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TITLE

Employee stock ownership, comparative analysis of ESOPs and designation of legal omissions and risks of the Armenian Legislation

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Employee stock ownership, comparative analysis of ESOPs and designation of legal omissions and risks of the Armenian Legislation

Introduction	3
Chapter 1	4
Introduction General Information on Employee Stock Ownership and ESOPs	4
Chapter 2	10
Positive and Negative aspects of Employee stock ownership (ESO)	10
Positive aspects of Employee stock ownership	10
Negative aspects of Employee Stock ownership	12
Chapter 3	15
Introduction of Stock ownership envisaged by the legislation of the RA	15
Regulation envisaged by the Law on Joint Stock companies of RA	15
Regulation envisaged by the Law on Limited liability companies of RA	20
Conclusion	23
Bibliography	23

Introduction

This paper thesis aims to provide data on historical background and contemporary development of the phenomenon “Employee stock ownership”. Taking into consideration the overall regulation and its recorded success so far, in this thesis I put more emphasize on the Employee stock option plans which is considered to be the most successful and widespread method in the world in terms of implementing employees financial participation.¹ The main research question is the following:” Employee stock ownership, comparative analysis of ESOPs and designation of legal omissions and risks of the Armenian Legislation”. This research also aims to provide information on the expedience and necessity of implementation and operation of Employee stock ownership schemes meticulously estimating all the advantages and drawbacks of the latter and focusing on the associated problems from the viewpoint of legal regulation and from the viewpoint of corporate governance.

In this regard, Armenian legal regulation is pushed forward as Armenia represents a developing economy where there is an increasing demand by recruiting companies especially by newly established IT companies to exercise Employee stock ownership schemes. Through my paper I thoroughly examined the regulating provisions envisaged by Labor code of the RA, Tax Code of RA, the law on Securities market of the RA, the law on Joint Stock companies etc.,

This thesis paper will consist of an introduction, four chapters, a conclusion, and a bibliography. The **Introduction will present general information and provide evidence on the expediency and necessity of the research.** **Chapter 1** will study up-to-date developments in the sphere of employee stock ownership, employee stock ownership schemes mainly focusing on employee stock option plans its methods and mechanisms of implementation from the perspective of international best practice. The Chapter will also cover Tax benefits prescribed for each of the discussed mechanisms. **Chapter 2** will illustrate negative effects and positive effects of the Employee stock options elaborating associated legal and managerial problems taking into consideration the interests of capital providers and labour providers. **Chapter 3** is designed to introduce relevant regulation of the issue

¹ Startup Employee Stock Options Plans (ESOPs) Overview and Best Practices available at <https://content.accion.org/wp-content/uploads/2018/08/Employee-Stock-Option-Plans-ESOP-Best-Practices-2.pdf> retrived on 05/05/2019

according to Armenian legal framework. The analysis will be mainly substantiated upon the provisions of the law on Limited liability companies, Joint Stock companies, revealing legislative gaps of Armenian legislation. Relevant provisions of Armenian Tax Code and Labor Code will also be analyzed in order to obtain the comprehensive overview of the regulation. **Conclusion** will outline main findings of the research and will be followed by a bibliography.

With this research I have had a preliminary objective to have my contribution in the development of the sphere and promote the awareness among business owners. In the scope of my research I come up with respective recommendations, after spotting all the latent risks and gaps existing in the current regulation. My choice of the topic first of all is conditioned by the increasing demand of the market, as well as by the absence of advisory and explanatory documents that could serve as guidelines for the recruiting companies that seek methods to offer shares to the employees. In case of efficient implementation this structures tend to balance and align interests of capital providers with those of labor providers giving the opportunity to attract and retain talents not only from Armenia but also overseas as well as furnish long term investment opportunities for newly set up companies. The underlying rationale behind the popularity of Employee stock ownership concept is the common belief that the Employees financial participation positively affects corporate performance of the companies. My research will represent various variables and effects of ESO through comparative analysis, basing upon different criteria such as comparing its efficiency in terms of size of the company in terms of the scope of availability of foreign participation.

Chapter 1

Introduction General Information on Employee Stock Ownership and ESOPs

Today, in the 21st century the most crucial investments are those made in human capital. People, values, and know-hows created by them increasingly become the most important asset in the capital of every company. Majority of these companies implement innovative mechanisms in order to attract new and talented employees, remain competitive in the market and provide additional economic guarantees to the employees to stay and grow within the

company. Being considered as part of compensation package² employee stock ownership encourages strong commitment and motivation among the employees, boosts employee job satisfaction and financial wellbeing by providing complementary financial incentives.³

During the last few decades there has been a touchable increase in the application and interest towards Performance related pay hereinafter referred to as (PRP). Actually there are 2 types of PRP:

- group incentive schemes and
- Individual incentives schemes⁴.

Individual incentive schemes tend to evaluate and reward individual performance of an employee. While in case of exercising a group incentive scheme, there is a robust correlation existing between the compensation package of the employees and the overall performance of the company. In this sense, group success is a viable factor to ensure dual satisfaction from the point of view of shareholders and from the perspective of employees. Employee stock ownership schemes among other types of employee financial participation such as profit sharing, broad based option sharing etc. are classified as group incentive schemes⁵. In this regard, many jurisdictions have implemented various plans to boost the acquisition of shares by employees. ESOPs have become widespread in the world during the past few decades.⁶ Historically, envisaged for top managerial positions as a part of their compensation plan, they have become popular among non-managerial employees as well. Actually, employee ownership can be exercised in a variety of methods, for instance employees can buy stock directly, they can be awarded a fraction of shares as a bonus, or they can receive stock

² Investopedia <<Employee Stock Options: Definitions and Key Concepts>> retrieved on 05/05/2019

² <<Getting Started In Employee Stock Options>> retrieved John Olagues and John Summa retrieved on 06/05/2019

³ Investopedia Employee Stock Options (ESO)

<https://www.investopedia.com/university/employee-stock-options-eso/> retrieved 05/05/2019

⁴ Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange (page 1)

⁵ Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange (page 1)

⁶ ESOP: A Viable Option for Retaining Key Employees? Available at <https://www.cleverism.com/esop-viable-option-retaining-key-employees/> on 05/05/2019

options, or obtain stock through a profit sharing plan.⁷ ESOPs usually pertain convenient tax regime, lower taxes and therefore it has become an important issue to consider for policy-makers, managers, and employees.

International best practice testifies that implication of Employee stock ownership increases overall performance and profitability of the company.⁸ It provides the employees of a sponsoring company with an opportunity to be involved in the corporate governance and in the management of that company. With an efficient use of Employee stock option mechanisms, hierarchy is diminishing rendering the corporate governance more efficient and collective. In other words, employee stock ownership combines ownership and control rights aligning the interests of capital providers with those of labor providers and representing a new approach in the Corporate Governance theory. Historically, The ESOP concept itself dates from the 1950s, and is attributable to San Francisco lawyer and investment expert Louis Kelso. In 1956, Kelso was invited to San Francisco and arranged the first ownership transfer to employees.⁹ He argued that capitalism would benefit from wider ownership of productive assets, and found employee ownership as a way of overcoming fundamental divisions between capital and labor. Louis Kelso considered that if workers received a greater share of profits they would be less likely to join unions or to seek wage increases, thus by spreading ownership, capitalism would become a stronger economic system. Louis O. Kelso once mentioned, “Thus, if you have a thousand people working in a factory and you increase the design and power of the machinery so that one hundred men can now do what a thousand did before, conventional wisdom says, ‘Voila! The productivity of the labor has gone up 900 percent!’ I say ‘hogwash.’ All you have done is wipe out 90 percent of the jobs, and even the remaining ten percent are probably sitting around pushing buttons. What the economy needs is a way of legitimately getting capital ownership into the hands of the people who now don’t have it”.¹⁰

⁷ How an Employee Stock Ownership Plan (ESOP) Works National center for Employee ownership?

⁸ Harvard Business Review How Well Is Employee Ownership Working?

<https://hbr.org/1987/09/how-well-is-employee-ownership-working> retrieved 05/05/2019

⁹ (Louis O. Kelso, Journal Asset Based Finance, 1982)

¹⁰ (Louis O. Kelso, Journal Asset Based Finance, 1982)

Considering its beneficial impact on overall performance of the companies and attributable benefits, the number of Employee stock option plans (ESOPs) has increased dramatically in recent years.¹¹ Employee stock option plans refer to the engagement of employees in corporate management of the company, as well as they represent additional financial guarantees for them. Through an ESOP, the sponsoring company awards a fraction of ownership in the firm to its employees, which gives employees not only residual, claims but also voting rights depending on the particular plan.¹² Employee stock option plans abbreviated as (ESOPs) are described as employee benefit plans that are used as a financial tool transferring ownership and providing an opportunity to the employees of a sponsoring company to invest in its stock. In this regard it is important to ascertain the differentiate existing between Employee stock option plans and Employee stock ownership plans. Interestingly, the term Employee Stock Option Plans is often confused with Employee Stock Ownership Plan, but the latter is under totally distinct regulation and is considered a retirement plan. ESOPs offer a number of benefits to shareholders of the company as well as to the employees.¹³ Historically, in 1999 11,500 ESOPs existed in the US, and correspondingly around 8 per cent of US and corporate equity was owned by the employees.¹⁴ Early ESOPs in the UK were initiated after April 1990, when 350 bus drivers, administrators, maintenance and garage staff of Chesterfield Transport bought the company that employed them from Chesterfield Borough Council¹⁵ through the use of credit organization mechanism.

So, on the one hand ownership portion in the company gives employees additional psychological and financial incentives of productivity impacting corporate performance; on the other hand, various conflicts of interest arise between different corporate actors mainly between major shareholders and employee stockholders, as they represent different interests. Studies suggest that ESOPs that succeed the most are those with larger number of outside shareholders who do not directly participate in the management of the company. Those cases

¹¹ ESOP: A Viable Option for Retaining Key Employees? Available at <https://www.cleverism.com/esop-viable-option-retaining-key-employees/> retrieved on 05/05/2019

¹² Employee Stock Ownership Plans, Firm Performance, and Monitoring by Outside Blockholders, Sangsoo Park & Moon H. Song, 1995

¹³ A Comprehensive Guide to ESOPs Crowe Horwath

¹⁴ Pendleton, Andrew.; Employee Ownership, Participation and Governance : A Study of ESOPs in the UK

¹⁵ Pendleton, Andrew.; Employee Ownership, Participation and Governance : A Study of ESOPs in the UK

diminish the level of collision and interest rendering the management of the company more effective and productive.

ESOP is used to transfer some portion of equity of the company to employees under the long-term investment schemes. In order to effectively exercise an ESOP issuing companies shall conclude contracts with their employees enabling them to buy a specific number of the company's shares at a fixed price within a certain period of time.¹⁶ The main underlying rationale behind this scheme is that the employees usually acquire shares at predominated price and eventually sale them with higher than the preliminary granted price of the options. These schemes also aim to provide wider market for shares providing the companies with investments and boosting the securities market.¹⁷ ESOPs provide peculiar schemes of attracting, retaining and encouraging talented employees. However, it is important to consider that Employee stock option plans are just options that could be purchased at a specified price before the exercise date. The mere fact that company has issued stock options does not entitle the employees with ownership rights towards company's shares. Moreover, the title of ownership is transferred only after the conclusion of sale and purchase agreement which shall take place after the vesting period and before expiration period stipulated by the contract. There are defined rules and regulations laid out in the Companies Rules which employers need to follow for granting of Employee stock ownership plans to their employees.¹⁸ ESOP's usually include the engagement of one or more trust funds in order to acquire, hold, and distribute equity to employees. There are also another mechanism that ensure employee stock ownership.

The preliminary Employee stock option plan was designed with the following structure. Companies were selling shares to a special institution that had raised its funds through loan obtainment. This institution would purchase the shares through use of the loan amount. Correspondingly, the firm would acquire the proceeds of the loan from the ESOP but would contribute over time to the ESOP afterwards. Loan proceeds were being paid by the

¹⁶ US securities and Exchange commission <<<https://www.sec.gov/fast-answers/answers-empopthtm.html>>> retrieved on 06/05/2019

¹⁷ Investopedia Employee Stock Options (ESO) <https://www.investopedia.com/university/employee-stock-options-eso/> retrieved on 05/05/2019

¹⁸ ESOP – The employer perspective <<<https://cleartax.in/s/esop-retrived>>> 06/05/2019

institution while the sponsoring company was paying off the loan amount releasing shares and transferring the subsequent amounts to the bank accounts of the employees.

With the development of sound regulation and policy, it increases investor confidence in investing in the stock market Employee Stock Ownership Program is important for the development of economic solutions in the market not only because of employee stock proprietary programs performing such a key role but stimulating economic growth in these markets with huge capital needs.

Typically, there are 2 preliminary types of stock options that the companies offer to their employees: incentive stock options hereinafter referred to as ISOs and non-qualified stock options hereinafter referred to as NSOs. First of all, NSOs in contrast to ISOs pertain to wider cycle of people engaged and through the efficient use of ESOP companies offer options for not only executive employees and top management of the company but also to non-executive employees, inter alia, consultants, lawyers, and in some cases even outside directors.¹⁹ Major difference between these types of stock are the differences in tax treatment. ISOs are targeted to the group of executive employees and top-management to which the company provides additional incentives. Researchers suggest that with prudent and professional tax planning the companies have the opportunity to minimize the taxes.

Chapter 2

Positive and Negative aspects of Employee stock ownership (ESO)

Positive aspects of Employee stock ownership

Employee stock ownership schemes have gained much attention among lawyers and economists as an efficient mechanism of compensation plan, as well as successful model of combining ownership and control rights. The negative and positive aspects of Employee

¹⁹ Getting the most value from your employees stock options [David Rae](https://www.forbes.com/sites/davidrae/2018/09/04/your-employee-stock-options/#17b912142e6e)
<<<https://www.forbes.com/sites/davidrae/2018/09/04/your-employee-stock-options/#17b912142e6e>>>
retrieved on 06/05/2019

Stock Ownership have become one of the most discussed and controversial topics during the last few decades.

The most attributable positive characteristic of Employee stock ownership is that it encourages workforce to put more efforts and energy and also retains human capital. The vision of probable ownership gives further incentives and motivation to the employees, improves their commitment towards the company, inspiring them to do more than expected by the simple Employment agreement. One of the main questions that arise in the context of discussions on Employee stock ownership is whether it results in positive change in terms of profitability of the company:

It is important to note, that according to majority of the researchers success of the company does not depend only on the single factor, whether the company offers shares to its employees or not. In this context, we shall assess the efficiency of the ownership structure, the extent to which employees are engaged in corporate governance of the company and the quality of their decision making. Therefore, the mere fact that employees are involved among other shareholders and have some fraction in decision making process depending on particular ESOP cannot guarantee a compelling success for the sponsoring company.

These mechanisms are also beneficial for shareholders to gain additional sum of money, since there exists special tax treatment for ESOPs depending on the jurisdiction ameliorating shareholder wealth. In this context, shareholders are also free to choose and reward their preferred group of people as shareholders, and there are industries such as banking industry, where it is very crucial to keep closed cycle of engaged people. Thus, coming from the protection of interests and confidentiality issues, employees who are already well informed about all the procedures of particular company are insiders and there is higher level of trust and certitude.

Japanese example in shared capitalism²⁰ is also highly representative, since from 1989-2013 more than 75% of all publicly traded companies listed on Tokyo Stock exchange were

²⁰ Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange (page 1)

offering shares to their employees.²¹ According to Tokyo Stock Exchange (TSE), in 2013, 91 percent of firms listed on TSE are reported to have ESO plans.²² Japanese ESO model suggests that increasing the stock option fraction for the existing employee stockholders is more efficient in terms of capital gain of the company than the involvement of new employees. Moreover, an interesting correlation have been found out, studies have shown that the success of ESO is related to size of the companies and the number of international investors, as these two factors complement to each other the employee stock ownership serves as an internal monitoring while international investors serve as external monitoring to mitigate risks and counterbalance.²³ It is notable to mention that in Japan executives of the company are not eligible to obtain stock options of the company. Japanese regulations of the law envisage a unique scheme of employee ownership opportunity it's the establishment of Trust fund by the company. Participation is on the voluntary basis and there are no tax-qualified incentives for the establishment of Trust funds. Participants are free to quit the fund whenever they want on the other hand reentrance is highly limited, they are also bound to sell their stock upon retirement at their market price.

Another major advantage is that ESOP stands as a working defense mechanism to overcome takeovers²⁴. Companies from time to time face financial difficulties and other competitor companies may purchase majority stake of particular company resulting in takeovers. In order to defeat takeovers long-term investment shall be exercised. So, an employee-owned portion of equity can balance the financing of the company and block takeovers, since employees are likely to encourage decisions taken by the management and cooperate with them. The most well-known case is the one of the Polaroid Corporation which managed to resist a hostile take-over by Shamrock in 1988 by an effective establishment of ESOP²⁵. The

²¹ Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange (page 1)

²² Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange (page 1)

²³ This study is conducted as a part of the Project “Frontiers of Analysis on Corporate Governance: Risk-taking and Corporate Governance” undertaken at Research Institute of Economy, Trade and Industry (RIETI) and as a project at Tokyo Stock Exchange.

²⁴ Employee Stock Ownership Plans and Shareholder Wealth: An Empirical Investigation Saeyoung Chang

²⁵ SHAMROCK HOLDINGS, INC. v. POLAROID CORP CIV. A. NOS. 10075, 10079.559 A.2d 257 (1989)

presence of the ESOP prevented Shamrock from acquiring the 85 per cent of equity or two-thirds of the votes necessary under Delaware law to permit immediate take-over.

Furthermore, the owners of the companies usually prefer to sell their business to key employees instead of competitors in the market, since they possess all trade secrets know-hows and documentation. Thus, from the best interests of the business it is the most prudent strategy to exit the company.²⁶ On the other hand these key employees may need further time and financial resources to be able to buy the company. In those cases establishment and effective operation of an ESOP will be a perfect alternative.²⁷

Negative aspects of Employee Stock ownership

Some researchers argue that the most commonly mentioned limited effectiveness of ESOPs is the free-rider effect that is caused due to the alignment of interests of the employees and shareholders. After the successful establishment of stock ownership plans there are fewer incentives to monitor shareholder employees, as after employee stock ownership the interests of the shareholders align with those of employees and control and ownership are not clearly separated in this regard. Due to a free-rider problem, highly diffused equity ownership among employees does not affect employee incentives and thus firm performance²⁸, the number of shareholders is increasing day by day, they benefit from the production of the company and do not make efforts to increase the firm value. Free rider problem is a fruitful area of inquiry specifically for large scale companies. In order to overcome this problem studies suggest the elaboration of peer monitoring and peer pressure imposes discipline in order to restore productivity results.²⁹ This mechanism works when a team is organized at a size that makes peer monitoring possible, and when there are expectations of a long-term relationship with

²⁶ This study is conducted as a part of the Project “Frontiers of Analysis on Corporate Governance: Risk-taking and Corporate Governance” undertaken at Research Institute of Economy, Trade and Industry (RIETI) and as a project at Tokyo Stock Exchange.

²⁷ Employee Stock Ownership Plans A business-perpetuation planning tool worth considering Chuck Coyne, ASA

²⁸ The Illusive Performance Effect of ESOPs: Evidence from China’s Reform Experiment* Xiangdong Ning School of Economics and Management Tsinghua University Beijing, China

²⁹ Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange

colleagues. On the other hand the overall effects of ESO plans on the smaller sized and recently incorporated companies are not investigated.³⁰

Another associated problem is in the core of agency theory. Agency problem becomes especially critical, when top management of the company acquires shares. The managers are more inclined to be opportunistic and take actions that are in their personal interest at the expenses of owners. Employee stock options are conceived as a mechanism to combine the conflicting interests of managers with those of shareholders, but in this case managers serve as both trustees and beneficiaries.³¹ Employee ownership would promote information sharing, thereby reducing asymmetries of information between managers and workers, and also monitoring of workers by each other. However, the danger of employee ownership is that it dilutes incentives and control rights and for this reason institutional investors usually place limits on the amount of equity that they are willing to share with employees. Stock options give management adverse incentives to invest in venturesome projects, putting emphasize on their own profit rather than the overall profitability of the company.³² Option holders usually possess a trivial fraction of company stock to bear the loss and the consequences of taken dangerous decisions are often carried out by the major shareholders. Option plans dramatically increase compensation plans for top management for instance, company A gives its CEO an option to buy 1% of its stock at current price, and that the CEO has the authority to decide on whether to take such schemes. In his or her own interest, the CEO will take Company B into the scheme. If the scheme is a success, the CEO's 1% of the stock will be worth \$10 billion times 1% or \$100 million. The exercise price at 1% of the current value \$1 billion is \$10 million.³³ There are also risks associated with employee stock ownership.³⁴ One of the examples of risks regarding the employee stock ownership is the possible conflict of interests between shareholder employees and non-shareholder employees, which in its turn

³⁰ Does Employee Stock Ownership Work? Evidence from Publicly-Traded Firms in Japan Takao Kato Colgate University, Tokyo Stock Exchange, IZA, TCER, CJEP, CCP, ETLA and Rutgers University Hideaki Miyajima Waseda University, IAS, RIETI and Tokyo Stock Exchange Hideo Owan Waseda University, RIETI and Tokyo Stock Exchange

³¹ The Fusion of Privilege and Power: ESOPs in Theory and Practice Craig P. Dunn and Catherine M. Daily

³² Calvin H. Johnson The University of Texas School of Law Page 1

³³ Calvin H. Johnson The University of Texas School of Law Why Stock and Stock-Option Compensation are Such a Terrible Idea Page 2

³⁴ Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure Michael C. Jensen, William H. Meckling

will negatively affect the working atmosphere. In order to circumvent such situations, shareholders shall represent some list of prioritized employees that correspond to this role of a shareholder by elaborating special mechanism with introduction of transparent and legitimate criteria.

In addition, employees and shareholders represent adverse and conflicting interests that may collide and in that case the efficiency of a company will be at stake. In this regard we shall differentiate 2 kinds of decision making³⁵

Participation in the corporate governance of the company (strategic decision making). Some researchers suggest that too much involvement of employees in the management may emanate to negative results and have adverse effect resulting into unproductivity and non-professionalism towards corporate governance. It is crucial to mention, that when employees are not experienced in decision making especially in cases when they had not occupied top managerial positions, their involvement may negatively affect the speed of taking decisions as well as the quality of taken decisions.³⁶

Participation to the day to day management (work decisions) of the company³⁷. On the other hand, employees are much more concerned and experienced in making day to day management decisions in order to promote information sharing and encourage commitment satisfaction from their work and employment.

Chapter 3

Introduction of Stock ownership envisaged by the legislation of the RA

Regardless of the fact that recently there has been a touchable increase in corporate culture of Armenia, today employee stock ownership plans are not very much applied and demanded. The expediency and demand of ESOPs strongly depends on the lack of efficient and lucid

³⁵ Pendleton, Andrew.; Employee Ownership, Participation and Governance: A Study of ESOPs in the UK

³⁶ Employee Stock Ownership, Involvement, and Productivity: An Interaction-Based Approach Andrew Pendleton*, Andrew Robinson*

³⁷ Employee Stock Ownership Plans, Management Motives, and Shareholder Wealth: A Review of the Evidence

regulation envisaged by the legislation of the RA. Today, most of reputable Law firms and IT companies seek methods to provide (stock) shares of the company to the employees in order to ensure better economic incentives of work, as well as create tight and close interconnections with employees holding key people within the company. This ownership opportunity also aims to make the employees work harder and be more enthusiastic and committed towards the company fostering the latter to reach its heyday of profitability.

Following Armenian Velvet revolution of 2018³⁸ change in the existing power occurred which also symbolized and initiated the start of “Economic revolution”. Newly elected Prime Minister Nikol Pashinyan stated “*We are going to replace the old economic model with an inclusive economic system meaning that all the citizens of the Republic of Armenia will have equal opportunities, accessibilities, liberties to carry out economic activities and be equal in the eyes of the law and tax services.*” Therefore, in the context of “Economic Revolution” employee stock ownership and employee stock option plans are a great topic to touch. However, regardless of the existence of specific regulating provisions in the Law and political will, the topic is not very much discussed in Armenia and there is total absence of case law on this matter. Legislative gaps create obstacles in the way of recruiting companies to offer, as well as for their employees to obtain stock (shares) of the company. Thus, it is important to mention that there are a great number of latent and evident legal risks.

Section 2 Regulation envisaged by the Law on Joint Stock companies of RA

ESOP is so far considered to be the most common and widespread legal tool to exercise employee stock ownership in the world.³⁹ The law on JSC’s of RA does not determine the notion of stock option. The definition of the concept stock option is found in the decision of the board of Central Bank of RA. Provided by part 11 of the above mentioned decision “*Option Transaction or Option*” is an agreement by which one party the option buyer acquires the right to sell (buy) a fixed asset within the time and price specified in the contract and the other party option seller assumes the acquisition of that asset.⁴⁰ It is notable that the opportunity to exercise Employee Stock Ownership in Armenia is regulated by Article 41 of

³⁸ Velvet Revolution and Political Developments in Armenia

³⁹ National center of employee ownership “ How an Employee Stock Ownership Plan (ESOP) Works”

⁴⁰ Part 11 the decision of the Board of Central bank of RA

the Law on Joint Stock Companies.⁴¹ According to above mentioned article, company staff may receive staff shares, which can be ordinary or preferred. Through the analysis of this provision a question arises regarding the target group of the regulation, it is not clear whether this opportunity may be granted to all the employees of the company or is specifically tailored for top executive management. In this regard, every company has different approaches of corporate governance, management structure and priorities and it would be suggested to make an amendment in the law and regulate this issue by the Charter of the company explicitly specifying group of recruits to whom staff shares may be offered to.

While discussing the opportunity to acquire staff shares, which can be ordinary or preferred it is notable to talk about voting powers pertaining to each type of share, putting emphasize on the possibility of participation in the corporate governance of the company. Consequently, pursuant to the regulation of the Law on JSCs⁴², holders of preferred shares will be deprived of voting rights, but on the other hand preferred shares furnish the holders with diversified portfolio of risks and stable proceeds, regardless the profits of the company. On the other hand, in case the employee has a primary objective to participate in the decision making process of the company, he/she will have no positive result, besides economic benefit pertaining to that portion of share. Taking into account possible collision of interests between shareholders and employee-shareholders in the context of Armenian corporate practice it would be advisable to establish an ESOP offering only preferred shares to the employees. It would be more acceptable from the perspective of major shareholders, as the level of conflicts of interest will diminish; furthermore, preferred shares will furnish the employees with an opportunity of fixed stable dividends and diversified risk.

Alongside with the development of corporate governance it will also be suggested to make amendment in the Law prescribing more classes of shares besides ordinary, preferred and convertible ones designed specifically for ESOPs and pertaining different rights and obligations based upon the practice area and corporate history of the companies and in case of necessity putting some restrictions on the voting powers.

⁴¹ Article 41 of the Law on Joint Stock companies of RA

⁴² Article 41 part 5 the Law on Joint Stock companies of RA

The next question that arises is the regulation of priority rights with regard to share acquisition among other shareholders of the company. Particularly, according to the Law, the shareholders have preferential rights to acquire shares in relations to third parties.⁴³

Therefore, the risk is that the law does not specify whether the company's employees are considered to be third persons within the framework of the ESOP or not. There is also a risk from the perspective of the employee that at the end of the vesting period they will not receive their shares because of exercise of preferential rights by the shareholders. It can be concluded, that the company may buy back or issue new shares for the staff reserving them in the special fund, however, there is no any statutory provision prohibiting the shareholders to exercise their preference right in case of the ESOP implementation. In this case, I suggest an amendment in the law stating that in terms of implementing ESOPs employees are not considered third persons in the process of acquisition of shares.

The law also prescribes a limitation stating that Employee shareholders shall not possess more than 25 percent of the equity of the company.⁴⁴ For comparison, in the USA the total amount of shares that can be issued for the operation of ESOPs is based on the decision of Board but typically ranges from 5% to 20% of the company's outstanding stock. Generally the recruits who did not participated in the establishment of the company get 15-20% of the company; in case of specific companies under certain conditions the percentage may reach up to 25%.⁴⁵ German regulation over ESOPs is much restrictive. According to section 193 paragraph 3 and section 71 of the German Stock Corporation act,⁴⁶ total amount of shares granted to employees through option plans shall not exceed 10% of its nominal capital of the company.

Through the comparative analysis it is evident that the extent of shares that can be offered to employees in terms of ESOPs according to Armenian legislation is not low and corresponds to international best practice. However, the regulation may give rise to problems related to restriction of percentage of stock that can be distributed to the company staff. Whereas, if the

⁴³ Article 47 part 1 The Law on Joint Stock companies of RA

⁴⁴ Article 41 part 1 The Law on Joint Stock companies of RA

⁴⁵ Startup Employee Stock Options Plans (ESOPs) Overview and Best Practices available at <https://content.accion.org/wp-content/uploads/2018/08/Employee-Stock-Option-Plans-ESOP-Best-Practices-2.pdf> 05/05/2019

⁴⁶ German Stock corporation Act Aktiengesetz (section 192,71) available at <https://docplayer.net/4833637-German-stock-corporation-act-aktiengesetz.html> on 06/05/2019

company decides to issue shares and distribute them to the employees it will face the harsh regulation prescribed by the law. Central bank shall also be concerned about this matter, since well regulation of the field and successful implication would emanate to the development of securities market. By an amendment of the law discretion can be provided to the Board of Directors to decide even higher percentage of shares, considering the structure and priorities of the company.

Another associated problem is that ownership rights over approximately quarter of the equity of the company may give rise to stakeholder conflicts, as major shareholders will have different priorities as compared to minor ones, whereas minor shareholders may raise complaints regarding employment conditions, wages etc. that may deteriorate their relations with major shareholders and put the efficiency of the corporate governance into danger. The next problem to touch is the ownership distribution structure between the other shareholders and employees. Since the ownership fraction that can be distributed to employees is restricted to 25 of Charter capital of the company, if each employee acquires a little portion of share, employee's voice will not be decisive with respect to voting powers of major shareholders. For instance, in case of discussion of distribution of dividends in the scope of general meeting, minority shareholders would not have enough say in decision making. In this sense, article 72 of the Law on Joint Stock companies stipulates the opportunity for minor shareholders to make suggestions for the annual meeting.⁴⁷ The article prescribes: Company shareholder who owns at least 2 percent of the Company's voting shares may, within 30 days after the end of the financial year or in a longer period foreseen by the Charter, submit a maximum of two suggestions on the annual Meeting agenda, as well as propose candidates for members of the board and the controls commission. The number of candidates proposed shall not exceed the number of members in each of these bodies. So, in order to solve this problematic issue 2 or more minority shareholders may unite their shares and represent their rights collectively making suggestions and participating in the governance of the company this consolidation will develop democracy in the company and will have balancing effect to restraint major shareholders.

⁴⁷ The Law on Joint Stock companies of RA (Article 72 part 1)

According to part 2 of article 41 on JSC's circulation of a staff share may be limited for a period of time stipulated by the Charter, but no longer than for 3 years starting the date of its allocation. In order to assess the efficiency of this regulation we shall consider this regulation from the perspective of the employers and from the perspective of employees. From the perspective of employees short term issuance period is not beneficial, since long term financial dependence will create closer ties and commitment highlighting human resource as a crucial capital for the company., Besides vesting period also refers to the possible increase of the stock price and employees will gain profits from stock option exercise⁴⁸ On the other hand taking into regard the corporate practice and business circulation of the companies in Armenia the proprietors of those shares with voting rights will not be able to get into business affairs of the company as longer time frame is needed to exercise information sharing and to get acquainted with management model of particular company. In this context, I would recommend that longer maximum time frame shall be stipulated by the law in order to furnish the opportunity to maximize the efficiency of the system.

Article 41 of the Law on Joint stock companies pushes forward 2 mechanisms permitting the employees to become stockholders of the company. It prescribes direct and indirect schemes of acquiring shares of the company. According to the first mechanism, two possibilities are proscribed.

- Buying back and reallocation of already issued shares
- Issuance of new (additional shares)

The company shall buy back part of its already issued shares from the shareholders, subsequently donating or selling these shares to its employees. In case of donation, the sponsoring company shall pay their value and in terms of accounting it's an additional expense for the company. The company may also issue additional shares setting a list of employees that have priority rights over particular shares. The company may also diminish the nominal value of issued shares and issue additional shares.

⁴⁸ Investopedia Employee Stock Option <https://www.investopedia.com/terms/e/eso.asp> retrieved on 05/05/2019

The indirect mechanism envisages the opportunity of employee shareholding throughout special trust fund. In this regard the Trust fund will manage employee shares, it will be the stakeholder and employees will have some shares in that fund, so in this sense we relate to indirect shareholding.

Labor Code of RA, that is considered to be special part of the legislation regulating relations between employees and employers, is silent with regard to legal issues concerning Employee stock ownership. There is a legal obstacle found in the Article 172 of the Labour Code of the Republic of Armenia. According to that article it is prohibited to pay wages by the use of commitments and securities, except cases provided by the Law, but the law does not specify the cases in which it is⁴⁹ So, regardless of the fact that the Law on JSC provides the opportunity to issue shares and transfer to employees the regulation of Labor Code can create further hardships for the issuing companies. From the analysis of the provision it may be concluded that it is prohibited to offer stock options as a part of salary but it is notable that under the regulations of labor Code the options may be provided as additional pay It would be advisable to have specific regulation of ESOPs in terms of labor law, specifying the underlying conditions the procedure of offering and acquiring shares, the differences between the provision of wage and provision of stock options and also set up standards regulating the stock option with the salary of the employee.

Section 3 Regulation envisaged by the Law on Limited liability companies of RA

Considering comparatively easier procedure of incorporation and low incorporation costs as well as the concept of asset partitioning and limited liability, great majority of Armenian incorporated legal entities are under the corporate structure of Limited Liability Company.

Article 3 part 1 of the Law on Limited liability companies gives the definition of a limited liability company, according to which an LLC is considered a Company founded by one or several persons with a Charter Capital divided into shares in amounts as determined by the company's Charter.⁵⁰ In comparison with Joint stock companies here the Charter Capital is

⁴⁹ "From employee to shareholder", Stephan Khzrtyan Legal Lab law boutique 12-Apr-2017

⁵⁰ The law on limited liability companies of RA (Part 1 article 3)

composed of shares (participation) and while exercising ESO we shall relate to the transfer of ownership of shares instead of ownership of stock.

The Law on Limited liability companies does prescribe neither mechanism nor procedure prescribing plans of Employee stock ownership. Thus, the legislative has not envisaged employee stock ownership process and under the conditions of total legislative omission, firms structured under limited liability companies shall change its organizational structure in order to be able to provide its stock to the employees in conformity with existing regulations. The latter may require high costs for the company and inconvenience regarding the shift of organizational structure.

Besides, if shareholders take a risk and offer shares to the employees under these conditions and absence of regulation, there is another legal nuance to esteem. According to article 11 part 6 of the Law on LLC's the number of Company Participants shall not exceed 49, otherwise the company shall be subject to reorganization into Joint Stock Company within one year, and upon expiry of that period, the company shall be subject to liquidation by judicial order, if the number of its participants is not reduced to the number set in this paragraph.⁵¹ This provision will create further problems when company's shares are offered to more than 49 participants and while exercising ESO it is recommended for the employers to take into future corporate plans inter alia the number of employees and the size of the company and the business circulation of the latter.

According to part 2 of the article 11 on the law on LLC's the participants of the company are considered individuals having ownership rights over the stock of the company upon its registration.⁵² According to article 13 of the above specified law the participants of the company shall ⁱⁱⁱ) Make investment in the equity of the company according to the articles of incorporation or according to the order decided unanimously by the participants of the company.

Concluding from the logic of the above mentioned provision the employees may make savings for a certain period of time from their wages and correspondingly invest the proceeds

⁵¹ The law on limited liability companies of RA (Part 6 article 11)

⁵² The law on limited liability companies of RA (Article 11 part 2)

into the Charter capital of the company or acquire proportional shares of the company.⁵³

With an implementation of this mechanism the employers have an opportunity to guarantee employee's financial participation with the implementation of Savings plan. It is notable that in case of Employee stock option plans and savings plans envisaged by the law on LLC's the preliminary objective alignment of the interests of the shareholders from one hand and of the employees from the other, promoting them to make efforts and reach to the monolithic purpose but there is a nuance of structure as in case of Savings plan we relate to employee stock ownership scheme which has totally different regulation from ESOPs.

There are also some norms regarding employee ownership procedure stipulated by the Law on securities market which do not have regulative purpose arrange some administrative matters. For example, the law on securities regulation of the RA prescribes some regulating norms, Article 6 part Stipulated that the requirement to publish a prospectus does not cover cases for public offers of securities if the securities shall be offered to the employees.⁵⁴

This section will focus on the taxation of stock options and stock ownership structures in terms of income tax and profit tax and the tax liabilities of the parties within the framework of employee stock ownership. It is notable that Armenian Tax Code in contrast with international best practice does not proscribe tax benefits or any privileges with regard to operation of ESOPs. Started from January 1 2018, after entry into force of the Tax Code the regulation is envisaged by the Tax Code of RA. I would like to refer to the topic on tax issues investigating regulation that is applicable to joint stock companies.

In terms of tax regulation, it is important to distinguish between the stages of implementation of employee stock ownership and the exercise of employee stock option plans, as each stage pertains to its distinct legal regulation. The object of taxation of income tax for the resident physical persons is gross income received from the sources of the Republic of Armenia and or the outside of the Republic of Armenia. According to part 27 of article 4 of the Tax Code the gross income is the total amount of revenue as defined in the Code subject to receipt or receipt in the reporting period.⁵⁵ Moreover, personal income defined by article 25 of article 4

⁵³ The Law on limited liability companies of RA (Article 13)

⁵⁴ The Law on the Securities market of RA (Article 6)

⁵⁵ Tax Code of RA (Article 4 part 27)

as an income attributable to the activity carried out by a natural person in the framework of labor or civil law contracts or on any other grounds.⁵⁶ In this sense, options are obtained from a distinct civil-law agreement, through employee stock ownership schemes or employee stock option plans, however they do not have any monetary expression and value assessment. As we can conclude, employee stock options do not correspond to any of the above-mentioned categories. Therefore, at this stage, the stock options are not subject to taxation; since neither of the parties receives actual proceed from this offer. The employee acquires the right to exercise his/her options and gain proceeds in case of availability of all required conditions. The second phase of stock option plans is the exercise of the option by the employee, which means that because of the acquisition of shares the employee becomes a participant / shareholder of the company and at this stage taxation applies. In order to enable the employees to exercise their rights it is necessary for the company to issue or buy back agreed quantity and value of shares in advance or from the market in order to sell them in the future.

Conclusion

As a summary of the above conducted analysis, this paper emphasizes that employee stock ownership schemes represent a sophisticated and complex phenomenon that requires serious calculation and planning. It is undoubted that in the 21st century the most important assets of the company are its employees and recruiting companies in this sense implement various mechanisms to retain them and create stronger ties with key people, these mechanisms also aim to guarantee further economic and psychological incentives for the employees having its result on the profitability of the company. Considered as a vivid example of Group incentive schemes, Employee stock ownership prioritizes the value of the unitarian achievements of the company highlighting the overall performance and profitability of the company. ESO schemes are interesting corporate mechanisms to encourage employees to foster their corporate performance, accountability. It also gives them the chance to the owners of the company to benefit from comparably favorable tax regime and make savings.

Among all the schemes under which Employee stock ownership is exercised, Employee stock ownership plans remain the most widespread and the most regulated. Companies who seek

⁵⁶ Tax Code of RA (Article 4 part 25)

methods to provide some fraction of stock of the company first of all have to exercise an efficient planning considering all the risks and downsides that the company can face in the scope of application of employee stock ownership.

On the one hand, Employee stock ownership is a solution to agency problem which represents an efficient mechanism to diminish agency costs of the company, since the preliminary aim of this concept is the alignment of interests of capital and labor providers. In this sense, some companies with efficient external and peer monitoring may record better results in corporate governance while for other companies this approach can give rise to free rider problem. Under some circumstances ESOP is an indestructible means to enjoy tax benefits and privileges, on the other hand inaccurate planning may result in more expenses. The emergence of profitability of the company is not dependent on the mere fact of offering shares to the employees, in this regard meticulous analysis, tax planning and calculations are omnipotent components to ensure the success of particular ESO scheme. The efficient and successful ESOP shall introduce the right balance between ownership and control rights, participatory powers in corporate governance with strong emphasize on information sharing, cooperation, mutual assistance and control. In comparison with international best practice the detailed analysis of regulatory provisions of RA legislation rendered evident that regardless the political will and curiosity of the companies to exercise particular plans, there is a strong necessity to amend the legislation and make some clarifications in the existing ones. The thorough examination of the relevant articles of Armenian legislation reveals a great number of both evident and latent legal risks. This thesis paper suggests to review the above mentioned suggestions and recommendation for the further development and improvement of the regulatory framework of the sphere.

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