Selling Your Creative Business – EMI Opportunities

In this series, Joe Lythgoe and Ayesha Chanda from our M&A team, talk to experts from across Lewis Silkin - sharing their top tips and valuable insights – about selling creative businesses.

During this episode in the series, Joe and Ayesha chat to Michael Birchall, an Associate in our Employee Incentives team, to discuss EMI options and key considerations on an exit.

Ayesha Chanda: Hello and welcome to Lewis Silkin's podcast series '*Selling Your Creative Business*'. The series is hosted by me Ayesha Chanda, an Associate in the Corporate team here at Lewis Silkin.

Joe Lythgoe: And me, Joe Lythgoe, a Senior Associate in the same team. In this series we'll be getting insights and tips from experts across the firm who all use their different areas of expertise to help creative businesses achieve their exits.

Ayesha: In the first episode in the series, we spoke to Jo Evans, Firm Chair and Corporate Partner to get her tips on preparing for an exit. Today, we're here with Michael Birchell, an Associate in our Employee Incentives team to discuss EMI options and key considerations on an exit.

EMI options are a common form of employee incentive and while they do offer a tax efficient option for attracting and rewarding talent, they also present certain complexities when it comes to selling. Hi Michael.

Michael Birchall: Hi both.

What are EMI options and why are they so popular?

Ayesha: So, diving straight in. Can you start by explaining what EMI options are and why they are so popular?

Michael: Yeah, no problem at all. A good place to start is that there are various different types of employee incentives which you could come across on an exit. These can generally be grouped together based on: firstly, the types of companies which usually operate each incentive, and secondly, whether the scheme attracts favourable tax treatment under its legislation, otherwise known as tax advantage schemes. Or, instead, whether it is a non-tax advantage scheme which are commonly known as unapproved schemes.

Enterprise Management Incentive (EMI) options, more commonly known and as we know it, as EMI options, are a type of tax-advantaged share option which are specifically targeted at your smaller, higher risk trading companies. As a type of share of option, the grant of an EMI option does not result in an immediate grant of shares up front. But, instead, the right to exercise the option and acquire shares in the future at a predetermined price per share, known as the exercise price. The hope is that between the grant of the option and its exercise, the value of the shares, over which the option is granted, will increase in value.

And then finally, EMI options are often drafted so that they are only exercisable on an exit. Most commonly a share sale. This incentivises employees to help grow the business as much as possible before a sale occurs.

Joe: So, what's the downside Michael? The employee doesn't pay anything when they get the option and then they just get upside, when it comes to sell. Is that right?

Michael: Exactly right. That's why they're so common as there are very little downsides. And as I'm sure will come on to, one of the only few limitations of EMI options is the limits set by legislation on the type of companies which can grant them.

Why are EMI options so popular for private companies in the creative sector?

Ayesha: Interesting. Well before we get onto those conditions, could you tell us a little bit more about why EMI options are so popular for private companies in the creative sector?

Michael: Yeah, no problem at all. For these types of companies, EMI options are by far the most common type of incentive we come across on a sale and there are various different reasons for this.

Firstly, they are a relatively flexible type of employee incentive. Unlike certain other incentive schemes, companies can pick and choose which employees are granted EMI options. As a result, companies often limit EMI options to their senior employees who are deemed to be a key part of the business. Also, from an admin perspective, they have a low setup cost and then, perhaps, the key reason that they're so popular is that they offer unparalleled tax advantages which are particularly generous for the employees receiving the options.

Broadly speaking, the tax advantages that I mentioned mean that any gain in the value of the shares between the grant of the option, and its exercise will fall within the more favourable capital gains tax regime as opposed to income tax. In addition, on the sale of the shares acquired through an EMI option, the employees may also benefit from what's called Business Asset Disposal Relief formerly known as Entrepreneur's Relief which may even further reduce the tax payable by the option holder.

It's also worth mentioning that an exercise of EMI options results in a corporation tax deduction for the employing company too. It gives benefits to both the employees and the employer company.

Joe: So not only do the employees pay nothing upfront when it comes to sell, they can pay as little as 10% tax on their proceeds. It's pretty good. You see why they're popular.

Michael: That's exactly right.

Why are EMI options targeted at smaller companies?

Joe: You mentioned that EMI options are targeted at smaller companies. Why is that?

Michael: Yeah, this all comes down to those statutory requirements which I mentioned earlier which must be met in order for a company to grant EMI options. For example, eligible companies must have gross assets of no more than £30 million and perhaps, more importantly, eligible companies must have fewer than 250 full-time employees. It's also worth flagging that there are other types of conditions which must be met for EMI options too. But these primarily relate to the type of employees which the options can be granted to, the class of share over which the option can be granted and the terms of the options themselves.

Joe: Would you say that generally most small, creative businesses would expect to be able to grant EMI options?

Michael: Yes, yeah, that's definitely the case. Particularly for your owner-managed and founder businesses.

Joe: But it's always worth having a check to make sure, against proper advice, to make sure that you definitely can. That something doesn't catch you out.

Michael: It definitely is. You don't want any nasty surprises.

What happens if you've granted EMI options to your employees, but your business doesn't meet the conditions of the scheme?

Ayesha: What actually happens if it turns out that those conditions haven't been met and you've granted these options, but they don't qualify for the favourable tax treatment. Do they disappear? What happens to those?

Michael: It's a very good question and it all comes down to the terms of the options themselves. But what we typically see in the option agreements which we come across is that in the situation you described where they don't qualify for EMI for any reason, they instead continue to exist. But just as a non-tax advantage option.

What's the best way to make sure your business meets the conditions to grant EMI options?

Joe: Okay, so you're a small business, you want to incentivise some of your key employees using the wonderful EMI options. What's the best way to make sure that you definitely meet all the conditions so that you won't end up with unapproved share options? Is that something that your team helps with?

Michael: It definitely is and that's something we help our clients with all the time. We're always happy to carry out what we call a health check. So if you have any existing EMI schemes in place, we'll be more than happy to look over their terms and look at the company itself and give a judgment as to whether they qualify for EMI treatment.

""'How do EMI options work during a sale?

Ayesha: Thank you, Michael. So, we've gone through what EMI options are, why they're so popular and you've explained that they're not actually shares that are issued upfront to employees but just an option to eventually exercise that right and receive shares. So, could you explain how that all works in the context of a sale?

Michael: No problem at all. Again, it's the situation that this all ultimately comes down to the terms of the EMI options. But for the EMI options that we come across on a day-to-day basis, you typically see them drafted so that they're only exercisable in connection with certain what we call 'exit events.' These exit events usually include a share sale of more than 50% of the company's shares. These types of options are commonly described as exit only options. For exit only options, they typically become exercisable immediately before completion of a share sale. This means that shares are issued or transferred to the option holders who have exercised their options immediately before completion of the share sale takes place.

This means that when the share sale eventually happens, the option holders can then sell their shares to the buyer and receive their portion of the sale proceeds, alongside the founders of the company. Speaking of founders as well, it's important from their perspective that the options are only exercised immediately before completion. Because if it's done any sooner, the founders shareholding could become significantly diluted for that period. Perhaps even more importantly, the option holders may unexpectedly benefit from any dividend or voting rights which may attach to the shares they acquire.

How do you make exit only EMI options work in reality during a sale?

Joe: Can you just tell us a bit about how that works in practice? Because presumably you can't get all the option holders in a room just before the deal's about to complete to sign something. So, how do you make that work in reality?

Michael: That's exactly right. So, when you're dealing with exit only options on a share sale, the option holders will need to be notified of the anticipated sale in advance. If they then choose to exercise their option, they'll then be required to submit notice of that to the company. And then to the extent any options remain unexercised upon completion, the buyer will be keen to ensure that those options lapse immediately because they will want to hold the entire share capital of the target company post completion.

Timing can be a bit tricky here. The process for informing option holders must be well thought out. Particularly where you've got numerous option holders. The founders will be keen to balance maintaining the confidentiality of the transaction with maintaining the trust of the option holders and giving them enough time to consider and understand the process. And then submit theirnotice of exercise really helps in disregard.

Joe: We've seen it happening where it's been really tricky. For instance, where every single employee in the business has the EMI option so you want to give enough time for them to consider whether they want to excise their option, which they normally do, but the paperwork is a bit fiddly and also as soon as you've told all the employees, it's very difficult if that deal doesn't go ahead. So, it's always an interesting balancing act to decide, when to tell them to get enough time but also to make sure you're comfortable the deal's going to go ahead.

Michael: That's exactly right. And you touched on it slightly there, but if you have the situation where, after notifying the employees, the option holders of the anticipated sale, but for whatever reason the sale doesn't actually take place, it's normally the case that the communications given to the employees and the documents surrounding the options are drafted so that in that unlikely event where the sale doesn't take place, then that doesn't affect the options and they can continue to exist and it will continue to apply for any potential future sale.

Joe: And that's why we involve you right? To make sure that it covers every scenario.

Michael: I'd like to think so.

Ayesha: Michael, in your experience though, as long as the process is explained thoroughly and the option holders are given sufficient detail, they're generally quite happy to go ahead and exercise their option because they generally just stand to gain don't they?

Michael: That's exactly right. In our experience, option holders are usually happy to exercise their options once they have understood that they will receive a portion of the sale proceeds, usually with relatively little risk or liability exposure. But of course, this will depend on the proportion of the total sale proceeds that they'll be receiving.

What are the tax considerations of granting more options during the sale process?

Joe: So, in our first podcast we heard from Jo Evans talking about how important it is to prepare a couple of years ahead of your exit to make sure that EMI options are in the right people's hands, the right number of shares are in the right number of hands. So, when you come to an exit the right people are getting the right amount of proceeds depending on their contribution to the business both historically and going forward. But often, we know it doesn't work out in practice and people will get quite far down the line with a deal process and then they think oh no, we want to grant some more EMI options to make sure that the right people are going to be shareholders immediately before the sale. What are the tax considerations there?

Michael: Yeah, it's a really good point and as we all know, it's a question which comes up quite often. Unfortunately, there's a bit of bad news in that respect when it comes to EMI options. That's because one of the conditions of the EMI legislation is that EMI options cannot be granted once arrangements are in place for the sale of the company. So, what that means in practice, is that once you get to the stage where you're negotiating with a buyer or, for example, you've entered into heads of terms for the sale of your company, then unfortunately it's the case that you're extremely unlikely to be able to grant any further EMI options. So that all goes back to the point again of the earlier you can plan in advance of the sale, the better.

One takeaway for a creative business looking to incentivise employees using EMI options

Joe: Yeah, we often speak to clients when they're just about to embark on their exit journey and we say stop! The first thing you need to do is think about your EMI options. Have you got them checked and do you need to give out anymore? So, thank you Michael, that's all been super helpful, and interesting. What would be the one takeaway for a creative business looking to incentivise employees using EMI options?

Michael: Yep, and you're going to get bored of hearing it, but the key point again just to really get across, is to put it simply, act now. If you're wanting to set up an EMI scheme for your employees you should consider this as soon as reasonably possible and well ahead of any future sale.

Also, we have seen first hand the complexities and issues which can arise if a seller only realises at a late stage and perhaps shortly before a proposed sale that one or more of their targets employees are under incentivised.

Ayesha: That's really helpful. Thank you Michael and it sounds like you and the rest of the team can basically help at every step of the way, from drafting the initial agreement and putting the plan in place, to doing a health check and managing the process on an exit. Is that right?

Michael: That's completely right. We're more than happy to help at any stage of the EMI process.

Ayesha: Great. Well thank you so much for joining us today. It's been great chatting with you. And thank you to our listeners. If you would like more information about anything we've discussed in this podcast, please get in touch with me or Joe and do look out for more podcasts in this series '*Selling Your Creative Business'*. Our contact details are on the Lewis Silkin website alongside some other useful resources.

For more information about anything discussed in this podcast, please get in touch with our team.

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