COMPANY LAW ISSUES AROUND EMPLOYEE SHARE-BASED COMPENSATION IN NIGERIA

Synopsis

Employee Share Based Compensation (**"ESBC"**) is becoming more prevalent among companies, particularly startups, as a means of motivating and promoting employee dedication. The advantages are numerous: ESBC encourages employee retention since shares typically have a vesting period or exercise requirement, aligns the interests of employees and shareholders in promoting the company's success and increasing the share price, and enables the company to compensate its employees without negatively impacting its cash flow. Whilst this may appear to be a fair and attractive bargain, a clear review of the Companies and Allied Matters Act 2020 (**"CAMA"**), indicates that most ESBCs might be unlawful.

This article aims to highlight the position of **Section 146 of CAMA** and its likely effects on the creation and execution of ESBC in Nigeria.

What Is ESBC?

ESBC is a corporate arrangement between a business and its employee(s), under which the company gives its employee(s) the right or option to acquire/own shares in the company subject to certain conditions. ESBC is usually granted to employees as part of their remuneration package, in addition to a cash salary and other employment benefits and it is usually conditional on the employee remaining in the employment of the company for a specified period.

The use of ESBC is rapidly evolving, taking different variations across different countries around the world, some of which are briefly discussed below:

1. Employee Share Option Schemes (**"ESOS"**): Here, employers create a share scheme which grants the employee(s) the option to acquire company shares at a specific price known as the "**Exercise Price"**, during a specific period of time, after which they cannot exercise their right to purchase the shares anymore. Typically, the Exercise Price is set at a discounted value to incentivize employees to buy the shares.

2. Employee Share Purchase Plan (**"ESPP"**): Under this option, employees are typically allowed to save money towards the purchase of shares through a variety of mechanisms. These mechanisms include making contributions directly from their paychecks, buying shares for a small deposit and paying the rest at a later date, or making regular contributions over time. On the purchase date, the accumulated contributions are used to buy company shares at the discounted price.

3. Share Incentive Plan (**"SIP"**): SIP is a type of share-based compensation mechanism adopted by employers to provide shares to employees as a reward or bonus for their contributions to the company. Unlike other share-based compensation plans, such as ESOP and ESPP, shares awarded under a SIP are immediately granted to employees and held in a trust until certain conditions are met. Typically, these conditions include a minimum period of employment or other performance-based criteria. Once the conditions are met, employees are free to either take possession of the shares or leave them in the trust.

4. Phantom Share Scheme (**"PSS"**): This is a type of employee share scheme in which an employer offers "fake" shares to its employee(s), which are tied to the value of the actual shares of the company. The employee is paid the equivalent dividends or rewards owed to them in cash, without actually owning any shares in the company.

This scheme can be advantageous to both employers and employees, as it allows employees to share in the company's success without the risks and complexities of owning actual shares.

Legality Of ESBC In Nigeria

Whilst the CAMA[1] does not expressly cover ESBC, some of its provisions acknowledge the practice and may serve as a legal foundation for its implementation and use in Nigeria. However, another provision in the CAMA appears to prohibit its adoption, creating some ambiguity in the legal framework surrounding ESBC.

1. This is the principal legislation on company matters in Nigeria.

2. *"every taxable person is liable to tax on income source inside or outside Nigeria, including ... any salary, wage, fee, allowance or other gain or prom from employment including compensation, bonuses, premiums, benefits or other perquisites allowed, given or granted by any person to any temporary or permanent employee....'.*

Section 186(d) of the CAMA provides that "a company may buy its shares by purchasing the securities issued to employees of the company pursuant to a scheme of stock option or any other similar scheme." This provision allows companies to purchase shares from employees who have acquired them through an ESBC.

Section 189(b) of the CAMA provides that "where shares are held as treasury shares, the company may at any time sell the shares (or any of them) for a cash consideration or transfer the shares (or any of them) for the purpose of or pursuant to an employees' share scheme." This provision allows companies to sell or transfer treasury shares to employees participating in an ESBC.

Additionally, S**ection 9(c) of the Fourth Schedule to the CAMA** requires the directors' report to contain a statement describing the action taken during the year to introduce, maintain or develop arrangements aimed at encouraging the involvement of employees in the company's performance through an employees' share scheme or by some other means. This provision places emphasis on the company's obligation to take appropriate measures to promote employee participation in the company's performance through ESBCs.

Despite the foregoing provisions which purportedly recognize and support ESBC, the legality of ESBC arrangements in Nigeria remains uncertain. **Section 146 of the CAMA,** states that "it shall be unlawful for a company to issue its shares at a discount."

This prohibition against issuing shares at a discount in the CAMA is not unique to Nigeria. However, in most jurisdictions, the law provides exceptions for specific circumstances, such as employee share schemes subject to certain conditions. In contrast, the CAMA does not have any exceptions to this provision for employee share schemes. As ESBC typically involve issuing shares to employees at a discounted or no cost rate to incentivize them, this provision raises questions about the legality of ESBC arrangements in Nigeria.

Notwithstanding, there are other regulations in Nigeria governing the issuance of shares of a company, such as the Investment and Securities Act, 2007 and Securities and Exchange Commission (**"SEC"**) Rules, 2013, which provide further guidance on the regulation of ESBC. Most notably, **the SEC Code of Corporate Governance for Public Companies (the "SEC Code"), Code 14.4,** provides that "where share options are adopted as part of executive remuneration or compensation, the Board should ensure that they are not priced at a discount except with the authorization of the SEC." Whilst this also stipulates that share-based compensation for directors cannot be issued at a discount, it further provides that this may be permissible with the consent of the SEC. However, it must be noted that the SEC Code is only applicable to Directors of public companies who may or may not be employees.

The provisions of **Section 146 of the CAMA** and **the SEC Code 14.4** are potentially in conflict. Whilst both laws prohibit the issuance of shares at a discount, the SEC Code recognizes an exception for share options schemes.

This inconsistency highlights the need for clear and comprehensive guidance from regulators in Nigeria on the subject of ESBC.

It is worthy to note also, that the Lagos State Inland Revenue Service (**"LIRS"**) issued a public notice (the **"Public Notice"**) regarding the taxation of employee shares and stock options.

The Public Notice, relying on **Section 3 of the Personal income Tax Act (PITA)**[2] provides that employee share options, which are typically offered at prices below the market value, are subject to tax compliance requirements. The Public Notice provides an alternative description of the discount, indicating that for publicly listed companies, the discount is the difference between the market value of the shares of the issuing company and the exercise price, while for non-listed companies, the discount is the difference between the exercise price and the price per share (the price per share is determined by dividing the net assets of the company issuing the shares (as reported in its penultimate financial statement) by its total number of shares).

By virtue of this Public Notice, the employer is required to compute tax on the difference between the share price and exercise price and remit to the relevant authority. However, while there might be a legal basis for the deduction of this tax in the PITA, the Public Notice conflicts with the CAMA, which prohibits the issuance of shares at a discount without any qualification. This conflict would pose challenges in its enforcement as the CAMA is the principal legislation regulating any company incorporated in Nigeria.

Certainly, in Nigeria, the legal framework surrounding ESBC is still evolving, and there is some conflict and ambiguity around its enforcement. As a result, it is crucial for companies in Nigeria to exercise prudence when offering ESBC and to refrain from issuing a discount on the value of its shares.

However, there may be ways for companies to structure ESBC at a discount to employees without contravening the provision of **Section 146 of the CAMA. Section 160 of CAMA** provides that the shares of a company may be paid up in cash or by a valuable consideration other than cash, either wholly or partly. This provision could be interpreted to allow the payment for shares to be referred to as a payment in valuable consideration rather than a discount on the value of the shares. In other words, the employee would not be receiving a discount, but instead would be paying for the shares in valuable consideration other than cash, by providing services outside the employee's job description or a form of bonus payment from the Company. This payment could be made either wholly in valuable consideration other than cash, or partly in cash and partly in valuable consideration other than cash.

For example;

If X company wants to issue four hundred thousand (400,000) shares to Employee B as part of a share option scheme, it can offer Employee B the option to purchase two hundred thousand (200,000) shares at its market value of N1 per share and provide that the remaining two hundred thousand (200,000) shares be paid in valuable consideration, such as Employee B's service to the company for a specified period of time. This way, the employee is not receiving a discount on the shares, but rather paying for the shares with a combination of cash and valuable consideration.

However, this interpretation may only be easily applicable for private companies as **Section 162 of the CAMA** requires that "*Where a public company agrees to accept payment for its shares otherwise than wholly in cash, it shall appoint an independent valuer who shall determine the true value of the consideration other than cash,*" making it more difficult to apply this interpretation in the case of a public company.

Conclusion

ESBC undoubtedly offers advantages to both companies and employees, and their use is becoming increasingly prevalent in Nigeria. However, as with other corporate matters, companies must ensure compliance with relevant laws and regulations, especially its primary legislation, which is the CAMA, when implementing ESBC schemes to avoid potential legal or tax liabilities.

Furthermore, while there are existing regulations in Nigeria that govern ESBC, there is a need for further clarity and collaboration among regulators on the subject, especially with regard to issuing shares at a discount and the use of ESBC schemes. It is clear that the Public Notice issued by the LIRS is in conflict with the provisions of the CAMA. However, this can be attributed largely to the lack of proper guidance and understanding of the CAMA on the subject. Hence, it is crucial for regulators to collaborate and ensure consistency in the law's application and interpretation on this subject.

In our considered opinion, the CAMA should be amended and follow the lead of other jurisdictions and regulations regarding the ESBC.

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