



COMPETITION

How the Competition Commission's ESOP impact study may shape future mergers

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South African companies often introduce Employee Share Ownership Plans ("ESOPs") for a variety of reasons. Through an ESOP, workers acquire shares in the firm in which they are employed without incurring an upfront cash outlay, entitling them to dividends and/or capital gains in their employer. Structuring an ESOP gives rise to complex legal, tax, accounting, and industrial relations questions. In recent years, the provisions of the Competition Act 89 of 1998 ("**Competition Act**") also come into play when ESOPs are introduced in the context of obtaining merger approval from South African competition authorities. In this context, a new study from the Competition Commission ("**Commission**") deserves attention.

Publication of the Commission's ESOP Impact Study

On 29 April 2026, the Commission published an impact study titled *Employee Share Ownership Plans (ESOPs): An Analysis of Key Design Principles to Create Value for Beneficiaries and Firms* ("**Study**"). The Study examines fifteen ESOPs implemented during the period FY 2019/2020 to FY 2022/2023. These ESOPs were mandated as merger conditions following the inclusion of section 12A(3)(e) into the Competition Act.

In summary, the Study evaluates the current design framework of ESOPs, assesses the financial implications of different funding models, and proposes recommendations intended to improve ESOP outcomes for beneficiaries and firms alike.

This article outlines the key findings and recommendations of the Study, with a view to assisting merging parties in understanding how the Commission is likely to approach the evaluation of proposed ESOPs in future merger proceedings.

Background

In 2019, various amendments to the Competition Act came into effect, including section 12A(3)(e) which is an explicit public interest ground relating to the spread of ownership. In terms of that section, the Commission and the Competition Tribunal (“**Tribunal**”) must, when evaluating a merger on public interest grounds, consider the effect the merger will have on the promotion of a greater spread of ownership, in particular, the increase in levels of ownership by historically disadvantaged persons [1] and workers in firms in the market.

Where the Commission or Tribunal finds that a merger does not adequately achieve this, for instance, where a proposed merger would result in a dilution of existing Broad-Based Black Economic Empowerment (“**B-BBEE**”) shareholding, it may require an ESOP to be established in one or more of the merging parties or the merged entity.

Key Findings

1. Design principles

When a merger condition requiring an ESOP is indicated, the Commission currently provides merging parties with a template outlining key ESOP design principles. In addition, guidance on ESOPs can be found in the Commission’s 2024 Revised Public Interest Guidelines which provide that an ESOP must hold a minimum range of 5% to 10% of the equity of a merging party or merged entity and must represent a broad base of workers – as opposed to a few highly skilled workers. The Study found that while the current template addresses certain fundamental elements, it leaves considerable design scope to the implementing firm – a discretion which can materially affect both the extent to which workers benefit and the cost to shareholders of implementing the ESOP.

The Study also found that ESOP beneficiaries frequently lack a clear understanding of how ESOPs function, and that beneficiary-nominated trustees often lack board representation and fiduciary competencies needed to meaningfully represent workers’ interests.

2. Funding and financial sustainability

A significant concern identified by the Study relates to the prevalent ESOP funding model. Of the fifteen ESOPs examined, eleven were funded through notional vendor finance (“**NVF**”). Of those eleven, interest was charged on the “debt” in respect of six of the ESOPs.

Where an ESOP is funded through NVF or a cash loan, the ESOP incurs a debt that must be settled over time. When the firm declares a dividend, the portion attributable to the ESOP’s shareholding is not paid in full to beneficiaries; instead, it is split between a payment to beneficiaries (also known as a “trickle dividend”) and a payment towards the outstanding debt. The ratio of this split varies among ESOPs: some allocate a higher portion to debt repayment with a smaller amount distributed to beneficiaries, or vice versa. The trickle dividend ratio is therefore a critical design variable – one that directly affects both the speed at which the debt is repaid and the quantum of income beneficiaries receive in the interim.

The Study found interest-bearing funding models to be especially problematic given that NVF, by its very nature, is a notional loan rather than an actual cash loan. Consequently, the charging of interest on an NVF debt is, in the Commission’s view, not warranted.

Since ESOPs funded with interest-bearing debt typically rely on dividends declared by the firm to service that debt, the Study found that, in most cases, dividends received by the ESOP are insufficient to cover the full interest charge for a year, resulting in the capital loan amount not being reduced. In the instance when no dividend is declared at all, the debt accumulates perpetually. In both scenarios, beneficiaries receive little to no dividend income. The implication, according to the Study, is that there is a gap between the transformative policy intent of ESOPs and their current outcomes.

The Study’s Recommendations

1. Financing the ESOP

The Study recommends that interest should not be charged on NVF as it makes ESOPs financially unsustainable. It further recommends that where discounts (ordinarily offered in the open market) and favourable terms to purchase shares offered as part of employer executive

incentive schemes are available, similar discounts and incentives should be extended to the purchase price of the ESOP's shareholding.

The Study explains that discounts would reduce the initial value of the ESOP debt. The Study identifies four categories of discounts that should be considered: (i) a minority discount (to compensate for the lack of control an ESOP has, given its small shareholding in the firm); (ii) a marketability discount (applicable to private firms to compensate the ESOP for its inability to swiftly convert shares into cash and for incurring administrative costs when doing so); (iii) a lock-in period discount (this relates to the number of years workers would be locked into the ESOP and restricted from selling or transferring ESOP shares to parties outside the firm); and (iv) a discount reflecting the B-BBEE points gained by the firm from having an ESOP as a shareholder.

The Study illustrates, through a series of financial scenarios, the impact that different funding approaches can have on both the value of an ESOP's debt and the dividend income received by beneficiaries over time. The modelling suggests that where interest-free funding is combined with discounting of the purchase price and actual annual payment of dividends, beneficiaries are more likely to receive meaningful dividend income, as debt is reduced more rapidly under such conditions.

2. Proposed mandatory design principles

The Study recommends that the following design elements be expressly included and specified in ESOPs –

- a specified implementation date;
- in respect of the structure of the ESOP, it must stipulate whether it will be established as a trust or a company. In either case, the ESOP should be established as a unitised structure whereby qualifying workers receive units rather than directly holding shares in the firm. The percentage shareholding to be held by the ESOP in the merging party or merged entity at the implementation date must also be specified;
- workers must not be required to pay to participate in the ESOP (i.e. merging parties must cover the costs associated with the establishment of the ESOP);
- the funding model must be specified (NVF, cash loan or full grant/donation) as well as the trickle dividend ratio;
- in respect of governance, the ESOP employee representatives should be entitled to nominate a director to the board of the firm in which the shares are held. Furthermore, the Study recommends that the ESOP, if structured as a trust, should appoint trustees (individuals nominated by the beneficiaries and the firm) to manage and administer the trust on behalf of the beneficiaries. The ESOP trustee composition should consist of either an equal number of beneficiary and firm-nominated trustees or, a majority of beneficiary-nominated trustees. Additionally, any costs associated with the operation of the board of trustees should be borne by the merged entity;
- the qualifying criteria for participation, such as the number of years worked and/or employee grade should be stipulated (with the exclusion of top/senior management of the firm), including the treatment of “bad leaver” events (e.g. resignations or dismissals) which would result in beneficiaries ceasing to participate in the ESOP;
- the participation benefits (e.g. dividends and/or capital gains) which beneficiaries can expect to receive should be clearly set out;
- mandatory training should be provided for beneficiaries, at no cost to the workers, covering the functioning of the ESOP, the terms of the ESOP trust deed and the tax implications of dividends received;
- more detailed legal and financial training should be provided for all ESOP trustees (at no cost to workers) in respect of the operation of the ESOP; and
- finally, a dispute resolution mechanism should be included to deal with potential disagreements between the merging parties and any independent legal or financial experts in relation to the reasonableness of fees/costs.

While the proposed design elements are more extensive than the Commission's current template, they are less prescriptive to some extent.

[2]

3. Design principles to be determined in consultation with workers

If an ESOP is anticipated, the Study recommends that the following design principles are determined in consultation with Workers, Worker Forums or Trade Unions before the merger is notified to the Commission. This is to prevent the ESOP being designed entirely by the parties with no worker input.

These include the duration of the ESOP (evergreen, buyback or hybrid), distribution of the trickle dividend, the class of shares to be issued, and the placement of the ESOP at either holding company or subsidiary level.

Duration of the ESOP

Duration is one of the most consequential design choices for an ESOP, as it determines how long the scheme will be in existence and whether beneficiaries will receive dividends, capital gains, or both. The Study identifies three duration models but does not recommend a particular one:

- An evergreen model. This model is intended to operate indefinitely, allowing new workers to continuously participate as they meet the qualifying criteria. While beneficiaries receive a steady stream of dividend income, they do not benefit from any appreciation in the value of the shares owned by the ESOP.
- A buyback model. This model, by contrast, operates for a fixed period – typically five years – after which the firm repurchases the shares and the ESOP is dissolved. This model allows beneficiaries to receive dividends during the life of the scheme and capital gains at the point of buyback.
- A hybrid model. This model combines elements of both the evergreen and buyback models. Under this model, a portion of the ESOP shares is bought back by the firm after a certain period, with the proceeds used to settle the outstanding debt. The remaining shares are then retained under an evergreen model, allowing the beneficiaries to continue receiving dividends on that portion of the ESOP's shareholding going forward.

Phantom ESOP schemes

Merging parties should be aware that the Commission's focus, both in the Study and in the Revised Public Interest Guidelines, is specifically on equity-based ESOPs that confer actual share ownership on worker beneficiaries. The Study itself expressly states that it does not evaluate alternative structures such as profit sharing schemes.

Under a phantom scheme, employees receive notional or 'phantom' shares that track the value of real shares and provide financial benefits linked to share price performance, but do not constitute actual share ownership. Employees therefore do not become shareholders in the firm, do not acquire voting rights, and do not receive dividends in the conventional sense.

Whilst phantom schemes have been employed in at least two cases that we are aware of, it is not clear that the Commission will regard them as meeting the requirements of section 12A(3)(e) of the Competition Act.

Placement of the ESOP

The Study recommends that positioning the ESOP at the operating subsidiary level may better incentivise workers, as their contribution is directly linked to that entity's profitability. However, where the subsidiary is not performing well, placement at corporate group level may be preferable to ensure beneficiaries can still receive dividends if the group is profitable overall, despite the subsidiary's poor performance.

Leavers from the ESOP

The Study further recommends that the definition of "good leaver" and "bad leaver" be determined in consultation with workers. In particular, firms should consider paying exiting beneficiaries regardless of their reason for exiting the firm. Beneficiaries who are retrenched, pass away, retire, or are permanently incapacitated or disabled should be treated as good leavers and receive 100% of their entitlement, while workers who resign or exit pursuant to a mutual separation agreement (commonly referred to as "bad leavers") should receive a pro rata payment. Notably, the Study does not prescribe the applicable pro rata percentage for bad leavers, leaving this to be determined in consultation with workers.

Alternative debt-reduction mechanisms

Lastly, the Study recommends that the ESOP consider alternative mechanisms to reduce the ESOP's debt such as (i) the purchase of additional shares in the firm which can be sold at a later stage when share prices appreciate; (ii) the purchase of shares in other companies from which income can be derived, or (iii) the undertaking of investments such as exchange-traded funds and fixed income investments.

Conclusion

The Study is the Commission's most detailed and comprehensive pronouncement to date on what constitutes an effective and sustainable ESOP from a competition enforcement perspective. While the Study's recommendations are not legally binding, the Study provides a clear signal of the standard against which the Commission is likely to measure proposed ESOP conditions in future mergers. Merging parties that engage with ESOPs as a substantive ownership remedy to comply with section 12A(3)(e) of the Competition Act, and structure them in accordance with the principles outlined in the Study, will be better placed to achieve merger approval efficiently.

Should you require advice on the structuring and implications of an ESOP, please feel free to contact any of the members of the Werksmans Competition Practice Area.

[1] According to section 3(2) of the Competition Act, a person is a historically disadvantaged person if that person –

- is one of a category of individuals who, before the Constitution of the Republic of South Africa, 1993 (Act No. 200 of 1993), came into operation, were disadvantageded by unfair discrimination on the basis of race;
- is an association, a majority of whose members are individuals referred to in paragraph (a);
- is a juristic person other than an association, and individuals referred to in paragraph (a) own and control a majority of its issued share capital or members' interest and are able to control a majority of its votes; or
- is a juristic person or association, and persons referred to in paragraph (a), (b) or (c) own and control a majority of its issued share capital or members' interest and are able to control a majority of its votes.

[2] For example, the current template prescribes a 35% trickle dividend ratio and a minimum two year employment period qualification.



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