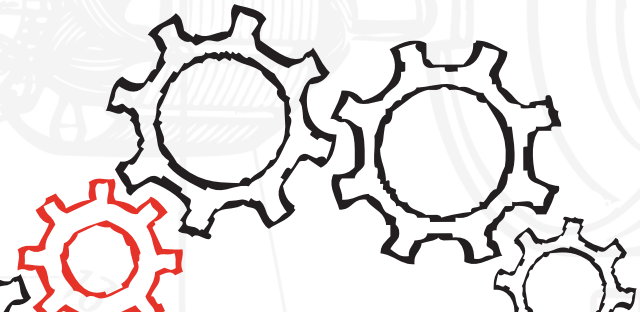
ISSUING EQUITY TO EMPLOYEES

When an inventor builds a machine, he makes sure that he knows how each of the parts work and how they fit together. The more planning and preparation he puts into the machine, the more smoothly it operates when he switches it on. If the same kind of detailed planning and preparation are put into the legal administration of a company, then selling that company should be a much smoother process. The intention of this series of articles is to assist with that planning by looking at some of the cogs in the machine and providing some insight into what each one does.



In the early stages of a company's life, issuing shares is a vital cog in the machine. When cash is scarce, having a pool of value that can be used, at very little cost to the company, to pay employees and even contractors is very attractive. Making employees into shareholders is also a powerful tool for incentivisation, as the value of the shares that the employees hold will depend on the success of the company – so it gives those employees another good reason to contribute to the company's success.

In line with its importance, making sure that this cog runs smoothly requires significant amounts of planning and preparation. Whether a sale or an IPO, problems with a company's equity will usually cause significant problems for an exit transaction – and trying to rectify those problems in the middle of a process can be a costly business.

NONISSUE LTD.

In its early stages, NonIssue Ltd. kept things relatively informal. Rather than bringing in full-time employees, friends and contacts were engaged to do jobs for NonIssue as and when required – and some of them were offered equity as part of their payment. The founders of NonIssue duly kept a record of all of the shares that they had issued, and made all the necessary filings with Companies House.

Unfortunately, NonIssue had failed to check that they had satisfied all of the technicalities of issuing shares. The directors had assumed that they were able to allot and issue shares as and when they wished, but in fact share allotments required authority from the company's shareholders and no such authority had ever been obtained.

This problem was not discovered until the investor putting up the majority

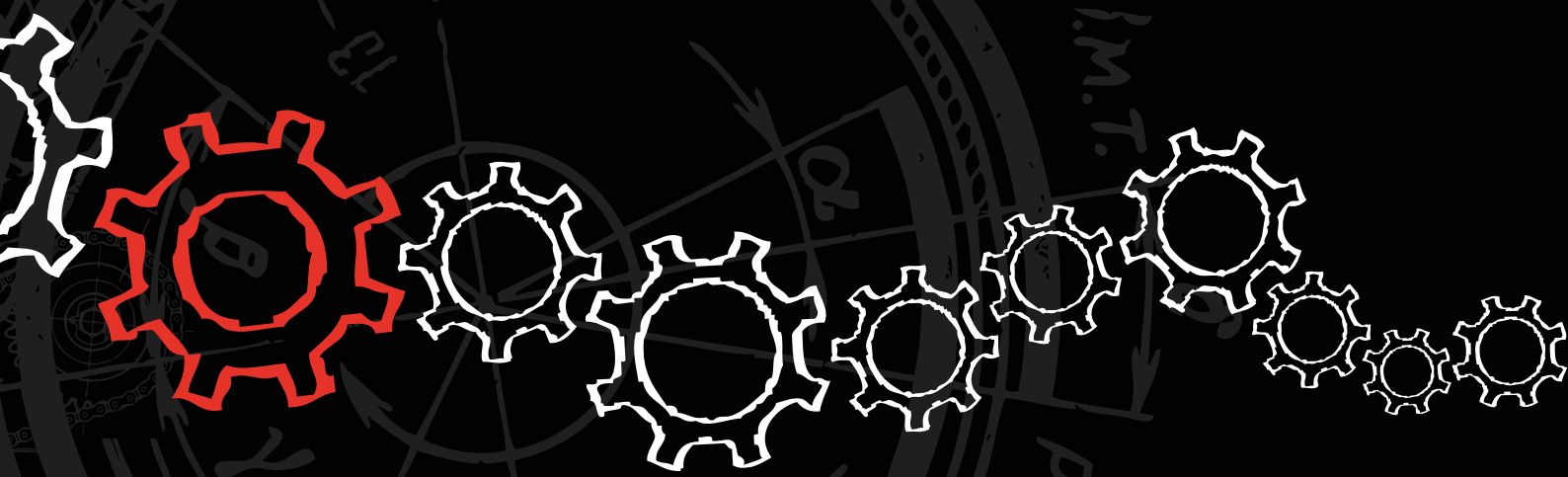
of NonIssue's B round funding brought in its legal advisers to conduct due diligence on NonIssue's records prior to the investment round. NonIssue had never properly engaged with its own lawyers, to keep costs down, and even when an investor in the A round insisted on seeing a shareholders' resolution authorising (among other things) the allotment of shares, the founders did not realise that they had failed to do the same for their other issuances. Once the problem had been identified, the investor agreed to put off the B round for a couple of weeks and NonIssue spent a costly fortnight getting proper authorities and ensuring that the shares were properly issued.

This specific situation should not arise any more - under changes made by the Companies Act 2006, the directors of a private company with only one class of share capital can now issue shares without prior shareholder authority unless the company's articles restrict them from doing so. That said, issuing shares in a company remains a process that requires various technical boxes to be ticked – and, if any are not, the issuance is void. Having to issue shares again, properly, will take time and far more cost than if the company had taken legal advice in the first place – particularly if there is a complication, such as a "shareholder" having sold on to a third party the shares that were never validly issued to them.

MINDCHANGE LTD.

MindChange Ltd. was a start-up that was also using its equity as currency to help finance its development. The pace of MindChange's development was quite rapid – so rapid, in fact, that while they had one particular friend of the business working on Project 1, the completion of Project 2 persuaded the directors to take MindChange in a slightly different direction. As a result Project 1 was no longer needed but, due to poor communication, the contractor remained unaware of Project 1's cancellation.

There was no paper contract between MindChange and the contractor, but there were various email exchanges that



pointed to a contractual relationship - and it was clear from the correspondence that if the contractor delivered Project 1 then he was entitled to a slice of MindChange's equity. Accordingly the board of MindChange, with shareholder authority, resolved to allot and issue shares to the contractor.

Unfortunately, the contractor took personally the decision to change the focus of MindChange. When the board of MindChange remained set on their new direction, the relationship between MindChange and the contractor broke down entirely. At this point, although the shares had been allotted, the contractor had not been entered in MindChange's register of members and hence the shares had not actually been issued.

The directors decided that they no longer wanted the contractor as a shareholder, and as no shares had been issued they believed that they could simply walk away. In fact, having resolved at a board meeting to issue the shares and already having received payment for the shares (the contractor's services), they were obliged to issue them. The mistake went undetected through several years (and funding rounds) – the only reference to it in MindChange's records was the board minute allotting the shares, the significance of which was not noticed in any due diligence process.

In the end it was the contractor himself who brought the issue to light – when news got around that MindChange was being bought out, and he wrote to MindChange asking to be paid out for his shares. Given that the terms of the contract were largely inferred from correspondence there may have been room to argue the point, but with a deal on the table the founders of MindChange rightly concluded that their buyer would not want to deal with the contractor's claim, and had no option but to use some of their sale proceeds to buy the contractor out. Had the problem been recognised at an earlier stage in MindChange's development, the price that the founders would have had to pay to buy out the contractor would have been much lower – or they could have looked more closely at their correspondence with the

contractor and tried to make the argument that the contractor had breached a term of their contract.

MALAFIDES LTD.

If shares are issued properly, the next priority should be to plan the rights and obligations that will attach to those shares. Will employees take the same shares as founders and management, with the same voting and dividend rights, or will there be a new class of shares with reduced voting rights so that employees can enjoy the economic value of the shares but without being able to influence the running of the company? Will there be a class of shares, held by the founders or (more often) an investor that can drag the employee shareholders into a sale? Will the employees' shares have the right (a "tag-along" right) to add some or all of their shares to a sale that someone else has arranged?

Depending on the make-up of the company and its shareholder base you could arrive at many different appropriate combinations of rights and obligations. Longer-term planning, however, is essential as amending the articles of a company to reduce the rights attaching to a class of shares is rarely simple. The law gives protection to shareholders, and changing the articles in a way that reduces or expropriates their rights potentially gives them a claim unless they voted in favour of the change.

Changing the articles to enable a sale of the company, without support from every shareholder, may not be possible at all. MalaFides Ltd. had two classes of share – one class had voting and economic rights, and the other class had only economic rights amounting to around five per cent. of the total value of MalaFides. The shareholders who held the voting shares located a buyer for the company, but the sole holder of the non-voting shares was unwilling to sell – and the articles of MalaFides did not provide the majority with any means to compel him to do so. After a number of offers were rejected, the voting shareholders held an EGM and voted to amend the articles to insert a drag right which could force the holder of the non-voting shares to sell.

The non-voting shareholder brought a claim against MalaFides and the other shareholders, on the grounds that they had added the drag right to the articles specifically to part him from his shares whereas the law requires shareholders to add such rights to articles in good faith and for the benefit of the company as a whole rather than their own interests (i.e. being able to sell their shares). He was awarded a temporary injunction that prevented the sale taking place, and the other shareholders then settled with him out of court.

Had this right been given to the voting shares at the time that share capital was divided into voting and non-voting, there would have been no question as to the good faith of the shareholders – but by failing to plan ahead, the shareholders doubtless ended up paying well over the odds for those non-voting shares. They were also fortunate that their buyer did not balk at the delay, or the knowledge that one former shareholder was taking a robust approach to protecting his position.

CONCLUSION

As these stories show, although issuing equity to employees is a powerful cog in any machine it is also one that demands care and attention. Failing to take care over the technicalities of allotment and issuance, or failing to plan out the rights and obligations that will attach to those shares, will store up expense for the company's future.