Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 17
Phantom Equity: Its Advantages and Disadvantages for Incentivizing Employees

By Megan Monson, Darren Goodman, Taryn Cannataro

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Megan Monson: Welcome to the latest episode of Just Compensation. I'm one of your hosts, Megan Monson, partner in Lowenstein Sandler's employee benefits and executive compensation practice group. And I'm joined by two of my colleagues today who I'll turn it over to introduce themselves.

Taryn Cannataro: Hi. I'm Taryn Cannataro, an associate in Lowenstein's executive compensation and employee benefits group.

Darren Goodman: And I'm Darren Goodman, a partner in the firm's executive compensation and employee benefits group.

Megan Monson: Today, we will be discussing a type of executive compensation that is often utilized by privately held companies that's used to incentivize management-level and other key employees, phantom equity. It can be particularly valuable when a company's stock has declined in value, as many companies have experienced.

Today, we want to provide you with an overview of what phantom equity is, why a company may or may not want to issue phantom equity, why an employee may or may not want to receive phantom equity, and a few other considerations to keep in mind when designing a phantom equity arrangement. So let's jump right in. Can you explain to us what phantom equity is?

Taryn Cannataro: Sure. The term phantom equity is a little bit of a misnomer because it's not in fact equity. Phantom equity is essentially a fancy name for a bonus whose value is tied to the value of the company. It's called phantom equity because even though its value is tied to the value of the company, no equity is actually issued.

Megan Monson: And why would a company want to utilize phantom equity rather than issuing traditional equity awards like stock options?

Darren Goodman: There are a number of reasons. A typical scenario is a startup that is planning to sell but its stock options are not providing sufficient value to incentivize the management team. New options wouldn't be a strong incentive because as we've covered on a prior podcast, options are almost always granted with an exercise price equal to the then fair market value. And if a company is planning to sell in the short term, there's

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not enough time for those options to appreciate significantly. Phantom equity allows management to share an existing value, creating a greater incentive.

More generally, phantom equity gives a company the ability to provide equity-like economics to its employees without issuing actual equity. There could be a few reasons that companies would want to do that. For example, they don't want employees to have stockholder rights, so they'd rather issue a phantom award. They could have employees overseas in a jurisdiction where it's more difficult to issue equity and a phantom equity is easier. So there's just a number of reasons that a company may want to go with the phantom route. And the company also doesn't have to worry about dilution of its existing stockholders if it gives a phantom right.

From an employee's perspective, phantom equity can be beneficial because unlike stock options, an employee normally is not coming out of pocket. They simply receive the phantom equity and they receive a payout under the plan if and when a payment trigger occurs, which we'll get into. And they also won't a ordinary income tax until the time that they actually receive payment.

Megan Monson: How would phantom equity awards work? When do they typically pay out? And how are payment amounts calculated? Can you provide a little bit of color on that?

Taryn Cannataro: There is considerable flexibility in structuring terms of phantom equity arrangements. But it's typical for companies to adopt a phantom plan. And then employees who are granted awards are given an award agreement. This is very similar to stock options where stock options are typically granted under an equity plan and each optionee is given an award agreement.

Payment timing can vary, but it's typical for plans to pay out only if and when a sale occurs except that payment to phantom holders are normally subject to the same contingencies, such as earn-outs, escrows, or indemnities, as equity holders in connection with the change in control. The payment amounts can be determined in a number of ways. The pool can be based on a percentage of net proceeds during a sale or appreciation over a set amount. So for example, 10% of net proceeds could be set aside for phantom award holders or 10% of net proceeds over a certain threshold, such as $10 million.

The value of phantom equity could also be tied to the value of a share of the company's common stock. For example, each phantom recipient could be given a fixed number of units and each unit would have a value equal to the value of a share of common stock. Finally, it would be typical for a plan to provide that the default is payment in cash, but if all or a portion of the sale proceeds are payable in shares, a corresponding portion of the phantom plan payments can also be paid in shares.

Megan Monson: That's very helpful, Taryn. So it sounds like in general, there's a lot of flexibility in terms of how phantom equity is structured and the company really has a lot of discretion on how they want to set it up. So since phantom equity is essentially a bonus, is it taxed the same way a bonus is taxed?

Darren Goodman: Similar, but not exactly the same. Ordinary income tax purposes, as mentioned, it typically is not taxed until if and when the phantom equity actually pays out. Depending on how the phantom equity is structured, it's possible that employment taxes, i.e., Social Security and Medicare taxes, apply at the time of vesting even though if nothing's been payable under the plan yet.

And it's also important to be aware that Section 409A of the Internal Revenue Code regulates phantom equity and you need to work with counsel to make sure that

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whatever phantom equity you are proposing works under 409A because if you have a 409A issue, it changes the tax treatment, so employees will be taxed in the year that they vest even if the phantom equity has not paid out. And that includes both ordinary income tax and a 20% penalty for violating 409A. So it's absolutely possible to do this in a way that works under 409A, but you have to consult with counsel.

One downside to granting phantom equity is that unlike an actual equity award, phantom equity payments will never be eligible for long-term capital gains treatment, which might make it less attractive to employees. Although if you're putting a plan in place shortly before a sale, there might not be time to meet the long-term capital gain holding period anyway because the person has to receive the equity and hold it for a year before selling it to get long-term cap gains.

Megan Monson: Thanks, Darren. That's very helpful. What are some other considerations to keep in mind when designing a phantom equity arrangement?

Taryn Cannataro: There are a number of design decisions involved in drafting the plan. Typically, you'll see a requirement for the employee to remain continuously employed through the date of payment or a change in control. However, we'll sometimes see phantom equity arrangements include a carve-out to allow employees to receive a payment in the event of a termination without cause or a resignation for good reason within a window prior to a change in control event, such as three or six months.

Commonly, we see phantom equity arrangements condition payments on the employee's execution and non-revocation of a general release of claims in favor of the company at the time of payment as well. Some plans require the employee to agree to be bound by restrictive covenants, such as confidentiality, non-disparagement and/or non-solicit or non-compete.

Phantom equity arrangements can also include an expiration date, meaning a date by when a sale must occur or the awards are forfeited without payment. We often see companies use seven years as an expiration date, but it varies. This is done so that the plan does not remain outstanding in perpetuity and the company has flexibility to restructure its compensation in the future.

Darren Goodman: I agree, Taryn. And one point I'd add is that unlike actual equity, phantom equity normally can't be rolled into buyer equity on a pre-tax basis. And that can pose an issue on some transactions.

Megan Monson: So you both have raised a lot of really helpful points throughout this discussion. Are there any traps to granting phantom equity that our listeners should be aware of?

Darren Goodman: There can absolutely be some tax and ERISA complexities beyond what we've already discussed. It really varies depending on the terms of the plan, but one point in particular to be aware of is that phantom plan payments are normally considered for purposes of determining whether Section 280G is triggered by a sale.

We've discussed 280G in depth on an earlier podcast episode, but at a very high level, 280G can result in a 20% excise tax in addition to ordinary income tax on the person receiving the phantom payments and a loss of tax deductions for the company unless the 280G issue is cleansed. We go into much more detail on what is 280G and how to cleanse a 280G issue on the earlier episode. And we recommend listening to that for more information.

Megan Monson: To wrap things up, do you see companies frequently issuing phantom equity? And if so, what are the circumstances?

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Darren Goodman: Absolutely. It can be a valuable tool in a number of situations. In the current market, where companies are experiencing declines, that's one scenario. But we regularly see it when there's a company where for whatever reason just actual equity award just won't suit their needs. And we do help companies put these in place all the time.

Megan Monson: Thanks, Darren. That's helpful. And just one point to add to that. I tend to see this also come up pretty frequently in companies that issue profits interest because they may not want to issue those on as wide of a scale basis to less senior management for tax reasons and a number of other issues that we're not going to get into today.

Darren Goodman: Yeah, I agree. That's a great point, Megan. So I often see a two-tier structure where the very senior management get the profits interest and the employees below that very senior level get a phantom equity arrangement.

Megan Monson: Great. Thanks, Darren. So overall, phantom equity can be a really useful tool to incentivize key employees, and it's a beneficial alternative to issuing actual equity for a number of the reasons that we've discussed today. It's helpful for companies to be aware of this option when considering how to best compensate their employees.

Today's episode is intended to give you a high-level overview of phantom equity arrangements and some of the benefits and drawbacks of these arrangements. But of course, it's by no means a comprehensive discussion of all considerations. As mentioned throughout this discussion, if you're planning to or thinking about implementing a phantom equity arrangement, we highly encourage you to consult with executive compensation counsel to help you optimize the tax and other benefits provided under the plan.

Thank you so much for joining us today. We look forward to having you back on our next episode of Just Compensation.

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