

Employee shares and stock options (3/31/17)

In today's business environment the remuneration of a company's key employees and management often includes something in addition to fixed salaries and bonuses. Some of the instruments aimed to motivate employees may even be unregulated. In reaction to these market trends, Parliament has passed extensive amendments to the Commercial Code this summer, which, among other things, change the treatment of employee shares and introduce new rules for the issue of employee stock options. This article explores some of these amendments.

Although these amendments were not part of the original version of the bill, proposals for including them in the Commercial Code came up before the second and third reading of the bill and were supported in its final version, which came into force on 13 July 2017. As a result, Latvia has a set of rules governing employee shares and stock options to help fight the shortage of skilled workers, as employee stock options are commonly used to incentivise staff and management elsewhere in Europe.

Employee shares

Although the Commercial Code has contained rules governing employee shares since it came into force, the July amendments change the current rules and create new conditions for issuing employee shares. Under the Commercial Code, employee shares are unalienable registered shares a company awards to its own employees, board and council members or to those of any companies forming the same group and whose total nominal value must not exceed 10% of the company's paid-up capital. So the law provides that not only the company's own employees, board and council members but also those working for other group companies are eligible for employee shares.

A company awarding employee shares can specify various share classes and provide that those are available for a fee or free of charge. Any free shares are paid out of the company's retained earnings. Where a fee is set for such shares, this is paid by the company's employees, board and council members. Another feature is that unlike free shares, those awarded for a fee entitle the holder not only to the company's dividends but also any surplus assets on winding-up. Employee shares paid by their holders entitle them (or their heirs) to a compensation (equal to their share of surplus assets on winding-up) also if the holder of employee shares discontinues their job or dies. Any employee share entitles its holder to vote at general meetings of shareholders and confers other rights if the company's articles of association expressly provide for this.

The general rule under the Commercial Code is that employee shares are awarded for the period during which the employee, board or council member carries out their job obligations. So employee shares will revert to the company at the end of the employee, board or council member status or when the person dies. But this treatment is not mandatory because the company's articles of association and share capital increase rules may provide for a different treatment.

Under paragraph 55 of the transition rules of the Commercial Code, amendments relating to the issue of employee shares will come into force from 2018. If a company has awarded employee shares to an employee or board member before 2018 and terminates employment with the employee or the board member is recalled or resigns, then any dealings with those employee shares will be governed by the rules in force on the date they were acquired.

Employee stock options

The inclusion of employee stock option rules in the Commercial Code was a very welcome move because this gives the owners an extra way of motivating their existing and potential staff. The employee stock option rules are very similar to the Commercial Code rules for convertible bonds, and so it is no surprise that the issue of employee stock options is governed by the Commercial Code rules for convertible bonds. An employee stock option is a security that entitles the company's own employees, board and council members or those working for other companies within the same group to acquire the company's shares. The company's right to issue employee stock options is restricted by the requirement that the total nominal value of shares that can be acquired by exercising employee stock options must not exceed 10% of the company's paid-up capital on the date it decides to award employee stock options.

A company can provide that the exercise of employee stock options is for a fee or free of charge. If the exercise of employee stock options results in an employee, board or council member acquiring shares free of charge, or for a fee below their nominal value, the shares will be issued at the expense of the company's retained earnings or out of a special reserve it has set up for the issue of such new shares.

Along with the decision to issue employee stock options, the company should approve its rules for the issue of employee stock options, giving the information prescribed by sections 245 and 248.1 of the Commercial Code. To account for employee stock options and any employees, board and council members holding them, the company should keep a register of employee stock options, detailing the employee stock option holders, the conversion of employee stock options, stating how many employee stock options are held by each holder, their nominal value and number, and how many shares can be acquired by each employee, board and council member as a result of conversion.

Given the personal nature of employee stock options, a company's employees, board or council members holding its employee stock options are permitted to dispose of them only if the company's articles of association or employee share issue rules provide for this.

Tax implications

Section 9(1)(43) of the Personal Income Tax Act provides that subject to several statutory criteria being satisfied, any income arising on the exercise of stock options awarded to an employee, council or board member under a contract of employment by the employer or by a company related to the employer, is excluded from the person's annual taxable income and is not taxed as long as the stock options have been awarded in line with a stock option exercise plan.