Myerson Corporate

Our guide to Employee Ownership Trusts for Law Firms

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You can find out more about our Corporate EOT Team by clicking here.

Employee Ownership Trusts For Law Firms

With succession planning for law firms continuing to be an underlying challenge, a number of law firms have made the transition to indirect employee ownership under the umbrella of an Employee Ownership Trust (EOT) in recent years.

EOT's are increasingly being seen as a potential exit mechanism which can benefit both the present owners of a law firm and that of its employees. EOTs also carry significant tax advantages and promote employee ownership as a concept and genuine succession strategy. This article will consider the advantages and disadvantages of law firms transitioning to an EOT and the factors that should be considered before pursuing such an ownership model.

Background

EOTs were established in 2014 with the aim of promoting employee ownership as a business model in the UK. The sale of shares to an EOT essentially entails the current owners of a company ceasing to have control of that company and transferring their shares to a trust (the EOT) to hold for the benefit of the current employees of the company who are the beneficiaries of the trust. Subject to limited exceptions all current employees of the company must be included as beneficiaries.

What are the advantages of an EOT for the selling members of a Law Firm?

A key incentive for current law firm owners is the beneficial tax treatment offered to them. The Finance Act 2014 offers 100% relief from CGT provided strict requirements are adhered to, which include (amongst others) that:

- the current owners cease to have control and the EOT acquires more than 50% of the issued share capital of the law firm (this is known as the "Controlling Interest Requirement"); and

- benefit from the EOT must be to all employees (subject to exceptions) and must be on the same terms. However, employees can receive different amounts dependent on their length of service, hours worked and their remuneration.

  Subject to satisfying the criteria, the selling shareholders effectively get a CGT rate of 0% on the disposal of their shares.

The sale to an EOT can offer both the opportunity to the selling members to either working in the firm (which might not necessarily be of appetite to a third-party buyer in a traditional share sale) or allow them to retire and provide a full exit route. The EOT model allows the law firm to continue to operate as it has done to date and can therefore prove an attractive option for law firm owners who wish to preserve the firm's independence and values, which might possibly be lost upon a sale to a third-party buyer or in a merger with another firm.

The sale of shares in a law firm to an EOT can also save time and money as it provides the selling shareholders an exit without the need to find a buyer that will conduct extensive due diligence on the firm (following which they may seek to change the terms of the proposed sale or ultimately withdraw their offer to purchase) and require the selling shareholders to give a series of warranties and indemnities relating to various aspects of the firm's business. Both are not necessarily required or need to be as extensive on a sale to an EOT.

Are there any disadvantages of an EOT for the selling member of a law firm?

As noted above, there are strict qualifying conditions attached to the available tax reliefs. There is therefore a risk that the tax reliefs could be lost if a disqualifying event occurs following the end of the tax year after the one in which the CGT relief is claimed, for instance the Controlling Interest Requirement ceasing to be met. Usually, the trust or the company will therefore undertake not to take steps that would result in the occurrence of a disqualifying event and possibly even indemnify the selling shareholders against the loss of any CGT relief.

It is also important to consider how many shares the EOT can afford to acquire (noting that this is often funded through future profits) and it may be that it takes a significant number of years to fully fund the consideration. There are, however, debt finance (and future re-finance) opportunities available which can help with this.

The primary disadvantage of the EOT for selling shareholders who are not seeking a full exit is the loss of control over the firm. This could lead to conflicts of interest with the selling members of the firm who retain a minority stake. The selling members should therefore be comfortable with this transition of power. A shareholders' agreement may help and is permitted under EOT ownership, provided that it does not indirectly preserve control with the selling members.

Finally, EOT projects are involving projects for most businesses, but even more so for law firms. It is normally a preliminary step for law firms to convert to an alternative business structure (ABS) prior to implementing the EOT.

What are the advantages of an EOT for the employees?

One of the main benefits of the EOT ownership is that it offers indirect employee ownership whereby the shares in the capital of the company are held on trust for the benefit of firm's employees. This is particularly beneficial for senior employees of the firm that might be seen as potential successor owners as under the EOT ownership model there is no individual contribution or liability for any employee of the firm and therefore one of the inherent risks associated with being a direct owner of a firm is removed.

The employees of a firm that is owned by an EOT can also benefit in the future success of the firm and be eligible to receive an annual bonus of up to £3,600 which will be income tax free (although bonuses will remain subject to national insurance contributions). Although this relief is only available if certain conditions are satisfied some of which mirror those that are applicable for CGT relief.

Whilst the employees will not be able to control the direction of the firm, if there is a large employee pool the firm could choose to set up an employee council, whose role will be to listen to the concerns of employees and feed those back to the trustee which may influence how the firm operates.

The sale of shares in a law firm to an EOT can also offer continuity to the current employees as they will continue in their current roles on their present contractual terms and there may be less change than what they may otherwise experience if the firm was sold to a third-party buyer or merged with another firm.

Are there any disadvantages of an EOT for the employees?

There are few disadvantages for the employees, although employees (particularly senior employees) who foresee themselves as future firm owners may feel that there is less scope for this under the EOT ownership structure. However, it is still possible to award employees with direct share ownership or offer share options should it be desirable.

Are there any advantages for law firms?

For the firm itself the EOT ownership model can help improve productivity and in turn the financial performance of the firm, as employees feel incentivised as they have an indirect stake in the firm.

The EOT ownership model can also ensure the long-term security of a firm's values and culture which are likely to be disrupted with more traditional succession options.

EOT ownership can also assist with the recruitment and retention of employees as it can act as a key differentiating factor for a firm in a sector that remains dominated by the traditional law firm ownership models.

There are many more points to consider when transitioning to an EOT, from the detailed requirements for relief, how employees may be rewarded within and outside the EOT ownership, to the effective management of the company and EOT going forward. For more information or assistance please contact our corporate team.

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If you would like further information about how we can help you, or if you have any questions, please don't hesitate to contact a member of our Corporate Team today.

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Because life is rarely **black** and **white.**

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