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Phantom equity has real advantages for agency owners and employees

Keeping the critical second-tier management motivated is especially important for PR firms, as these executives typically have front-line responsibility for maintaining important client relationships. Moreover, a business will enhance its value – if it wishes to position itself for a possible future sale – by assuring that second-tier management is appropriately compensated and, thus, likely to remain in place following an ownership change.

One way of keeping key employees properly motivated is to foster a sense of ownership in the business. Perhaps the most direct way is by compensating these employees with actual stock of the firm. However, many owners are hesitant to grant stock and risk ceding control or diluting ownership of their business.

An increasingly popular arrangement is to structure an equity participation plan that does not convey actual stock shares. Sometimes called “phantom equity” plans, these arrangements typically provide participating employees with some or all of the benefits of stock ownership without actually providing them with equity shares. These plans are binding contracts and can be very effective for both the agency owner and the executive.

These plans can take several forms. A common one is for the company to promise to pay select employees a bonus if it performs well financially over a defined performance period. Often, the company formulates this as a grant of hypothetical units (e.g., 1,000 phantom stock units). At the same time, the company may commit to a formula that will determine the units’ value in the future (e.g., based on company earnings or perhaps the valuation of its shares). Payout of the units can be subject to a vesting schedule, so the employee receives the benefit over time.

Another form of a phantom equity plan is for the company to promise to pay the employee a portion of the net sales price if and when the company is sold. For

example, the agency may promise to pay the employee a percentage of the purchase price or perhaps a percentage of the purchase price that exceeds a certain specified amount. Again, the promise can be expressed in the form of hypothetical units (e.g., 1,000 phantom stock units).

A phantom equity plan has advantages for both the company and executives. They include:

For the company:

1. Incentivizes employees without relinquishing equity and ownership rights.
2. Flexible design, including payout in the event of ownership transfer or following a performance period.
3. No cash outlay until sale takes place or profits are booked.
4. Provides executives with a disincentive to leave if payout is conditioned on continued employment through the payout date.

For executives:

1. Economic benefits of ownership, without actual ownership risks.
2. No cash outlay to purchase stock.
3. Targeted payouts can be triggered by the company reaching certain performance objectives or restructuring/sale of the company.
4. Cash payouts instead of holding illiquid stock.

Of course, before considering this equity alternative, savvy agency owners and executives must weigh its benefits and consult experienced legal counsel. ■

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