LONG-TERM INCENTIVE PRACTICES

A GUIDE TO PRACTICES, PROVISIONS, PROS & CONS
OF KEY LONG-TERM INCENTIVE PROGRAMS

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Why Utilize Long-Term Incentives

Long-term incentives are market competitive tools intended to attract, motivate and retain current and future key employees for the long-term growth of the Company. The overall intent should be to:

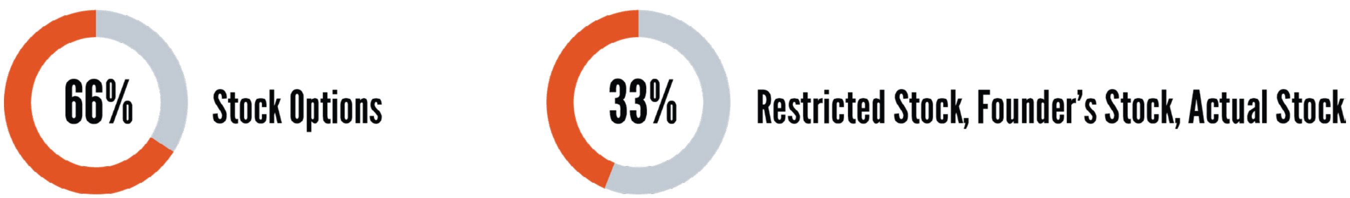
- Support the Company's long-term growth, goals and objectives;
- Be simple to understand and communicate;
- Provide a long-term incentive for select key employees to receive awards for achieving long-term performance goals;
- Provide key employees the opportunity to share in value creation and be motivated to create maximum shareholder value;
- Provide key employees with meaningful, market-competitive long-term wealth building opportunities;
- Provide liquidity opportunities for award recipients upon the satisfaction of a vesting period;
- Provide a material retention handcuff to key employees; and
- Provide the Company with the flexibility to administer the Plan such that capital is conserved in a manner to ensure long-term growth goals and objectives are achievable.

Long-Term Incentive Prevalence

THE FOLLOWING ARE TRENDS IN THE USAGE OF LONG-TERM INCENTIVES ("LTI"):

- A study of 300 private companies with revenues ranging from $100M to $5B indicates that 56% utilize LTI plans. The following describes the corporate structure for companies to have LTI:

- 98% of public companies offer LTIs to key employees. Private companies and not-for-profits have increasingly adopted LTI plans to be competitive with public company counterparts.
- Of those private companies that provide LTI, companies philosophically decide whether to use actual stock or cash, with the majority (51%) utilizing cash-settled plans. This percentage is projected to increase in the coming years.
- When utilizing actual stock, the prevalence of LTI vehicles in private companies is as follows:



- When utilizing in cash, the prevalence of LTI vehicles in privates companies is as follows:

Long-Term Incentive Trends

DILUTION

When utilizing equity or cash for LTI, the potential dilution to owners is 5-15%, with most companies targeting 10% potential dilution in growth of the Company value from the date the LTI is awarded.

ELIGIBILITY

Companies typically restrict eligibility to employees that have P&L responsibility, are key value creators, or are key employees to retain for the future. A common base salary level that restricts eligibility is $100,000.

VESTING

Companies either provide vesting on a three, four, or five year basis, with four years being the most common. Vesting of actual equity is established on upon a transaction event such as IPO, sale, death, disability, or retirement. Vesting of cash-settled plans is time/performance based.

LIQUIDITY

Payout is commonly made upon vesting utilizing the operating cash flow of the Company or upon a transaction event. Companies that pay dividends to owners often establish a dividend equivalent right to provide pro rata payouts to eligible participants.

AWARD VALUE

The long-term incentive award value should approximate the annual incentive payout or greater to ensure there are sufficient handcuffs to retain the employee and drive long-term decision making over short-term performance.

> Example:
>
> **$200,000** BASE SALARY
>
> **$50,000 - $75,000** ANNUAL INCENTIVE OPPORTUNITY
>
> **$75,000 - $100,000** LONG-TERM INCENTIVE OPPORTUNITY (Future value determined by long-term growth)

Long-Term Incentive Design Questions

The following questions should be considered by Ownership prior to the strategy meeting in preparation for the long-term incentive plan design.

- What is the Company's ultimate exit strategy, if any?
- What is the exit strategy timeline?
- Do you want to award actual stock?
- Do you want to require a purchase element?
- On a scale of 1 – 10 (1 being least important and 10 being most important), rank by importance:

  Attraction ____ **Retention** ____ **Motivation** ____

- On a scale of 1-10, how important are retirement benefits as a part of the long-term incentive/retention strategy?
- Is the Company considering liquidity opportunities prior to a transaction?
- What percentage of the Company or growth in the Company is ownership willing to share?
- Would the Company rather full value awards or appreciation awards?
- Does the Company want to pay dividends/dividend equivalent rights?
- How often do you want to make awards?
- What performance metrics does the Company want to reward?
- What termination events does the Company want to accelerate and/or provide payouts for? (change in control, retirement, death, disability)
- Does the Company want to have buy-back provisions?
- Does the Company want to provide discounted payouts for vested awards upon voluntary termination?

Restricted Stock

KEY PROVISIONS

- Outright grant of shares to employees with restrictions as to sale, transfer and pledging;
- Restrictions lapse over a period of time (e.g., three to five years);
- As restrictions lapse, employee has unrestricted shares which he or she may sell, transfer, or pledge;
- If employee terminates employment, all unvested shares are forfeited;
- During restriction period, employee receives dividends (if provided) and can vote the shares (unless non-voting stock awarded).

TAX IMPACT ON EMPLOYEE

- At grant – no tax;
- As restrictions lapse – the current market-value of vested shares are taxed as ordinary income;
- Dividends received during restriction period are taxed as ordinary income.

TAX IMPACT ON COMPANY

- No tax deduction at grant;
- As restrictions lapse, the Company receives tax deductions equal to employee's ordinary income;
- No tax deduction at sale;
- Dividends paid during restriction period are not deductible.

(1) Assumes 83(b) election is not made. If an 83(b) is made, employee recognizes income on the date the restricted stock was issued, and the company receives an immediate tax deduction for the initial value of the shares (but not for subsequent appreciation during the restriction period); dividends paid during the restriction period are not deductible.

EARNINGS IMPACT

- Fair market value at grant charged to earnings over restriction period;
- Subsequent appreciation not charged to earnings;
- Immediate dilution of EPS for total shares granted.

Restricted Stock

ADVANTAGES

- No employee investment required;
- Promotes immediate stock ownership;
- Charge to earnings is fixed at time of grant;
- If stock appreciates, Company's tax deduction exceeds fixed charge to earnings;
- Aligns employees' interests with shareholders;
- Recognizable to most employees;
- Offers employees potential long-term appreciation as Company grows.

DISADVANTAGES

- Immediate dilution of EPS;
- Employee may incur tax liability before shares are sold;
- No liquidity due to lack of marketability;
- Most valuable is liquidity event is projected in the near future (change-in-control or IPO)
- Employee can retain ownership of vested shares post-termination;
- Employee may pay tax (at vesting) at a higher stock price than the date of sale.

How Restricted Stock Works

TIMING	1 —— YEARS ——	3
Restricted Stock Unit	**Grant**	**Restrictions Lapse**
Fair Market Value	$15 →	$25
Dividends	$0 →	$1.00
Employee Investment	$0 →	$0
Employee Gain	$0 →	$26.00
Employee Tax(1)	$0 → ($25.00 x 35%) + ($1.00 x 35%)	$9.10 Tax Due
Employee Net Gain (After Tax)	$0 →	$16.90 Net Gain

(1) Assumes the employee is subject to an ordinary income tax rate of 35%. If an 83(b) election was made within 30 days of the award, the employee would be taxed on the fair value of the stock at grant as ordinary income, with subsequent appreciation treated as a capital gain. Dividends received after an 83(b) election are taxed at long-term capital gains rate. 83(b) elections are not typically with a high prices stock because the employee cannot recover taxes paid at grant if he or she forfeits the shares or if the shares decrease in value.

Incentive Stock Options or ISOs

KEY PROVISIONS

- Employee may buy stock at a specified price (not less than 100% of fair market value) for a given period of time (ten-year maximum);
- Options may be exercised in any sequence;
- The annual value of ISOs which become exercisable in any one year cannot exceed $100,000 per individual;
- Appreciation from grant to sale qualifies for capital gain treatment, provided holding period requirements are met (stock must be held at least two years after grant and one year after exercise).

TAX IMPACT ON EMPLOYEE

- At grant – no tax;
- At exercise – no tax, assuming holding period requirements are met;
- At sale – appreciation from grant price taxed at capital gains' rate.

TAX IMPACT ON COMPANY

- At grant – no tax deduction;
- At exercise – no tax deduction;
- At sale – no tax deduction unless employee fails to meet holding period requirements.

EARNINGS IMPACT

- Under FAS123(R), as of June 15, 2005, any unvested stock options or new awards will have an associated charge to earnings utilizing Black-Scholes or Binomial models (approximately 25-60% of fair market value);
- Dilutes EPS through common stock equivalents.

Incentive Stock Options or ISOs

ADVANTAGES

- Employees' tax liability is deferred until stock is sold (employee can control);
- Long exercise period allows employee flexibility and can be retentive;
- Employee may defer taxes or may sell the stock earlier in a disqualifying disposition;
- Motivates performance to increase stock price;
- Provides greatest leverage with rising stock price.

DISADVANTAGES

- Company loses tax deduction;
- Charge to earnings on the assumption that there will be value to recipient (which may not happen);
- Spread at exercise is considered tax preference item for purposes of computing alternative minimum tax;
- More dilutive than restricted stock because greater number of shares are needed;
- Employee investment is required;
- May be demotivating in down market;
- May artificially increase overhang.

How Incentive Stock Options Work

TIMING	1	YEARS	6
Incentive Stock Option	**Grant**	**Exercise**	**Sale**
Fair Market Value	$5 →	$10 →	$12
Employee Investment	$0 →	$5	
Employee Gain at Exercise	$0 →	$5	
Employee Tax at Exercise (1)	$0 →	$0 Tax Due	
Employee Gain at Sale		→	$7.00
Employee Tax at Sale (2)		→	$1.05
Employee Net Gain at Sale (After Tax):		→	$5.95 Net Gain

(1) Assumes the employee exercises and holds the shares for one year after exercise and two years after grant.
(2) Assumes long-term capital gain rate of 15%.

Phantom Stock

KEY PROVISIONS

- An arrangement whereby an employee receives the appreciation in the book, fair market or formula value of a specified number of shares over a set period of time (e.g., three to ten years);
- Payable in cash;
- Employee may receive dividend equivalent rights.

TAX IMPACT ON EMPLOYEE

- At grant – no tax;
- At vesting – appreciation is taxed as ordinary income on the date of payment.

TAX IMPACT ON COMPANY

- At grant – no tax deduction;
- At vesting – company receives tax deduction equal to employee's ordinary income.

EARNINGS IMPACT

- Appreciation is charged to earnings each quarter on a mark-to-market adjustment basis;

Phantom Stock

ADVANTAGES

- Aligns employee interests with shareholders;
- Promotes ownership but does not dilute actual ownership (when paid in cash);
- No employee investment required;
- Company receives matching tax deduction at vesting;
- Can be very retentive.

DISADVANTAGES

- Unpredictable charge to earnings;
- May result in substantial cash outflows if paid in cash;
- Does not lead to direct stock ownership;
- Less flexibility since valuation date is set in advance;
- Will require a third-party valuation or valuation calculation;
- Employee is taxed on phantom income unless payout is matched up with vesting;
- Can be subject to 409A deferred compensation rules.

How Phantom Stock Works

TIMING	1 —— YEARS ——	5
Phantom Stock	**Grant**	**Vesting**
Fair Market Value	$10 →	$20
Employee Investment	$0 →	$0
Employee Gain	$0 →	$10 Ordinary Income
Employee Tax[1]	$0 → ($10.00 x 35%)	$3.50 Tax Due
Employee Net Gain (After Tax)	$0 →	$6.50 Net Gain

(1) Assumes the employee is subject to an ordinary income tax rate of 35%.

Stock Appreciation Rights (Cash Settled)

KEY PROVISIONS

- These awards look and feel similar to a stock option; whereby, the base price is generally equal to the company's underlying fair market trade value on the date of grant;
- The SAR will typically vest upon completion of a time requirement (i.e., 3-5 years);
- The SAR may be exercised anytime after the vesting date and before the expiration date. Often times a company will have the right to call the exercise at the company's discretion;
- The value of the SAR is settled in cash by calculating the difference between the grant price and the exercise or settlement price multiplied by the number of SARs.

TAX IMPACT ON EMPLOYEE

- At grant – no tax;
- At settlement – employee is taxed at ordinary income tax rates for the value received;

TAX IMPACT ON COMPANY

- At grant – no tax deduction;
- At payment – company receives tax deduction equal to employee’s ordinary income.

EARNINGS IMPACT

- At the end of each reporting period, SAR's "fair value" is remeasured (e.g., marked to "fair value") and amortized over the remaining requisite service period less amounts previously recognized;
- "Fair Value" is determined using an option pricing model (e.g., Black-Scholes or binomial model);
- At the end of each reporting period after the requisite service period is completed, the SAR's "fair value" would continue to be remeasured (e.g., marked "fair value") each reporting period until settlement and any increase/ decrease in the "fair value" would be immediately recognized as a compensation cost or income;
- Upon settlement of SAR, compensation cost is trued-up to equal the SAR's intrinsic value (i.e., spread) on the date of settlement.

Stock Appreciation Rights (Cash Settled)

ADVANTAGES

- Aligns employee and shareholder interests;
- Allows for participants to time the exercise and realize maximum value;
- Allows for participants to smooth business and industry cycles and volatility by holding SARs over a longer period;
- Allows for participants to realize wealth accumulation due to early SAR grants growing in value over a longer period of time;
- Is not restricted by 409A.

DISADVANTAGES

- To grant SARs settled in cash and not be restricted by 409A, it will require a separate plan just for the SAR awards;
- The opportunity for participants to realize SAR value over a long period of time can create a large, compounding liability for the Company if participants hold for a long period of time and the company value grows;
- Participants may exercise at a time best for them, but possibly not best for the Company.

How Stock Appreciation Rights Work

TIMING	1 ——— YEARS ———	4
Stock Appreciation Rights	**Grant**	**Sale**
Fair Market Value	$5 →	$12
Employee Investment	$0 →	$0
Employee Gain at Sale	$0 → ($12.00 - $5.00)	$7
Employee Tax (1) at Sale	$0 → ($7.00 x 35%)	$2.45
Employee Net Gain at Sale (After Tax)	$0 → ($7.00 - $2.45)	$4.55

(1) Assumes the employee is subject to an ordinary income tax rate of 35%.

Performance Units

KEY PROVISIONS

- Grants of units with absolute dollar value (e.g., $30.00) with payout contingent on meeting stated performance targets over a specified period (usually three to five years);
- To the extent that targets are met, the dollar value of units is payable in cash and/or stock;
- If minimum performance threshold is not met, units are forfeited;
- Frequently used as a financing mechanism for equity plans.

TAX IMPACT ON EMPLOYEE

- At grant – no tax;
- At payment – payout taxed as ordinary income.

TAX IMPACT ON COMPANY

- At grant – no tax deduction;
- At payment – Company receives tax deduction equal to employee's ordinary income.

EARNINGS IMPACT

- Value of performance units is charged to earnings to the degree goals are achieved over the performance period;
- Charge to earnings is fixed assuming maximum payout; any payout less than maximum is reconciled at the end of the performance period.

Performance Units

ADVANTAGES

- No employee investment required;
- Company receives tax deduction;
- Performance oriented for non-market activity/strategic initiatives;
- Potential maximum charge to earnings is fixed at grant;
- Employee's tax liability can be paid out of award;
- Helps finance options;
- No dilution of shares outstanding unless paid in stock.

DISADVANTAGES

- Difficulty in setting performance targets, especially in cyclical businesses;
- Does not lead to direct stock ownership unless paid in stock;
- May result in substantial cash outflows if paid in cash;
- No tax advantages to employee.

How Performance Units Work

TIMING	1 — YEARS —	3
Performance Unit	**Grant**	**End of Performance Period**
Unit Value	$30 — Targets Met? YES → / NO →	$30 Paid in Cash / $0 Units Lapse
Employee Investment	$0 →	$0
Employee Gain (If Target Met)	$0 → ($30.00 x 35%)	$30 Ordinary Income
Employee Tax(1)	$0 →	$10.50 Tax Due
Employee Net Gain (After Tax)	$0 →	$19.50 Net Gain

(1) Assumes the employee is subject to an ordinary income tax rate of 35%.

Deferred Compensation Plans

KEY PROVISIONS

- An arrangement whereby an employee is credited with contributions to a deferred compensation account;
- Employee may elect to defer income on a pre-tax basis;
- Account balances are credited with investment earnings;
- Company may declare a rate or allow employee to control asset allocation from several investment options;
- Payable in cash.

TAX IMPACT ON EMPLOYEE

- At grant – no tax;
- At payment – ordinary income.

TAX IMPACT ON COMPANY

- At grant –
    - Cash – no tax deduction;
    - P&L – deferred tax asset;
- At payout – Company receives tax deduction equal to employee's ordinary income.

EARNINGS IMPACT

- Employer contributions accrued over vesting period;
- Appreciation is charged to earnings as credited to account balance.

Deferred Compensation Plans

ADVANTAGES

- Discretionary, discriminatory contributions;
- Does not dilute actual ownership;
- Easy to understand;
- Can be very retentive.
- Discretionary, discriminatory contributions;
- Does not dilute actual ownership;
- Easy to understand;
- Can be very retentive.

DISADVANTAGES

- Unpredictable charge to earnings if liability is not hedged with an asset;
- Does not lead to direct stock ownership;
- Participants are unsecured creditors of the Company.

QUESTIONS? CONTACT US »

MORE INFORMATION ON INCENTIVE PLAN DESIGN »

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