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Implementing Employee Owner Status

Response from the Employment Lawyers Association

8 November 2012

ELA Response to consultation issued by the Department for Business Innovation & Skills: 'Implementing Employee Owner Status'

INTRODUCTION

The Employment Lawyers Association ("ELA") is a non-political group of specialists in the field of employment law and includes those who represent Claimants and Respondents in the Courts and Employment Tribunals. It is therefore not ELA's role to comment on the political merits or otherwise of proposed legislation, rather to make observations from a legal standpoint. ELA's Legislative and Policy Committee is made up of both Barristers and Solicitors who meet regularly for a number of purposes including to consider and respond to proposed new legislation.

A sub-committee was set up by the Legislative and Policy Committee of the ELA under the chairmanship of James Warren (Field Fisher Waterhouse LLP) to consider and comment on the "Implementing Employee Owner Status" consultation paper. Its report is set out below. A full list of the members of the sub-committee is annexed to this report.

1. OVERVIEW

1.1 The Government has invited views on specific questions laid out in the consultation paper. Given that the consultation opened on 18 October 2012 and responses are required by 8 November 2012, ELA must protest the limited timeframe given to prepare a response to such a significant proposal with wide ramifications across employment and company law. It could well have resulted in some matters being overlooked.

1.2 Our comments reply to the specific questions posed and are divided according to the chapter arrangement in the consultation paper. Also included are additional discussion comments that we felt required consideration.

1.3 In summary, ELA would make the following general points:

(a) At present the potential set up, administrative and "running" costs of the proposed scheme seem likely to outweigh any perceived benefits for all but a minority of employers and companies;

(b) Significant tax and administrative complications arise out of the proposed scheme although it is recognised that some see notable tax advantages if they do take it on board;

(c) Where the proposal may appeal is for medium and larger businesses able to establish employee benefit trusts, afford share price valuations and who otherwise have the necessary administrative resources; those small businesses which might benefit most by avoiding the disruption of tribunal claims are also less likely to be able to use the scheme;

(d) The proposal seems unlikely to significantly improve and/or alter labour market flexibility and the maternity provisions in particular may harm rather than improve the position;

(e) There may be a negative impact on the cost of disputes and/or access to justice if employee disputes are simply transferred into share valuation and buy back arguments in a fully costed court regime; and

(f) There is a risk that the positive message of greater employee share ownership is tainted by the requirement for employees to sacrifice certain employment rights.

1.4 In the light of the above points, a number of members within our group expressed real concern that the proposal as it currently stands may not achieve its stated policy goals.

2. EMPLOYMENT STATUS

Question 1 – How can the government help businesses get most out of the flexibility offered and the different types of employment status?

1.1 In order to assist employers to get the most out of the flexibility offered, it is ELA's view that the Government should not only deal with the employment related issues but also the corporate and tax implications of the intended share ownership arrangements. In our view, it would be helpful for the Government to ensure that appropriate mechanisms are in place to simplify the process by which a company can acquire the shares on departure of the employees as this would increase workability of the scheme and likely boost interest and participation in it by both employers and employees. Even with existing employee share ownership arrangements (other than public companies), there are invariably drawn out and expensive disputes that require independent third party valuations. Not only might this increase costs for both the company and the individual employee, but there may also be a negative impact on access to justice if arguments are simply transferred from the forum of an employment tribunal to the courts in disputes about potentially quite complex share valuations.

1.2 The new status is designed to be flexible and save employers having to worry about unfair dismissal claims and/or redundancy as well as issues arising from flexible working requests. However, the fact that even as employee owners the individuals are able to make claims in relation to discrimination or for automatically unfair dismissal reasons will in our view restrict employers from feeling secure that individuals will not raise claims against the company (even if this would have an impact on the company and therefore their shares). In that regard, in order to give businesses an opportunity to get the most out of this flexibility, strict rules and guidance should be provided as to what would allow an "employee owner" to raise some form of employment tribunal proceedings and more particularly put employees at risk of costs/expenses in the event that spurious claims are raised as a means of avoiding the employee owner status. It may be that the employee might be at risk of losing the value of his/her shares should he/she be unsuccessful in such an employment tribunal application. However, any such proposals would need to provide fair balance between the parties; if the measures regarding costs/expenses were too draconian, this would affect employee enthusiasm and take up for employee-owner status.

Question 2 – Do businesses feel able to use all three employment statuses? If not, what restricts the use of different statuses?

2.1 ELA is concerned that in setting up and running this proposed scheme significant one off and ongoing administrative costs will unavoidably be incurred by employers. To this

end, businesses may not feel able or willing to bear the burden of these costs, especially without the benefit of certainty as to whether both employees and other businesses alike are going to participate in this proposed scheme. In addition, it is ELA's view that many businesses will be put off from using the new employee owner status because of the uncertainty around the costs (both in terms of the price to be paid for the shares, and the advice needed to process the transaction) of buying back shares in the event an employee leaves.

2.2 Notwithstanding the associated administrative costs, most medium to small employers will inevitably find it difficult to cope with the use of all three employment statuses. At present there is often confusion amongst employers over the different rights that employees and workers have and indeed this already leads to disputes. Adding a further category of employment status may make the management of this even harder for employers.

2.3 Having such a variety of statuses available for all workers may lead to not only confusion in management terms but also potentially disharmony amongst employees as different rights are asserted in different ways. Employers will have to be careful that by embracing the possibility of employing people in this new status, they do not end up creating a 2 or 3 tier workforce (e.g. creating distinct classes of employees who are expected to take shares/contract out, such as directors). Many small to medium size employers may not appreciate the benefits of this new category, particularly if there is no assurance that using the new category will absolutely avoid tribunal claims, given that it is likely that employees who are unable to raise an unfair dismissal claim will, when the relationship ends acrimoniously, look for some alternative means of raising a claim i.e. discrimination etc.

2.4 Consideration should also be given to whether employee owners should have a clear name/label to distinguish their status from other employees who may hold shares or an interest in their employer (for example, S.205A Employees).

3. HOW THE NEW EMPLOYMENT STATUS WILL WORK IN PRACTICE

Question 3 – What restrictions, if any, do you think should be attached to the issue of shares or types of shares?

3.1 We assume that most private companies will wish to offer shares to employee owners that have restricted voting rights, so that control can remain with the core group of shareholders/founders. Unless the company already has a class of non voting shares, one will need to be created. This inevitably will lead to further costs in implementing the proposals.

3.2 In addition, it may be that many employers will want to place a limit on the percentage of shares which are owned by employee owners in order to avoid a situation where the shareholders lose control over the company and/or suffer unacceptable dilution. In that regard a restriction, or at least the allowance of restrictions, for employers who wish to limit the influence/control that the employee owners have may be required.

3.3 In the context of private companies, it is likely that they will wish to impose restrictions on the transferability of the shares held by employee owners to avoid the situation where employee owners seek to offer their shares for sale to each other and/or third parties. In

addition, companies may wish to impose "drag along" rights to force employee owners to sell their shares in the event the majority shareholders agree to sell their shares to a third party buyer. These restrictions may require changes to the articles of association of the company.

Question 4 – When an employer buys back forfeit shares, should this be at full market value or some other level (e.g. a fraction of market value) should some other level be allowed in certain circumstances?

4.1 The shares should be at a market value, although this may depend on the circumstances in which the employee leaves (if this is the event that triggers the buy back). Employee owners will have demonstrated commitment to the company by taking up the employee owner status. If the employment terminates, perhaps through no fault of theirs, why should the company only be required to pay a fraction of the market value for the shares? ELA notes that the intention behind the whole proposal is that the employees will gain by being a shareholder and that they will not be required to pay capital gains tax on the increase of value. If any gain which is accrued during their employment can simply be wiped out by the employer in a post termination entitlement only to pay a fraction of the share value, it removes much of the attraction for employees to take up this status. Having said that, it is problematic to oblige companies to buy back shares from employee owners for a market value. The company or the shareholders may not have the cash resources to fund the repurchase of shares and cannot commit to doing so in advance, and at the time the shares are initially offered to employees.

4.2 It may be that the Government would be required to specify some form of "*bad* leaver" provision which, in particular circumstances, would allow the employer not to give the employee the full value for his/her shareholding after his/her employment ends. It may be appropriate in circumstance where an employee has committed gross misconduct or some other breach of contract which would justify immediate termination of his/her employment - in such limited circumstances it may be appropriate for the employee to only be given a fraction of the market value of his/her shares. The position is less clear in circumstances where post-termination conduct might affect the position e.g. if an employee who has given many years of loyal service then chooses to leave and join a competitor, should that be permitted to constitute bad leaver status? However, the existence of good and bad leaver provisions inevitably add to the risk of increased litigation. Further, it may be the perception of certain employers that if the actions of the employee cost the company money, provision should be made that rather than having a counter claim in any form of action, the employer is able to off-set the loss against the value of the shares. Although this may be something an employer might be tempted to provide, in our view this should be prohibited; this would in effect amount to double jeopardy as the employee owner would have already given up his/her rights to bring a claim for unfair dismissal.

4.3 ELA notes that if the value of the shares was left to be determined by the respective employer and employee, the imbalance of power in such a relationship is likely to favour the employer. This would leave the employee in an uncertain position and potentially increase the risk of litigation. It would also impact on other employees' perception of the employee owner scheme and potential take up.

Question 5 – How should a company go about carrying out a valuation of the shares? What would the administrative and cost impact be for a company if an independent valuation was required?

5.1 Carrying out a valuation is likely to be far from straightforward and is highly likely to involve considerable administration and costs. The issues arising from valuation are addressed further in sections 4, 6.18 and 6.25. In employment tribunal terms, even in a gross misconduct situation an employee is entitled to receive pay (including accrued holiday pay) etc up to the actual date of termination of his/her employment. It would be unfair then for any accrued increase in value of the shareholding to be simply wiped out on termination by only offering a fraction of their value. Whilst this does not arise in most current employment situations, in corporate situations where shareholders fall out or disagree, the process of valuing shares is invariably drawn out and expensive. Whilst this new status may in theory avoid unfair dismissal and employment tribunal proceedings being raised, if there was to be a dispute over the value of the shares it would be highly likely that this would involve considerable cost to both parties in having accountants carry out a valuation of the shares and then potentially a Court action for recovery of the value of these shares.

5.2 It would seem that to impose a minimum threshold of £2,000 for the offer of shares could cause many companies to not qualify for this new proposal. This is because the value of equity in a start up business may be minimal. Presumably founder shareholders will wish to take advantage of the new status and exemption from capital gains tax on sale of shares, but they will be prevented from doing so because of the value thresholds. This will lead to the inequitable situation where founders will pay a higher rate of capital gains tax on sale of their shares than employee owners, a potentially demotivating factor.

5.3 As a general point, ELA notes that shares may have no rights attached to them at all yet be valued at £2000 if the employer guarantees to buy them back on termination (for any reason) for £2000. Without adequate safeguards, this would appear to introduce Adrian Beecroft's proposal to introduce compensated "no fault" dismissals: an idea, which the government announced it would not pursue.

4. ENSURING INDIVIDUALS TAKING UP EMPLOYEE OWNER STATUS UNDERSTAND IMPLICATIONS

Question 6 – The Government would welcome views on the level of advice and guidance that individuals and businesses might need to be fully aware of the implications of taking on employee owner status.

Summary of recommendations

6.1 ELA suggests that:

(a) Employees will need to be properly protected in respect of any proposed employee ownership arrangements and we suggest that such protection should be in line with the current requirements relating to compromise agreements;

(b) Employee owner arrangements should be in writing;

(c) Independent financial advice may also be required by both parties;

(d) Both employees and employers will need to be made aware of the employment law, company law and tax issues arising from their proposed arrangement, and appropriate safeguards may need to be in place in order to level the playing field of the assumed and actual imbalance of bargaining power between the employer and employee; and

(e) Employers and employees will need to be provided with guidance on the financial risks associated with shareholdings.

Requirement to seek legal advice for employee owners

6.2 In ELA's view, all employees who are considering whether or not to take on employee owner status should be required to seek legal advice from an independent adviser.

6.3 ELA suggests that it would be incompatible with current employment legislation to permit a prospective employee owner to enter into such an arrangement without the requirement for him/her to seek the same level of independent legal advice.

6.4 Taking independent legal advice from an independent advisor before agreeing to waive statutory employment rights under a compromise agreement is a requirement of section 203 of the Employment Rights Act 1996. This is a safeguard intended to protect employees by ensuring they receive the advice necessary to help them understand their legal rights and the consequences of signing a legally binding document. Additionally, the legal advice requirement ensures the employee obtains the benefit of the adviser's insurance cover and gains a right of remedy if he/she suffers loss as a result of inadequate or incomplete advice.

6.5 ELA does not anticipate that employers themselves will have the expertise required to ensure the employee can give his/her informed consent to becoming an employee owner.

6.6 If the prospective employee owner does enter into the arrangement without the level of awareness needed to provide his/her informed consent, then ELA considers that there is a risk that challenges to his/her employment owner status could arise as a result. For example, employees who are not fully advised may seek to argue that they would not have accepted the ownership status had they been made aware of a particular issue or risk and/or argue that the agreement to enter into employee owner status may be set aside or treated as ineffective. In ELA's view, a tribunal is likely to be sympathetic to such arguments where there is any suggestion that the employee was provided with inadequate, incomplete or misleading information, particularly as the concept of informed consent is already well-established in employment law (for example, in relation to TUPE).

6.7 Therefore, if it were to be the responsibility of the employer to provide the relevant information advising the employee of the consequences of becoming an employee owner, that may potentially expose the employer to a range of claims including for misrepresentation, negligence, discrimination, as well as any tribunal claims asserting the continuing right to rely on the purportedly waived rights.

6.8 Additionally, the employer will not have the benefit of insurance cover in the same way as a legal adviser and will therefore be solely responsible for meeting the costs of any legal actions which arise.

6.9 There is also the clear risk of a conflict of interest if the employer is able to advise an employee owner on this sort of arrangement.

6.10 Therefore, in ELA's view, an independent legal adviser is likely to be best placed to provide the advice necessary to ensure the employee owner is fully aware of the implications of taking on employee ownership status (albeit we also note that the legal issues raised are technical and broad, covering the employment, corporate and taxation fields; some non specialist advisers might struggle to provide comprehensive assistance).

6.11 ELA also considers that a requirement to seek independent legal advice is particularly important here as we anticipate that most employers proposing employee owner arrangements will have the benefit of legal advice. Accordingly, there is a risk that the employee will be at a relative disadvantage if he/she does not also have the benefit of independent advice.

6.12 Nevertheless, ELA is mindful that, under the Financial Services & Markets Act 2000 (‘FSMA’), there is currently a restriction on the financial advice that persons who are not authorised by the FSA can provide. Therefore, unless they have the relevant authorisation, it would potentially be a criminal offence for either the employer or an independent legal adviser to advise on the investment itself.

6.13 ELA would therefore suggest that consideration needs to be given to whether prospective employee owners (and employers) should be required to take independent financial advice on the proposed employee ownership arrangement. Consideration may also need to be given to providing employee owners with a 'cooling-off" period after they forfeit their rights and whether employee owners will require advice before they surrender their shares.

6.14 In any event, as a minimum, both the employee and employer should be encouraged to take independent financial advice. Additionally, it may be appropriate to require that the parties are given access to standard financial investment ‘warning’ information and example forecast calculations (in line with current FSA requirements). ELA would suggest that such standard information documents would need to be produced by the relevant Government department and made freely available to the parties.

6.15 Finally, given the complexity of issues involved, ELA is also concerned that the cost of legal advice for the prospective employee may be prohibitive (particularly as some smaller or medium sized employment practices may not have the expertise to provide advice on the tax and company law issues described below.) However, it is noted that, in practice, employers will generally contribute (whether in whole or in part) towards the cost of the independent adviser as part of any compromise agreement arrangement. Whilst ELA nevertheless maintains its suggestion that a requirement for the employee to seek independent advice is provided, it is therefore anticipated that the practice of the employer paying for the advice is likely to continue and may therefore mean that the cost of setting up an employee owner relationship actually becomes more prohibitive for the employer.

Issues of which the employee will need to be ‘fully aware’

6.16 **Affected employment rights:**

6.16.1 An employee will need to understand which employment rights he/she will be waiving by becoming an employee owner. Equally, he/she should also be made aware of which rights will be retained.

6.16.2 Advice on these issues must also include an assessment of the value of the rights being waived so that the employee is able to assess whether or not he/she should accept the proposed terms.

6.16.3 In relation to statutory redundancy payments, for example, in order to understand the value of the right he/she will be waiving by becoming an employee owner, the employee will need to be made aware of how statutory redundancy payments work (including the qualifying criteria) and how redundancy payments are calculated. The employee will also need to understand the circumstances in which the right to receive such a payment might be triggered.

6.17 **Shareholders' rights:**

6.17.1 As a starting point, the employee will first need to understand the type of shares he/she will be receiving.

6.17.2 Secondly, the employee will need to be provided with an explanation of the rights attached to those shares, both in terms of the general rights afforded to shareholders under the Companies Act 2006 and also in terms of any employer specific rights which may be provided for under the company's articles of association or any relevant shareholders' agreements. In particular, employees will need to be given details of how many shares they will receive, what percentage of the issued share capital this represents, what voting rights they will receive (if any), what dividend rights they will receive (if any), what restrictions on transfer of shares exist (if any), issues regarding dilution of their proposed holding, their rights in the event of liquidation and where they will rank as a shareholder (both in relation to dividends and on the event of a liquidation). The communication of all these issues to employees not used to such issues will be a challenge.

6.17.3 The employee will also need to be provided with an explanation of the rights attached to other shares held by other shareholders as there may be different types of shares which feature different rights which may impact upon the type of share the employee in question is to hold. For example, preference shares will usually carry no voting rights, may carry a dividend and would rank higher than ordinary shares in the event of a liquidation.

6.18 **Valuation issues:**

6.18.1 The employee will need to be made aware of the risk that the value of his/her shares may go down as well as up and that, in the event of an insolvency situation, it may not be possible to recover anything on his/her shares.

6.18.2 As set out above, in light of the effect of FSMA, ELA would therefore suggest that it will be necessary for the Government (and potentially HMRC and/or the FSA, or its successor) to produce and provide guidance documents to be given to potential employee owners and employers.

6.19 **Taxation issues:**

6.19.1 Employees will also need to receive advice on the tax consequences of entering into employee owner contracts. For example, they would need to be made aware that income tax (and possibly national insurance contributions) will be payable on receipt of the shares, if the employee does not pay a market value for them.

6.19.2 If the shares acquired are not readily convertible assets, any income tax will not be collected through PAYE. The result of this is that the employee owner will also need to be made aware of the requirement to complete a self-assessment tax return. This is something he or she may never have done before, as a basic or higher rate taxpayer, with no additional sources of income other than salary.

6.19.3 Employees should also be told that their gains on disposal of their shares will be exempt from capital gains tax. Equally, employees must be told what will happen to the shares if their employment is terminated. It is noted from the consultation document that it is proposed that employers may be allowed to require employees to sell their shares when they leave the company for a reasonable price. If this proposal is adopted then, where relevant, employees will need to be made aware that this requirement is in place. They should also be informed that should the ultimate sale price of the shares exceed the then current market value, they will be liable for income tax and NIC charges on the excess.

6.19.4 In addition, it will be advisable for employee owners to sign a "431 joint election" on acquiring their shares, to take them out of the restricted securities regime under ITEPA 2003. Further advice and communication will be required to inform employees of the implications of making such an election.

Issues the employer will need to be ‘fully aware’ of

6.20 As a starting point, ELA considers it more likely that the employing business will take legal advice as a matter of routine before adopting any employee owner arrangements.

6.21 Whilst there is no requirement in the Employment Rights Act 1996 for employers to take legal advice before entering into a compromise agreement, in practice such advice will be taken as a matter of course in most circumstances. Therefore, ELA does not consider that it is necessary to oblige employers to take legal advice, provided that there is a requirement that prospective employees take legal advice (thereby removing the obligation for the employer to explain the issues involved to the employee).

6.22 Nevertheless, ELA is of the view that there are a number of issues which will have to be made clear to employers before they offer employee owner arrangements, whether through guidance notes or whether through a central advice agency (such as ACAS).

6.23 **Affected employment rights:**

6.23.1 The employer will need to understand which employment rights the employee will be waiving. Equally, it should also understand which rights the employee will retain (such as discrimination and whistle blowing rights).

6.23.2 The employer should also be made aware of the potential value of the rights the employee will be waiving so that the employer can assess whether or not it wants to offer the proposed terms.

6.24 **Shareholders' rights:**

6.24.1 The employer will first need to understand whether its articles of association allows it to offer the shares to the employee owner. If not, then amendments to the articles and/or an increase in the share capital will be required.

6.24.2 In order to determine what type of shares it wants to offer, the employer will also need an explanation of the various rights it can choose to attach (or not attach) to the employee owner's shares and the statutory rights provided under the Companies Act 2006.

6.25 **Valuation and taxation issues:**

6.25.1 As with the prospective employee owner, the employer will need to be made aware of the risks that exist in relation to the potential fluctuation in value of the shares, particularly as the cost and complexity for an employer of 'buying-back' the shares (if required) could be onerous, especially if the shares have increased significantly in value. See previous comments regarding the funding problems of obliging employers to buy back shares for value.

6.25.2 As valuation is not an exact science, the employer is likely to need to take financial advice regarding valuing the shares before making the offer to the potential employee owner. It is not clear whether HMRC will have to agree the employers' valuations, or whether they will be self-assessed. If it is the former then consideration needs to be given as to whether HMRC have the resources to deal with the share valuation issues.

6.25.3 Additionally, given the potential for abuse, ELA would suggest that there is a requirement for an independent financial valuation before the employer can make the offer of shares to the prospective employee owner and a second requirement for a financial valuation in the event that the employee is required to sell his/her shares on termination. This could add significantly to the cost of dismissing employees, and could be a major factor in businesses deciding not to offer the new employee owner contract.

The employment rights excluded from employee owner status

5. UNFAIR DISMISSAL

Question 7 – What impact will allowing individuals limited unfair dismissal protection and equity shares have on employers' appetite for recruiting?

7.1 It is ELA's view that this proposal will not have a significant impact on employers' appetite for recruitment. Our detailed reasons are set out below, but in summary, this is because:

(a) Employee owner contracts only apply to a specific and limited corporate model;

(b) Flexibility in the employment relationship has already significantly increased due to the increase in the qualifying period for unfair dismissal protection; and

(c) There is minimal benefit to employers if unfair dismissal claims are simply replaced by complex discrimination and Public Interest Disclosure Act claims.

7.2 The proposal is potentially divisive because it only applies to companies limited by share capital and established under the Companies Act 2006 or earlier legislation. It also excludes community interest companies. Sole traders, partnerships, limited liability partnerships, companies limited by guarantee, charities and many areas of professional employment, as well as public sector employers, will be unable to offer "employee owner" contracts. The proposal will have no impact on these sectors unless business owners convert to a corporate model and many will be unable to do this.

7.3 The basis of the suggestion is that employment rights hamper economic growth and that the risk of being taken to an employment tribunal and the costs of providing employment rights can create obstacles to hiring employees.

7.4 To the extent this is factually correct, removing rights should remove barriers. It has to be recognised, however, that this is a very contentious proposition. The OECD has recognised that the UK has one of the most lightly regulated labour markets in the developed world, and is performing well, according to both the consultation document and Equality Impact Assessment. There is limited evidence that increased flexibility in the UK labour market will stimulate growth and experience of our clients informs us that there are many more significant factors hindering growth than employment rights.

7.5 Also, as the qualifying period for claiming unfair dismissal has increased from one to two years for employees taken on after April 2012, there is already more flexibility in the employment relationship. It appears to us to be unclear that this proposal will give share-issuing companies greater confidence to recruit.

7.6 ELA questions the extent to which employers consider the existence of protection against unfair dismissal and the potential costs of termination at the beginning of the employment relationship. Our experience is that the decision is determined principally by analysis of other factors, such as current and projected performance, future business needs, business strategy, and the requirement for a person with a particular skill or contacts to operate the business effectively.

7.7 Companies that adhere to best practice and follow fair procedures may consider their exposure to potential unfair dismissal compensation awards to be relatively low and not worth the value of share ownership, even at the lower end of the scale. The cost and administration of providing these shares to every employee owner has to be balanced against the real or perceived exposure to compensation for unfair dismissal and redundancy. Most employment relationships do not end in a tribunal claim or through redundancy, and if there are disputes on termination, many of these are settled for less than the median unfair dismissal award.

7.8 There must therefore be a concern that this proposal will appeal to just those employers from whom employees need most protection i.e. those that do not generally follow fair process when terminating employment.

7.9 In addition, as the protection against automatically unfair dismissal remains intact, the fact that a person cannot claim ordinary unfair dismissal may give little comfort at the recruitment stage. A woman dismissed for being pregnant, for example, would still be able to sue for a discriminatory dismissal even if her right to claim unfair dismissal had been removed. Also, the employment protections required by EU law will remain, so for example, although an employee owner may give up the right to request flexible

working, an employer's refusal to consider a request might still give rise to a claim of indirect sex discrimination. There must be a risk, discussed in more detail below, that a claim by a disgruntled departing employee owner would be couched in terms of a discrimination or whistle blowing complaint. If employers perceive this to be the case, the apparent benefits of hiring an individual with limited unfair dismissal rights may be minimal and the proposal may not impact significantly on an employer's willingness to hire. Many employers considering this step are likely to be advised of the limitations of the exemptions.

7.10 It is difficult to predict the take-up of this proposal, but for many employers, the trade-off of granting shares in the company to a prospective employee together with the potential administrative difficulties of forfeiture on termination may mitigate against this route. There will also be a number of technical complexities associated with this proposal (discussed elsewhere in this paper) which are likely to be a disincentive. One such complexity is making arrangements for the interrelationship between shares issued to employees under existing arrangements (such as EMI schemes) and shares distributed to buy-out rights.

Question 8 – What benefits do you think introducing the employee owner status in with limited unfair dismissal rights will have for companies?

8.1 In summary ELA speculates that in terms of benefits, employer owner status:

(a) May help to recruit high calibre candidates (but is only applicable to companies with positive growth forecast and/or where there is significant potential for share price growth); and

(b) May reduce employers' insurance premiums and legal costs (although this may be offset by the potential requirement to obtain legal advice to use this scheme).

8.2 Generally ELA is of the view that predicting the benefits of this concept is much more difficult than analysing the problems that will be associated with its use. ELA can only surmise the potential impact as set out below.

8.3 To the extent that it is correct that fear of potential unfair dismissal claims hamper employers' wishes to recruit, then the proposal may increase the likelihood of hiring. As discussed above however, it is ELA's view that the impact on recruitment is unlikely to be significant.

8.4 Where larger shareholdings are offered, employers may experience positive performance outcomes from employee owners whose interests are more closely aligned with those of the businesses.

8.5 Companies with good growth forecasts but limited capital may be attracted to this proposal as a way of recruiting high quality individuals on lower salaries than might otherwise be the case because the employee will be offered a share of the business. However, given that the employee has no protection against unfair dismissal (save where the dismissal is automatically unfair), cannot contest an unfair termination and that the employee may forfeit the shares on termination for less than true market value, the perception of the employer may be negated by the perception of the employee of the disadvantages of employee ownership.

8.6 The proposal may be of particular interest to companies in private equity structures where the initial share price is low, but where there is potential for significant share price growth. The proposal may also be wide enough to apply to management 'sweet equity' in a private equity structure. Sweet equity is the term given when ordinary shares are issued to management at a lower price in order to incentivise performance. Such equity often has nominal or low value on issue and so could be below the £2,000 limit.

8.7 The proposal might provide an opportunity for private equity management to benefit from a significant capital gains tax benefit. A complete exemption for capital gains tax on any gain would be seen as a further improvement on the current 10% rate under Entrepreneurs Relief with potentially fewer conditions (not all managers can benefit from Entrepreneurs Relief owing primarily to the 5% ownership rules). Government may not have intended the proposal to operate in this way and the references in the paper to anti-avoidance measures may cover this possibility, in which case no benefit should accrue.

8.8 Possibly there may be a reduction in employers' insurance premiums and in the cost of retaining lawyers and consultants if the risk of employment claims is reduced. Initially this will be balanced by the cost of obtaining advice on using the scheme and insurers will require evidence of reduced claims before cutting their premiums.

8.9 The question asks about potential benefits to companies, but these have, as a matter of logic, to be balanced against potential disadvantages. We set out some of these below.

8.10 The proposal may place additional burdens on many companies in the service provision sector. The consultation document indicates that TUPE will apply to employee owners in the same way that it currently applies to employees but more thought needs to be given to how this will work in practice. Would the TUPE transfer be considered a dismissal/termination of employment for the purposes of triggering a forfeiture of shares? Many small companies would wish to recover the shares from employee owners at the point of transfer but what would happen to those employee-owners who transfer? Would there be an obligation on the transferee to retain the status and offer transferring employee owners shares in the transferee company? And, if so, on what terms and what happens if the transferee has no share capital? If the transferee objects or cannot provide shares how is the contractual promise not to sue for unfair dismissal to be excluded from the ambit of the usual rule that all contractual rights transfer?

8.11 These issues need to be addressed as they could otherwise significantly complicate negotiations for TUPE transfers. For some organisations where business control changes regularly, the administrative burden could make employee owner status prohibitive. This is addressed further in the response set out in section 25.

8.12 There is a real concern that certain individuals may be attracted to the employee owner status when it is not in their best interest to do so. It may be difficult for employees to ascertain the true value of their rights as the proposal really requires employees to calculate the monetary worth of their potential future employment rights against the likelihood of their future employer's commercial success - a difficult exercise. There will be a concern that employees will be short sighted and undervalue their employment rights. Further, if the company fails and the employee loses his/her job, the shares will be worthless and the employee will have no right to a statutory redundancy payment or to a payment from the National Insurance Fund.

8.13 Whilst capital gains tax reliefs are central to the proposals, it is not proposed to give relief from any potential up front income tax charge on the issue of the shares. Income tax charges on shares in unlisted companies pose particular problems where the employee is gifted shares having more than a nominal value, but where the employee is unable to sell sufficient shares to cover the income tax liability. Without income tax relief, the benefits for employees receiving awards at the lower end of the scale are limited – there would need to be significant share price growth for these employees to exceed the current capital gains annual exemption of £10,600.

8.14 In practice, take-up may be low as employees may not be willing to incur an income tax liability in relation to the shares acquired at the start of employment and forfeit potentially valuable employment rights in return for an uncertain potential gain in the value of the shares and a speculative future capital gains tax saving. Although in this current economic climate, there is a concern that employees may be obliged to accept this new status if it is the only basis upon which an employer is willing to offer employment. In practice, individuals may have little choice but to consent to an employee owner employment status.

Question 9 – Do you think these benefits will be greater for larger, smaller or start-up businesses?

9.1 The consultation document envisages that the employers most likely to employ employee owners are fast growing small and medium-sized companies with a requirement for a flexible workforce, but the ability to offer "employee owner" contracts will be available to companies of all sizes. However, a lot of small businesses will be excluded if they are structured other than as a company limited by shares (see above at paragraph 7.2).

9.2 In summary, it is ELA's view that:

(a) The proposal will appeal mostly to medium and larger businesses which are able to establish employee benefit trusts, afford share price valuations (where the companies are unlisted) and who have more sophisticated Human Resource teams able to process the associated administration; and

(b) Those companies which might have been able to benefit the most (by avoiding the disruption of tribunal claims on a small business environment) are the least likely to be able to make use of the scheme.

9.3 ELA is concerned that the complexities of the share arrangements and, in particular, the likely need to establish an employee benefit trust to purchase the shares for employee owners and make awards, may put off smaller businesses.

9.4 Genuinely small and start-up businesses may struggle to establish the minimum value of £2,000 worth of shares to take advantage of employee owner status.

9.5 The proposal may be unattractive for some small companies as giving several employee owners a shareholding of even £2,000 each could result in a large proportion of the total share capital being held by employees. Additionally, small companies may find it difficult to raise the funds to pay an exiting employee the value of their increased shareholding.

9.6 It may, however, appeal to the founders of new companies who may elect to become employee owners to avoid capital gains tax and the proposal does not seem to prevent this (although the minimum valuation condition remains a concern).

9.7 The proposal may be of particular interest to companies held in private equity structures where the initial share price is low, but where there is potential for significant share price growth. The consultation document envisages that the employer may insert contractual provisions to require employees to sell back their shares on leaving, dismissal or redundancy. However, to protect employees, ELA would suggest that the government require the employer to buy back the employee's shares at a reasonable value if shares were surrendered. This raises significant issues for unlisted companies. If such companies are required to undertake a share valuation each time an employee leaves, the cost of doing this is likely to be prohibitive.

9.8 Large companies with a significant number of employees may see this as an opportunity to limit their exposure to potential future costs associated with employment claims.

Question 10 – What impact, if any, do you think the employee owner status will have on employment tribunal claims, e.g. for discrimination?

10.1 As take up of the scheme is difficult to predict, so too is any impact on tribunal claims.

10.2 In practice, there is a risk that claims for automatically unfair dismissal and/or discrimination may increase. This has been considered in some detail in paragraphs 1.2, 2.3 and 7.9 above. Advisors are bound to consider with disgruntled employees whether any other avenues to the tribunal are available.

10.3 There is a risk of an increase in civil claims, for example in relation to whether the circumstances of forfeiture trigger the requirement to pay "reasonable value" for the shares. Good and bad leaver provisions usually determine rights on the forfeiture of shares. If the true reasons for leaving are disputed (e.g. the employer claiming that the employee's conduct amounts to gross misconduct, and that as a consequence it can reacquire the shares at par), the employee will have to go to the civil courts to resolve the issue. However, this is really an employment claim that properly belongs in an employment tribunal.

10.4 There is little guidance on how to assess "reasonable value". Whether or not surrendered shares can be purchased at full market value or a proportion of that amount and whether this should be varied in certain circumstances forms part of the consultation. Without clarity and guidance on this important aspect of the proposal, there is a risk of satellite litigation.

6. STATUTORY REDUNDANCY PAY

Question 11 – What impact do you think introducing the employee owner status with no statutory redundancy pay will have for businesses, in particular, smaller businesses and start-up businesses? What negative impacts do you anticipate and how might these be mitigated?

11.1 In summary, in ELA's view the elimination of statutory redundancy pay will not have a significant impact on businesses but care must be taken to impress upon employers the need still to follow a documented and fair procedure upon any termination (which would

include the obligation on an employer to consult with employee owners in a collective redundancy situation).

11.2 It is unlikely that this proposal will have much impact on levels of recruitment from the employer's perspective, as no business employs someone with the intention of making him redundant. Further, although the obligation to make a statutory redundancy payment is a cost for businesses, employees need two years' continuous service to qualify. In any event ELA does not consider that statutory redundancy pay is always so prohibitively high as to deter most employers from recruiting if there is a business need to do so. Even if an employer does recruit an employee and considers that the role might need to be made redundant in the future, the exposure to a statutory redundancy payment can be calculated and is therefore certain; furthermore, an employer can avoid a claim by making the payment. In our experience, employers are more concerned about unfair dismissal claims, as they are more difficult to avoid and harder to quantify (and settle) when they do arise.

11.3 However, employers who offer new recruits employee owner status may find that it affects their ability to recruit and retain the best staff. An employee might be unwilling to accept employee owner status because of his loss of the right to statutory redundancy pay. If the employee is a key recruit, the employer might be forced to offer him normal employee status, which could cause friction with existing employees on employee owner contracts. Alternatively, the employer may incentivise his acceptance of employee owner status by offering an increase in the number of shares he will receive in return for giving up the right to statutory redundancy pay. This could prove costly for employers. Possibly more concerning, an employee may question why a role is only offered on the basis that statutory redundancy pay is not available and may question what the value is of holding shares in a company that will not gamble on its own success.

11.4 There is also a real danger that employers will obtain a false sense of security from the new proposal and consider that they are able to "fire at will". The proposed exclusion of rights still leaves the employer bound by equalities legislation and numerous other statutory provisions, which make it risky for an employer to dismiss without a documented process having been followed. For example, an employee may still complain that he/she has been selected for redundancy because of a protected characteristic or because a discriminatory criterion has been used in assessing which employees should be made redundant. If the employer has relied on employee owner status and not followed a procedure or consulted the employee owner, that employer will find it more difficult to prove that the decision was in no sense because of the protected characteristic.

11.5 There are specific risks even in the context of genuine redundancy dismissals. There is a risk that an employer might not realise that an employee owner would still be entitled to a contractual redundancy payment (if these are paid by the organisation) so could find itself being sued for breach of contract if the payment is not made. This should be made clear in any guidance that is produced for employers.

11.6 Perhaps more seriously for smaller businesses and start up businesses, they may not realise that an employee owner will still have the right to be consulted collectively in relation to any redundancies and again this should be explained. Employers may be confused as to whether or not individual consultation would be required, as the remedy for a failure to consult on an individual basis would normally be an unfair dismissal

claim, which the employee owner would be unable to bring, and this should be clarified. ELA would suggest that the Government should consider the inherent conflict in the proposal that employee owners will have the right to benefit from collective redundancy consultation but no right to a redundancy payment or compensation if unfairly selected for redundancy on grounds of employee owner status.

11.7 Given the above, we do not consider that the employee owner proposal will significantly reduce red tape at the dismissal stage or reduce the possibility of exposure to litigation and uncertain compensation after dismissal. This applies particularly to small businesses and start-ups, as these undertakings are less likely to have the administrative resources to navigate these risks or to have developed policies and trained management.

7. MATERNITY LEAVE NOTICE PERIODS

Question 12 – What impact will this change to maternity notice period have on employers?

12.1 This change will have little positive impact on employers, as most employees tend to return to work from maternity leave on the date they originally stated. In fact, the proposal could have a negative impact on employers. Given the increased notice employees need to provide of a return to work, it will be very difficult for employees to reduce the duration of their maternity leave. Therefore in practice employees who are unsure how much maternity leave they need may be more inclined to under-estimate the duration of their maternity leave and extend it later as required. This would make it harder for employers to assess their business needs.

12.2 Once again there is also a danger, especially for small businesses without a Human Resources department, that employers take advantage of this new freedom without considering the applicability of existing employee protection. ELA foresees, for example, that overly rigid insistence on the full 16 weeks' notice being provided could give rise to the impression that the employer does not want the employee to return to work at all. This could result in reduced employee morale in returning employees and potentially a consequential increase in discrimination claims.

Question 13 – What, in your view, would employers do if employees wish to return early without giving 16 weeks' notice?

13.1 This depends principally on whether the employer has recruited maternity leave cover. If it has, it is likely to hold the returning employee to the 16 weeks' notice unless it can terminate the cover on shorter notice. If it has not recruited cover (or is using an agency worker), it may be happy for the employee to return to work without giving 16 weeks' notice.

13.2 It is unlikely that anyone employed as maternity leave cover would have more than one month’s contractual notice, and the statutory notice period is one week for each year worked. In ELA's view, as the covering employee can be terminated very easily, most employers are likely to be accommodating of an employee owner’s wish to return early on less than 16 weeks’ notice.

Question 14 – How will these changes impact on a company's payroll provisions?

14.1 These changes will have little, if any, impact on a company's payroll provisions. It takes a couple of minutes to reinstate an employee's salary when she returns from maternity

leave so it will not make any difference whether the employer has 8 or 16 weeks' notice of her return.

Question 15 – What effect will a compulsory 16 weeks' early return notice period have on the length of maternity leave that mothers take or adoption leave that parents take?

15.1 This is unlikely to have much effect since, in our experience, new parents plan in advance how much leave they will take based on the period for which they can afford to be off work. The notice they have to give in order to return early is irrelevant to the length of leave they take.

15.2 However, where the employee owner wishes to shorten her period of maternity leave, a 16 week notice period would in practice often frustrate this. Employee owners who are uncertain of how much leave they wish to take would be well-advised to take a shorter period and then extend it. In ELA's view, it is more difficult for employers to have to extend the period of maternity cover than to shorten it.

8. THE RIGHT TO REQUEST FLEXIBLE WORKING

Question 16 – Do you think 4 weeks is the right period? If not, why not? What would be the impact of a shorter or longer period?

16.1 No doubt employee owners would prefer a longer period and employers would prefer a shorter period, or even a requirement that the employee owner make a request before he or she returns from parental leave, but a balance has to be struck somewhere and four weeks is not unreasonable. A shorter period would make it easier for employers to plan; however, it could also increase the time spent by line management and HR in the first weeks of an employee's return. A longer period would increase uncertainty for employers and perhaps make it less likely that requests would be granted, as the employee owner would already have worked his or her previous pattern of work for some time so it would be harder to argue that it is not workable.

16.2 It is hard to see how this provision increases flexibility for employees; an employee owner with £2,000 worth of shares does not have a sufficient vested interest in the business to be able to persuade an employer to accede to his request for flexible working. The extent of flexibility for employees will therefore depend in part on the value of the shareholding offered to the employee-owner and the perception of their ability to increase in value. As employee-owners are particularly vulnerable to dismissal, they may not feel that they have a secure enough status to make such a request.

16.3 If a request for flexible working is turned down on grounds that the employee owner perceives are discriminatory, the employer may face a discrimination claim and it is important that any guidance produced for employers warns them of this risk. In addition, an employee owner might try to allege discrimination to put pressure on an employer to agree to his/her request. This situation can arise even with the statutory right to request but perhaps the incentives would now be greater.

9. RIGHT TO REQUEST TIME TO TRAIN

Question 17 – What impact do you think this proposal would have on the ability of employee owners to access support for training?

17.1 The proposal is to remove a right to request time to train that specifically applies to employees in businesses with 250 or more employees. As the employee owner proposals are not aimed at this sort of business and we are of the view that they are less likely to use the employee owner status, we therefore consider that this proposal will have a limited effect. Further, we consider that employers with these sort of resources are still likely to offer training to employees on an informal basis.

Implications for other aspects of law

10. COMPANY LAW

Question 18 – Do you have any comments on the Government's intention not to amend Company Law to implement the employee owner proposal?

18.1 Company law will impinge on a company's ability to implement employee ownership in two principal areas – the issue of new shares and a company's ability to repurchase shares from an employee owner. ELA notes that this is an area that is also the subject of recommendations in the *Nuttall Review of Employee Ownership* and on which the Government has issued a separate consultation (*Employee Ownership and Share Buy Backs: Consultation*). However, as the issue and repurchase of shares will be central to any effective and flexible employee ownership model, ELA's view is that amendments to company law and/or to the regulatory regime governing employee benefit trusts would be desirable. Further detail on the particular difficulties that would need addressing is set out below.

18.2 Section 580 Companies Act 2006 provides that it is unlawful for a UK registered company to issue shares at a discount to nominal value. The alternatives for ensuring nominal value is paid up are:

(a) The employee owner pays cash equal to the nominal value of the shares. This is unlikely to be acceptable to an employee owner where they are also giving up employment rights in consideration of receipt of the shares. Also, the employee owner may not have the requisite cash to fund the payment.

(b) The company accepts the waiver of the employment rights as consideration equal to the nominal value of the shares. Under this route the company would need to be satisfied that the value of the rights being given up was at least equal to the nominal value of the shares. This raises questions about how those rights should be valued (including whether their value varies by reference to length of service, age, salary etc). Companies would need certainty on this valuation issue to ensure they were not contravening company law. Certainty on valuation of both employment rights and the shares themselves is also desirable from a tax perspective (see further response to Question 19 below).

(c) The company accepts the performance of future services as consideration for the nominal value of the shares. The valuation issues are easier with this route as a

company can ascertain what it would otherwise have paid for those services. However, a public company is prohibited from accepting payment of its shares in return for an undertaking to do future work or perform services (section 585 Companies Act 2006).

18.3 The Companies Act 2006 also imposes various restrictions on share buy-backs and how they are financed. A company may only buy-back shares if the purchase (i) is out of distributable profits (start up companies are unlikely to have profits available for this purpose, and the proposal to allow payment by instalments in the Employee Ownership and Share Buy Backs Consultation only partially addresses this); (ii) is out of proceeds of the issue of new shares made for the purpose of financing the share buy back; (iii) by following the procedure for a purchase of shares by a private company out of capital; or (iv) by a reduction of capital. In addition, private companies which buy back their own shares are required to cancel those shares (unlike a public company which may hold its own shares in treasury). The inability to hold treasury shares imposes additional cost and burden on private companies wishing to implement employee ownership.

18.5 It is therefore ELA's view that amendments to company law would be desirable to reduce the regulatory burden on companies wishing to implement employee ownership.

18.6 It is possible to address the difficulties arising on issue and repurchase of shares by use of an employee benefit trust. Again, the use of a trust model is advocated in the Nuttall Review of Employee Ownership (along with an outline of the typical benefits and structure and so those are not repeated here). However, there are problems associated with the use of an employee benefit trust as follows:

(a) There are costs involved in establishing an employee benefit trust and additional costs in operating the trust on an ongoing basis. It also imposes an additional administrative burden on companies (for example, with annual returns to HMRC).

(b) The use of a trust may be confusing for employees who may not be familiar with how employee benefit trusts operate. This may make less sophisticated employees less likely to take up an offer of employee ownership.

(c) The trustee of an employee benefit trust must have regard to principles of trust law in deciding how to appoint trust property (i.e. when transferring shares to any person) – in particular, the trustee would have to have regard to its fiduciary duties to its beneficiaries and be satisfied that it was not in breach of those duties by delivering shares to individuals in return for them waiving their employment rights.

(d) If the employee benefit trust is resident in the UK and transfers shares to an employee owner, it will be treated as making a disposal for the purposes of capital gains tax – and so will be subject to a corresponding tax charge on the market value of the shares (irrespective of the value it actually receives for the shares).

(e) Most employee benefit trusts are set up so that the class of beneficiaries meets the requirements of section 86 of the Inheritance Tax Act 1984 – which requires the class of beneficiaries to be defined by reference to employment with a

particular trade or profession or body carrying on a trade or profession. The consultation paper states that for the purposes of other taxes, employee owners will be treated as employees. It would be helpful to have confirmation that if employee owners are included in the class of beneficiaries, a trust will still be capable of satisfying section 86. Without that confirmation, there may be additional tax charges for the trust and therefore an additional layer of cost for a company wishing to implement employee ownership.

18.7 In terms of company law, one issue is how the shares are to be treated as "paid up" when they are issued to the employees. It is unlawful for a UK registered company to issue shares at a discount to nominal value (section 580 of the Companies Act 2006). The shares therefore need to be paid up at least as to nominal value when they are issued to the employees (even if they are issued as unpaid, it would need to be on the basis that payment is due at some point in the future at least to cover the nominal value – and the Companies Act model articles for private companies do not include provision for non-paid or partly paid shares as it is assumed that private companies will not have them). What is the consideration to be for the issue of shares to the employees? Is it in consideration of giving up the employment rights and if so how can the company determine that the value of giving up those rights is equal at least to the nominal value of the shares? Is it to be in return for the performance of future services? Presumably there will not be any payment in cash by the employee? A public company is prohibited by the 2006 Act from accepting payment of its shares in return for an undertaking to do future work or perform services (section 585 of the 2006 Act). Public companies are also required to value any consideration for shares that is not in cash (subject to certain exceptions for share consideration).

18.8 The complexity of the issue of how shares would be "handed back" if an employee left is also alluded to in the paper, including in particular the restrictions on share buy-backs. As mentioned above at paragraph 18.3, share buy-backs can only be made if the purchase is out of distributable profits (start-up companies are unlikely to have profits available for this purpose) or the proceeds of the issue of new shares or by following the procedure for a purchase of shares by a private company (not a public company) out of capital or by following the routes for a reduction of capital.

11. TAX

Question 19 – The Government welcomes views on particular safeguards that would need to be applied, in order to minimise opportunities for abuse.

19.1 In summary, ELA is of the view that at a minimum the following safeguards should be applied:

(a) Agreeing with HMRC before the implementation of the scheme a quick and easy way of determining share value; and

(b) An obligation to include in the relevant documentation a formula or mechanism by which a "reasonable price" for the shares can be calculated, in relation to the buy back of shares on termination of employment.

19.2 The consultation states that the shares will be subject to income tax and NICs under the normal rules that apply for shares acquired by reason of employment. Those rules are

complex and the timing and value of the income tax charge will depend on the nature and duration of any restrictions attaching to the shares, any consideration given by the employee owner for the shares and any elections made by the employee owner and employer[1]. However, in many circumstances it is likely that an employee owner will have to pay income tax upon receipt of the shares. Employee and employer national insurance contributions are also likely to be payable. The company will be required to account for these through PAYE if the shares are considered readily convertible assets. That will result in a dry tax charge for the employee owner (i.e. the employee owner will have an income tax bill but will not be receiving any cash out of which it can meet that liability). A company may also incur penalties etc if it fails to operate PAYE in those circumstances.

19.3 In contrast to the position for income tax, the consultation states that employee owners will not have to pay capital gains tax on any gains they make on these shares. In practice, given the level of the annual capital gains allowance as previously mentioned in paragraphs 8.6 and 8.11, this exemption will be of little or no value to employee owners who receive low values of shares.

19.4 Given the respective potential income tax and capital gains tax charges, the proposal could lead to parties using techniques to manipulate values of shares – effectively reducing the share value at the time they are acquired by the employee owner. For example, by using so-called growth shares where the shares have a very low value at the date they are acquired by an employee owner but the rights attaching to the shares become more valuable on certain trigger events (e.g. the company meeting certain earnings targets).

19.5 ELA notes that the Government is currently consulting on a General Anti-Abuse Rule which would potentially allow any abusive avoidance to be closed down. However, ELA is of the view that there are more targeted steps which could be taken to discourage avoidance in conjunction with employee ownership and also provide companies and employee owners with greater certainty over the tax implications of implementing employee ownership.

19.6 Two potential alternatives would be (i) to exempt entirely from the charge to income tax any shares acquired by an employee owner in consideration of the waiver of his employment rights or (ii) for tax legislation to provide expressly that where an employee owner acquires shares, the value of those employment rights given up can be treated as payment (in whole or in part) for the shares.

19.7 The first alternative has the benefit of simplicity as it removes any difficulties over valuing the rights which an employee owner has given up. This would be particularly advantageous where a company is taking on new hires as it may be difficult to attribute significant value to the employment rights an individual is waiving when he/she do not yet have the requisite length of service for an unfair dismissal claim or redundancy payment.

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[1] In particular whether an election under section 431 Income Tax (Earnings and Pensions) Act 2003 is made.

19.8 The second alternative (where an employee owner effectively pays full value for the shares by giving up his employment rights) is arguably the position under current tax law but companies will need absolute clarity on the issue given the adverse implications for failure to operate PAYE. In addition, as noted elsewhere in this paper (including at paragraph 6.25), companies would need a mechanism whereby the waived employment rights could be valued. It would also be important that the value attributed to the rights is sufficiently high that it is actually possible to mitigate the income tax charge.

19.9 In addition, ELA considers that it will be important for companies to be able to arrive at a robust valuation for their shares at any given time. At present it is possible to agree a valuation with HMRC for tax purposes but the process is not straightforward and can be quite lengthy. Many private companies who need to determine their share value engage third party valuers – adding an additional layer of cost. If companies are to implement employee ownership successfully then a quick and easy way of determining a share value and agreeing that value with HMRC will be important. To the extent that HMRC are involved in the valuation process, consideration should be given to the impact of a significant take up of the employee owner proposal which may involve considerable administration, costs and potential bottlenecks in the process.

19.10 For completeness, ELA notes that under the tax regime governing restricted securities (Chapter 2 of Part 7 of ITEPA 2003), it is possible in certain circumstances to delay the timing of the income tax charge so that it does not arise at the date the shares are acquired. However, this is unlikely to be palatable to employee owners and companies as it is likely to mean income tax is due on a higher value (with an associated increased cost of employer national insurance contributions for the company).

19.11 ELA also considers that it would be helpful to have clarity on whether an individual must still be an employee owner at the date they dispose of the shares in order to benefit from the capital gains tax exemption or whether it is sufficient that the shares were acquired in consideration for the waiver of employment rights. On the one hand, if it is sufficient for the shares to have been acquired in consideration for the waiver of employment rights, companies and employees could agree to the temporary waiver of employment rights in order to allow employees to benefit from the capital gains tax exemption without giving up their employment rights in the longer term. On the other hand, if an individual must still be an employee owner at the date he disposes of shares to benefit from the exemption, this will have important timing implications for the repurchase of shares by companies from departing employee owners. In many circumstances it is unlikely to be practical to purchase shares from employee owners at the point they leave a company; for example, it may be necessary to undertake a valuation exercise to ascertain the price at which the shares are to be repurchased.

Question 20 – The Government welcomes views on whether the existing tax rules which apply to share-for-share exchanges (such as might happen when a company is taken over) and schemes of reconstruction should apply where shares issued in return for taking up the new status are involved.

20.1 ELA sees no reason in principle why the tax rules on share-for-share exchanges should not extend to shares issued in return for becoming an employee owner. However, as any gains on the disposal of the shares will be exempt from capital gains tax, the rules

may have little practical purpose unless the exemption can be lost if employee owner status is lost before the shares are sold.

20.2 The situation involving share-for-share exchanges does provide potential issues. For example, if a buyer of the business in which the employee owner has shares offers shares in consideration for the purchase, will those new shares be exempt from capital gains tax when they are ultimately sold? If not, then presumably the employee owner will wish to elect not to roll over his or her gain on sale into the new shares (in the same way an election in respect of entrepreneurs' relief is possible) but crystallise the disposal, and claim the complete exemption from capital gains tax as well as a higher base cost of the new shares.

12. GENERAL QUESTIONS

Question 21 – What impact do you think the proposal will have on labour market flexibility – that is, in relation to hiring and letting people go?

21.1 The consultation paper suggests that two barriers to hiring new employees are:

(a) the cost of providing some employment rights; and

(b) the fear of being taken to the employment tribunal.

21.2 In summary, ELA does not view the proposal as having a significant effect on labour market flexibility.

21.3 On the assumption that these barriers really exist some of the amendments to the employment rights of employee owners will reduce anxieties for employers. For example, there is a clear cost saving attached to removing the right of employee owners to receive a statutory redundancy payment. Whilst there is no direct cost saving to employers by removing the right of employee owners to request flexible working and time to train, there will be a marginal saving of management time in not having to consider such requests from employee owners.

21.4 Removing statutory protection from unfair dismissal for employee owners reduces the claims that such employees can bring in the employment tribunal. However, since 6 April 2012 employees require two years' continuous employment before they are able to bring that claim. Most issues with performance or conduct with new hires are likely to arise within the first two years of employment and this proposal may therefore have little impact on the thinking of employers. Further, employees will still be able to bring a number of claims to an employment tribunal (e.g. automatic unfair dismissal or for discrimination). Discrimination claims in particular are usually more complex and costly to litigate than unfair dismissal, and there is no cap on the compensation.

21.5 As previously mentioned in paragraphs 1.2, 2.2 and 7.9, employers might therefore be concerned that as employee owners are unable to bring unfair dismissal claims, they will bring other claims that may also be difficult to deal with. To the extent that fear of litigation, with its attendant costs, deters employers from recruiting (as to which we have doubts), the proposal may give employers some assurance that there is a reduced risk of litigation in a dismissal situation, but for the reasons we have given we doubt this will be significant in practice.

21.6 It is entirely unclear how requiring employees returning from maternity/adoption leave to provide increased notice of their early return to work will meet either of the stated objectives and it is unlikely that "planning for maternity periods" is a barrier to hiring new staff. In ELA's view this provision will have little or no impact on labour market flexibility.

21.7 If the stated issues are really major barriers to recruitment, then the employee owner proposal might encourage employees to recruit new staff. However, there are a number of other factors (such as the cost of labour, lack of suitable candidates, whether there is sufficient work to require new employees and general lack of confidence in the market) that in our opinion are likely to have a greater influence on whether or not employers take on new staff.

21.8 With regards to letting people go, as noted above, employers are likely to be concerned that employee owners will bring alternative claims to unfair dismissal. It may, however, give employers greater confidence to dismiss than they have presented in dismissing employee owners; in particular those who do not have a protected characteristic under the Equality Act 2010. That of course could prove to be double-edged on equality grounds depending on the distribution of shares amongst any particular workforce but that is very difficult to quantify in any meaningful way.

21.9 Labour market flexibility should perhaps also be considered from the employee's perspective. It may attract employees to have a choice whether to be employee owners or employees. If there were a genuine choice between the two, the employee owner proposal could be good for labour market flexibility.

21.10 However, in practice it may be unduly complicated for employers to have staff working under different contracts (as employees and employee owners) with different employment rights, as discussed briefly in paragraphs 2.1 and 2.2. In our view, most employers are likely to offer only one sort of employment status: as employee owners or employees. Most individuals will not have sufficient bargaining power to negotiate the status of their choosing and to this extent, the proposal again would have little or no effect on labour market flexibility.

Question 22 – Would you be likely to take up the new status? What would the impact of the status be on your business?

22.1 ELA is an apolitical membership association comprised of specialists in the employment law field. Members include solicitors, barristers, trade unions, the voluntary sector, industry and the judiciary. As such, the proposed status will have no impact on ELA as a membership association.

Question 23(A) – What are your views on the take up of this policy by companies?

23A.1 The impact assessment concedes that it is difficult to predict the take-up and we agree. Some companies may be enthusiastic about elements of the employee owner proposal because it increases the range of choice that companies can utilise when taking on new staff and it reduces the complexity and number of employment rights held by employee owners.

23A.2 Our view, on balance and subject to the obvious difficulties of speculating, is that take up of the employee owner proposal may be limited for a number of reasons (some of which have previously been discussed in response to questions 1, 2, 8 and 9).

23A.2 Most importantly, although the employee owner proposal purports to achieve simplicity, in order to have employee owners the employer would need an employee share scheme. Where there is an existing scheme, this may make the employee owner proposal more appealing as it could be adapted and utilised to suit the employee owner model. However, many companies will not have employee share schemes in place. Setting up an employee share scheme is relatively complex, requiring specialist advice and considerable investment of management time in considering issues such as what rights the shares should have and how to manage an exit situation. These up front costs are likely to deter many companies from pursuing the employee owner model (see paragraph 7.10).

23A.3 Whilst the proposal may reduce the risk of litigation for unfair dismissal at the employment tribunal, companies may be concerned that this will be replaced by litigation regarding the valuation of shares in the civil courts (as previously commented in paragraphs 1.1, 5.1 and 10.3).

23A.4 There may also be concerns about the reputational effect of taking up the employee owner proposal for some companies. There could be bad press for large employers if they are seen to be "buying out" employment rights. The impact of this factor requires assessment of the PR impact of the scheme which we are not best qualified to carry out but for a number of our clients their reputation as good employers matters to them and this will become of greater importance once the current economic climate improves. If the scheme attracts notoriety (as we think it may) this will put this category of employers off.

23A.5 Finally, the employee owner model might affect companies' ability to recruit and retain the best candidates. Faced with a choice between an employer who offers a role as an "employee" as opposed to an "employee owner", individuals can be expected to take up the employee role (though this may not be the case in respect of companies with very high growth forecasts, as discussed in paragraph 8.4). From an employee's perspective, there is less job certainty when one is an employee owner, and some commentators have gone as far as suggesting that it could even affect an employee owner's ability to obtain a mortgage or obtain certain types of insurance. We do not endorse this view but it does illustrate the degree of concern this proposal has generated and the opposition it will face.

Question 23(B) – What are your views on the take up of this policy by individuals?

23B.1 In ELA's view, most individuals would not choose to become employee owners rather than employees (though note the discussion at paragraphs 8.12 and 8.14).

23B.2 Employee owners will be easier to dismiss than employees. Reduced job security is likely to be a major concern to many individuals; particularly in the current economic environment where there is a lot of competition for each vacancy that arises.

23B.3 Further, as was borne out by the Fourth Work-Life Balance Employee Survey, the availability of flexible working is "very important" for 23% of employees and the importance of flexibility has increased over the last six years.

23B.4 One of the main advantages of employee ownership, as supported by the Nuttall Review, is increased employee satisfaction and engagement. However, these benefits are less likely to be enjoyed by employees in a scenario where they can be easily dismissed and employees are likely to be more concerned about putting forward controversial proposals.

23B.5 The proposal does have some merits from the employees' point of view; primarily that they would be awarded between £2,000 - £50,000 in fully paid up shares. Obviously, individuals would be more likely to embrace the proposal if the shares offered were on the higher end of that spectrum, whereas £2,000 of shares would be quite low remuneration for all the rights that an individual would be giving up. However, it is ELA's view that the prognosis or perception of potential growth in value may be as important if not more important than the initial size of the offer.

23B.6 The proposal also offers capital gains tax relief on any gains arising from the shares that they receive. This is only of benefit if the shares actually do make gains – there is obviously always a risk that the value of the shares could go down (or even that the employer could become insolvent). As has been previously discussed in paragraphs 8.6, 8.11 and 19.3 above, there is already a tax free annual allowance from capital gains tax to the value of £10,600 (in the 2012/13 tax year). Employee owners' shares would therefore have to make substantial gains in order to benefit from anything above the standard capital gains tax allowance that all individuals are already entitled to. Any gains would also be subject to income tax, NICS and (upon sale) stamp duty.

23B.7 It is our view that most individuals would not choose to be employee owners. It offers some benefits but the value of the employment rights that they are giving up and the feeling of security that protection from unfair dismissal provides will outweigh these. It may be a suitable model for a relatively small band of particularly engaged and informed individuals who are not risk averse; perhaps those in the sort of cutting edge, rapidly growing companies at which the proposal is aimed.

13. EQUALITY IMPACT ASSESSMENT

Question 24 – What are your views on the equality impact assessment? Are there other equality and wider considerations that need to be considered?

24.1 The equality impact assessment suggests (amongst other things) that with regard to the right to request flexible working, men and women will not be disproportionately affected. However, in ELA's view, removing the right to request flexible working is arguably to have a disproportionate effect on women as opposed to men.

24.2 ELA is concerned with the limited nature of the analysis. It considers that the Fourth Work Life Balance Survey does not support BIS' findings. Amongst other things:

(a) Women are more likely to work part-time (30 hours or less per week) than men (40% to 13% respectively) (section 2.2);

(b) Women are more likely to take up school term-time working (33% compared to 22%, rising to 42% to 24% for those with dependent children) (table C3.30 and C3.31)

(c) Women are more likely to job share (10% compared to 7%, rising to 14% to 4% for those with dependent children) (table C3.39 and C3.40)

(d) Women are more likely to work flexitime (51% compared to 46% overall; for those with dependent children the figures are 59% compared to 48%)) (table C3.18 and C3.19);

(e) Women are more likely to work temporarily reduced hours (17% to 12%) (table C3.36); and

(f) Women are more likely to work from home (45% to 43%) (table C3.21).

24.3 The only flexible working categories which men take up more than women are those of annualised hours and compressed hours, both of which involve working full time hours but calculated in a different manner.

24.4 The figures used within table 4 of the equality impact assessment show the take up of flexible working by full-time employees. We do not know the source of these figures but they do not match the figures at Table C6.1 of the Fourth Work-Life Balance Survey which are as follows:

	All full-time employees	
	Full-time, flexible working	**Full-time, no flexible working**
Female	42%	58%
Male	39%	61%
All full-time employees	40%	60%

24.5 This shows, in contrast to the figures in table 4, that even in full-time work, women are more likely to take up flexible arrangements. However, using these figures also has an impact on the results; as noted above, more women than men work part-time (as opposed to full-time) hours, which are excluded from the figures in table 4. If these figures were included, no doubt it would illustrate that there is far greater take up across the board of flexible working for women than men.

24.6 Flexible working is also more important to women than men when deciding to work for an employer. According to the Fourth Work Life Balance Survey, 33% of women, compared to 14% of men, say it is very important. 70% of men, compared to 47% of women, say the availability of flexible working is not important.

24.7 It is possible to suggest that any women taking up roles as employee owners know that they are giving up the right to request flexible working and will not therefore be

disproportionately affected. However, although employers cannot compel existing employees to become employee owners, they can choose to only offer new staff employee owner contracts. In theory applicants can seek to negotiate the terms of their employment and ask to be employees instead of employee owners; in practice there is a clear imbalance of power. In the ELA's view many applicants, including women, will therefore be forced into taking a job with employee owner status; in particular given the current competition for jobs and levels of unemployment.

24.8 Therefore, in ELA's view, removing the right to request flexible working is likely to have a disproportionate effect on women as opposed to men.

24.9 Similarly, the headline findings of the report suggest that there could be a disproportionate impact on certain age groups if the right to flexible working was removed. Those aged under 25 and over 60 are more likely to work part-time hours.

24.10 ELA can foresee that given the potential shift in forums for litigation from the employment tribunals to the civil courts (as deliberated above mainly in paragraphs 1.1, 5.1, 10.3 and 23A.3), removing the right to request flexible working may also have a disproportionate effect on groups which tend to be poorer or otherwise would struggle to access the normal courts system. We would suggest that this be an issue to be further examined.

14. ADDITIONAL CONSIDERATION

A. What is the interrelation between TUPE and employee owner status?

25.1 One issue that is not dealt with in the consultation but which ELA feels is essential to address, is the question of what would happen to employee owners following a TUPE transfer. This raises a number of potential issues.

25.2 The right to participate in the share scheme is likely to be a term of employee owners' employment contracts. Under TUPE, a transfer will not operate to terminate the employment contract but will have the effect after the transfer as if the contract was originally made between such employee owners and the transferee

25.3 However, in practice the transferee cannot provide that the transferred employee owners will remain in the transferor's share option scheme after they leave the transferor's employment.

25.4 General case law has determined that in such cases, the transferee may need to offer transferring employees participation in a share scheme of substantial equivalence, although the transferee cannot be obliged to provide a scheme with any unjust, absurd or impossible features.

25.5 It is unclear whether government foresees the same approach. However, if so, this could make companies adopting the employee owner model less attractive to purchasers, as there would be time and cost involved in ensuring that there was a substantially equivalent scheme. If the individuals were able to participate in a substantially equivalent scheme post-transfer, it would seem sensible that their employee owner status would continue with the transferee.

25.6 If it were not possible to offer a substantially equivalent scheme (for example, because the transferee was in the public sector/was a partnership and therefore not able to issue shares), it is unclear what would happen. It would seem sensible that the employee owners would revert to being employees after the date of transfer - otherwise they would have the detriment of employee owner status (reduced employment rights) without the benefit (share ownership). Thought would need to be given to whether they would need to be given some sort of compensation by the transferee, as they would have lost the right to participate in their employer's share scheme/a substantially equivalent scheme. Should their rights be 'bought out' for financial compensation or would the reinstatement of their full employment rights be considered sufficient?

25.7 We consider that there are a number of other issues regarding the interrelation between TUPE and employee owners. For example, prior to a TUPE transfer, the employee owner will not have any rights to unfair dismissal/statutory redundancy pay. Assuming that in some circumstances on transfer the employee owner will revert to being an employee, presumably their employment rights resurrect from the date of transfer (and their continuity of employment will have been preserved under TUPE). They may therefore have sufficient length of service to bring unfair dismissal/redundancy pay claims. However, presumably they cannot rely on pre-transfer events committed by the transferor to found such claims? If they could, this would clearly be an area of concern to a transferee. In addition the existing rules relating to the provision of information before a transfer may require change. We have not considered this in detail given the short time allocated to this consultation but suggest that the issue should not be overlooked

B – If it is intended that tribunals will determine claims in relation to employee owners, tribunal jurisdiction/contracting out rules will require rewriting.

C – The proposal could open the door to tax-saving schemes and may require anti-avoidance provisions to stop employees shuttling around a large group collecting £50,000 of shares each time they take on a new role. This is a particular risk given that it is open to the employer to choose not to require forfeiture of shares on termination.

D – ELA would welcome clarification on the scope of protection for employee owners. For example, will the Acas Code on discipline and grievance apply to employee owners?

E – Has consideration been given to how part time employees will be treated? How will the offer of shares be made to them? The proposal is not clear as to whether this would be pro rata to their time commitment. Given the risk of potential discrimination litigation, this requires careful handling, especially in light of fluctuating share valuations.

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