

What are phantom shares?

An in-depth look at phantom shares as cash-based incentives that mirror stock value without granting equity or shareholder rights.



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This brief note examines the legal nature of phantom shares. For educational purposes, we will use as reference a template *Phantom Stock Agreement* found in the public disclosures of WMS Industries Inc., a Delaware corporation (the “**Template PSA**”).¹ We highlight the concept and supply the sample operative clause from the Template PSA. Phantom shares are not actual equity but contractual rights to cash payments equal to the value of a corresponding number of real shares. Section 1 of the Template PSA provides:

These shares of Phantom Stock represent the right to receive solely in cash the value of an equivalent number of shares of WMS Industries Inc. Common Stock as described below. This Phantom Stock will NOT be credited with dividends[.]

Phantom stockholders are not shareholders. They lack voting, dividend, and ownership rights. Section 9 provides:

Shares of Phantom Stock are not shares of the Company’s common stock. Neither the Grantee [...] shall have any of the rights and privileges of a holder of the Company’s common stock.

The company is the grantor, issuing phantom stock under its employee incentive plan. The recipient (employee or executive) is the grantee, whose name and number of phantom shares are specified.

The phantom stock’s payout is in cash, determined by the market price of actual shares on the vesting date, not through stock issuance. Section 3 provides:

The cash value of the shares of Phantom Stock shall be calculated based on the closing price of the Company’s common stock on the vesting date[.] The payment of the value of the shares of Phantom Stock shall be made no later than ten (10) days thereafter.

Phantom shares exist only as internal accounting entries. They are not securities certificates or negotiable instruments. The caption of the Template PSA provides:

This is not a stock certificate or a negotiable instrument. This grant of Phantom Stock is a voluntary, revocable grant from the Company and Grantee hereby acknowledges that the Company and the Employer Group have no obligation to make additional grants in the future. UPON RECEIPT OF YOUR SIGNED AGREEMENT, A BOOKKEEPING ENTRY WILL BE ENTERED INTO THE COMPANY’S BOOKS AND RECORDS TO EVIDENCE THE PHANTOM STOCK GRANTED TO YOU.

¹ Form of Phantom Stock Agreement, Exhibit 10.6 to WMS Industries Inc., Registration Statement on Form S-8 (SEC No. 333-132319), filed Oct. 21, 2010, available at <https://www.sec.gov/Archives/edgar/data/350077/000119312510251922/dex106.htm>

Vesting occurs on the specified vesting date, contingent upon continued employment with the company-grantor. The grantee must still be employed on the vesting date to receive value. Once vested, payment is made in cash based on the market value of the company's common stock at that date. Section 3 of the Template PSA states:

Subject to the terms and conditions set forth in this Phantom Stock Agreement, the shares of Phantom Stock covered by this grant shall vest on the vesting date set forth on the cover page of this Phantom Stock Agreement, provided the Grantee is employed by the Employer Group on the date of vesting. The cash value of the shares of Phantom Stock shall be calculated based on the closing price of the Company's common stock on the vesting date[.] [...] The payment of the value of the shares of Phantom Stock shall be made no later than ten (10) days thereafter.

Unvested phantom shares are forfeited if the employee-grantee resigns voluntarily or is terminated for cause or misconduct. Thus, the right to vest depends strictly on employment status and conduct. Section 5 provides:

Your right to the Phantom Stock under this Phantom Stock Agreement, to the extent the restrictions have not lapsed, shall terminate immediately upon your voluntary Termination of Service or if Termination of Service occurs by action of the Company by reason of your willful refusal to perform your duties or for 'cause'.

Even vested phantom shares may be forfeited or withheld if the grantee violates plan provisions, company policy, or engages in harmful conduct. This adds a moral conduct condition to the vesting benefit. See Section 7 of the Template PSA.

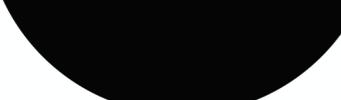
The employee-grantee's acceptance of restrictive covenants (confidentiality, non-competition, and non-solicitation obligations) serves as usual consideration for the phantom stock grant. The company-grantor may specify additional consideration (for example, continued employment or performance). See, e.g., Section 6 of the Template PSA.

Since phantom shares are cash-settled, they are treated as ordinary income at the time of payment (not capital gains), subject to income and payroll tax withholding.

Although phantom shares are not actual equity, there may be SEC disclosure requirements for employee benefit plans involving securities-based compensation or equity-linked awards to employees, even if the award itself is cash-settled. This depends on the jurisdiction.

Got questions? You may send us an e-mail to attorney@geronimo.law.

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About Our Firm

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Russell Stanley Q. Geronimo is the founder and managing lawyer of the firm. He served in all branches of government, i.e., executive, legislative, and judicial, and in their respective top-level offices, i.e., Office of the President, Senate, House of Representatives, and Supreme Court. He was an associate at SyCip Salazar Hernandez & Gatmaitan. His areas of focus include derivatives and cross-border financial transactions, deals and M&A, securities and investments, PPP and project finance, and general corporate practice.

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