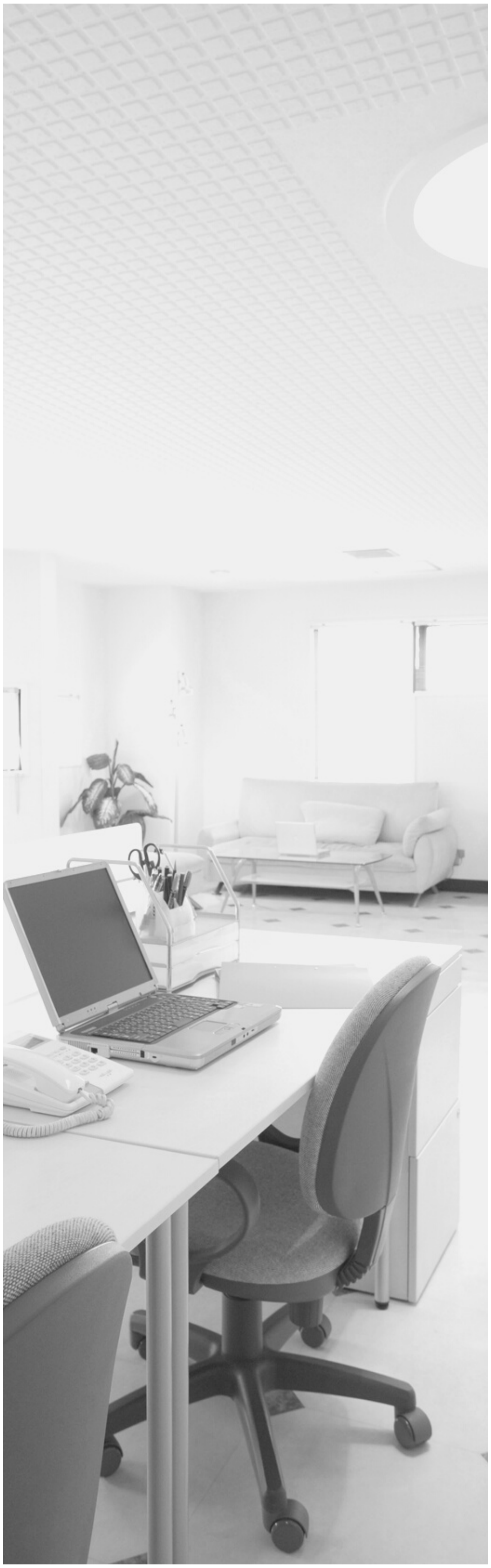
KEY EMPLOYEE INCENTIVE PLANNING

RAINIER GROUP

A Northwest Firm Advising Businessess Nationally for Over 30 Years

1 100TH AVE NE, BELLEVUE, WA 98004



Key Employee Planning

Non-qualified deferred compensation plans are designed to provide incentive and reward key employees and are not governed by the special tax rules for ‘qualified’ plans, such as 401 (k) and other profit-sharing arrangements. Unlike qualified plans, which are deductible to the company when funded, but only taxed to the participant at withdrawal, non-qualified plan payments are not deductible to the company until funds are actually paid to the participants. Their non-qualified nature, however, allows much more flexibility in participant selection, vesting schedules and forfeiture rules.

This document will describe several types of plan and discusses the provisions that these plans should contain.

NON-QUALIFIED PLAN BASICS

While more flexible than qualified plans, non-qualified plans must follow the rules in code section 409A, and in ERISA. Several points to keep in mind when putting a non-qualified plan in place:

- No special tax treatment: As noted above, benefit payments are deductible from the company only when paid to the participants, not when funds are set aside for their future payment.
- Select group as participants: To avoid having to follow the more restrictive ERISA requirements, non-qualified plans are normally set up with a select group of participants, not the larger population of employees, to qualify for the “Top-Hat” exception.
- Little payment flexibility: Once benefits are earned, there is very little discretion on the part of the company or participant on when or in what manner benefits are paid. The employee cannot choose to ‘withdraw’ funds or defer them for a longer period. The payment provisions must be set at the time funds are deferred and followed thereafter.
- Unfunded plan: Unlike qualified plans, where contributions are set aside in a trust for the benefit of the participants, shielded from company creditors, a non-qualified plan must remain ‘unfunded’. Assets can be set aside for future payment to the participants, but these assets must be subject to the claims of creditors and cannot be secured.
- High contribution flexibility: Non-qualified plans do not have to follow the anti-discrimination rules or contribution limits of qualified plans. This means that the allocation of benefits can be based on any number of factors, from a simple percentage of salary’ basis, to benefits based on the growth of the company, to a fully discretionary employer contribution.

- High vesting flexibility: If exempt from ERISA guidelines, the plan vesting schedule
- Can be set as desired by the company.
- High flexibility in setting payment provisions: Although the company and participants can have no discretion in starting benefit payments, the benefit payment provisions in the plan itself can be very flexible. Benefit payments can be triggered at a set time, at retirement, at termination, at death or disability, at a company change of control, or for 'financial emergency'. These payment provisions are set up at the time of the plan's drafting.

TYPES OF PLAN

There are many types of non-qualified deferred compensation plans, but among the most common are:

PHANTOM STOCK

The employee is "credited" with an ownership stake equal to a certain percentage of the company but does not receive any shares. At some point in the future this stake is "re-purchased" by the company. The value of the company, and the portion of that value attributed to the employee's phantom shares, determines the amount of the payment.

Example:

The company is valued at $15,000,000. The employee is credited with a 1% phantom ownership in the company (then worth $150,000) at the plan's inception. The plan promises to pay the benefit over 5 years beginning at the employee's retirement provided certain conditions are met. Assuming the conditions are met, and employee retires 13 years later when the company is valued at $50,000,000, the employee would be paid 1% of that value ($500,000) over 5 years.

How the Plan Creates an Incentive:

- The employee is contractually tied to the business in exchange for the promise to be paid additional cash compensation in the future. So long as the employee fulfills the contract, the company is obligated to pay.
- The benefit is directly tied to the company's value, providing incentive to grow the company.

Items Worth Noting

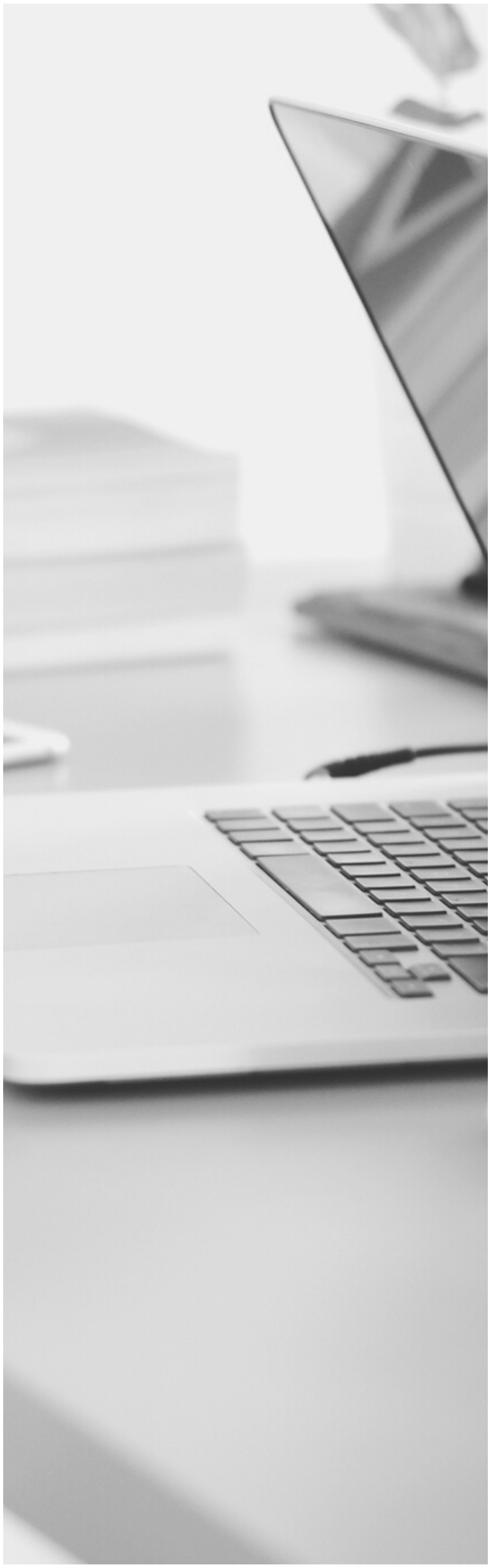
- The employee pays income tax on the value of the compensation received. As long as specific rules regarding “constructive receipt” are followed and the plan is “unfunded”, tax is due as payments are actually received by the employee.
- The employer receives a tax deduction for the compensation paid to the employee. The employer is required to withhold taxes.
- The terms are completely flexible at the plan’s inception. At the beginning of the plan, the employer determines the size and timing of all phantom stock grants, contractual conditions, payment terms, etc.
- The company’s obligation to pay is usually carried on the company’s financials as a liability.
- Avoids providing employees with actual ownership in the company.
- Allows an employee to obtain the benefit of stock ownership without making an investment.

Key Features

- Phantom stock plans emphasize a feeling of ‘ownership’.
- There is an immediate (but unvested) benefit at grant.

STOCK APPRECIATION RIGHTS

In concept, a SAR plan works much like options do in the context of a publicly traded company. Each participant is issued several Stock Appreciation Rights (SARs) in the company. At the time of issue, the rights are worth nothing: the ‘execution price’ (analogous to a strike price in an option) of the SAR is the same as the current per SAR value of the company. As the company grows, the difference between the current value and the execution price enables the participant to benefit from the growth in value of the company.



Example:

The company is valued at $15,000,000. The employee is credited with appreciation rights on 1% of the company at the plan's inception. The Stock Appreciation Rights (SARs) are worth zero at inception as the execution price is set at the current value of the shares. The plan promises to pay its benefit over 5 years beginning at employee's retirement provided certain conditions are met. The employee retires 13 years later when the company is valued at $50,000,000. The employee is paid $350,000 for the appreciation in value ($500,000 - $150,000 = $350,000) over 5 years.

How the Plan Creates an Incentive

- The employee is contractually tied to the business in exchange for the promise to be paid additional cash compensation in the future. So long as the employee fulfills the contract, the company is obligated to pay.
- The size of the benefit is entirely determined by the growth of the company after SARs are granted.

Items Worth Noting

The employee pays income tax on the value of the compensation received. As long as specific rules regarding "constructive receipt" are followed and the plan is "unfunded", tax is due as payments are actually received by the employee.

- ·The employer receives a tax deduction for the compensation paid to the
- Employee. The employer is required to withhold taxes.
- The terms are completely flexible at the plan's inception. At the beginning of the plan, the employer determines the size and timing of all phantom stock grants, contractual conditions, payment terms, etc.
- The company's obligation to pay is typically noted on the corporate financial statements and may even be carried as a liability in some circumstances. Valuing this obligation for financial reporting is difficult to impossible.
- Avoids providing employees with actual ownership in a company.
- Allows an employee to obtain the benefit of stock appreciation without making an investment.
- The agreement need not make provision for proportional distribution of earnings to phantom unitholders.

Key Features

- SARs emphasize company growth. The largest benefits are generated when the employees grow the company.
- There is no immediate benefit at grant.
- SARs mirror options and are often useful in competing for good employees with public competitors who offer options in their compensation packages.

DEFERRED BONUS

The employee is credited with a bonus to be paid at a specified time in the future, assuming they are still employed. This bonus can be paid in a lump sum or over a period of years.

Example:

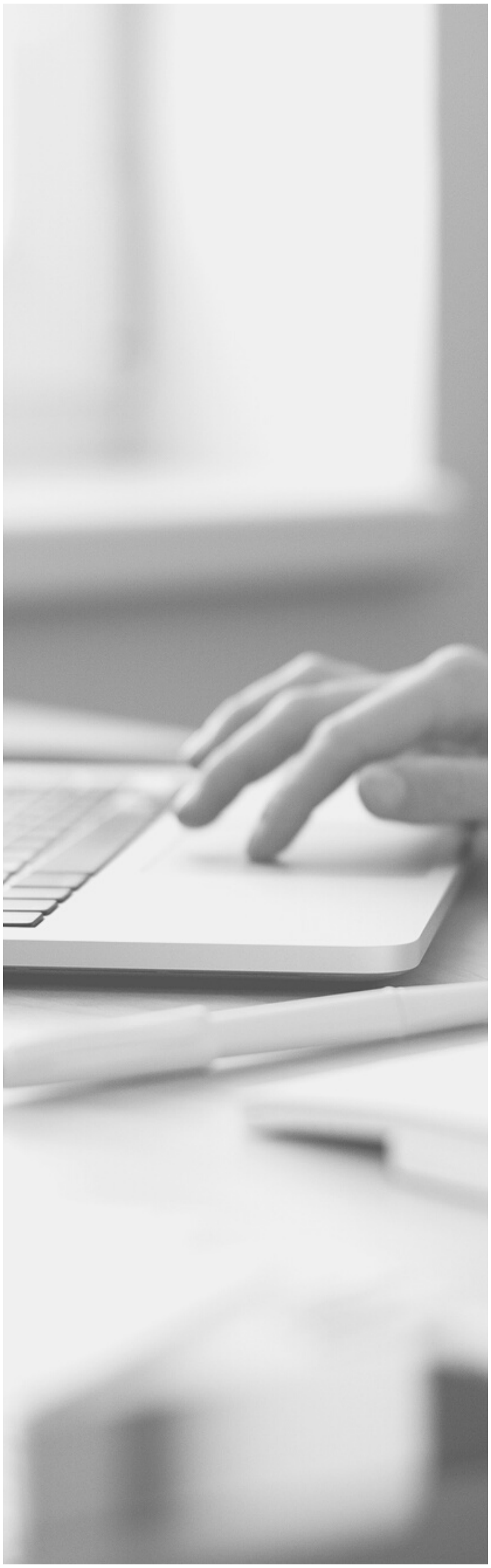
The company bonuses 5% of its operating income to participants. These bonuses are deferred for three years. If an employee remains employed for three years after the grant, the benefit is paid. If an employee terminates employment before that time, all deferred benefits are forfeit.

How the Plan Creates an Incentive

- As annual bonuses are granted, employees always have significant deferred bonuses outstanding. Since these sums would be forfeit if they were to leave, the employee has a strong incentive to remain with the company.

Items Worth Noting

- The employee pays income tax on the value of the compensation received. As with the other plans, tax is due as payments are received by the employee.
- The employer receives a tax deduction for the compensation paid to the employee. The employer is required to withhold taxes.
- The terms are completely flexible at the plan's inception. At the beginning of the plan, the employer determines the size and timing of all phantom stock grants, contractual conditions, payment terms, etc.
- The company's obligation to pay is usually carried on the company's financials as a liability.
- Deferred bonus plans are typically used in situations where the participants are lower-level key employees, where perceived 'ownership' is not important.



Key Features

- Emphasizes employee retention.
- Creates incentive to maximize current-year production.
- No feeling of "ownership".

TYPICAL CONCERNS AND ISSUES

GRANTING BENEFITS

Grants, whether they are phantom stock, SARs or deferred bonuses, can be made using a formula defined in the plan agreement, but it is far more common for grants to be made on a discretionary basis by the company management or board of directors.

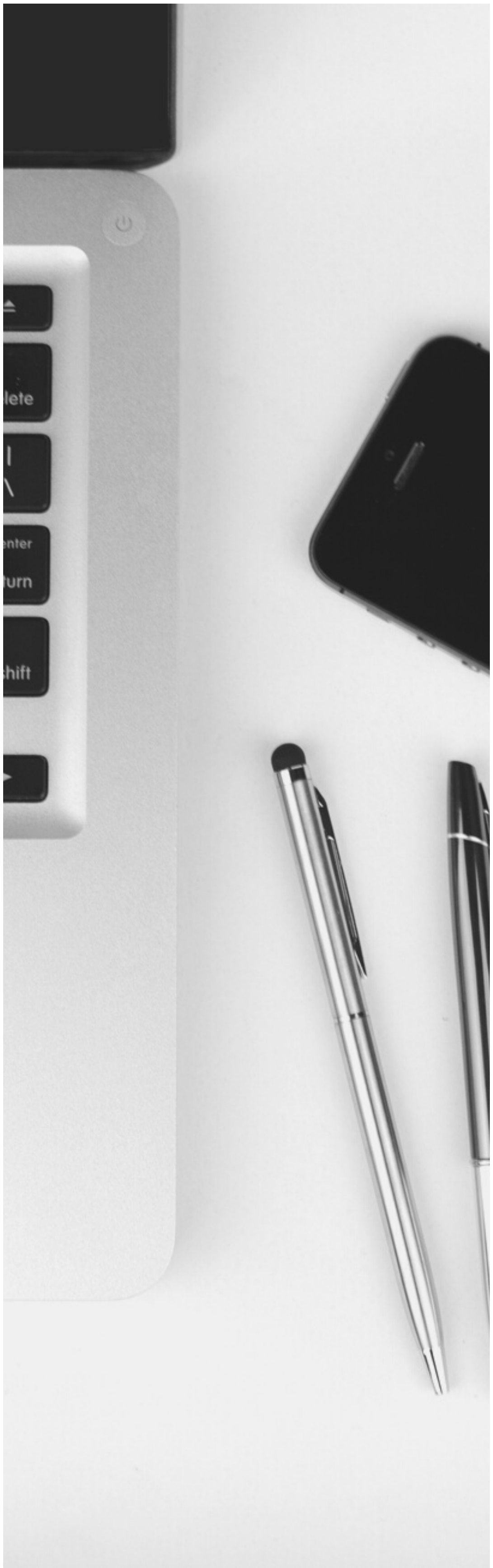
- SARs and phantom stock are typically granted rarely, and at the discretion of management. However, it is not uncommon for shorter-term SARs (five to ten years) to be made on a rolling basis: smaller grants are made annually instead of single large grants. This structure emphasizes retention, as participants will constantly have large unvested benefits outstanding.
- Deferred bonuses usually use a 'target and formula' approach. That is, the annual bonus is determined by a formula that is written into the plan, but the targets that must be reached to justify a bonus are set by the board of directors at the beginning of each year. This target level is left to the company's discretion.

MATURITY DATES

When should a deferred benefit be paid out to the participants? Should there be a five-year term on the maturity of SARs or should we wait until retirement before the participants receive their benefits? The selection of the maturity date depends on the objectives the plan is designed to meet.

Long-Term Maturity or Retirement Plan

Usually only used for SAR or Phantom Stock plans, a long-term maturity period or a plan that waits to make payments until the participant has retired is used in those instances when you want to reward long-term employees for a lifetime of work. Often used when



the majority of participants are older and nearing retirement, this type of plan does not provide a large incentive to younger employees as the potential payment is so far out into the future.

This type of plan will usually have large but rare grants, and very long vesting periods and is intended to provide the participants with supplemental retirement income. They are not usually useful to provide funding for a potential future buyout of the company.

Mid-Term Maturity
SAR and Phantom Stock plans with a mid-term maturity date (five to seven years) provide significant incentive to younger employees to maximize company growth and to stick with the company. The benefit is long enough to allow the benefit to grow to a significant level, but short enough that employees feel that they might be able to collect them in a reasonable time frame
.
This type of plan will usually have smaller but more frequent grants than a retirement plan. Benefits can be structured so the participants can use them as funding to buy stock in the company.

Short-Term Maturity
Short-term maturities (2-4 years) are most often used with deferred bonus plans. SARs and Phantom Stock plans usually require a longer period to build up significant benefits.

The short-term maturity, tied to a plan where deferred bonuses are always outstanding and unvested, heavily emphasizes employee retention and immediate income growth.

OTHER TRIGGERING EVENTS

Should the plan make benefit payments in the event of retirement, death, disability, termination, company sale or another event?

Retirement

Often, mid-term plans will have a provision fully vesting participant when they reach retirement age and permitting them to take benefits when they retire. Such a provision greatly reduces the retention qualities of the plan if a significant number of key employees are near retirement age. On the other hand, such a provision can be an attractive way to provide employees with significant retirement funds.

Death

Usually, plans have a provision to fully vest and pay accrued benefits to the heirs of a deceased participant.

Disability

As with death, disabled participants who are no longer able to work usually become fully vested in their benefit and receive payments immediately. The plan must consider a proper definition of disability and care must be taken to ensure that the plan benefits will not offset other disability payments.

Termination Without Cause

Participants whose employment is terminated, either voluntarily or non-voluntarily but without cause, are typically paid their accrued but unpaid vested benefits. Most plans delay the payment of vested benefits, either for several years or until the normal maturity date of the SARs or Phantom Stock. This keeps the payment of these amounts ‘at risk’ to ensure compliance with non-compete, non-solicitation and confidentiality agreements.

Note that deferred bonus plans usually have ‘cliff vesting’ (see below) which essentially eliminates any payment of benefit at termination.

Of course, any termination ‘For Cause’ will cause forfeiture of all benefits, vested or unvested.

Company Sale

If control of the company passes from the current shareholders, the benefit payments might be triggered. Usually this provision is set up so that, if the company or its assets are sold to a third-party, the key employees will share in the windfall.

Thought should be given in formulating this provision so that it is triggered only when a true sale has occurred, typically excluding sales to other key employees or plan participants.

At the time of sale, the value of the company is usually adjusted to the sale value and not the 'plan value' (see below.) Many times, the payment of all or a part of the benefit is delayed for a couple years to ensure the participants stay with the company after the acquisition.

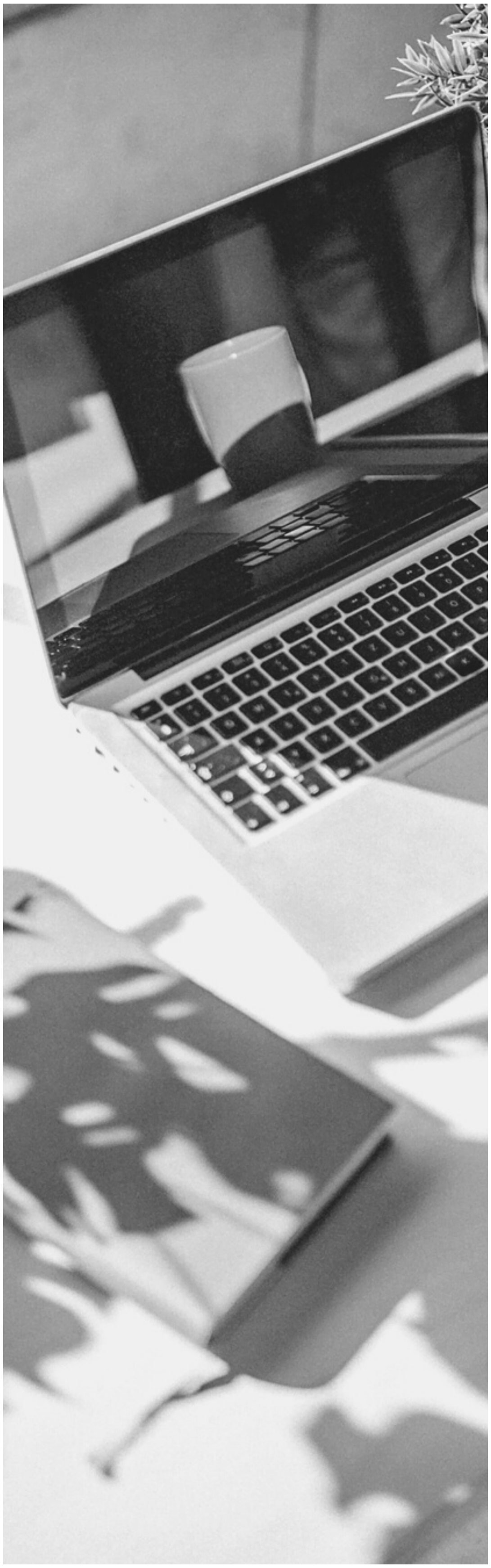
Other Events

409A permits payment of plan benefits for 'financial emergencies' or other extreme circumstances. There is much uncertainty as what would qualify as an emergency under the law, and most plans do not permit benefit payments for anything other than retirement, death, disability, termination or sale of the business.

PAYMENT TERMS

Will payments be made in a lump sum, or should they be paid out over a number of years. Plans with lower benefits, such as rolling deferred bonuses, will usually be paid out in a lump sum. Since there are always substantial unvested benefits outstanding, a lump sum payout is unlikely to dilute the incentive to stay with the company.

For the larger payments typically associated with SAR and Phantom Stock plans, the benefit is usually spread out over a number of years. This not only reduces the cash flow impact on the company, but it also extends the incentive for participants to comply with non-compete, non-solicitation and confidentiality agreements, as any outstanding but unpaid benefits would be forfeit if the agreements were violated.



VESTING

Any delays between the time the employee is ‘granted’ with a benefit and the time and way benefits are actually received fall under the broad category of Vesting. In non-qualified plans vesting is up to the employer establishing the plan. Vesting needs to be long enough to provide the incentive to stay with the company, and short enough to make the benefit attainable.

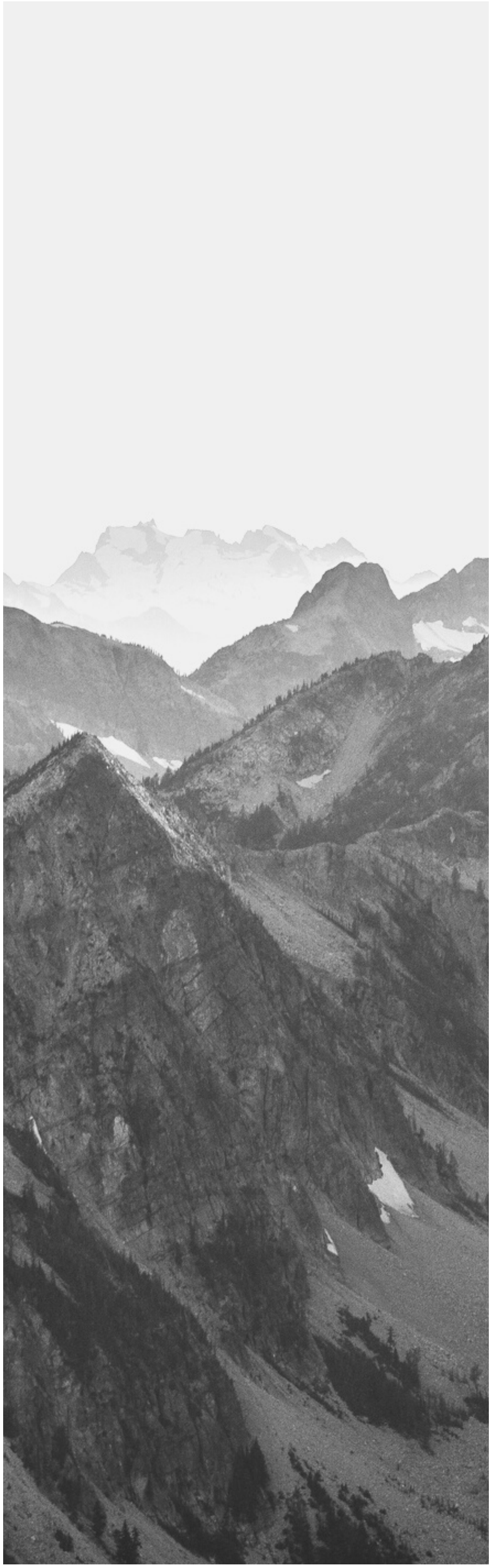
A “vested” benefit is one where the benefit will be paid if a triggering event were to occur. For instance, in a deferred bonus plan with a five-year deferral and 20% annual vesting, an employee quitting at the end of the third plan year would be 60% vested in the deferred bonus, and that percentage of his deferred benefit would be paid to him.

For shorter-term SARs and deferred bonuses, ‘cliff vesting’ is often used. No vesting occurs until maturity, at which time the participant is 1 00% vested and the benefit is paid.

Often, if a mid-term plan is used, there will be an initial period of zero vesting followed by steady vesting for the remainder of the term. This helps maximize the employee-retention features of the plan.

NON-COMPETE, CONFIDENTIALITY AND NON-SOLICITATION

Typically, a company will have non-compete, non-solicitation and confidentiality agreements with its key employees or will use the creation of the plan as a catalyst to create such agreements. These provisions are often difficult to enforce, but one way of giving these provisions some teeth is to make the payment of plan benefits contingent on their satisfaction.



ESTIMATED COMPANY VALUE

Stock Appreciation Rights plans, and Phantom Stock plans require some way to value the company on a consistent basis. One strategy is to have the company valued annually by a professional, but this is seldom used due to the expense involved.

Far more common is the use of a formula, which is applied annually and consistency, and which takes into account those aspects of the company you want to incentivize. For instance, if profit maximization and growth is the primary goal (as it often is) then the company could be valued using a profit capitalization approach. If there is some financial ratio that is important to the proper operation of the company, that ratio can be incorporated into the company value as well.

It is good to select a valuation formula that will consistently under-value the company when compared to what the company might be sold for on the open market. This allows any third-party sale to be seen as a ‘windfall’ to the participants and reduces any anxiety that key employees might have over an impending sale.

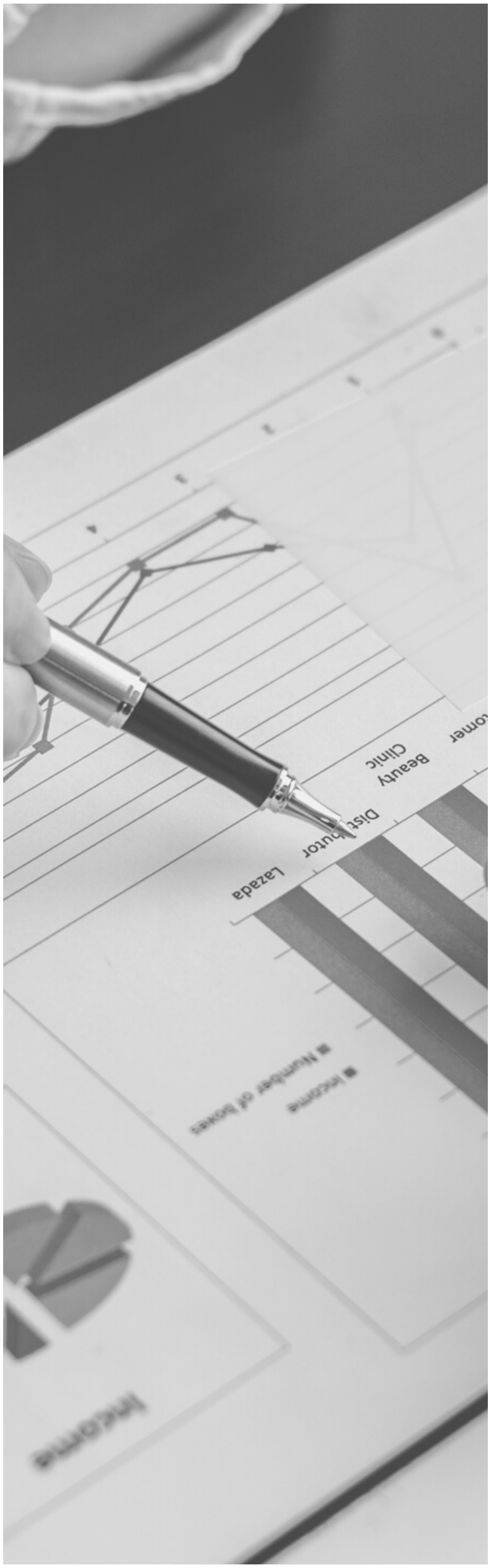
FUNDING

All plans create an obligation that the corporation must satisfy in the future. These obligations may or may not be funded or “saved for” by the company at the company’s discretion.

If funds are earmarked for the plan they are subject to general corporate creditors and obligations – they cannot be guaranteed to the plan.

REGULATION AND REPORTING

Most of these plans must be filed with the Department of Labor. In some cases, the plans must report annually, but the reporting is typically simplified.



The obligation is often reflected on the corporation's financial statements in some manner. The method depends several variables. Typically, the plan is shown as an estimated liability on the balance sheet or mentioned in the notes to the financial statements.

CONSTRUCTIVE RECEIPT

The ability to contractually promise a future benefit, pay it over time, and have the employee avoid taxation before the benefit is paid depends on compliance with tax rules regarding "constructive receipt." Basically, if the employee risks losing the benefit, and they cannot trigger the payment of the benefit at will, they are not in constructive receipt of the value and are not taxed.

DOCUMENTATION

These plans are evidenced by a written legal document, a contract executed by the corporation and the employee.

Often, particularly when actual stock ownership is offered, other legal agreements are present, such as shareholder agreements, employment agreements, and agreements precluding the employee from competing directly with the employer.

ADDITIONAL POINTS ON SELECT TOPICS

WHAT NON-QUALIFIED MEANS

- Qualified Plans (401 (k), Simple Plans, Profit Sharing Plans, IRA's, etc.)
- Non-Qualified (Everything else)
- Taxation Difference

TYPES OF PLAN

Not Really Deferred Compensation

- Salary Continuation Plan
- Non-Compete Agreements

Really Deferred Compensation

- SERPs (Supplemental Employee Retirement Plans)

Keeping Score

- SAR Plans (Stock Appreciation Rights)
- Phantom Stock Plans
- Other Wacky Plans

ERISA Rules

ERISA applies to many types of compensation plans that provide post-employment benefits. Since non-qualified deferred compensation plans sometimes provide post-employment benefits ERISA can be an issue. The typical approach is to structure the plan to avoid ERISA's application to avoid its vesting limitations, reporting requirements, disclosure requirements and funding requirements.

How to Avoid ERISA

- "Top Hat" Exception (unfunded and for a select group of executives)
-

Only Remaining Requirement

- A claims procedure must be described in document.
- Brief written description of plan to Secretary of Labor.

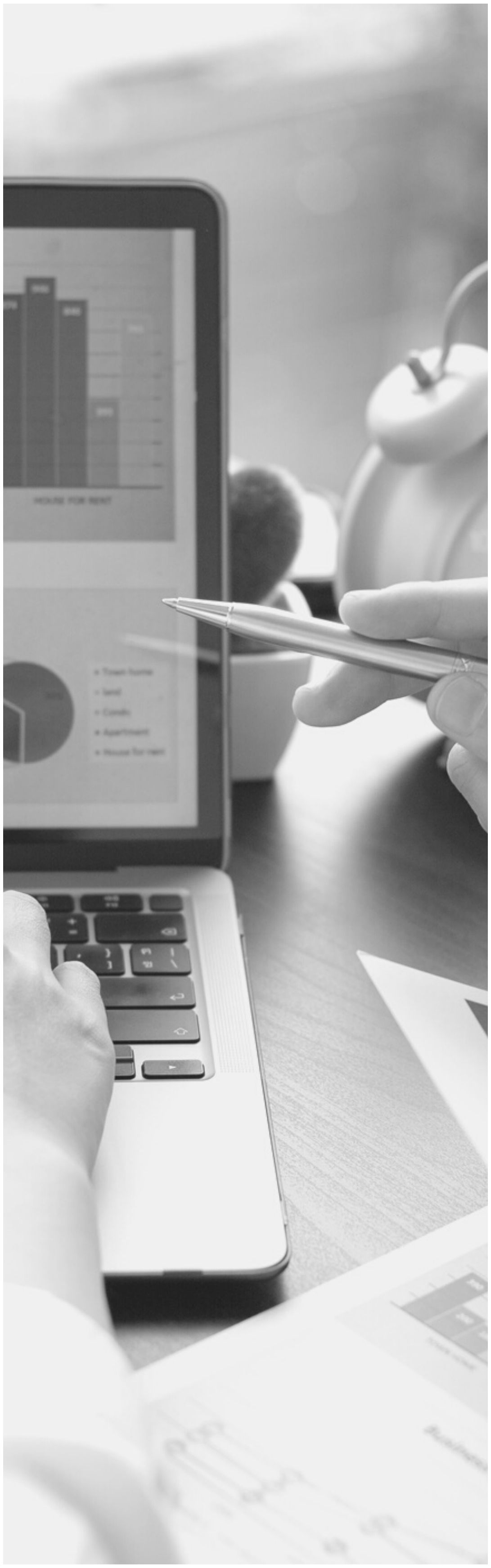
Income Tax Rules

Desired Results

- Company does not receive a deduction until benefit paid.
- Key employee is not taxed until benefit paid.

Requirements to Get These Results

- Must be Unfunded
- No Constructive Receipt
- No Economic Benefit
- "Deferral" Before Service



Definitions

- Funded vs. Unfunded - Accounts part of the general account of the employer and subject to claims of creditors
- Constructive Receipt - Employee can never have access to deferred sums unless a certain activity occurs (retirement, death, disability, etc.)
- Economic Benefit - There must be a “substantial risk of forfeiture” to avoid immediate taxation. A substantial risk of forfeiture exists when the employee’s rights to enjoyment of the property are conditioned upon future performance.
- Election to defer before service

Social Security Rules

- Reduction of Benefit - Benefits from a deferred compensation plan are not considered income for offsetting social security benefits.
- Payment of Taxes - If Social Security and Medicare taxes are paid during employment they will not be due at retirement. Since the employee will be earning a wage during that time, little actual tax will need to be paid (except Medicare)
- If no Security Tax is paid during the plan it will be taxable at retirement. This might be payable in a lump sum so, once again, the SS payroll limit will keep taxes low.

Plan Design (SAR’s Seem Most Common So This Describes Sar, But It Can Be Modified for Other Types Of Plans)

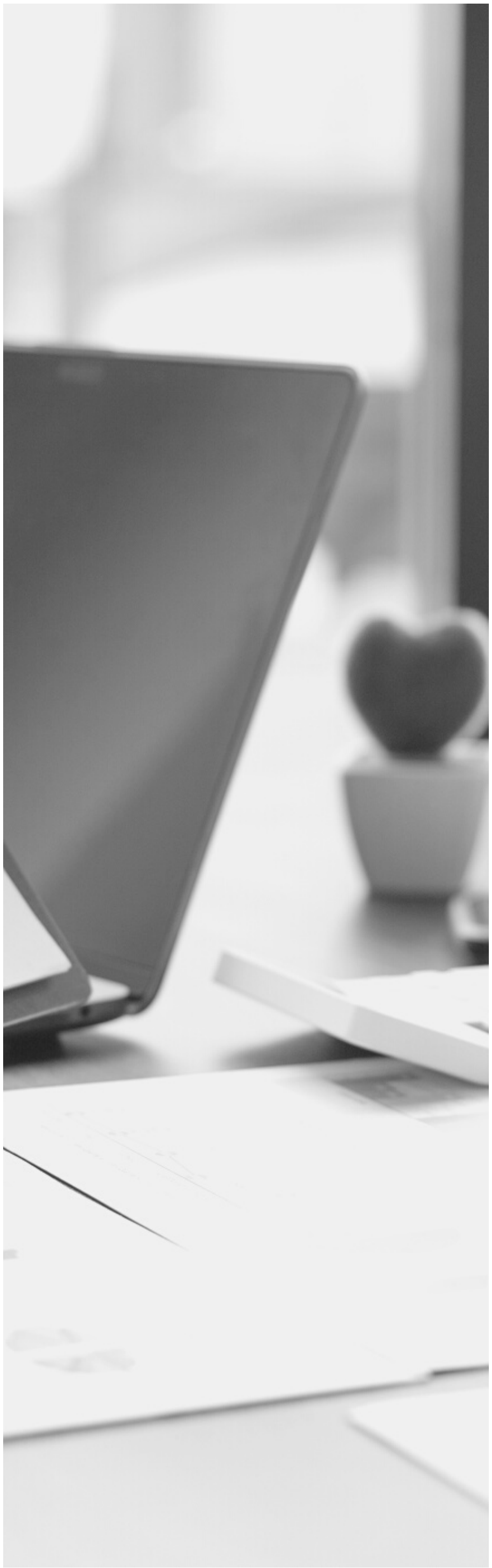
Intent, or what the company wants to accomplish, dictates the SAR plan’s structure. This means any plan can be as unique as the company sponsoring it. Typically, SAR plan sponsors want to tie the employees to the company for the long term, to create an incentive for them to maximize the growth and potential sale value of the company; to enforce non-compete, non-solicitation and confidentially agreements; and to reward for their efforts.

Basic Characteristics

A plan of this type can have virtually any provision. SAR plans tend to have some or all of the following characteristics:

- Written Plan Document: The provisions of the plan are spelled out in detail in a written document.
- Benefits Paid in the Future: Benefits can be paid at any time; however, it is typical to see payments tied to specific future events (such as retirement, death, or disability) or on the passage of time (such as minimum of 10 years' service).
- Spread Out Payments: Payments can be made over any reasonable period of time. However, we usually see payments spread over a number of years to provide an incentive to meet non-compete, non-solicitation and confidentially agreements.
- Rolling SAR Grants: Although not explicitly a provision in most plans, there is typically an expectation that additional grants will be made to participants who are promoted or who otherwise perform exceptionally. By making "rolling" grants, the employer can ensure that the key employees will always have an outstanding benefit that they will have to abandon if they leave the company.
- Vesting: No vesting schedule is required, and any can be used. We often see benefits vesting over three to five years for plans whose benefits are not events based. However, events-based payments (such as normal retirement age) can effectively negate vesting schedules and may even cause confusion. A good plan document can help by providing examples of how vesting works if it is used.
- Participation in Buyout: The participants benefits are often triggered if the company is purchased, and the benefits usually mirror the price paid by the acquirer. This provides incentive to maximize the company's attractiveness to outside investors.

Note that in some plans where there is a desire to tie the current employees to the company even after the buyout, the buyout triggers only part of the SAR's, and the remainder are adjusted to reflect the price paid by the purchaser. This is done to make the company more



attractive to a purchaser, especially in those cases where the value of the company is concentrated in the expertise of its employees.

- Payment at Normal Retirement: SAR's are typically viewed as a way to provide extra retirement benefits to selected employees who finish their careers with the company.
- Payment at Death or Disability: Premature death or disability of a participant often triggers a payment of SAR benefits. Many times, vesting is automatically accelerated in these circumstances, as the participants has little or no control over these events. Companies often purchase life insurance to back this kind of obligation.
- Forfeiture: The plan may eliminate benefits for any reason and the plan may be terminated in whole or in part at any time. However, most plans specify events that cause forfeiture, such as violations of company policy, breach of employment or other agreements, termination of employment before events-based payouts etc.
- Flexibility: Participants can be given options when taking benefits. By example, do payments start at retirement or later, or are they paid to the participant or to others the participant designates. Typically, such flexibility is limited by tax rules so that the participant is not taxed when they have the right to choose how to take their benefit.

Definition of Value

Any definition of value for the stock may be used. In most cases we see some type of formula or standard specified in the document. We sometimes see companies use
outside appraisers to determine value to avoid perceived conflicts of interest, and when such appraisers are used we also see provisions specifying the applicability of minority or marketability discounts. Some plans go so far as to specify rules or restrictions on company actions that might negatively impact SAR plan values. By example requiring adjustments to earnings for above market compensation paid to owners, or for SAR

payments made to other participants, or restricting company distributions.

Scope of Value and Participation

SAR plans may be defined as narrowly or broadly as desired. We most often see plans structured to set aside a maximum percentage of the company's equity to be measured for SAR participation (such as 25%) and note that whatever the percentage is, that company management estimates it is small enough to be well within the company's ability to pay benefits to several participants at once yet large enough to drive sufficient dollar value to excite the individual participants.

Funding

Most SAR plans are unfunded, meaning companies do not often set monies aside in anticipation of future payments. However, some companies do retain funds, and some buy insurance (typically life or disability) to back payments in those circumstances. Any earnings in funds set aside for SAR payments are taxed to the company.

Modification

Most SAR plans are subject to unilateral modification and/or termination by the company. When companies modify such plans, it can be difficult to maintain employee good will when potential benefits decrease, and plan changes usually become a perception management exercise in addition to whatever financial consideration drive plan changes. The practical result is pressure to have plan modifications result in richer benefits. This creates an incentive to the company to carefully consider the plan provisions the first time, and/or to start small, testing the plan among a smaller group (or with lower percentages of the company) and growing the plans scope over time.

Negotiation

Plan sponsors should anticipate participants’ attempts to negotiate or modify how the plan applies in specific circumstances that cannot be anticipated. The good news is that such modifications can be considered at that time.

Communication

Formal communication of company performance and anticipated plan benefits reminds employees why they should continue those activities that will ultimately pay them money. Communications must be carefully structured to avoid over promising or modifying the plan yet reinforce the incentive and excitement the plan is designated to provide. Typically, we see plans communicate formally to participants at least annually. A sample format is attached.

This document may contain general commentary about taxation that is not tax advice and should not be misconstrued as such. The Rainier Group recommends you seek tax advice from an experienced, credentialed tax advisor with a detailed understanding of your specific situation.

All models, subroutines, and projections should be considered as illustrative for the purposes of discussion and not determinative in terms of result or intent. Significant effort is made to assemble, and
correlate raw data provided by client, to apply appropriate assumptions in order to predict a range of possible outcomes, to generate reasonable projections based on those data and assumptions and to present reasonable recommendations based thereon. However, there can be no assurance that the projected results will be achieved because of unknowable factors beyond the control of the Rainier Group, such as the vagaries of business conditions, financial markets, the state of the economy, new programs initiated by government or business leadership, lawsuits, future changes to tax laws and the like.

Nothing contained herein is intended as investment advice subject to regulation under federal or state securities laws. However, in the event any regulator or regulatory body asserts or concludes otherwise, nothing contained herein represents the past performance of any party’s investments and cannot in and of itself be used to determine which securities to buy or sell, or when to buy or sell them. Furthermore, nothing contained in this disclosure shall constitute a waiver of any rights that a client may have under federal or state securities laws.

Under no circumstances will The Rainier Group, its employees or shareholders be liable to client for any incidental or consequential damages either for inaccuracies in the financial models presented, for failure to attain projected results or unsuccessful recommendations, and client's actual damages, if any, resulting from Rainier Group errors shall be strictly limited to the smaller of (a) the actual amount of the damage suffered by client as a result of such errors, or (b) the fees paid to the Rainier Group by client for the engagement in question