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Employee Stock Option Plans and Effects on M&A Practices in Türkiye

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Employee stock option plans ("**ESOP**") have found an intensive and diverse practice in the United States of America ("**USA**"), especially in the 1970s, with plans designed particularly for employees, known as ESOPs. With the global acceleration of technology and digitalization, it has been observed that especially, newly founded start-ups seek to provide various benefits to their employees, who has a key role to their operations, through ESOPs and ESOP agreements. In fact, companies provide their key employees with the opportunity to become shareholders in the company or to benefit from share ownership through ESOPs if they meet the vesting conditions within the scope of the option they have been promised.

1. ESOPs and Considerations within the scope of M&A Transactions

The widespread use of ESOPs in Türkiye in recent years is undoubtedly attributable to many advantages of the concept for both the company and the persons who can be considered as key employees. From the perspective of the key employes ESOPs plans appear as a method that increases the employee's loyalty, motivation and performance toward the company and allows him/her to combine his/her own interests with the company in addition to his/her remuneration under the employment agreement. From the company's perspective, ESOPs play a significant role in terms of the company's ability to recruit qualified employees for its activities as well as to retain them while developing its activities.

Within this scope, during an M&A deal, mainly the following considerations can be taken into account:

a) Due Diligence

- **Determining the Existing Structure**: In order to ensure that the relevant ESOP is long term applicable for the company's investment strategy, it is vital to design an appropriate plan for each company based on criteria such as the company's culture and the nature of its activities and operations (company's capital, volume, shareholding structure, investment strategy and objectives, etc.). Determination of the existing ESOP structures is one of the main aspects of a due diligence process. In certain cases, these plans may not be reflected in the company records or communicated in compliance with legal rules and thus, updating the current structure could be required.

- **Exit Obligations under Current Plans**: Existing ESOP schemes of a company must be evaluated to review if they are affected by an M&A transaction, as certain types of plans can create payment obligations to ESOP holders in case of an exit or change in ownership in the company.

b) Deal Structure

Determining the ESOP structure to be applicable following the investment constitutes an important aspect of structuring an M&A deal. For instance,

  - **Deciding on the New ESOP Structure**: This item shall be considered as a step while constructing the deal. when a takeover or new investment is concerned, since new investors may be focused on employee retention after the investment is completed. In that sense, with ESOP plans becoming more and more widely available in Türkiye, it has become essential to determine and evaluate the existing ESOP structures of a target company prior to an M&A transaction, which constitutes an important aspect of the due diligence process.

- **Purchase Price Considerations**: ESOPs can be determined as an additional benefit in addition to purchase price for the founders of a target company, who would be retained in the company after the takeover is completed. This entices the founders and other key employees who are ESOP holders into becoming more focused on company business after the deal is completed, as they would be eligible for additional benefits afterwards, relying on the success of the company.

- **Valuation and Cap Table Effects**: Another key evaluation point would be to decide whether a new ESOP pool will be created within the scope of the investment. Target companies may sometimes provide ESOP benefits to the employees, which are not actually reflected in the capitalization table (i.e cap table) of the company prior to the investment. If that is the case, new investors may prefer that the dilutive effect of the existing ESOP plans are reflected into the capitalization table prior to the investment. Alternatively, new ESOP plans can be formulated in a manner which is dilutive both for current and new investors.

- **Cross-Border Aspects and Tax Implications**: Multinational companies which have operations in various countries are also able to introduce ESOP plans from different subsidiaries besides Turkey. Applicability of such plans and tax considerations would also be part of the structuring process for an M&A deal.

- **Employee Communication**: Impact of the M&A deal on ESOP participants shall be considered and communicated to employees prior to closing of the deal, as there may be approval mechanisms (including under labour law) to be incorporated into transaction documents, especially if there will be a change in the ESOP plan or benefits thereunder.

2. Types of ESOPs in Türkiye

Although there is not a commonly adopted system under the Turkish law, ESOPs can be used in accordance with the current Turkish Commercial Code No. 6102 ("**TCC**") and Turkish Code of Obligations No. 6098 ("**TCO**"). Considering the current practices in Türkiye, we observe that ESOPs are basically designed in two forms.

- First alternative would be creating a plan in which the key employee becomes a direct shareholder of the company at a price lower than the market value, i.e. at a price determined specifically for him/her by the company or free of charge ("**Direct Stock Option**"); and
- The second alternative would be a plan in which the key employee does not become a shareholder in the company directly but benefits from certain financial rights attached to the shares ("**Phantom Stock Option**").

In practice, it is also observed that the companies design ESOPs to implement both plans by stipulating a hybrid structure.

It is vital that the structure of an ESOP is designed by considering the company's volume, investment strategy, the number and position of key employees to whom the option is intended to be granted. In addition, since the benefit in question is intended to provide long term advantages, it is important to ensure that the ESOP structure is drafted in a straightforward manner and is operationally easy to follow-up in future.

Despite the fact that the processes of both ESOPs are parallel in their main outlines, as previously stated, each type of ESOP has its own distinct and diverse characteristics, as we will discuss below:

- **Direct Stock Option Plans:** In such plans, the company (and/or the founders) either (i) transfers a certain amount of the shares in their ownership or (ii) issue new shares by way of capital increase to the key employee for him/her continuing to work for the company.

For example, if the company grants a stock option to a key employee over its own shares TCC allows companies to acquire their own shares at a price that does not exceed 1/10 of their authorized or issued capital. Pursuant to this provision, companies may make their key employees direct shareholders in the company through their own shares to be acquired as part of their investment strategies and may offer the value and/or earnings of these shares to their key employees to the extent that the option conditions are met. However, since the company's acquisition of its own shares is subject to special rules, periods and procedures within the framework of the TCC, we observe that ESOPs are not structured in this way, especially in the recent years.

In these cases, the company (and/or the founders) may specifically request that various mechanisms such as right of first refusal, tag-along right or drag-along right be applied to these shares. In particular, to fulfill these obligations, the implementation of mechanisms such as pledges or usufruct rights on the shares allocated to the employee may provide comfort to the company in the event of a prospective exit or future investment.

- **Phantom Stock Option Plans:** Instead of giving shares to their key employees and making them a direct shareholder in within the company as explained above, companies may also grant options also known as Phantom Stock Options or Shadow Stock Options to their key employees, by giving them the right to acquire the value and/or earnings of the shares subject to the option in cash to the extent that the vesting conditions are met. With a Phantom Stock Option, companies provide their key employees with an additional benefit in addition to their remuneration, and although the key employee cannot directly hold shares in the company, he/she will still be able to financially benefit from the shares.

For example, in case of an exit which involves sale of shares of the Company or a public offering, the key employee will be able to benefit of those shares at a value corresponding to the phantom shares to which he/she is entitled to or the company may allocate the right to receive dividends, which is one of the rights attached to the shares, to the key employee.

Since non-voting shares are not available under the Turkish Commercial Code, phantom stock option plans are more commonly preferred by investors, as it gives the freedom to companies to customize their ESOPs based on their organizational and shareholder structure, capital, volume, and other factors.

It should be noted that in terms of both types of ESOPs, the parties are free to determine the content and terms of ESOPs in accordance with the principle of freedom of contract, and they are free to reflect the content that they deem necessary in these agreements, so long as the structure is formulate within the boundaries of mandatory provisions of the legislation as well as labor law rules.

3. Main Steps for ESOPs

While there would be certain differences between types of ESOP schemes, generally, the main steps of ESOPs ("**ESOP Steps**") both in Türkiye, which are similar to that of ESOP schemes in Europe and USA, are as follows:

a) Step One: Creation of ESOP and Making its Announcement / Presentation to the Key Employee: As an initial step, the company should determine the type of ESOP that it intends to offer to its key employee (*ESOPs in which the key employee becomes a direct shareholder in the company, or ESOPs in which the key employee does not become a shareholder in the company but only benefits from certain financial rights and benefits attached to the shares, or hybrid ESOPs*), taking into consideration the company's culture and investment strategy. Legal structure shall then be formed based on the determined plan.

Then, the company should establish a specific policy with well-defined vesting conditions and disclose the requirements that the relevant key employee must fulfill to benefit from the ESOP chosen by the company. At this point, developing an appropriate design for an ESOP in a way to include the key employee's expectations will serve as a guide for the key employee's own appraisal.

In practice, the vesting conditions stipulated under ESOPs are generally based on time or performance criteria. In any case, when determining the vesting conditions under an ESOP, even if the company has employees with different levels of seniority, positions and titles within its organization, the vesting conditions for employees in the same category should be based on objective criteria (*e.g. minimum working time requirement, performance-based criteria, determination of the seniority for the employees eligible for ESOPs, etc.*) in order to demonstrate that key employees with equal status under labor law are treated in accordance with the "principle of equal treatment".

In practice, it is also being observed that ESOP agreements are directly executed by key employees and the company, instead of a general ESOP plan announcement.

b) Step Two: Undertaking of the Stock Option: The second step is the preparation and execution of an ESOP agreement between the key employee and the company (and/or the founder).

c) Step Three: Pre-Vesting Period: This is the step where the vesting conditions for the key employee to be entitled to an ESOP must be fulfilled by the relevant employee.

This step can be determined based on the company's investment strategy as well as the fulfillment of certain performance criteria required by the key employee's seniority/position, such as (i) the duration of the key employee's continuous and active employment within the company, (ii) the fulfillment of certain performance criteria required by his/her seniority/position. In an ESOP where the vesting structure is based on time, the vesting periods can also be divided into different time slots; for example, the initial vesting can be made after a certain period of time from the signing date of an ESOP agreement ("**Initial Vesting Period**"), followed by periodic vesting periods, in which additional options can be granted for specific periods ("**Periodic Vesting**") following the Initial Vesting Period.

In addition, the vesting structure under an ESOP may also be performance-based. In such a case, the key employee is required to fulfill his/her obligations stipulated under the ESOP in accordance with the key performance indicators (KPIs) assigned by the company (and/or the founders). In practice, there are also cases where vesting conditions are attached to both time and key performance indicators, resulting in a hybrid structure.

To give an example for this step, in case of an ESOP where the vesting structure is based on time, if the vesting condition is determined as the key employee's continuous and active employment in the company for three years, the three-year period in question is the "pre-vesting" period.

d) Step Four: Vesting: In the fourth step, the key employees who meet the conditions specified in ESOPs are now entitled to acquire relevant options.

e) Step Five: Exercise of the Vested Option: This final step will have different consequences depending on the type of ESOP chosen by the company. If an ESOP is designed in such a way that the key employee becomes a shareholder in the company, the key employees who fulfills the vesting conditions will own the shares subject to the option at a lower price than the market value or free of charge. On the other hand, if an ESOP is designed in such a way that the key employee does not become a shareholder in the company, but only benefits from some financial rights and benefits attached to the shares, the key employee will benefit from them (e.g. receive dividends etc.) upon fulfilling the vesting conditions regarding the shares subject to the option. It should be noted that the company may also impose certain conditions on the use of options granted under ESOPs. For example, the key employee may use the rights subject to the option at the time of a transfer/sale of a certain number of company's shares of the (*aka*. exit), the company's public offering or the company's round of investment (the terms of which have been determined).

4. Analysis of ESOPs within the Scope of Tax Legislation

Both types of ESOPs include processes that need to be elaborated within the scope of tax legislation. The following can be considered as important processes that should be examined within the scope of tax legislation: in case the key employee is eligible to be granted a Direct Stock Option, he/she may acquire the shares promised to him/her by the company and/or the founders within the scope of the option, gain profit from them, and dispose thereof; on the other hand, in case the key employee is eligible to be granted a Phantom Stock Option, he/she may acquire the financial rights and benefits attached to the shares within the scope of the option, and gain profit from them.

Undoubtedly, each country's tax legislation may contain specific provisions (tax advantages, etc.) for the processes related to both types of ESOPs. The fundamental reason for the widespread use of ESOPs in the USA is that these plans allow companies to benefit from various tax advantages and incentives. On the other hand, Turkish tax legislation does not contain any specific regulations governing ESOPs.

Furthermore, in practice, companies residing in Türkiye also include key employees of their parent companies or subsidiaries residing abroad in their ESOPs. Undoubtedly, in this case, in order to correctly determine the taxation that will arise in the processes related to the ESOPs designed by the company at international level, it is necessary to structure these plans by consulting with lawyers and tax consultants who are experts in the fields of capital markets and tax legislation of both Turkish legislation and the relevant foreign country's legislation.

a) Income Tax Under ESOPs

According to Article 61 of the Income Tax Law No. 193 ("**Law No. 193**"), remuneration is defined as "*benefits provided in cash or in kind, and other benefits that may be represented by money, paid to employees in return for their services rendered to an employer in connection with a specific workplace*". Therefore, both an employee's direct shareholding in the company provided by a Direct Stock Option and the provision of economic benefits to a key employee without granting him/her a shareholding in the company provided by a Phantom Stock Option can be qualified as a remuneration in accordance with the mentioned Article 61 of the Law No. 193.

b) Withholding Tax within the Scope of ESOPs

Pursuant to paragraph 1 of Article 94 of the Law No. 193, withholding tax will be withheld in accordance with Articles 103 and 104 of the Law No. 193 from payments that are considered as a remuneration within the scope of Article 61 of the Law no. 193 (*except for those benefiting from exemptions*). In this context, trading companies residing in Türkiye are obliged to withhold withholding tax from the income taxes of their employees, who are the beneficiaries, when they make payments in cash or on account under the option. Therefore, the shares to be granted to the key employee by the domestic company at a low price or free of charge within the scope of a Direct Stock Option, or the benefits related to the shares to be provided to the key employee within the scope of a Phantom Stock Option will also be included to the employee's payroll and be subject to withholding tax.

In case the shares to be granted to the key employee at a low price or free of charge within the scope of a Direct Stock Option, or the benefits related to the shares to be provided to the key employee within the scope of a Phantom

Stock Option are provided to an employee residing in Türkiye, by a foreign company; the acquired share/benefit will be considered to be as a remuneration in terms of the tax legislation, however, since the taxation through withholding tax is not possible in such a case, the employee must declare and pay this income, which is qualified as a remuneration, through the annual income tax declaration.

c) ESOPs and Practice of Gains from Appreciation

Within the scope of a Direct Stock Option, pursuant to repeating Article 80/1 of the Law No. 193; "*gains from the disposal of securities or other capital market instruments, except for those acquired without consideration and shares belonging to full-fledged taxpayer institutions and held for more than 2 years*" are qualified as gains from appreciation.

Therefore, in the event that the key employee is granted with a Direct Stock Option, if the shares subject to the option are the shares of a joint stock company, in accordance with Article 80/1 of the Law No. 193, if these shares are held by the key employee for 2 years from the date of acquisition and then disposed of, the profit obtained will not be considered as gains from appreciation and will not be subject to income tax. We would also like to emphasize that there is no such an exception for limited liability companies and foreign companies regardless of their kind.

5. Conclusion

ESOPs are a method used by companies to motivate their key employees for the long-term development of their corporate structure and corporate culture, as well as to increase their loyalty to the company. In this regard, key employees aim to contribute to the company's growth by aligning their interests with those of other shareholders of the company.

In the USA, the tax regulations on ESOPs and tax incentives have provided the basis for the widespread implementation of ESOPs. We are of the opinion that special regulations to be made on the subject in our country will enable these methods to become more widespread in practice.

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