *Employee Share Ownership and Profit Sharing in the European Union*, Report prepared for the European Foundation for the Improvement of Living and Working Conditions, 2001, at 5.

97. See Pendleton et al., *supra* note 93.

98. See Lenne et al., *supra* note 5, at 12.

99. Peter Cramton et al., *ESOP Fables: The Impact of Employee Stock Ownership Plans on Labor Disputes* (University of Maryland, Working Paper, Sept. 2005).

the composition of disputes from more costly strikes towards 'hold-outs.'<sup>100</sup>

A number of studies from the U.S. have found that unionisation has had some discernible effects on the structure and operation of employee share ownership. In a recent study, Yates compared organisational structures and practices among companies with four distinct relationships between organised labour and employee stock ownership.<sup>101</sup> She concluded that work practices in the unionised, majority employee-owned companies were characterised by more equality, better communication, more training, more opportunities to participate and a more co-operative relationship between management and employees. In companies where union members held a minority share of the company, there was some evidence, though more limited, of more participative management. The lowest levels of communication, training and participation were found in the non-unionised ESOP companies.<sup>102</sup> Yates concluded that 'economic democracy through share ownership contributes to favourable working conditions for unionised employees in rough proportion to their share of ownership.'<sup>103</sup> McHugh, Cutcher-Gershenfeld and Polzin found from their study of sixty-eight Michigan ESOPs that union members' participation in the ESOP was broadly correlated with more participation in employee relations but not in company management and governance; that ESOPs with unionised participants were more likely to own a majority of their company shares; that the benefits of employee ownership where union members were participants were allocated in a more egalitarian manner; and that ESOPs with unionised members were more likely to offer participation in selecting board members and to have union representation on the board.<sup>104</sup>

### 2.4.3 *Why do employers implement ESOPs and why do employees participate?*

In Australia, there has been little empirical research into why companies adopt employee share ownership plans. Barnes et al. conducted two case studies of enterprise-level ESO schemes, seeking to gain insight into how supposed objectives of

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100. A 'hold-out' is a labor dispute in which the trade union agrees to work under the terms of the expired agreement while negotiations continue.

101. Jacquelyn Yates, *Unions and Employee Ownership: A Road to Economic Democracy?*, 45 *INDUS. REL.* 709 (2006).

102. *Id.* at 728.

103. *Id.* at 729.

104. See Patrick P. McHugh et al., *Employee Stock Ownership Plans: Union Influence and Stakeholder Interest*, 20 *ECON. & INDUS. DEMOCRACY* 535 (1999).

ESO are understood by business managers and employees.<sup>105</sup> From their interviews, the authors reach the tentative conclusion that both management and employees adopt a 'nebulous' employee engagement rationale for the implementation of ESO schemes, rather than focusing on the potential for ESOPs to provide incentives for specific kinds of behaviour. This research also looked at the role the tax concession regime has played in shaping the implementation and management of the two companies' ESOPs. The authors found that the tax concessions did not operate as a significant incentive for these two companies.

In 2004, the Employee Share Ownership Development Unit commissioned a large-scale survey of business in Australia which sought to measure how businesses with and without plans regarded the benefits of ESOPs. It found that businesses were more likely to agree that ESOPs provided benefits related to organisational culture, workplace relations and human resource strategies rather than rationales based on improved performance, a better working environment, competitive salary packaging or tax benefits for employees. Finally, the *Shared Endeavours* report cites research conducted by Stradwick in 1999 for the AEOA, which involved a survey of ESOPs in most of the Australian Stock Exchange's top 500 companies. Preliminary findings suggested that 90 percent of companies introduced ESOPs to increase employee identification with the interests of shareholders; 80 percent to provide a benefit for employees; 40 percent because it was a tax effective way of rewarding employees; 29 percent to increase labour productivity; and 7 percent to enhance recruitment and retention.<sup>106</sup>

Research from the U.K. has found that employers adopted ESOPs for a diversity of reasons, though employers are often vague about the precise nature of the incentive or motivation.<sup>107</sup> Writing in 2001, Sesil, Kruse and Blasi identified at least sixteen large-scale empirical studies of this question. They conclude that the studies do not support any one dominant explanation for the adoption of ESOPs.<sup>108</sup>

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105. See Andrew Barnes et al., *Employee Share Ownership Plans: Evaluating the Role of Tax and Other Factors Using Two Case Studies*, 35 AUSTL. BUS. L. REV. 73 (2007).

106. See, e.g., LESLEY BADDON ET AL., PEOPLE'S CAPITALISM: A CRITICAL ANALYSIS OF PROFIT-SHARING AND EMPLOYEE SHARE OWNERSHIP 89-90, 280 (1989); Philip Dewe et al., *Employee Share Option Schemes: Why Workers Are Attracted to Them*, 26 BRIT. J. INDUS. REL. 1, 1-2 (1988).

107. See, e.g., BADDON ET AL., *supra* note 106, 89-90, 280; Dewe et al., *supra* note 106, at 1-2.

108. Sesil et al., *supra* note 70, at 8.

Research focusing on employees' perspectives on ESOPs is scarcer,<sup>109</sup> and it is recognised as an area needing further research.<sup>110</sup> In Australia, research appears to consist of Barnes and his cowriters' two case studies and data collected by the ESODU in 2004. The authors found that employee resistance was among the most frequently cited barriers to the implementation of ESOPs.<sup>111</sup>

In Europe, research on how employees perceive ESOPs is also limited. It tends to draw upon the theoretical literature relating to risk aversion and portfolio diversification. In the U.K., Pendleton has examined whether employee stock option holders choose to keep or sell their stock on exercise and the influences on their decisions to do so.<sup>112</sup> Analysing data from a survey of over 24,000 employees (with a 24 percent response rate) in eleven publicly-listed companies with all-employee stock option plans in the U.K., Pendleton found that over 40 percent of employees retain their shares for a year or more after exercise, and that the most important individual-level influences on the decision whether to keep or sell their shares were the structure of investment portfolios, the reasons for participating in the stock option plan and age. His findings suggested that income and risk preferences have little direct influence.

In the late 1980s, Dewe, Dunn and Richardson surveyed employees within a single U.K. company with an employee share option scheme. They wanted to understand why workers were attracted to the scheme.<sup>113</sup> In particular, the authors sought to

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109. This observation is also made in Andrew Pendleton, *Sellers or Keepers? Stock Retentions in Stock Option Plans*, 44 HUM. RESOURCES MGMT. 319, 321 (2005); and in Douglas Kruse, *A Guide to Doing Academic Research on Employee Ownership*, (National Centre for Employee Ownership (May 2007)), available at <http://www.nceo.org/library/research.html> (last visited Aug. 31, 2006). Both authors also note that existing work was largely conducted in the 1980s and thus is likely to be out of date.

110. See Pendleton, *supra* note 109, at 331. See also Erik Poutsma & Fred Rondeel, *Complementarities of Financial Participation and Other Forms of Participation: Human Resource Management for Performance*, Report of the Workshop Held on Oct. 14, 2005, at 22.

111. See Barnes, *supra* note 105; TNS Social Research, *Employee Share Ownership: Summary of Awareness, Attitudes and Endorsement* (Commissioned by the Department of Employment & Workplace Relations Services for Australians, research presentation, 2004) [hereinafter ESODU Research], available at [http://www.workplace.gov.au/NR/rdonlyres/195C003B-A87A-4982-A674-E780AEF97B2A/0/ESO\\_presentationv3.pdf](http://www.workplace.gov.au/NR/rdonlyres/195C003B-A87A-4982-A674-E780AEF97B2A/0/ESO_presentationv3.pdf). This research (based on qualitative interviews) identified a number of factors as influencing employee willingness to take up shares. These included the performance of the share price; the size and age of the company; the value and type of the shares; previous experience with share schemes; life stage and current financial position; understanding of share ownership generally; and existing employee relations and trust of management.

112. See Pendleton, *supra* note 109.

113. Dewe et al., *supra* note 106.

explore the relationship between attitudes to work, opinions of employee share schemes held by employees and the intention to join such a scheme.<sup>114</sup> The authors found that workers favoured joining when they felt positive towards share option schemes in general, regardless of their particular attitude toward the company. To the authors, the most striking finding of their study was that work attitude variables did not have a strong association with intention to participate in the scheme: that is, 'workers who feel a strong sense of commitment to the company are no more likely to want to take part in the scheme than those who do not.'<sup>115</sup>

A more recent French study focused on employee decisions about whether to participate in shares offered by France Telecom as it underwent a partial privatisation.<sup>116</sup> The authors' results were largely, though not entirely, consistent with theoretical models of investing behaviour which predict that workers with more financial wealth and higher salaries will invest more money in ESOPs.

#### 2.4.4 *Characteristics of companies adopting ESOPs*

A further strand of the literature has sought to identify the characteristics of companies that adopt ESOPs.<sup>117</sup> Some authors interested in this issue have approached the question from the basis of economic theory, while others have adopted an industrial relations perspective. The studies within the economic/organisational literature make a number of broad predictions concerning the characteristics of companies adopting ESO.<sup>118</sup> First, employee share ownership is more likely to be used where employee performance is difficult to monitor because of certain features of work organisation and job design (such as companies where intellectual capital is the main source of customer value, in large companies or in companies experiencing fast growth).<sup>119</sup> The second prediction is that group-based rewards such as ESOPs will be attractive to companies when individual incentive-based pay is costly to operate. Thus ESOPs tend to be viewed as

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114. *Id.* at 13.

115. *Id.* at 19.

116. See Francois Degeorge et al., *Selling Company Shares to Reluctant Employees: France Telecom's Experience*, 71 J. FIN. ECON. 169 (2004).

117. For a brief analysis of this literature, see Pendleton, *supra* note 21, at 756-61.

118. *Id.*

119. Maya K. Kroumova & James C. Sesil, *Intellectual Capital, Monitoring, and Risk: What Predicts the Adoption of Employee Stock Options?*, 45 INDUS. REL. 734, 735 (2006).

an alternative to individual incentives, such as individual performance-based pay mechanisms.

In a 2006 article, Pendleton examined the economic literature that draws upon agency theory to explain the existence of ESO in companies. He examined the data from the U.K. Workplace Employee Relations Survey (1998) to ascertain whether share plans substituted for direct monitoring or individual incentives. He found that ESO was often implemented alongside individual incentives. According to Pendleton, this suggested that broad-based ESOPs, while providing weak incentives by themselves, are used to mitigate dysfunctional effects of individual incentives by engendering cooperation and trust. They also encouraged employees to think about and act on performance outcomes by reference to a longer time frame.<sup>120</sup>

The studies conducted from an industrial relations perspective have focused on the relationship between ESO and other forms of employee participation. The findings of these studies vary greatly. Some studies have found a positive correlation between financial participation and other forms of employee participation.<sup>121</sup> Several of these earlier studies, however, failed to distinguish between ESO and profit-sharing.<sup>122</sup> In 1997, Pendleton examined data from the 1990 U.K. Workplace Industrial Relations Survey in an attempt to identify what kinds of companies implement broad-based employee share schemes.<sup>123</sup> He found that the characteristics of workplaces with ESO varied significantly from those with profit-sharing arrangements or those with no form of financial participation. Pendleton argued that his findings were more consistent with the industrial relations-based explanations for the adoption of ESO than with economic-based ones.<sup>124</sup> According to Pendleton, workplaces that have implemented ESOPs tended to have other forms of employee representation and participation, such as joint consultative committees, to determine pay by collective bargaining and to have high levels of union density.<sup>125</sup> He noted that his findings support the conclusion that companies may use multiple forms of incentives and that employee share ownership plans may be com-

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120. *Id.* at 753.

121. Michael Poole, *Factors Affecting the Development of Employee Financial Participation in Contemporary Britain: Evidence from a National Survey*, 26 *BRIT. J. INDUS. REL.* 21 (1988); and Andrew Pendleton, *Characteristics of Workplaces with Financial Participation: Evidence from the Workplace Industrial Relations Survey*, 28 *INDUS. REL. J.* 103 (1997).

122. Pendleton, *Characteristics of Workplaces with Financial Participation: Evidence from the Workplace Industrial Relations Survey*, *supra* note 121.

123. *Id.*

124. *Id.* at 116.

125. *Id.* at 113.

plementary to other forms of financial participation.<sup>126</sup> In Australia, Tuberville has conducted a study similar to that conducted by Pendleton, using data from the Australian Workplace Industrial Relations Surveys in 1990 and 1995. Tuberville's findings suggested that financial participation (defined as collective forms of profit sharing or employee share schemes) did not seem to correlate with 'representative forms of employee representation,' such as joint consultative committees and worker representation on company boards. Rather, financial participation was strongly associated with continuous improvement and total quality management techniques.<sup>127</sup>

In contrast, drawing upon data collected from listed companies in Finland, France, Germany, the Netherlands, Spain and the U.K., Kalmi, Pendleton and Poutsma concluded in 2004 that while there is some evidence of a correlation between profit sharing and other participatory practices, such a correlation is missing with respect to employee equity plans.<sup>128</sup>

#### 2.4.5 *Majority employee-owned companies*

A small strand of the ESO literature from the U.K. and the U.S. has focused on companies that have transferred substantial portions of equity to employees.<sup>129</sup> Given the higher levels of equity held by employees in such companies, ESOPs embody the potential to facilitate much greater levels of employee participation, particularly at the level of corporate governance.<sup>130</sup> These studies have generally adopted a case study approach, exploring the origins, forms and performance of employee-owned companies.

Much of the work on employee-owned enterprises in the U.K. has focused on the bus industry, where ESOPs were a common mechanism to facilitate management-employee buyouts in

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126. Pendleton, *supra* note 21, at 753.

127. See Sarah Tuberville's oral submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations' Inquiry into Employee Share Ownership in Australian Enterprises, Official Committee Hansard, Sept. 8, 1999, at 290-92.

128. Kalmi, *supra* note 85.

129. In the U.K., see, e.g., Pendleton et al., *The Impact of Employee Share Ownership Plans on Employee Participation and Industrial Democracy*, *supra* note 86, at 44; Pendleton et al., *Employee Participation and Corporate Governance in Employee-Owned Firms*, *supra* note 87; Lisa Trehwhitt, *Employee Buyouts and Employee Involvement: A Case Study Investigation of Employee Attitudes*, 31 *INDUS. REL. J.* 437 (2000); and PENDLETON, *supra* note 54. In the U.S., see John Logue & Jacquelyn S. Yates, *Worker Ownership American Style: Pluralism, Participation and Performance*, 20 *ECON. & INDUS. DEMOCRACY* 225 (1999).

130. Pendleton et al., *supra* note 87, at 205; Christopher Mackin & Fred Freundlich, *Representative Structures in Employee-Owned Firms*, 7 *J. EMPLOYEE OWNERSHIP L. & FIN.* 91 (1995).

the context of privatisation of the industry in the late 1980s. Focusing on ESOPs within the bus industry, Pendleton et al. have conducted an extensive empirical study on the extent to which ESOPs extend employee involvement in decision-making.<sup>131</sup> In an article published in 1996, Pendleton et al. examined the possibility that companies with ESOPs that confer majority ownership on employees have different levels of employee participation vis-à-vis 'conventional' companies. The authors concluded that companies with majority employee ownership often did develop different structures for employee participation. In particular, they tended to implement forms of employee participation that were more representative-based, and which tended to focus on strategic rather than task-related decisions.<sup>132</sup> More broadly, Pendleton has argued that U.K. ESOPs vary widely in the extent to which they lead to greater levels of employee participation. Pendleton has argued that 'the objectives, philosophies and interests of the key actors involved in conversions to employee ownership have a critical influence on the reasons for employee ownership, the level of employee shareholding, and the forms of participation and governance adopted.'<sup>133</sup>

There does not appear to be any study conducted in Australia concerning if and how majority employee-owned companies differ from those companies that transfer smaller amounts of equity to employees.

## 2.5 EMPLOYEE SHARE OWNERSHIP AND CORPORATE GOVERNANCE

The relationship between employee share ownership and corporate governance has been explored from a number of different perspectives.<sup>134</sup> Hollo identifies three main ways in which ESOPs may affect corporate governance.<sup>135</sup> First, they may provide corporate directors with a means to manipulate corporate control in their favour. The second issue relates to shareholder neutrality: in particular, the potential issues arising from the ca-

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131. The results of this study are published in numerous articles and in Pendleton, *Employee Share Ownership, Participation and Governance in the U.K.*, *supra* note 54.

132. Pendleton et al., *supra* note 87, at 222–23.

133. PENDLETON, *supra* note 54, at 182.

134. This review adopts a broad understanding of corporate governance as concerned with "who controls the firm, in whose interest the firm is governed and the various ways whereby control is exercised." Howard Gospel & Andrew Pendleton, *Finance, Corporate Governance and the Management of Labour: A Conceptual and Comparative Analysis*, 41 BRIT. J. INDUS. REL. 557, 560 (2003).

135. See Elana R. Hollo, *The Quiet Revolution: Employee Stock Ownership Plans and Their Influence on Corporate Governance, Labor Unions and Future American Policy*, 23 RUTGERS L.J. 561, 577–92 (1992).

capacity of ESOPs to dilute holdings of shareholders.<sup>136</sup> The third way in which ESOPs may affect corporate governance is the potential for employees, through ESOP participation, to have a greater say in the governance of the company.

The first and second issues appear to have received little attention in Australia. The concern that ESOPs are used by corporate directors as a means of securing or reinforcing their own autonomy appears to be dominant in the United States but not elsewhere.<sup>137</sup> The concern is that directors structure an ESOP in a way that entrenches their own power through, for example, appointing an ESOP trustee that is sympathetic to their interests or simply passing a large block of shares to employees who are generally aligned to management.<sup>138</sup> ESOPs have been a common defence in the U.S. to hostile takeover bids, and there has been a considerable amount of U.S. case law on this issue.<sup>139</sup> Fine concludes from his survey of the U.S. literature: 'Whatever the historical and specific motives that informed the formation of ESOPs, they have become more and more heavily embroiled in the general process of corporate strategy, with limited actual and potential deference to the interests of employees.'<sup>140</sup> In Australia, however, as Aitkin and Wood have noted, ESOPs are too small a proportion of issued capital to be a useful defence against takeover.<sup>141</sup>

Many authors have referred to the potential for employee share ownership to increase employee influence in corporate governance. Employee share ownership is regarded as a means of overcoming the problems associated with shareholder primacy and the role of employees as 'outsiders' in corporate governance.<sup>142</sup> Employee share ownership can provide a means of 'in-

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136. *Id.* at 586.

137. *Id.* at 577-78. See also Lilli A. Gordon & John Pound, *ESOPs and Corporate Control*, 27 J. FIN. ECON. 525 (1990); William N. Pugh, Sharon L. Oswald & John S. Jahera Jr., *The Effect of ESOP Adoptions on Corporate Performance: Are There Really Performance Changes?*, 21 MGMT. DECISION ECON. 167, 169 (2000).

138. Pugh et al., *supra* note 137, at 167. See also Upinder S. Dhillon & Gabriel G. Ramirez, *Employee Stock Ownership and Corporate Control - An Empirical Study*, 18 J. BANKING & FIN. 9 (1994) (finding that ESOPs have primarily been adopted in the U.S. as a defensive measure against hostile take-overs).

139. Hollo, *supra* note 135, at 577-86.

140. Ben Fine, *ESOP's Fable: Golden Egg or Sour Grapes?*, in POLITICAL ECONOMY AND THE NEW CAPITALISM: ESSAYS IN HONOUR OF SAM AARONOVITCH 178, 188 (Jan Toporowski ed., 2000).

141. Aitken & Wood, *supra* note 5.

142. Lenne et al., *supra* note 5, at 9. See, e.g., Jennifer Hill, *At the Frontiers of Labour Law and Corporate Law and Labour Law: Enterprise Bargaining, Corporations and Employees*, 23 FED. L. REV. 204, especially at 222 (1995); and Adam Reynolds, *Do ESOPs Strengthen Employee Stakeholder Interests?*, 13 BOND L. REV. 95 (2001).

ternalising the stakeholder-company relationship.<sup>143</sup> There are two principal mechanisms through which the interests of employees may be taken into account in corporate governance: via expansion of the fiduciary duties of directors, and, by rights of participation in the corporate decision-making process.<sup>144</sup> Through employee share ownership, employees become shareholders and thus, theoretically, are able to protect their interests through the mechanism of share ownership.<sup>145</sup> As noted by Pendleton, one of principal attractions of employee share ownership in Anglo-Saxon economies is that it gives employee stakeholders additional rights to those they possess as workers without violating the principles of existing company law.<sup>146</sup>

Only a few authors in Australia have addressed this issue in any depth. In their recent paper, Lenne, Mitchell and Ramsay noted 'the distance between the current debate on ESO and the fundamental question of employee participation in corporate governance.'<sup>147</sup> A decade earlier, Hill conceded that employee share ownership had rarely been accompanied by participation in corporate governance. However, somewhat optimistically, Hill noted that there were 'signs of major changes.' She pointed to a number of 'progressive' companies that had structured their plans in a way so as to achieve employee participation in corporate decision-making, '. . . such as through pass-through voting of shares, ability to direct the trustee how to vote, or representation at the level of trustee.'<sup>148</sup> However, she supports these observations solely by references to the United States.

In Australia, Adam Reynolds has examined the legal basis upon which employees as shareholders could promote their claims within the context of Australian corporate law, either as members of an ESOP or as independent investors.<sup>149</sup> He begins by emphasising the fact that, as a distinct group, there is little legal support for the view that employees should be regarded as legitimate stakeholders in Australian corporate governance and emphasises that employees have no directly enforceable interests under the *Corporations Act*. Reynolds then raises the question

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143. Steen Thomsen, *Corporate Values and Corporate Governance*, 4 CORP. GOVERNANCE 29, 35 (2004). See also HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* (1996).

144. Hill, *supra* note 142, at 209.

145. As Hill notes, this presumes some level of adequacy of shareholders rights of participation. *Id.* at 222.

146. Andrew Pendleton, *Stakeholders as Shareholders: The Role of Employee Share Ownership*, in *STAKEHOLDER CAPITALISM* 169, 172 (Gavin Kelly et al. eds., 1997). This point is also made in Lenne et al., *supra* note 5, at 7.

147. Lenne et al., *supra* note 5, at 28.

148. Hill, *supra* note 142, at 222.

149. Reynolds, *supra* note 142.

of whether participation in an ESOP may change this situation. He examines a range of provisions in the *Corporations Act* that could be used by employee shareholders to promote their unique set of interests.<sup>150</sup> He concludes, however, that these remedies are all unlikely to affect the governance of the company in a practical sense or enable employees to promote their interests as *employees*. Reynolds concludes that employee shareholders have only a 'slightly higher level of enforceable interests' in Australia.

A number of authors have sought to justify employee share ownership on the basis that it has the capacity to improve company economic performance. In contrast to other types of shareholders which may be interested only in short-term dividend returns or share price maximisation, employee shareholders may be more interested in good governance and in the long-term success of the companies.<sup>151</sup> For Michie and Oughton, employee share ownership provides a means of overcoming the 'short termism' which has long been recognised as a problematic for U.K. industry: 'the continual pressure to deliver "shareholder value" above all can have a damaging effect not only on the interests of other stakeholders but on long-term investment in the business itself.'<sup>152</sup> Employee owners are likely to have a longer time horizon and to have additional objectives than simply the short term maximisation of profits, such as long term job security.<sup>153</sup> In addition, unions have maintained that favourable working conditions for employees means that companies will be more productive and better able to manage risk, thereby ensuring se-

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150. *See id.* In particular, Reynolds notes that employee groups, as minority shareholders, have the legal capacity to be heard through calling shareholder meetings and to propose resolutions (referring to Corporations Act, 2001, §§ 249D, 249F, 249N(1) (Austl.) [hereinafter Corporations Act]); the potential for employee shareholders to enforce their stakeholder rights under the Minority Oppression provisions of the Act; and the potential for employee shareholders to form a distinct 'class.'

151. *See, e.g.,* Jonathan Michie & Christine Oughton, *Employee Share-Ownership Trusts and Corporate Governance*, 1 CORP. GOVERNANCE 4 (2001) (regarding practices in the U.K.). While the authors concede that the act of making employees shareholders would not of itself be sufficient to remedy the current problems – the interests of other stakeholders also need to be taken into account – they identify employee share ownership as one means through which positive reform could take place. *See* Sanford M. Jacoby, *Corporate Governance and Employees in the United States*, in CORPORATE GOVERNANCE AND LABOR MANAGEMENT: AN INTERNATIONAL COMPARISON 33, 37 (Howard Gospel & Andrew Pendleton eds., 2005) (regarding practices in the U.S.).

152. Michie & Oughton, *supra* note 151, at 6.

153. Pendleton, *supra* note 146, at 173.

cure economic performance of the company and in turn, affording greater potential returns for shareholders.<sup>154</sup>

For others, however, it is the potential for employee participation in corporate governance that is one of the least appealing aspects of ESOPs.<sup>155</sup> Hansmann has argued that, in the U.S., greater participation by employees in corporate governance with ESOPs leads to inefficiency. Hansmann examines the extent to which various forms of worker ownership, including 'partial' ownership through ESOPs, are more efficient than others. He proceeds from the presumption that the market tends to select relatively efficient organisational forms.<sup>156</sup> Therefore, he suggests, it is possible to draw inferences about the efficiency of worker ownership as an organisational form by examining 'the circumstances under which it thrives and the particular configurations it takes.'<sup>157</sup> He identifies and examines a range of costs and benefits implicit in worker ownership. Benefits, for example, include improved worker productivity, lower monitoring costs, 'worker lock-in' and employee satisfaction that may arise from participation in the process of collective decision-making. Among the major costs of employee ownership are the costs of raising capital to fund the issue of shares, risk-bearing and costs associated with collective worker governance. Hansmann's examination of existing evidence on the incidence of various forms of employee ownership suggests that collective governance costs are high when the workforce exhibits any substantial degree of heterogeneity, as there is greater potential for conflicts of interest among the worker-owners. He also observes that decision-making is inefficient where workers share voting control with non-worker investors of capital.<sup>158</sup>

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154. See Kirsten Anderson & Ian M. Ramsay, *From the Picketline to the Boardroom: Union Shareholder Activism in Australia*, 24 *COMPANY & SEC. L.J.* 279 (2006). See also Kirsten Anderson et al., *Union Shareholder Activism in the Context of Declining Labour Law Protection: Four Case Studies*, 15 *CORP. GOVERNANCE: AN INT'L REV.* 45 (2007).

155. See, e.g., Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-Managed Firms and Codetermination*, 52 *J. BUS.* 469 (1979) (arguing that employee equity holdings create an entrenched workforce with corporate governance power). See also Olubunmi Faleye et al., *When Labor has a Voice in Corporate Governance* (Nat'l Bureau of Econ. Research, Working Paper No. 11254, 2005).

156. See Henry Hansmann, *When does Worker Ownership Work? ESOPs, Law Firms, Codetermination and Economic Democracy*, 99 *YALE L.J.* 1749, 1755-56 (1990) (conceding that the effectiveness of market selection should not be exaggerated).

157. *Id.* at 1756.

158. *Id.* at 1812.

Turning his attention to ESOPs, Hansmann observes that ESOPs in the U.S. generally provide for participation in earnings but not in control. He notes:

ESOPs are quite paradoxical when viewed in terms of conventional perspectives on worker ownership. The common view seems to be that worker participation in corporate governance is highly desirable but that the risk and the high cost of capital that workers face if they participate in ownership of a firm that is at all capital-intensive are serious liabilities. By these criteria, one would expect worker ownership to be structured to maximise workers' participation in control but to minimize their contributions of capital. ESOPs, however, have just the opposite character.<sup>159</sup>

Drawing upon his original presumption that market forces select the most efficient forms of worker participation, Hansmann questions why there is not more worker control in companies with ESOPs. He finds that the fact that workers do not participate in corporate governance strongly suggests that those responsible for structuring ESOPs believe that the benefits of worker ownership are outweighed by the costs. Hansmann concedes that the creation of ESOPs without voting rights might be explained in part by the determination of management to maximise their autonomy. He tentatively concludes, however, that there is 'considerable circumstantial evidence' to suggest that direct worker participation in the control of enterprises with a heterogeneous workforce is too costly. While Hansmann is careful to acknowledge that a range of factors beyond the 'market' may explain why ESOPs have evolved in the way they have, his work still appears to downplay the important roles played by the legal regulation of ESOPs, including taxation issues, and by enduring political, economic, and industrial structures and institutions.<sup>160</sup>

In the U.S. context, Faley, Mehrotra and Morck have sought to empirically examine the effects of labour ownership and control on corporate governance.<sup>161</sup> They argue that their findings demonstrate that 'publicly-traded firms whose employees have a greater voice in corporate governance deviate more from value maximization, spend less on new capital, take fewer risks, grow more slowly, create fewer new jobs, and exhibit lower

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159. *Id.* at 1799.

160. Similarly, Jeffrey Hirsch has described Hansmann's conclusions as 'unsatisfying', and criticised Hansmann for comparing worker-owned companies to an ideal version of the investor-owned company that simply does not exist in reality. Jeffrey Hirsch, *Labor Law Obstacles to the Collective Negotiation and Implementation of Employee Stock Ownership Plans: A Response to Henry Hansmann and Other "Survivalists"*, 67 *FORDHAM L. REV.* 957, 979-80 (1998).

161. See Faley et al., *supra* note 155.

labor and total factor productivity.<sup>162</sup> They conclude that their findings 'cast a serious doubt on the simple premise that labor equity participation causes a convergence of interest between workers and shareholders.'<sup>163</sup>

In practice, however, employee share ownership influences corporate governance only to a limited extent. Parkinson has observed, that 'the object [of ESOPs] has been . . . to achieve financial participation rather than participation in decision-making.'<sup>164</sup> Similarly, Pendleton has expressed doubts that employee share schemes actually provide employees with additional 'voice.'<sup>165</sup> Pendleton explains:

Employee shareholders do not usually have any special status, and the main vehicle to exert influence is the conventional one of the Annual General Meeting. In this forum employee shareholders are treated as individual shareholders (rather than as a collective entity) and, since AGMs tend to be dominated by company directors and institutional shareholders, it is not easy for employees to express their views and interests.<sup>166</sup>

Several commentators have reached similar conclusions in the U.S. context. Rosen has observed that ESO has not led to increased impact of employees in corporate decision-making.<sup>167</sup> For Jacoby, only a few U.S. companies, particularly those with substantial employee share ownership, have created mechanisms that enable employee views to be communicated to senior management and to the board, such as formal representation systems and board seats for employee or union representatives.<sup>168</sup> He emphasises that 'the vast majority of employee owners have no governance mechanisms available to express their unique interests as both owners and employees.'<sup>169</sup> He notes that the extent to which employees are given voice in U.S. companies is limited by a number of factors, including labour law (in particular, it is unlawful for employers to play a role in establishing representative bodies) and the legal presumption that boards represent the interests of shareholders.<sup>170</sup>

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162. *Id.* at 3.

163. *Id.* at 28.

164. JOHN PARKINSON, CORPORATE POWER AND RESPONSIBILITY: ISSUES IN THE THEORY OF COMPANY LAW 423 (1993).

165. Pendleton, *supra* note 146, at 174-75.

166. *Id.* at 175.

167. Baddon et al., *supra* note 106.

168. Jacoby, *supra* note 151, at 47.

169. *Id.* at 53.

170. JOSEPH BLASI & DOUGLAS KRUSE, THE NEW OWNERS: THE MASS EMERGENCE OF EMPLOYEE OWNERSHIP IN PUBLIC COMPANIES AND WHAT IT MEANS TO AMERICAN BUSINESS 245 (1991).

Authors concerned with facilitating increased employee participation in corporate governance through employee share ownership have proffered a range of potential solutions. Both Pendleton and Michie and Oughton have suggested that the use of trust structures to administer ESOPs may enable employees to take a more proactive role in corporate governance, as trustees may canvass employee opinion and vote employee shares as a block.<sup>171</sup> Michie and Oughton first note that the tax incentives for ESOPs could be restructured so they encourage employee shareholders to actively participate in trusts, giving them a collective voice. Schemes would only be eligible for tax concessions if they are designed and operated in an open and democratic manner. Secondly, the authors note that such schemes are only likely to endure if a special body is established to develop and monitor such approaches to ESO.<sup>172</sup> Pendleton also suggests that non-executive directors could be appointed to the board with a remit to represent employee interests.<sup>173</sup>

Jacoby identifies a number of potential means through which to 'link' ownership by employees to governance. First, employee owners should be given board representation, as 'this is consistent with their heavy investments—financial and human capital—in the employing company.' Second, trustees of pensions and ESOP plans should be legally permitted to give weight to the special concerns of employee owners. Third, policy makers should encourage the adoption of other innovative mechanisms for bringing employee concerns to a company's strategic decision makers. Finally, Jacoby argues that more should be done to promote the use of stock options among general employees, as this may translate into a corresponding role in governance.<sup>174</sup>

Despite offering a number of ways in which employee share ownership could be restructured so as to contribute to better corporate governance, Pendleton concedes that such measures are unlikely to be adopted voluntarily, particularly in the context of an Anglo-Saxon corporate governance model. If policy makers seek to mandate such participative schemes, many companies will simply be deterred from adopting ESOPs.<sup>175</sup>

A critical issue bearing on the extent to which ESO translates into greater worker influence is whether ESOPs confer voting rights or merely financial distribution rights on employees.

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171. Michie & Oughton, *supra* note 151, at 7; Pendleton, *supra* note 146, at 175.

172. See Michie & Oughton, *supra* note 151, at 8.

173. Pendleton, *supra* note 146, at 175.

174. Jacoby, *supra* note 151, at 53–54.

175. Pendleton, *supra* note 146, at 175.

In the U.S., employee shareholders in publicly held ESOP companies must be able to vote their shares and can direct trustees on how to vote, whereas employee shareholders in privately owned ESOP companies are not required to have voting shares.<sup>176</sup> Most ESOPs do not confer voting rights on employee shareholders or assign voting rights to a trustee.<sup>177</sup> This may be contrary to motivations for implementing ESO schemes, such as to transfer capital ownership and control to employees.<sup>178</sup>

## 2.6 COMPARATIVE APPROACHES

While there are comparative studies of employee share ownership, these comparisons are generally between the countries of Europe, or between Europe and the U.S.<sup>179</sup> In Europe, a number of reports have contrasted the incidence and nature of ESO, and the regulatory frameworks in the EU Member States.<sup>180</sup> Aitken and Wood appear to be the only authors who have sought to compare the experience of ESO in the U.S. and U.K. with that in Australia.<sup>181</sup> Their analysis, however, is very broad and also now out-dated.

Gospel and Pendleton have offered an explanation for the higher incidence of ESOPs in the U.K. and the U.S. in comparison with European countries in the context of their discussion of the impact of differing financial structures and corporate governance practices on labour management practices. They observe that ESO 'appears to reflect a need for bonding mechanisms in contexts where financial calculation is especially important, and where the capacity to generate commitment via employee voice is limited.'<sup>182</sup> Two recent analytical papers have compared the incidence and development of employee share ownership in the EU and the U.S. and have sought to account for the variations.

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176. McHugh et al., *supra* note 81, at 278. For an interesting, brief discussion of the history behind the current U.S. policy, in particular on whether ESOPs should be structured so as to facilitate control, not just ownership, see Bagchi, *supra* note 83, at 17–18.

177. Hirsch, *supra* note 162, at 960; NIELS MYGIND & CHARLES P. ROCK, *Financial Participation and the Democratization of Work*, 14 *ECON. & INDUS. DEMOCRACY* 163, 170–71 (1993).

178. See DARYL D'ART, *ECONOMIC DEMOCRACY AND FINANCIAL PARTICIPATION: A COMPARATIVE STUDY* 115 (1992).

179. See, e.g., Judith K. Thompson, *Promotion of Employee Ownership through Public Policy: The British Example*, 27 *J. ECON. ISSUES* 825 (1993); Roger W. Clark & George C. Philippatos, *Employee Stock Ownership Plans (ESOPs): An International Comparison and Analysis*, 24 *MANAGERIAL FIN.* 19 (1998).

180. See, e.g., Andrew Pendleton & Erik Poutsma, *Financial Participation: The Role of Governments and Social Partners* (European Found. for the Improvement of Living & Working Conditions, 2004).

181. Aitken & Wood, *supra* note 5.

182. Gospel & Pendleton, *supra* note 134, at 570.

In 2003, Blasi et al. contrasted ESO in the two locations and offered suggestions for policymakers in both jurisdictions.<sup>183</sup> In 2005, Bagchi sought to explain why employee ownership varies across institutional environments.<sup>184</sup> He examines the development of employee share ownership in the United States, Germany and Sweden. Bagchi's thesis is that the institutional background—in particular the existing corporate and labour law frameworks—in the context of which employee share ownership is developed significantly determines its course.

### 3. AN OVERVIEW OF EXISTING DATA ON EMPLOYEE SHARE OWNERSHIP IN AUSTRALIA

This section provides an overview of existing data on ESO in Australia. It is concerned with broad-based employee share ownership plans: plans in which the majority of employees within the company are eligible to participate. It begins by briefly outlining the key quantitative studies on ESO undertaken in Australia over the last decade. It then looks at the incidence of ESO; trends over time; the incidence of various types of ESOPs; awareness of ESO among business; characteristics of companies with ESO; characteristics of employees taking up shares; and attitudes of businesses towards ESO. Finally, for comparative purposes, it provides data on the incidence of ESO in North America, Europe and Asia. The conclusion identifies areas in which our knowledge of employee share ownership remains very limited.

#### 3.1 OVERVIEW OF KEY STUDIES

The most recent data on employee share ownership in Australia was collected in 2004 through two surveys. The first study, commissioned by the Employee Share Ownership Development Unit (ESODU), was conducted by TNS Social Research, ACT.<sup>185</sup> The ESODU research involved: in-depth interviews with advisors, human resource managers and owners of businesses with and without ESOPs; case studies of businesses with ESOPs, including interviews with CEOs, senior managers, human resource managers, finance officers and employees; and, finally, a quantitative survey of 1000 sample businesses, via telephone interviews with HR managers or the owner/operator. This survey was limited to businesses with five or more employees,

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183. Joseph Blasi et al., *An Assessment of Employee Ownership in the United States with Implications for the EU*, 14 INT'L J. HUMAN RES. MGMT. 893 (2003).

184. Bagchi, *supra* note 83.

185. ESODU Research, *supra* note 111.

and stratification included business size and major industry groups. The survey covered a number of issues associated with employee share ownership, including: incidence; level of company awareness of employee share plans; reasons for implementing ESOPs; barriers to take up of ESO; effects of ESO; and effectiveness of plans in relation to the objectives of the plans.

Also in 2004, the Australian Bureau of Statistics (ABS) measured the incidence of employee share ownership using data compiled from the Employee Earnings, Benefits and Trade Union Membership survey, conducted as a supplement to the Australian Bureau of Statistics (ABS) monthly Labour Force Survey (LFS) in August 2004.<sup>186</sup> The ABS conducted similar surveys in 1999 and 1994.<sup>187</sup>

Several private consulting companies have conducted surveys of employee share ownership in Australia. In 2003, KPMG surveyed 800 Australian businesses. It focused on all employee share schemes, not just broad-based ones. It looked at what type of companies had schemes; the types of schemes; reasons for schemes; hurdles; perceptions of board or management on effect of ESOP on employee behaviour and attitudes; as well as reasons for implementing or rejecting schemes.<sup>188</sup> In 2002, Mercer Human Resource Consulting conducted a much smaller survey, based on responses from 167 participants. Remuneration Planning Corporation (RPC) has also carried out analyses of employee share plan practices in 1995, 1997 and 1999, based on publicly disclosed information from Australia's top 350 public listed companies.<sup>189</sup>

Finally, information is available from the 1995 and 1990 Australian Workplace Industrial Relations Survey (AWIRS) data, which was collected from private sector workplaces with twenty or more employees.<sup>190</sup> This information includes statistics on workplace variables, such as industry type.

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186. Austl. Bureau of Statistics, *Spotlight: Employee Share Schemes*, Australian Labour Market Statistics (Cat. No. 6105.0), Jul. 2005, available at <http://abs.gov.au/Ausstats/abs@.nsf/7d12b0f6763c78caca257061001cc588/eb4112383cbc0e73ca257259007d6c70!OpenDocument> [hereinafter ABS 2005].

187. Austl. Bureau of Statistics, *Employment Benefits*, 1994 (Cat. No. 6334.0.40.001), Aug. 1994.

188. KPMG, *Employee Share and Option Schemes Survey Report*, Aug. 2003.

189. See Remuneration Planning Corporation, *Employee Share Ownership in Australian Enterprises*, (Submission to the H.R. S. Comm. on Employment, Educ. & Workplace Relations, May 1999).

190. ALISON MOREHEAD ET AL., *CHANGES AT WORK: THE 1995 AUSTRALIAN WORKPLACE INDUSTRIAL RELATIONS SURVEY* (Addison Wesley Longman ed., 1997).

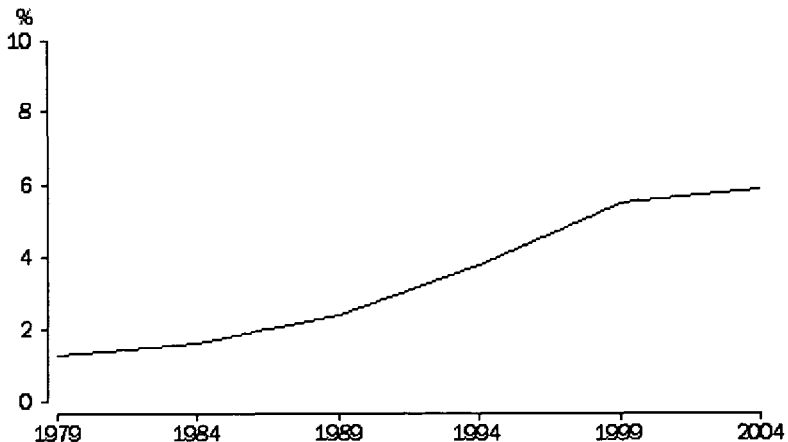
### 3.2 INCIDENCE OF ESOPs IN AUSTRALIA

The 2004 ESODU research found that one in ten businesses surveyed (10 percent) had some form of employee share ownership. Only 4 percent of businesses surveyed had a broad-based ESOP, which was open to at least 75 percent of employees.<sup>191</sup> While only 44 percent of businesses with a plan had a broad-based one (meaning there are significantly more executive share plans than broad-based ones in operation in Australia), the majority of plans implemented in the period 2003–2004 were open to all employees, indicating a move towards broad-based schemes. The 2004 ABS data indicated that 5.9 percent of a total 481,300 employees held shares as a form of employment benefit.

### 3.3 TRENDS OVER TIME

ABS data indicates that an increasing number of employees are taking up shares as a form of employment benefit. In 1979, the proportion of employees who received shares as an employment benefit was 1.3 percent.<sup>192</sup> Between 1989 and 1999, the percentage of full and part-time employees owning shares in their companies increased from 2.4 percent to 5.5 percent.<sup>193</sup> In 2004, the proportion of employees who received shares as an employment benefit was 5.9 percent.

Figure 1: Proportion of employees receiving shares



Source: ABS, Australian Labour Market Statistics (Cat. No 6105.0), July 2005.

191. ESODU Research, *supra* note 111, at 21.

192. ABS 2005, *supra* note 186, at 2. For a brief discussion of the incidence of ESOPs in Australia in the 1950s to 1970s, see Aitken & Wood, *supra* note 5, at 148.

193. Austl. Bureau of Statistics, *Employee Earnings, Benefits and Trade Union Membership, Aug. 1999* (Cat. No. 6310.0), Feb. 2000, at 33 [hereinafter ABS 1999].

The 1995 AWIRS data found an aggregate increase in ESO schemes open to any employee between 1990 and 1995 from 16 percent to 22 percent.<sup>194</sup> However, in only 28 percent of these workplaces did more than half of the employees hold shares.<sup>195</sup>

### 3.4 TYPE OF PLAN

Few of the surveys have delved into the precise type of employee share plans being used by companies. Many of the surveys do not even distinguish between executive or broad-based schemes, let alone between the particular types of equity offered to employees. The ESODU found that 44 percent of businesses with a plan had a 'broad-based one' (that is, open to more than 75 percent of employees).<sup>196</sup> In terms of the type of equity offered, 62 percent of businesses with a plan offered shares, while 31 percent offered options and 7 percent had units.<sup>197</sup>

The 2003 KPMG data found that option and option-type schemes remain the most popular type of equity-based compensation scheme in Australia (constituting 49 percent of all plans). This was followed by tax-exempt share plans (12 percent of plans); deferred share plans (7 percent); loan schemes (8 percent); share discount schemes (5 percent); phantom share schemes (1 percent) and 'other' (18 percent).

The 1997 RPC data also indicates that option plans are the most widely held type of employee share plan: constituting 55 percent of the ESOPs available in Australia's top 350 listed companies. Another 24 percent are loan plans. Subscription plans, which are funded out of a company's total remuneration budget and which tend more often to be aimed at rank-and-file employees, rate only 8 percent.<sup>198</sup> RPC found that only 65 (18.5 percent) had 'meaningful' employee share plans. 'Meaningful' was defined as 'greater than 50 employee participants and/or representing more than 2 percent of the capital of the company.'<sup>199</sup>

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194. MOREHEAD ET AL., *supra* note 190, at 222.

195. *Id.*

196. ESODU Research, *supra* note 111, at 23.

197. *Id.* at 24.

198. Remuneration Planning Corporation, *The Employee Share Plan Report 1997*, cited in Australian Employee Ownership Association, Submission on Employee Share Ownership, (Submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations, Apr. 15, 1999), at 5.

199. RPC survey, cited in SHARED ENDEAVOURS, *supra* note 1, at 24.

### 3.5 AWARENESS OF EMPLOYEE SHARE OWNERSHIP

The ESODU research measured the percentage of businesses that were aware of ESOPs, that is, aware of ways of providing employees with some ownership or equity in the business.<sup>200</sup> 91 percent of businesses displayed a 'general awareness' of such schemes. 65 percent were aware of the availability of ESO plans to all employees; only 49 percent were aware that there was no need for companies with ESOPs to be listed on the stock exchange; and only 23 percent were aware of the availability of tax exemption for broad-based employee share ownership plans.

The highest rate of awareness was among public companies listed overseas (87 percent), followed by companies with over 100 employees (85 percent), companies with an annual turnover of over \$50 million (81 percent) and companies with mostly white collar workers (79 percent). Businesses that displayed the most familiarity with ESO were those in the sectors of property and business services and personal and other services (both below 50 percent); those businesses that rated their organisational culture as 'good' or 'average' but not 'excellent;' and businesses with mostly blue-collar workers (60 percent).

### 3.6 CHARACTERISTICS OF COMPANIES WITH EMPLOYEE SHARE OWNERSHIP

#### 3.6.1 Sector

In 2004, the ESODU found that manufacturing had the highest incidence of employee share ownership (22 percent), followed by finance and insurance (19 percent) and communication services (15 percent).<sup>201</sup> Broad-based plans were more likely to be found in construction (84 percent of plans), manufacturing (92 percent), and least likely in retail (14 percent) and property and business services (20 percent).<sup>202</sup>

In the same year, the ABS found that the finance and insurance industry had the highest proportion of employees holding shares in the company in which they are employed (32 percent). While only 4 percent of employees worked in finance and insurance, this industry accounted for 21 percent of all employees who received shares as an employment benefit. The finance and in-

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200. ESODU Research, *supra* note 111, at 6–11.

201. *Id.* at 21. It is unclear whether these statistics relate to broad-based ESOPs or all ESOPs.

202. *Id.* at 23.

insurance sector was followed by mining (16 percent) and communication services (16 percent).<sup>203</sup>

In 1995, the AWIRS found that employee share ownership schemes were most commonly found in retail, finance, and insurance, and least likely in health and community services, cultural and recreational services, and construction.<sup>204</sup>

### 3.6.2 *Company size*

According to the ESODU research, 30 percent of large businesses (100 or more employees), 39 percent of companies with more than fifty offices in Australia and 32 percent of companies with an annual turnover of over \$50 million had ESOPs. Only 8 percent of private companies had ESOPs. 10 percent of companies with only one office in Australia and 9 percent of small businesses (five to nineteen employees) had ESOPs.<sup>205</sup>

According to the 1995 AWIRS data, 2 percent of private sector workplaces that were part of a larger organisation had an ESOP, as opposed to 3 percent of single workplace organisations.<sup>206</sup> 16 percent of workplaces with between 20 and 49 employees had ESOPs whilst 43 percent of workplaces with between 200 and 499 employees had such plans.

Larger companies are more likely to have broader-based ESOPs. The 1995 AWIRS found that, of those workplaces with between twenty and forty-nine employees with an ESOP, 53 percent had less than 10 percent ownership by non-managerial employees. The corresponding figure for workplaces with between 200 and 499 employees is 22 percent. Conversely 42 percent of these larger workplaces with ESOPs had more than 50 percent non-managerial participation in the schemes, compared to just 22 percent of the workplaces with between twenty and forty-nine employees.

### 3.6.3 *Stock market listing*

Employee share ownership is more common among listed companies. The ESODU found that public listed companies

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203. ABS 2005, *supra* note 186, at 2. In 1999, the ABS found that the industries with the highest number of employees with employee shares are finance and insurance, manufacturing and retail. The ABS noted that the industries with high levels tend to reflect the influence of a small number of very large companies in those industries. In the finance sector, the inclusion of employee share ownership provisions in enterprise bargaining agreements in the major banks has been a very strong influence.

204. MOREHEAD ET AL., *supra* note 190, at 222.

205. ESODU Research, *supra* note 111, at 22.

206. MOREHEAD ET AL., *supra* note 190, at 222.

were 'far more likely' to have ESOPs (52 percent).<sup>207</sup> The 2003 KPMG survey found that 80 percent of public listed companies had at least one ESO scheme (the survey did not specify, however, the proportion of these that were broad-based).<sup>208</sup>

The 2003 KPMG survey also found that 38 percent of 'public unlisted companies'—including subsidiaries of foreign parent companies and privatised Government bodies—had employee share schemes. 16 percent of private companies had at least one employee share scheme. The 1995 AWIRS data indicated that 22 percent of private workplaces had employee share schemes.

### 3.7 CHARACTERISTICS OF EMPLOYEES RECEIVING SHARES

#### 3.7.1 *Type of employment*

The ABS found in 2004 that 7 percent of full-time employees received shares as an employment benefit. This contrasts with 3.4 percent of part-time employees.<sup>209</sup> The 1999 ABS data found that 6.9 percent of full time employees held shares as an employment benefit in their main job, compared with 2.2 percent of part-time employees.<sup>210</sup>

#### 3.7.2 *Occupation*

In 2004, the ABS found that managers and administrators were the occupations with the highest proportions of employees who held shares as an employment benefit (12 percent). This was followed by 'advanced clerical and service workers' (11 percent) and 'Associate professionals' (8 percent). The ABS found a correlation between employees who receive shares as an employment benefit and higher mean weekly earnings. The ABS noted that this reflects the high proportion of employees receiving shares in industries where employees have high earnings.<sup>211</sup>

In 1999, the ABS found that 5.5 percent of employees had employee shares. 12.6 percent of managers and administrators had employee shares, compared to 5.15 percent of non-managers and administrators.

#### 3.7.3 *Trade union membership*

In 2004, the ABS found that the proportion of employees who received shares as an employment benefit was higher for

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207. ESODU Research, *supra* note 111, at 22.

208. KPMG, *supra* note 188, at 3.

209. ABS 2005, *supra* note 186, at 2.

210. ABS 1999, *supra* note 193, at 33.

211. ABS 2005, *supra* note 186, at 3.

trade union members (8.5 percent) than employees who were not trade union members (5.3 percent).<sup>212</sup>

### 3.8 ATTITUDES OF BUSINESSES IN AUSTRALIA TOWARDS EMPLOYEE SHARE OWNERSHIP

Few studies have sought to empirically assess why businesses in Australia adopt or do not adopt ESOPs. In 2005, Barnes et al. conducted two case studies, with the goal of better understanding why workplaces implement ESO schemes.<sup>213</sup> The study consisted of structured interviews with management and employees at two companies: National Australia Bank and Palm Springs Ltd. The findings are largely based on the perceptions of interviewees concerning the motivations behind implementing ESO schemes and their effects once implemented. While the findings clearly cannot be generalised due to the limited nature of the research, the studies do provide valuable insight into how particular companies perceive ESO. The second main source of information on the attitudes of businesses within Australia towards ESO is the 2004 ESODU research.

#### 3.8.1 *Rationale for implementing ESO*

Barnes et al. concluded that their two case study companies implemented employee share ownership plans on the basis of an indirect and quite broad 'alignment of interests' rationale, rather than as incentives for specific types of behaviour (such as improving employee loyalty or organisational productivity). This research also looked at the role the tax concession regime has played in shaping the implementation and management of the two companies' ESOPs. The authors found that the tax concessions did not operate as a significant incentive for these two companies.

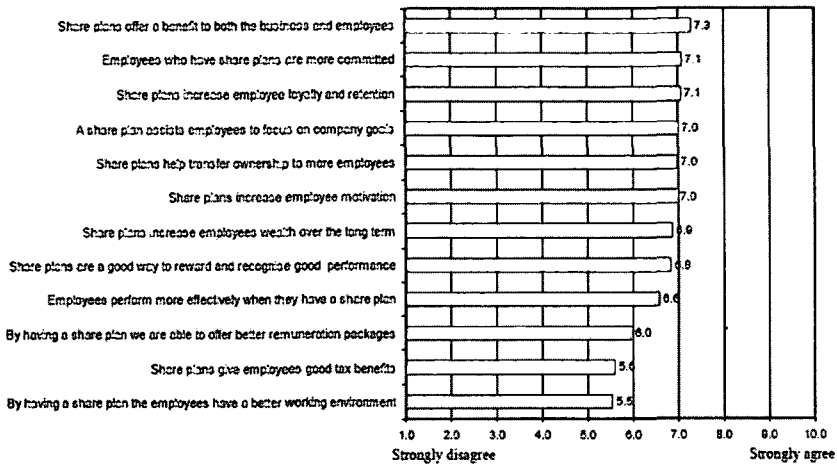
The ESODU sought to measure how businesses with and without plans viewed the benefits of ESOPs. It found that businesses were more likely to agree that ESOPs provided benefits related to organisational culture and workplace relations and human resource strategies than to agree that ESOPs led to improved performance, a better working environment, or that they provided competitive salary packaging or tax benefits for employees (see Figure 2 below).

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212. *Id.*

213. Barnes et al., *supra* note 105.

Figure 2: Benefits of ESOPs, businesses with and without plans  
(average level of agreement out of 10)



Source: TNS Social Research, 'Employee Share Ownership in Australia: Aligning Interests – Executive Summary' (Report prepared for the Department of Employment and Workplace Relations, 2004).

### 3.8.2 Barriers to ESO implementation

The ESODU study (2004) sought to measure the main barriers perceived by businesses to implementation of ESO.<sup>214</sup> The study identified the main barriers as employers' belief that ESO was not relevant to their businesses, practical issues regarding legal and tax complexities, and employee resistance. 54 percent of businesses owners surveyed thought there were better ways of rewarding employees and 67 percent found that employees would prefer other benefits.<sup>215</sup> In regards to the regulatory framework, the study found that significant barriers were the limited tax incentives or complicated tax treatments depending on the plan type, the corporation laws disclosure requirements, which employers regarded as burdensome, as well as annual valuation requirements, which can be expensive, complex and difficult for unlisted companies.

The ESODU study conducted qualitative research with employees. It found that employee resistance to ESO participation was based on the following factors: 1) the performance of the share price; 2) the size and age of the company; 3) the value and type of shares; 4) previous experiences with share schemes; 5) life stage and current financial position; 6) general understanding of

214. ESODU Research, *supra* note 111, at 18–20.

215. *Id.*

share ownership; and 7) existing employee relations and trust of management.

Finally, the *Shared Endeavours* report cites research conducted by Stradwick in 1999 for the Australian Employee Ownership Association (AEOA), which involved a survey of ESOPs in most of the Australian Stock Exchange's top 500 companies. Preliminary findings suggested that 90 percent of companies introduced ESOPs to increase employee identification with the interests of shareholders; 80 percent to provide a benefit for employees; 40 percent because it was a tax effective way of rewarding employees; 29 percent to increase labour productivity; and 7 percent to enhance recruitment and retention.<sup>216</sup>

### 3.8.3 Perceived effectiveness of ESO

The ESODU study (2004) sought to assess how businesses with ESO plans regarded the effectiveness of their plans. Only 14 percent of companies believed their share plans had been 'extremely effective' in delivering on its objectives. 37 percent of companies believed that the share plan had been 'effective' in delivering on its objectives. 41 percent of respondents felt that the share plan had been 'neither effective or not effective.' Only 1 percent of companies felt that their share plan had been 'not at all effective' in delivering on its objectives.<sup>217</sup>

## 3.9 INTERNATIONAL COMPARISONS

There are significant difficulties in comparing data on employee share ownership from different countries. First, little data is available on many countries, particularly those outside Europe and the United States.<sup>218</sup> Secondly, even if countries do measure the incidence and nature of employee share ownership, they often employ very different indicators. In the U.S., for example, statistics tend to measure the percentage of adult employees participating in ESOPs, whereas those in the EU focus on the percentage of workplaces with ESOPs. Thirdly, countries have very different ESO forms and structures, which significantly undermines any efforts to compare national findings.

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216. Richard C. Stradwick, *Submission to the House of Representatives Standing Committee on Employment, Education and Workplace Relations*, research conducted for Australian Employee Ownership Association, May, 1999, cited in SHARED ENDEAVOURS, *supra* note 1, at 34.

217. ESODU Research, *supra* note 111, at 22.

218. For a discussion of the difficulties in examining employee share ownership in Africa and Asia, see Wright et al., *supra* note 7.

### 3.9.1 *The United States*

It is widely recognised that the United States has the highest proportion of employee share ownership. The available data, however, is confusing, as there are a variety of different mechanisms through which workers in the U.S. may hold shares in the company for which they work, and studies differ from each other with regard to which plans they include or exclude. In 1998, it was estimated that around 7 percent of the private sector workforce held shares through ESOPs and stock bonus plans specifically.<sup>219</sup> The U.S. General Social Survey in 2002 found that 21.2 percent of the private sector workforce held shares in the company for which they work, while 13.1 percent hold options.<sup>220</sup> The same survey conducted in 2006 found that the percentage of the private sector workforce holding shares and options had declined to 17.5 percent and 9.3 percent respectively.<sup>221</sup> Interestingly, in contrast to Australia, the vast majority of ESOPs in the U.S. are found in unlisted businesses.<sup>222</sup> Canada is not discussed here due to a dearth of statistics available on employee share ownership in that country.<sup>223</sup>

### 3.9.2 *Europe*

In Europe, data collected from a major 1999–2000 survey of over thirty countries, including fourteen EU Member states, found that just under one-third (31 percent) of ‘organisations’ with more than 200 employees had a share ownership scheme. 52 percent of these ESO schemes were broad-based (involving over half the workforce).<sup>224</sup> The United Kingdom had the highest incidence of broad-based ESO schemes (30 percent), followed by France (23 percent), the Netherlands (21 percent), Ireland (16 percent), Denmark (15 percent) and Finland (15 percent). The southern European countries (Greece, Italy, Portugal and Spain) had low incidences of broad-based schemes (7 percent or lower).<sup>225</sup>

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219. John Logue & Jacquelyn S. Yates, *Worker Ownership American Style: Pluralism, Participation and Performance*, 20 *ECON. & INDUS. DEMOCRACY* 225, 225 (1999).

220. Survey and survey results are available at <http://www.nceo.org>.

221. Press Release, Nat'l Centre for Employee Ownership, *New Data Shows Widespread Employee Ownership in U.S. (2007)*, available at <http://www.nceo.org/library/widespread.html>.

222. *SHARED ENDEAVOURS*, *supra* note 1, at 53.

223. Clark and Philippatos also appear to have struggled to find reliable data on Canada. See Clark & Philippatos, *supra* note 179.

224. Pendleton et al., *supra* note 96, at 27.

225. *Id.* at 31.

Data collected by the European Foundation from a large-scale survey in ten EU countries in the early 1990s found that around 7 percent of workplaces sampled had employee share ownership schemes. The highest rate of diffusion of ESO was in the U.K. (23 percent), but was below 10 percent in all other EU countries surveyed.<sup>226</sup> According to the 1998 U.K. Workplace Industrial/Employee Relations Survey, 24 percent of workplaces with twenty-five or more employees had employee share plans.<sup>227</sup>

### 3.9.3 Asia

While there is still comparatively little attention paid to employee share ownership in developing countries, there have been some studies conducted on ESO in the newly industrialised countries. In South Korea, while comprehensive information on ESOPs is not available, it has been estimated that, by 1997, more than 99 percent of listed companies had an Employee Share Ownership Association (ESOA), which is required by law to manage ESOP stock, and which is similar to an ESOP trust in the U.S.<sup>228</sup> In 1997, just under one million employees in publicly traded companies participated in ESOPs.<sup>229</sup> It is unclear, however, what percentage of these ESOPs are broad-based. More recently, Kato, Lee and Ryu have reported that, in 2000, around 52 percent of publicly traded companies had ESOPs. Around 30 percent of the labour force in companies with ESOPs participates in the plan.<sup>230</sup>

While it is widely observed that Japan has high levels of employee share ownership in comparison with other countries, there does not appear to be recent data on the incidence of ESO in Japan. Data collected in 1988 found that more than 90 percent of all companies listed on Japan's stock exchange markets had an ESOP, and almost 50 percent of the labour force in companies with ESOPs participated in the plan.<sup>231</sup>

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226. Colin Gill & Hubert Krieger, *Recent Survey Evidence on Participation in Europe: Towards a European Model?*, 6 EUR. J. INDUS. REL. 109, 124 (2000).

227. Pendleton, *supra* note 54, at 80.

228. B. Cin & S. Smith, *Employee Stock Ownership and Participation in South Korea: Incidence, Productivity Effects and Prospects*, 6 REV. DEVELOPMENT ECON. *supra* note 8, at 263, 267 (2002).

229. *Id.*

230. Takao Kato, Ju Ho Lee & Jang-Soo Ryu, *The Productivity Effects of Profit Sharing, Employee Ownership, Stock Options and Team Incentive Plans: Evidence from Korean Panel Data 5* (APEC Study Centre, Columbia University, Discussion Paper, 2005).

231. Jones & Kato, *The Scope, Nature and Effects of Employee Stock Ownership Plans in Japan*, *supra* note 8, at 352.

### 3.10 SUMMARY

There are few quantitative studies into employee share ownership in Australia. Nevertheless, we can draw several broad observations from the existing data. First, while the incidence of ESO in Australia remains lower than in the U.K. and the U.S., it is on the increase. Second, Australian companies appear to view employee share ownership in terms of potential benefits to organisational culture and workplace relations. Third, ESOPs are much more likely to be found in larger and publicly listed companies, in companies with offices overseas, and in particular industry sectors. Finally, from the data collected by the Australian Bureau of Statistics, we can observe that employee share ownership is more common among full-time employees, employees with higher weekly earnings, and in certain occupations.

The extent to which we can draw upon the existing data to understand the nature and extent of broad-based employee share ownership in Australia, however, is limited. A number of the studies fail to differentiate between narrow and broad-based ESOPs. Surveys have also tended to draw on a relatively small sample size. We still have very little understanding of how businesses in Australia are structuring their employee share ownership plans, and how, if at all, they are integrating employee share ownership into their broader human resource management strategies.

## 4. THE CORPORATE LAW FRAMEWORK

There is no singular piece of legislation regulating the establishment or administration of ESOPs in Australia. Companies proposing to offer securities to employees must ensure they comply with a myriad of regulatory requirements. These regulatory considerations emanate principally from corporate law and taxation law. This section focuses on the corporate law aspects of broad-based employee share schemes.

Rules governing employee share ownership plans within a company may be found in a company's own constitution. Beyond this, the principal statute in Australia governing corporations—the *Corporations Act 2001* (Cth)—contains a number of general requirements relating to disclosure, fundraising and licensing that are relevant to the initial implementation and ongoing administration of an ESOP. While the Act contains several provisions relating specifically to employee share schemes, it does not generally provide for different treatment of employee shares. For this reason, the Australian Securities and Investments Commission (ASIC) has issued a Policy Statement and Class Order that provide conditional relief from specific disclosure and licensing

provisions within the *Corporations Act* for companies establishing eligible employee share schemes.

Permeating the Australian corporate law regulatory framework for employee share plans is the concern of regulators to strike an appropriate balance between recognising the public policy objective of promoting broad-based employee share plans whilst protecting the interests of potential employee investors and existing shareholders. Whether the current balance struck between these objectives is the most desirable one remains the subject of contention.

This section of the paper is structured as follows. Part 4.1 outlines the disclosure requirements upon companies when issuing securities to employees. It identifies the general requirements under the *Corporations Act* and examines the conditional relief from these provisions provided by ASIC. Part 4.2 considers how the *Corporations Act* regulates the funding of employee share schemes. Part 4.3 looks briefly at employee share scheme trusts. Part 4.4 outlines Australian Stock Exchange (ASX) Listing Rules relevant to employee share schemes. Part 4.5 examines potential legal issues arising from companies in relation to financial services licensing and securities hawking. Part 4.6 looks briefly at the extent to which companies may impose restrictions upon employee shares. Part 4.7 identifies and briefly outlines relevant corporate governance standards. Part 4.8 outlines the broad accounting standard requirements upon companies in relation to employee share schemes.

Part 4.9 of the paper turns to consider how the current law governing directors' duties in Australia may regulate the implementation of employee share schemes. It looks at the duty of directors to act in good faith for the benefit of the company as a whole and the duty to issue shares for a proper purpose. Finally, it identifies how an employee shareholder who believes a director has abused his or her powers may challenge such actions. After exploring the regulatory framework governing the establishment of employee share schemes, this paper turns to consider, in Part 4.10, the extent to which the *Corporations Act* provides avenues through which employee shareholders can seek to promote and protect their unique set of interests. Finally, Part 4.11 identifies the key criticisms of the corporate law framework in this area.

#### 4.1 DISCLOSURE REQUIREMENTS WHEN ISSUING SECURITIES TO EMPLOYEES

##### 4.1.1 *General requirements under the Corporations Act 2001 (Cth)*

Companies seeking to offer their employees shares must comply with the general disclosure requirements in Part 6D.2 of the *Corporations Act*, unless there is a specific exemption in the Act or relief is provided by ASIC.<sup>232</sup> Generally speaking, a company intending to offer employees shares is required under Part 6D.2 of the Act to issue a prospectus.<sup>233</sup> Such disclosure requirements are primarily intended to ensure that investors in newly issued securities of a corporation have access to the information which a reasonable investor would require for the purpose of making an investment decision.<sup>234</sup>

There are two exemptions from the disclosure requirements in section 708 of the Act which may potentially provide relief for companies wishing to establish employee share schemes. First, a company may be exempt from the disclosure requirements where the offer is a small scale offering.<sup>235</sup> This exemption applies provided that three conditions are met. First, the offers must be personal offers for issue or sale of a body's securities.<sup>236</sup> Second, none of the offers must result in a breach of the twenty investors ceiling. The twenty investor ceiling will be breached where the offer results in the number of people to whom securities have been issued exceeds twenty in any twelve month period.<sup>237</sup> Third, none of the offers must result in a breach of the \$2 million ceiling. The \$2 million ceiling will be breached if the offer results in the amount raised exceeds \$2 million in any twelve month period. ASIC has observed that this exemption for small scale offerings may be useful for small proprietary companies that wish to establish employee share schemes. Even for small companies with more than twenty employees, the exemption could be used repeatedly, providing the 12 month limit has expired each

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232. Corporations Act § 706.

233. *Id.* § 709.

234. ROBERT AUSTIN & IAN M. RAMSAY, *FORD'S PRINCIPLES OF CORPORATIONS LAW* ¶ 22.010 (13th ed. 2007).

235. Corporations Act § 708(1).

236. § 708(2) (defining a personal offer).

237. § 708(3)(a).

time.<sup>238</sup> This exemption, of course, will be of limited utility to large companies issuing shares under an ESOP.<sup>239</sup>

A second potential exemption may apply where shares are provided to employees at no cost. Under section 708(15), disclosure to investors is not required when no consideration is to be provided for the issue or transfer of the shares. Section 708(16) provides a similar exemption for options issued for no consideration. Sartori warns, however, that ASIC has taken a narrow view of this exemption, finding that where continued employment is a condition of the securities grant, consideration has been provided.<sup>240</sup>

Finally, where a body is seeking, through an issue of securities, to raise no more than \$5 million, the company may use a simpler form of disclosure document—an Offer Information Statement (OIS)—in lieu of a prospectus. Under section 709, a company may use an OIS when the amount of money to be raised by issue of the securities, when added to all amounts previously raised by the issuing body, its related bodies corporate and entities controlled by the issuer's controller and the controller's associates, is \$5 million or less.<sup>241</sup>

The Government has expressed its opinion that an OIS provides an appropriate level of disclosure for employees of unlisted companies and their financial advisers.<sup>242</sup> However, Austin and Ramsay note that the utility of section 709 for small and medium-sized enterprises is limited due to the requirement in section 715 that an OIS include a copy of an audited financial report with a balance date within the last six months. They observe that many such enterprises are generally not under any requirement to have their financial statements audited, and the appointment of an auditor only for the purposes of the OIS is likely to be disproportionately expensive.<sup>243</sup>

*The Corporate and Financial Services Regulation Review Proposals Paper*, released by the Parliamentary Secretary to the Treasurer in November 2006, has proposed to increase the threshold amount in section 709(4) from \$5 million to \$10 million

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238. Austl. Sec. & Invest. Comm'n, Inquiry into Employee Share Ownership in Australian Enterprises, (Submission in relation to the H.R. S. Comm. on Employment, Educ. & Workplace Relations Inquiry into Employee Share Ownership, Jul. 27, 1999), at 2.

239. Sartori, *supra* note 4, at 79.

240. *Id.*

241. Corporations Act § 709(4).

242. Commonwealth of Austl., Corporate and Financial Services Regulation Review: Proposals Paper, (Nov. 2006), at 64.

243. AUSTIN & RAMSAY, *supra* note 234, ¶ 22.300 (noting that, while ASIC has identified the circumstances in which it may give relief from this requirement in PS 157, these circumstances appear very limited).

and to provide that amounts issued under employee share schemes by unlisted companies are excluded from this calculation.<sup>244</sup> These reforms are intended to facilitate the spread of employee share schemes in unlisted companies.

#### 4.1.2 *Conditional relief from disclosure provisions provided by ASIC*

ASIC has power under the *Corporations Act* to specify exemptions from the disclosure requirements in Pt 6D.2.<sup>245</sup> ASIC has issued a Policy Statement and a Class Order that provide conditional relief to listed companies seeking to establish employee share schemes.

ASIC's Policy Statement 49 (PS 49), first issued in 1993 and substantially revised in 2003, sets out the basis upon which ASIC will provide conditional relief from the disclosure and licensing provisions of the *Corporations Act* for offers made under employee share schemes where the company is listed on the ASX or an approved foreign exchange.<sup>246</sup> It is ASIC policy to give conditional relief to companies where the purpose of the share offer is to involve employees in ownership of the corporate employer rather than for fundraising purposes, and if there are otherwise adequate protections for employees.<sup>247</sup> Policy Statement 49 notes that:

[t]he disclosure provisions and the Australian financial services (AFS) licensing requirements of the Act may apply to ESSs [Employee Share Schemes] in a way that is disproportionately burdensome where financial products are made available in order to promote a relationship between an employer and employee that is ongoing and substantial with a common perceived goal.<sup>248</sup>

ASIC justifies the exemption on the basis that the employer-employee relationship 'is additional to, and distinct from, the interest a shareholder may have in an issuing corporation. The existence of this mutual interdependence reduces some of the risk that the disclosure provisions and the licensing provisions were intended to address.'<sup>249</sup>

The Policy Statement notes that the disclosure relief provided through the Class Order is conditional. The conditions in

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244. Commonwealth of Austl., *supra* note 242, at 64.

245. Corporations Act § 741(1). For the power to grant exemptions from PDS requirements, see § 1020F(1).

246. Austl. Sec. & Invest. Comm'n, Policy Statement 49, issued 1993, reissued 2003, amended 2004, ¶ 49.1, [hereinafter PS 49], available at [http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps49.pdf/\\$file/ps49.pdf](http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/ps49.pdf/$file/ps49.pdf).

247. PS 49, ¶ 49.3.

248. PS 49, ¶ 49.5.

249. *Id.*

the Class Order are designed with three objectives in mind: 1) to ensure that the aim of the offer is not fundraising. (Accordingly, ASIC has imposed a 5 percent limit on the number of shares that can be issued under an eligible employee share scheme.);<sup>250</sup> 2) the offer sufficiently supports the long-term mutual interdependence between the offeror and the offeree; and 3) adequate disclosure is provided to investors.<sup>251</sup> ASIC ensures adequate disclosure to investors by providing that conditional relief will only be granted where the shares offered to employees are in a class listed on the ASX or an approved foreign exchange; the options being issued for free or for nominal consideration and the underlying shares are in a class listed on the ASX or an approved foreign exchange; and where the company to have been listed for at least twelve months at the time of the offer.<sup>252</sup> Additional conditions of disclosure relief are imposed for contribution plans and offers made through a trust.<sup>253</sup>

PS 49 emphasises that ASIC has not provided class order relief to partly paid shares, on the basis the such offers may expose employees to levels of risk that outweigh the benefits from allowing reduced disclosure. Nonetheless, ASIC will consider case-by-case relief where the arrangements do not expose the employee to significant liabilities.<sup>254</sup>

While the PS does not extend class order relief to casual employees, it does note that ASIC will consider extending relief offers to casual employees or contractors on a case-by-case basis. In doing so, ASIC will consider the length of time the employee has been in the employment of the company and the likely ongoing relationship between the parties.<sup>255</sup>

ASIC Class Order 03/184, issued in 2003, offers three exemptions from the disclosure provisions of the *Corporations Act*.<sup>256</sup> The first exemption offers disclosure relief for offers of shares, units of shares, options and stapled securities. The second exemption provides disclosure and other relief for offers involving a contribution plan (defined as a plan under which a participating eligible employee may save money by regular deductions from wages or salary towards paying for shares offered

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250. This means that an employee share scheme offer cannot exceed 5 percent of the total number of issued shares in that class of the issuer at the time of the offer. PS 49, ¶ 49.32. See also PS 49, ¶ 49.33–49.34.

251. PS 49, ¶ 49.20.

252. *Id.*

253. PS 49, ¶ 49.21.

254. PS 49, ¶ 49.25.

255. See PS 49, ¶ 49.38–49.40.

256. The fourth exemption in the Class Order relates to licensing and hawking relief. This is dealt with in Part 4.5 of this paper.

under an employee share scheme).<sup>257</sup> The third exemption provides disclosure relief for offers of options by an unlisted body. The overall effect of these detailed provisions is to provide conditional relief from the need to produce a prospectus for certain offers of shares or options over unissued shares made to full time or part time employees under an employee share scheme.

## 4.2 FUNDING EMPLOYEE SHARE SCHEMES

In designing an employee share scheme, companies must choose how the shares offered to employees are to be funded. Shares may be bought on market or issued and paid for by loans from the company to the employee participant or funded out of a share of profits or salary sacrifice arrangements. Less commonly, employees may be issued shares at a market or predetermined price but only required to pay up a small portion of their value, remaining liable for any unpaid amounts of the shares.<sup>258</sup> Most employee share plans involve some financial contribution from the company. In financing the employee shares, a company must comply with the relevant fundraising provisions within the *Corporations Act*.

### 4.2.1 *Restrictions on a company acquiring an interest in its own shares*

The *Corporations Act* imposes a general prohibition upon a company limited by shares acquiring an interest in shares in itself.<sup>259</sup> This extends to cases where the interest is taken by way of security for repayment of a loan. Section 259B identifies four exceptions to this general rule, including one that specifically relates to 'employee share schemes.' An 'employee share scheme' is defined in section 9 of the Act as:

- a scheme under which shares (or units in shares) in the company or a holding company may be acquired:
- (a) by, or for the benefit of:
    - (i) employees of the company, or of a related body corporate; or
    - (ii) directors of the company, or of a related body corporate, who hold a salaried employment or office in the company or in a related body corporate; or
  - (b) by a corporation all of whose members are:

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257. See Austl. Sec. & Invest. Comm'n, Class Order 04/184, Interpretation 6. Note that the Class Order specifies terms and conditions that must be included in the contribution plan.

258. COMMONWEALTH OF AUSTRALIA, EMPLOYEE SHARE OWNERSHIP DEVELOPMENT UNIT, DEVELOPING AN EMPLOYEE SHARE OWNERSHIP PLAN (2003).

259. Corporations Act, § 259A. The rationales behind this general rule are identified in Austin & Ramsay, *supra* note 237, ¶ 24.360.

- (i) employees of the company, or of a related body corporate; or
- (ii) directors of the company, or of a related body corporate, who hold a salaried employment or office in the company or in a related body corporate.

A company is permitted to take security over its own shares under an employee share scheme, provided that the scheme is approved by a resolution of members in general meeting of the company and, if it has a parent domestic corporation (defined in section 9 to mean a corporation that is incorporated or formed in Australia or external territory), the parent company also approves.<sup>260</sup>

#### 4.2.2 *Restrictions on a company financially assisting a person to acquire its shares*

Companies may seek to encourage employees to participate in employee share schemes through offering shares at less than market value, providing low interest loans to employees or offering the shares free. Under the *Corporations Act*, a company is permitted to financially assist a person to acquire shares in itself or in its holding company in stated circumstances, including if the giving of the assistance is exempted by section 260C.<sup>261</sup> Providing shares as a gift to employees or at less than market value or making a loan to employees to purchase shares are all forms of 'financial assistance.'<sup>262</sup> Section 260C(4) states that financial assistance is exempted from section 260A if it is given under an employee share scheme that has been approved by a resolution of members in general meeting of the company, and, if it has a parent domestic corporation, the parent company also approves.<sup>263</sup>

#### 4.2.3 *Employee share buy-backs*

A company wishing to establish an employee share scheme may be reluctant to issue new shares, as this will dilute the value of existing shares. The Act permits a company to buy back its own shares from existing shareholders so long as the buy-back does not materially prejudice the company's ability to pay its creditors and the company follows the procedures laid down in Part 2J Division 2 of the Act. The Act provides specifically for employee share scheme buy-backs. The procedure for an 'em-

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260. Corporations Act, § 259B(2).

261. *Id.* § 260A(1).

262. See *Re VGM Holdings Ltd.* (1942) Ch. 235 (regarding the making of a gift); see *Shearer Transport Co. Pty. Ltd. v. McGrath* (1956) V.L.R. 316 (regarding the making of a loan to a person to purchase shares in the company).

263. Corporations Act § 259B(2).

ployee share buy-back' is outlined in section 257B. An 'employee share buy-back' is defined in section 9 as:

A buy-back under a scheme that:

- (a) has as its purpose the acquisition of shares in a company by, or on behalf of:
  - (i) employees of the company, or of a related body corporate; or
  - (ii) directors of the company, or of a related body corporate, who hold a salaried employment or office in the company or in a related body corporate; and
- (b) has been approved by the company in general meeting.

The procedure for an employee share buy-back will differ depending upon whether the proposed buy back exceeds the 10/12 limit. This limit refers to 10 percent of the smallest number of votes attached to 'voting shares' at any time 'during the last 12 months.'<sup>264</sup> Where the proposed buy-back does not exceed this limit, a company must lodge notice of its intention with ASIC at least fourteen days prior to the intended buy-back,<sup>265</sup> cancel the shares on registration of transfer,<sup>266</sup> and notify ASIC of the cancellation of the shares.<sup>267</sup> Where the 10/12 limit is exceeded, a company can still buy back its shares but it must obtain approval of the terms of the buy back agreement in general meeting by ordinary resolution.<sup>268</sup> A company that is listed on the ASX will also need to lodge the relevant documentation with ASX when it decides to make an employee share buy-back.<sup>269</sup>

#### 4.2.4 *On-sale of securities*

Where securities are issued under an employee share scheme and then resold within twelve months, the sale could fall under the on-sale provisions in the *Corporations Act*.<sup>270</sup> The Act seeks to prevent circumstances in which an issuer which offers new shares for investment seeks to avoid its disclosure obligations by issuing the securities to a single entity who will then on-sell them to investors through identifying certain circumstances in which a secondary sale will be treated as a first issue.<sup>271</sup> Section 707(3) of the Act requires that a body comply with the same disclosure requirements had the issuer offered its securities directly to investors where the offer of a body's securities for sale is

264. *Id.* § 257B(4). *Id.* § 9 (defining 'voting share').

265. *Corporations Act* § 257F.

266. *Id.* § 257H.

267. *Id.* § 254Y.

268. *Id.* § 257C.

269. Austl. Stock Exchange, Listing Rule 3.8A, [hereinafter Listing Rule], available at <http://www.asx.com.au/ListingRules/chapters/Chapter03.pdf>.

270. This issue is explored in Sartori, *supra* note 4, at 80.

271. AUSTIN & RAMSAY, *supra* note 234, ¶ 22.030.

made within twelve months after their initial issue without a disclosure document and where the initial transaction was for the purpose of subsequent on-sale.

ASIC has issued a Class Order (CO) that, providing certain requirements are met, provides relief from the on-sale provisions in the Act for employee share schemes. ASIC Class Order 04/671 provides class order relief from section 707(3) where the securities were issued without disclosure to investors under Part 6D.2, because the issuer relied on CO 03/184 or on an individual instrument of relief granted by ASIC to the issuer which provided relief from Part 6D.2 with respect to an employee share scheme.<sup>272</sup>

#### 4.3 ESOP TRUSTS

Employee share ownership plans are generally structured in one of two ways: the shares or options may be issued directly to employees or to a trustee to hold in trust for the employees. A company may choose to administer an ESOP through a trust for a range of reasons, including, for example, to administer the various performance and/or vesting conditions that apply to an ESOP; to enable the orderly and cost effective acquisition and disposal of small share holdings; and to enable a company to control and manage its share registry costs.<sup>273</sup>

If an ESOP is to be administered through a trust, then the company will need to draw up a relevant trust deed and nominate a trustee. While the *Corporations Act* imposes requirements for trusts, relief may be available under CO 03/184. The Class Order provides conditional relief from the disclosure provisions in the *Corporations Act* in cases where an offer is made through a trust, provided that a number of conditions relating to the design and administration of the trust are met.<sup>274</sup>

#### 4.4 ASX LISTING RULES

Employee share schemes within companies listed on the ASX are also regulated by the ASX Listing Rules.<sup>275</sup> The ASX Rules provide for two main exceptions from generally-applicable requirements for 'employee incentive schemes.' An employee incentive scheme is defined in Chapter 19 as: (1) a scheme for the issue or acquisition of equity securities in the entity to be held by, or for the benefit of, participating employees or non-executive

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272. Austl. Sec. & Invest. Comm'n, Class Order 04/671, Schedule D.

273. COMMONWEALTH OF AUSTR., *supra* note 258.

274. See Austl. Sec. & Invest. Comm'n, Class Order 03/184, Schedule 4.

275. These rules are binding by virtue of sections 793C and 1101B of the Corporations Act.

directors of the entity or a related entity; or (2) a scheme which, in ASX's opinion, is an employee incentive scheme.

Under ASX Listing Rule 7.1, an entity must not issue, or agree to issue, equity securities amounting to more than 15 percent of the issued capital in any rolling twelve month period without shareholder approval unless an exception applies. Rule 7.2, Exception 9, provides that an issue under an employee incentive scheme is exempt from the requirement in Listing Rule 7.1 if, within three years before the date of issue, one of the following occurred:

- (a) in the case of a scheme established before the entity was listed—a summary of the terms of the scheme was set out in the prospectus, Product Disclosure Statement or information memorandum;
- (b) holders of ordinary securities have approved the issue of securities under the scheme as an exception to this rule. The notice of meeting must have included each of the following:
  - a summary of the terms of the scheme;
  - the number of securities issued under the scheme since the date of the last approval; and
  - a voting exclusion statement.

The second exception is found within Chapter 10 of the Listing Rules, which regulates transactions between an entity and a person in a position to influence the entity. Under ASX Listing Rule 10.11, unless one of the exceptions in Listing Rule 10.12 applies, an entity must not, without first obtaining the approval of holders of ordinary securities, issue or agree to issue equity securities to a related party or a person whose relationship with the entity or a related party is, in ASX's opinion, such that approval should be obtained. However, Rule 10.12, Exception 4 recognises that Rule 10.11 does not apply to cases in which the person is a person referred to in Rule 10.14 and receives the securities under an employee incentive scheme with approval under that rule.

Rule 10.14 states that an entity must not allow any of the following persons to acquire securities under an employee incentive scheme without the approval of holders of ordinary securities of the acquisition: a director of the entity; an associate of a director; or a person whose relationship with the entity or a person referred to in Rules 10.14.1 or 10.14.2 is, in ASX's opinion, such that approval should be obtained.<sup>276</sup> This rule does not apply to securities purchased on market under the terms of a

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276. The notice for this meeting to obtain approval must comply with either Rule 10.15 or 10.15A. Listing Rules, 10.14.

scheme that provides for purchase of securities by or on behalf of employees or directors. Finally, a company proposing to establish an employee share scheme must also notify ASX of the proposed issue of securities in accordance with Listing Rule 3.10.3.

#### 4.5 FINANCIAL SERVICES LICENSING AND SECURITIES HAWKING

If a company includes advice about the employee share scheme in any document offering shares to employees, it may be providing 'financial services' under the *Corporations Act*. The Act requires that any body providing 'financial services' must hold an Australian Financial Services License (AFSL). A person provides a financial service if he or she performs one of the functions identified under section 766A, including the provision of financial product advice. Companies establishing an ESOP, or trustees issuing securities to employees, may be providing financial product advice, which is defined in the Act as:

a recommendation or a statement of opinion, or a report of either of those things, that:

- (i) is intended to influence a person or persons in making a decision in relation to a particular financial product; or
- (ii) could reasonably be regarded as intended to have such an influence.<sup>277</sup>

Where an employee share scheme has disclosure relief by virtue of ASIC Class Order 03/184, ASIC also provides relief from the requirement to hold an AFSL for persons involved in the operation of the employee share scheme. This relief, however, is subject to the condition that the financial service consists ' . . . of general advice reasonably given in connection with an offer referred to in those exemptions (including any general advice given in the offer document) where the offer document for the offer includes a statement to the effect that any advice given by the person in connection with the offer is general advice only, and that employees should consider obtaining their own financial product advice from an independent person who is licensed by ASIC to give such advice.'<sup>278</sup> This exemption from the need to have an AFSL also applies where the employee share scheme is administered through a trust, provided that certain conditions are met.<sup>279</sup>

In addition, a company offering securities to its employees may run afoul of the prohibitions against securities hawking contained in sections 736, 992A and 992AA of the *Corporations Act*.

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277. *Corporations Act*, § 766B(1).

278. *Austl. Sec. & Invest. Comm'n*, Class Order 03/184, [5].

279. *Id.*, [6].

These provisions prohibit the issue or sale of securities arising out of unsolicited contact with investors, including offers made to employees. The prohibitions apply only to unsolicited telephone calls and meetings. They do not apply to other common forms of communications such as email, letters, facsimiles, brochures or media advertisements.<sup>280</sup>

Under paragraph [7] of ASIC Class Order 03/184, a person who is eligible for relief from the disclosure provisions in Part 6D.2 of the Act will automatically be exempt from sections 736, 992A and 992AA in relation to offers made in the course of, or because of, unsolicited meetings or telephone calls reasonably held or made in connection with the offer.

The Corporate and Financial Services Regulation Review has recently proposed to extend the relief from the licensing, advertising and hawking requirements of the Act through Class Order 03/184 to unlisted companies that have made the offer of shares under an OIS or other disclosure document.<sup>281</sup>

#### 4.6 IMPOSITION OF RESTRICTIONS ON SHARES

A company may wish to impose restrictions upon the shares offered to employees under an employee share scheme. Such restrictions may be designed, for example, to discourage employees from selling their shares within a certain time frame; to provide the company with some security that money owing will be collected from employees; or to preserve control of the company.<sup>282</sup> Restrictions on the rights attaching to shares may be desirable within small companies where the company wishes to establish an employee share scheme but wants to ensure control remains with an individual or family. The *Corporations Act* recognises a company may issue different classes of shares and may determine any rights and restrictions attaching to the shares. Where a company's constitution provides for employee shares and designates the incidents attaching to this class of shares, Australian courts have limited themselves to determining the appropriate construction of such clauses.<sup>283</sup>

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280. AUSTRAL. SEC. & INVEST. COMM'N, *THE HAWKING PROHIBITIONS: AN ASIC GUIDE* 8 (Jul. 2002, reissued May 2005).

281. Commonwealth of Austl., *supra* note 242, at 64.

282. Nick C. Brash, *Does Australian Law Help or Hinder the Establishment of Employee Share Schemes?*, (1995) (PhD thesis, University of Melbourne), at 657-58.

283. *See, e.g., O'Donnell v. Thor Industries Pty. Ltd. and Another* (1977) 14 A.L.R. 61 (where a dispute arose concerning whether an employee, when relinquishing his shares upon termination of employment in accordance with the company's constitution, was entitled to payment for his shares); *Stillwell Trucks Pty. Ltd. v. Nectar Brook Investments Pty. Ltd.* (1993) 12 A.C.S.R. 334 (concerning valuation of employee shares after cessation of employment).

#### 4.7 CORPORATE GOVERNANCE STANDARDS

A number of other organisations in Australia are active in setting standards for the implementation and administration of employee share plans, particularly for listed public companies. These include the Investment and Financial Services Association (IFSA), the Australian Institute of Company Directors (AICD), the Australian Shareholders Association (ASA) and the Australian Employee Ownership Association (AEOA). The Employee Share Scheme Guidelines, endorsed by the above four organisations, provide guidance for Boards and shareholders in relation to the development of broad-based employee share schemes.<sup>284</sup> While the Guidelines refrain from recommending any particular structure for employee share scheme on the basis that different plans may be appropriate for different companies, they do articulate several key principles relating to the structure of share schemes; the number of shares and options issued under ESOPs; and transparency and accountability. In relation to designing schemes, the Board should, for example, ensure adequate corporate education processes are in place to explain the inherent risks and rewards of share ownership and the details of the plan's operation to employees and should make such a scheme available to all employees where appropriate. In relation to restrictions on share schemes, a 'reasonableness test' should be applied to the volume of shares and options issued under an ESOP. In addition, ordinary shares issued as a result of an ESOP should rank equally with other shares owned by existing investors, including that employee shareholders should be able to receive dividends and voting rights. Finally, the guidelines promote transparency and accountability in employee share schemes, principally through providing that all ESOPs should be fully disclosed and justified to shareholders.

#### 4.8 ACCOUNTING STANDARDS

In 2004, the Australian Accounting Standards Board (AASB) issued AASB 2: Share-based Payment, which mirrors the International Accounting Standards Board's (IASB) International Financial Reporting Standard 2: Share-based Payment.<sup>285</sup> All Australian companies, with the exception of small

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284. INT'L FIN. & SEC. ASS'N, EMPLOYEE SHARE SCHEME GUIDELINES (IFSA Guidance Note No. 13, May 2000).

285. AUSTR. ACCOUNTING STANDARDS BD., AASB 2, *available at* <http://www.aasb.com.au/> (follow "AASB Standards" hyperlink; then follow "AASB 2 Share-based Payment" file).

proprietary companies, are obliged to comply with the Standard by virtue of section 296(1) of the *Corporations Act*.<sup>286</sup>

Very broadly, the Standard requires an entity to recognise share-based transactions, including those with its employees, in its financial statements. An entity is required to disclose information so that readers of its financial statements are able to understand the nature and extent of share-based payment arrangements that existed during the reporting period, including expenses associated with the transactions in which share options are granted to employees; how the value of the equities was determined; and the effect the issue of equities has on the entity's profit or loss.

In its *Basis for Conclusions on IFRS 2 Share-based Payment*, the IASB articulated its considerations in formulating the Standard.<sup>287</sup> Given that the Australian standard mirrors the international one, it can be presumed that the policy rationales are also similar. The Basis for Conclusions specifically addresses the issue of whether 'broad-based' employee share plans should be subject to the same accounting requirements as other types of employee share plans.<sup>288</sup> The Board recognised concerns expressed by some that broad-based plans should be exempt from an accounting standard on the basis that the plans were not part of remuneration for employee services and that recognition within financial reports of an expense in relation to such plans was inimical to government policy to encourage employee share ownership. The Board concluded, however, that in principle there was no reason to treat broad-based plans differently. This conclusion rested on two broad considerations. First, the fact that the schemes were available only to employees was deemed by itself to be sufficient to conclude that the benefits provided represented employee remuneration. 'Remuneration' is construed widely to include all benefits to employees, and the 'services' provided by employees is also broad enough to encompass all benefits provided to the company in return, including, for example, increased productivity or employee commitment. Sec-

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286. *Corporations Act* § 292. A small proprietary company is not subject to the general statutory requirements to produce a financial report unless it is controlled by a foreign company for all or part of the accounting period, and the small proprietary company's profit or loss for the period is not covered by accounts of the foreign company lodged with ASIC (*Corporations Act* § 292(2)) or shareholders holding 5 percent or more of the voting shares in the company direct it to prepare financial statements and reports no later than twelve months after the end of the financial year concerned (*Corporations Act* § 293) or ASIC requests that the company prepare financial statements (*Corporations Act* § 294).

287. International Accounting Standards Board, *International Financial Reporting Standard 2: Share-based Payment: Basis for Conclusions* (2006).

288. *Id.*, BC8-BC18.

only, the public policy objectives of some governments in encouraging employee share ownership was not, in the Board's opinion, a valid reason for according broad-based plans different treatment.

#### 4.9 DIRECTORS' DUTIES

In establishing an employee share scheme, directors are required to exercise their powers in accordance with their duties under general law and statute. Of particular relevance to a decision to issue shares to employees are the duties on directors to act in good faith in the best interests of the company and for a proper purpose. In most cases, a decision to establish an employee share scheme will not be controversial, as it will be easily justifiable on the basis that it has the potential to benefit the company through, for example, attracting and retaining skilled employees or leading to improvements in organisational productivity. There are, however, circumstances in which a decision to issue shares under an employee share plan may be deemed by the courts to be an improper use of directors' powers.

This section explores how directors' duties limit the purposes for which directors may establish employee share schemes. It examines the position under Australian law, briefly considering, in turn, the duty of directors to act in good faith in the best interests of the company and the duty to issue shares for a proper purpose. It is in this latter circumstance, where a decision to establish an employee share scheme is taken in the context of a hostile takeover, that the issue of directors' duties comes to the fore.

##### 4.9.1 *The duty to act in good faith for the benefit of the company as a whole*

Directors are under a fiduciary and statutory obligation to act in good faith for the benefit of the company as a whole.<sup>289</sup> The courts are generally reluctant to closely scrutinise the decisions of directors; as emphasised by Lord Greene MR in *Re Smith & Fawcett*, directors must act 'bona fide in what they consider—not what the court may consider—is in the best interests of the company.'<sup>290</sup> In Australia, not only are directors not under any general or statutory obligation to consider the interests of employees, but, where they do, they may be vulnerable to actions by general shareholders for failing to consider the interests of

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289. *Re Smith & Fawcett Ltd.* (1942) Ch. 304; Corporations Act §§ 181(1) & 184(1).

290. *Re Smith & Fawcett Ltd.* (1942) Ch. 304, at 306.

existing shareholders.<sup>291</sup> Therefore, a decision to implement an employee share ownership plan in a form and manner that substantially benefits employees at the expense of the company could conceivably leave directors vulnerable to an action for breach of their general duty to act in good faith in the interests of the company as a whole. In addition, in circumstances where a decision taken by directors will adversely influence the interests of one class of shareholders (e.g., ordinary shareholders vis-à-vis employee shareholders), the directors are required to act fairly as between the members of the differing classes.<sup>292</sup>

#### 4.9.2 *Takeovers and the duty to issue shares for a proper purpose*

It is in the context of hostile takeovers that the use of employee share schemes is most likely to give rise to allegations of breach of directors' duties.<sup>293</sup> In some instances, a defensive tactic employed by directors against a hostile takeover bid is the allotment of shares to a 'friendly' holder. Employee share plans provide a mechanism through which directors may create a substantial group of shareholders—employees—that tends to be sympathetic to management interests.<sup>294</sup> In circumstances where a board of directors decides to implement an employee share scheme in close temporal proximity to the threat of a hostile takeover, the courts are faced with the difficult task of determining whether the share issue was undertaken in good faith in the best interests of the company and for a proper purpose.<sup>295</sup> In

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291. *Parke v. Daily News Ltd.* (1962) Ch. 927.

292. *Mills v. Mills* (1938) 60 C.L.R. 150.

293. There is a significant body of case law in the United States on this issue. See, for example, *Podesta v. Calumet Industries, Inc.*, 1978 WL 1088 (N.D. Ill. 1978); *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255 (2d Cir. 1984); *Shamrock Holdings Inc. v. Polaroid Corp.*, 559 A.2d 257 (Del. 1989); *NCR Corp v. American Telephone & Telegraph Co.*, 761 F. Supp. 475 (S.D. Ohio, 1991); *RCM Sec. Fund, Inc. v. Stanton*, 928 F.2d 1318 (2d. Cir. 1991). For discussion, see Gina Marie Agresta-Richardson, *Employee Stock Ownership Plans: Uncertainties Plaguening the Duties of the ESOP Fiduciary with Respect to Voting and Defensive ESOPs*, 14 AKRON TAX J. 92 (1999); Eric J. Grannis, Note, *A Problem of Mixed Motives: Applying Unocal to Defensive ESOPs*, 92 COLUM. L. REV. 851 (1992); Brett McDonnell, *ESOP's Failures: Fiduciary Duties when Managers of Employee-Owned Companies Vote to Entrench Themselves*, 2000 COLUM. BUS. L. REV. 199; Margaret E. McLean, *Employee Stock Ownership Plans and Corporate Takeovers: Restraints on the Use of ESOPs by Corporate Officers and Directors to Avert Hostile Takeovers*, 10 PEPP. L. REV. 731 (1983); and Hollo, *supra* note 156.

294. RODD LEVY, *Takeovers: Law & Strategy* ¶10.5.2 (2d ed. 2002).

295. Since the Corporate Law Economic Reform Program Act 1999 (Cth) (Austl.) [hereinafter Reform Program Act], actions taken by directors in listed companies or those with more than fifty members in the context of a contested takeover will be examined by the Takeovers Panel rather than by the courts. Reform Program Act § 659AA. Nonetheless, civil and criminal proceedings can still be brought after

most cases, it will be the duty to issue shares for a proper purpose which will be the subject of scrutiny.

The duty upon directors to exercise their powers, including the power to issue shares for a proper purpose, has its source in general law and in sections 181 and 184 of the *Corporations Act*. In applying the proper purposes doctrine, Australian courts will first identify the nature of the power exercised by the director and the purpose for which it was conferred.<sup>296</sup> This purpose, and the limitations within which the power can legitimately be exercised, will generally be ascertained through a close examination of the company constitution.<sup>297</sup> In the absence of relevant internal rules, the court will infer the purpose from the type of company, its activities and its constitutional structure. The court will then determine the substantial purpose for which the power was in fact exercised, in order to determine whether the power was exercised honestly and in the interests of the company.<sup>298</sup> In seeking to determine whether a particular exercise of power is within the proper purposes for which it was conferred, the courts will look to the subjective motivations of the directors.

The courts have recognised that there are many valid reasons for issuing shares beyond raising capital.<sup>299</sup> Courts will not interfere where they deem the dominant purpose of the share issue to be a legitimate commercial objective. Directors are not, however, entitled to use their powers to issue shares for the dominant purpose of consolidating or ensuring their own continuing control through attempting to preserve the existing majority or

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the conclusion of a takeover bid, or with the consent of ASIC or the Minister. Reform Program Act § 659B(1). The Takeovers Panel is a peer review body with part time members appointed from Australia's takeovers and business communities. It has the power to declare circumstances in relation to a takeover, or to the control of an Australian company, to be unacceptable. The Panel has issued Guidance Note 12: Frustrating Action [hereinafter Guidance Note], to provide guidance on actions of target company directors that may frustrate a takeover bid. In this Guidance Note, the Panel emphasises that the task of enforcing directors' duties lies with the courts; the Panel is concerned with the likely effect of action on the target shareholders' ability to decide on the offer (Guidance Note, ¶12.17). The Panel may declare there to be unacceptable circumstances even if there is not a breach of directors' duties (Guidance Note, ¶12.18) or may decide not to make a declaration of unacceptable circumstances even where directors' duties have been breached. Nonetheless, as Austin and Ramsay note, whether or not a director has used his or her powers for a proper purpose is still relevant to Panel deliberations. See the discussion in AUSTIN & RAMSAY, *supra* note 234, ¶8.205. Where the Panel has found circumstances to be unacceptable, it has wide powers to make orders under Corporations Act, § 657D.

296. *Howard Smith Ltd. v. Ampol Petroleum Ltd.* (1974) A.C. 821.

297. *Mills*, 60 C.L.R. 150; *Ngurli Ltd. v. McCann* (1953) 90 C.L.R. 425.

298. *Howard Smith Ltd.*, A.C. 821.

299. *Id.*; *Harlowe's Nominees Pty. Ltd. v. Woodside (Lakes Entrance) Oil Co. NL* (1968) 121 C.L.R. 483.

creating a new majority.<sup>300</sup> The courts have generally proved more willing to scrutinise board decisions in relation to the duty to exercise powers for a proper purpose than the general duty to act in good faith for the benefit of the company.<sup>301</sup>

### *Mixed purposes*

Directors who decide to implement an employee share plan in the context of a takeover bid will generally argue that they have done so for a proper purpose (i.e. to benefit the company through improved employee commitment etc), whereas those who allege a breach of duty will argue that the primary motive of the share allotment was to affect control of the company. In most cases, it will be likely that the evidence will suggest the directors were influenced by both considerations: that is, that they had multiple purposes. In deciding whether a decision motivated by a number of purposes is valid, it has long been established in Australia that one looks to the substantive or dominant objective for which the action was directed.<sup>302</sup> However, more recently in *Whitehouse v. Carlton Hotel Pty. Ltd.*, Mason, Deane and Dawson JJ, *obiter dicta*, opined that the preferable test is 'but for' the impermissible purpose, the power would not have been exercised.<sup>303</sup> In circumstances where a decision to implement an employee share scheme is prompted by a takeover bid, the differences between these two tests would appear important. Applying the conventional test, it appears that, even where directors are spurred into reaching a decision to issue shares by the presence of a hostile takeover bid, this will not be held invalid if the decision is otherwise commercially justifiable.<sup>304</sup> However, applying the 'but for' test, the fact that the takeover attempt triggered action would invalidate the decision.<sup>305</sup>

The decisions reached in *Hogg v. Cramphorn*<sup>306</sup> and *Condraulics Pty. Ltd. v. Barry & Roberts Ltd.*<sup>307</sup> both concerned the

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300. *Hogg v. Cramphorn* (1967) Ch. 254; *Howard Smith Ltd. v. Ampol Petroleum Ltd.* (1974) 1 All E.R. 1126; *Whitehouse v. Carlton Hotel Pty. Ltd.* (1987) 162 C.L.R. 285.

301. AUSTIN & RAMSAY, *supra* note 234, ¶ 8.060.

302. *Mills v. Mills*, 60 C.L.R. 150.

303. *Whitehouse*, 162 C.L.R. 285 at 294. The 'but for' test was applied by Judge Hodgson in *Darvall v. North Sydney Brick & Tile Co. Ltd.* (1987) 16 N.S.W.L.R. 212.

304. *Pine Vale Investments Ltd. v. McDonnell & East Ltd.* (1983) 8 A.C.L.R. 199.

305. "Presumably, this would exclude an improper consideration that was subordinate to other proper considerations but which triggered action." AUSTIN & RAMSAY, *supra* note 234, ¶ 8.250 (noting in relation to the 'but for' test).

306. *Hogg*, (1967) Ch. 254.

307. *Condraulics Pty. Ltd. v. Barry & Roberts Ltd.* (1984) 2 A.C.L.C. 408.

validity of a decision to implement an employee share plan taken in the context of a hostile takeover bid and demonstrated the difficulty in determining whether a particular share issue is motivated by a proper purpose.

In *Hogg v. Cramphorn*, the directors of a company that was the subject of a takeover bid established a trust for the benefit of the company's employees and authorised the company to lend money on an interest-free basis to the trust to permit it to purchase unissued shares in the company. The shares were issued with voting rights that were sufficiently weighted to ensure that the directors, their supporters and the trustees would continue to enjoy majority voting power. The share issue was challenged by a minority shareholder. It was undisputed that the employee share scheme was formulated in such a manner as to effectively thwart the takeover bid. The court found that but for the takeover bid, the scheme would not have come into existence. The court also accepted, however, that in implementing the scheme, the directors honestly believed their actions to be in the best interests of the company and its employees. The court concluded that 'an essential element of the scheme, indeed its primary purpose, was to ensure control of the company by the directors and those whom they could confidently regard as their supporters. . . .'<sup>308</sup> Referring to precedent that established that the purpose of issuing shares to create a sufficient majority to retain control was not recognised as a proper purpose, the court held that the directors had used their power improperly to issue shares.

In the more recent case of *Condraulics Pty. Ltd. v. Barry & Roberts Ltd.*,<sup>309</sup> the Supreme Court of Queensland was also asked to consider whether a proposal to introduce an employee share scheme made in the context of a takeover bid was a proper exercise of directors' powers. The initial proceedings were brought by two companies that were seeking to take over a third company. Shortly before their official take-over announcement, the plaintiffs received a notice convening the annual general meeting of the target company, which proposed a motion to consider and pass a resolution authorising the board of directors to provide money to a trustee for the purposes of administering an employee share scheme. The plaintiffs sought an injunction restraining the defendant from passing this resolution on two bases, one of which was that the proposal to establish an employee share scheme was motivated by an improper purpose on the part of the board of directors. The plaintiffs did not, however, object

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308. *Hogg*, (1967) Ch. 254, at 267, per Judge Buckley.

309. *Condraulics* (1984) 2 A.C.L.C. 408.

to evidence provided by directors demonstrating that they had been considering the introduction of an employee share scheme for some time before the takeover threat eventuated.

On appeal, McPherson J, with whom Derrington J concurred, held that the evidence provided only allowed for a 'possible inference' that the scheme proposed by directors had been prompted by a lack of good faith. McPherson J observed that, on the basis of *Mills v. Mills*, the substantial or primary motive influencing the director must be improper. His Honour observed:

A coincidence in the timing of the proposal with the making of the take-over offer is, without more, not ordinarily sufficient to raise an inference of the necessary impropriety of purpose: *Winthrop Investments v. Winns Ltd.* (1979) 4 ACLR 1, 12; *Pine Vale Investments Ltd. v. McDonnell & East Ltd.* (1983) 8 ACLR 1999, 210.<sup>310</sup>

McPherson J accepted, as the trial judge had, evidence provided by the managing director of the company that the company had been considering introducing such a scheme for some time before the take-over announcement. He also accepted the managing director's explanation that the overriding motivation of the members of the board of directors was to give effect to a long held belief that the introduction of such a scheme would encourage employee loyalty and so benefit the company. McPherson J proceeded to uphold the initial finding that the plaintiffs had failed to make a case that the directors had breached their duty to exercise their powers for a proper purpose.

These two cases show the fine distinctions that the courts are asked to draw on the basis of the evidence before them. The task before the court is to determine as a question of fact whether the exercise by directors of a corporate power was such that, but for the existence of the takeover threat, an allotment of shares under an employee share plan would not have taken place. Directors appear to have a much greater chance of defending their actions where they can demonstrate that they were considering introducing an employee share scheme prior to the existence of the hostile takeover bid.<sup>311</sup> As Austin and Ramsay conclude, 'There seems to be no escape for the tribunal of fact from the difficult task of deciding whether one of a number of purposes can be taken to have been more important than others in the minds of the directors.'<sup>312</sup>

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310. *Condraulics Pty. Ltd. v. Barry & Roberts Ltd.* (1984) 8 A.C.L.R. 915, at 920.

311. See LEVY, *supra* note 294, at 147 (noting that "directors of a company will be better able to defend a decision to issue shares if they can demonstrate that they have been considering the particular share issue or transaction for some time before any takeover bid emerged").

312. AUSTIN & RAMSAY, *supra* note 234, ¶ 8.240.

### *Standing to challenge*

Shareholders who believe a director abused his or her powers to allot shares to employees may wish to challenge the decision. An individual shareholder may be granted leave by the court to bring a derivative action for breach of duty by a director on behalf of the company under Part 2F.1A of the *Corporations Act*, where the company is unwilling or unable to bring an action on its own behalf.<sup>313</sup> A shareholder may also have standing to bring a personal action where the breach of duty constitutes a breach of a personal right. Where a court deems an allotment of shares to be a breach of a director's duty, the allotment is voidable rather than void.<sup>314</sup>

#### 4.10 EMPLOYEE SHAREHOLDERS: RIGHTS AND REMEDIES

A further set of corporate law considerations arise after an employee share scheme has been established. In seeking to protect their interests as minority shareholders, employee shareholders have available to them the range of statutory and equitable remedies that are available to all minority shareholders in Australian companies. Commentators, however, have questioned whether employee share ownership has the potential to bring employee voice into the corporate governance structures of companies.<sup>315</sup> The following section examines whether corporate law in Australia provides legal mechanisms through which employee shareholders can pursue their interests as *employees*, not simply as shareholders. It identifies and briefly explores three avenues: the right to call general meetings and propose resolutions; the

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313. A court will grant an applicant permission to bring a derivative action under Pt 2F.1A if five criteria are satisfied: (i) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them; (ii) the applicant is acting in good faith; (iii) it is in the best interests of the company that the applicant be granted leave; (iv) there is a serious question to be tried by the court; and (v) either at least fourteen days before making the application to the court, the applicant gave written notice to the company of the intention to apply to the court for leave and of the reasons for applying; or it is appropriate for the court to grant leave even though notice was not given to the company. *Corporations Act* § 237(2). See also Ian M. Ramsay & Benjamin B. Saunders, *Litigation by Shareholders and Directors: An Empirical Study of the Statutory Derivative Action*, (Centre for Corporate Law & Securities Regulation, The University of Melbourne, Research Report, 2006).

314. *Winthrop Investments Ltd. v. Winns Ltd.* (1975) 2 N.S.W.L.R. 666; *Harlowe's Nominees Pty. Ltd.*, 121 C.L.R. 483.

315. See, e.g., Hugh Collins, *Employee Shareholders*, 16 *INDUS. L.J.* 268 (1987); Hill, *supra* note 142; Michie & Oughton, *supra* note 151; Reynolds, *supra* note 143; Jonathan Michie & Christine Oughton, *Employee Participation and Ownership Rights*, 2 *J. CORP. L. STUDIES* 139 (2002); and Lenne et al., *supra* note 5.

minority oppression provisions in the Corporations Act; and statutory constraints on variation of class rights.<sup>316</sup>

#### 4.10.1 *Capacity to call shareholder meetings and propose resolutions*

Provided that the employee shareholders hold at least 5 per cent of the votes that may be cast at a general meeting or constitute at least 100 members, they have the statutory power under the *Corporations Act* to call an extraordinary general meeting.<sup>317</sup> The meeting must be held for a proper purpose, which means that the resolution that the members seek to be passed 'must be within the power of the members to consider and pass.'<sup>318</sup> They may also put forward a resolution to be considered at a general meeting.<sup>319</sup> Any such resolution, however, cannot relate to matters which are vested by the company's constitution in the company's directors.<sup>320</sup> This may limit the extent to which employee shareholders can bring employment-related matters to the attention of shareholders.<sup>321</sup>

The capacity of employee shareholders to use the general meeting to influence the conduct of the business, however, will generally be very limited due to the fact that, in most cases, employees only hold a very small minority of the company's shares. Nonetheless, as Anderson and Ramsay have argued in relation to union shareholder activism, while such methods may not lead to the successful passage of resolutions, they may be effective in placing matters on the AGM and board's agenda and bringing pressure to bear on the company.<sup>322</sup>

#### 4.10.2 *Minority oppression*

Under section 232 of the *Corporations Act*, a court may impose a range of orders where it is satisfied that the company's

316. Reynolds, *supra* note 142, at 105–06.

317. Corporations Act § 249D.

318. NRMA v. Snodgrass (2001) 19 A.C.L.R. 769. For further discussion, see Kirsten Anderson and Ian Ramsay, *From the Picketline to the Boardroom: Union Shareholder Activism in Australia*, 52–55 (Centre for Corp. Law & Securities Regulation and Centre for Employment & Labour Relations Law, The University of Melbourne, Research Report, 2005). For a substantially revised and abbreviated version of this paper, see Kirsten Anderson and Ian Ramsay, *From the Picketline to the Boardroom: Union Shareholder Activism in Australia*, 24 *COMPANY & SEC. L.J.* 279 (2006).

319. Corporations Act § 249N.

320. See *Gramophone & Typewriter Ltd. v. Standley* (1908) 2 K.B. 89; *John Shaw & Sons (Salford) Ltd. v. Shaw* (1935) 2 K.B. 113. See also Anderson & Ramsay (original version of paper), *supra* note 318, at 51.

321. *Id.* at 51–52.

322. *Id.*

affairs are being conducted in a way that is 'contrary to the interests of the members as a whole' or 'oppressive to, unfairly prejudicial to, or unfairly discriminatory against, a member or members whether in that capacity or in another capacity.' This is one of the most commonly used corporate law remedies used by shareholders.<sup>323</sup> Key to the use of this action by employee shareholders is that the conduct, act or omission may affect the member in his or her capacity as a member or in any other capacity.<sup>324</sup> Austin and Ramsay have observed that this may provide a basis for action for a member employed by the company where he or she is prejudiced in the capacity of employee. They note that whether 'the section is attracted would seem to depend on whether, in the circumstances, the employment relation was a way in which the member received a return for investment or whether the employment was independent of being a member.'<sup>325</sup>

The breadth of instances in which this remedy may be used makes it a potentially powerful tool for employee shareholders. In particular, it has been used in the past to appeal against payment of excessive remuneration to directors; the improper diversion of business; and the denial of access to information. While such concerns may be felt by all shareholders, they may be felt particularly acutely by employees concerned with maintaining job security.

#### 4.10.3 *Challenging the validity of a variation of class rights*

If employee shareholders are recognised as members of a particular class, they may be afforded the statutory protections offered to class right holders in Part 2F.2 of the Act. In particular, they may have a cause of action to challenge a variation or cancellation of shares under section 246D.

A category of shares will constitute a 'class' where the shares differ sufficiently in respect of rights, benefits, disabilities, or other incidences, as to make them distinguishable from any other category of shares.<sup>326</sup> In *Clements Marshall Consolidated Ltd. v. ENT Ltd.*,<sup>327</sup> Neasey J of the Supreme Court of Tasmania found on the facts of the case that the employee shares did constitute a 'class' as they were a category of shares that differed sufficiently

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323. Ian Ramsay, *An Empirical Study of the Use of the Oppression Remedy*, 27 AUSTL. BUS. L. REV. 23 (1999).

324. Corporations Act § 233(e).

325. AUSTIN & RAMSAY, *supra* note 234, ¶11.470.

326. *Clements Marshall Consolidated Ltd. v. ENT Ltd.* (1988) 6 A.C.L.C. 389, 393.

327. *Clements Marshall Consolidated Ltd. v. ENT Ltd.* (1988) 13 A.C.L.R. 90.

from ordinary shares in respect of voting rights, dividend rights, liability to calls and other aspects.<sup>328</sup>

The classification of employee shares as a particular class of shares becomes important if the company seeks to vary or cancel the legal rights attaching to the shares. A company seeking to do this must follow the procedures prescribed in section 246B of the *Corporations Act*. Moreover, where the procedures are followed and the class of shares is varied or cancelled, section 246D(1) of the Act provides that members with at least 10 percent of the votes in a class may apply to the court to have the variation, modification or cancellation set aside.<sup>329</sup> The Court is empowered to set aside the variation, modification or cancellation if it is satisfied that it would unfairly prejudice the members of the class.<sup>330</sup>

#### 4.11 KEY CRITICISMS OF THE CORPORATE REGULATORY FRAMEWORK FOR EMPLOYEE SHARE SCHEMES

The adequacy of the current corporate law framework governing employee share ownership plans has been the subject of considerable contention. Critics of the current laws include the Australian Employee Ownership Association (AEOA) and the Employee Ownership Group (EOG), both committed to promoting employee share ownership in Australia; a number of ESOP plan managers and consultants; and the authors of the *Shared Endeavours* Majority Report. The following section divides the current body of criticism into two broad categories. First, it looks at the most significant and sustained criticism of the current regulatory regime: the difficulties it poses to the implementation of ESOPs in small and medium-sized companies. It then turns to consider specific criticisms directed at the nature of relief offered by ASIC.

##### 4.11.1 *Obstacles to employee share ownership in unlisted companies*

The corporate law regulatory regime is criticised for imposing costs and compliance burdens that may effectively deny unlisted companies access to ESOPs.<sup>331</sup> As explained above, the

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328. *Id.* at 93.

329. This application must be made within one month of the variation, modification or cancellation. *Corporations Act* § 246D(6).

330. *Id.* § 246D(6).

331. See, e.g., Aust. Employee Ownership Ass'n, *Our Policy*, available at <http://www.aeoa.org.au>; EMPLOYEE OWNERSHIP GROUP, *EMPLOYEE SHARE OWNERSHIP IN AUSTRALIA: THE FUTURE*, available at [http://www.employeeownershipgroup.com.au/docs/eog\\_policy\\_document\\_-\\_the%20future.pdf](http://www.employeeownershipgroup.com.au/docs/eog_policy_document_-_the%20future.pdf); Ed Charles, *Share and Share Alike*, 75(10) *IN THE BLACK* 28 (2005); Lenne et al., *supra* note 5; and numerous

ASIC Policy Statement 49 only provides relief to companies listed on the Australian Securities Exchange for more than twelve months. Unlisted companies or 'sunrise' companies that are newly listed are not eligible for ASIC class order relief. Many commentators have emphasised the costs imposed on unlisted, particularly smaller, businesses by the disclosure requirement under section 708 of the *Corporations Act 2001* (Cth), which requires any company making an offer in excess of twenty people or for over \$2 million to issue a prospectus.<sup>332</sup> In its submission to the Nelson Inquiry, for example, Ernst & Young emphasised:

The ASIC policy statement 49 could be described as a general prohibition on the issue of shares or options to employees of an unlisted company without a prospectus. Whilst the prospectus requirement may not be onerous for companies associating an ESOP with an initial public offering (IPO) they are very significant and often unsurmountable for small/medium unlisted companies.<sup>333</sup>

The difficulties posed to small and medium companies by the current prospectus rules were recognised by the *Shared Endeavours* Majority Report. The Report noted that although limited reforms would be implemented through the Corporate Law Economic Reform Program (CLERP):

Nevertheless, the Committee does recognise that the amended legislation and Policy Statement 49 together may not provide sufficient relief for certain types of enterprise. Consequently, the existing disclosure arrangements may still act as a disincentive to those enterprises when they consider establishing an employee share plan.<sup>334</sup>

The two principal advocacy groups for employee share ownership in Australia—the AEOA and EOG—are both critical of the current disclosure requirements imposed on unlisted companies. Both organisations describe the prospectus requirements for unlisted companies and small companies as 'a major obstacle' to the diffusion of employee share schemes in unlisted companies.<sup>335</sup> This contention appears to be supported by empirical research: a survey of 1000 businesses commissioned by the

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submissions to the House of Representatives Standing Committee on Employment, Education and Workplace Relations' inquiry into employee share ownership in 2000, available at <http://www.aph.gov.au/house/committee/ewr/eso/index.htm>.

332. Charles, *supra* note 331.

333. ERNST AND YOUNG, EMPLOYEE SHARE OWNERSHIP PLANS: COMMENTS REGARDING ISSUES FOR SMALL/MEDIUM COMPANIES AND POSSIBLE SOLUTIONS TO ENABLE SUCH COMPANIES TO OFFER PARTICIPATION IN ESOPs, (Submission No. 20.1 to the H.R. S. Comm. on Employment, Education & Workplace Relations' Inquiry into Employee Share Ownership, 2000).

334. SHARED ENDEAVOURS, *supra* note 1.

335. Austl. Employee Ownership Ass'n, *supra* note 331.

Department of Workplace Relations Employee Share Ownership Development Unit (ESODU) in 2004 found that 'burdensome corporations law requirements' were seen as a 'significant barrier' to business in taking up ESO.<sup>336</sup>

The *Shared Endeavours* Majority Report recommended ASIC:

- monitor the provisions of CLERP and Policy Statement 49 in respect to employee share plans;
- advise the Government as to any required amendments to facilitate the operation of the CLERP in respect of employee share plans without unduly increasing investor risk;
- if necessary, amend Policy Statement 49 so as to facilitate the creation and operation of employee share plans, especially in regard to unlisted, small and medium companies, and those in sunrise industries without unduly increasing investor risk; and
- advise the Treasurer on the feasibility of a specific disclosure document designed to be used by the operators of employee share plans that cannot otherwise use the disclosure exemption provisions or the OIS provisions of the CLERP Act.<sup>337</sup>

The Government rejected this recommendation, arguing that the limited nature of the exemption from prospectus requirements offered by ASIC was necessary in order to ensure that the primary purpose of issuing shares to employees was to foster the employment relationship, rather than as a means of corporate fundraising.<sup>338</sup> Moreover, it argued that CLERP had introduced certain exemptions from the fundraising regime with a focus on assisting small and medium companies and that these reforms struck an appropriate balance between the objectives of facilitating efficient fundraising and ensuring appropriate investor protection. The Government also rejected the Majority Report's recommendations that ASIC monitor the use of employee share schemes and report to the Government on the basis that ASIC was not ordinarily responsible for law reform or for reporting to Government on specific issues. Instead of a formal reporting process to Government, ASIC has the ability to review and modify its policy statements should it consider further relief is warranted or grant individual relief on a case-by-case basis. More recently, however, the Corporate and Financial Services Regula-

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336. ESODU research, *supra* note 111.

337. SHARED ENDEAVOURS, *supra* note 1, at 186.

338. H.R. S. COMM. ON EMPLOYMENT, EDUCATION & WORKPLACE RELATIONS, GOVERNMENT RESPONSE TO 'SHARED ENDEAVOURS: AN INQUIRY INTO EMPLOYEE SHARE OWNERSHIP IN AUSTRALIA', available at <http://202.14.81.34/house/committee/ew/esofreport/govresp.pdf> (last visited Jan. 13, 2008).

tion Review Consultation Paper identified the potential expense and effort required for unlisted companies to compile a prospectus as an issue for consultation.<sup>339</sup>

Today, both the AEOA and the EOG offer proposals for reform of the current disclosure regime for unlisted companies seeking to introduce employee share schemes. The AEOA proposes lifting the prospectus requirements for unlisted companies in cases where complete 'downside risk protection' on the value of shares is provided.<sup>340</sup> The EOG proposes that ESOPs should be exempt from the prospectus requirements. Necessary investor protection, it argues, can be secured by a minimum prescribed disclosure regime. A proposed 'ESOP Disclosure Document' is appended to the EOG Policy. The model is based on the OIS (as defined in section 715(1) of the *Corporations Act*), and, it is proposed, would apply to offers made to employees to acquire shares in the company, but not in cases where an ESOP is being used to acquire a majority of the ordinary shares in a company. In the latter case, section 709 of the Act would prevail. The EOG proposes that this regime be implemented either by ASIC, in reliance on its powers of exemption or modification, by Government direction to ASIC in relation to the exercise of these powers, or by legislative reform.<sup>341</sup>

The Business Law Section of the Law Council of Australia has also expressed an opinion in relation to the relief available for unlisted companies, arguing that the current regime should not be fundamentally changed as there is no reason to presume that, in most cases, employee investors are any more informed than other retail investors. It follows that employee investors should be afforded similar protections to retail investors under Chapter 6D of the *Corporations Act*. The Council does, however, argue that there is scope for extending relief in minor ways where the investor protection principles of Chapter 6D have been satisfied. These include, for example, extending the relief offered by ASIC Class Order 03/184 to unlisted companies where nominal consideration is provided and the company satisfies other conditions which ensure that the potential employee investors are reasonably informed.<sup>342</sup>

*The Corporate and Financial Services Regulation Review Proposals Paper*, released by the Parliamentary Secretary to the

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339. COMMONWEALTH OF AUSTRALIA, *supra* note 242, at 34.

340. Austl. Employee Ownership Assoc., *supra* note 331; EMPLOYEE OWNERSHIP GROUP, *supra* note 331, at 5.

341. EMPLOYEE OWNERSHIP GROUP, *supra* note 331, at 6.

342. See LAW COUNCIL OF AUSTRALIA, SUBMISSION IN RESPONSE TO THE APRIL 2006 CONSULTATION PAPER FOR THE CORPORATE AND FINANCIAL SERVICES REGULATION REVIEW 18–19 (May 24, 2006).

Treasurer in November 2006, while proposing to extend the relief offered in Class Order 03/184 in respect to licensing, advertising and hawking requirements to unlisted companies, does not endorse extending relief to unlisted companies in relation to disclosure requirements.

#### 4.11.2 *Limitations of ASIC Class Order Relief*

##### *The 5 percent ceiling*

To be eligible for relief under ASIC Policy Statement 49, an offer of shares to employees must not exceed more than 5 percent of the shares issued in that class of shares as at the date of the offer. As noted above, this requirement is imposed by ASIC to ensure that the share issue is not proceeding for fundraising purposes. During the Nelson Inquiry, a number of listed companies with employee share plans criticised this requirement, as it significantly restricted the number of shares the company could offer to employees.<sup>343</sup>

##### *Limitation of relief to full and part-time employees*

ASIC Policy Statement 49 does not extend class order relief to the provision of shares to casual employees. ASIC will, however, consider extending relief to offers to casual employees or contractors on a case-by-case basis. In doing so, ASIC will consider the length of time the employee has been in the employment of the company and the likely ongoing relationship between the parties.<sup>344</sup> The limitations of the Class Order raise equity concerns. Inequities in access and entitlements to company shares, which are common in practice due to varying eligibility requirements within and between organisations, would appear to be exacerbated by the relevant requirements in the ASIC Policy Statement. The restriction is also contrary to the policy of the Australian Council of Trade Unions (ACTU) on employee share schemes, which stresses the need for all employees within an organisation to be eligible to participate.

## 4.12 SUMMARY

Australian companies seeking to implement broad-based employee share ownership plans must comply with a range of regulatory requirements embodied in the *Corporations Act* relating to disclosure, fundraising and licensing. These provisions are intended to protect investors in relation to public share offerings. While they no doubt offer protection to employees who are con-

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343. See SHARED ENDEAVOURS, *supra* note 1, at 182.

344. See PS 49, ¶¶ 49.38–49.40.

sidering taking up shares in the company for which they work, the provisions are generally ill-suited to serving the different objectives for which companies implement employee share ownership plans. In recognition of the public policy objective of promoting employee share ownership, ASIC now provides conditional relief from specific provisions within the Act for companies establishing eligible employee share schemes.

Critics have argued that the current regime, while facilitating the diffusion of employee share ownership in larger, listed companies, does little to enable employee share ownership in small and medium-sized companies. It is also argued that the conditional relief provided by ASIC significantly limits the extent to which companies may confer significant shareholdings upon employees and offer shares to casual employees.

The extent to which the current regulatory regime shapes and constrains current employee share ownership practice in Australia remains unclear. Tentative observations suggest that its impact is significant. For example, employee share ownership remains relatively rare in the SME sector; employee share ownership is noted for its 'shallowness' (while there are many employees owning shares, they own relatively few) in larger companies; and casual employees are much less likely to be employee shareholders. More work is needed, however, to understand whether current practice is a reflection of the objectives and priorities of industry actors or whether it is the result of the significant constraints imposed by the corporate law regulatory regime.

## 5. THE TAXATION LAW FRAMEWORK

Taxation law has featured prominently in the regulation of ESOPs in Australia. Indeed, it is largely through reforms to the taxation law framework over the past several decades that the Australian Government has sought to promote, and shape employee share ownership. This section examines the taxation treatment of employee share ownership plans and the effect of these tax rules on current practice in the area. It also identifies the major criticisms of the current regulatory regime. While this section is predominately concerned with broad-based employee share ownership plans—plans in which a majority of employees in the company are eligible to participate—it does briefly discuss executive-based plans. This is because it is impossible to discuss the taxation aspects of broad-based ESOPs in Australia without discussing the perennial concern of regulators to prevent the abuse of such plans by company executives.

Part 5.1 briefly traces relevant legislative developments. Part 5.2 examines the current taxation treatment of employee shares

or options. Part 5.3 looks at current market practice in the area. Finally, Part 5.4 identifies some of the key difficulties associated with the current taxation regime of employee share schemes.

### 5.1 LEGISLATIVE DEVELOPMENTS

Since the mid-1970s, Australian Governments have sought to reform the taxation regime so as to facilitate broad-based employee share ownership, while also seeking to limit the scope for abuse of employee share plans for aggressive tax planning purposes.

The first legislative provision for the taxation of employee shares in Australia was introduced in 1974 by the Whitlam Government.<sup>345</sup> The impetus for the legislation was the decision in *Donaldson v. FCT*,<sup>346</sup> which held that assessable income would include the value of an option even though the option could not be assigned and could not be exercised for a period of three years. The value was said to be whatever a willing but not anxious person would be prepared to pay for it. The legislative reforms were introduced as one of a raft of taxation law amendments and did not form the basis of extensive debate in the Federal Parliament.

Section 26AAC was inserted into the Income Tax Assessment Act 1936 (Cth) ('ITAA') to govern the taxation of employee benefits in the form of share issues or grants of rights to acquire shares.<sup>347</sup> As the Australian Taxation Office (ATO) later explained: "Section 26AAC and ESAS [employee share acquisition schemes] were intended to encourage employees to acquire an interest in their employer company and to allow employees some control."<sup>348</sup>

Section 26AAC provided for the taxation of benefits that arose from shares or rights acquired in a company under an employee share acquisition scheme where the shares or rights were a consequence of employment or services rendered by the taxpayer or a relative. The shares or rights acquired could be in the employing company or in another company. Section 26AAC provided for the value received under an option or share plan to be measured at the time of the exercise of the option or when restrictions relating to shares were lifted, rather than, as had

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345. *Id.* at 12.

346. *Donaldson v. FCT* (1974) A.T.C. 4192.

347. Inserted by Income Tax Assessment Act (No. 2), 1974, (Cth.) (Austl.).

348. SHARED ENDEAVOURS, *supra* note 1. See also AUSTRALIAN TAXATION OFFICE, 'SUBMISSION TO THE H.R. S. COMM. ON EMPLOYMENT, EDUCATION AND WORKPLACE RELATIONS' INQUIRY INTO EMPLOYEE SHARE OWNERSHIP 6, Submission No. 24, (Apr. 30, 1999).

been held in *Donaldson*,<sup>349</sup> when the rights were acquired. This meant that if the shares were subject to restrictions or conditions, so that the employee was prohibited from disposing of the shares or could be divested of ownership, then the employee was only taxed on the discount in the year when the restrictions or conditions were lifted. There was no limit on the period of deferral. The taxpayer could, however, elect to be taxed in the year in which the shares or rights were acquired.

The second significant stage in the regulation of employee share ownership schemes came in the mid-1990s. Reforms were inspired in large part by concerns that section 26AAC ITAA 1936 was being misused to create plans specifically designed for aggressive tax planning.<sup>350</sup> In its 1993 Budget, the Keating Labor Government announced a review of employee share plans, and in the 1994–1995 Budget, then Treasurer Ralph Willis announced significant reforms to employee share ownership in order to facilitate broad-based schemes whilst limiting the potential for misuse. In 1995, the Keating Government introduced Division 13A into the ITAA 1936.<sup>351</sup> In his second reading speech, the deputy treasurer explained that the reforms were intended to reduce the unintended exploitation of the existing legislation and to increase the taxation benefits available to share schemes that encourage employees to own shares in the company for which they work.<sup>352</sup>

The changes narrowed the concessions available to employee share schemes to those where the shares were issued in the employer company or holding company of the employer company and which were available to at least 75 percent of all permanent employees. The provisions provided that the amount to be included in a taxpayer's assessable income in respect of shares or rights acquired under an employee share plan would be the difference between the value of the share or right and any amount paid by the taxpayer to acquire the share or right. Generally, the amount was to be included in assessable income in the year that the share or right was acquired. However, providing the rights or shares satisfied certain criteria, an employee who acquired a share or right under an employee share scheme may have been eligible for the following:

- An exemption concession: an income tax exemption initially to a value of \$500 per employee per year for qualify-

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349. *Donaldson*, (1974) ATC 4192.

350. SHARED ENDEAVOURS, *supra* note 1, at 12. See also AUSTRALIAN TAXATION OFFICE, *supra* note 351, at 4.

351. Taxation Laws Amendment Bill (No. 2) (1995) (Austl.).

352. COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, H.R., Official Hansard, Jun. 22, 1995, at 2083.

ing shares that are issued to employees under a scheme operated on a non-discriminatory basis; or

- A deferral concession: a deferral of taxation initially for up to five years on qualifying shares and rights. In order to be qualifying, the scheme offering the shares or rights had to meet certain requirements.

The reforms were supported by the Democrats and the Greens but opposed by the Liberal/National Party opposition.<sup>353</sup> While supportive of employee share schemes and cognisant of the need for reform of the existing provisions in section 26AAC, the opposition criticised the reforms on the basis that the 'complex set of income tax rules' would 'make employee share acquisition schemes less attractive and less available to the Australian work force.'<sup>354</sup> They would, according to numerous opposition members, both threaten the viability of existing schemes and restrict the proliferation of schemes in the future. In particular, the opposition criticised the qualifying conditions for obtaining the tax concessions as too restrictive, including the requirement that the shares be ordinary shares, thus excluding from the concessional and deferral regime those types of companies that do not issue ordinary shares; the tax treatment of share options for taxing a potential gain that may never be realised; and the five-year maximum deferral period for being too short (thus resulting in many international share option plans attracting tax before employees acquire shares). Despite the opposition, the measures came into force and apply from March 28, 1995.

Even before his election to office in 1996, John Howard expressed his commitment to the promotion of employee share plans. In the 1996-1997 Budget, the newly-elected Coalition government provided for the amendment of the taxation concessions for employee share schemes to 'build a greater sense of employee participation in the success of Australia businesses.'<sup>355</sup> This was to be achieved by doubling the value of shares or rights that were eligible for the tax concession under a share scheme from \$500 to \$1000 a year per employee, with a corresponding increase in the deduction available to employers; and reducing

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353. COMMONWEALTH OF AUSTRALIA, VOTES AND PROCEEDINGS, H.R., Official Hansard, Jun. 22, 1995, at 2214; Nov. 20, 1995, at 4324.

354. COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, H.R., Official Hansard, Jun. 22, 1995, at 2087 (speech of Peter Costello).

355. THE HON. PETER COSTELLO MP, TREASURER, BUDGET 1996-1997: MEETING OUR COMMITMENTS (Aug. 20, 1996) available at [http://parlinfoweb.aph.gov.au/piweb/view\\_document.aspx?id=4&table=BUDGET](http://parlinfoweb.aph.gov.au/piweb/view_document.aspx?id=4&table=BUDGET), 75.

the participation conditions for the concessional arrangements from three quarters to two thirds of permanent employees.<sup>356</sup>

The Coalition Government's election commitments were included in one of a litany of proposed, and largely unrelated, amendments embodied in the *Taxation Laws Amendment Bill (No. 4) 1996* and debate surrounding these other amendments appeared to overshadow those relating to employee share schemes.<sup>357</sup> Nevertheless, there appeared a broad consensus in both Houses of Parliament that broad-based employee share plans should be promoted and thus that the increase in the value of shares that could be exempt from \$500 to \$1000 was desirable. Debate over the proposed amendments to employee share plans in the Senate, however, focused on the proposed reduction of the required threshold for employee share schemes from 75 percent to 66 percent and a change from 'employees' to 'permanent employees.'<sup>358</sup> Both of these proposed changes were opposed by the Labor opposition and the Democrats on the basis that it was restrictive of the development of employee share schemes that were open to as many employees as possible and on a fair basis.<sup>359</sup> The proposal to reduce the threshold from 75 percent to two-thirds was rejected in the Senate.

The Coalition Government also amended the corporate law requirements for employee share schemes. The *Corporate Law Economic Reform Act 1999* relaxed the prospectus requirements for companies initiating employee share plans, subject to a number of conditions.

## 5.2 THE CURRENT TAX TREATMENT OF EMPLOYEE SHARES OR RIGHTS

The taxation regime for shares acquired by employees in respect of employment is found in Division 13A of Part III *Income Tax Assessment Act 1936* (ITAA 1936) and Sub-division 130A of the *Income Tax Assessment Act 1997* (ITAA 1997) (the capital gains tax provisions). Division 13A of the ITAA 1936 applies to

356. *Id.* The budget statement identified the financial implications of this amended concession to be a reduction of \$15 million for each year from 1996 to 1999.

357. This Bill originated in the House of Representatives as the Taxation Laws Amendment Bill (No. 4) 1996 on Dec. 12, 1996, and was introduced into the Senate as Taxation Laws Amendment Bill (No. 1) 1997 on Mar. 17, 1997.

358. See COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, SEN., Official Hansard, Jun. 27, 1997, at 5444.

359. See COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, SEN., Official Hansard, Jun. 27, 1997, at 5444, 5464 (speech of Nick Sherry); COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, SEN., Official Hansard, Jun. 27, 1997, at 5449 (speech of Cheryl Kernot); and COMMONWEALTH OF AUSTRALIA, PARLIAMENTARY DEBATES, SEN., Official Hansard, Jun. 27, 1997, at 5464-65 (speech of Dee Margetts).

the acquisition of a share or right under an employee share scheme. The general rule governing the taxation treatment of employee shares is that the issuing of shares or rights under an employee share scheme is treated as a substitute for cash income for services. Tax is imposed, at marginal income tax rates, at the time the share or right is acquired. The amount to be included in the employee's assessable employment income is the difference between the market value of the share or right and any consideration provided: that is, the amount of the discount provided to the employee or service provider.<sup>360</sup> For example, where a company issues an employee a share with a market value of \$1.01 and the employee paid one cent as the issue price for the share, the employee would include the \$1.00 acquisition discount in their taxable income. Rules are provided for calculating the market value of the share or right. Despite the reference to *employee* share schemes, this treatment also applies to shares acquired by contractors in exchange for services rendered.<sup>361</sup>

Under Division 13A, two alternative concessions are available for shares or rights provided under schemes that satisfy certain requirements. The first type of concession allows for discounts of up to \$1000 to be provided tax-free to an employee or service provider per income year (the *exemption concession*). The second type of concession allows for tax on the discount to be deferred for up to ten years (the *deferral concession*).

This section looks first at when an employee 'acquires a share or right under an employee share scheme' for the purposes of Division 13A. It then outlines the two concessions available to 'qualifying rights' under the Division.

### 5.2.1 *Acquisition of a share or right under an employee share scheme*

Division 13A applies where any shares or rights are acquired under an employee share scheme. Shares or rights are acquired under an employee share scheme if the shares or rights are acquired in respect of, directly or indirectly, employment or services rendered. The shares or rights may be acquired by an employee or a service provider or by an associate of the employee or service provider. The Division contains rules for determining the amount to be included in assessable income.

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360. Income Tax Assessment Act, 1936, §§ 139B(2) & 139CC(2) (Austl.) [hereinafter ITAA 1936].

361. *Id.* § 139(C).

*Any shares or rights*

Division 13A applies when an employee or service provider acquires any shares or rights under an employee share scheme, whether they are shares or rights in the employer company, a related company or any unrelated company. However, in order to obtain access to the concessions, it is necessary for the shares or rights to be in the employer company or a holding company of the employer.<sup>362</sup> It is also necessary that the shares are ordinary shares and that the options only give rights to acquire ordinary shares.<sup>363</sup> In the 2006 Budget, the Government announced that it would allow certain stapled securities to be provided, and legislation to introduce the amendments has now completed its passage through Parliament.<sup>364</sup>

The term 'rights' is not defined but is commonly taken to mean rights to acquire shares, e.g., options. An option involves the right, but not the obligation, to acquire shares in the future at a fixed price (the exercise price). In some cases the person acquiring the option pays to acquire that right but commonly in the employment case the option is acquired for no consideration. In a recent Class Ruling, CR 2006/101 (the BHP-Billiton Ruling), the Commissioner took the view that an employee will not acquire a 'right' (i.e. a right to acquire a share) under an employee share scheme for the purposes of Division 13A on the grant of the right where, at the time that the right is granted, it is conditional and subject to the exercise of the employer company's absolute discretion.

In another Class Ruling, CR 2006/103 (the Brambles Ruling), the Commissioner ruled that regardless of whether or not a participating employee is given a choice to receive cash instead of a share, the employee will retain the right to acquire a share on exercise of an option or share right. The Commissioner did note that where the scheme operates so that the employer makes the ultimate decision as to whether an employee receives a share or cash in lieu of a share, the right granted to the employee will not be considered a right to acquire a share for the purposes of Division 13A.

The term 'rights' could also encompass other sorts of rights, such as rights that vest without the recipient exercising an option or those rights that replicate shares, such as 'phantom shares.' However, as already noted, in order to access the concessions, the rights must be rights to acquire ordinary shares.<sup>365</sup>

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362. *Id.* § 139CD(3).

363. *Id.* § 139CD(4).

364. *Tax Laws Amendment (2007 Measures No.1) Act 2007.*

365. *Id.*

The acquisition of a share as a result of exercising a right acquired under an employee share scheme is not treated as the acquisition of a share (presumably to avoid double counting).<sup>366</sup>

It is important to note that, in order to attract the operation of Division 13A, shares or rights must be acquired at a discount. The acquisition of shares for consideration equal to or greater than market value will not be within the Division even if accompanied by some other benefit such as a low or interest-free loan.

*Acquired by an employee or service provider (or an associate)*

A person acquires a share when it is transferred or allotted to that person or when a person acquires a legal or beneficial interest in the share from another person.<sup>367</sup> Division 13A applies to both employees and independent contractors acquiring shares.<sup>368</sup> Division 13A also applies if an associate of the employee or service provider acquires shares as a result of the employment or provision of services.<sup>369</sup> An associate in this context includes a relative, a partner, a trustee of a trust under which the taxpayer or an associate is capable of benefiting,<sup>370</sup> and related companies.<sup>371</sup> In such a case the employee or service provider will be subject to tax on the discount received by the associate.<sup>372</sup> Although shares or rights provided to an associate will be subject to tax under Division 13A, only shares or rights provided to an employee will be eligible for the concessions.<sup>373</sup>

*Under an employee share scheme*

Shares or rights will be acquired under an employee share scheme if they are acquired directly or indirectly in respect of employment,<sup>374</sup> or if the parties are not in an employment relationship, in respect of services rendered.<sup>375</sup> That is, there does not need to be any particular form of scheme but rather there must be some connection between the acquisition of the shares, and the employment or services provided. If the acquisition falls within Division 13A, it will be taxed under that Division rather than the other provisions of the income tax legislation. Further-

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366. ITAA 1936, § 139C(4).

367. *Id.* § 139G.

368. *Id.* §§ 139C(1) & (2).

369. *Id.*

370. For the position where the trust is an employee share trust, see *infra*.

371. ITAA 1936, § 139GE.

372. *Id.* § 139D.

373. *Id.* § 139CD(3).

374. *Id.* § 139C(1).

375. *Id.* § 139C(2).

more, the acquisition will not give rise to fringe benefits tax (see below).

Shares will not be taken to be provided under an employee share scheme (and therefore not subject to Division 13A), if they are acquired for market value.<sup>376</sup>

### *Calculating the amount to be included in assessable income*

The rules for determining the amount to be included in assessable income vary according to whether the discount is assessable immediately or is deferred.

When the discount is included in assessable income in the year the share or right is acquired, the amount is the market value of the share or right less any consideration paid or given.<sup>377</sup>

When the taxing time is able to be deferred (see below) and the taxpayer disposes of the share or right within thirty days of the relevant 'cessation time' in an arm's length transaction, the amount to be included is the amount received on disposal less any consideration given, including any amount paid to exercise a right to acquire a share.<sup>378</sup>

When the taxing time is able to be deferred and the taxpayer does not dispose of the share or right within thirty days in an arm's length transaction, the amount to be included is the market value of the share or right at cessation time less any consideration given, including any amount paid to exercise a right to acquire a share.<sup>379</sup>

Where a right to acquire a share is lost without having been exercised (whatever the reason), the right will be taken never to have been acquired and any tax paid will become refundable, through an amended assessment if necessary.<sup>380</sup> This reflects the fact that tax may become payable even before the rights vest and that an employee may be required to pay tax before any benefit is derived. The ability to claim a refund some time later may be of little comfort in these circumstances.

### *Complex valuations of shares or rights required*

Division 13A contains rules for determining the market value of both listed and unlisted shares and rights on a particular day.<sup>381</sup> This includes quite complex rules for determining the market value of unlisted rights depending on whether the right

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376. *Id.* § 139C(3).

377. *Id.* § 139CC(2).

378. *Id.* § 139CC(3).

379. *Id.* § 139CC(4).

380. *Id.* § 139DD.

381. *Id.* Subdiv. F of Div. 13A.

must be exercised within ten years or not.<sup>382</sup> For example, a ten year option with an exercise price equal to current market value of the underlying share will have a taxable value of 18.4 percent of the exercise price/current market value.<sup>383</sup> In the case of both unlisted shares and unlisted rights, the issuing company will often need to have valuations done by qualified valuers at the time shares or rights are being provided which could give rise to significant cost issues. More significant is the fact that valuations may need to be done on an individual basis at cessation time which could prove to be a significant ongoing cost for the employer.

### 5.2.2 *Qualifying for concessions*

In addition to setting out that the acquisition of shares by an employee at a discount will give rise to assessable income, Division 13A also offers employees two concessions if certain conditions are met. In order to be eligible for either concession the shares (or rights) must be 'qualifying shares or rights.' There are six conditions relevant to determining whether a share is a 'qualifying share' but only five of those conditions apply in determining whether a right is a 'qualifying right':<sup>384</sup>

- (1) the share or right must be acquired under an employee share scheme;
- (2) the share must be in the company which is the employer of the taxpayer or in the holding company of the employer company. The concessions are not available if the recipient is not in an employment relationship (i.e. a contractor) or if shares or rights are acquired by an associate of an employee or if the shares are shares in an unrelated company;
- (3) the share must be an ordinary share and the right must be a right to acquire an ordinary share (although note the position in relation to 'stapled securities' (see below));
- (4) in the case of shares, at least 75 percent of permanent employees must be entitled (or have been entitled) to participate in this or another employee share scheme. Permanent employees are those employed full-time or permanent part-time with thirty-six months service. It is still possible however to have two schemes—one that meets the 75 percent requirement and another scheme

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382. *Id.* §§ 139FC & 139FJ–FN.

383. *Id.* § 139FM.

384. *Id.* § 139CD.

that is only available to, say, executives. This condition does not apply to schemes granting rights;

- (5) the employee's legal or beneficial interest in shares of the company must not exceed 5 percent; and
- (6) the employee must not be in a position to control more than 5 percent of the votes that could be cast at a general meeting of the company.

If the shares or rights are qualifying shares or rights, the taxpayer may be able to claim the exemption concession or the deferral concession but not both as the taxpayer must make an election.<sup>385</sup>

(a) *The exemption concession*

A taxpayer who acquires a 'qualifying share or right' may elect to have the discount included in assessable income in the year in which the shares or rights are acquired and receive \$1000 worth of discount tax-free,<sup>386</sup> if three additional conditions are satisfied:

- (1) there is no forfeiture of ownership conditions;
- (2) shares or rights may not be disposed of for a minimum of three years (unless employment ceases earlier); and
- (3) the scheme and any related scheme for the provision of finance must be operated on a non-discriminatory basis.<sup>387</sup>

An employee share scheme or a related scheme for the provision of finance will be non-discriminatory if it is open to at least 75 percent of permanent employees and the essential features of the scheme are the same.<sup>388</sup>

(b) *The deferral concession*

The deferral concession is designed to address the problem that the acquisition discount is *prima facie* taxed as a realised gain on acquisition date, giving the employee a cash tax liability which he or she needs to pay from other cash resources.<sup>389</sup> If the shares or rights are qualifying shares or rights, and the taxpayer does not make an election to be taxed up-front, the discount amount will be deferred and included in assessable income at a

385. *Id.* §§ 139BA & 139E.

386. *Id.* § 139BA(2).

387. *Id.* § 139CE.

388. *Id.* § 139GF.

389. Cameron Rider, *Sellers of Labour or Investors of Intellectual Capital? Conceptual Problems in the Taxation of Employee Share Ownership in IP Spin-off Companies* 16 (Intell. Prop. Res. Inst. of Austl., Working Paper, 2005).

future time (referred to as the 'cessation time').<sup>390</sup> However, if there are no restrictions preventing the taxpayer from disposing of the shares or conditions that could result in forfeiture, the cessation time will be the time at which the shares are acquired.<sup>391</sup>

Where *shares* are not subject to tax at the time of acquisition, the cessation time is the earliest of when the restrictions on disposal or possibility of forfeiture end, the shares are disposed of, when employment ceases, or ten years.<sup>392</sup>

Where *rights* are not subject to tax at the time of acquisition, the cessation time is the earliest of when the rights are exercised, when the rights are disposed of, when employment ceases or ten years.<sup>393</sup> If the right is exercised to acquire shares and restrictions apply or the shares are subject to forfeiture, cessation time is when the restrictions end (to a maximum of ten years).<sup>394</sup>

A problem that arises in this area is that a liability to pay tax can arise before any real benefit is received. For example, an employee may leave employment perhaps as a result of retirement and be required to pay tax even though the rights have not vested and may not vest for some time. As already noted, the ability to claim a refund at a later time under section 139DD does not necessarily relieve the burden that this may impose.

### 5.2.3 Taxation treatment of employer

The issue of shares or rights by a company will not generally involve any cost to the employer, and so there is no amount that can be deducted. However, recent changes to the Accounting Standards require companies to expense share-based compensation provided to an employee or director, measured at the fair value at the date of grant (generally when terms are agreed between the employer and employee).<sup>395</sup> This has led to concern that ESOPs will impact the company's profitability even though there is no actual tax deductible expense.<sup>396</sup>

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390. ITAA 1936, § 139B(3).

391. *Id.* § 139CA(1).

392. *Id.* § 139CA.

393. *Id.* § 139CB.

394. *Id.* § 139CB(1)(c).

395. See AUSTL. ACCOUNTING STANDARDS BD., *supra* note 285. International Financial Reporting Standards apply from Jan. 1, 2005. See International Financial Reporting Standards, IFRS 2.

396. Press Release, Peter Costello, Treasurer, Government Reaffirms the Existing Corporate Taxation Treatment of Options Granted To Employees (Apr. 30, 2004) (announcing that there would be no change to the deductibility provisions despite changes to the Accounting Standards relating to expensing options granted to employees) available at [http://www.treasurer.gov.au/DisplayDocs.aspx?doc=press\\_releases/2004/026.htm&pageID=003&min=phc&Year=2004&DocType=0](http://www.treasurer.gov.au/DisplayDocs.aspx?doc=press_releases/2004/026.htm&pageID=003&min=phc&Year=2004&DocType=0).

Where shares or rights are acquired on-market, for example by a trust established for the purpose by the employer company, a deduction will be available. The company providing the shares or rights under an employee share scheme (either the employer or the holding company of the employer company) may be entitled to claim a deduction for some of the costs associated with the scheme. For example, it should be possible to claim a deduction under the general deduction provision for the costs associated with setting up and administering the scheme.<sup>397</sup> Where a deduction would not otherwise be available, Division 13A provides a deduction to a maximum of \$1000 for shares or rights that are qualifying and also satisfy the exemption concessions.<sup>398</sup> Contributions of money or property to an employee share trust may also be deductible but only at the time the employee or associate acquires the shares or rights.<sup>399</sup>

A final issue for employers is whether the provision of shares or rights under an employee share scheme will give rise to a fringe benefits tax liability, as is discussed below.

#### 5.2.4 Other taxing provisions

On general principles, it is possible that the provision of shares or rights as remuneration could give rise to tax either as a non-cash benefit or as a fringe benefit. It is also possible that any subsequent disposal of the shares or rights could give rise to capital gains tax liability.

The provisions of Division 13A are an example of statutory income and as such an amount determined under the Division is included in assessable income.<sup>400</sup> If Division 13A applies, then a number of other taxing provisions, such as section 15-2 ITAA 1997 (formerly section 26(e) ITAA 1936) (employment benefits) and section 21A (business benefits), are expressly excluded from applying.<sup>401</sup> However, those provisions may need to be considered if Division 13A does not apply.

*Prima facie*, the provision of shares or rights would give rise to a liability for the employer to pay fringe benefits tax. However, the definition of 'fringe benefit' expressly excludes a benefit constituted by the acquisition of a share or right that falls within Division 13A<sup>402</sup> or the acquisition of money or property by cer-

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397. Income Tax Assessment Act, 1997, § 8-1 (Austl.) [hereinafter ITAA 1997].

398. ITAA 1936, § 139DC.

399. *Id.* § 139DB.

400. ITAA 1997, §§ 6-10.

401. ITAA 1936, § 139DE.

402. Fringe Benefits Tax Assessment Act, 1986 (Cth.), § 136(1), ¶ (ha) (Austl.) (definition of 'fringe benefit') [hereinafter FBTA 1986]. There is also an

tain employee benefit trusts.<sup>403</sup> It should be noted though that the provision of other benefits, such as the provision of financial assistance to acquire the shares or rights, could give rise to fringe benefits tax liability for the employer.

A final point to note is that the subsequent disposal of shares or rights may give rise to capital gains tax liability. The interaction between Division 13A and the capital gains tax provisions is considered below.

### 5.2.5 *Interaction with capital gains tax*

As outlined above, the general position is that the discount an employee receives on market value at the time of acquisition of the share will be taxed on acquisition under Division 13A (subject to the concessions). For capital gains tax purposes, the difference between the cost base (generally market value) and consideration on disposal will be taxed as a capital gain.<sup>404</sup> As a general rule, the disposal of a share or right will give rise to a capital gain if the consideration on disposal (or in certain cases the market value at disposal) is greater than the cost base of the share or right.<sup>405</sup> A capital loss will arise if the capital proceeds are less than the reduced cost base.<sup>406</sup> The cost base of a share or right acquired under an employee share scheme depends on whether the discount is subject to tax at the time the shares or rights are acquired or whether liability to tax is deferred.

If the discount on shares or rights is subject to tax on acquisition, the cost base of the share or right will be market value at the time of acquisition.<sup>407</sup> This means that the discount will be taxed under Division 13A and the taxpayer will then be able to use the market value at the time of acquisition to determine the capital gain or loss.

If tax is deferred and the share or right is disposed of within thirty days of cessation time, the capital gains tax provisions do not apply.<sup>408</sup> This means that the difference between market

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equivalent provision for benefits provided under a previous legislative scheme applying to employee share schemes in existence before 1995. *Id.* at § 136(1), ¶ (h).

403. *Id.* § 136(1), ¶ (hb).

404. Net capital gains and net capital losses are calculated under ITAA 1997, Parts 3-1 & 3-3. A net capital gain is included in assessable income. *Id.* § 102-5. A net capital loss can be carried forward and offset against future capital gains. *Id.* § 102-15.

405. *Id.* § 104-10(4). Division 116 provides rules for determining 'capital proceeds.' Divisions 110 and 112 provide rules for determining 'cost base.'

406. *Id.* §§ 104-10(4). The reduced cost base is a modified cost base used to calculate a capital loss. It does not include certain costs that can be included to determine a gain. *Id.* Subdiv. 110-B.

407. *Id.* § 130-80(2).

408. *Id.* § 130-83(2).

value of the share or right and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A.

If tax is deferred and the share is disposed of more than thirty days after cessation time, the cost base of the share is market value at cessation time.<sup>409</sup> This means that the difference between market value of the share or right at cessation time and the amount the taxpayer paid to acquire it will be subject to tax under Division 13A. Any subsequent increase in the value of the share or right will be subject to tax as a capital gain.

An important point to note is that since September 1999, certain capital gains have been eligible for the 'CGT discount,' which means that only 50 percent of the nominal gain is included in assessable income.<sup>410</sup> This may mean that it is advantageous to bring forward the taxing time under Division 13A and to receive less of any relevant gain in the value of shares or rights as an 'income' gain subject to tax under Division 13A and more of any relevant gain as a 'capital' gain.

### 5.2.6 *Recent developments*

#### *Rollover relief*

Changes in 2004 provide for CGT rollover relief for shares acquired under an ESOP where a corporate restructure occurs. Where an employee has deferred tax liability under an ESOP, the taxing point could be triggered where the shares or rights are acquired under a takeover or other corporate restructure. From July 1, 2004, rollover relief is available in respect of the shares or rights provided the takeover or restructure is for 100 percent of the company, the consideration received is 'matching shares or rights' in the acquirer and certain other conditions are satisfied.<sup>411</sup>

#### *Cross border employee shares or rights*

Measures introduced in 2005 apply to an individual who works in more than one country or changes country of residence.<sup>412</sup> The legislation provides that where a person acquires shares or rights while employed offshore and then later becomes an employee in Australia while still engaged in employment or service relevant to the acquisition, the person will be subject to

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409. *Id.* § 130-83(3).

410. *Id.* Div. 115. A number of conditions must be satisfied to take advantage of the discount, e.g., the shares, must have been held for at least twelve months.

411. See ITAA 1936, §§ 139DQ-139 DS, and ITAA 1997, §§ 130-83 & 130-95.

412. The measures were introduced by the New International Arrangements (Foreign-owned Branches and Other Measures) Act, 2005 (Cth) (Austl.).

Division 13A at the point of becoming an Australian employee.<sup>413</sup> The measures generally apply from June 25, 2005.

### *Stapled securities*

Current law requires qualifying shares to be ordinary shares and rights to give the right to acquire ordinary shares. In the 2006 Budget, the Government announced that it would extend the employee share scheme concessions and related capital gains tax treatment to stapled securities that include an ordinary share and are listed on the Australian Stock Exchange. The measures are contained in *Taxation Laws Amendment (2007 Measures No 1) Act 2007* which took effect on April 12, 2007.

### 5.3 CURRENT PRACTICE

One of the difficulties in identifying current trends is that comprehensive information on the number, nature and extent of employee share plans in Australia, and the number of employees in plans is not collected by any government department such as the Australian Bureau of Statistics. Nor is data collected by bodies such as the ATO or the Australian Securities and Investment Commission (ASIC), despite both bodies having significant regulatory responsibilities in the area. In *Shared Endeavours*, it was suggested that over 5 percent of the Australian workforce holds equities under employee share plans.<sup>414</sup> This contrasts with approximately 7 percent in the U.K., 10 percent in the U.S., and 23 percent in France.<sup>415</sup>

Despite the lack of official information, several private bodies have conducted surveys that provide some insights into current practice. In 2003, KPMG released the results of a survey of 800 Australian companies entitled 'Employee Share and Option Schemes Survey Report.'<sup>416</sup> That report identified that employees of public listed companies are significantly more likely to be offered equity based compensation schemes than employees of other companies. Specifically, 80 percent of public listed companies that responded had some sort of scheme, compared with 38 percent of public unlisted companies and 16 percent of private companies.

In relation to the types of schemes being offered there would appear to be significant diversity as to the type of equity, the nature of the employee contribution (if any), and the condi-

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413. ITAA 1936, § 139BA(2), (2A).

414. SHARED ENDEAVOURS, *supra* note 1, at 26.

415. Lenne et al., *supra* note 5, at 1.

416. Another survey by Mercer Human Resources Consulting was released in 2002.

tions that must be satisfied. For example, the survey found that the most common types of schemes were option or option-based schemes, as opposed to share plans (49 percent of schemes were in this category). The key differences relate to an entitlement to dividends (not available under an option plan) and downside risk protection (not generally available under a share plan). Under an option plan, employees are offered options which can be exercised after a vesting period (usually three to five years) for a stated exercise price. The option itself (as opposed to the underlying share) is granted for nil or nominal payment. There is no commercial downside risk in holding options. That is, if the shares are 'out of the money' (i.e. the share price is less than the exercise price), the employee simply does not exercise the option. Rather the option is only exercised if and when the shares are 'in the money' (i.e. the share price exceeds the exercise price). If the shares remain out of the money, the options are simply allowed to lapse. Prior to the exercise of the option, the employee does not receive dividends and has no other shareholder rights. The survey found that the most common type of option plan set the exercise price at the market value at the time the options were granted (MEPO) but there were also plans with lower exercise prices (LEPO) as well as zero exercise price options (ZEPO). Plans with a zero exercise price have been becoming more common. Another significant feature is the development of Performance Rights Plans which generally involve the issue of options for no consideration with a nil exercise price but subject to the satisfaction of various performance criteria. This is particularly the case with executive remuneration as opposed to all-employee schemes. The most common performance hurdle was found to be Total Shareholder Return (TSR), but others included earnings per share (EPS) and share price performance.

The survey also identified that 12 percent of companies with a scheme had a \$1000 tax-exempt plan. As already notified to access this exemption the employee must elect to be taxed upfront. The view was expressed in the survey that the decline in the use of such plans could be linked to the state of the share market generally in the period covered by the survey and that companies are less likely to offer free or discounted shares to employees during periods of slow profit performance.

If the acquisition of shares or rights requires some contribution by the employees, there are various methods available to achieve this other than requiring the employee to provide cash. For example, the acquisition may occur as a result of a salary sacrifice so that the employee elects to receive part of their remuneration as shares, rather than as cash (i.e., the employee's cash

salary is reduced). Provided the requirements of Division 13A are met, the employee will be entitled to tax deferral. One high profile salary sacrifice arrangement is that of the CEO of ANZ who was reported to have earned only \$49 in cash salary last year (i.e. less than \$1 per week), receiving the rest of his remuneration in shares and performance rights in ANZ. Loan plans, discussed above are also a common way of financing acquisitions. Typically the loan will be limited in recourse to the value of the shares so that there is no downside risk.

There has also been a trend by employers to have plans operated through a trust or to use a third party 'plan company.' This is seen as providing flexibility as to the source of shares to be provided under the plan, that is, either existing shares acquired on market or new shares issued by the company. The use of a third party can also address the issue of deductibility. The introduction of accounting standards in 2004 that require companies to expense the value of share and option grants has highlighted the fact that such companies will generally not be entitled to claim a deduction despite the accounting requirement.

Another trend identified in the press has been the practice of executive employees hedging shareholdings, that is, locking in profits but still holding shares in order to seek concessional capital gains tax treatment and/or to limit disclosure to shareholders. For example, the CEO of Channel Seven recently exercised 500,000 options and immediately entered into put and call options over the resulting shares. The CEO of Westpac recently exercised 677,886 options and immediately entered into cap and collar arrangements with CBA.<sup>417</sup> This hedging trend appears to replace the sale of vested option arrangements which were common a couple of years ago. The Australian Council of Super Investors found that thirty-four companies were engaging in hedging even though many companies did not respond to its call for information.<sup>418</sup>

What does appear to be the case is that ESOPs are strongly based on Australian income tax law and changes to it. For example, in the early to mid-1990's, ESOPs were put on hold for two years between the period starting when the Government announced that the old tax regime (section 26AAC) would be replaced and ending when the Government announced the rules now comprising Division 13A. Similarly, a current trend is to implement plans for stapled securities in light of the changes introduced in 2007. This is a very major development given the

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417. Christopher Webb, *Directors Dealings*, SUNDAY AGE, May 14, 2006, at 29.

418. Michael West, *Push to ban bosses' secret deals*, THE AUSTRALIAN, Aug. 14, 2006, at 19.

prevalence of listed property trusts and infrastructure funds in the market.

### 5.3.1 *Performance hurdles*

One trend that has been identified is that companies are becoming more likely to include various performance hurdles that must be met before the rights are exercised. This cannot be attributed to any changes in the tax treatment of ESOPs but can probably be linked to changes in corporate legislation and changes in shareholder expectations relating to executive remuneration, especially in light of media reports of extremely large payouts to (often failed) executives.

For example, the AASB introduced Accounting Standard AASB 124 in 2005 which requires disclosure of the value of all forms of executive remuneration. Furthermore, the *Corporations Act* was amended in 2004 and now requires mandatory reporting of a company's remuneration policy. The Australian Securities Exchange urges companies to 'remunerate fairly and responsibly' and provides for shareholders of listed companies to ask questions about, or comment on, the remuneration report and also to pass a non-binding resolution on the adoption of the remuneration report.

The issue, especially in relation to CEOs, generally seems to be about how much remuneration should be fixed and how much should be variable or 'at risk.' There is also generally considerable discussion about the appropriateness of various measures of performance.

### 5.3.2 *The provision of shares or rights using an employee share trust*

The provision of shares or rights through an employee share trust involves transferring shares, rights, money, or other property to a trustee to enable the trustee to acquire shares on-market and subsequently to provide those shares or rights to employees or their associates. The use of such a trust can provide a number of benefits to an employer. For example, according to *Shared Endeavours*, one benefit is that it reduces the number of entities subject to taxation and focuses taxation liability on the beneficiaries of the plan.<sup>419</sup>

The provision of shares or rights to a trust, or the transfer of money or property to enable shares or rights to be acquired, will have no immediate tax consequences for the employee. This is because the employee will only acquire the share or right when

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419. SHARED ENDEAVOURS, *supra* note 1, at 124–28.

he or she acquires the legal or beneficial interest in the share or right from the trustee. This is implicitly recognised in Division 13A, which provides for deductibility in respect of the provision of money or property to a person for the purpose of enabling another person (the ultimate beneficiary) to acquire a share or right under an employee share scheme, but not until the ultimate beneficiary acquires the share or right.<sup>420</sup> This suggests that the acquisition by the trust will not be treated as an acquisition by an associate of the employee even if the employee is 'capable of benefiting under the trust.'<sup>421</sup> Furthermore, the section dealing with acquisition of a share or right merely refers to acquisition from another person (not necessarily from the employer).<sup>422</sup> For capital gains tax purposes, the first element of the cost base (or reduced cost base) is market value when the employee first acquired a beneficial interest in the share or right.<sup>423</sup>

The trustee of the employee share trust does not acquire a share or right under an employee share scheme if it is 'the trustee of a trust whose sole activities are obtaining of shares, or rights to acquire shares, and providing those shares or rights to employees of a company or to associates of those employees.'<sup>424</sup> This is consistent with the general tax treatment of trusts. For capital gains tax purposes, where a beneficiary of an employee share trust becomes absolutely entitled to a share or right, any capital gain or loss the trustee (or beneficiary) makes is disregarded if: the beneficiary is an employee of a company; or the terms of the trust require or authorise the trustee to transfer shares or rights; the rights acquired under an employee scheme and the employee did not acquire the shares for more than the trustee's cost base.<sup>425</sup>

An important consideration for the employer proposing to provide shares or rights at a discount is the issue of deductibility.<sup>426</sup> This is because the issue of shares or options by a company does not generally involve a deductible outgoing, even though it clearly involves some sort of 'cost' to shareholders of the issuing company. However, it is generally accepted that an employer will be entitled to a tax deduction under the general

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420. ITAA 1936, §139DB.

421. Although the Commissioner has long held the view that the trustee could be an associate (*see* TR 1999/5), the Full Federal Court has recently held that this is not the case. *See* FCT v. Indooroopilly Childrens Services (Qld) Pty. Ltd. (2007) F.C.A.F.C. 16 (Feb. 22, 2007).

422. ITAA 1936, § 139G(d) & (e).

423. ITAA 1997, § 130-85(3).

424. ITAA 1936, § 139C(5)

425. ITAA 1997, §§ 130-90.

426. Other benefits of establishing an employee share trust include the fact that it facilitates forfeiture and disposal where necessary.

deduction provision<sup>427</sup> in respect of a non-refundable contribution made to an employee share trust for the purpose of the trust using those funds to provide shares to employees of the contributor (by way of subscription or on-market acquisition) as part of an employee's remuneration package. This is implicitly recognised by a provision that allows a deduction where money or property is provided under a trust arrangement (although not until the employee actually acquires the shares or rights).<sup>428</sup>

An advantage of establishing an employee share trust is that the provision of money or property to a trust will not attract fringe benefits tax where 'the sole activities of the trust are obtaining shares, or rights to acquire shares in the employer company or its holding company and providing those shares or rights to employees or associates of the employees.'<sup>429</sup> As noted below, the provision of other benefits, such as financial assistance, may give rise to fringe benefits tax liability for the employer.

### 5.3.3 *The provision of shares or rights accompanied by a low or interest-free loan*

The provision of a loan by an employer (or associate or a third party under an arrangement) to an employee (or an associate) will attract the operation of the *Fringe Benefits Tax Assessment Act 1986* (Cth) as a benefit provided in respect of employment.<sup>430</sup> The value of the benefit is the difference between a benchmark rate of interest and the rate of interest actually paid.<sup>431</sup> If the loan is provided interest-free or at an interest rate below the benchmark rate, the difference will be subject to fringe benefits tax and tax will prima facie be payable by the employer at 46.5 percent on the 'grossed-up value' as defined. However, as the loan is used to acquire income producing assets (the shares or rights), the value of the benefit will be reduced to zero under a rule known as the 'otherwise deductible' rule.<sup>432</sup> The employer will not be subject to tax with respect to the loan benefit provided. Furthermore, the employee will not be subject to tax with respect to the loan.<sup>433</sup>

If the loan is used to acquire shares or rights at a discount, Division 13A will apply to the discount, and if the conditions dis-

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427. ITAA 1997, § 8-1.

428. ITAA 1936, § 139DB.

429. FBTA 1986, § 136(1), ¶ (hb) (definition of 'fringe benefit').

430. *Id.* § 136(1) (definition of 'fringe benefit').

431. *Id.* § 18. The 'benchmark interest rate' is determined by the Reserve Bank. For the FBT year ending Mar. 31, 2006 the rate was 7.05 percent.

432. *Id.* § 19.

433. ITAA 1936, § 23L.

cussed above apply, the employee will be able to access the concessions.

If the loan is used to acquire shares or rights at full market value, the shares themselves will not be subject to Division 13A and the employee will not be able to access the concessions.

A point for private (i.e., non-listed) companies is that the making of a loan to an employee who is a shareholder in the company (or an associate of a shareholder) could be treated as a deemed dividend from the company and therefore included in the assessable income of the recipient.<sup>434</sup> There is, however, an exception if the loan is made solely for the purpose of enabling a shareholder or associate to acquire shares or options under an employee share scheme, but only if the shares or rights are qualifying shares or rights within Division 13A.<sup>435</sup>

An alternative way in which to finance the acquisition of shares may be to offer the shares or rights at market value and enter into a salary sacrifice arrangement with the employee (see below).

#### 5.3.4 *Plans that fall outside Division 13A*

If shares or rights are offered at a discount to employees but the shares or rights are non-qualifying, the benefit received will be subject to tax under Division 13A but no concessions will be available. Examples include:

- Shares or rights in a company that is not the employer or the holding company of the employer;
- Where the recipient is not in an employment relationship but is an independent contractor;
- Where the recipient is an associate of an employee;
- Where the plan or another plan relating to shares is not open to at least 75 percent of permanent employees (i.e. employees with at least three years service with the company);
- Where the employee becomes entitled to more than 5 percent of the shares in the company;
- Where the shares are not ordinary shares or the rights are rights to acquire shares that are not ordinary shares; or
- Where the rights are provided in a business structure other than a company, e.g. units in a unit trust<sup>436</sup> or interests in a partnership.

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434. *Id.* § 108 & Div. 7A (§§ 109B–109X).

435. *Id.* § 109NB.

436. The recent changes that permit the issuing of stapled securities do permit entities such as listed property trusts to come within Division 13A.

Where a scheme falls outside Division 13A, it is necessary to consider other taxing provisions, such as sections 6-5 and 15-2 (employment benefits) of ITAA 1997. There are two other situations that need to be considered. The first is a scheme that involves the provision of shares or rights at full market value, and the second involves schemes that offer interests that are not 'shares or rights.'

### *Offering shares or rights at full market value*

The acquisition of shares or rights for a consideration equal to the market value of the shares or rights when they are acquired is not an acquisition under an employee share scheme and therefore is not covered by Division 13A.<sup>437</sup> Generally, the provision of shares or rights to employees for market value would not give rise to a benefit and so would not attract any tax liability. An employer may, however, prefer to provide the benefit by other means. For example, the provision of an interest free loan will generally not attract fringe benefits tax liability where the loan funds are used to acquire income-producing assets such as shares (see above). However, the making of a loan in these circumstances may attract the deemed dividend provisions, and the exclusion that applies where the loan relates to an employee share scheme within Division 13A will not be available (see above). Alternatively, the acquisition of shares or rights may be financed by a salary sacrifice arrangement. The main issue here will be to ensure that the salary sacrifice arrangement is 'effective.' The Commissioner has indicated that such an arrangement will be effective if the arrangement is entered into before the amount to be sacrificed has been earned.<sup>438</sup> If the arrangement is not effective, the Commissioner will treat the amount as having been derived by the employee and require the amount to be included in assessable income. The normal practice is to make these arrangements at the start of an income year to ensure that they are treated as effective. Regardless of how the acquisition is financed, the employee will be able to derive any capital gains on the shares as a discount capital gain and to only pay tax on 50 percent of the nominal gain. This may be regarded as a preferable way to provide the benefit, particularly as it means that the shares or rights do not have to try to fit within the restrictive conditions that must be satisfied to enable an employee to access the Division 13A concessions.

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437. ITAA 1936, § 139C(3).

438. Tax Rul. 2001/10 (Austl.).

### *Schemes that offer interests that are not shares or rights*

Division 13A only applies when the interest being provided is a 'share or right.' Some employers have chosen to step outside the Division and offer benefits that replicate share ownership but do not involve the acquisition of shares or rights. These schemes are sometimes referred to as 'replicator share plans' or 'phantom,' 'synthetic' or 'shadow' plans. *Shared Endeavours* noted that replicator share plans are used 'where the company cannot or is unwilling to issue equities in itself.'<sup>439</sup> The plans provide benefits that 'mimic the benefits they would have received had they held shares in the company.'<sup>440</sup> Benefits provided under such plans will not be subject to tax under Division 13A and will not be eligible for concessions under that Division. Any non-cash benefit received by an employee in respect of employment will be subject to tax either under section 15-2 ITAA 1997 (which requires the recipient to include the value to the taxpayer of the benefit in assessable income) or as a fringe benefit (in which case the employer will pay tax on the value of the benefit as determined under the FBTAA 1986). Typically the plan will aim to provide the benefit at market value to avoid payment of tax and to provide the benefit either in the form of a low or interest-free loan or salary sacrifice to fund the acquisition of the interest. Alternatively, or in addition, the benefit may be derived if the shares when subsequently disposed of are eligible for discount treatment.

Although these types of schemes may avoid the operation of Division 13A, *Shared Endeavours* noted that they were not used very much in Australia.<sup>441</sup> This may be related to the fact that under the Financial Services Regulation provisions in the *Corporations Act 2001* (Cth), such rights will probably be treated as derivatives and be subject to the onerous disclosure obligations in Chapter 7 of the *Corporations Act*.

#### 5.4 DIFFICULTIES WITH THE CURRENT TAX REGIME

There are a number of problems in the use of the tax concessions as a tool for regulating employee share schemes. These issues are outlined broadly below.

##### 5.4.1 *Cost and complexity*

If an employer wishes to offer shares to employees, it must comply with regulatory requirements in the *Corporations Act*

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439. SHARED ENDEAVOURS, *supra* note 1, xxi.

440. *Id.*

441. *Id.* at 20.

2001 (Cth) designed to provide information to investors. Although ASIC has provided conditional relief from disclosure requirements for employee share schemes, the preconditions for accessing this relief can be quite difficult to satisfy.<sup>442</sup> Employers and employees also need to consider the detailed taxation requirements. As already noted, there are different consequences depending on what is offered, on what terms the offer is made, and on a range of other structural issues. For these reasons start-up costs for employers can be very high. Legal drafting of documents is expensive, as they must be precise (for tax purposes) and helpful for employees (in plain English). There are also costs of educating the administrators—for example, those in human resources or in the company tax group and legal groups. Standard or ‘off the shelf’ plans invariably fall foul of the tax rules, with serious consequences. There are added costs if binding tax rulings are sought, which is common but often unnecessary.

On-going costs of administering an employee share plan can be high especially if an external administrator is used. Also, there may be costs associated with obtaining external advice for unique employee circumstances that continually arise. Educating employees (both administrators of the plans and participants) and responding to queries, especially if they are not commercially literate, can also be costly. Furthermore there is a need to review plans and documents each time an offer is made, given the rapid and numerous changes in tax law.

#### 5.4.2 *Inflexibility*

Work done to date suggests that a ‘one-size fits all’ approach to the concessions is increasingly less appropriate to meet the emerging diversity and flexibility of the workplace and work practices across the spectrum, from small start-up companies in sunrise industries to large listed companies with transnational workforces. For example, one of the authors has been involved in a study that highlighted the difficulty faced by a start-up company in meeting the conditions for the available tax concessions.<sup>443</sup> Rider has also argued that there are conceptual problems in treating an individual involved in an intellectual property commercialisation who receives shares in exchange for his or her labour in the same way as an employee who receives

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442. See *supra* Section 4.

443. Cameron Rider et al., *Taxation Problems in the Commercialisation of Intellectual Property*, ch. 9 (Intell. Prop. Res. Inst. of Austl., Working Paper, 2005) available at <http://www.law.unimelb.edu.au/ipria/events/Taxation%20problems%20in%20the%20commercialisation%20of%20IP.pdf>.

fixed cash salary regardless of the fortunes of the enterprise.<sup>444</sup> In his view such persons are more like at-risk investors and should receive the tax treatment available to investors.<sup>445</sup>

The limited terms on which ESOP benefits may be provided and the limited component of overall remuneration which they can provide, also reflect an outdated view of the appropriate taxation treatment of labour income.

#### 5.4.3 *Stringency of requirements to access concessions in Division 13A*

The qualifying rules for the two concessions in Division 13A have attracted significant criticism. In particular it is argued that the rules are too strict and have the effect of constraining the growth of employee share ownership in Australia.<sup>446</sup> The restriction of employee share schemes to companies that issue ordinary shares or rights is problematic for smaller companies.<sup>447</sup> Companies who cannot or are unwilling to issue ordinary shares to employees are unable to access the concessions in Division 13A. This is more likely to be the case where the company is small and control is highly valued by the owners. It is also clear that if the business is structured as a trust or a partnership rather than as a company, the provisions of Division 13A do not apply.

Limiting the availability of both concessions under Division 13A to employees who hold a legal or beneficial interest in more than 5 percent of the shares in the employer, or are in a position to cast, or control the casting of, more than 5 percent of the maximum number of votes that may be cast at a general meeting of the employer, has also come under sustained criticism. The 5 percent limit may prevent smaller businesses from accessing the taxation concessions. It also prevents employee buyouts from occurring under Division 13A.<sup>448</sup>

The requirement that the scheme or another scheme be available to 75 percent of permanent employees is also problematic for start-up companies with a small number of employees. It should be noted that the Commissioner does have discretion to determine that the condition has been satisfied,<sup>449</sup> and it may be that, in the case of a new company, the Commissioner would do so if the scheme was open to 75 percent of current employees.

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444. Rider, *supra* note 390, at 2.

445. *Id.*

446. See, e.g., Mong, *supra* note 27, at 416; Employee Ownership Group, *supra* note 334.

447. See, e.g., SHARED ENDEAVOURS, *supra* note 1; Employee Ownership Group, *supra* note 334, at 5; Lenne et al., *supra* note 5.

448. SHARED ENDEAVOURS, *supra* note 1, at 155.

449. ITAA, 1936, § 139CD(5).

The reference to permanent employees as full or part-time employees with at least thirty-six months service makes this condition impossible to satisfy for start-up companies. It may, however, be possible to obtain the deferral concession which is often seen as a more attractive option for providing executive remuneration.

*Shared Endeavours* made a number of recommendations to ease some of the requirements for qualifying shares and rights, particularly to facilitate the use of employee share schemes in 'sunrise enterprises'.<sup>450</sup> The Government, however, did not support any of these recommendations.<sup>451</sup>

#### 5.4.4 The \$1000 tax exemption

The \$1000 tax exemption available under Division 13A has been criticised for being too low. According to Price, for example, it 'equates to the bare minimum of employee ownership'.<sup>452</sup> In submissions to the Nelson Committee, a number of companies and accountancy firms argued that the threshold was too easily exceeded, particularly where employees are given the opportunity to participate in both share and option plans.<sup>453</sup> The Australian Employee Ownership Association (AEOA) argued that the effect of the \$1000 threshold was to encourage wide but not deep employee shareholding. In its submission to the Nelson Committee, KPMG presented results from its survey, which found that 35 percent of respondents stated that they would introduce an employee share scheme if the tax exemption were increased to \$2000 per employee per year.<sup>454</sup> Submissions to the Committee also argued that the exemption should be indexed. These arguments were rejected by the Treasurer, who argued that the Government had already doubled the exemption (from \$500 to \$1000) and that indexing the concession would be anomalous, given that neither personal income tax scales nor the income free threshold are indexed.<sup>455</sup> The *Shared Endeavours* Majority Report recommended that the tax-exempt concession be increased, though it conceded that it was difficult to specify an increased

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450. SHARED ENDEAVOURS, *supra* note 1, §§ 4.129, 4.130, 4.142, 4.153, 4.164, 4.176, 4.182, 4.198 (Recommendations 32–39).

451. Press Release, Peter Costello, Treasurer, Government Response to Nelson Report on Employee Share Ownership (Mar. 27, 2003), available at <http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2003/014.htm&pageID=003&min=phc&Year=2003&DocType=0>.

452. Geoff Price, *Employee Ownership: Reform Opportunity Lost?*, KEEPING GOOD COMPANIES, July 2003, at 331.

453. See SHARED ENDEAVOURS, *supra* note 1, at 152–55.

454. *Id.* at 153.

455. *Id.* at 154.

amount in the absence of Treasury estimates of the costs associated with any such reforms.<sup>456</sup>

#### 5.4.5 *Capital Gains Tax treatment*

An aspect of the current taxation treatment of employee shares that has attracted considerable criticism is the extent to which employee share schemes should attract the CGT discount treatment for capital gains. Price has argued that there is a 'glaring inconsistency' in the taxation treatment of plans under Division 13A in which tax-exempt plans attract CGT discount treatment but tax-deferred plans do not.<sup>457</sup> With tax-deferral plans, the gains in value on employee shares are also taxed as income. This inconsistency is also criticised by the Employee Ownership Group, who argues that this creates a bias towards exempt plans.

*Shared Endeavours* recommended that all employee share schemes should have the same CGT treatment afforded to superannuation and other tax-advantaged investment savings vehicles.<sup>458</sup>

#### 5.4.6 *Potential for Abuse*

In its Dissenting Report to *Shared Endeavours*, the minority argued that although the original intention of the tax concessions for ESOPs was to encourage the ownership of shares in companies by the employees of those companies, over a number of years such plans had 'become vehicles for aggressive tax planning for the benefit of company executives.'<sup>459</sup> Wariness of policy reform on employee share ownership in the past has been attributed in part to the Treasury's fear of tax abuse.<sup>460</sup>

The lack of published information relating to the number, structure and incidence of ESOPs makes it difficult to identify particular types of abuses but this is an area that certainly requires more attention.

The Dissenting Report emphasised that the government should encourage the growth of what it termed 'genuine' or 'bona fide' employee share plans and should develop anti-avoidance measures to deal with the abuse of plans 'that are available only to executive, high income employees and have as their real

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456. *Id.* § 4.129 (Recommendation 32).

457. Price, *supra* note 452, at 330.

458. SHARED ENDEAVOURS, *supra* note 1, § 4.67 (Recommendation 27).

459. *Id.* at 280.

460. Price, *supra* note 452, at 331.

purpose the tax effective or tax free provision of remuneration.<sup>461</sup>

### 5.5 SUMMARY

While a diverse range of rationales have been put forward for employee share ownership, it is difficult to determine precisely which of these underpin contemporary regulatory initiatives towards the practice. Government needs to identify exactly what the underlying policy rationale is for providing the tax concessions that are currently available. A further concern is that various aspects of the tax treatment imposed on ESOPs appear to be inefficient. Some of those concerns relate to the bias in favour of listed companies and against small and start-up companies, the different tax treatment that applies to employee share owners compared with other investors, and the different tax treatment afforded to different types of employee remuneration.

An overriding concern is the lack of data available on various aspects of ESOPs. This lack of data makes it difficult to identify whether the tax rules operate to encourage or to discourage employee share ownership and what steps any future government should take in either trying to encourage employee share ownership or to act to restrict potential abuses of the concessions.

### 6. CONCLUSION

This paper has sought to provide an overview of broad-based employee share ownership plans in Australia. After reviewing the diverse literature on employee share ownership, the paper examined what is known about ESOP practice in Australia. The paper emphasised the dearth of available evidence on Australian companies' objectives and practices regarding employee share ownership.

The paper then outlined the regulatory framework governing ESOPs in Australia. The main public regulation is found in the area of corporate and tax law. Both regulatory sources restrict the availability of concessional regimes to employee share ownership plans that meet various prescribed requirements. The current framework has been criticised for being inflexible and for failing to recognise the diversity of objectives for which companies may seek to implement broad-based employee share ownership. In particular, critics have argued that the current regulatory regime severely inhibits the widespread adoption of employee share ownership in the SME sector. Without greater insight into

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461. *Id.* at 277.

company objectives and practice, however, it remains very difficult to determine whether and to what extent regulatory reform is desirable.