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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Phantom Stock Plans

Phantom stock plans, which are also known as shadow or unit stock plans, are a type of stock based incentive compensation to permit key employees the ability to share in a company's success without giving the employee any actual equity in the business. Phantom stock option plans are generally administered by a committee, selected from non-employee members of the board of directors of the company who will not be participants, that award compensation units to key employees of the company. The award of units by the administrative committee does not convey any actual ownership in the company. A phantom share unit is a credit in a participant's account for an amount equal to the value of the company's actual shares. Once the units are awarded to the participant's account, it is credited with changes in share value, along with dividends and other distributions by the company to its stockholders of actual shares.

Generally, phantom stock plans provide that dividends and changes in a company's capital structure are taken into account in valuing the participant's interest under the plan. If a dividend is paid on the company's outstanding stock, an equal prorated amount is credited to each unit held by a participant. In addition, if a company changes its capital through a stock split or stock dividend, the number of units held by a participant is adjusted accordingly in proportion to the change.

There is generally no taxable income for the participants in phantom stock plans until units are redeemed in the participant's account. At the same time, there is no tax deduction for the company until it becomes obligated to pay the employee for units held in his account. Payments to participants are taxed at ordinary income tax rates.

Since participants in phantom stock plans do not hold "real" shares or have any actual equity in the company, participants are not eligible to vote at stockholder meetings of the company. Phantom stock plans are ideal and provide flexibility for privately owned businesses, since units awarded to participants do not dilute the ownership interest of stockholders of the company.

Phantom stock plans are also attractive to Subchapter S corporations. Under the provisions of the Internal Revenue Code, a Subchapter S corporation can have no more than 100 stockholders and may only have one class of stock. Phantom stock units are not treated as a separate class of stock and

do not count toward the maximum number of stockholders.

Phantom stock plans are an effective tool in providing incentives to attract and retain key employees, while at the same time maintaining the equity interest of the existing shareholders.

Employment and Change in Control Agreements

As consolidation continues in the financial sector, banks and bank holding companies should consider the use of employment agreements and change in control agreements for key senior management. In the event a bank or bank holding company has either of these agreements in place, they need to be reviewed from time to time to determine if revisions are needed because of economic or legislative changes, including changes in tax laws.

An employment agreement is generally defined as an agreement between a company and its employee which specifies the rights and obligations of each. The term of an employment agreement will normally run for a fixed period of time or it may run for a fixed term plus rolling renewal periods. One of the advantages of a rolling renewal period in an employment agreement is that the parties do not have to renegotiate the agreement at the end of the fixed term. Besides the term, an employment agreement will normally specify such things as duties, salary, bonus, benefits, disability, death and retirement.

A change in control agreement is designed to become effective upon a change in control of the company. A few examples of events constituting a change in control are as follows:

- A third party acquires 50% or more of the outstanding voting stock of the company.
- The company is a party to a merger or consolidation which results in 50% or more of the voting stock of the company being converted into securities of another entity.

- The sale or disposition of all or substantially all of the company's assets.
- A change in the composition of the board of directors within a specific period of time, resulting in fewer than a majority of the directors continuing to serve as directors.

A change in control agreement serves at least two purposes. It assures that key management personnel will be available both prior to and following the transition in the change in control of a company. Secondly, it assures key management personnel that they will be employed and continue to have their existing authority, duties and compensation.

Employment agreements and change in control agreements generally contain provisions regarding the protection of confidential information belonging to the company, and a noncompete period prohibiting the executive from competing with the company for a specific period of time and in a specific geographic area following the termination of employment. In addition, both agreements may address termination for cause by the company for acts of the employee, such as fraud, conviction of a felony, excessive absences without approval, use of drugs or alcohol and similar conduct. At the same time, both agreements should provide protection for the executive by allowing termination for good cause, such as reduction in salary, demotion or relocation without the executive's consent. Unlike a termination for cause by the company, a termination for

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good cause by the employee will generally allow the executive to receive the compensation and benefits under the remaining term of the agreement had the agreement remained in force. It is best to utilize the services of a professional to make sure that the agreements comply with applicable law.

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