The flexibility of a nonqualified plan, combined with the long-term performance focus, makes phantom stock an ideal solution for many companies and, as accounting and tax rules evolve, perhaps for all companies.

Expanding the Phantom Stock Concept

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As traditionally designed, phantom stock plans have followed a fairly straightforward pattern: The employer offers the employee a part of the appreciation in the company's value without engaging in the buy-sell transactions required for actual equity ownership. While primarily used in privately owned companies unwilling to share ownership, phantom stock plans also exist in public companies as stock appreciation rights (SARs)—originally not as an ownership alternative but as a method of dealing with securities trading restrictions on corporate insiders.

The concept has been further translated into *performance unit* plans, which are similar to phantom stock plans but typically base compensation on measures other than company stock value. Similarly, *performance share* plans are essentially performance unit plans that pay out in stock rather than cash.

Over the past few years, most public companies have abandoned SARs because of changes in securities regulations—only 12% of the largest 200 industrial companies granted SARs in 1992, compared with 55% in 1988, according to a 1993 study by Frederic W. Cook & Co., Inc. Yet 28% of these companies made awards of performance units and 24% granted performance shares; these percentages have been stable over the past five years.

Among private companies, however, phantom stock is surging in popularity. In a recent CPM survey of 200 private firms, 10% of the companies reported using phantom stock while another 5% expressed interest in establishing some type of phantom stock program. These percentages may appear low, but only 38% of these companies are using stock options or other equity-based compensation plans, while virtually all public companies use them. Moreover, as discussed below, many compensation programs that function as phantom stock plans are labeled otherwise.

THE PHANTOM STOCK CONCEPT

In a phantom stock program, an employee receives the contingent right to share in the company's growth in economic value over several years. But no stock certificates are issued, no voting rights exist, and dividend equivalents are rarely provided. Phantom "shares" are awarded at the beginning of a performance cycle. Their initial value is equal to the fair market value per share of company stock, or an alternative measure considered a proxy for fair market value, such as book value. The increase in phantom share value is measured over the performance period, with the cash value paid at the end of the cycle—although in some plans the employee may elect when to cash in the shares and receive the value, much like a stock option or SAR.

SEVEN FACTORS DRIVING PHANTOM STOCK POPULARITY

Regardless of the subtleties of plan design or the label—phantom stock, performance units, or performance shares—long-term incentive plans that pay awards based on performance measures other than mere appreciation in the market price of the company's shares—and without actual equity ownership—are increasing in popularity. This trend is driven by at least seven factors:

1. Increasing prominence of private companies in the economy. Private companies always have been a major economic force in the U.S. economy: While roughly 7,500 publicly held U.S. firms have over $5 million in annual revenue, nearly 250,000 private companies exceed that size. In addition, while there has been a surge in initial public offerings (IPOs) fueled by the recent strength of the stock market, the number of private companies is increasing much faster. There were approximately 700 IPOs in 1993 (and the number will likely surpass that in 1994), but more than 700,000 new corporations were formed during the year. Many of these new companies will likely remain private, even if they grow to a significant size.

The restructuring of American industry, while costing hundreds of thousands of jobs in larger companies, has resulted in the formation of many of these new businesses. Many of these new firms are prospering despite the economic difficulties in the early 1990s. With growth comes the challenge of offering competitive compensation programs.

Private companies often struggle with developing long-term compensation programs that link key employee pay to shareholder value without using actual equity. Companies with the goal of going public typically are not averse to sharing equity with employees through stock options, due to the great financial efficiency of these compensation plans. But companies that intend to stay private, or that are unwilling to share equity at this point in their corporate life cycle, must seek other alternatives.

2. Compensation pressures from the 1980s bull market. As private companies provide an increasing proportion of the jobs in our economy, private ownership creates compensation challenges. Many executives in private firms feel they missed the bull market of the 1980s when many public company executives, and even nonexecutive employees, received significant compensation from stock options. Microsoft Corporation, by some estimates, has created over 2,000 millionaire employees from stock options awarded since its initial public offering in 1986. The gains from the stock option awards issued to some 1,200 employees in 1989 alone now average nearly $1 million per employee. While public companies have the luxury of shifting some of their compensation costs to the securities markets, private companies must fund these programs directly. The 1989 Microsoft option grants have delivered nearly $1 billion in compensation, far outstripping the company's profit and cash flow in any year since its founding.

3. Capital accumulation needs of employees. The generation of baby boomers is increasingly realizing that they may not achieve the nest egg they need for a secure, comfortable retirement through the previous generation's sources: Social Security, defined benefit pension plans, and continuously increasing real estate values. As individuals enter their 40s, retirement income concerns become paramount as other financial needs (e.g., college tuition for their children) cut into personal savings. They often look to their employers to provide a primary source of retirement income.

4. Increasing limits on qualified retirement plans. The income tax changes contained in the Omnibus Budget Reconciliation Act of 1993 (OBRA) significantly decreased the potential benefits from qualified retirement plans for those with higher earnings (the amount of employee compensation that may be taken into account when calculating qualified retirement plan benefits fell from $235,840 to $150,000). Qualified plans alone no longer can provide an adequate retirement income for higher-paid employees. If a company wishes to provide equitable retirement benefits to all employees despite the regulatory limits, a nonqualified program must make up the difference.

5. ***Increasing interest in deferring current cash compensation.*** Increased marginal tax rates resulting from OBRA also rekindled interest in deferring current compensation. The 401(k) plan limits allow little opportunity for executive and management employees to defer significant amounts of income, again requiring nonqualified deferral programs to meet these needs.

6. ***Increasing emphasis on linking short-term rewards to long-term performance.*** Many public companies are increasing the link between short-term and long-term results and rewards by paying annual bonus earnings in shares of stock that cannot be sold for several years. Companies including ALCOA, Bear Stearns, and General Motors have recently disclosed in their annual proxy statements that they require payment of some or all of the annual bonus to officers in restricted stock. Often, private companies are interested in emulating this approach without using actual equity.

7. ***Proposed changes in stock option accounting.*** The Financial Accounting Standards Board (FASB) has proposed new accounting rules requiring companies to recognize a compensation expense for employee stock options. This would create an environment in which stock options are no longer earnings-neutral (except for minimal dilution) and will increase the attractiveness of other types of long-term incentive plans.

Some analysts have projected that, if these rules are adopted, many companies will be compelled to abandon stock options and instead use performance shares because of the changes in the relative cost/benefit.

PLAN DESIGN ALTERNATIVES

Many alternatives are available for developing a phantom stock plan that meets strategic and financial objectives and rewards the behaviors that support those objectives. The plan design process requires a series of decisions on individual plan provisions.

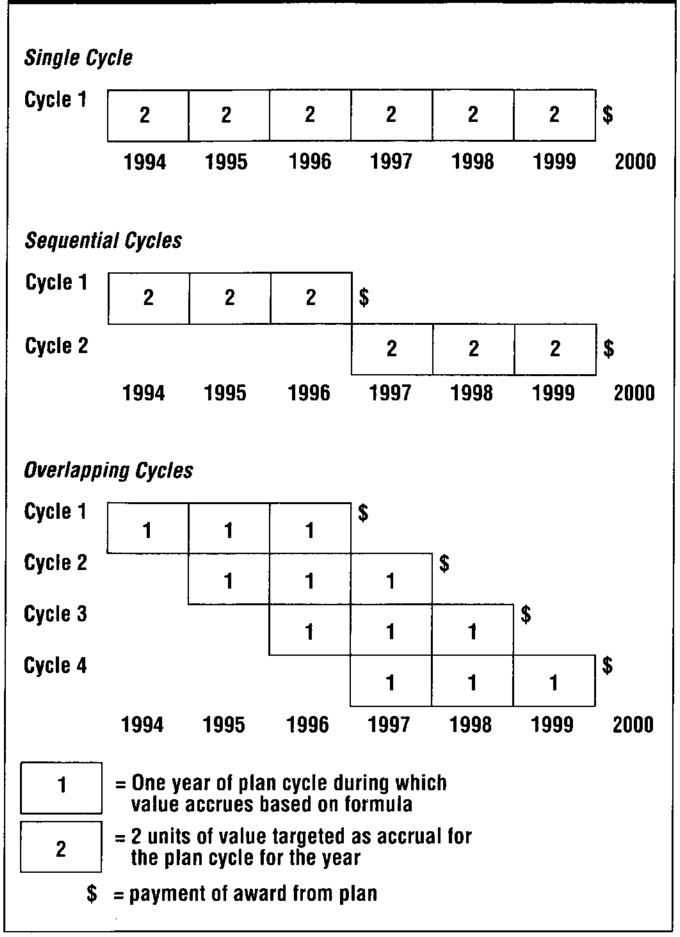
Performance Measurement

The ultimate purpose of a compensation program is to communicate and reward behaviors that contribute to the company's success. In a long-term incentive plan, this success usually is measured through increases in share value. But rewarding for increases in fair market value may be inconsistent with the company's strategy. In a private company, a focus on fair market value assumes the desire for a future market transaction through sale of the company, a merger, or a public offering of shares. If this is the case, using actual equity through stock options or stock awards is more financially efficient. In companies that intend to stay private, shareholder value is a function of economic return to the owners over time, not the company's estimated value in the marketplace.

Rewarding for increases in fair market value may not fit the firm's strategy.

Using fair market value as the sole performance measure may result in significant compensation when company financial performance is substandard but the stock market is soaring. Or the increase in fair market value may outstrip the company's ability to pay, to the extent the market is valuing performance criteria other than profit and cash flow, such as growth potential. This can result in a company being obligated to reward for increases in value but not having the cash available to make award payments. For example, McCaw Telecommunications will be acquired by AT&T for $12.6 billion—a multiple of over five times annual revenue. Yet in its years as a public company, McCaw has had cumulative financial losses of over $2 billion and negative cumulative cash flow as revenues grew from 1987 to 1993 at an annually compounded growth rate of 52%.

EXHIBIT 1
Illustration of Phantom Stock Performance Cycles



For these reasons, selecting the appropriate performance measures for a phantom stock plan must be based on the company's business and financial strategies—without assuming market value is the appropriate measure. Phantom stock then is essentially a performance unit plan that accrues funding based on any of several formulas:

• Book value (total shareholder equity).

• A multiple of earnings, cash flow, or book value based on multiples in the public marketplace.

• Percent of profit.

• Percent of operating cash flow above a return threshold (for example, 10% of cash flow after a return on equity of 12% has been achieved).

• Percent of economic value added, a measure of economic returns above the cost of capital. (See *The Quest for Value*, G. Bennett Stewart, III, HarperCollins Publishers, Inc., 1991.)

• A complex formula attempting to estimate all decision dynamics in the marketplace, such as the following example (altered to ensure confidentiality) used by a large private company: *Book value per share, plus earnings per share, multiplied by a price/earnings ratio equal to 60% of the prevailing price/earnings ratio of publicly traded peer companies.*

Volumes of research demonstrate that economic value and shareholder returns are poorly related to traditional accounting measures such as earnings-per-share growth and return on equity. This supports the need for companies to understand clearly the underpinnings of value in their industry as well as their corporate objectives when establishing performance measures.

The process establishing performance measures also should include consideration of the organization level at which performance is measured. While a phantom stock plan designed to emulate stock options may be based on overall company value and performance, these plans often include measures at the business unit, department, and even individual level. Many companies have used phantom stock to reward a business unit within a company that is so large or diversified that the performance of a single unit does not significantly affect, and is not reflective of, overall corporate performance. If the parent company uses stock options as a primary long-term reward vehicle, rewarding key employees for business unit performance may be accomplished through phantom stock based on business unit results.

Performance Periods

Inherent in a long-term incentive plan is a multiyear performance period, which provides rewards for decisions and behaviors that create value beyond the current accounting period. A company may establish a single performance cycle, sequential cycles, or a series of overlapping cycles (see Exhibit 1). Overlapping cycles offer greater retention incentives—as the first multiyear cycle pays out, others are already in progress. Most phantom stock plans have three- to seven-year cycles, varying primarily by whether overlapping cycles are used. A series of five three-year plans beginning in successive years may provide the same retention incentive as a single seven-year cycle.

Overlapping cycles result in less compensation paid at the end of any given cycle and avoid the large single payouts from the plan that have created problems in some companies: For example, the employee receives a significant sum that allows an early exit from the firm and, in the worst case, supplies seed capital to start a competing enterprise. The use of overlapping cycles requires greater attention to the objective-setting process to ensure that performance objectives among cycles are consistent. For example, a growth-oriented five-year cycle beginning in 1994 and a margin-oriented cycle beginning in 1995 may be in conflict and appear contradictory. Of course, any plan must allow for adjustment of objectives and/or performance levels in the event of significant changes in business objectives or strategies.

The length of the performance period ideally should parallel the decision-result cycle of the business—that is, the span from the time a decision is made until the economic results of that decision are clear. In the apparel industry, this time frame is often only six months; in the electric utility industry, it may be five to 20 years. Of course, these cycles must be balanced with motivational considerations—employees may not be motivated by a 10- or 30-year incentive plan, although such plans do exist. For example, the Coca-Cola Company issues restricted stock awards that vest at retirement, death, disability, or a change in control subject to a minimum termination age of 62 and five years' service after date of grant. ALCOA pays part of its executives' annual bonuses in "career" restricted stock that vests at retirement.

Vesting

The right to receive the appreciation value of the phantom shares is usually contingent on satisfying a vesting schedule, similar to those used in pension plans and stock option programs. The vesting schedule may be *incremental* (for example, 25% of the shares vest each year over four years) or *cliff vesting* (where all the shares vest only at the end of the four-year period). Philosophically, cliff vesting focuses on retention while incremental vesting recognizes the progressive contributions of the employee over the period.

Vesting also may be based on performance factors, further strengthening the link between rewards and performance. For example, phantom share value may be based on a multiple of earnings, but require average earnings growth of 10% or more over three years for the phantom shares to vest.

Award Payment

Once the amount of compensation has been determined at the end of a performance period, it may be paid either in cash or actual shares. Cash payments are typical in companies that do not wish to share ownership, which is often the impetus for a phantom stock plan. Equity payouts can provide a transition from a cash to an equity-based program. Many plans give the option to the Board of Directors to provide flexibility—if an IPO is imminent, paying in shares may be advantageous. Shares often include restrictions on transfer (a vesting schedule or holding period) to ensure continued long-term focus.

Phantom stock may be used with other compensation approaches.

With cash, the company may pay either in a lump sum or installments, or it may let the employee choose the payment timing when the plan cycle begins. Installment payments are sometimes used to avoid the seed capital problem and can allow tax planning flexibility for the employee, particularly in light of recent tax changes. When contingent on continued employment, installment payments can add another retention incentive.

NEW APPLICATIONS FOR PHANTOM STOCK

Phantom stock has many possible uses beyond merely a nonequity approach to long-term incentive compensation. To meet the many challenges described earlier, phantom stock programs may be used with other compensation approaches to reinforce company objectives. Some possibilities include:

Nonqualified Deferred Compensation Plans

The company may allow the employee to defer receipt of the cash compensation—salary and/or bonus—until a future date, such as retirement. The deferred amounts may remain invested in phantom shares. Linking growth of the deferred funds to company performance measures can create a voluntary phantom stock plan. Or a company may set up a nonqualified 401(k)-type plan for those affected by qualified plan limits, with deferred amounts invested in phantom shares. Often, these plans are designed to mirror the company's qualified plan.

Supplemental Retirement Plans

To establish a retirement program for selected key employees, a company can use the phantom stock approach to determine the amount of employer contributions as a basis for growth in fund value over the deferral period. The company may establish a potential range of contribution each year, with the actual amount determined by financial performance. These amounts are then invested in phantom shares, with the ultimate value of deferred funds tied to phantom share value.

Annual Incentive Plans

The company can require deferred payments from annual incentive plans to be invested in phantom shares. In one company, half the annual bonus award must be deferred into phantom stock, and the employee may invest some or all of the remainder in phantom stock. This emulates the rapidly growing practice among public companies of paying all or part of annual bonuses in shares or restricted shares.

Stock Purchase Plans

The company may allow or require purchase of the phantom shares to ensure a commitment by the individual rather than a no-risk gain opportunity. Key employees may be offered the opportunity to purchase phantom shares with cash, or the company may provide a loan or installment payment program. This can provide a key group with an opportunity to become "phantom owners"—and can easily be converted to real ownership if company objectives change.

Financial Considerations

A current disadvantage of phantom stock versus stock options is the accounting treatment, although the FASB proposal would change the dynamics to some extent. Under current accounting rules, the increase in phantom share value must be recognized as a compensation expense. Under the FASB proposal, the treatment of phantom stock would not change; the stock option expense would be recognized based on the estimated value of the option.

Generally Accepted Accounting Principles (GAAP) also require interperiod tax allocation when the tax deduction occurs in a period after the accounting expense is charged. This is one of the disadvantages of any multiyear deferred compensation program: the earnings charge must be accrued each period, but the tax deduction does not occur until the award is paid. Of course, there is little if any real economic disadvantage, as the company retains the cash until the award payment date.

The employee is taxed and the company deducts the compensation expense when the award is paid. The award payment is taxed as ordinary income—and under OBRA's tax rates, this is significantly higher than the capital gains rate possible with stock or Incentive Stock Options, and is subject to withholding.

Termination Considerations

In designing long-term incentive programs, many companies neglect the consequences of employee terminations—including voluntary and involuntary termination (with cause and without), retirement, death, and disability. There is no right answer for these provisions; the plan must reflect the company's intent with the plan, its philosophy, and to some extent the operation of other compensation and benefit programs. For example, the status of unvested phantom shares upon the death of the employee takes on more importance if the company does not provide adequate life insurance coverage.

CHANGE IN CONTROL

As discussed, many companies implement phantom stock programs because they do not wish to share ownership outside a select group and/or do not anticipate a future market transaction. Yet the company must anticipate a change in control—and have plan provisions describing the treatment of vested and unvested phantom shares upon such a change, perhaps allowing conversion into actual equity.

One company—a subsidiary of a privately held firm—instituted a phantom stock program assuming the subsidiary would never be sold or otherwise change its ownership structure. Years later, their industry's dynamics required a considerable capital infusion to remain competitive. The parent company attempted to structure a public offering of the subsidiary's shares, but the phantom stock plan inadvertently contained a provision creating an enormous financial liability upon a public offering—and ultimately squelched the transaction. The subsidiary was sold to a competitor at a much lower price than would have been obtained in a public offering.

This illustrates the impact of a single plan document provision and an assumption about the future when all eventualities are not considered and included in the plan design and documentation.

Change in control provisions should reflect and support the company's business strategies. These run the gamut, reflecting the differences in intent among business owners. Phantom stock plans may include:

- Pro rata accelerated vesting with immediate payout upon a change in control
- Fully accelerated vesting with payout
- Vesting and payout *only* upon a change in control (if the sole objective is selling the company)
- No additional vesting at the change in control—only vested shares are cashed out
- Conversion into shares of actual equity at the change in control, sometimes with additional restrictions such as a new vesting period on the shares to ensure retention of key employees after the change.

ADVANTAGES AND DISADVANTAGES OF PHANTOM STOCK

The discussion above illustrates that, like any other compensation program, phantom stock plans have many advantages and disadvantages.

Advantages for the company:

- Present owners have no dilution of ownership.
- Minority shareholder situations are avoided.
- Employee rewards are tied to shareholder gains.
- Because the plan is not a qualified plan, it is generally exempt from IRS and ERISA requirements, and the company has tremendous flexibility in determining plan participation and design features.
- Multiyear performance periods provide a performance-based retention device for key employees.
- Payment is deferred until performance results create the economic value required for award payment—a self-funding approach.

Advantages for the employee:

- Employees may not have to purchase shares or exercise stock options, both of which require a cash outlay.
- They don't need to seek or wait for the development of a market for the shares.
- They have the possibility of valuable gains far in excess of other forms of compensation such as base salary and annual bonuses.

Disadvantages for the company:

- Accounting charges to earnings may be significant and are not always predictable at the outset of the plan. While private companies are often not as sensitive to reported earnings, loan covenants or financial institution capital ratios may require managing reported earnings.
- The tax deduction is deferred until the award is paid to the employee.

• Cash outflows required for award payments may be burdensome or ill-timed.

Disadvantages for the employee:

• Employees have no actual equity ownership unless the award is paid in stock.

• If the performance period is fixed, they have no control over the timing of the payment.

• Lump sum awards may create a significant tax liability, particularly with the current tax structure.

• Capital gains treatment will not apply to award payments.

CONCLUSION

Whether we call it phantom stock, stock appreciation rights, performance shares, performance units, deferred compensation, or any other name, multiyear programs going beyond stock price appreciation can be an important element of compensation, one that private and public companies alike must consider. The flexibility of a nonqualified plan, combined with the long-term performance focus, makes phantom stock an ideal solution for many companies and, as accounting and tax rules evolve, perhaps for all companies.

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