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Retaining Key Employees Through 'Phantom' Stock Plans

Entrepreneur's Notebook
By Mark Lipis

If the stock market rally that's been holding on since October means the economy is on the road to recovery, owners of many small to mid-sized businesses face a new and tricky problem: how to keep key employees from jumping ship just when the going gets good.

In hard times, key employees earn your loyalty by helping you fend off disaster. They also burnish their managerial skills, becoming attractive candidates in the job market when good times return. Sometimes, just as you need them most, they find other opportunities.

The solution?

A compensation package tuned to the needs of the moment – meaning one that will make the good work done by your key employees in hard times more valuable to them and to you if they stick around as things improve.

You have two tools to work with in designing compensation plans – stock and cash – and how you use them reflects both your willingness to share successes but also your plans for the future. In particular, if the prospect of good times ahead leads you to think of leaving your firm in the foreseeable future, it will pay you to use these tools wisely.

Offering shares

Let's say you anticipate exiting in five years, perhaps by selling to a strategic buyer or to a competitor, and you want to retain control of 100 percent of your stock in the meantime. Your company's net worth stands at $10 million today, and with hard work you think you might grow it to $20 million before you cash out.

A phantom stock plan might be a good approach under these circumstances, in large part because it meets your need to keep equity in your own hands and your key executives' need to have some stake in your success.

Phantom stock plans are non-qualified deferred compensation plans – they don't receive special treatment under federal tax law.

The good news is that you can discriminate in favor of your highly paid people with phantom stock plans, something you can't do in qualified retirement plans.

Phantom stock plans allow your key people to earn units, or phantom shares, if they meet certain specified goals during the life of the plan, promising to pay each one a sum of money for each unit

earned when the plan terminates. As a rule, the value of each unit reflects the value of the company's stock. As the value of the stock grows, so does the value of the phantom stock.

The effect is that your key people participate in reaping the rewards of growth even as they help to create it. This allows you to give special treatment to those people most responsible for your success, in the form of powerful incentives. Indeed, at its heart the effective phantom stock plan is an effort to tie your prosperity together with that of your key people, putting you on the same page when it comes to growing your business.

Best of all for the business owner who wants to keep control, you don't dilute your ownership with a phantom stock plan.

Thus, assuming each unit is worth $100 a share and you sell your company five years down the road at $150 a unit, you give each employee a sum equal to $50 multiplied by the number of phantom stock shares credited to his or her account.

Another advantage of this strategy is that everybody cashes out simultaneously, using money generated by the sale of your business.

Plans generally have vesting schedules; those who quit before vesting leave their money behind. Plans usually also have special provisions for employees who retire, die or become disabled before the plan terminates.

Assessing downside

There are two potential drawbacks to a phantom stock plan. First, although these plans impose a future, not current, obligation on the employer, your accountant will probably insist on charging the obligation against earnings for the growth each year.

Such a charge is not a deductible expense, so your financial statements may show a reduction in earnings with no corresponding deduction against taxes – a disadvantage should you need a loan from a commercial bank in the meantime. You will, however, get a deduction when the plan actually pays benefits, so the deduction is really just deferred, not lost. Second, your key people must report the actual payments when received as income taxed at ordinary, not at capital gains, rates.

Another potential drawback is that as people vest, they earn the value of their phantom stock units. Thus, even if you haven't sold the company, you'll still need cash to pay benefits. Assuming your company's value has increased, this shouldn't be a problem.

These things aside, a phantom stock plan is an attractive approach for the employer who, having come through hard times with the help of key people, wants to make sure they stick around long enough to benefit from good times. Indeed, it can cement the relationship between you and your key people – because even as good times make the fruits of hard work apparent to everybody, those who help you grow that fruit get to pick some of it for themselves.

For more information, contact Mark Lipis at Lipis Consulting, Inc. at 310-445-4393, or mlipis@lipisconsulting.com. For more information on Lipis Consulting, visit www.lipisconsulting.com.