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Long-term Compensation: Real Equity or Phantom Stock?

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The rationale for providing long-term compensation to key employees is well recognized. Shareholders, business owners, and Boards want to motivate, reward and retain key employees to promote long term thinking, grow the business and build shareholder value. At the same time, talented and entrepreneurial employees are looking for opportunities to become owners, to share in the success and create wealth for themselves and their families? So what's the right way to deliver the long term compensation: sharing real equity or using phantom stock?

Like many other business decisions, the choice of real or phantom equity can be a challenging one. The answer is dependent on your philosophy, corporate governance and culture, objectives, corporate structure, and the desires of your key employees.

I have always advocated that if the use of real equity is practicable, it serves as the best way to deliver long-term compensation. The key employees become shareholders and are treated at par with other shareholders. This may include voting rights, dividend rights and the opportunity for capital gains once the shares are earned and vested. This is the case for virtually all public companies which use their shares as the "currency" to deliver at least part, if not all, of the long-term compensation. Real equity works for certain privately-held businesses which hold a philosophy of key employee ownership and are prepared to manage the issues of having minority shareholders. Real equity may also be used as part of a shareholder succession plan – replacing one generation of owners with the next.

However, in many cases, particularly with closely-held businesses and not-for-profit organizations, the use of real equity is not possible or practicable. Examples include a family business that desires to keep ownership of the stock in the family or a single business owner who doesn't want to deal with minority shareholders. Many corporate attorneys will advise their clients against having minority owners because of the issues it presents.

Issues with Having Minority Shareholders

- Governance issues including minority shareholder rights to dissent against mergers and other significant corporate transactions.
- Minority shareholders of private companies may have unrealistic expectations regarding their role in corporate decision making.
- Minority shareholders may have voting rights (if common shares with voting privileges are used).
- Minority shareholders owning enough stock individually or collectively may create obstacles to corporate action and have the right to petition a court for the involuntary dissolution of the corporation. During times of great opportunity or immense hardship, minority shareholders can cause trouble.
- Minority shareholders may exercise inspection rights and force privately-owned businesses to produce their accounting records.
- It may be difficult to terminate the employment of a minority shareholder.
- Minority shareholders may make claims of excessive compensation of majority owners or question expense reimbursements.

Phantom Stock

This is a form of compensation where a company promises to pay cash at some future date, in an amount equal to the market or formula value of a number of shares of its stock. Thus, the payout will increase if the stock price rises, and decrease if the stock falls, but without the recipient actually receiving any stock. Like other forms of stock-based compensation plans, phantom stock broadly serves to encourage employee retention, and to align the interests of recipients and shareholders. Recipients are typically employees, but may also be directors, third-party vendors, or others.

In general terms, phantom stock is a compensation plan that confers the right to receive cash at a future point in time, typically tied to a valuation formula. Economically, phantom stock can be designed to replicate the value of real stock. The amount of cash is linked to the value of the company's stock or the appreciation in the value of the stock after the date of the phantom stock award.

The award is usually contingent upon the phantom stockholder's continued employment with the company, i.e. retention of key management.

When a business is sold, the phantom stockholder might receive an amount equal to the cash the recipient would receive if he or she owned the same percentage of the corporation's stock (or the appreciation in value of an equivalent amount of stock). Some plans also include participation in dividends paid to shareholders.

Designed and administered properly, phantom stock should be non-taxable until the cash is paid, generating ordinary income for the employee and a deduction for the company.

Plans that are limited to only key employees should be free from the burdens of ERISA rules governing participation, vesting, funding and fiduciary responsibilities.

Implementing a phantom stock plan should cost less in legal and accounting fees than a formal stock program with buy-sell agreements.

Phantom stock is a way to share a stake in a business while avoiding the need for the new "owner" to invest cash or suffer taxable income. Most importantly, phantom stock avoids the risks inherent in having additional shareholders.

Highlights: Real Equity v. Phantom Stock

Element	Real Equity	Phantom Stock
Alignment	Very effective at aligning key employee interests with shareholders since employees become shareholders	Economically aligns interests of key employees with shareholders
Rewards	Dependent on stock price at time shares are sold – could be market price (if market for shares), valuation formula or appraisal	Dependent on valuation formula or appraisal at time phantom shares are paid
Voting Rights	May or may not provide voting rights – depends on type of stock used (voting or non-voting)	No voting rights
Dividend Rights	Common shares with dividend rights are typically used	No dividend rights are provided; however, dividend equivalent bonuses are often used to provide equitable results for phantom shareholders
Funding	Generally, no assets are set aside to fund redemption of real shares although effective cash planning for anticipated redemptions is advisable	Generally, no assets are set aside to fund payment of phantom shares although effective cash planning for anticipated payments is advisable; while not prevalent, may set aside funds, e.g. in a rabbi trust, to meet future payment requirements
Tax Treatment	Unless purchased for fair value, shares transferred are taxable as ordinary income (wages) at fair value when vested; it is possible to pay taxes early if Section 83(b) election available; option gains are taxable upon exercise Once shares acquired and income recognized, future appreciation taxable as capital gains Company takes tax deduction equal to amount included in income of key employee	Phantom shares are taxable as wages when paid. There is no opportunity for capital gains (all ordinary) Company takes tax deduction equal to amount included in income of key employee No taxable event until payment No opportunity for capital gains (all ordinary)
Retention	Vesting schedules used to promote retention	Vesting schedules used to promote retention

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