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Using Phantom Stock Plans as a Valuable Tool in Retaining Employee Drivers

Written by: Written by Anthony J. Vizzoni, Esq. and Kent L. Schwarz, Esq. , Becker LLC

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Driver hiring and driver retention continues to be a critical challenge to the successful operation of trucking companies. One business tool available to trucking company owners is the implementation of so-called phantom stock or phantom equity plans to attract and retain key employees, including truck drivers.

A phantom equity plan is an employee benefit plan or contractual agreement that provides select key employees with economic benefits resulting from company performance without actually providing the employee participants with any equity or ownership interest in the company. The participating employees have a contractual right to compensation that can be structured in various ways to mirror equity value and/or to allow participation on a sale of the company. In order to be effective, any company implementing a phantom stock plan should be anticipating future growth so as to offer potential economic upside to the participant employees.

Plans of this type are subject to various tax provisions, particularly Section 409A of the Internal Revenue Code (the "Code") which provides rules related to deferred compensation. Plans subject to Code Section 409A must comply with various rules related to the timing of deferrals and payout events, reporting, and other matters. Failure to comply can result in acceleration of income for the employee, penalties to the employee, and interest charges. Plans can be structured so as to be outside of the purview of Section 409A, if for example, the appreciation unit is granted at fair market value.[1] The value should be established by a reasonable valuation method, in accordance with Treasury Regulations established under Section 409A, to be fair market value at the time of grant. Permissible payment events under Section 409A are death, disability, separation from service, a fixed time, and a change of control of the company.

The simplest form of an incentive plan is a change of control bonus plan that allows participant employees to participate on a sale of the company. This type of plan matches the payment event with a liquidity event avoiding cash flow issues for the company. It could be coupled with a routine annual bonus plan. Under a more sophisticated plan, an employer can

establish the total number of appreciation units to be awarded to eligible employees as are determined by the company's board of directors or by other process. The company board may implement standards for eligibility by employees in the plan, such as vesting criteria which can be very flexible. For example, vesting may be based on time of service with the company or, in the case of drivers, individual safety performance measured by the number, or lack of, driving tickets, number, or lack, of vehicle accidents, frequency of damage to trailers or cargo, conformance with company policies and procedures, or other criteria. Once vested, payment events might include "good leaver" events such as death, disability, termination without cause, retirement, or a sale of the company. Under this type of plan, the board will typically award appreciation units to participant employees based on the terms and conditions of the plan. The appreciation units represent a bookkeeping account and do not represent actual ownership in the company or carry the right to vote on company matters. The incentive plan can provide for forfeiture of appreciation units in the event of termination of employment, for cause events such as violation of company policies, or other events.

[1] Since fair market value is subjective, an employer never can be 100% sure if the grant is outside of Code Section 409A, thus best business practice would be to structure the plan to comply with Code Section 409A.

As an example of how the incentive plan can work, let us consider a closely held trucking company that has decided to sell itself due to the pending retirement of the owner, who was the sole owner of the company. The target selling company was attractive to the buyer because the seller had a good pool of truck drivers, the majority of which had been with the company for most of their respective driving careers. To achieve this high driver retainage standard, the company had in place an incentive plan which provided that the bonus to plan participants was equal to ten percent of the net closing proceeds received by the company upon the company sale. The company recognized $15,000,000 in net closing proceeds from the sale and thus the amount of sale proceeds allocated for the plan was set at ten percent, therefore making the bonus pool equal to $1,500,000 ($15,000,000 x 10%). The company had 500 authorized appreciation units and, at the time of sale, 400 vested appreciation units were outstanding, so that each participant received a bonus of $3,000.00 per vested, non-forfeited appreciation unit ($1,500,000 bonus pool divided by 500 total authorized appreciation units). The 400 vested units were vested 250 units to the company drivers that qualified under the plan and 150 units to other employees of the trucking company. In this case, the employee participants shared in $1,200,000 of the net closing proceeds ($750,000 to the drivers and $450,000 to the other employees), since not all of the authorized units were issued and/or vested. The remaining $300,000 attributable to unvested and/or non-issued units remained with the company.

A company also may require compliance with restrictive covenants in order for participants to be eligible for the incentive plan and to pay out any bonus pools or payment based on the sale of the company. Such covenants are more likely to be enforceable when accompanied by valuable consideration such as phantom equity grants. For example, the restrictive covenants may place restrictions on the driver participants' ability to compete with competitors of the company which may be beneficial to the company in negotiating the sale of its business, depending how the sale transaction is structured.

Also, from the purchasing company's perspective, the purchaser may be especially concerned about retaining the selling company's workforce structure, especially drivers. Indeed, intoday's market environment, it is not uncommon to see marketplace growth by trucking companies acquire other trucking companies mainly for the driver pool as the most significant asset of the target company. Further, if a buyer acquires all or the bulk of the assets of the selling company, any buyer would naturally be concerned about not having sufficient drivers to operate purchased trucks as drivers may leave the selling company after the close of the sale. The existence of an incentive plan in place with the purchasing company may protect against this uncertainty, and provide the purchaser with a comfortable level, as to post sale driver retention. Also, as stated above, a seller's incentive plan may condition payment upon a change of control on acceptance of employment with the purchaser if offered at the same or a better compensation level. If the buyer purchases the stock or membership interest of the selling company, then any existing restrictive covenants (including those imposed in connection with the incentive plan) may remain in force, which would also give the buyer comfort that the workforce would remain intact after a closing of the purchase and sale transaction.

In summary, phantom equity plans can be a valuable tool for employee retention. They are flexible tools and can be structured in various ways. However, it is important to keep in mind the applicable tax rules including Section 409A when structuring a plan.