PHANTOM STOCK:

THE IDEAL PLAN FOR GROWING PRIVATE COMPANIES

The Ideal Plan

"I have a key employee who's asking for some stock in the company or else he may move on—should I give it to him?" This is a question with which many owners of closely held businesses wrestle. It is multi-layered in its implications; however, the answer is really pretty simple: "No. But you should be glad he's asking for it! This is a great opportunity."

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The question the key employee poses reveals both good news and bad news to an owner. The good news? One of the talented producers in the company recognizes that the business has a compelling and profitable future. He believes in the future so much that he wants a piece of it. And he's confident enough to believe he deserves it. This is why the question represents such a great opportunity. The bad news? Sharing equity in a private company is a pain. And it's often one of the most inefficient ways to share value—from both the owner's and employee's perspective.

The scenario is understandable. Top performers expect to be paid well; and if they help create economic value, they deserve some of what they've created.

Instinctively, owners assume that employees with equity will be better employees. If employees have stock perhaps they will think and behave like owners. Maybe they will have greater incentive to manage expenses, service customers, innovate, work hard and even invest their own money in the business.

These are correct instincts and reactions. It's obviously desirable to engender an ownership stake, or at least an ownership mentality, among employees. However, the means to achieving those attractive outcomes shouldn't create more problems than it solves, and too often that's what happens when closely held business owners go down the path of equity sharing.

Why Not Stock or Options?

Granting stock or even stock options will not usually address all of the issues a business owner needs to consider when creating a value sharing arrangement for key contributors. Here's why.

Let's take a look at three different ways to get stock into the hands of Sally, the leader of your national sales team, and the potential consequences of each approach.

1. You can simply give Sally some stock. More formally, this is called a Restricted Stock Grant (or one of its variations). Congratulations, you have a new partner-shareholder. She'll be entitled to take a look at the books. She may want to discuss the new compensation program—hers and yours! She'll be entitled to her share of profit distributions. And so on. You get the idea. Of course, you'll control the majority of the shares and the final decisions. But the nuisance factor may become intense. If you're lucky, Sally won't be interested in those details. She'll trust you and be truly grateful for the award—so she won't want to cause problems. That's good. But we have to consider the tax consequences. Your award of stock to Sally results in an immediate tax cost for her. Let's say your accountant tells you your stock is worth $10 per share. If you give her 5,000 shares that's $50,000 of value.

Sally will need to pay taxes on that value. As far as the IRS is concerned, it's as if you gave her $50,000 of cash. Now, assuming you placed restrictions (like a vesting schedule) on the shares (which you should do), she could defer the income taxes until she vests. In that case, however, if your share price goes up (which you're both hoping for) she'll wind up paying taxes on the higher amount. Sally will love the idea of getting stock, but she may not love the idea of coming up with the money to pay the taxes. There are more potential problems ahead. What if things don't work out with Sally? If you let her go (or if she chooses to move on) what will become of her shares? Will you buy them back? Or will she just retain them? You'll really like the latter solution when you discover that Sally went to work for a competitor. By the way, if you do buy them back how will the value be determined? And don't expect a tax deduction for the redemption. You'll buy them back with after-tax dollars. There's more, but the point's made. Making employees shareholders opens up a Pandora's Box of potential headaches.

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2. Sally could buy stock. Now she's putting her own money into the deal. Investing her own capital will tie Sally more closely to the success of the company. Hopefully so. It's not the worst of ideas. But, you still have many of the same problems described above. The open books. The discussion about your compensation. The little chat about the size of dividends. Redemption issues. Buy-and-sell agreements. Termination-of-employment loose ends. And does Sally even have the cash to buy in? If she was going to be concerned about the taxes

on a grant, how is she going to come up with the full amount needed to purchase the shares? Maybe you'll consider lending her the money. Think about that one. You'll loan her the money that she can give back to you (to buy the stock) so that you can have all the headaches described above? Some employers envision allowing her to use her share of company dividends to repay the loan. How is this any different than giving her stock in the first place—you're paying yourself back for helping her buy some of your stock by reducing the dividends you would otherwise have been entitled to? That's quite a partnership!

3. Public companies use stock options. Why shouldn't you? This would enable Sally to acquire some stock at a fair price and get capital gain taxation if you sell the company some day. Maybe. Maybe not. First of all we still have a cash-flow concern. Sally will need to come up with enough cash to exercise her option after the vesting period has passed. Let's say the stock is worth $10 today (same as above) and you give her 5,000 options to buy the stock at that price. Her three-year vesting period passes and Sally scrapes together the $50,000 to exercise her options. Let's assume the company share price has grown to $18 in the meantime. She now has $40,000 of new equity value (($18-$10) X 5,000). There are two different types of options—nonqualified and qualified (or incentive). There's not enough space here to cover the differences in taxes except to say that incentive options, generally, produce a better tax result for Sally and a worse tax result for you. Meanwhile, Sally may now be in a position for capital gain taxation under a future transaction (i.e., sale of the company or IPO) assuming the event occurs at least a year from the date of the exercise of the options. However, what if neither

event ever occurs? You're back to our original problems of redemptions, dividends, etc. Typically, closely-held businesses seldom produce the "future transaction" that the employee was relying upon. As a result the majority owner and the owner-employee face the grind of negotiating a "fair" price for the stock at the time of a future separation of service. How well do you think you'll enjoy that future conversation with Sally's attorney?

The bottom line: the financial results of stock or stock option awards can appear to justify the effort—under the perfect circumstances. But reality is never as simple as you expect it to be. The majority of private company owners will regret the move to stock awards for employees. The perceived value of employee ownership is, nine times out of ten, not nearly worth the price.

Phantom Stock – The Better Approach

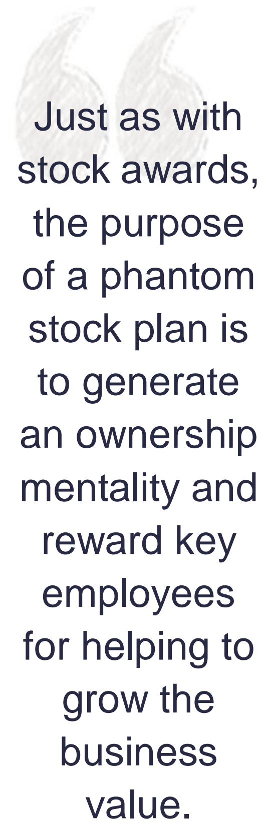
Each of the ideas for Sally outlined above has merit. Granting stock is relatively simple and clear-cut. It provides instant recognition and value. It's great, particularly, for someone who's been with you for awhile and has made a contribution to your past success. But, the concept carries the baggage described above.

Having Sally buy stock also is intriguing. It deepens her commitment and aligns her with both short-term and long-term goals of the company. But again, there's baggage.

Stock options are attractive because they're win-win. Sally only wins if shareholders see their stock value go up. Sally is tied to future growth of the company. But, again, the baggage issue looms large.

What if we could replicate any or all of these approaches without making Sally an actual owner? Is it possible to generate the ownership value and mentality without the baggage? In a word, yes. We can do it with phantom stock.

Phantom Stock Defined



A phantom stock plan is a contractual agreement wherein a company promises to make cash payments to employees upon the achievement of certain conditions. What's the purpose? Just as with stock awards, the purpose of a phantom stock plan is to generate an ownership mentality and reward key employees for helping to grow the business value.

However, phantom stock has one big advantage—there is no sharing of actual equity with the employees. No requirement to open the books. No ownership rights. No need to pay dividends (although some plans do). The existing owners stay in control of 100% of the stock or interest in the company.

At the same time, phantom stock can create comparable or even identical value as actual stock. Here are the key things that happen when you create a plan on behalf of employees.

1. First, you must establish a way to value the phantom shares. In essence, you're trying to identify the value of the company. You can obtain a formal appraisal or you can establish the value by a formula. The latter will work best in most situations. Perhaps the formula will reflect a multiple of EBITDA or Net Income. Any reasonable formula can work. To be safe, use a

formula that is going to be less than the actual fair market value you might sell the company for some day. You don't want the employees' phantom shares to be valued higher than your own.

2. The next step is to create some phantom shares. Pick a number—1 million, 10 million—the number doesn't matter as long as you have enough to make the plan work with the number of eligible participants you anticipate. This part can sometimes seem confusing or cause concern. "Wait," you might be thinking, "shouldn't I use the same number of shares we have outstanding in the company? Aren't I trying to 'shadow' the movement of actual stock?" Actually, no. We don't like the term 'shadow stock' because we're not trying to replicate actual shares. We're simply trying to provide an attractive award for employees at a future date. As you'll see, it doesn't matter whether there are more or fewer shares in the plan than in your company. Let's do an example using EBITDA (earnings before interest, taxes, depreciation and amortization) as our value indictor:

EBITDA	$10,000,000
Multiple selected	5
Formula Value	$50,000,000
Shares selected	5,000,000
Starting share price	$10

3. Now let's design our plan. Remember that with actual stock plans we had three choices: (a) give shares, (b) sell shares, or (c) give options (to buy in the future at today's price). Guess what? We have the same three options. We can simply award Sally (our national sales leader) some phantom shares. Or we

can "sell" her some. Or we can create a phantom option. Let's look at all three in a little more detail.

a) Full value grant. We could give Sally some shares that are valued, in full, at $10 per unit. We're going to specify some conditions and restrictions (see #4 below). Nonetheless, we're committing the full $10 in value times the number of shares we decide to give her. If we give her 5,000 shares she'll start with a true value of $50,000 (subject to vesting and other restrictions). At some future date she'll redeem those awards for real cash. Assuming EBITDA grows to $18,000,000 on her redemption date, Sally will receive a check for $90,000.

What about Sally's taxes? Well, remember that with actual stock awards Sally would pay taxes when she received the grant or when the vesting lapsed. With phantom awards, Sally pays no taxes until she actually receives her award value (e.g., the $90k). In this way, she never has to pay income taxes until she's in receipt of the actual cash. It's true that had she received actual stock (and paid the taxes up front) she might have saved some taxes in the long run. However, with phantom stock your tax deduction (i.e., the company's) is higher than it would have been with actual stock. In the first case (actual stock), your deduction was for $50,000, thus a tax benefit of $20,000 (assuming 40% bracket). With the phantom stock example, you get to deduct the full $90,000, resulting in a tax benefit of $36,000. If you're feeling guilty about Sally's taxes go ahead and give her more shares,

enough to result in your “after-tax cost” being the same.

b) Sell phantom shares. This is commonly referred to as a Deferred Stock Unit plan—a form of deferred compensation. Here’s how it would work. Sally would be given the opportunity to defer some of her cash compensation (e.g., salary or bonus) into units of phantom stock. Said differently, Sally would “convert” some of her future pay to phantom stock.

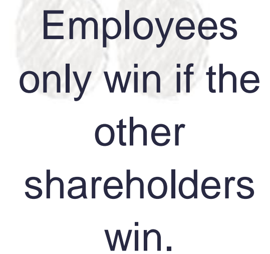
An example: Assume Sally makes $200,000 in annual salary. She might defer up to 25% (let’s say) of her salary into the plan. Assuming she does so she would acquire a deferred compensation interest that would have $50,000 worth of starting value. In other words, she would have 5,000 units of phantom stock (at $10/share) credited to her deferred comp account.

Technically, you’re not selling shares to her. She’s not acquiring an ownership right in exchange for writing you a check. She’s deferring some of her income into an unsecured account that is measured by the growth of the phantom share price. But it has the same essential effect as selling Sally phantom shares. She is voluntarily foregoing wages in order to ‘invest’ in the company! That’s a pretty serious commitment. Plus, it’s much better for Sally tax-wise than buying actual stock. Why? Because she gets to do it with pre-tax dollars.

Tax-wise for you it’s not perfect, but it’s not so bad. You (or the company) will forego the current

tax deduction on the income Sally chooses to defer. However, it's a delayed deduction, not a lost deduction. Instead, of getting the deduction today of $50,000 (wages) you'll get the future deduction on $90,000 (assuming our EBITDA growth example given above).

c) Phantom Stock Options. This one is a favorite of many private business owners. Stock options (real ones) are attractive because they're "win-win." Employees only win if the other shareholders win (by seeing their stock price go up by a value that exceeds the amount by which they were diluted). In a public company environment there are markets that help to handle the exercise of the option. However, in a private company no such market exists. Instead, the employee and the company sponsor have to work out the cash flow mechanics of the exercise. And there's no "cashless exercise" arrangement that permits the employee to get a reduced number of shares by surrendering a portion of his options to cover the strike price.



Employees only win if the other shareholders win.

So let's use phantom options. Easy. Recall that phantom stock is a cash compensation arrangement. Assume we give Sally 5,000 phantom options with a starting value of $10. What will she really have at that point? Nothing—because the options must go up in value before she realizes any gain. But later, when the phantom share price reaches $18 and it's time for redemption, Sally is simply handed a check

for $40,000 (($18-$10) X 5000). No muss, no fuss. Sally doesn't need to scrape together the $50,000 to exercise the options. She simply receives a nice payment that reflects a reward for her contribution to growth in company EBITDA. Sally has tight alignment with the shareholders without the pain and complication of dealing with a stock transaction. (And you have a happy employee without the headaches of another shareholder.)

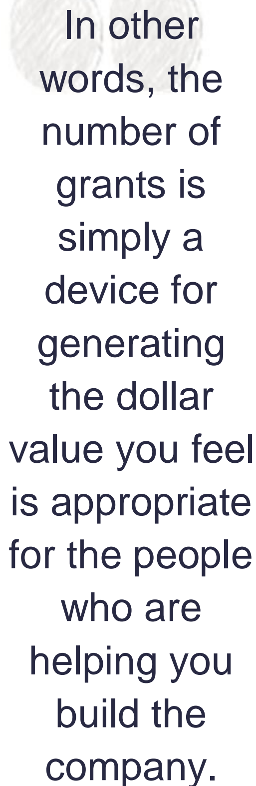
By the way, what's described here as a phantom stock option is also known as a Stock Appreciation Right. However, some find the term phantom stock option more appealing and descriptive.

4. So you've selected a plan type for Sally—full value grants, deferred stock units, or phantom stock options. Or maybe you've done a combination of two or more—which may be the right thing for your company. What's next?

Now you need to fine tune the plan provisions. Select a vesting schedule for full value and option awards. Determine the year in which they'll be paid out. (It doesn't necessarily have to coincide with the vesting period.) And over what period of time do you want to pay them out? In a lump sum? Or over 3 or 4 or 5 years? Then there are possible scenarios to define and refine: change-in-control, separation of service, disability of a participant, death, termination (for cause or not for cause), and so forth. The plan will need to be pulled together into a document that outlines what will occur under each of these circumstances. You're going to want some help with these issues. Seek advice from

someone who's had experience dealing with these plans. He or she can help you see the pros and cons of these important decisions.

5. The last thing to do (other than actually enrolling Sally in the plan) is to determine how many shares you're going to give her. (We're assuming, at this point, you're doing full value shares or phantom options.) We mentioned earlier that the number of shares you establish in the plan wasn't crucial…at least then. Now it becomes important. You don't want to award too few, or too many. So how do you decide?



In other words, the number of grants is simply a device for generating the dollar value you feel is appropriate for the people who are helping you build the company.

It's best not to get hung up on the number of shares you award. Focus instead on the potential future value of the shares as a percentage of the growth in the company. This will usually require some spreadsheet modeling. First, project the possible future value of the company over some period of time, given your favorite growth assumptions. Now carve out a percentage (start with 15%) of the growth (not the total value) that you'd consider sharing with your leaders. Then, allocate that to the positions or people you'd consider for participation. Now, calculate the number of grants that will produce the targeted values. In other words, the number of grants is simply a device for generating the dollar value you feel is appropriate for the people who are helping you build the company.

This approach to grants achieves the following results:

- Guidelines for grants are established within a pre-approved budget, thus simplifying the annual award process;
- Shareholders are assured that value dilution is being managed within reasonable limits;
- Employees can receive a forecast of value that demonstrates potential personal earnings tied to company growth.

Best Practices

As with any rewards strategy, there are plans that work well and others that fail. To ensure your approach to Phantom Stock has a greater chance of success, here are some "do's and don'ts" to consider.

1. Don't do one-time grants. Schedule and award grants annually. Make each grant a celebration. One-time grants always lead to regrets (e.g., "I shouldn't have given him so many.")

2. If you're not sure which type to use, go with phantom options. There's less risk. No increase in value results in no payments to employees. Even if your share price goes down in some years employees can still come out ok (as long as you're doing annual grants—see #1).

3. That said, consider some full value grants for the key long-term employees who've been with you "through thick-and-thin." This will give them some starting credit for prior contributions. Perhaps you'll just do this in the first plan year, and then include them in your annual option awards. (This could be done for as few as one employee.)

4. Start with a small group and expand participation as time goes by. It’s always easier to add participants than to subtract.

5. Schedule payouts every five to six years. (Sooner is ok, but longer is not.) Unlike regular stock options and restricted stock, employees cannot (with some exceptions) choose when they’ll “exercise” or “redeem” their shares. You, the plan sponsor, decide. The temptation will be to push the payment date out too long. This has two negative results: (a) the value may compound for a long time resulting in very large payouts, and (b) employees will have no way to access their money unless they quit—not the ideal scenario.

6. Don’t make your formula (for share price calculation) too complicated. We’ve seen plans where the company officers don’t even understand the formula (or can’t remember why some things were included). Keep it simple. “Hey gang, if we grow profits we all make money!”

7. Don’t ignore the rules. Most phantom stock plans will be subject to ERISA (the Fed’s 1974 rules on pensions) and Internal Revenue Code Section 409A. Sorry. There are rules. Fail to know and follow them at your own peril.

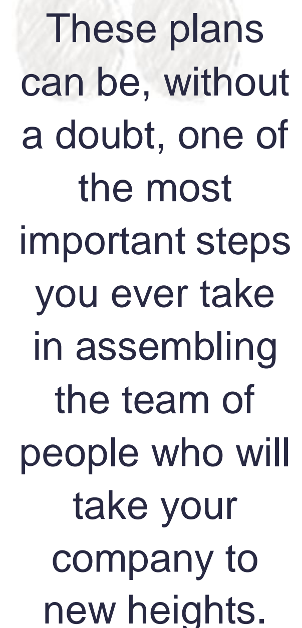
8. Don’t try this at home. Get advice. It’s risky to decide upon the best choices for a phantom stock plan without the guidance of someone who’s done it before, a lot. You may intend to give away 10% of the growth of your company to your employees and you wind up giving away 30% via bad design and operation. This is important. Get help.

9. That said, don’t use your attorney as your principal advisor. Your lawyer will be needed in the process—towards the end—to make sure the documents are in order. But, your attorney will not be experienced at the realities of plan operation. Find someone who’s lived with, slept with and eaten with phantom stock over the years. Let them put the structure on your important decisions. Then use your attorney to “cross the t’s and dot the i’s.”

10. Manage the plan effectively. Don’t start the plan and forget about it. Keep it fresh. Be flexible. Communicate it. Give the employees statements that show their value. This is a big investment. Use it wisely.

Final Thoughts

This white paper has been an introduction to the processes you can follow to properly structure a phantom stock plan. Hopefully you’ve learned something of value. These plans can be, without a doubt, one of the most important steps you ever take in assembling the team of people who will take your company to new heights. However, there’s something more important that getting the right structure. You need to create the right mindset.



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If you create a “perfect” plan but don’t establish the right mindset your plan will flop. You’ll wonder what went wrong with the plan. But it won’t be the plan’s fault. It will be yours. Ultimately, it’s your job to

see that the employees not only understand the plan but that they are inspired by it.

Mindset relates to the perception of the plan in the minds of participants. When you make Sally a participant in this plan she should feel like she was just made a partner in the company. She should understand that her financial future is tied to yours (and vice versa). She should realize that you trust her to help produce the results that will create value for both of you.

Always position the plan in a positive light. Explore and discover ways to make your plan one of the highlights of your relationship with your key people. You’re investing in them. Make sure they know how much you value their efforts and how much you trust them to generate great results. Your phantom stock plan is a symbol of your commitment to a partnership relationship. They aren’t getting actual stock but they don’t really want those headaches anyway. They want to know that they have a chance to participate in the value they help create. A phantom stock plan, properly designed, can do just that because it sends the right message about the future:

We’re building a great company.
We’ve got the right people.
We’re united as partners in our financial success.
Let’s go make it happen.

Ready to Speak to a Compensation Specialist?
If you would like to speak with an expert about your business goals and pay strategy, email Tom at tjordan@mpninc.com or call us at (210) 615-1800.

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Thomas J. Jordan specializes in the design, implementation, funding and the administration of executive and key employee incentive plans. As part of his exit planning advisory services he has developed stay bonuses, stock appreciation rights, phantom stock plans, executive deferred compensation plans and performance-based incentives for hundreds of organizations.

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