EMPLOYEE INCENTIVES IN LBOS

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While not as common as among listed companies, employee shareholding plans have witnessed increased success in unlisted companies. The Equalis Index, which measures the share performance (dividends reinvested) of unlisted companies that have implemented an employee shareholding scheme, had risen 12% by the end of June 2019 compared with a year earlier and had doubled over 3 years.

This increase can also be seen in private equity operations even if the trend still remains relatively unnoticed since there are only a dozen such operations every year involving an employee shareholding scheme for a company's staff, besides the management packages that allow managers and directors to invest in the company.

Initially seen as a means to infuse motivation and social cohesion in the workforce, employee shareholding schemes have now become a pillar of corporate social responsibility (CSR) with the social aspect having been enshrined in law by the Pacte Act of 22 May 2019 which amended article 1833 of the French Civil Code. That article stipulated that every company must have a lawful object and be formed in the common interests of the shareholders, to which the new law has added that it must also be managed in line with its corporate interests, taking into account the social and environmental consequences of its business.

It is quite likely that employee shareholding will continue to develop in the future, especially in the case of private equity operations.

Our substantive law provides tools that can respond to the limitations connected to these operations and the expectations of investment funds. The legal arsenal has been enriched by the provisions of the Pacte Act. One of the objectives of that law is to enable a greater redistribution

of value within companies, in particular by promoting and expanding the savings options available to employees.

I Investments in Employee Mutual Funds (FCPE) as part of a Company Savings Plan (PEE)

Employees usually gain the opportunity to be equity holders in their company through an Employee Mutual Fund (FCPE) which comes under the regulated framework of a Company Savings Plan (PEE). Such funds are regulated by the French Financial Markets Regulator (AMF) and managed by a management company also regulated by the AMF.

The establishment of an FCPE, should its formation and AMF endorsement be expected, can be included in the preparation and implementation of a private equity operation. However, establishing an FCPE is a lengthy process – often longer than the buyout – and the energy and focus required to ensure the success of the buyout usually pushes the execution of any employee shareholding scheme until after the end of the private equity transaction.

The rules applicable to FCPEs are suitable to the requirements of controlling interests.

Firstly, an FCPE can hold any type of security, equity or otherwise, issued by the company. This offers a certain freedom and flexibility in terms of the type of investment that can be proposed to employees.

Secondly, the establishment of an FCPE does not deprive the majority shareholder of control over the company's management and ownership structure to the extent that an employee shareholding FCPE may enter into a shareholders' agreement containing standard provisions framing that control.

Moreover, the Pacte Act has added several changes to the PEE system in order to encourage employee shareholding plans.

Employer contributions were previously conditional on the contribution of an employee. The Pacte Act breaks this link and enables the employer to make a unilateral contribution provided it is done for all employees. Article 3332-11 of the French Labour Code, as amended, stipulates that the securities acquired through a unilateral contribution must be held by the employee for a minimum of five years. In addition, the payment of the employer contribution is also encouraged through the lowering of the company's social security contribution for this payment to 10% (previously 20%) for companies with over 50 employees and 0% for businesses with less than 50 staff. However, a decree of 20 August 2019 implementing provisions of the Pact Act has set out the conditions for unilateral contributions and limited them to 2% of the Annual Social Security Cap, which is approximately €800.

Up to now, employees have shown a marked reluctance to purchase securities in their own company, preferring instead to opt for low-risk investments. To redress this lack of enthusiasm, the Pacte Act permits employees to request the liquidation of their holdings in their PEE before the end of the minimum five-year holding period if the cash will be used to buy shares in the company or exercise options granted under the conditions set out in article L. 225-177 or L. 225-179 of the Commercial Code.

Finally, the Pacte Act (with the subsequent order no. 2019-1067 of 21 October 2019) amended article L. 227-2 of the Commercial Code by expanding the opportunities for a simplified joint-stock company (SAS) to offer its securities. It should be recalled that, under the previous regime, article 227-2 of the Commercial Code placed a ban on an SAS to publicly offer its securities unless such offers fell within article L. 411-2 (paragraphs I.2, I.3, I bis and II) of the Finance and Monetary Code, in other words, operations requiring a minimum investment of €100,000 per employee or those reserved for fewer than 150 people (limited range of investors).

With the combined effect of the aforementioned statute and order and with reference to Regulation (EU) 2017/1129 of 14 June 2017 (paragraph 4(i) of article 1), simplified joint-stock companies are now generally permitted to undertake operations where its securities are offered, allotted or to be allotted to existing or former directors or employees by their employer or by an affiliated undertaking provided that a document is made available containing information on the number and nature of the securities and the reasons for and details of the offer or allotment.

Employee shareholding offers will certainly benefit from these provisions of the Pacte Act. But it has also introduced another interesting novelty for employees that should be seized upon.

II Sharing capital gains with employees

The other innovation of the Pacte Act (article 162) also falls within the current trend of impact investing and CSR. The statute has introduced a unique mechanism that allows a shareholder of a company to agree to share with

the employees a part of the capital gains obtained when selling his/her securities.

This undertaking to share capital gains must be stipulated in a contract signed by the securities holder and the company whose securities will be sold; the employees are not party to this contract. The purpose of the contract is to set out the conditions and arrangements for sharing the gains with the employees subject to certain legal restrictions, such as the contract being applicable for at least five years and a limit of 10% on the total realised gains that can be shared.

This contract should stipulate in particular (i) the amount of the capital gain to be distributed as a percentage and, where applicable, as a total value, and (ii) the conditions of eligibility. With regard to the latter, this mechanism must be to the benefit of all employees provided the individual worked for the company during all or part of the period between the signing of the contract and the departure of the relevant shareholder and the length of service required to be eligible is no less than three months and no more than two years.

Such an agreement on the sharing of capital gains also requires the prior existence of a PEE within the relevant company. Any amount shared out under such an agreement will be paid by the exiting shareholder to the company which has to then distribute the gains among the employees in the form of a unilateral employer contribution, either equally among the employees or in proportion to their salary or time at the company.

In practice, this legal mechanism could be used by private equity funds to establish a strong link between employees and the gain in value of the business in which the fund intends to invest. This aspect, like management packages, could become a factor in differentiating between funds competing for the same investment. It will be the responsibility of outgoing shareholders and management of the target company to use it as an important component in assessing acquisition bids.

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All the investment mechanisms mentioned above enable companies and their shareholders to establish employee shareholding plans and the recent changes enacted by the Pacte Act should develop these mechanisms further.

In particular, the possibility of the company to unilaterally contribute to the PEE may well alleviate the reticence of employees to invest their savings in their workplace.

All stakeholders in a company, i.e. shareholders, managers and social partners, will need to acquaint themselves with these arrangements that attach value to the commitment of employees and assist in aligning the various interests within a company to foster its advancement for the benefit of all.