The Alchemy of Ownership

Use Phantom Stock Plans to Improve Retention and Grow Revenue

An Informative White Paper for the Owners of Private and Closely Held Companies

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Sixty-nine percent of U.S. companies report talent shortages—the highest in over a decade.[1]

Midsize companies face a serious challenge from larger and smaller competitors to attract and retain top performers—the executives or key employees, who can make a measurable difference in the growth of your company.

These performers drive innovation, progress, and revenue.
You cannot afford to lose them.

But the challenge is not only finding talent; the deeper challenge is finding the right senior executive or the right succession team to push forward on success goals.

How to find and select the right candidate preoccupies most recruiting and hiring professionals daily. Assuming they do find the right candidate, what happens when a few years later, top performers then exit the team—from CEOs to vice presidents of sales—transitions do not always go smoothly.

Remember crash and burn examples of the past and present?

Richard Fuld, Lehman Brothers; Kenneth Lay, Enron; Bernard Ebbers, WorldCom. And now, sudden departures from Adam Neumann, WeWork; Kevin Burns, JUUL; Devin Wenig, eBay; and Carlos Ghosn, Nissan Motor. These examples are extreme and apply to larger companies. Nonetheless, 1,332 CEOs left in record numbers in 2019.[2]

On top of this top-level churning, we're in the early stage of a major workforce transition: Boomers retired, retiring, or soon-to-be.

Twelve million baby boomers own their own companies, and 70 percent of them will retire over the next two decades. Nearly 47 percent of business owners over age 65 **have not prepared a transition or succession plan for themselves or their companies.**

Successful or not, transitions cause ancillary costs of the attract-recruit-reward challenge such as promoting searches, relocation requirements, sign-on bonuses, referral awards, plus the overhead costs of your human resources talent or any other managers involved in hiring.

[1] ManpowerGroup Reports 4th Quarter and Full Year 2019 Results
[2] "Why Have More Than 1,300 CEOs Left Their Post in the Last Year," Nov. 6, 2019, NBC News, Claire Atkinson, senior media editor

For senior-executive roles, the outlays have been estimated at **213 percent of the annual salary**.[3] Costs rise exponentially if you lose six, 12, or 18 months finding the ideal candidate.

Add to talent shortages and retirement pressure, a major skills gap in the national workforce. At a minimum, training budgets must grow and upskilling must begin now. Consider the impact of the two statistics below:

> ***"Skilled workers are going to become even more in demand as America's manufacturing industry is projected to have 2.4 million unfilled positions over the next 8 years."***
>
> ***Industry Week***

83%

of employers report having a significant number of employees who are at or approaching traditional retirement age (65). Source: 2018 Willis Towers Watson, U.S. Longer Working Careers survey.

Larger, publicly traded companies attract top performers with generous benefits like full stock grants or stock options, restricted shares and units, or other forms of long-term equity compensation.

Smaller companies are more inclined to attract top-performers with innovative, fast-paced cultures and ground-floor IPOs. Mid-market companies must balance both sides to retain their talent.

Competitors use their best hunting skills to win another company's star contributor. And star contributors often experience instant gratification with a new employer, whether for more money, more benefits, or more upward mobility. Better offers appeal to most valuable employees and executives.

[3] *The Power of Planning,* a study of 200 privately held businesses by Wilmington Trust.

How can midsize companies influence top-performers to stay on the team, drive up revenue, and meet business goals without stock equity?

How can owners offer financially worthy benefits without diluting control of their companies?

What do you do to solve these questions?

Profile: Small and Midsize Companies

First, let's define the term small and midsize company. Typically, these companies support workforces of fewer than 1,000 employees.

Large Firms	**1,000+ Employees**
Midsize Companies	**100-999 Employees**
Small Businesses	**‹ 100 Employees**

By revenue size, definitions vary widely from $5 million to $3 billion. Many financial professionals consider the middle market from $5 million to $100 million and $100 million to $500 million, as well as up to $3 billion.

To these hard-working owners, we speak. You've heard the expression *'Everything has its price.'* When it comes to employee compensation and benefits—one of the heaviest burdens on your balance sheet—you can grow your company and share the bounty with those who helped get you there or who will help you get there in the future.

In our paper, we show you how to recruit, reward, and retain top talent without paying the price of diluting stock— giving up any measure of corporate control.

The key is to use your alchemy of ownership, that special blend of traits that enable you to take risks, make hard decisions, and build something of value. Help your key employees and executives think critically and perform like owners, wired to build, grow, and sustain the company you've built.

Any business owner who has built a multi-million-dollar company, and I've built three, grapples with this desire: "*If only my employees could walk in my shoes, they'd get it, they'd feel my passion and commitment.*"

Business owners represent a special breed. You see problems as opportunities, competition as motivating, and making money as exhilarating. You're ambitious. Resilient. Consistent. And driven to produce results. Think of these age-old questions.

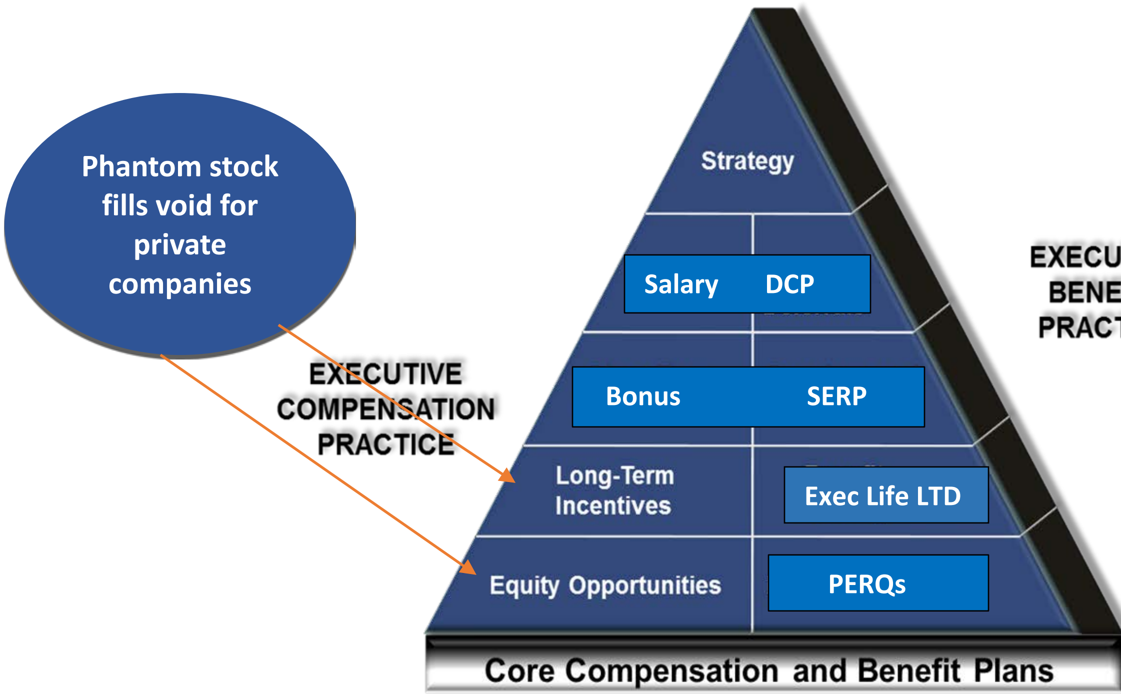
Can ownership be taught?
Can you change attitudes?
Are entrepreneurs born or made?

Influence executive behavior with the right mixture of leadership and reward. You can act now to invest in executives and help them feel like owners. Some owners need to be the alpha on the team. Other owners want to find ways to democratize the team in exchange for corporate growth.

If you only knew how. Soon, you will.

Revisit Executive Compensation and Benefit Plans

Allow me to present a super-short lesson on how to view executive compensation and benefits. Picture two supporting beams of long-term structure as in the chart below. Now pay close attention to the lower-left corner.



Find Your Balance with Phantom Stock

When top management, highly compensated employees, or financial advisors review employee compensation plans, they strive to balance both sides of the above equation.

For large, publicly traded companies, management can issue ownership to key employees in **various equity and long-term incentive plans**. But midsize company owners are reluctant to dilute their shares or give outright equity ownerships to employees for reasons from compliance and voting rights to control and complexity.

We urge you to consider using **phantom stock** to replace for the lower-left corner, without giving up ownership control or voting rights.

In best practices, the right combination of compensation and employee benefits form the company's integrated total rewards program. Why? Because well-designed compensation and benefit plan, especially with stock awards, balance the total

compensation and benefits strategy. With phantom stock in its compensation mix, small to midsize companies can begin to eliminate their traditional disadvantage.
Now let's review the type of long-term incentives in practice, then single out one that can become your secret ingredient: Stock grants, phantom shares, and phantom stock option plans.

Example: Full Value Stock Grant

This type of stock is common currency among large, publicly traded companies. These companies can use this currency to attract and retain key executives. To illustrate, I'll use the pseudonym Agilon Technologies to discuss how the CEO, Bob Sheridan, and his compensation committee, decide to put a golden handcuff on his senior vice president of sales, Margaret Sterling.

Sheridan arrives at a long-desired milestone, $20,000,000 in revenue. He decides to give Sterling 10,000 shares in the company valued at the full price of $15, subject to certain provisions and a vesting schedule.

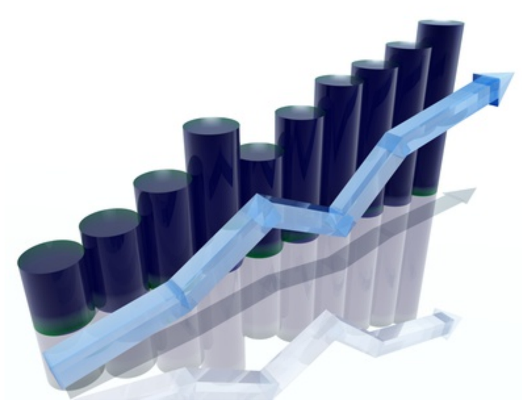
The day arrives when she is fully vested in those shares granted, usually five years. The stock now has a market value of $20 per share, so her shares reached a market value of $200,000.

She can cash those shares in or hold them for long-term gains. The stock grants add an extra inventive above base salary, short-term bonus, and other attractive benefits offered by the company. These grants become part of the company's long-term incentive compensation strategy with some shares granted each year.

So how do privately held companies compete as it relates to long-term incentive plans and equity compensation? The Phantom Stock Option Plan.

Defining the Phantom Stock Option Plan

This benefit plan offers select employees and senior executives many of the benefits of stock ownership without the owner giving up any company stock, sometimes referred to as 'shadow stock.' Rather than receiving physical stock, the employee receives shadow stock. Though not real, the phantom stock follows the price movement of the company's actual stock.



Phantom stock is a contractual agreement between a corporation and recipients of phantom shares granting employees the right to a cash payment at a designated time or in association with a designated (trigger) event in the future. The payment amount is tied to the market value of an equal number of shares of corporate stock.

The payout amount increases as the stock price rises and decreases if it falls—remember, the recipient does not receive actual stock or have any of the rights of shareholders.

Like other stock-based compensation plans, the mission of phantom stock brings alignment between employees and shareholders, adds to share value, and encourages retention of employees, managers, directors, or even third-party vendors.

Many factors come into play when designing and implementing a phantom stock plan, beginning with the company's business strategy. Phantom stock plans also take many forms: valuation, participation, and allocation of shares, redemptions, timing, dividends and vesting, all of which affect plan success.

Types of Plans

Phantom stock programs include performance phantom share plans, phantom stock options (appreciation only) and full value phantom plans as follows:

Performance Phantom Share Plan (PPS)

PPS plans are performance-contingent, pay denominated in phantom stock, and earned over a performance period if certain performance goals are attained. The performance period typically is a three to five-year duration. Usually, grants are made every year as a consistent incentive device, which results in overlapping performance goals.

PPS contains two distinct performance-based factors. First, the key employees must reach certain pre-determined performance targets to be awarded phantom shares.

Companies adopt this type of structure because they want to tie the plan to factors the employee can control, such as revenue growth, net income, and more. You can vary the shares by employee and by the degree you reach target goals. Financial targets include such measures as pre-tax income, revenue increase, or EBITDA (Earnings Before Interest, Tax, Depreciation and Amortization.)

The second performance factor rests on the potential improvement in value for phantom stock value appreciation. Once awarded, phantom shares may still remain subject to vesting schedules or other restrictions. The tax effect on employees mimics phantom stock, resulting in ordinary income taxation to employees when they convert to an actual cash payment.

Case Study: Financial Services Company

The company designed the plan for the top 10 senior managers out of a total employee base of 1,200. It considered using two financial matrices (EBITDA and revenue) as the performance targets but settled on one to keep the plan simple—gross revenues.

They set the target at 20 percent average annual growth of revenue with a three-year measurement period to earn the award. Each unit granted had a three-year vesting period and paid the award in cash at the end of year five. The company allowed deferral on the cash payment into its deferred compensation plan so that money would be available for senior managers' retirement.

Even with the 20 percent revenue growth set over three-years , it did pay a lesser reward for growth above 7.5 percent (25% of target), and a higher reward for growth over 20 percent.

As an example, in year one, employee A was given 100 units worth $1,000 each. At the end of three years, the company met 75 percent of the target (i.e., 15% growth); therefore, his reward was $75,000, paid in cash in year five.

In the second year, the executive earned another grant of 100 units for the second three-year cycle (units awarded could be zero or any amount determined by the company).

During these three years, the company exceeded the target of 20 percent, hitting 25 percent growth (150% of target), so the reward was worth $150,000, which was paid five years from the grant date. The company informally funded the plan with corporate-owned life insurance (COLI) to hedge the liability and maintain available cash during the payout periods.

Full Value Phantom Stock

This approach offers another reward mechanism for deferred compensation, which creates a similar result to restricted stock. The sponsoring company determines a phantom stock price for the shares either through a formula or outside evaluation (valuation discussed later).

Award employees some number of phantom shares that may carry specific terms and conditions. At some point, active employees receive a cash payment equaling the value of the original shares plus the appreciation. For example, assume an employee receives 1000 shares of phantom stock with a starting price of $10. At a pre-determined future date, the company calculates the value of the phantom stock price and pays the employee the full value.

Assume in our example, the share price grows to $25. The company will pay the employee $25,000. The phantom stock plans do not result in shareholder dilution because no transfer of actual shares occurred. **Employees do not become owners per se, but they do realize the same results as if they owned the shares.** This realization is <u>a point where the employee may begin to think like an owner</u>.

Case study: Medical Research Company

> This company designed a plan for the CEO (hired professional) and his six direct reports. The company allocates 12.5% of "units" for the Board Compensation Committee to issue at its discretion, on the CEO's recommendation. Valuation on the shares (units) occurs at entry to the plan, typically within one year of employment, and then revalued annually. The vesting period is seven years.
>
> Valuation equals seven times EBITDA plus cashless interest-bearing debt. Unit valuation determined at entry and subtracted from the unit value at exit (resignation, retirement, termination), then multiply the difference by the number of units allocated to each person. Typically, allocate 1-1.5% per person, depending on his or her role.

Phantom Stock Option Plans (PSO)

Here comes the crème brûlé in our stock confection. A phantom (faux) stock option plan offers an equity-flavored incentive analogous to a stock option plan in a publicly-traded company. PSO plans solve the corporate owner's need to retain control of what he has built and simultaneously keep employees motivated and invested in their contribution to corporate growth.

So, like a stock option plan, a PSO plan gives the employee the right to purchase shares at today's price (without issuing real shares). Example: The employee is awarded 1,000 phantom shares currently priced at $10. He may purchase them now, or wait until the end of the vesting period when he would expect appreciation in the shares, say five years. If he waits, and at the end of the vesting period, the share price is $16, the company will pay him the spread of $6,000 (the difference between the purchase price ($10) and the current price ($16) times the number of shares).

PSO plans work much like stock appreciation rights (SAR) plans where the employee receives the appreciation versus the full value. Also, many companies allow the employee the option of deferring those gains.

Case study: Software Development Firm

The company designed a plan for its executives at vice president level and above (approximately 50 people). The company offered awards annually based on company and individual performance. A three-year vesting covered each block of grants with the cash payments scheduled to begin in year four.

The company allowed employees to tax defer payouts into the company's nonqualified deferred compensation plan, which allowed a menu of mutual fund investments with various payout options, including at retirement.

The shares were valued at five times EBITDA. With the three-year rolling vesting schedule (every grant vests over three years), the employee always leaves cash on the table if he or she leaves the company.

Define Objectives First

Before deciding which plan direction to pursue, consider your plan objectives by asking yourself a few practical questions:

Do you want to reward your select group for past contributions to company success or future contributions? What are realistic retention targets?

Are intended participants in the plan new to the company or long-term employees? What's the composition?

What matters more to you—preserving or growing company value?
Should you include strategic and financial goals in the performance criteria?

Phantom Stock Fits

If you are serious about a balanced and effective long-term incentive plan, then consider issuing phantom stock. Again, when well-designed, phantom stock plans motivate and retain key employees without letting go of any company ownership.

Such plans hold the potential to yield payoffs like equity grants or stock options. By building phantom stock into your benefits strategy, you can pass along the same financial reward to consistently valuable executives or employees without incurring any of the risks or complications typically associated with equity sharing.

How Phantom Stock Works

Let's master the internal workings of phantom stock. Imagine that you want to incentivize a top-performing employee to ensure long-term loyalty. You give him or her a bonus amount based on the market appreciation value of your company's stock over a certain period, and proportional to his or her salary level.

Decide to influence and shape behavior in your select group. If they hold skin-in-the-game through stock, then the responsibility of ownership will influence the group to hold the interests of the company above their own and grow its value.

Diamond in the Rough

Phantom stock is the diamond in the rough of executive compensation and benefits. Conventional wisdom says give stock to incent ownership. That may be true if you are planning an IPO. But outright stock grants bring headaches.

For example, when you share real equity with executives, you're required to open the books, give ownership rights, and pay dividends. Worse yet, you will give up some control of the stock and interest in the company. *Why do that if there's a smarter solution?*

The application of phantom stock is simple and straightforward. Many forward-thinking companies establish a formula that provides some retirement benefits to the "employee stockholder." This action strengthens employee retention and further enforces a non-compete provision that extends beyond employment years.

Imagine a company setting up a ten-year plan with the employees in a position to earn stock equal to one to ten percent of the company's assessed value. At the endpoint, the employees cash out over ten years, and collect not more than 10 percent of his or her accumulated value each year.

All-Important Plan Design

Let's discuss the appropriate design of an effective phantom stock plan. When you issue phantom stock, you also develop the building blocks of deferred compensation which, in turn, produces tax-deferred wealth accumulation and retirement advantages.

Select the design that best fits your company's objectives.

If you're not sure which type of plan design to use, consider going with the phantom stock option design to award the appreciation in value of your company. You will experience less risk with no increase in value and no payment to the employee.
There are five basic steps to plan design:

1. **Determine, then designate, a foundational value to each unit/share equal to the value of company common stock.**

   Commit to a formal appraisal to establish company value. Most companies use some multiple of EBITDA or net earnings.

   You may want your formula value of the stock to be a number less than the market value you might use to sell the company one day. The employee-participant can always realize that value if you sell the company.

Real Valuation

The determination of corporate worth is essential when setting up phantom stock plans or any other financial arrangements. In our experience, owners sincerely believe they know and understand their company's value but, upon closer assessment, discover they are off the mark.

In our firm, it is a sound business practice to secure an outside valuation firm for your appraisal. We can recommend excellent providers to you.

2. **Identify the composition of your select reward group**. Typically, if your workforce equals 1,000, you will not number the highly compensated group more than 10 percent, just as you would in a nonqualified deferred compensation plan. However, from our experience, a 1,000-employee company would have much less than 10 percent of the employees in such a plan.

   Be sure this exercise meets the requirements of the Department of Labor guidelines for nonqualified plans to avoid any potential for ERISA penalties. Start with a small group and expand as time goes by. It's always easier to expand the group than contract it.

3. **Award these unit shares to select employees as deferred compensation** by your compensation committee. Don't do one-time grants. Set up a pool and a schedule and award grants annually. We've learned this method is the best way to inspire continued motivation for key employees.

   Let's say you decide on 10 million shares. Remember, this does not equate to real shares. You may distribute these shares over time. You are only creating an attractive reward for employees in the future, not true stock. Here's a rough formula based on EBITDA:

EBITDA	Shares selected
Multiple selected	5
Formula Value	$100,000,000
Shares selected	10,000,000
Shares price	$15

Multiple advantages result from these five actions.

In general, stock ownership motivates an employee to improve performance and company profitability. With this stronger financial bond to the employee, the employer-owner gains a competitive edge or 'glue in the seat' to hold his best employees in place for a longer period than thought possible.

Be vigilant. Executive search moves fast in most business sectors, particularly healthcare, financial services, and technology.

Redemption/Distribution of Shares

4. **Once you have granted the shares, spell out your plan,** and indicate when the executive can cash in his/her shares.

   Remember, in most cases, phantom stock settles in cash. So, a plan design could indicate payments due in, let's say, five years. Once that date arrives, the sponsoring company then calculates the amount due and makes a payment to the employee, normally in cash. The payment processes as any other compensation and taxes are withheld.

   The plan document should carefully detail how to make payments under various triggering events such as:

   - In-service events (allowing payment while still employed)
   - Separation of service (voluntary)
   - Separation of service (involuntary)
   - Termination for cause
   - Retirement
   - Disability
   - Death
   - Leave of absence (with pay and without pay)
   - Change-in-control
   - Termination of the plan

   Payments can be structured as a lump sum or over a period, such as 5, 10, or 15 years. When doing so, companies need to determine whether such installment payments include interest or whether the employee payments remain subject to fluctuations in value (under the plan formula).

Dividends

Most plans do not pay dividends, although they could. In our study of companies with phantom stock plans, one company paid a dividend that was a percentage of pre-tax profits. Management felt that the plan could produce more value if it also had a short-term year to year focus on pre-tax profits.

Vesting

We arrive now at the final step in plan design—vesting. Since we're discussing a nonqualified plan, <u>you are not subject to the required vesting schedules</u> in qualified plans, though your vesting schedule should reflect your plan goals.

5. **Set your vesting schedule**. The most prevalent vesting schedule is three, four, or five years. However, the impact is different depending on the vesting approach. As an example, your plan could feature a five-year cliff vesting schedule, which means at the end of five years, the employee vests 100 percent in all shares granted. Alternatively, you could have an award vest 1/3rd, 1/3rd, 1/3rd, or 20% a year for five years.

Or, the company could have a class-year vesting schedule, which means if the company grants 100 shares this year, those grants will vest in five years. Then if they grant an additional 100 shares next year, those will vest five years later, which is six years from today. This laddering effect compels the employee to always leave something on the table if they leave early.

Most plans offer accelerated vesting for events such as death or disability of the employee or change in control (COC) of the company. On COC, you need to define what that means; for example, major shareholder selling more than X amount of their ownership or outright sale.

Other factors to consider when designing your plan:

Dark Cloud—Tax Treatment

Plan and participant taxation may give you pause. Tax and regulatory requirements tend to cast a seemingly dark cloud over phantom stock. For example, the cash accumulated to pay for the benefit may be subject to an excess accumulation earnings tax (a tax applied to set aside too much money in reserve versus using it for business needs).

From a tax standpoint, treat phantom stock plans like nonqualified deferred compensation (NQDC) arrangements. In general, they are subject to Section 409A, which includes detailed provisions regarding the timing and form or distributions.

If benefits payout when vested, Section 409A does not apply. If payments defer beyond the vesting date, or if the awards link to a deferred compensation plan, then Section 409A does apply.

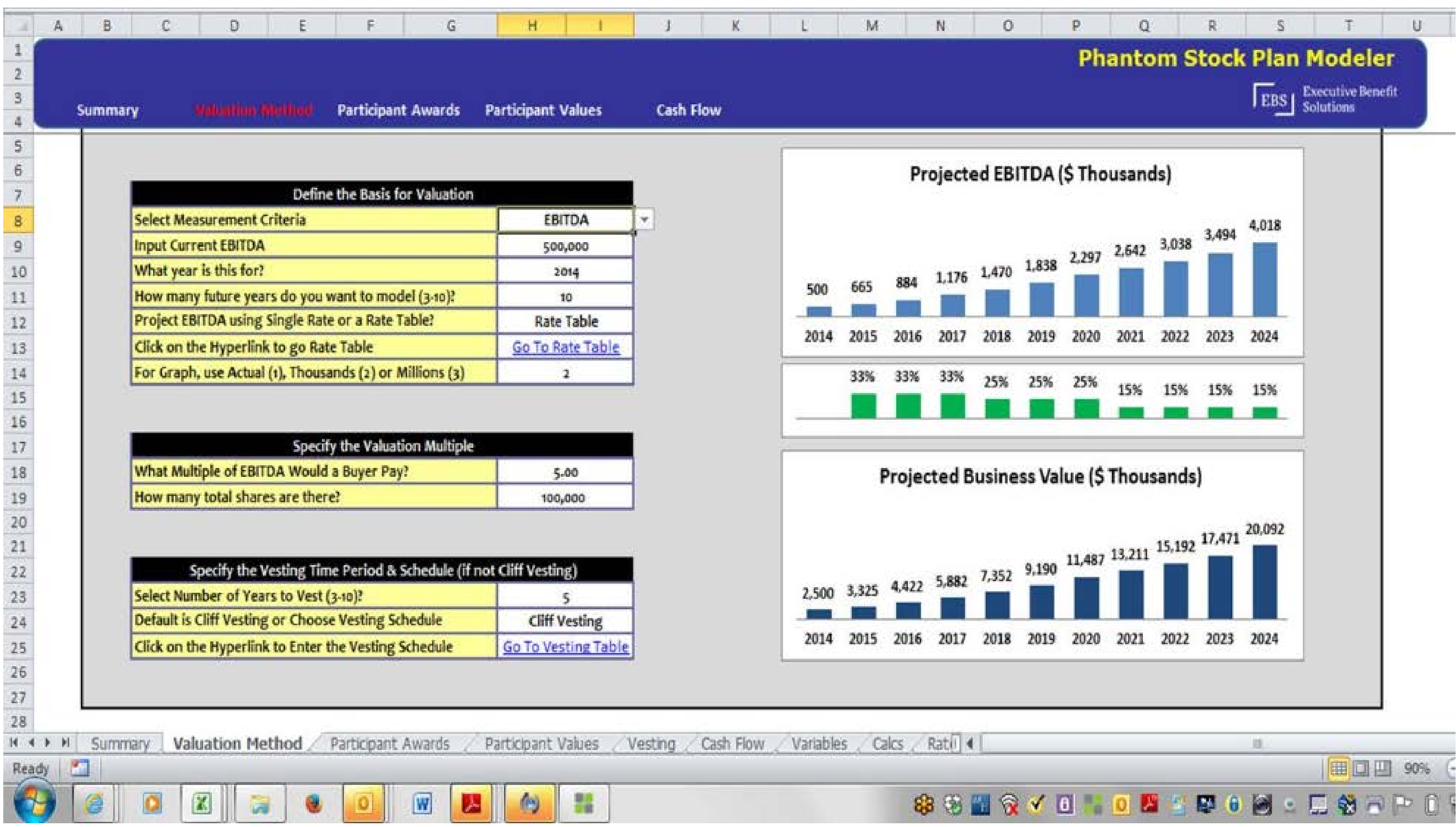
If a plan includes deferred payment options (beyond the vesting date) and complies with the Section 409A requirement, then taxes are not due by the employee until triggered by the actual receipt of benefit payments. At this point, the company is entitled to a tax deduction, but only in the year payment is physically made.

FICA taxation is different. Whether or not the payment of awards defers, FICA and Medicare taxes remain due and payable upon vesting.

Recognize, too, that you cannot report or deduct any taxable income when contingent credits are made to a participant's account. This requirement shows why it is important to project out how large this liability can get, as cash must be available eventually to make the benefit payment.

Executive Benefit Solutions, with its **Phantom Stock Modeler**, can assist in calculating various scenarios toward growth. In fact, you can participate in a live-action demonstration of our proprietary modeler as we build various scenarios. Review the sample screenshots below to understand the significant data output:

Valuation



Participation Awards

Phantom Stock Plan Modeler

Summary | Valuation Method | Participant Awards | Participant Values | Cash Flow

EBS Executive Benefit Solutions

Phantom Stock Awards

#	First Name	Title	Salary	Bonus	1 2015	2 2016	3 2017	4 2018	5 2019	6 2020	7 2021	8 2022	9 2023	10 2024	
1	John Smith	COO	350,000	150,000	1.00%	1.00%	1.00%	1.00%	1.00%						
2	Jim Douglas	CFO	325,000	125,000	3.00%										
3	Jane Doe	SVP Marketing	300,000	100,000	2.75%										
4	Nancy Jenkins	SVP Manufacturing	275,000	85,000		2.00%									
5	Jack Jones	SVP HR	250,000	75,000			1.50%								
6															
7															
8															
9															
10															
					6.75%	3.00%	2.50%	1.00%	1.00%	0.00%	0.00%	0.00%	0.00%	0.00%	<==Annual Awards
					6.75%	9.75%	12.25%	13.25%	14.25%	14.25%	14.25%	14.25%	14.25%	14.25%	<==Cum Awards

Summary / Valuation Method / Participant Awards / Participant Values / Vesting / Cash Flow / Variables / Calcs / Rat

Participant Values

Phantom Stock Plan Modeler

Summary | Valuation Method | Participant Awards | Participant Values | Cash Flow

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		2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023	12/31/2024
Growth Rates Selected:			33%	33%	33%	25%	25%	25%	15%	15%	15%	15%
Company Value:		2,500,000	3,325,000	4,422,250	5,881,593	7,351,991	9,189,988	11,487,485	13,210,608	15,192,199	17,471,029	20,091,684
Shrs/Value:	100,000	25.00	33.25	44.22	58.82	73.52	91.90	114.87	132.11	151.92	174.71	200.92
Annual Awards:			4.00%	3.00%	2.50%	1.00%	1.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Value to Participants:			55,688	162,669	341,439	536,267	798,181	1,125,575	1,371,120	1,653,496	1,978,230	2,351,673
% of Company to Participants:			1.67%	3.68%	5.81%	7.29%	8.69%	9.80%	10.38%	10.88%	11.32%	11.70%

1 John Smith

Year	Cal Year	Equity Award	Shares Granted	Base Value	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019	12/31/2020	12/31/2021	12/31/2022	12/31/2023	12/31/2024
1	2015	1.00%	1,000	25,000	8,250	19,223	33,816	48,520	66,900	89,875	107,106	126,922	149,710	175,917
2	2016	1.00%	1,000	33,250		10,973	25,566	40,270	58,650	81,625	98,856	118,672	141,460	167,667
3	2017	1.00%	1,000	44,223			14,593	29,297	47,677	70,652	87,884	107,699	130,488	156,694
4	2018	1.00%	1,000	58,816				14,704	33,084	56,059	73,290	93,106	115,894	142,101
5	2019	1.00%	1,000	73,520					18,380	41,355	58,586	78,402	101,190	127,397
6	2020	0.00%	0	0						0	0	0	0	0
7	2021	0.00%	0	0							0	0	0	0
8	2022	0.00%	0	0								0	0	0
9	2023	0.00%	0	0									0	0
10	2024	0.00%	0	0										0
		5.00%	5,000		8,250	30,195	73,975	132,791	224,691	339,566	425,722	524,802	638,743	769,776
					0.25%	0.68%	1.26%	1.81%	2.44%	2.96%	3.22%	3.45%	3.66%	3.83%

Summary / Valuation Method / Participant Awards / Participant Values / Vesting / Cash Flow / Variables / Calcs / Rat

As you can see, the modeler tackles terabytes of data and creates formulas and visual presentations in real time. You stay fully informed as you decide next steps.

We turn now to brief reference to accounting concerns.

Accounting Issues

Phantom stock plans settled in cash generally require variable accounting, which requires on-going interim calculations of the related compensation expense. The company should accrue the estimated compensation expense over the same timeframe as awards accumulate.

Equally important, you must adjust company financials each year to account for any added share awards earned by an employee-participant and account for any increase or decrease in share price value.

Note that in variable award stock options, a charge amortizes only over a vesting period. But with phantom stock or SARS (stock appreciation rights) settled in cash, the charge accrues during the vesting period. Once vesting occurs, you take share price increases as they occur.

Other Issues

ERISA: It is important to consider the ERISA implications of plan design. If plan design calls for deferral of compensation until retirement, ERISA may apply, subject to the "Top Hat" exemption for unfunded plans for a select group of management or highly compensated employees.

Securities Laws: Even though no company shares will be issued, in conjunction with most phantom stock plans, the plan may be considered an offer to sell securities under federal securities laws. However, exemptions exist in such rules for privately held companies that may apply.

Applicability for S Corporations and LLCs: Phantom stock plans work well for both S Corporations and LLCs. Design these plans on either a full value or an appreciation basis and tailored to the specific needs of participants aligned with the sponsoring entity's objectives. Note that for LLCs, phantom plans are phantom unit plans with the option to structure and mirror a capital interest, a future profits interest, or both.

Finally, some S Corporations and LLCs use the performance units' structure versus a phantom stock format to tie participants' long-term compensation to specific performance criteria, and not share price. In this scenario, it's desirable to use different performance criteria for different key employees or to incorporate strategic and financial goals. Significant flexibility exists.

For example, you could base performance unit value on incremental revenue for the sales team, and a combination of revenue and operating income for others. Also, the unit value could include an opportunity cost of capital factor.

Financial Matrices

Executive Benefit Solutions builds models and selected financial matrices around your plan design. As an example, when designing a phantom performance plan, you may choose to use two or more financial matrices to value units awarded to employees. As discussed earlier, you can convert the units to cash payments at a future date.

Our proprietary modeler helps to communicate the value to the employee so he or she can see the impact on improving the targeted matrices. The modeler is important in the plan communication when making grants at various prices over a series of years.

Funding the Plan

Phantom stock programs, as with nonqualified plans, do not require cash funding. Plan participants will not know in advance how much they will receive in benefits. The benefit amount depends on the participants' performance and the sponsoring employer.

Employees need and want assurance the company sets aside enough money to pay the benefits they earn. Therefore, some companies do set aside dollars in anticipation of plan payment obligations.

Reasons for informal funding:

> To provide a degree of benefit security to participants;

> To match plan liabilities with a pool of assets; and

> To reduce plan cost through tax-advantaged pre-funding.

Usually, companies set up sinking funds, which is another cash asset on their balance sheet to pay benefits. They may use COLI mentioned earlier, which can provide benefits in the event of early death of the employee and cash values for benefit payments.

Companies can also use mutual funds and other assets. As mentioned above, the application of captive insurance strategies also brings unique tax benefits to both the company and participants.

Securing Your Plan

If you set aside funds, you can move out from under the regulatory clouds by segregating stock funds into a rabbi trust or a captive insurance company. This action enables employees to pay tax on the benefit when it is promised, not when paid. You carry a fiduciary obligation to protect your select group's phantom stock; it may be the only way to fill the upcoming retirement gap.

The centerpiece of a rabbi trust is the employer-owner's commitment to place investments in the trust and to earmark these investments to fund obligations under the plan. A frequent issue in phantom stock plans arises over how the employer-owner informally funds his or her promise to pay plan benefits.

The essential tension in nonqualified plan design lies between the need to maintain the plan as unfunded (so that benefits are not currently taxable and the plan is not subject to most of Title I of ERISA), but still secures employee benefits.

The most common solution to this dilemma is the rabbi trust, an irrevocable, employer-established grantor trust set up by the company to hold assets, separate from the other company assets, for purposes of paying future participant benefit obligations.

The rabbi trust protects participants from financial events caused by change-in-control or change-in-heart of the employer. However, for the phantom stock plan and participant accounts to maintain tax-deferred status, the assets of the rabbi trust are available to general creditors of the company in the event of the company's insolvency, subject to the claims of the company creditors.

Documentation, Implementation and Communication

At this stage, you're ready to convert the concept of your plan design and strategic decisions into the appropriate documentation. Normally, phantom plans require three documents: a formal plan document, an employee plan agreement, and an employee plan summary. Of note, five main areas of administration demand focus of the employer-plan sponsor:

- finance
- accounting
- human resources
- legal
- administration

Coordinate administration across all departments above for data accuracy and assurance you can execute with consistency. The company may handle all these functions internally or seek the help of an experienced third-party administrator. Executive Benefit Solutions delivers the resources needed to fully coordinate and service a dedicated account team to ensure your plan runs smoothly.

Critical factors hedge on the quality of communication and education. Plans can fail if employees do not understand the true value provided by the employer. Further, they may not understand how to use their plans in the context of their overall financial goals.

Access to financial planning is a key determinant of success for both employer and employee. Consider the practical technology platform from My Financial Coach (MFC). The firm offers a Fortune 500-quality financial planning benefit at a reasonable cost. Certified Financial Planners facilitate understanding of employee benefits and how to effectively integrate professional and personal financial goals.

Ready for a Phantom Stock Option Plan? Find Out

Perhaps, you wish to set up your own phantom stock plan but you're not sure of how to set aside secured funds given constant demands on cash flow. Experts at Executive Benefit Solutions will assist you model key assumptions with our Phantom Stock Modeler and run scenarios of plan liabilities, benefits, and future cash flow needs.

Visit www.executivebenefitsolutions.com and run some of the models yourself, or call us, and we will be happy to walk you through a few examples.

Six Points Worth Remembering

At this point in our paper, you may be on information overload. Apologies and appreciation for your read. If you only remember these six valuable points, you'll be ahead of most midsize company owners.

1. **Collaborate with executive benefit professionals early in consideration**
2. **Determine a value formula for the stock** and the amounts to issue
3. **Decide to work with an expert on plan design**
4. **Design the plan around your corporate objectives**
5. **Fund the plan, set aside assets**
6. **Secure the plan with a rabbi trust**

And, One Last Point:

In recent years, EBS has completed a significant amount of work relating to the restructuring of existing phantom equity plans that did not work as originally intended as a result of faulty design or changes in corporate structure, composition of the leadership team, operating conditions or shareholder objectives.

If your plan has lost its original intention or effectiveness, we invite you to discuss its structure with EBS during which we may offer modifications to improve its ability to meet shareholders' objectives and create value for participants.

Influence Employees to Think Like Owners

Through your leadership, principles, and actions, you built a quality workforce. To do so today in the world of work, you will need to work a lot harder. We recommend owners re-examine working environments, training programs, and your benefits plan, at a minimum. As you find deficiencies, commit to improvement. Execute as flawlessly as possible. And educate the knowledge ownership by example and by reward.

With a well-incentivized and performance-driven team beside you, the best of both worlds merge— enthusiastic employees and a lock on your stock.

Above all, your decision to develop a phantom stock plan will create meaningful and measurable value in the lives of people you respect and rely on to contribute to company growth.

EBS Executive Benefit Solutions

EBS is an independent executive benefits consulting firm providing total plan management services with respect to programs specifically designed for key employees and professionals. Those services include:

- Consulting with respect to plan design
- Structuring of related financing and benefit security arrangements
- Design and management of participant communication, education and enrollment processes
- Management of any informal funding assets
- On-going plan administration and technical support

More information on EBS may be found at: www.executivebenefitsolutions.com.

For more information on bringing Phantom Stock Option Plans into your business growth strategy, we invite you to contact one of our managing directors nearest you:

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