PHANTOM EQUITY: AN EQUITY-LIKE ALTERNATIVE FOR GROWING COMPANIES

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As every entrepreneur knows, it's difficult to attract and retain talent for your company—and when cash is tight, it only gets harder. To bridge the gap between what a growing company can pay its team in cash compensation and what team members are expecting for their long hours and hard work, growing companies often turn to restricted stock or stock option plans (for corporations) or profits interest plans (for LLCs). These equity incentive plans are designed to provide additional value to the company's team members in the form of actual equity ownership resulting in direct participation in the economic benefits of the future growth of the company. In most cases, this value is realized upon an "exit event" when the company is sold to a third-party acquirer (or, less common these days, upon an IPO).

Despite the popularity of such plans, they come with some disadvantages. For example, granting stock and profits interests results in expanding the number of actual legal owners of the company. This means: (1) additional administrative burdens—such as managing a large shareholder base or preparing numerous K-1s; (2) additional accounting and appraisal costs—such as the annual, independent valuations generally required to grant awards under such plans; (3) additional legal risks—as stockholders and profits interest holders are generally owed fiduciary duties; (4) additional current taxes paid by employees—as an award of restricted stock may be a taxable event, and an award of profits interests may result in an employee being required to pay his or her own self-employment taxes; and (5) the financial burden of repurchasing vested shares or profits interests from former employees (or otherwise leaving an equity "overhang" in the hands of people no longer working to grow the company).

To avoid these complications, entrepreneurs and their growing companies may want to consider an equity-like alternative known as "phantom equity." In its essence, phantom equity is a contractual right to participate in the economic results of a growing company's exit event, without requiring the award (and the associated burdens) of actual equity ownership. Phantom equity plans or agreements come in various shapes and sizes but regularly include the same vesting, hurdle and forfeiture requirements as traditional equity incentive plans. In addition, phantom equity plans generally share the following attribute that traditional equity incentive plans are designed to achieve: If there is a successful exit event, the phantom equity holders receive a percentage of the payout.

With a phantom equity plan, this participation is typically achieved by the company allocating an aggregate percentage of an exit event payout to the plan (say, 5% of sale proceeds), and then that pool of proceeds is shared among participants in the plan based on their holdings of "phantom shares" or "phantom units." It is important to structure phantom equity so that it complies with tax laws (including 409A), and phantom equity may not be appropriate for a founder or other key person with a significant equity stake who may be seeking capital gains treatment upon an exit event (as phantom equity payouts are always taxed as ordinary

income).

However, to incentivize a growing company's team at-large, phantom equity may be the efficient solution. Phantom shares or units are not real equity in the legal sense, but they do constitute real sharing in the value of a growing company's exit—and that may be the payoff your hard-working team members are looking for.

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