EQUITY INCENTIVE PROGRAMS

Eddy J. Rogers, Jr.
Andrews Kurth LLP

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Almost every start-up business and many established businesses share a common problem: how to enhance the overall value of the enterprise by granting key members of the enterprise—key employees, directors, consultants, and sometimes every employee—an equity interest in the company. While some compensation experts have questioned the correlation between equity ownership, motivation and resultant enhanced enterprise value, the desire to grant key participants an equity interest in an enterprise has been a constant theme in corporate structuring. The methods by which equity is directed to key participants have become both more complex and more diverse over the years, offering each enterprise a variety of different programs tailored to its particular situation (especially its tax position and whether its securities are privately held or publicly traded). Currently experts are rethinking their devotion to certain forms of equity incentives; many companies have acknowledged recently that equity incentive grants are an expense to their companies and have pledged to reflect such costs in their operating results. The selection of programs is not easy and depends not only upon the goals sought to be reached but also on the tax consequences of each choice and management pre-dispositions concerning whether an employee should pay for his interest, get a “free ride” with any appreciation in value, or “earn” an interest in the equity granted.

This article focuses more on equity programs for privately-held enterprises than public ones, and the subject matter is further limited to analysis of equity awards to those who are render personal services to an enterprise—employees, consultants, directors, and in some instances promoters.

I. GENERAL

Equity incentives awards to members of management and other service providers fall into six broad categories. Although the situation rarely constitutes an “equity incentive program,” during the early stages of a business, special opportunities arise that permit the award of equity interests on a tax favorable basis, usually by fine-tuning the capitalization of the company. The six general categories are as follows:

1. Stock Award and Restricted Stock Plans. The award of stock to an employee can often promote a sense of reward and participation for employees with less dilution to existing shareholders than other programs. As with most other equity plans, the award of stock is usually subject to certain conditions, that is, “earning” the stock by continuing employment and agreeing to forfeit “unearned” shares in the event of his departure. Please refer to the discussion of vesting, below. The principal benefit of a stock award is that it grants a true ownership interest in the enterprise and thus represents a source of immediate participation to the recipient. If the value of his interest goes up or goes down, the owner feels it. By its very nature this form of equity incentive makes the interests of the recipient of the grant closely correlated to those of other shareholders. Generally, stock bonuses create ordinary income to the recipient and a non-cash deduction for the issuer when the stock is no longer subject to forfeiture. A stock award variant is issuance of “restricted stock units, which call for the issuance of stock in the future as conditions (usually continued employment) are fulfilled

2. Incentive Stock Options. Incentive stock option (“ISO”) plans are creatures of the Internal Revenue Code (the “Code”); the significant benefit created under the Code is that no regular income tax is recognized on shares purchased by the exercise of an ISO until and unless the recipient sells the shares he has purchased; long term capital gain rates are paid when shares are sold if holding period requirements are met. The substantial difference now between ordinary income rates and the capital gain rate makes ISOs more attractive. In order to qualify as an ISO, tax rules require that all options be issued at an exercise price equal to or greater than the fair market value of the company’s stock at the date of grant. Substantial stockholders (i.e. those who own 10% or more of the issuing company’s stock) who receive ISOs are subject to special rules requiring the exercise price to be 110% of market value at the date of grant. Also, options for substantial stockholders can only be outstanding

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©Eddy J. Rogers, Jr. 2003. Reproduction permitted only with attribution. All other rights reserved. As will be seen, this memo is very general and is devoid of the usual lawyerly footnotes except to point out more complex areas related to this topic. The purpose of this memo is to inform you of available alternatives; thus, you should discuss any decision with your attorney and accountant before seeking to implement it. This memo is also to some extent time sensitive and does not include new matters, especially tax aspects, arising after November 1, 2003.

2 The traditional masculine convention is used for convenience; no offense intended -- obviously this memo speaks with gender neutrality.
for a term of five years, as distinguished from ten years for non-substantial shareholders. From an employee’s standpoint at least, ISOs are usually the most favorable plan. Since no tax benefits arise from ISOs for the issuer, and since options if exercised will not ordinarily generate a purchase price equal to the then fair value of the stock, ISOs do not possess the advantages for the issuing company offered by other plans.

3. Non-Qualified Stock Options (“NQSOs”). This broad category of stock options generally refers to options that are not ISOs. Like ISOs, NQSOs are options to purchase stock at a given price (they need not be issued at fair market value at the date of the grant). The exercise differential, however, also generates a deduction to the corporation. Because this type of equity benefit often creates taxable income to the recipient at the worst time—when no cash is being received by the party recognizing the income—a number of NQSO plans add a cash bonus feature designed to pay the option holder cash at the time of his option exercise with which to pay all or a portion of the resultant tax. Since the issuing corporation obtains a deduction at the same time (both from the NQSO exercise and the cash bonus payment), the payment of a cash bonus by the enterprise partially or wholly neutralizes the tax impact resulting from an option exercise both to the NQSO holder and to the enterprise.

4. Stock Purchase Plans. These plans, unlike stock bonus awards, are generally fashioned to allow a broad group of employees and others to purchase stock, either from existing shareholders or from the corporation; while most plans offer a modest discount of 10-15% from the perceived fair value of the stock, many plans require the recipient to pay full present value for stock, in many instances the sale is on the low end of fair market value. To lock in value presently in an environment of appreciating value, some stock purchases even permit payment for the stock over a period of time. This type of plan is most attractive to those enterprises that believe an employee should pay full value for shares for the equity ownership interest received. Given the difficulties of determining fair market value of the stock, these plans are more popular with public companies than with private ones.

5. Stock Appreciation Right (“SAR”) Plans. Technically these rights are not an equity ownership interest in an enterprise; they are a form of deferred compensation. An SAR plan, sometimes referred to as a “phantom stock” plan, emulates stock ownership in that it grants to an employee or other recipient deferred compensation payments based on the appreciation of the enterprise’s stock over a stipulated period. Since these plans are not tax qualified plans, they are quite flexible. For instance, payment of stock appreciation payments may be made over a period of time, may be made in cash, or even in shares of common stock of the enterprise at the fair market value of the stock at the time of payment, although invariably the SAR plans that the author has composed seek to ensure that any stock received is marketable on the date of receipt. These incentive plans are perceived as ideal for key employees who seek to build up a cash fund preparatory to retirement but want to share in the success of their employer’s increased value. All SAR payments (cash or stock) are fully taxable to recipients as ordinary income upon receipt; payments are deductible by the enterprise when made. From an accounting standpoint, however, the amount of any increased value each year accruing to the accounts of recipients is a non-cash charge against earnings.

6. Employee Stock Ownership Plans (“ESOPs”) and Profit Sharing Plans Owning Enterprise Stock (“KSOPs”) . This memorandum does not permit full discussion of ESOPs or KSOPs, but often an ESOP is a component of an overall employee equity incentive plan for companies. The benefit of an ESOP is simply that stock ownership “trickles down” to a broad base of employees of the company and gives a sense of participation in the ownership throughout all employees. A number of tax advantages exist for ESOPs and for controlling persons who establish ESOPs, but the greatest disadvantage of both an ESOP and a KSOP is that there are strict rules preventing discriminatory allocation of stock ownership benefits in favor of highly compensated employees. Thus, top management—the most likely group to be motivated by equity participation—is limited each year in the amount of equity to be received through such plans.

7. Special Opportunities In Start-Ups. During the startup and early stages of a venture, the organizational group should address equity participation arrangements in order to insure that low cost equity is available to members of key management who are unable to contribute

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2 Strictly speaking, an “SAR plan” refers to a plan in which payments are measured by the appreciation of shares over a base or beginning value; a “phantom stock” plan refers to a plan which pays to a recipient the full value of “phantom” shares, as if the recipient owned and was selling actual shares.
large amounts of capital. Typically low cost equity is created by issuing senior securities—preference common stock, preferred stock, debt securities or hybrid securities—to those who contribute cash or property. By creating securities senior to common stock at inception, lowering the fair market value of the common stock, significant amounts of equity can be passed to founders, managers, directors and other employees at minimal cost.

After the next section, each type of plan is discussed in detail; for the mathematically inclined, the appendix summarizes each of the three most frequently utilized types of plans in terms of both economic costs and tax costs.

II. CONTROL AND OTHER COMMON PLAN FEATURES

Before discussing each of the varieties of equity participation in more detail, a word should be proffered on the variety of control features available to ensure that equity awards are not granted to people who either do not deliver anticipated future contributions or who leave the company prematurely, running the risk to the enterprise that equity has been given up without the anticipated quid pro quo being received. In eliminating this risk, however, enterprises must insure that equity benefits cannot be terminated or forfeited arbitrarily; otherwise the recipient will not regard the equity award of substantial value. Among the control features available are the following:

1. Termination Agreements. Most options—whether they are ISOs or NQSOs—terminate upon or shortly after an option holder leaves his enterprise’s employment or association with the enterprise. Such termination provisions are also typical of SARs. In such instances, the enterprise simply seeks to end the “free ride” the option holder or SAR recipient is receiving. Since the purpose of the plan is to motivate the recipient to contribute continuously to the progress of the enterprise, by definition when the association ends, the benefit should end. Thus, most options require exercise (that is, investment) upon termination of the holder’s association with an enterprise; SAR plans generally terminate the recipient’s interest completely upon termination of employment and pay, in cash or over a period, the value of the SAR on the date of termination. Others “freeze” the value in a manner that prevents further appreciation, separating the termination of further benefit from the payment date. Stock bonuses are also often granted with a “hook”; when the recipient terminates his association with the company the company often retains a buy-back right, sometimes at the same favorable discount as the shares were sold or awarded.

2. Vesting. Most entrepreneurs believe that recipients of equity awards should “earn” their equity ownership interest. Accordingly, each of the equity incentive plans described below can be implemented with a “vesting schedule”, which means that the employee “earns” his equity based upon a certain schedule of vesting during the continuation of his employment. In most instances, the schedule is simply a time requirement in which the recipient vests a certain percentage proportion of his award as time passes (normally two to five years) and the recipient continues his association with the enterprise. However, the vesting schedule may hinge on achieving certain financial or other performance levels by the company, performance levels specifically applicable to the recipient, or the accomplishment of certain developmental levels by the company.

3. Buy-Sell Agreements. Most every private enterprise should have a buy-sell agreement or buy-sell provisions in the corporation’s bylaws at the time equity awards (other than SARs) are made to permit the issuing enterprise to retrieve its equity upon critical events in the life of a shareholder or of the enterprise itself. If an equity recipient dies, becomes disabled, divorces, or leaves the employment of the company, provision should be made for the parties remaining with the enterprise to purchase the enterprise stock owned by the departee. In the event a stockholder desires (or is forced) to sell his shares for financial or other reasons, the company or its shareholders should have a first right of refusal. The typical buy-sell agreement for a company with employee-owned shares requires an offer of sale upon termination of employment; some agreements, however, distinguish between “for cause” and “without cause” terminations.

4. Securities Laws. Almost every equity incentive plan poses securities laws issues. Federal and state laws apply to any issuance of shares or equity participation rights. In most cases the issues are quite solvable if the legal requirements are addressed prior to the adoption of a program. The scope of this article is limited to a discussion of the alternatives available; a discussion of securities law compliance would lengthen this article considerably. Don’t forget, though, that the securities laws must be addressed!
III. STOCK AWARD AND RESTRICTED STOCK PLANS

With the trend toward expensing the cost of issuing stock options, restricted stock plans have become much more popular. Issuers also have quickly realized that since stock awards represent fewer shares, given their immediate value, issuances of restricted stock usually results in less dilution than option awards. Finally stock awards never are "under water"; the stock fluctuates but holds some value, whereas stock options that are under water can become essentially valueless, at least in the eyes of the holder.

Stock award plans range from extremely formal plans administered by a disinterested committee of the board of directors, many times approved by shareholders, to ad hoc awards of stock to specific employees based upon performance. A stock award burdens the recipient with ordinary income to the extent of the fair market value of the stock at the time the award is received. Similarly, the issuer receives a deduction in an equal amount. From this simple thought a number of different types of stock awards have been generated.

Special problems arise if a stock award is made with vesting or other restrictions that impair the present value of the award of the company. In general, taxes are incurred not upon award but when the restrictions on the right of ownership of the securities lapses; thus, if a stock bonus is made with vesting requirements, taxes—perhaps substantial—will be incurred as restrictions lapse if the value of the stock has appreciated in the interim. In an environment of rapidly appreciating stock, this could become quite a penalty to any employee receiving such stock. If a company desires to place restrictions on a recipient's stock, such as vesting, the recipient should consider filing a Section 83(b) election under the Code if the employer will permit that; that election allows the employee to be taxed on the value of the stock presently as if the restrictions did not exist. In this manner, the recipient can avoid incurring higher taxes when the restrictions lapse, presuming importantly that the stock will appreciate. Be forewarned, however, that such an election must be filed within 30 days after receipt of such stock. A minor disadvantage of Section 83(b) elections is that if a recipient forfeits the stock because he leaves his company prior to meeting value of the stipulated vesting requirements, the recipient is not permitted to recognize a loss on the value of the amounts forfeited. The opportunity to use an election under Section 83(b) should be considered whenever any equity of potential value is received with restrictions on the enjoyment of value—for instance when common shares are purchased at formation at a low value, but subject to vesting or forfeiture upon departure.

In some instances, a stock award is tied to a cash bonus in an amount sufficient to pay taxes on the stock bonus. In such cases the cash bonus may also be "grossed up" to take into account that the cash bonus is taxable as well. Payment of this type of cash bonus, at least in the author's experience, is often opposed by top management and controlling shareholders since the effect of a grossed up cash award is to give the recipient "free" shares. While the issuing company is not "out" any cash—the combined deductions gained from the stock and cash bonuses roughly offsetting the cash paid out—the company has received no tangible benefit from issuing its shares, other than to reward the recipient for his contribution. Supplemental cash bonuses are discussed in more detail under non-qualified stock options, infra, p. 8. As a result, most stock bonus awards require the recipient to pay his own taxes on the stock bonus as the recipient’s "investment" in the stock.

Microsoft and Martha Stewart Enterprises have recently made a splash by offering recipients of stock options that are "under water" (i.e. the exercise price is higher than current market) restricted stock or "restricted units". These rather complicated programs are beyond the scope of this article, but the "restricted units" are worth considering, since for the issuer they are simpler than restricted stock with vesting restrictions. Restricted units are usually issued pursuant to a formal plan (which are, or shortly will be, required to be approved by shareholders for all listed public companies). Restricted stock unit plans simply represent the promise of the issuer to issue stock at a future date, essentially equivalent to vesting. By issuing a promise rather than the stock itself, the recipient is not franchised to vote the "units" and has no tax issues because he or she has not received anything immediately. Restricted stock units also foreclose any Section 83(b) election for the recipient but eliminate any controversy concerning the value of the stock received. Also, stock unit awards avoid the treatment of dividends on "unvested" stock, and they avoid tax issues for recipients based outside the U.S. (some countries disregard vesting restrictions and tax awards immediately).

An entirely different set of rules applies to the issuance of interests in limited liability companies and limited partnerships that elect to be treated as partnerships for tax purposes. Since...
Equity Incentive Programs

At one time, deeply discounted stock purchase plans were all the rage; with option plans receiving recent criticism for being too generous to recipients and not really correlating the interests of shareholders with recipients, these plans may stage a come-back. This type of plan is similar in some ways to a stock bonus plan, but instead of a simple award of shares, such a plan permits recipients to purchase stock at a discount from fair market value. This plan’s purported advantage is that it forces the recipient to make a monetary commitment in receiving equity above and beyond any tax due. Any discount, however, is taxable to the recipient when the stock is purchased; likewise the discount creates a deduction for the issuer. One reason why these plans are unpopular is that the purchase plan—being voluntary in almost every case—tends to allow parties with greater resources to purchase more stock than parties with lesser resources, and since individual situations vary greatly, the unevenness of such a program to specific employees is perceived to be a detriment. As a result, other types of plans, not requiring substantial real investment have been more popular. See Section V below also, which addresses stock purchase plans in general.

A third variant of the stock bonus plan is a bonus plan that permits recipients to receive incentive bonuses, usually tied to personal performance, either in cash or in stock. While this type of plan allows flexibility of choice in the recipient, this type of plan also suffers from the same unevenness that discount purchase plans hold in regulating who the ultimate recipients of the company’s stock should be. If the goal of the enterprise is to provide incentives to top and middle management by giving each member of management a feeling of participation in ownership, the offer of the cash alternative will simply mean that some members of management do not ultimately end up owning any equity. Of course, many would argue that such a plan’s result is beneficial—those motivated by cash can receive cash, and those motivated by equity can receive equity.

IV. STOCK OPTIONS.

A. Incentive Stock Options.

ISOs, unlike all other equity programs, can only be granted to full-time employees. In general, the employee is not taxed for any appreciation in the value of the ISO or upon exercise of the ISO; taxable income is only recognized upon sale of the stock that has been purchased pursuant to the exercise of the option. A major benefit is that the taxable income resulting from the sale of ISO stock will be capital gain in the event that the employee does not sell the stock within two years from the grant of his ISO nor within one year after the exercise of his option (a sale before either such dates is a “disqualified disposition”). A long-term capital gains rate of 10% generally applies to the sale or exchange of shares held longer than twelve (12) months.

If the ISO has been granted after 2000, the employee gains an even better tax advantage: the capital gain is taxed at a top rate of 18 percent as long as the employee holds the shares for at least five years after exercise. Unlike NQSOs, the enterprise obtains no benefit from an ISO plan, since it receives no deduction at the time of the grant of his option, the exercise of the option or the sale of stock by the employee.

ISOs must be exercisable at not less than the fair market value of the underlying stock on the date of the grant. In most cases, the options can be exercisable for up to ten years, but for an individual recipient who directly or indirectly owns more than 10% of the company’s stock, the options may only be outstanding for five years. In addition, for a 10% or more owner, the exercise price of the options must be priced at not less than 110% of the fair market value of the company’s stock on the date of the grant. Generally, the tax benefits created by an ISO are not available to a holder unless the option is exercised within three months of leaving employment; accordingly, most plans call for a cancellation of ISOs three months after termination of employment. Indeed, most enterprises see no reason for continuing employee options, whether qualified or unqualified, for any lengthy period after the recipient has terminated his employment or other relationships with an enterprise.

Like most tax advantaged programs, ISOs possess a number of fairly complicated rules, some of which offer substantial additional benefits. For instance, ISOs can be exercised and paid for with shares of the company already owned by the holder; in this manner a stockholder who bought shares early and at a low cost can trade in his
shares and received a credit at then current fair market value when he pays the exercise price of his ISOs. Indeed, the ISO plan can even permit the holder to “net” his exercise by deducting that number of optioned shares with a net fair market value at the date of exercise equal to the aggregate exercise price of all options being exercised! The great benefit of the share exercise alternative is that no tax is due upon the exchange of the old non-ISO shares to pay for new ISO stock, and the recipient is out no cash. If ISO-acquired shares are used to pay for new ISOs (“pyramiding” or “bootstrapping”), taxable income must be recognized if the “trade” is within the time periods that create a “disqualified disposition” (see the first paragraph of this section).

Only $100,000 worth of incentive stock options can become exercisable by an employee in any given year. Mind you the test is exercisability, not grant. For instance, a key employee could receive $500,000 worth of options (e.g. 100,000 shares exercisable at $5.00 per share, the then current fair market value) and the options would still qualify if at the time of the grant the board stipulated that only 20% of the shares (or $100,000) became vested each year on the anniversary date of the option award.

There are a number of technical requirements to comply with in creating an ISO plan. The plan must be written, and shareholders must approve the plan within one year after being adopted by the board of directors. Options can be granted prior to the requisite shareholder approval but are usually issued subject to obtaining stockholder approval. Finally, care must be taken, especially with regard to issuing large blocks of ISOs, to analyze alternative minimum tax implications relating to option exercises; the difference between the exercise price and the fair market value on the date of exercise is a tax preference item, a component of the alternative minimum tax computation.

Problems often arise in the ISO environment through discomfort of the board of directors of a privately held company in determining accurately the fair market value of the stock of the company on the date of the grant. The Internal Revenue Code simply requires that the attempt to value the company stock must be made in good faith. While this requirement simply of good faith gives some leeway in the discretion of the board of directors or the stock option committee granting options, a serious attempt must be made to obtain a reasonable assessment of the value of the company’s stock. There is no requirement that an independent valuation be obtained, but if one can be acquired at reasonable cost, an internal or outside written evaluation could go a long way in establishing good faith. Of course, if options are being granted in a publicly-held company, the “good faith” concern is of little moment because of the supposed ability of the public market to establish “fair market value.”

Many companies refuse to issue ISOs under the theory that there is little motivation for a recipient ever to exercise his or her options except upon the occurrence of a liquidity event, like the sale of the company, in which case the option will be exercised or cashed out and the capital gain standards never attained. For these companies non-qualified options become the equity incentive of choice.

B. Non-Qualified Stock Options

Unlike ISOs, NQSOs gain no special tax benefit under the Code. The principal detriment to NQSOs is that ordinary income is ordinarily recognized by the holder (presuming the option was issued for rendering services to the enterprise) on the date of exercise of the option, measured by the difference between the fair market value of the stock on the date of exercise and the exercise price. NQSOs may be granted either pursuant to a plan or, as with stock bonuses, may be granted on an ad hoc basis. Because no special tax treatment is desired, NQSOs are quite flexible. They can contain, as ISOs can, vesting restrictions and performance restrictions. There is no employment requirement. Unlike ISOs, NQSOs do not generally need to be approved by shareholders. NQSOs are the equity fringe benefit of choice for grants to less than full-time employees such as consultants and directors.

Another flexible aspect of NQSOs is that the exercise price of the option can be literally any price; there is no requirement that the option exercise price of an NQSO be set based upon the stock’s present fair market value. If options are granted to a person rendering services and the options are immediately exercisable at a price far less than fair market value, the IRS may contend that income must be recognized on the value of the option at the time it is received. Most tax practitioners believe that NQSOs granted at an exercise price representing less than a 20-25% discount from fair market value on the date of

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2 The exercise of an ISO may result in liability under the alternative minimum tax, a topic that is beyond the scope of this article. While the alternative minimum tax has been in effect for some time to tax high income individuals, if the income recognized from an employee’s exercising options is too high, it could trigger the alternative minimum tax.
grant will not trigger tax recognition at the date of grant. In order to avoid the element of appearing to grant present compensation, however, NQSOs are in fact often granted at an exercise price approaching fair market value at the time of issuance in order to both to avoid the tax issue and to provide an ongoing incentive to the recipient.

C. Special Option Issues

1. “Gross-up” Cash Bonuses Tied to NQSOs. Because of the negative tax consequences of NQSOs, NQSOs are often tied with the additional benefit of cash bonuses payable at the time of the exercise of a non-qualified option. At first, the thought of granting cash bonuses upon exercise of a non-qualified option seems rather odd, but in thinking of the taxes to be paid and saved by both parties (importantly assuming that the issuing enterprise has taxable income at the time of option exercise), the grant of cash bonuses in connection with the exercise of options is simply a way of neutralizing the tax consequences of NQSOs so that neither the company nor the NQSO recipient receives any net cash penalty or benefit as the result of tax consequences incurred in connection with the grant and exercise of NQSOs. As noted above, the technique is also commonly used with stock bonuses. Perhaps the best way of explaining this is by way of an example. Assume that a corporation grants an NQSO for 1,000 shares exercisable at $10 per share to a director in connection with his agreement to serve as a director of the company; assume further that over the years the underlying stock becomes worth $100 per share and holds that value when the director exercises his option. The director would recognize income of $90 per share at the time he exercises his option. The director would recognize income of $90 per share at the time he exercises his option. At the same time, the company would obtain a $90 deduction. The deduction is worth $0.345 per dollar to a profitable enterprise with annual income over $100,000, and the maximum tax for most individual taxpayers is approximately 40%. Of course, the payment of a cash bonus to the director to pay his taxes is also taxable income, and to avoid the complex equation involved in “catching up”, the cash bonus paid is usually “grossed up” to be roughly equivalent to the total amount of taxes to be paid by the director both upon exercise of his options and upon receipt of his bonus. In our example, if the enterprise pays a bonus to the director equal to $60.00 per share in cash, the cash bonus would take care of most of the tax bill (ignoring any state income taxes) payable by the director as the result of exercise of his options. While the assurance of payment of a cash bonus at the time of exercise is often made informally, in most cases the obligation to pay a cash bonus is tied in as part of a specific non-qualified stock option plan that gives an entitlement to the option holder so that he may be assured that he will receive the cash to pay his taxes.

A summary of the above example in a table would demonstrate that neither the option holder nor the company would be out any cash cost with a cash bonus tied to a non-qualified option plan.

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<tr>
<td>Income or Deduction</td>
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<td>upon receipt of cash bonus</td>
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<td>Net cash or tax benefits received or paid</td>
<td>-0- ($60 - $60)</td>
<td>($3) ($53 - $50)</td>
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2. Accounting Aspects of Options. A great deal of turmoil prevails in this area as this article is written. Certainly the grant of massive amounts of options by public companies in the past has led to abuses tied to the fact that options granted to employees and other service providers are not required to be recognized as a present expense by the company issuing the options. That will change, however; FASB recently enacted a rule that beginning in 2005 option awards will have to be recognized as an expense. There are exceptions to the current non-recognition rules, of course; for instance, if an NQSO is granted at a discount from market value, the discount is accounted for and amortized over a reasonable period as an expense, usually the vesting period or the life of the option. Please note that stock appreciation rights, discussed below, unlike options, are treated as a current expense for accrual accounting purposes. When assessing what kind of options to issue - ISOs
versus NQSOs at fair market value versus NQSOs at a discount - discussion should be had with the enterprise’s accountant, inasmuch as the treatment of options for financial reporting purposes varies according to the types of options issued. In the current reform-minded environment, many companies are electing to treat the fair market value of options that are granted as a current non-cash expense. Since January 1, 1998, publicly-held companies have been required to report earnings per share both the traditional way and in a manner that reflects the impact on earnings had the options been expensed. Which methodology to use is a complex and difficult decision, especially considering the difficulty of placing a value on current option grants. Generally though, under current accounting rules until 2005, options granted at fair market value do not generate a charge to earnings unless the company so elects; instead any differential between the option exercise price and its present value, net of the related tax benefit, will be taken into account each reporting period as a dilution of equity when computing earnings per share under the so-called “treasury stock” method of stock related compensation accounting. The alternative, of course, is to recognize options for what they are: a form of compensation expense. That road is fraught with difficulty, however. Valuation of options is much more difficult than valuing stock. There is no uniform agreement on the methodology to be used; the most prevalent is the Black-Scholes model, but that model takes volatility into account and can lead to what many believe to be overstated option expense.

3. Option Exercises: Other Methods of Raising the Exercise Price. One other set of problems should be mentioned in connection with both ISOs and NQSOs: the problem of raising sufficient cash to be able to pay for the options as they become exercisable if cash bonuses are not used. Notwithstanding substantial appreciation in the securities which are the subject of an option, raising the cash to exercise the option, particularly if there is a related income tax liability associated with the exercise of the option, may make for a difficult situation. Some option recipients may not have the capacity to borrow money or to look to savings to generate the funds for the option exercise. A number of other methodologies exist to solve the problem should the issuing company desire to do so. First, the employee could be allowed to sell other shares he owns; indeed either ISOs or NQSOs could provide specifically that the exercise price could be paid by trading in previously owned shares in exchange for the option exercise price (see Section IV A., above). In the case of ISOs, in a “disqualified transaction” and NQSOs, the exercise of an option by paying for same with shares remains a taxable transaction and gain will be recognized as if the option exerciser had, in effect, used cash to exercise his option related to the traded shares and then had sold such stock for cash to exercise the additional option. A third way to allow an employee to have sufficient funds is to grant a cash appreciation bonus or set aside a vested or unvested savings account to permit the payment of cash funds at the time the employee wishes when a sort of “sinking fund” with which to exercise the option. A fourth method usable for NQSOs but not for ISOs is to lower the exercise price as the appreciation increases. This arrangement is sometimes called a “1-UP-1-DOWN” arrangement, and for each dollar of appreciation in the value of the stock, the exercise price is reduced by $1.00. For that matter, as the stock appreciates, the exercise price could be reduced only by the amount that the income tax bill increases; that is, it would be just as appropriate to reduce the option exercise price by the probable tax bill (say, $.37) for each dollar of appreciation. Complex tax issues arise with this last alternative, however; consult with your tax attorney or accountant if you choose this method.

When all is said and done, however, it has been the author’s experience that directors and key management seldom wish to make the receipt of shares, whether by bonus or by options, “free” for the employee. There is a justifiable belief that unless the recipient of options pays something for his shares, he will not value the equity ownership interest as much. Accordingly, while various schemes—particularly cash bonuses—can be constructed to alleviate the stock exercise price payment cash crunch and alleviate the penalty of the tax bill, most issues prefer to make the employee pay most or all of the tax bill and most or all of the stock exercise price.

A variety of other alternatives besides bonuses exist to alleviate the cash burden of exercise; some involve third parties. For instance, if a company wants to encourage a key employee who doesn’t have any available cash to exercise a stock option, the company could arrange for his borrowing funds through a bank and agree to guarantee the loan of the employee. In that way, the employee becomes fully liable to repay the loan, but the company offers its credit to ensure repayment. In such arrangements, of course, the stock purchased usually stands as security for repayment of the loan so that neither the company
nor the bank ultimately will be hurt if the employee does not repay the loan, unless of course the stock value declines, in which case potentially disastrous complications could arise.

V. STOCK PURCHASE PLANS

A number of companies have attempted to sell stock to employees on some favored basis in order to motivate employees to “buy in” to the enterprise and avoid the “gift” flavor of many of the transactions described above. The most common benefit extended is financing for the purchase. In most every state it is now permissible for the company to sell both its treasury shares (that is, shares previously issued that have been repurchased by the company) and unissued shares in exchange for a promissory note, and most attorneys also feel it is safe to grant a cash bonus to an employee or other person, with the recipient required to use the cash proceeds from the bonus to purchase shares of stock in the company. As suggested above in the option exercise environment, the Company could also arrange for a purchaser of its stock to borrow at a financial institution, agreeing to guarantee the obligation.

More aggressively, many companies reach the same result by lending money to a proposed equity recipient on arms-length terms, with the proceeds of the loan to be used by the equity recipient to purchase stock. There are some benefits to such an arrangement. The equity recipient is clearly on the hook for a debt to the corporation, which is enforceable. The recipient has received nothing for “free.” On the other hand, the equity recipient is permitted to purchase without being out any immediate cash and does not have to go to a financial institution to borrow the money, where borrowing might be difficult. The company as well is out no cash because it has lent the cash to an equity recipient, has received a note in return, and has received the cash back as an equity purchase. Some jurisdictions—importantly not including Texas, Delaware and Nevada—prohibit the issuance of stock other than for cash, property and services actually rendered. Careful counsel should be obtained in this area.

A slight variant to this type of arrangement in states in which the issuance of stock for promissory notes or future services is prohibited is an arrangement involving a stock subscription agreement in which a proposed equity recipient is permitted to exercise a stock subscription agreement pursuant to which the company obligates itself to sell and the stock subscriber obligates himself to purchase a stipulated number of shares at a stipulated price over a period of time. Since a stock subscription agreement takes on the flavor of a stock option if the subscription payment period is extended over a long period of time, most attorneys feel that a stock subscription agreement with an extended payment period should be analyzed from a tax standpoint as a form of NQSO rather than as a simple stock subscription, even though the transaction is a binding purchase transaction rather than an option to purchase. However, if the payment period is relatively short—especially over a single tax year—the stock subscription arrangement should be regarded as a simple stock purchase for tax purposes.

Stock purchase plans often play a crucial role in buying out existing stockholders who want to sell or who are required to offer to sell under a buy-sell arrangement. Most enterprises do not have excess cash to buy out shareholders but the enterprise often seeks to keep its stock “in the family” by facilitating purchases by key management. Often the enterprise will lend cash or guarantee obligations of the purchaser in such transactions at a financial institution; in other instances the seller will accept a payout over a period of time with an adequate down payment (which the Company arranges) and a pledge of the shares purchased.

Special problems arise in partial redemptions of shares of a majority owner—usually the buyback is treated as a dividend taxed at higher ordinary income rates rather than at capital gain rates. Special counsel is needed to adapt mechanisms to avoid this high ordinary income tax rate.

VI. STOCK APPRECIATION RIGHT AND PHANTOM STOCK PROGRAMS.

Stock appreciation right, or SAR, and phantom stock plans have been around for some time. The rights of a recipient under an SAR or phantom stock plan are nothing more than contractual rights, and an SAR or phantom stock recipient has none of the rights of a stockholder. From an accounting and tax standpoint, an SAR or phantom stock plan is simply one more variant of a deferred compensation program not technically involving equity. This type of plan generally grants a recipient units under a written plan in which units equal a share of stock in the enterprise. Like stock options, this plan usually provides for an equitable adjustment in the event of the issuance of additional shares and is designed to reward a recipient in the same manner as if the recipient had owned shares in the company. As with stock options and stock

Equity Incentive Programs
bonuses, these plans can have vesting requirements (and usually do) and invariably address the same issues that buy-sell arrangements address to provide for such events as termination of employment, death, disability and divorce. As with most other equity incentive plans, if an enterprise’s stock is publicly traded, the valuation is easy to compute. However, SAR and phantom stock plans are not typically used by public companies since stock appreciation is treated as a compensation expense for accounting purposes. Thus, if a company’s publicly-traded stock appreciates rapidly over a short period, the appreciation under this type of program can become a significant non-cash expense impacting the earnings of the company.

SAR and phantom stock plans are extremely flexible since no special tax benefits are sought through such plans. Generally, payments are deductible by an employer when paid and ordinary income to the recipient when received, unless the cash appreciation amount is actually set aside in an escrowed account of the recipient. The most common plans provide for a vesting period over three to five years with the units continuing to appreciate (or depreciate) as if the recipient owned shares of the company as long as he is employed; when the employee retires or terminates, he receives payments upon his departure. Payments, of course, can be made while the recipient remains employed—either as a stipulated part of the plan’s structure or at the election of the enterprise or the employee.

SAR plans generally seem to be preferred over phantom stock plans because in the former only the appreciation in value above current value is paid to the recipient; in phantom stock plans units are awarded in “shares” in a manner that parallels stock bonus awards—but without the immediate tax liability associated with stock bonuses. For a private enterprise, phantom stock plans can offer many of the benefits of stock bonus awards without the disadvantages of such awards (for instance, creating employee-shareholders who might exercise their various shareholder rights).

One particular problem with SAR and phantom stock plans in private companies is establishing a fair formulation of valuation. There are a number of formulas available—book value (with or without some premium, either fixed or a percentage); book value adjusted to reflect appreciation or depreciation of assets; multiples of earnings standards (gross profit, cash flow, or after tax earnings); standards based on comparable companies; or a blend of the above.

Alternatively a subjective standard could be adopted—for instance the determination of an investment banker. Recipients, however, are usually suspicious of subjective formulas, believing that the company may direct the method of valuation to its advantage, and of objective formulas, believing that mathematical computations may not reflect “true” fair market value.

While many employers do adopt formal plans applicable to large groups of employees, there is no need for uniformity, and it has been the experience of the author that most SAR plans are specifically tailored to individual recipients. Thus, younger employees could be given the right to let their units continue to appreciate during employment, while older recipients could be awarded units under a separate plan which grants fixed benefits after a certain period, say five years, with a fixed payment thereafter with interest. Some enterprises adopt by a plan in which units are awarded each year, such that a recipient can expect to receive a number of unit awards over a period of years.

Some plans seek to make payment of vested amounts in stock. Such payments essentially are equivalent to, and create the same income tax problems as, stock bonus payments (see Section III). Other problems arise with the award of shares rather than cash under an SAR or phantom stock plan; besides the rather obvious securities laws problems, the award of shares in a non-publicly traded company is usually not perceived as a great benefit; most plan recipients look forward to the day that their equity award can be turned into cash in some fashion, and it has been the experience of the author that employers hold out as a major benefit of this type of plan that payments will be made in cash and will not involve payment of illiquid stock to recipients. Since these plans are attractive to employers who do not wish to undergo further dilution of the equity value of the company and do not wish to accord to recipients the rights of shareholders, the award of shares as the ultimate form of payment is usually neither satisfactory to the enterprise considering that type of plan nor to the recipient who would rather ultimately have cash rather than stock in the enterprise.

Since this is a contractual plan and is often dependent upon the good faith of all the parties to make sure that it works, a usual provision of SAR and phantom stock plans is that in the event that the company is sold or control changes, benefits under the plan become immediately vested. Most plans also provide that if the company is sold the
SAR and phantom stock benefits become payable immediately.

As with NQSOs and stock bonuses, shareholder approval is usually not sought for SAR and phantom stock plans.

VII. EMPLOYEE STOCK OWNERSHIP PLANS ("ESOPs") AND PROFIT SHARING PLANS OWNING STOCK OF THE SPONSORING COMPANY ("KSOPs").

Since this memorandum is devoted principally to rewarding key members of management with equity incentives, little need be said about employee stock ownership plans or profit sharing plans which own stock in the enterprise. Extensive published articles are available on the use of ESOPs and KSOPs, which will be provided on request. ESOPs and KSOPs generally are best used for the following situations:

1. ESOPs and KSOPs can be useful in order to create an aura and a reality that all long-term employees are owners of the company.
2. ESOPs and KSOPs work well in an environment as one component of a multi-faceted equity incentive program in which an ESOP is utilized to insure that all employees of the company have some equity participation, and a combination of stock bonus plans, ISOs and NQSOs are utilized to motivate management, including consultants and directors. Ownership of the company's stock through a profit sharing plan possesses the benefit that not all of the funds of such a plan need be invested in company stock, and ESOP provisions requiring the voting of the shares of the company under certain stipulated conditions by the beneficiaries of the plan do not apply to KSOPs.
3. ESOPs and KSOPs can be used to finance acquisitions, to dispose of a division or a subsidiary, as a takeover defense, to recapitalize an enterprise or to defer gain on sale of a company by a dominant insider or insider group.

In light of the recent large losses incurred by retirement plans that held stock the sponsor company—most notably Enron—the use of stock to fund retirement plans has lost most of its luster.

VIII. SPECIAL OPPORTUNITIES DURING STARTUP PHASE

All the incentive plans discussed above can be utilized in startup situations. However, in the incorporative process of a startup, additional opportunities present themselves to permit key employees and contributors of services and ideas to share in the equity of the corporation to a greater extent than might be permissible if a pro rata contribution of all the enterprise's necessary capital were required of all participants. Typically in a startup there are two groups: one group with capital and a second group putting the deal together or possessing management skills. In order to reward both groups fairly, the most typical capital configuration of a startup corporation is to grant to the capital contributing party a senior security that will acknowledge the capital contribution and permit a return of (and often a return on) that capital prior to distributions to management and promoters—ordinarily a debenture (which is usually subordinated) or a preferred stock (with or without a dividend feature). The capital-contributing party also ordinarily receives an associated equity security—e.g., common stock, convertible securities or stock warrants or options. Creating various levels of senior securities has been used routinely in acquisitions to permit existing management (and often M&A firms) to receive ten to thirty percent of the base common stock equity of the LBO enterprise at low cost; such equity, however, is usually greatly burdened with substantial debt layers and one to three levels of preferred stock.

Regardless of whether the enterprise is a startup enterprise or a leveraged buy-out, the goal in creating senior securities is to depreciate the initial value of the base equity of the corporation, the common stock, so that its initial present value is minimal. In this manner, the management contributors or the technology contributors can purchase substantial equity with a modest investment. Although in most instances it is possible to structure the transaction in a manner that permits the management and the technology contributors to pay very little in cash to receive equity in the corporation, there is nothing to prevent the equity received from being subject to the very same control restrictions discussed earlier in this memo, such as vesting requirements based on time or performance criteria and restrictions related on resale.

Often a startup group retains an attorney for advice on incorporation long before the process is begun to raise substantial amounts of money. In such instances it is often wise to incorporate immediately and have each of the parties contribute some modest amount of cash or property to the corporation to receive stock. In such instances, especially if sufficient time has passed between the incorporation date and the insertion of investment capital by third parties receiving senior securities, there will be no tax consequences to the equity recipients who receive substantial amounts of equity, sometimes at quite
nominal cost, when investors purchase equity at a higher price than paid by the formation group.

**IX. SUMMARY**

Many different types of equity incentive plans are available to an enterprise that seeks to reward its key contributors. In many cases multifaceted programs are created that incentive and motivate recipients in unintended ways and grant awards to participants who are not motivated by the program offered. The goal is to reward key participants in an enterprise for success achieved both by the enterprise and by the individual.

While many commentators note that ISOs are not the most cost effective method of granting equity incentives from the employer’s standpoint, particularly from a tax perspective, ISOs remain a popular type of plan because of the benefits—tax and non-tax—accorded to recipients and because of the perceived complexity of creating non-qualified option or stock bonus plans with tied cash bonus programs.

NQSOs and SAR and phantom stock plans, on the other hand, do offer an enterprise tax benefits. The greatest problem of SAR plans for privately held companies lies in insuring that a fair formulation is achieved in valuing the units. As most of the readers of this memo know, valuation of non-publicly traded companies is a very difficult process, and valuations of most private companies should be stated as being within a range of values rather than as a specific amount. Accordingly, the most effective SAR and phantom stock plans have adopted specific, objective formula, usually based on book value appreciation or earnings levels.

Stock bonus plans offer equity to key participants, with less dilution to the issuer, but cash demands and taxability limit their use.

It should be obvious from the discussion above that with all the alternatives available, the best long-term approach is to avoid seeking a universal solution to equity incentive rewards. Different people are motivated by different plans, and many enterprises adopt two or three different types of plans specifically tailored to the age and personality of those receiving the benefits and the subjective preferences of those creating the equity incentives.

An oft-ignored aspect of fashioning the appropriate equity plan is to analyze the potential reactions of recipients in the event the enterprise does not do well; too often recipients feel “entitled” to some reward and feel “shorted” if nothing is received. With ISOs and SARs in particular, the sought-for incentive in such plans will be lacking if a company’s prospects become clouded.

Another truism seems to be that in any rapidly growing organization personalities change; any equity incentive plan must insure that people who leave the company prior to accomplishment of their missions are not rewarded without making the requisite contribution and that those who make the requisite contribution do receive the reward expected.

The basic motivation and benefit of equity incentive rewards is that no one realizes any gain under such programs unless the entire enterprise appreciates in value. That is the whole purpose of any equity plan. Coupled with cash bonus incentive plans, the participants in a growing enterprise should be properly motivated to achieve success for their enterprise.
TAX AND ECONOMIC EFFECTS OF STOCK BONUS

Assumptions:
Value of Stock 10,000
Individual Ordinary Income Tax Rate 37%
Corporate Tax Rate 35%

CALCULATIONS WITHOUT CASH BONUS GROSS UP

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CALCULATIONS WITH CASH BONUS GROSS UP

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### Tax and Economic Effects of Incentive Stock Options

Assumptions:
- Spread on Grant: 0
- Tax Effects on Grant: 0
- Exercise Price: 1,000
- Value Upon Exercise: 2,000
- Ultimate Sale Price: 10,000
- Individual Capital Gain Tax Rate: 15%
- Corp. Tax Rate: 35%

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If the options are ISOs, no tax is due on exercise; if NQSOs, there would be a tax of $370, assuming a tax rate of 37%.

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Net Economic Benefit (Cost) 7800 (7430 if the exercise was taxed) 1000 (1,000)
TAX AND ECONOMIC EFFECTS OF NON QUALIFIED STOCK OPTIONS  
( Issued at an exercise price equal to fair market value with taxable event upon exercise of stock option )

Assumptions:
- Spread on Grant: 0
- Tax Effect on Grant: 0
- Exercise Price: 1,000
- Value upon Exercise: 2,000
- Ultimate Sale Price: 10,000
- Individual Tax Rate: 37%
- Individual Capital Gain Tax Rate: 15%
- Corp. Tax Rate: 35%

**ILLUSTRATION WITHOUT GROSS UP**

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**ILLUSTRATION WITH GROSS UP ON EXERCISE**

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* Assumes sale 12 months or more after exercise.
**TAX AND ECONOMIC EFFECTS OF STOCK APPRECIATION RIGHT**

Assumptions:
- Values on Issuance: $1,000
- Value on Date of Payment: $10,000
- Tax on Grant: 0
- Cash Ultimately Payable: 9,000
- Individual Tax Rate: 37%
- Corp. Tax Rate: 35%

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