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IS PHANTOM EQUITY A SECURITY UNDER NORTH CAROLINA LAW?

Phantom equity (also referred to interchangeably as “phantom units” or “phantom stock”) has been utilized in recent years by companies who wish to motivate their employees by issuing them contractual rights to a share of company profits (often upon a triggering event such as the sale of the company). Phantom equity provides some of the **benefits** to the employee of owning real equity, while the employer avoids granting actual equity to the employees. Granting “real equity” can potentially require owners to give up voting power, require sharing of company financials with the investing employees, create fiduciary duties to the employee, and/or provide other rights and responsibilities to the employee. Phantom equity has arisen as a mechanism to avoid some of the negatives of issuing real equity for employers while still providing employees with owner-like economic benefits. What is not always certain, however, is whether phantom equity is a security under federal and state securities laws. If phantom equity is a security, employers may be subject to registration requirements upon the issuance of phantom equity and employees may have access to causes of action against their employer under federal and state securities laws. The North Carolina courts recently in *Higgins v. Synergy Coverage Sols., LLC, 2020 NCBC 4 (North Carolina Business Court, 2020)* ruled as a case of first impression that phantom equity is generally not a security under North Carolina law.

Higgins v. Synergy

In *Higgins*, **litigation** arose from the termination of plaintiff Arlene B. Higgins from her **employment** with Synergy Coverage Solutions, LLC. *Id.* at *4. One of the plaintiff’s numerous claims against her former employer was a claim under the North Carolina Securities Act (“NCSA”). *Id.* at *79. The defendant moved to dismiss this claim under the theory that the phantom stock the plaintiff had purchased from the defendant was not a security under the NCSA. *Id.* The court noted that phantom stock is not listed as a security in the North Carolina statutes and that no North Carolina court had addressed whether a phantom stock is a security under the NCSA. *Id.* at *80. Turning to federal guidance, the court noted that “several federal courts have persuasively reasoned that phantom stock is not ‘stock’ under federal securities laws because it does not grant the holder equity.” *Id.* at *85. Utilizing this reasoning, the North Carolina court concluded that “the Phantom Units [do not] represent ‘real equity’ in Synergy Holdings. Rather, the Phantom Units are instruments that are assigned value under a formula provided in the Plan upon the sale of Synergy Holdings at or above a certain price As such, the Phantom Units are not ‘stock’ within the NCSA.” *Id.* at *86. The court concluded, “Higgins has failed to plead that the Phantom Units constitute a ‘security’ under the NCSA. Plaintiff’s NCSA claim must therefore be dismissed for failure to allege an offer or sale of a

security under the statute.” *Id.* at *91. It is important to note that the facts and circumstances of each particular case, as the court references in *Higgins*, can play a large role in determining whether phantom equity is considered a security. Moreover, although *Higgins* speaks to the North Carolina treatment of phantom equity, the court did not ultimately address the also looming question of how a federal court would treat the phantom equity under federal securities laws. Accordingly, this article does not in any way address this question of federal law.

JAH Can Help

The **attorneys** at JAH are available to counsel you on your phantom equity plans, including assisting you with drafting your plan in a manner intended to avoid treatment of your company’s phantom equity as a security. Our corporate attorneys will navigate these and other complicated legal concepts so that you don’t have to. Click here to contact a member of our **Corporate Group** if you are in need of assistance.

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