

The Exquisite Reality of Phantom Stock

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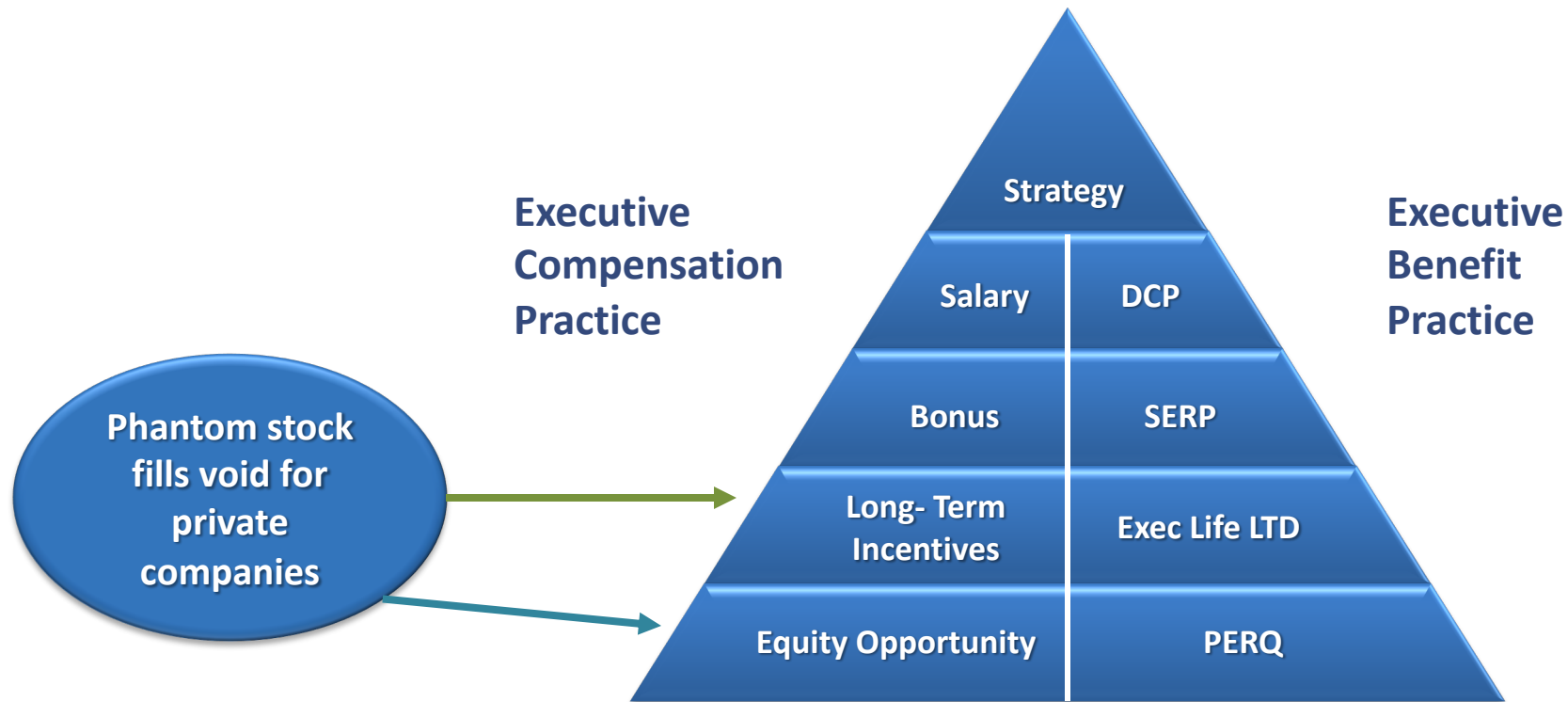
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MARKETPLACE

- “The number of people leaving their jobs climbed to the highest level in 5 years” – U.S Dept of Labor, October 2014
- “4.8 million people left their jobs in October 2014; half of those being voluntary separations” – Wall Street Journal, December 9, 2014
- “The more people quit, the more incentive there is for employers to reward for staying proactively – Jim O’Sullivan- Chief Economist, High Frequency Economics

THE ESSENTIAL AGREEMENT

- How can small and midsize privately owned companies compete with larger public firms to attract, retain and reward key value creators?*

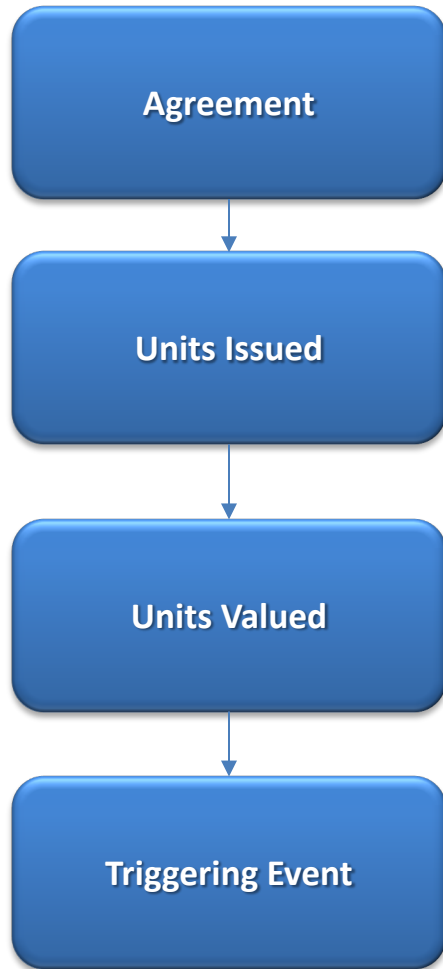


WHAT IS PHANTOM STOCK?

1. A Nonqualified Deferred Bonus
2. Awards Made in Units Like Stock
3. Unit Price is Tied to a Formula (or appraisal) that Reflects Company Value
4. Settled in Cash (almost always)

PHANTOM PLAN STRUCTURE

Structure



Rationale for Plan

- Attract & Retain Key Employees
- Align Goals
- Create Value for Shareholders & Employees

Privately Held Companies That Do Not Want to Give Out Equity Use Phantom Stock

Note: Plans are Subject to Rules Under IRC Section 409A

DEVELOP PLAN CONCEPT & BUDGET

- Identify the Purpose of the Plan
- Forecast Your Future Company Value
- Identify Potential Key Employees to Participate
- Carve Out the Plan “Budget”
- Select the Right Plan Design

DEVELOP PLAN PURPOSE



FORECAST FUTURE COMPANY VALUE



**EBS Modeler Enables You to
Project the Future Value of
the Phantom Shares and the
Liability on Company's
Balance Sheet.**

THREE TYPES OF PLANS

Full Value Phantom Stock Plan

- Deferred cash bonus program based on a set price for shares (example: \$10/share)
- At a pre-determined future date, the company calculates value & pays employee full value in cash

Performance Phantom Share Plan

- Contains two distinct performance elements:
 - Pre-determined performance targets
 - Value of stock appreciation

Phantom Stock Option Plan

- Structured as a stock appreciation rights plan
- Also a deferred cash bonus plan which creates similar result as a stock option plan
- Employees rewarded some number of shares of phantom options
- Like a stock option, employee paid spread between option price & market value



PLAN DESIGN DECISIONS

Redemptions/Distributions

- Date or event occurs
- Payment under various circumstances
 - ✓ in-service events (for active employees)
 - ✓ separation of service (voluntary)
 - ✓ separation of service (involuntary)
 - ✓ termination for cause
 - ✓ retirement
 - ✓ disability
 - ✓ leave of absence
 - ✓ change-in-control
- Payments in lump sum or over time

Control Over Timing of Distributions*

- Employer and employee

*Must comply with IRC § 409A

PLAN DESIGN DECISIONS

Valuation

- Presumed value based on formula (example 3X EBITDA*) on valuation

- Number of shares used in the plan

*(earnings before interest, taxes, depreciation and amortization)

Participants

- Criteria for who should be in the plan
- Legal restraints (select group of highly compensated or management)

Allocation of Value & Awarding of Grants

- Base salary ratio
- Level of employee
- Grant different amounts for different levels (e.g., 40% of salary group 1, 25% of salary group 2)
- Performance shares: grant based on pre-determined targets



PLAN DESIGN DECISIONS

Dividends

- Phantom dividends
 - ✓ paid only to vested participants
 - ✓ paid when shareholders receive dividends
 - ✓ portion of profits over a target
- No dividends (most plans do not pay dividends)

Vesting Schedule*

- Not required to have a schedule
- Cliff vesting
- Graded vesting (example: 20% per year)
- Class-year vesting
- Accelerated vesting (change of control, death, disability)



FUNDING THE PLAN

Phantom stock programs, as with nonqualified plans, do not require cash funding. However, 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.



Case Study 1

SOFTWARE DEVELOPMENT FIRM

CASE STUDY 1

Industry	Revenue Size	Description of Plan	Funding
Software development firm	\$26 million	<ul style="list-style-type: none">• Annual Grants of stock appreciation rights to 8 selected employees.• Awards were offered annually based on company and individual performance. - Vesting was over three years for each block of grants.• Cash redemptions were scheduled to begin in year four.• Company allowed employee to defer payout into company's nonqualified plan.	<ul style="list-style-type: none">• Company self-funded & payout• Company funded grant deferral in deferred compensation plan with corporate-owned life insurance (COLI)

Case Study 2

MEDICAL RESEARCH

CASE STUDY 1

Industry	Revenue Size	Description of Plan	Funding
Medical Research	\$800 million	<ul style="list-style-type: none">• Plan designed for CEO (hired professional) & his 6 direct reports.• Company allocates 12.5% of “units” for Board Compensation Cmte to issue at its discretion, on CEO’s recommendation.• Units valued at entry to plan, typically within 1 yr of employment, then annually with 7 yr. vesting period.• Valuation = 7X EBITDA + cash < interest-bearing debt. Valuation determined where per unit value @ entry & subtracted from exit (resign, retire, term) & difference multiplied by # units allocated to each person	<ul style="list-style-type: none">• Annual accruals (annual expense) on the P&L and deferred comp liability on balance sheet.<ul style="list-style-type: none">• Considering informal funding

PLAN IMPLEMENTATION STEPS

- Plan Documentation
- Accounting
- Communication and educational tools

Executive Benefit Solutions, LLC

EBS is an executive benefits consulting firm which provides total plan management services with respect to supplemental compensation and benefit programs designed exclusively for highly compensated senior executives and professionals

We work with plan sponsors to improve the effectiveness of compensation and benefit programs, and to control related costs.

More information about the firm can be found at: www.executivebenefitsolutions.com.

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DISCLOSURES

Phantom stock plans are a form of a Deferred Compensation and do not represent equity ownership in the Company. Phantom stock plans may be subject to either ERISA and/or IRC Section 409A depending upon the structure of the plan. Companies should seek guidance from qualified advisors if they wish to avoid these regulations.

Executive Benefit Solutions does not offer legal or tax advice. Please consult the appropriate professional regarding your individual circumstance.

Not intended for use with plan participants or the general public.