Phantom STOCK CAN PROVIDE REAL BENEFITS

BY ANDREW N. KARLEN, ESQ.

Key non-family employees can be just as important to the successful operation of a family-owned business as the family members that own it. Perhaps even more so in some instances, such as when an owner wants to retire and the next generation of the family is not ready to assume the reigns of management.

Attracting, retaining and motivating these employees can therefore be a major challenge. It is also important to note that in today's marketplace, a competitive salary alone is not sufficient for talented managers. Key employees will look closely at the entire compensation package when deciding whether to join or remain with a company.

One way to meet this challenge is for the family business to offer especially valuable key non-family employees participation in a plan that enables them to own stock in the company. The surface attractions of this idea are that stock can build loyalty while motivating key employees to work harder.

But, many families are unwilling to share ownership beyond the family. Aside from family policy reasons, there is concern that non-family shareholders might demand notification of shareholders' meetings, voting rights and permission to inspect the company's books and records. From the employee's perspective, a small equity interest in closely held company shares does not afford employees any real voice in company affairs. Additionally, the employee may not know what the stock is really worth unless the company goes public.

Phantom stock can provide a solution for this dilemma. The phantom stock plan is a contractual arrangement whereby the company issues hypothetical shares (also called units) to an employee that at a later date can be converted, depending upon the terms of the plan, into cash, actual stock or a combination of the two.

When the phantom stock units are convertible into cash, the company promises to pay the employee a sum equal to the rise in value over a specified period of time, e.g., between the issuance of the phantom stock units and the employee's retirement, or when the value reaches a certain number, or in a given year. Compensation and benefits attorney Richard Harmon noted that this strategy, commonly known as a "stock appreciation right" (SAR) awards the employee the increase in the stock's valuation measured from a specified date, generally the date of the award, through the date of payment on the phantom shares.

As the name implies, no stock is actually issued. Instead, an account is established for the employee, and bookkeeping entries are made to it as units are awarded. For example, let's say the phantom stock plan units are valued at the market value of the company's stock shares, and that a key manager is awarded 1,000 units when the fair market value of a real share of the company's stock is $50. The manager retires five years later, when the fair market value of a real share of the company's stock is $70. Since the price of the phantom shares tracks the price of the real shares, the manager would be entitled to a cash payment equal to the increase in value of 1,000 shares, or $20,000.

Or, a phantom stock plan might credit the employee with deferred compensation each year. The deferred compensation is converted into phantom shares that are credited to the employee's phantom stock account.

The colloquial use of the word "phantom" can generate resistance in some employees. An employee who covets equity ownership may interpret the word "phantom" as representing an illusion. When that occurs, it is important to provide the employee with accurate information and encourage him to seek independent verification. Phantom can be a mutually beneficial way to reward valuable non-family employees without weakening family control.

The features of phantom stock plans vary. I therefore recommend that companies considering a phantom stock plan need to address the following questions:

Which employees should be included and how many phantom stock units should be issued?

Phantom stock is intended to be a long-term incentive, limited to those few key employees that are expected to have the most important roles in the company's growth. However, the morale of those employees who are not included in the plan shouldn't be ignored. It may be wise to inform these employees whether they will ever have the opportunity to be awarded phantom stock.

Since the IRS regards phantom stock plans as non-qualified, the participation requirements under ERISA that apply to qualified plans are generally not an impediment in selecting which employees will be awarded phantom stock. In addition, there is flexibility to link an employee's performance to rewards. For example, phantom stock awards to division managers can be based on the performance of their respective divisions, rather than the performance of the company as a whole.

When will the phantom shares be given and when will payment be made?

The company must decide when the phantom shares will be issued, how many will be issued, how often they will be re-valued and when they will be redeemed. Payment is typically at retirement, death or termination of employment. However, companies often establish vesting schedules, so that employees who leave before they are vested will not receive the benefits of the phantom stock plan. In addition, a company might consider making payments on phantom stock at intervals of, for example, five years so that key employees won't become frustrated while awaiting their benefits.

How will the value of the phantom stock units be determined?

One alternative is valuation by an outside appraiser. Such valuations are expensive, however. If the valuation method is based on a formula, a family that chooses this method may consider having an initial appraisal done and applying the appraiser's formula themselves in subsequent years. Other valuation methods are book value or a multiple of earnings.

How will the company come up with the cash to make the payments?

Without advance planning, the company's cash position can be seriously impacted when the time comes to meet phantom stock obligations. A company may establish a cash reserve and budget for annual contributions to the plan at a rate commensurate with increases in its stock's value. If the plan is linked to employees' retirement, an employee may be paid over several years, thereby reducing the strain on the company's cash position. Or, if some of the payment is to occur upon an employee's death, the company can take out life insurance on the employee to fund that obligation.

How is phantom stock taxed?

From a tax perspective, the employee does not recognize income when the phantom shares are issued. The employee will recognize ordinary income, and the company will receive a deduction, at the time the phantom shares are converted.

What if the company pays a dividend on its real shares?

Dividends may be paid to the holders of phantom stock units or credited to their accounts and paid at a later date. The idea would be to align the financial benefits of the holders of phantom shares with those of the owners of real shares. The company can deduct such dividends, which are regular income to the employees.

What is the status of the company's obligation to the participating employees?

Phantom stock plans make the participating employees general creditors of the company. Once vested, the company owes the employee the money, even if the employee leaves on hostile terms.

What if the value of the stock decreases?

If the value of the company decreases, the employee won't incur any liability, but neither will he or she receive the intended benefit of the phantom stock plan. The company may want to consider a provision that would counter such a decrease, particularly where the employee has performed well during the period between the award of the phantom stock units and the time when he or she is permitted to convert them to cash, stock or a combination of them.

What if the company is sold?

The phantom stock plan should be binding upon anyone who buys the company.

What are some of the potential negatives of phantom stock?

Recognition and the prospect of additional income aside, the designated employees will realize that they have not received an actual ownership interest in the company. And, the payment of the appreciation in the phantom shares is considered taxable wages, subject to withholdings and applicable employment taxes. From the company's point of view, phantom stock benefits reduce the company's net earnings, which can affect its financial statements.

Despite these potential negatives, a phantom stock plan can provide key non-family employees with the economic benefits of owning stock without the family giving up actual equity and without the employee bearing the risks attendant to investment. Phantom stock plans can enhance a company's efforts to attract, and particularly to retain, key non-family employees by aligning their interests with those of the company and through vesting schedules that function as "golden handcuffs."

Andrew Karlen is a partner in the law firm Karlen & Stolzar, LLP, a law firm headquartered in White Plains. He counsels family-owned and other closely held businesses in matters concerning business succession planning, transactions and growth. He is a member of the Family Firm Institute and Attorneys for Family Held Enterprises. He can be reached at ankarlen@karlenstolzar.com *and at (914) 949-4600.*