

READING INTERNATIONAL INC
Form 10-Q
November 03, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2011

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission file number 1-8625

READING INTERNATIONAL, INC.
(Exact name of Registrant as specified in its charter)

NEVADA
(State or other jurisdiction of incorporation or organization)

95-3885184
(IRS Employer Identification No.)

500 Citadel Drive, Suite 300
Commerce, CA
(Address of principal executive offices)

90040
(Zip Code)

Registrant's telephone number, including area code: (213) 235-2240

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding twelve months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer Accelerated filer Non-accelerated filer

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Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. As of November 3, 2011, there were 21,411,348 shares of Class A Nonvoting Common Stock, \$0.01 par value per share and 1,495,490 shares of Class B Voting Common Stock, \$0.01 par value per share outstanding.

READING INTERNATIONAL, INC. AND SUBSIDIARIES

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PART I – Financial Information

Item 1 – Financial Statements

Reading International, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets (Unaudited)

(U.S. dollars in thousands except par value amounts)

| | September 30, 2011 | December 31, 2010 |
|---|-----------------------|----------------------|
| ASSETS | | |
| Current Assets: | | |
| Cash and cash equivalents | \$ 26,757 | \$ 34,568 |
| Receivables | 4,664 | 5,470 |
| Inventory | 805 | 989 |
| Investment in marketable securities | 2,731 | 2,985 |
| Restricted cash | 2,253 | 2,159 |
| Deferred tax asset, net | 770 | -- |
| Prepaid and other current assets | 3,868 | 3,536 |
| Assets held for sale | 4,155 | 55,210 |
| Total current assets | 46,003 | 104,917 |
| Property held for and under development | 85,791 | 35,702 |
| Property & equipment, net | 212,985 | 220,250 |
| Investment in unconsolidated joint ventures and entities | 10,642 | 10,415 |
| Investment in Reading International Trust I | 838 | 838 |
| Goodwill | 21,342 | 21,535 |
| Intangible assets, net | 18,329 | 20,156 |
| Deferred tax asset, net | 12,996 | -- |
| Other assets | 9,557 | 16,536 |
| Total assets | \$ 418,483 | \$ 430,349 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current Liabilities: | | |
| Accounts payable and accrued liabilities | \$ 14,559 | \$ 15,930 |
| Film rent payable | 4,390 | 5,757 |
| Notes payable – current portion | 49,114 | 108,124 |
| Taxes payable | 25,778 | 23,872 |
| Deferred current revenue | 7,637 | 8,727 |
| Other current liabilities | 135 | 141 |
| Total current liabilities | 101,613 | 162,551 |
| Notes payable – long-term portion | 120,737 | 83,784 |
| Notes payable to related party – long-term | 9,000 | 9,000 |
| Subordinated debt | 27,913 | 27,913 |
| Noncurrent tax liabilities | 2,267 | 2,267 |
| Other liabilities | 36,057 | 32,195 |
| Total liabilities | 297,587 | 317,710 |
| Commitments and contingencies (Note 13) | | |
| Stockholders' equity: | | |
| Class A non-voting common stock, par value \$0.01, 100,000,000 shares authorized, 31,675,518 issued and 21,411,348 outstanding at September 30, 2011 and 31,500,693 issued and 21,308,823 outstanding at December | 218 | 216 |

31, 2010

| | | |
|---|------------|------------|
| Class B voting common stock, par value \$0.01, 20,000,000 shares authorized and 1,495,490 issued and outstanding at September 30, 2011 and at December 31, 2010 | 15 | 15 |
| Nonvoting preferred stock, par value \$0.01, 12,000 shares authorized and no issued or outstanding shares at September 30, 2011 and at December 31, 2010 | -- | -- |
| Additional paid-in capital | 134,376 | 134,236 |
| Accumulated deficit | (61,045) | (76,035) |
| Treasury shares | (4,093) | (3,765) |
| Accumulated other comprehensive income | 50,550 | 57,120 |
| Total Reading International, Inc. stockholders' equity | 120,021 | 111,787 |
| Noncontrolling interests | 875 | 852 |
| Total stockholders' equity | 120,896 | 112,639 |
| Total liabilities and stockholders' equity | \$ 418,483 | \$ 430,349 |

See accompanying notes to unaudited condensed consolidated financial statements.

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Reading International, Inc. and Subsidiaries
Condensed Consolidated Statements of Operations (Unaudited)
(U.S. dollars in thousands, except per share amounts)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|------------|------------------------------------|-------------|
| | 2011 | 2010 | 2011 | 2010 |
| Operating Revenue | | | | |
| Cinema | \$61,867 | \$55,303 | \$173,577 | \$161,582 |
| Real estate | 4,817 | 5,286 | 14,332 | 14,027 |
| Total operating revenue | 66,684 | 60,589 | 187,909 | 175,609 |
| Operating expense | | | | |
| Cinema | 48,643 | 44,811 | 138,352 | 129,973 |
| Real estate | 2,496 | 2,142 | 7,371 | 6,519 |
| Depreciation and amortization | 4,297 | 3,874 | 12,718 | 11,626 |
| Impairment expense | -- | -- | -- | 2,239 |
| General and administrative | 4,173 | 4,198 | 13,163 | 13,020 |
| Total operating expense | 59,609 | 55,025 | 171,604 | 163,377 |
| Operating income | 7,075 | 5,564 | 16,305 | 12,232 |
| Interest income | 466 | 340 | 1,307 | 986 |
| Interest expense | (7,746) | (3,955) | (17,923) | (11,765) |
| Net gain (loss) on sale of assets | 1 | -- | (66) | 350 |
| Other income (expense) | 6 | 20 | 79 | (690) |
| Income (loss) before income tax benefit (expense), equity earnings of unconsolidated joint ventures and entities, and discontinued operations | (198) | 1,969 | (298) | 1,113 |
| Income tax benefit (expense) | 39 | (885) | 13,177 | (13,669) |
| Income (loss) before equity earnings of unconsolidated joint ventures and entities, and discontinued operations | (159) | 1,084 | 12,879 | (12,556) |
| Equity earnings of unconsolidated joint ventures and entities | 454 | 293 | 1,087 | 910 |
| Income (loss) before discontinued operations | 295 | 1,377 | 13,966 | (11,646) |
| Income (loss) from discontinued operations, net of tax | (5) | 1 | 35 | 31 |
| Gain on sale of discontinued operation | -- | -- | 1,656 | -- |
| Net income (loss) | \$290 | \$1,378 | \$15,657 | \$(11,615) |
| Net income attributable to noncontrolling interests | (253) | (136) | (667) | (505) |
| Net income (loss) attributable to Reading International, Inc. common shareholders | \$37 | \$1,242 | \$14,990 | \$(12,120) |
| Earnings (loss) per common share attributable to Reading International, Inc. common shareholders – basic and diluted: | | | | |
| Earnings (loss) from continuing operations | \$-- | \$0.05 | \$0.58 | \$(0.53) |
| Earnings from discontinued operations, net | -- | -- | 0.07 | -- |
| Basic and diluted earnings (loss) per share attributable to Reading International, Inc. common shareholders | \$-- | \$0.05 | \$0.65 | \$(0.53) |
| Weighted average number of shares outstanding – basic | 22,782,534 | 22,804,313 | 22,759,488 | 22,772,166 |
| Weighted average number of shares outstanding – diluted | 22,979,952 | 22,850,811 | 22,956,906 | 22,772,166 |

See accompanying notes to unaudited condensed consolidated financial statements.

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Reading International, Inc. and Subsidiaries
Condensed Consolidated Statements of Cash Flows (Unaudited)
(U.S. dollars in thousands)

| | Nine Months Ended September 30, | |
|--|------------------------------------|-------------|
| | 2011 | 2010 |
| Operating Activities | | |
| Net income (loss) | \$ 15,657 | \$(11,615) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | |
| (Gain) loss recognized on foreign currency transactions | 14 | (12) |
| Equity earnings of unconsolidated joint ventures and entities | (1,087) | (910) |
| Distributions of earnings from unconsolidated joint ventures and entities | 598 | 910 |
| Loss provision on impairment of asset | -- | 2,239 |
| Gain on sale of assets | (1,590) | (350) |
| Change in valuation allowance on net deferred tax assets | (15,127) | -- |
| Gain on sale of marketable securities | (8) | -- |
| Depreciation and amortization | 12,718 | 11,642 |
| Amortization of prior service costs | 246 | 228 |
| Amortization of above and below market leases | 302 | 682 |
| Amortization of deferred financing costs | 1,001 | 982 |
| Amortization of straight-line rent | 689 | (279) |
| Stock-based compensation expense | 142 | 44 |
| Changes in operating assets and liabilities: | | |
| Decrease in receivables | 753 | 3,890 |
| Decrease in prepaid and other assets | 142 | 31 |
| Decrease in accounts payable and accrued expenses | (1,171) | (832) |
| Decrease in film rent payable | (1,323) | (2,500) |
| Increase taxes payable | 1,911 | 12,813 |
| Increase (decrease) in deferred revenues and other liabilities | 3,214 | (1,482) |
| Net cash provided by operating activities | 17,081 | 15,481 |
| Investing activities | | |
| Acquisitions | (3,917) | (5,359) |
| Purchases of and additions to property and equipment | (4,761) | (9,057) |
| Change in restricted cash | (119) | (1,573) |
| Purchase of notes receivable | (2,784) | -- |
| Purchase of marketable securities | -- | (62) |
| Sale of marketable securities | 124 | 30 |
| Distributions of investment in unconsolidated joint ventures and entities | -- | 200 |
| Collection of note receivable | 6,750 | -- |
| Cinema sale proceeds from noncontrolling shareholder | 1,867 | -- |
| Net cash used in investing activities | (2,840) | (15,821) |
| Financing activities | | |
| Repayment of long-term borrowings | (124,859) | (15,370) |
| Proceeds from borrowings | 105,311 | 15,525 |
| Capitalized borrowing costs | (774) | (265) |
| Repurchase of Class A Nonvoting Common Stock | (328) | (251) |
| Proceeds from the exercise of stock options | -- | 253 |
| Noncontrolling interest contributions | 163 | 200 |
| Noncontrolling interest distributions | (655) | (1,028) |

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| | | |
|--|-----------|----------|
| Net cash used in financing activities | (21,142) | (936) |
| Effect of exchange rate changes on cash and cash equivalents | (910) | 1,388 |
| Increase (decrease) in cash and cash equivalents | (7,811) | 112 |
| Cash and cash equivalents at beginning of period | 34,568 | 24,612 |
| Cash and cash equivalents at end of period | \$26,757 | \$24,724 |

Supplemental Disclosures

Cash paid during the period for:

| | | |
|------------------------|----------|----------|
| Interest on borrowings | \$12,907 | \$10,712 |
|------------------------|----------|----------|

| | | |
|--------------|---------|-------|
| Income taxes | \$1,881 | \$594 |
|--------------|---------|-------|

Non-cash transactions

| | | |
|---|---------|------|
| Foreclosure of a mortgage note to obtain title of the underlying property | \$1,125 | \$-- |
|---|---------|------|

| | | |
|---|------|---------|
| Reduction in note payable associated with acquisition purchase price adjustment | \$-- | \$4,381 |
|---|------|---------|

| | | |
|---------------------|------|-------|
| Deemed distribution | \$-- | \$877 |
|---------------------|------|-------|

| | | |
|------------------------------|------|---------|
| Capital lease asset addition | \$-- | \$4,697 |
|------------------------------|------|---------|

| | | |
|--------------------------|------|---------|
| Capital lease obligation | \$-- | \$5,573 |
|--------------------------|------|---------|

See accompanying notes to unaudited condensed consolidated financial statements.

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Reading International, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements (Unaudited)
For the Nine Months Ended September 30, 2011

Note 1 – Basis of Presentation

Reading International, Inc., a Nevada corporation (“RDI” and collectively with our consolidated subsidiaries and corporate predecessors, the “Company,” “Reading” and “we,” “us,” or “our”), was founded in 1983 as a Delaware corporation and reincorporated in 1999 in Nevada. Our businesses consist primarily of:

- the development, ownership and operation of multiplex cinemas in the United States, Australia, and New Zealand; and
- the development, ownership, and operation of retail and commercial real estate in Australia, New Zealand, and the United States.

The accompanying unaudited condensed consolidated financial statements were prepared in accordance with accounting principles generally accepted in the United States of America (“US GAAP”) for interim reporting and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X of the Securities and Exchange Commission (“SEC”) for interim reporting. As such, certain information and disclosures typically required by US GAAP for complete financial statements have been condensed or omitted. The financial information presented in this quarterly report on Form 10-Q for the period ended September 30, 2011 (the “September Report”) should be read in conjunction with our 2010 Annual Report which contains the latest audited financial statements and related notes. The periods presented in this document are the three (“2011 Quarter”) and nine (“2011 Nine Months”) months ended September 30, 2011 and the three (“2010 Quarter”) and nine (“2010 Nine Months”) months ended September 30, 2010.

In the opinion of management, all adjustments of a normal recurring nature considered necessary to present fairly in all material respects our financial position, results of our operations, and cash flows as of and for the three and nine months ended September 30, 2011 and 2010 have been made. The results of operations for the three and nine months ended September 30, 2011 and 2010 are not necessarily indicative of the results of operations to be expected for the entire year.

Marketable Securities

We had investments in marketable securities of \$2.7 million and \$3.0 million at September 30, 2011 and December 31, 2010, respectively. We account for these investments as available for sale investments. We assess our investment in marketable securities for other-than-temporary impairments in accordance with Accounting Standards Codification (“ASC”) 320-10 for each applicable reporting period. These investments have a cumulative unrealized gain (loss) of \$5,000 and \$(43,000) included in accumulated other comprehensive income at September 30, 2011 and December 31, 2010, respectively. For the three months and nine months ended September 30, 2011, our net unrealized loss on marketable securities was \$138,000 and \$30,000, respectively. For the three and nine months ended September 30, 2010, our net unrealized loss on marketable securities was \$263,000 and \$520,000, respectively. During the three months and nine months ended September 30, 2011, we sold \$21,000 and \$126,000, respectively, of our marketable securities with a realized gain of \$11,000 and \$2,000, respectively.

Refinanced Long-Term Debt

On June 24, 2011, we replaced our Australian Corporate Credit Facility with BOS International (“BOSI”) of \$115.8 million (AUS\$110.0 million) with the proceeds from a new credit facility from National Australia Bank (“NAB”) of \$110.5 million (AUS\$105.0 million). See Note 11 – Notes Payable and Subordinated Debt (Trust Preferred Securities).

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Plans to Refinance Credit Facility

The term of our New Zealand Credit Facility with Westpac matures on March 31, 2012. Accordingly, the September 30, 2011 outstanding balance of this debt of \$21.5 million (NZ\$28.0 million) is classified as current on our balance sheet. We are currently in discussions with our lender as to the renewal of this facility.

Deferred Leasing Costs

We amortize direct costs incurred in connection with obtaining tenants over the respective term of the lease on a straight-line basis.

Deferred Financing Costs

We amortize direct costs incurred in connection with obtaining financing over the term of the loan using the effective interest method, or the straight-line method, if the result is not materially different. In addition, interest on loans with increasing interest rates and scheduled principal pre-payments, is also recognized using the effective interest method.

Accounting Pronouncements Adopted During 2011

FASB Accounting Standards Update (“ASU”) 2010-06 – Fair Value Measurements

ASU 2010-06 requires additional disclosures about the transfers of classifications among the fair value classification levels and the reasons for those changes and separate presentation of purchases, sales, issuances, and settlements in the presentation of the roll forward of Level 3 assets and liabilities. Those disclosures are effective for interim and annual reporting periods for fiscal years beginning after December 15, 2010. The adoption of this portion of the ASU did not have a material effect on the Company's financial statements.

New Accounting Pronouncements

FASB ASU No. 2011-05 - Comprehensive Income (Topic 220): Presentation of Comprehensive Income

ASU No. 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in two separate but consecutive statements, eliminating the option to present other comprehensive income in the statement of changes in equity. Under either choice, items that are reclassified from other comprehensive income to net income are required to be presented on the face of the financial statements where the components of net income and the components of other comprehensive income are presented. This amendment is effective for our Company in 2012 and will be applied retrospectively. This amendment will change the manner in which the Company presents comprehensive income but will not change any of the balances or activity.

FASB ASU No. 2011-08 - Intangibles—Goodwill and Other

ASU No. 2011-08 relates to a change in the annual test of goodwill for impairment. The statement permits an entity to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. This amendment is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. This amendment will change the manner in which the Company performs its goodwill impairment test.

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Note 2 – Equity and Stock-Based Compensation

Stock-Based Compensation

During the nine months ended September 30, 2011 and 2010, we issued 174,825 and 148,616, respectively, of Class A Nonvoting shares to certain executive employees associated with the vesting of their prior years' stock grants. During the three and nine months ended September 30, 2011 and 2010, we accrued \$188,000 and \$563,000, respectively, in compensation expense associated with the vesting of executive employee stock grants.

Employee/Director Stock Option Plan

We have a long-term incentive stock option plan that provides for the grant to eligible employees, directors, and consultants of incentive or nonstatutory options to purchase shares of our Class A Nonvoting Common Stock and Class B Voting Common Stock. Our 1999 Stock Option Plan expired in November 2009, and was replaced by our new 2010 Stock Incentive Plan, which was approved by the holders of our Class B Voting Common Stock in May 2010.

When the Company's tax deduction from an option exercise exceeds the compensation cost resulting from the option, a tax benefit is created. FASB ASC 718-20 relating to Stock-Based Compensation ("FASB ASC 718-20"), requires that excess tax benefits related to stock option exercises be reflected as financing cash inflows instead of operating cash inflows. For the three and nine months ended September 30, 2011 and 2010, there was no impact to the unaudited condensed consolidated statement of cash flows because there were no recognized tax benefits from stock option exercises during these periods.

FASB ASC 718-20 requires companies to estimate forfeitures. Based on our historical experience and the relative market price to strike price of the options, we do not currently estimate any forfeitures of vested or unvested options.

In accordance with FASB ASC 718-20, we estimate the fair value of our options using the Black-Scholes option-pricing model, which takes into account assumptions such as the dividend yield, the risk-free interest rate, the expected stock price volatility, and the expected life of the options. We exclude the dividend yield from the calculation, as we intend to retain all earnings. We expense the estimated grant date fair values of options issued on a straight-line basis over the vesting period.

For the 157,700 options granted during 2010, we estimated the fair value of these options at the date of grant using a Black-Scholes option-pricing model with the following weighted average assumptions:

| | |
|-----------------------------|----------|
| | 2010 |
| Stock option exercise price | \$5.07 |
| Risk-free interest rate | 2.736% |
| Expected dividend yield | -- |
| Expected option yield | 7.23 yrs |
| Expected volatility | 33.01% |
| Weighted average fair value | \$1.88 |

We did not grant any options during the nine months ended September 30, 2011.

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Based on prior years' assumptions, and, in accordance with the FASB ASC 718-20, we recorded compensation expense for the total estimated grant date fair value of stock options that vested of \$47,000 and \$142,000 for the three and nine months ended September 30, 2011, respectively, and \$23,000 and \$44,000 for the three and nine months ended September 30, 2010, respectively. At September 30, 2011, the total unrecognized estimated compensation cost related to non-vested stock options granted was \$156,000, which we expect to recognize over a weighted average vesting period of 0.95 years. 90,000 options were exercised during the nine months ended September 30, 2010 having a realized value of \$138,000 for which we received \$253,000 of cash. There were no options exercised during the nine months ended September 30, 2011. The grant date fair value of options vesting during the three and nine months ended September 30, 2011 was \$47,000 and \$142,000, respectively, and \$23,000 and \$44,000 for the three and nine months ended September 30, 2010, respectively. The intrinsic, unrealized value of all options outstanding, vested and expected to vest, at September 30, 2011 was \$273,000 of which 91.3% are currently exercisable.

Pursuant to both our 1999 Stock Option Plan and our 2010 Stock Incentive Plan, all stock options expire within ten years of their grant date. The aggregate total number of shares of Class A Nonvoting Common Stock and Class B Voting Common Stock authorized for issuance under our 2010 Stock Incentive Plan is 1,250,000. At the discretion of our Compensation and Stock Options Committee, the vesting period of stock options is usually between zero and four years.

We had the following stock options outstanding and exercisable as of September 30, 2011 and December 31, 2010:

| | Common Stock Options Outstanding | | | | Weighted Average Exercise Price of Options Outstanding | |
|--|----------------------------------|-----------|-------------------|--|--|------------------------|
| | Class A | | Class B | | Class A | Class B |
| Outstanding- January 1, 2010 | 589,750 | | 150,000 | | \$5.51 | \$ |
| Granted | 122,600 | | 35,100 | | \$4.23 | \$ |
| Exercised | (90,000) | | -- | | \$2.76 | \$ |
| Outstanding- December 31, 2010 | 622,350 | | 185,100 | | \$5.65 | \$ |
| No activity | -- | | -- | | \$-- | \$ |
| Outstanding-September 30, 2011 | 622,350 | | 185,100 | | 514,753 / 277,501 | 3,913,822 / 11,869,350 |
| Brad A. Morrice <i>Vice Chairman, President and Chief Operating Officer</i> | 9,434 | 376,114 | 251,416 / 277,499 | | 2,400,461 / 11,869,350 | |
| Edward F. Gotschall <i>Vice Chairman Finance</i> | | | 637,957 / 277,501 | | 4,331,863 / 11,869,350 | |
| Patrick J. Flanagan <i>Executive Vice President and President of New Century Mortgage</i> | 134,672 | 5,421,228 | 22,499 / 306,247 | | 245,065 / 12,324,038 | |
| Kevin M. Cloyd <i>Executive Vice President and President of NC Capital</i> | 9,000 | 302,595 | 14,250 / 55,250 | | 322,955 / 1,856,252 | |

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The amounts set forth represent the difference between the estimated fair market value of \$63.91 per share as of December 31, 2004 and the exercise price of the in-the-money options, multiplied by the applicable number of shares underlying such options.

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Section 16(a) Beneficial Ownership Reporting Compliance

Under Section 16 of the Exchange Act, our directors and executive officers and the beneficial holders of more than 10% of our common stock are required to file reports with the Securities and Exchange Commission of their ownership of and transactions in our common stock. The Securities and Exchange Commission requires that we disclose any late filings of Section 16 reports during the last fiscal year. Based solely on our review of reports furnished to us and written representations that no other reports were required during the 2004 fiscal year, our directors, executive officers and beneficial holders of more than 10% of our common stock complied with Section 16(a) filing requirements during fiscal 2004 with the exception of: Messrs. Fredric Forster and Michael Sachs who each filed a late form Form 4 on November 2, 2004 with respect to the reporting of 2.15 shares and 2.87 shares, respectively, granted to them on October 29, 2004, and Messrs. Robert Cole and Edward Gotschall who each filed a late Form 4 on January 29, 2004 with respect to the surrender of shares back to us to settle tax withholding obligations arising in connection with the vesting of restricted stock awards on January 21, 2004.

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AUDIT COMMITTEE REPORT

To the Board of Directors
of New Century Financial Corporation

March 10, 2005

Our Committee has reviewed and discussed with New Century Financial Corporation's management and its independent auditing firm, KPMG LLP, New Century Financial Corporation's audited consolidated financial statements as of and for the year ended December 31, 2004. In addition, we have discussed with KPMG LLP the matters required by Statement on Auditing Standards No. 61 (Communication with Audit Committees), as amended.

Our Committee has also received and reviewed the written disclosures and the letter from KPMG LLP required by Independence Standards Board Standard No. 1 (Independence Discussions with Audit Committees), and we have discussed with that firm its independence. We also have discussed with New Century Financial Corporation's management and KPMG LLP other matters, including management's report and KPMG LLP's report and attestation on internal control over financial reporting in accordance with Section 404 of the Sarbanes-Oxley Act of 2002, and received such assurances from them as we deemed appropriate.

Management is responsible for New Century Financial Corporation's system of internal controls and the financial reporting process. KPMG LLP is responsible for performing an independent audit of the consolidated financial statements in accordance with generally accepted auditing standards and issuing a report thereon. Our Committee's responsibility is to monitor and oversee these processes.

Based on the foregoing review and discussions and a review of the report of KPMG LLP with respect to the consolidated financial statements, and relying thereon, we have recommended to New Century Financial Corporation's Board of Directors the inclusion of the audited consolidated financial statements in New Century Financial Corporation's Annual Report on Form 10-K for the year ended December 31, 2004, for filing with the Securities and Exchange Commission.

AUDIT COMMITTEE

Michael M. Sachs, Chairman

Fredric J. Forster

Donald E. Lange

Richard A. Zona

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REPORT OF COMPENSATION COMMITTEE

To the Board of Directors
of New Century Financial Corporation

March 10, 2005

The Compensation Committee evaluates the performance and compensation levels of New Century's senior executives and considers management succession and related matters. The Compensation Committee also administers the 2004 Plan.

The Compensation Committee was formed in connection with New Century's conversion to a real estate investment trust (a REIT) in 2004. As part of the REIT conversion, New Century was formed and its predecessor, New Century TRS Holdings, Inc. (formerly, New Century Financial Corporation), became a wholly-owned subsidiary of New Century. This report covers 2004 compensation paid by New Century TRS Holdings, Inc. prior to the REIT conversion as well as 2004 compensation paid by New Century following the REIT conversion.

Overall Compensation Policies

The Compensation Committee's overriding objective is to structure executive compensation in a way that helps to achieve New Century's strategic and financial goals. To this end, the Compensation Committee is guided by the following basic principles:

- (1) Compensation-levels should be appropriate to attract, retain and motivate talented executives and should be competitive with levels for executive officers of similar companies.
- (2) A substantial portion of each executive officer's annual compensation should be linked to New Century's overall financial performance.
- (3) Executive officers should have a strong incentive to advance long-term strategic and financial goals, and not solely concentrate on shorter-term financial performance.
- (4) The tax implications to New Century and its executive officers of various payments and benefits should be considered in structuring total executive compensation.

The Compensation Committee relies principally on three forms of compensation to pursue these policies: annual salary, annual bonus and stock-based awards.

2004 Executive Compensation

Factors Considered. The 2004 compensation for each of Messrs. Cole, Morrice, Gotschall, Flanagan, and Cloyd was a function of (1) pre-established base salary compensation under their employment agreements, (2) a bonus based on pre-established return on equity targets (except for Mr. Cloyd's bonus, as described in more detail below), and (3) a discretionary grant of stock options in recognition of New Century's financial performance and the significant contribution they each made to this performance.

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Base Salary. The Compensation Committee increased the annual base salary for each of Messrs. Cole, Morrice, Gotschall and Flanagan to \$550,000 effective as of January 1, 2004. The Compensation Committee based this increase principally upon its subjective review of the executives' past performance and the nature and responsibility of the executives' position, and upon a review of pay-

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levels of similar positions with comparable companies in the industry. Mr. Cloyd's base salary for 2004 was \$245,833.

The 2005 annualized base salary level for each of Messrs. Cole, Morrice, Gotschall and Flanagan is \$569,250. Each of the executives voluntarily waived a greater base salary increase that was otherwise called for by their employment agreements.

Bonus. Based on New Century's return on equity in 2004, each of Messrs. Cole, Morrice, Gotschall and Flanagan received a cash bonus of \$825,000 and restricted shares of New Century stock valued at \$2,562,900 at the time of grant. The 2004 bonus targets for Messrs. Cole, Morrice, Gotschall and Flanagan were determined in accordance with their respective employment agreements and were based on the ratio of earnings before income taxes compared to average stockholders' equity for the year.

Mr. Cloyd's 2004 bonus, \$1,278,710, was based principally upon New Century's 2004 loan production volume, net income and operating margin results when compared against pre-established targets.

Stock-Based Compensation. In 2004, the Compensation Committee granted to each of Messrs. Cole, Morrice, and Gotschall an option to purchase 75,000 shares of our common stock, Mr. Flanagan an option to purchase 100,000 shares of our common stock, and Mr. Cloyd an option to purchase 20,000 shares of our common stock. The grants were based upon the Committee's evaluation of individual current performance, assumption of significant responsibilities, anticipated future contributions, ability to impact overall corporate and/or business unit financial results, each executive's total compensation package, options and other stock awards previously granted, dilution effects, and industry practices and trends.

Independent Compensation Consultants. The Compensation Committee retains a compensation consulting firm to provide advice regarding New Century's executive compensation policies. The Compensation Committee considered the advice of this firm in, among other things, establishing the new base salary-levels and in approving the stock option grants referred to above.

Tax Deductibility Under Section 162(m)

Section 162(m) of the U.S. Internal Revenue Code of 1986 generally disallows a tax deduction to public corporations for compensation in excess of \$1 million paid to the corporation's chief executive officer and to each of the four other most highly compensated executive officers as of the end of any fiscal year. However, Section 162(m) exempts certain performance-based compensation from the deduction limit if certain other requirements are met. The stock options referred to above, as well as the 2004 bonuses for each of Messrs. Cole, Morrice, Gotschall, and Flanagan, are performance based compensation under Section 162(m). The Board of Directors and the Compensation Committee reserve the authority, however, to award non-deductible compensation in other circumstances as they deem appropriate.

COMPENSATION COMMITTEE

Fredric J. Forster, Chairman

Harold A. Black

Donald E. Lange

William J. Popejoy

Michael M. Sachs

Terrence P. Sandvik

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ANNEX A

NEW CENTURY FINANCIAL CORPORATION

2004 PERFORMANCE INCENTIVE PLAN

(Composite Plan Document Reflecting Proposed Amendments)

1. PURPOSE OF PLAN

The purpose of this New Century Financial Corporation 2004 Performance Incentive Plan (this **Plan**) of New Century Financial Corporation, a Maryland corporation (the **Corporation**) is to promote the success of the Corporation and to increase stockholder value by providing an additional means through the grant of awards to attract, motivate, retain and reward selected employees and other eligible persons.

2. ELIGIBILITY

The Administrator (as such term is defined in Section 3.1) may grant awards under this Plan only to those persons that the Administrator determines to be Eligible Persons. An **Eligible Person** is any person who is either: (a) an officer (whether or not a director) or employee of the Corporation or one of its Subsidiaries or Affiliates; (b) a member of the Board; or (c) an individual consultant or advisor who renders or has rendered bona fide services (other than services in connection with the offering or sale of securities of the Corporation or one of its Subsidiaries or Affiliates) to the Corporation or one of its Subsidiaries or Affiliates and who is selected to participate in this Plan by the Administrator; provided, however, that a person who is otherwise an Eligible Person under clause (c) above may participate in this Plan only if such participation would not adversely affect the Corporation's compliance with applicable laws. An Eligible Person who has been granted an award (a **participant**) may, if otherwise eligible, be granted additional awards if the Administrator shall so determine. As used herein, **Subsidiary** means any corporation or other entity a majority of whose outstanding voting stock or voting power is beneficially owned directly or indirectly by the Corporation; **Affiliate** means any corporation or other entity a significant portion of the equity of which is beneficially owned directly or indirectly by the Corporation (regardless of whether such entity qualifies as a Subsidiary), as determined by the Administrator; and **Board** means the Board of Directors of the Corporation.

3. PLAN ADMINISTRATION

3.1 The Administrator. This Plan shall be administered by and all awards under this Plan shall be authorized by the Administrator. The **Administrator** means the Board or one or more committees appointed by the Board or another committee (within its delegated authority) to administer all or certain aspects of this Plan. Any such committee shall be comprised solely of one or more directors or such number of directors as may be required under applicable law. A committee may delegate some or all of its authority to another committee so constituted. The Board or a committee comprised solely of directors may also delegate, to the extent permitted by applicable law, to one or more officers of the Corporation, its powers under this Plan (a) to designate the officers and employees of the Corporation and its Subsidiaries and Affiliates who will receive grants of awards under this Plan, and (b) to determine the number of shares subject to, and the other terms and conditions of, such awards. The Board may delegate different levels of authority to different committees with administrative and grant authority under this Plan. Unless otherwise provided in the Bylaws of the Corporation or the applicable charter of any Administrator: (a) a majority of the members of the acting Administrator shall constitute a quorum, and (b) the vote of a majority of the members present assuming the presence of a quorum or the unanimous written consent of the members of the Administrator shall constitute action by the acting Administrator.

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With respect to awards intended to satisfy the requirements for performance-based compensation under Section 162(m) of the Internal Revenue Code of 1986, as amended (the **Code**), this Plan shall be

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administered by a committee consisting solely of two or more outside directors (as this requirement is applied under Section 162(m) of the Code); provided, however, that the failure to satisfy such requirement shall not affect the validity of the action of any committee otherwise duly authorized and acting in the matter. Award grants, and transactions in or involving awards, intended to be exempt under Rule 16b-3 under the Securities Exchange Act of 1934, as amended (the **Exchange Act**), must be duly and timely authorized by the Board or a committee consisting solely of two or more non-employee directors (as this requirement is applied under Rule 16b-3 promulgated under the Exchange Act). To the extent required by any applicable listing agency, this Plan shall be administered by a committee composed entirely of independent directors (within the meaning of the applicable listing agency).

3.2 Powers of the Administrator. Subject to the express provisions of this Plan, the Administrator is authorized and empowered to do all things necessary or desirable in connection with the authorization of awards and the administration of this Plan (in the case of a committee or delegation to one or more officers, within the authority delegated to that committee or person(s)), including, without limitation, the authority to:

- (a) determine eligibility and, from among those persons determined to be eligible, the particular Eligible Persons who will receive an award under this Plan;
- (b) grant awards to Eligible Persons, determine the price at which securities will be offered or awarded and the number of securities to be offered or awarded to any of such persons, determine the other specific terms and conditions of such awards consistent with the express limits of this Plan, establish the installments (if any) in which such awards shall become exercisable or shall vest (which may include, without limitation, performance and/or time-based schedules), or determine that no delayed exercisability or vesting is required, establish any applicable performance targets, and establish the events of termination or reversion of such awards;
- (c) approve the forms of award agreements (which need not be identical either as to type of award or among participants);
- (d) construe and interpret this Plan and any agreements defining the rights and obligations of the Corporation, its Subsidiaries and Affiliates, and participants under this Plan, further define the terms used in this Plan, and prescribe, amend and rescind rules and regulations relating to the administration of this Plan or the awards granted under this Plan;
- (e) cancel, modify, or waive the Corporation's rights with respect to, or modify, discontinue, suspend, or terminate any or all outstanding awards, subject to any required consent under Section 8.6.5;
- (f) accelerate or extend the vesting or exercisability or extend the term of any or all such outstanding awards (in the case of options or stock appreciation rights, within the maximum ten-year term of such awards) in such circumstances as the Administrator may deem appropriate (including, without limitation, in connection with a termination of employment or services or other events of a personal nature) subject to any required consent under Section 8.6.5;
- (g) adjust the number of shares of Common Stock subject to any award, adjust the price of any or all outstanding awards or otherwise change previously imposed terms and conditions, in such circumstances as the Administrator may deem appropriate, in each case subject to Sections 4 and 8.6, and provided that in no case (except due to an adjustment contemplated by Section 7 or any repricing that may be approved by stockholders) shall such an adjustment constitute a repricing (by amendment, cancellation and regrant, exchange or other means) of the per share exercise or base price of any option or stock appreciation right;

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- (h) determine the date of grant of an award, which may be a designated date after but not before the date of the Administrator's action (unless otherwise designated by the Administrator, the date of grant of an award shall be the date upon which the Administrator took the action granting an award);
- (i) determine whether, and the extent to which, adjustments are required pursuant to Section 7 hereof and authorize the termination, conversion, substitution or succession of awards upon the occurrence of an event of the type described in Section 7;
- (j) acquire or settle (subject to Sections 7 and 8.6) rights under awards in cash, stock of equivalent value, or other consideration; and
- (k) determine the fair market value of the Common Stock or awards under this Plan from time to time and/or the manner in which such value will be determined.

3.3 Binding Determinations. Any action taken by, or inaction of, the Corporation, any Subsidiary or Affiliate, or the Administrator relating or pursuant to this Plan and within its authority hereunder or under applicable law shall be within the absolute discretion of that entity or body and shall be conclusive and binding upon all persons. Neither the Board nor any Board committee, nor any member thereof or person acting at the direction thereof, shall be liable for any act, omission, interpretation, construction or determination made in good faith in connection with this Plan (or any award made under this Plan), and all such persons shall be entitled to indemnification and reimbursement by the Corporation in respect of any claim, loss, damage or expense (including, without limitation, attorneys' fees) arising or resulting therefrom to the fullest extent permitted by law and/or under any directors and officers liability insurance coverage that may be in effect from time to time.

3.4 Reliance on Experts. In making any determination or in taking or not taking any action under this Plan, the Board or a committee, as the case may be, may obtain and may rely upon the advice of experts, including employees and professional advisors to the Corporation. No director, officer or agent of the Corporation, or any of its Subsidiaries or Affiliates, shall be liable for any such action or determination taken or made or omitted in good faith.

3.5 Delegation. The Administrator may delegate ministerial, non-discretionary functions to individuals who are officers or employees of the Corporation or any of its Subsidiaries or Affiliates.

4. SHARES OF COMMON STOCK SUBJECT TO THE PLAN; SHARE LIMITS

4.1 Shares Available. Subject to the provisions of Section 7.1, the capital stock that may be delivered under this Plan shall be shares of the Corporation's authorized but unissued Common Stock and any shares of its Common Stock held as treasury shares. For purposes of this Plan, **Common Stock** shall mean the common stock of the Corporation and such other securities or property as may become the subject of awards under this Plan, or may become subject to such awards, pursuant to an adjustment made under Section 7.1.

4.2 Share Limits. The maximum number of shares of Common Stock that may be delivered pursuant to awards granted to Eligible Persons under this Plan (the **Share Limit**) is equal to the sum of (a) 5,661,971 shares, plus (b) the number of any shares subject to stock options granted under the Corporation's 1995 Stock Option Plan (the **1995 Plan**) and outstanding as of the date the Board approved this amended version of the Plan (the **Board Approval Date**) which expire, or for any reason are cancelled or terminated, after the Board Approval Date without being exercised, plus (c) the number of any shares of restricted stock granted under the 1995 Plan that are outstanding and unvested on the Board Approval Date that are forfeited, terminated, cancelled or otherwise reacquired by the

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Corporation without having become vested; provided that in no event shall the Share Limit exceed 9,951,881 shares (which is the sum of the 5,661,971 shares set forth above, plus the maximum number of shares subject to options previously granted and outstanding under the 1995 Plan as of the Board Approval Date, plus the maximum number of shares subject to restricted stock awards previously granted and outstanding under the 1995 Plan that had not vested as of the Board Approval Date).¹ The following limits also apply with respect to awards granted under this Plan:

- (a) The maximum number of shares of Common Stock that may be delivered pursuant to options qualified as incentive stock options granted under this Plan is 2,000,000 shares, subject to the Plan limit set forth above.²
- (b) The maximum number of shares of Common Stock subject to those options and stock appreciation rights that are granted during any calendar year to any individual under this Plan is 750,000 shares.
- (c) Additional limits with respect to Performance-Based Awards are set forth in Section 5.2.3.

Each of the foregoing numerical limits is subject to adjustment as contemplated by Section 4.3, Section 7.1, and Section 8.10.

4.3 Awards Settled in Cash, Reissue of Awards and Shares. To the extent that an award is settled in cash or a form other than shares of Common Stock, the shares that would have been delivered had there been no such cash or other settlement shall not be counted against the shares available for issuance under this Plan. In the event that shares are delivered in respect of a dividend equivalent, stock appreciation right, or other award, only the actual number of shares delivered with respect to the award shall be counted against the share limits of this Plan. Shares that are subject to or underlie awards which expire or for any reason are cancelled or terminated, are forfeited, fail to vest, or for any other reason are not paid or delivered under this Plan shall again be available for subsequent awards under this Plan. Shares that are exchanged by a participant or withheld by the Corporation as full or partial payment in connection with any award under this Plan or the 1995 Plan (with respect to such a payment in connection with any award under the 1995 Plan, only to the extent such transaction occurs after the Effective Date), as well as any shares exchanged by a participant or withheld by the Corporation or one of its Subsidiaries to satisfy the tax withholding obligations related to any award under this Plan or the 1995 Plan (with respect to such an exchange or withholding in connection with any award under the 1995 Plan, only to the extent such transaction occurs after the Effective Date), shall be available for subsequent awards under this Plan. Refer to Section 8.10 for application of the foregoing share limits with respect to assumed awards. The foregoing adjustments to the share limits of this Plan are subject to any applicable limitations under Section 162(m) of the Code with respect to awards intended as performance-based compensation thereunder.

4.4 Reservation of Shares; No Fractional Shares; Minimum Issue. The Corporation shall at all times reserve a number of shares of Common Stock sufficient to cover the Corporation's obligations and contingent obligations to deliver shares with respect to awards then outstanding under this Plan (exclusive of any dividend equivalent obligations to the extent the Corporation has the right to settle such rights in cash). No fractional shares shall be delivered under this Plan. The Administrator may pay cash in lieu of any fractional shares in settlements of awards under this Plan. No fewer than 100 shares may be purchased on exercise of any award (or, in the case of stock appreciation or purchase rights, no

¹ As of the Board Approval Date, the aggregate share limit was 1,661,971 shares, subject to adjustment as contemplated by clauses (b) and (c) of the first sentence of Section 4.2. Stockholders are being asked to approve an amendment to the Plan that would increase the aggregate share limit by an additional 4,000,000 shares so that the new aggregate share limit would be 5,661,971 shares, subject to adjustment as contemplated by clauses (b) and (c) of the first sentence of Section 4.2.

² The Plan currently includes a limit on incentive stock option grants of 450,000 shares. Stockholders are being asked to increase this limit by an additional 1,550,000 shares so that the new incentive stock option limit would be 2,000,000 shares.

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fewer than 100 rights may be exercised at any one time) unless the total number purchased or exercised is the total number at the time available for purchase or exercise under the award.

5. AWARDS

5.1 Type and Form of Awards. The Administrator shall determine the type or types of award(s) to be made to each selected Eligible Person. Awards may be granted singly, in combination or in tandem. Awards also may be made in combination or in tandem with, replacement of, as alternatives to, or as the payment form for grants or rights under any other employee or compensation plan of the Corporation or one of its Subsidiaries or Affiliates. The types of awards that may be granted under this Plan are:

5.1.1 Stock Options. A stock option is the grant of a right to purchase a specified number of shares of Common Stock during a specified period as determined by the Administrator. An option may be intended as an incentive stock option within the meaning of Section 422 of the Code (an **ISO**) or a nonqualified stock option (an option not intended to be an ISO). The award agreement for an option will indicate if the option is intended as an ISO, otherwise it will be deemed to be a nonqualified stock option. The maximum term of each option (ISO or nonqualified) shall be ten (10) years. The per share exercise price for each option shall be determined by the Administrator at the time of grant of the award and may be less than the fair market value of a share of Common Stock at that time; provided that the per share exercise price of an option intended as an ISO shall be not less than 100% of the fair market value of a share of Common Stock on the date of grant of the option. When an option is exercised, the exercise price for the shares to be purchased shall be paid in full in cash or such other method permitted by the Administrator consistent with Section 5.5.

5.1.2 Additional Rules Applicable to ISOs. To the extent that the aggregate fair market value (determined at the time of grant of the applicable option) of stock with respect to which ISOs first become exercisable by a participant in any calendar year exceeds \$100,000, taking into account both Common Stock subject to ISOs under this Plan and stock subject to ISOs under all other plans of the Corporation or one of its Subsidiaries (or any parent or predecessor corporation to the extent required by and within the meaning of Section 422 of the Code and the regulations promulgated thereunder), such options shall be treated as nonqualified stock options. In reducing the number of options treated as ISOs to meet the \$100,000 limit, the most recently granted options shall be reduced first. To the extent a reduction of simultaneously granted options is necessary to meet the \$100,000 limit, the Administrator may, in the manner and to the extent permitted by law, designate which shares of Common Stock are to be treated as shares acquired pursuant to the exercise of an ISO. ISOs may only be granted to employees of the Corporation or one of its subsidiaries (for this purpose, the term **subsidiary** is used as defined in Section 424(f) of the Code, which generally requires an unbroken chain of ownership of at least 50% of the total combined voting power of all classes of stock of each subsidiary in the chain beginning with the Corporation and ending with the subsidiary in question). There shall be imposed in any award agreement relating to ISOs such other terms and conditions as from time to time are required in order that the option be an **incentive stock option** as that term is defined in Section 422 of the Code. No ISO may be granted to any person who, at the time the option is granted, owns (or is deemed to own under Section 424(d) of the Code) shares of outstanding Common Stock possessing more than 10% of the total combined voting power of all classes of stock of the Corporation, unless the exercise price of such option is at least 110% of the fair market value of the stock subject to the option and such option by its terms is not exercisable after the expiration of five years from the date such option is granted.

5.1.3 Stock Appreciation Rights. A stock appreciation right or **SAR** is a right to receive a payment, in cash and/or Common Stock, equal to the excess of the fair market value of a specified number of shares of Common Stock on the date the SAR is exercised over the **base price** of the award as established by the Administrator at the time of grant of the award, which base price may be less than

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the fair market value of a share of Common Stock on the date of grant of the award. The maximum term of an SAR shall be ten (10) years.

5.1.4 Other Awards. The other types of awards that may be granted under this Plan include: (a) stock bonuses, restricted stock, performance stock, stock units, phantom stock, dividend equivalents, or similar rights to purchase or acquire shares, whether at a fixed or variable price or ratio related to the Common Stock, upon the passage of time, the occurrence of one or more events, or the satisfaction of performance criteria or other conditions, or any combination thereof; (b) any similar securities with a value derived from the value of or related to the Common Stock and/or returns thereon; or (c) cash awards granted consistent with Section 5.2 below.

5.2 Section 162(m) Performance-Based Awards. Without limiting the generality of the foregoing, any of the types of awards listed in Section 5.1.4 above may be, and options and SARs granted with an exercise or base price not less than the fair market value of a share of Common Stock at the date of grant (**Qualifying Options** and **Qualifying SARs**, respectively) typically will be, granted as awards intended to satisfy the requirements for performance-based compensation within the meaning of Section 162(m) of the Code (**Performance-Based Awards**). The grant, vesting, exercisability or payment of Performance-Based Awards may depend (or, in the case of Qualifying Options or Qualifying SARs, may also depend) on the degree of achievement of one or more performance goals relative to a pre-established targeted level or level using one or more of the Business Criteria set forth below (on an absolute or relative basis) for the Corporation on a consolidated basis or for one or more of the Corporation's subsidiaries, segments, divisions or business units, or any combination of the foregoing. Any Qualifying Option or Qualifying SAR shall be subject only to the requirements of Section 5.2.1 and 5.2.3 in order for such award to satisfy the requirements for performance-based compensation under Section 162(m) of the Award. Any other Performance-Based Award shall be subject to all of the following provisions of this Section 5.2.

5.2.1 Class; Administrator. The eligible class of persons for Performance-Based Awards shall be officers and employees of the Corporation and its Subsidiaries. The Administrator approving Performance-Based Awards or making any certification required pursuant to Section 5.2.4 must be constituted as provided in Section 3.1 for awards that are intended as performance-based compensation under Section 162(m) of the Code.

5.2.2 Performance Goals. The specific performance goals for Performance-Based Awards (other than Qualifying Options and Qualifying SARs) shall be, on an absolute or relative basis, established based on one or more of the business criteria set forth on Appendix A hereto (**Business Criteria**) as selected by the Administrator in its sole discretion. To qualify awards as performance-based under Section 162(m), the applicable Business Criterion (or Business Criteria, as the case may be) and specific performance goal or goals (**targets**) must be established and approved by the Administrator during the first 90 days of the performance period (and, in the case of performance periods of less than one year, in no event more than 25% of the performance period has elapsed) and while performance relating to such target(s) remains substantially uncertain within the meaning of Section 162(m) of the Code. Performance targets shall be adjusted to mitigate the unbudgeted impact of material, unusual or nonrecurring gains and losses, accounting changes or other extraordinary events not foreseen at the time the targets were set unless the Administrator provides otherwise at the time of establishing the targets. The applicable performance measurement period may not be less than three months nor more than 10 years.

5.2.3 Form of Payment; Maximum Performance-Based Award. Grants or awards under this Section 5.2 may be paid in cash or shares of Common Stock or any combination thereof. Grants of Qualifying Options and Qualifying SARs to any one participant in any one calendar year shall be subject to the limit set forth in Section 4.2(b). The maximum number of shares of Common Stock which may be

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delivered pursuant to Performance-Based Awards (other than Qualifying Options and Qualifying SARs, and other than cash awards covered by the following sentence) that are granted to any one participant in any one calendar year shall not exceed 750,000 shares, either individually or in the aggregate, subject to adjustment as provided in Section 7.1. In addition, the aggregate amount of compensation to be paid to any one participant in respect of all Performance-Based Awards payable only in cash and not related to shares of Common Stock and granted to that participant in any one calendar year shall not exceed \$10,000,000.00. Awards that are cancelled during the year shall be counted against these limits to the extent permitted by Section 162(m) of the Code.

5.2.4 Certification of Payment. Before any Performance-Based Award under this Section 5.2 (other than Qualifying Options and Qualifying SARs) is paid and to the extent required to qualify the award as performance-based compensation within the meaning of Section 162(m) of the Code, the Administrator must certify in writing that the performance target(s) and any other material terms of the Performance-Based Award were in fact timely satisfied.

5.2.5 Reservation of Discretion. The Administrator will have the discretion to determine the restrictions or other limitations of the individual awards granted under this Section 5.2 including the authority to reduce awards, payouts or vesting or to pay no awards, in its sole discretion, if the Administrator preserves such authority at the time of grant by language to this effect in its authorizing resolutions or otherwise.

5.2.6 Expiration of Grant Authority. As required pursuant to Section 162(m) of the Code and the regulations promulgated thereunder, the Administrator's authority to grant new awards that are intended to qualify as performance-based compensation within the meaning of Section 162(m) of the Code (other than Qualifying Options and Qualifying SARs) shall terminate upon the first meeting of the Corporation's stockholders that occurs in the fifth year following the year in which the Corporation's stockholders first approve this Plan.

5.3 Award Agreements. Each award shall be evidenced by a written award agreement in the form approved by the Administrator and executed on behalf of the Corporation and, if required by the Administrator, executed by the recipient of the award. The Administrator may authorize any officer of the Corporation (other than the particular award recipient) to execute any or all award agreements on behalf of the Corporation. The award agreement shall set forth the material terms and conditions of the award as established by the Administrator consistent with the express limitations of this Plan.

5.4 Deferrals and Settlements. Payment of awards may be in the form of cash, Common Stock, other awards or combinations thereof as the Administrator shall determine, and with such restrictions as it may impose. The Administrator may also require or permit participants to elect to defer the issuance of shares or the settlement of awards in cash under such rules and procedures as it may establish under this Plan. The Administrator may also provide that deferred settlements include the payment or crediting of interest or other earnings on the deferral amounts, or the payment or crediting of dividend equivalents where the deferred amounts are denominated in shares.

5.5 Consideration for Common Stock or Awards. The purchase price for any award granted under this Plan or the Common Stock to be delivered pursuant to an award, as applicable, may be paid by means of any lawful consideration as determined by the Administrator, including, without limitation, one or a combination of the following methods:

services rendered by the recipient of such award;

cash, check payable to the order of the Corporation, or electronic funds transfer;

notice and third party payment in such manner as may be authorized by the Administrator;

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the delivery of previously owned shares of Common Stock;

by a reduction in the number of shares otherwise deliverable pursuant to the award; or

subject to such procedures as the Administrator may adopt, pursuant to a cashless exercise with a third party who provides financing for the purposes of (or who otherwise facilitates) the purchase or exercise of awards.

In no event shall any shares newly-issued by the Corporation be issued for less than the minimum lawful consideration for such shares or for consideration other than consideration permitted by applicable state law. In the event that the Administrator allows a participant to exercise an award by delivering shares of Common Stock previously owned by such participant and unless otherwise expressly provided by the Administrator, any shares delivered which were initially acquired by the participant from the Corporation (upon exercise of a stock option or otherwise) must have been owned by the participant at least six months as of the date of delivery. Shares of Common Stock used to satisfy the exercise price of an option shall be valued at their fair market value on the date of exercise. The Corporation will not be obligated to deliver any shares unless and until it receives full payment of the exercise or purchase price therefor and any related withholding obligations under Section 8.5 and any other conditions to exercise or purchase have been satisfied. Unless otherwise expressly provided in the applicable award agreement, the Administrator may at any time eliminate or limit a participant's ability to pay the purchase or exercise price of any award or shares by any method other than cash payment to the Corporation.

5.6 Definition of Fair Market Value. For purposes of this Plan, fair market value shall mean, unless otherwise determined or provided by the Administrator in the circumstances, the last price for a share of Common Stock as furnished by the National Association of Securities Dealers, Inc. (the **NASD**) through the NASDAQ National Market Reporting System (the **National Market**) for the date in question or, if no sales of Common Stock were reported by the NASD on that date, the last price for a share of Common Stock as furnished by the NASD through the National Market for the next preceding day on which sales of Common Stock were reported by the NASD. The Administrator may, however, provide with respect to one or more awards that the fair market value shall equal the last price for a share of Common Stock as furnished by the NASD through the National Market available on the date in question or the average of the high and low trading prices of a share of Common Stock as furnished by the NASD through the National Market for the date in question or the most recent trading day. If the Common Stock is no longer listed or is no longer actively traded on the National Market as of the applicable date, the fair market value of the Common Stock shall be the value as reasonably determined by the Administrator for purposes of the award in the circumstances. The Administrator also may adopt a different methodology for determining fair market value with respect to one or more awards if a different methodology is necessary or advisable to secure any intended favorable tax, legal or other treatment for the particular award(s) (for example, and without limitation, the Administrator may provide that fair market value for purposes of one or more awards will be based on an average of closing prices (or the average of high and low daily trading prices) for a specified period preceding the relevant date).

5.7 Transfer Restrictions.

5.7.1 Limitations on Exercise and Transfer. Unless otherwise expressly provided in (or pursuant to) this Section 5.7, by applicable law and by the award agreement, as the same may be amended, (a) all awards are non-transferable and shall not be subject in any manner to sale, transfer, anticipation, alienation, assignment, pledge, encumbrance or charge; (b) awards shall be exercised only by the participant; and (c) amounts payable or shares issuable pursuant to any award shall be delivered only to (or for the account of) the participant.

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5.7.2 Exceptions. The Administrator may permit awards to be exercised by and paid to, or otherwise transferred to, other persons or entities pursuant to such conditions and procedures, including limitations on subsequent transfers, as the Administrator may, in its sole discretion, establish in writing. Any permitted transfer shall be subject to compliance with applicable federal and state securities laws.

5.7.3 Further Exceptions to Limits on Transfer. The exercise and transfer restrictions in Section 5.7.1 shall not apply to:

- (a) transfers to the Corporation,
- (b) the designation of a beneficiary to receive benefits in the event of the participant's death or, if the participant has died, transfers to or exercise by the participant's beneficiary, or, in the absence of a validly designated beneficiary, transfers by will or the laws of descent and distribution,
- (c) subject to any applicable limitations on ISOs, transfers to a family member (or former family member) pursuant to a domestic relations order if approved or ratified by the Administrator,
- (d) if the participant has suffered a disability, permitted transfers or exercises on behalf of the participant by his or her legal representative, or
- (e) the authorization by the Administrator of cashless exercise procedures with third parties who provide financing for the purpose of (or who otherwise facilitate) the exercise of awards consistent with applicable laws and the express authorization of the Administrator.

5.8 International Awards. One or more awards may be granted to Eligible Persons who provide services to the Corporation or one of its Subsidiaries or Affiliates outside of the United States. Any awards granted to such persons may be granted pursuant to the terms and conditions of any applicable sub-plans, if any, appended to this Plan and approved by the Administrator.

6. EFFECT OF TERMINATION OF SERVICE ON AWARDS

6.1 General. The Administrator shall establish the effect of a termination of employment or service on the rights and benefits under each award under this Plan and in so doing may make distinctions based upon, inter alia, the cause of termination and type of award. If the participant is not an employee of the Corporation or one of its Subsidiaries or Affiliates and provides other services to the Corporation or one of its Subsidiaries or Affiliates, the Administrator shall be the sole judge for purposes of this Plan (unless a contract or the award otherwise provides) of whether the participant continues to render services to the Corporation or one of its Subsidiaries or Affiliates and the date, if any, upon which such services shall be deemed to have terminated.

6.2 Events Not Deemed Terminations of Service. Unless the express policy of the Corporation or one of its Subsidiaries or Affiliates, or the Administrator, otherwise provides, the employment relationship shall not be considered terminated in the case of (a) sick leave, (b) military leave, or (c) any other leave of absence authorized by the Corporation or one of its Subsidiaries or Affiliates or the Administrator; provided that unless reemployment upon the expiration of such leave is guaranteed by contract or law, such leave is for a period of not more than 90 days. In the case of any employee of the Corporation or one of its Subsidiaries or Affiliates on an approved leave of absence, continued vesting of the award while on leave from the employ of the Corporation or one of its Subsidiaries or Affiliates may be suspended until the employee returns to service, unless the Administrator otherwise provides or applicable law otherwise requires. In no event shall an award be exercised after the expiration of the term set forth in the award agreement.

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6.3 *Effect of Change of Subsidiary Status.* For purposes of this Plan and any award, if an entity ceases to be a Subsidiary or other Affiliate of the Corporation, as determined by the Administrator, a termination of employment or service shall be deemed to have occurred with respect to each Eligible Person in respect of such Subsidiary or other Affiliate who does not continue as an Eligible Person in respect of the Corporation or another of its Subsidiaries or Affiliates that continues as such, as determined by the Administrator, after giving effect to the transaction or other event giving rise to the change in status.

7. ADJUSTMENTS; ACCELERATION

7.1 *Adjustments.* Upon or in contemplation of: any reclassification, recapitalization, stock split (including a stock split in the form of a stock dividend) or reverse stock split (stock split); any merger, combination, consolidation, or other reorganization; any spin-off, split-up, or similar extraordinary dividend distribution in respect of the Common Stock (whether in the form of securities or property); any exchange of Common Stock or other securities of the Corporation, or any similar, unusual or extraordinary corporate transaction in respect of the Common Stock; or a sale of all or substantially all the business or assets of the Corporation as an entirety; then the Administrator shall, in such manner, to such extent (if any) and at such time as it deems appropriate and equitable in the circumstances:

- (a) proportionately adjust any or all of (1) the number and type of shares of Common Stock (or other securities) that thereafter may be made the subject of awards (including the specific share limits, maximums and numbers of shares set forth elsewhere in this Plan), (2) the number, amount and type of shares of Common Stock (or other securities or property) subject to any or all outstanding awards, (3) the grant, purchase, or exercise price (which term includes the base price of any SAR or similar right) of any or all outstanding awards, (4) the securities, cash or other property deliverable upon exercise or payment of any outstanding awards, or (5) (subject to Sections 7.8 and 8.8.3(a)) the performance standards applicable to any outstanding awards, or
- (b) make provision for a cash payment or for the assumption, substitution or exchange of any or all outstanding share-based awards or the cash, securities or property deliverable to the holder of any or all outstanding share-based awards, based upon the distribution or consideration payable to holders of the Common Stock upon or in respect of such event.

The Administrator may adopt such valuation methodologies for outstanding awards as it deems reasonable in the event of a cash or property settlement and, in the case of options, SARs or similar rights, but without limitation on other methodologies, may base such settlement solely upon the excess if any of the per share amount payable upon or in respect of such event over the exercise or base price of the award. With respect to any award of an ISO, the Administrator may make such an adjustment that causes the option to cease to qualify as an ISO without the consent of the affected participant.

In any of such events, the Administrator may take such action prior to such event to the extent that the Administrator deems the action necessary to permit the participant to realize the benefits intended to be conveyed with respect to the underlying shares in the same manner as is or will be available to stockholders generally. In the case of any stock split or reverse stock split, if no action is taken by the Administrator, the proportionate adjustments contemplated by clause (a) above shall nevertheless be made.

7.2 *Automatic Acceleration of Awards.* Upon a dissolution of the Corporation or other event described in Section 7.1 that the Corporation does not survive (or does not survive as a public company in respect of its Common Stock), then each then-outstanding option and SAR shall become fully vested, all shares of restricted stock then outstanding shall fully vest free of restrictions, and each other award granted under this Plan that is then outstanding shall become payable to the holder of such award; provided that such acceleration provision shall not apply, unless otherwise expressly provided by the Administrator, with

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respect to any award to the extent that the Administrator has made a provision for the substitution, assumption, exchange or other continuation or settlement of the award, or the award would otherwise continue in accordance with its terms, in the circumstances.

7.3 Possible Acceleration of Awards. Without limiting Section 7.2, in the event of a Change in Control Event (as defined below), the Administrator may, in its discretion, provide that any outstanding option or SAR shall become fully vested, that any share of restricted stock then outstanding shall fully vest free of restrictions, and that any other award granted under this Plan that is then outstanding shall be payable to the holder of such award. The Administrator may take such action with respect to all awards then outstanding or only with respect to certain specific awards identified by the Administrator in the circumstances. For purposes of this Plan, **Change in Control Event** means any of the following:

- (a) The acquisition by any individual, entity or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act (a **Person**)) of beneficial ownership (within the meaning of Rule 13d-3 promulgated under the Exchange Act) of 25% or more of either (1) the then-outstanding shares of common stock of the Corporation (the **Outstanding Company Common Stock**) or (2) the combined voting power of the then-outstanding voting securities of the Corporation entitled to vote generally in the election of directors (the **Outstanding Company Voting Securities**); provided, however, that, for purposes of this definition, the following acquisitions shall not constitute a Change in Control Event; (A) any acquisition directly from the Corporation, (B) any acquisition by the Corporation, (C) any acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Corporation or any affiliate of the Corporation or a successor, or (D) any acquisition by any entity pursuant to a transaction that complies with Sections (c)(1), (2) and (3) below;
- (b) Individuals who, as of the Effective Date, constitute the Board (the **Incumbent Board**) cease for any reason to constitute at least a majority of the Board; provided, however, that any individual becoming a director subsequent to the Effective Date whose election, or nomination for election by the Corporation's stockholders, was approved by a vote of at least two-thirds of the directors then comprising the Incumbent Board (including for these purposes, the new members whose election or nomination was so approved, without counting the member and his predecessor twice) shall be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial assumption of office occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board;
- (c) Consummation of a reorganization, merger, statutory share exchange or consolidation or similar corporate transaction involving the Corporation or any of its Subsidiaries, a sale or other disposition of all or substantially all of the assets of the Corporation, or the acquisition of assets or stock of another entity by the Corporation or any of its Subsidiaries (each, a **Business Combination**), in each case unless, following such Business Combination, (1) all or substantially all of the individuals and entities that were the beneficial owners of the Outstanding Company Common Stock and the Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 50% of the then-outstanding shares of common stock and the combined voting power of the then-outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the entity resulting from such Business Combination (including, without limitation, an entity that, as a result of such transaction, owns the Corporation or all or substantially all of the Corporation's assets directly or through one or more subsidiaries (a **Parent**)) in substantially the same proportions as their ownership immediately prior to such Business Combination of the Outstanding Company Common Stock and the Outstanding Company Voting Securities, as the

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case may be, (2) no Person (excluding any entity resulting from such Business Combination or a Parent or any employee benefit plan (or related trust) of the Corporation or such entity resulting from such Business Combination or Parent) beneficially owns, directly or indirectly, 25% or more of, respectively, the then-outstanding shares of common stock of the entity resulting from such Business Combination or the combined voting power of the then-outstanding voting securities of such entity, except to the extent that the ownership in excess of 25% existed prior to the Business Combination, and (3) at least a majority of the members of the board of directors or trustees of the entity resulting from such Business Combination or a Parent were members of the Incumbent Board at the time of the execution of the initial agreement or of the action of the Board providing for such Business Combination; or

- (d) Approval by the stockholders of the Corporation of a complete liquidation or dissolution of the Corporation other than in the context of a transaction that does not constitute a Change in Control Event under clause (c) above.

7.4 *Early Termination of Awards.* Any award that has been accelerated as required or contemplated by Section 7.2 or 7.3 (or would have been so accelerated but for Section 7.5, 7.6 or 7.7) shall terminate upon the related event referred to in Section 7.2 or 7.3, as applicable, subject to any provision that has been expressly made by the Administrator, through a plan of reorganization or otherwise, for the survival, substitution, assumption, exchange or other continuation or settlement of such award and provided that, in the case of options and SARs that will not survive, be substituted for, assumed, exchanged, or otherwise continued or settled in the transaction, the holder of such award shall be given reasonable advance notice of the impending termination and a reasonable opportunity to exercise his or her outstanding options and SARs in accordance with their terms before the termination of such awards (except that in no case shall more than ten days' notice of accelerated vesting and the impending termination be required and any acceleration may be made contingent upon the actual occurrence of the event).

7.5 *Other Acceleration Rules.* Any acceleration of awards pursuant to this Section 7 shall comply with applicable legal requirements and, if necessary to accomplish the purposes of the acceleration or if the circumstances require, may be deemed by the Administrator to occur a limited period of time not greater than 30 days before the event. Without limiting the generality of the foregoing, the Administrator may deem an acceleration to occur immediately prior to the applicable event and/or reinstate the original terms of an award if an event giving rise to an acceleration does not occur. The Administrator may override the provisions of Section 7.2, 7.3, 7.4 and/or 7.6 by express provision in the award agreement and may accord any Eligible Person a right to refuse any acceleration, whether pursuant to the award agreement or otherwise, in such circumstances as the Administrator may approve. The portion of any ISO accelerated in connection with a Change in Control Event or any other action permitted hereunder shall remain exercisable as an ISO only to the extent the applicable \$100,000 limitation on ISOs is not exceeded. To the extent exceeded, the accelerated portion of the option shall be exercisable as a nonqualified stock option under the Code.

7.6 *Possible Rescission of Acceleration.* If the vesting of an award has been accelerated expressly in anticipation of an event or upon stockholder approval of an event and the Administrator later determines that the event will not occur, the Administrator may rescind the effect of the acceleration as to any then outstanding and unexercised or otherwise unvested awards.

7.7 *Golden Parachute Limitation.* Notwithstanding anything else contained in this Section 7 to the contrary, in no event shall an award be accelerated under this Plan to an extent or in a manner which would not be fully deductible by the Corporation or one of its Subsidiaries or Affiliates for federal income tax purposes because of Section 280G of the Code, nor shall any payment hereunder be accelerated to the extent any portion of such accelerated payment would not be deductible by the

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Corporation or one of its Subsidiaries or Affiliates because of Section 280G of the Code. If a participant would be entitled to benefits or payments hereunder and under any other plan or program that would constitute parachute payments as defined in Section 280G of the Code, then the participant may by written notice to the Corporation designate the order in which such parachute payments will be reduced or modified so that the Corporation or one of its Subsidiaries or Affiliates is not denied federal income tax deductions for any parachute payments because of Section 280G of the Code. Notwithstanding the foregoing, if a participant is a party to an employment or other agreement with the Corporation or one of its Subsidiaries or Affiliates, or is a participant in a severance program sponsored by the Corporation or one of its Subsidiaries or Affiliates, that contains express provisions regarding Section 280G and/or Section 4999 of the Code (or any similar successor provision), the Section 280G and/or Section 4999 provisions of such employment or other agreement or plan, as applicable, shall control as to any awards held by that participant (for example, and without limitation, a participant may be a party to an employment agreement with the Corporation or one of its Subsidiaries or Affiliates that provides for a gross-up as opposed to a cut-back in the event that the Section 280G thresholds are reached or exceeded in connection with a change in control and, in such event, the Section 280G and/or Section 4999 provisions of such employment agreement shall control as to any awards held by that participant).

- 7.8 Section 162(m) Limitations.** To the extent limited by Section 162(m) of the Code in the case of an award intended as performance-based compensation thereunder and necessary to assure the deductibility of the compensation payable under the award, the Administrator shall have no discretion under this Plan (a) to increase the amount of compensation or the number of shares that would otherwise be due upon the attainment of the applicable performance target or the exercise of the option or SAR, or (b) to waive the achievement of any applicable performance goal as a condition to receiving a benefit or right under the award.

8. OTHER PROVISIONS

- 8.1 Compliance with Laws.** This Plan, the granting and vesting of awards under this Plan, the offer, issuance and delivery of shares of Common Stock, the acceptance of promissory notes and/or the payment of money under this Plan or under awards are subject to compliance with all applicable federal and state laws, rules and regulations (including but not limited to state and federal securities law, federal margin requirements) and to such approvals by any listing, regulatory or governmental authority as may, in the opinion of counsel for the Corporation or one of its Subsidiaries or Affiliates, be necessary or advisable in connection therewith. The person acquiring any securities under this Plan will, if requested by the Corporation or one of its Subsidiaries or Affiliates, provide such assurances and representations to the Corporation or one of its Subsidiaries or Affiliates as the Administrator may deem necessary or desirable to assure compliance with all applicable legal and accounting requirements.
- 8.2 Employment Status.** No person shall have any claim or rights to be granted an award (or additional awards, as the case may be) under this Plan, subject to any express contractual rights (set forth in a document other than this Plan) to the contrary.
- 8.3 No Employment/Service Contract.** Nothing contained in this Plan (or in any other documents under this Plan or in any award) shall confer upon any Eligible Person or other participant any right to continue in the employ or other service of the Corporation or one of its Subsidiaries or Affiliates, constitute any contract or agreement of employment or other service or affect an employee's status as an employee at will, nor shall interfere in any way with the right of the Corporation or one of its Subsidiaries or Affiliates to change a person's compensation or other benefits, or to terminate his or her employment or other service, with or without cause. Nothing in this Section 8.3, however, is intended to adversely affect any express independent right of such person under a separate employment or service contract other than an award agreement.

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8.4 Plan Not Funded. Awards payable under this Plan shall be payable in shares or from the general assets of the Corporation, and no special or separate reserve, fund or deposit shall be made to assure payment of such awards. No participant, beneficiary or other person shall have any right, title or interest in any fund or in any specific asset (including shares of Common Stock, except as expressly otherwise provided) of the Corporation by reason of any award hereunder. Neither the provisions of this Plan (or of any related documents), nor the creation or adoption of this Plan, nor any action taken pursuant to the provisions of this Plan shall create, or be construed to create, a trust of any kind or a fiduciary relationship between the Corporation or one of its Subsidiaries or Affiliates and any participant, beneficiary or other person. To the extent that a participant, beneficiary or other person acquires a right to receive payment pursuant to any award hereunder, such right shall be no greater than the right of any unsecured general creditor of the Corporation.

8.5 Tax Withholding. Upon any exercise, vesting, or payment of any award or upon the disposition of shares of Common Stock acquired pursuant to the exercise of an ISO prior to satisfaction of the holding period requirements of Section 422 of the Code, the Corporation or one of its Subsidiaries or Affiliates shall have the right at its option to:

- (a) require the participant (or the participant's personal representative or beneficiary, as the case may be) to pay or provide for payment of at least the minimum amount of any taxes which the Corporation or one of its Subsidiaries or Affiliates may be required to withhold with respect to such award event or payment; or
- (b) deduct from any amount otherwise payable in cash to the participant (or the participant's personal representative or beneficiary, as the case may be) the minimum amount of any taxes which the Corporation or one of its Subsidiaries or Affiliates may be required to withhold with respect to such cash payment.

In any case where a tax is required to be withheld in connection with the delivery of shares of Common Stock under this Plan, the Administrator may in its sole discretion (subject to Section 8.1) grant (either at the time of the award or thereafter) to the participant the right to elect, pursuant to such rules and subject to such conditions as the Administrator may establish, to have the Corporation reduce the number of shares to be delivered by (or otherwise reacquire) the appropriate number of shares, valued in a consistent manner at their fair market value or at the sales price in accordance with authorized procedures for cashless exercises, necessary to satisfy the minimum applicable withholding obligation on exercise, vesting or payment. In no event shall the shares withheld exceed the minimum whole number of shares required for tax withholding under applicable law. The Corporation may, with the Administrator's approval, accept one or more promissory notes from any Eligible Person in connection with taxes required to be withheld upon the exercise, vesting or payment of any award under this Plan; provided that any such note shall be subject to terms and conditions established by the Administrator and the requirements of applicable law.

8.6 Effective Date, Termination and Suspension, Amendments.

8.6.1 Effective Date. This Plan is effective as of March 5, 2004, the date of its approval by the Board (the **Effective Date**). This Plan shall be submitted for and subject to stockholder approval no later than twelve months after the Effective Date. Unless earlier terminated by the Board, this Plan shall terminate at the close of business on the day before the tenth anniversary of the Effective Date. After the termination of this Plan either upon such stated expiration date or its earlier termination by the Board, no additional awards may be granted under this Plan, but previously granted awards (and the authority of the Administrator with respect thereto, including the authority to amend such awards) shall

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remain outstanding in accordance with their applicable terms and conditions and the terms and conditions of this Plan.

8.6.2 Board Authorization. The Board may, at any time, terminate or, from time to time, amend, modify or suspend this Plan, in whole or in part. No awards may be granted during any period that the Board suspends this Plan.

8.6.3 Stockholder Approval. To the extent then required by applicable law or any applicable listing agency or required under Sections 162, 422 or 424 of the Code to preserve the intended tax consequences of this Plan, or deemed necessary or advisable by the Board, any amendment to this Plan shall be subject to stockholder approval.

8.6.4 Amendments to Awards. Without limiting any other express authority of the Administrator under (but subject to) the express limits of this Plan, the Administrator by agreement or resolution may waive conditions of or limitations on awards to participants that the Administrator in the prior exercise of its discretion has imposed, without the consent of a participant, and (subject to the requirements of Sections 3.2 and 8.6.5) may make other changes to the terms and conditions of awards. Any amendment or other action that would constitute a repricing of an award is subject to the limitations set forth in Section 3.2(g).

8.6.5 Limitations on Amendments to Plan and Awards. No amendment, suspension or termination of this Plan or change of or affecting any outstanding award shall, without written consent of the participant, affect in any manner materially adverse to the participant any rights or benefits of the participant or obligations of the Corporation under any award granted under this Plan prior to the effective date of such change. Changes, settlements and other actions contemplated by Section 7 shall not be deemed to constitute changes or amendments for purposes of this Section 8.6.

8.7 Privileges of Stock Ownership. Except as otherwise expressly authorized by the Administrator or this Plan, a participant shall not be entitled to any privilege of stock ownership as to any shares of Common Stock not actually delivered to and held of record by the participant. No adjustment will be made for dividends or other rights as a stockholder for which a record date is prior to such date of delivery.

8.8 Governing Law; Construction; Severability.

8.8.1 Choice of Law. This Plan, the awards, all documents evidencing awards and all other related documents shall be governed by, and construed in accordance with the laws of the State of Maryland.

8.8.2 Severability. If a court of competent jurisdiction holds any provision invalid and unenforceable, the remaining provisions of this Plan shall continue in effect.

8.8.3 Plan Construction.

(a)

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Rule 16b-3. It is the intent of the Corporation that the awards and transactions permitted by awards be interpreted in a manner that, in the case of participants who are or may be subject to Section 16 of the Exchange Act, qualify, to the maximum extent compatible with the express terms of the award, for exemption from matching liability under Rule 16b-3 promulgated under the Exchange Act. Notwithstanding the foregoing, the Corporation shall have no liability to any participant for Section 16 consequences of awards or events under awards if an award or event does not so qualify.

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- (b) **Section 162(m).** Awards under Section 5.1.4 to persons described in Section 5.2 that are either granted or become vested, exercisable or payable based on attainment of one or more performance goals related to the Business Criteria, as well as Qualifying Options and Qualifying SARs granted to persons described in Section 5.2, that are approved by a committee composed solely of two or more outside directors (as this requirement is applied under Section 162(m) of the Code) shall be deemed to be intended as performance-based compensation within the meaning of Section 162(m) of the Code unless such committee provides otherwise at the time of grant of the award. It is the further intent of the Corporation that (to the extent the Corporation or one of its Subsidiaries or awards under this Plan may be or become subject to limitations on deductibility under Section 162(m) of the Code) any such awards and any other Performance-Based Awards under Section 5.2 that are granted to or held by a person subject to Section 162(m) will qualify as performance-based compensation or otherwise be exempt from deductibility limitations under Section 162(m).

8.9 Captions. Captions and headings are given to the sections and subsections of this Plan solely as a convenience to facilitate reference. Such headings shall not be deemed in any way material or relevant to the construction or interpretation of this Plan or any provision thereof.

8.10 Stock-Based Awards in Substitution for Stock Options or Awards Granted by Other Corporation. Awards may be granted to Eligible Persons in substitution for or in connection with an assumption of employee stock options, SARs, restricted stock or other stock-based awards granted by other entities to persons who are or who will become Eligible Persons in respect of the Corporation or one of its Subsidiaries or Affiliates, in connection with a distribution, merger or other reorganization by or with the granting entity or an affiliated entity, or the acquisition by the Corporation or one of its Subsidiaries or Affiliates, directly or indirectly, of all or a substantial part of the stock or assets of the employing entity. The awards so granted need not comply with other specific terms of this Plan, provided the awards reflect only adjustments giving effect to the assumption or substitution consistent with the conversion applicable to the Common Stock in the transaction and any change in the issuer of the security. Any shares that are delivered and any awards that are granted by, or become obligations of, the Corporation, as a result of the assumption by the Corporation of, or in substitution for, outstanding awards previously granted by an acquired company (or previously granted by a predecessor employer (or direct or indirect parent thereof) in the case of persons that become employed by the Corporation or one of its Subsidiaries or Affiliates in connection with a business or asset acquisition or similar transaction) shall not be counted against the Share Limit or other limits on the number of shares available for issuance under this Plan.

8.11 Non-Exclusivity of Plan. Nothing in this Plan shall limit or be deemed to limit the authority of the Board or the Administrator to grant awards or authorize any other compensation, with or without reference to the Common Stock, under any other plan or authority.

8.12 No Corporate Action Restriction. The existence of this Plan, the award agreements and the awards granted hereunder shall not limit, affect or restrict in any way the right or power of the Board or the stockholders of the Corporation to make or authorize: (a) any adjustment, recapitalization, reorganization or other change in the capital structure or business of the Corporation or any subsidiary or affiliate, (b) any merger, amalgamation, consolidation or change in the ownership of the Corporation or any subsidiary or affiliate, (c) any issue of bonds, debentures, capital, preferred or prior preference stock ahead of or affecting the capital stock (or the rights thereof) of the Corporation or any subsidiary or affiliate, (d) any dissolution or liquidation of the Corporation or any subsidiary or affiliate, (e) any sale or transfer of all or any part of the assets or business of the Corporation or any subsidiary or affiliate, or (f) any other corporate act or proceeding by the Corporation or any subsidiary or affiliate. No participant, beneficiary or any other person shall have any claim under any award or award agreement against any member of the Board or the Administrator, or the Corporation or any

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employees, officers or agents of the Corporation or any subsidiary or affiliate, as a result of any such action.

8.13 Other Company Benefit and Compensation Programs. Payments and other benefits received by a participant under an award made pursuant to this Plan shall not be deemed a part of a participant's compensation for purposes of the determination of benefits under any other employee welfare or benefit plans or arrangements, if any, provided by the Corporation or one of its Subsidiaries or Affiliates, except where the Administrator expressly otherwise provides or authorizes in writing. Awards under this Plan may be made in addition to, in combination with, as alternatives to or in payment of grants, awards or commitments under any other plans or arrangements of the Corporation or one of its Subsidiaries or Affiliates.

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APPENDIX A

BUSINESS CRITERIA

The Business Criteria referred to in Section 5.2.2 of the Plan shall mean any one or a combination of the following terms. These terms are used as applied under generally accepted accounting principles or in the Corporation's financial reporting. The Business Criteria applicable to an award may be established with respect to the Corporation (on either a stand alone or consolidated basis) or any applicable Subsidiary, division, segment, or unit.

Before-Tax Net Income. Before-Tax Net Income means net income from operations before reduction for income taxes with the following adjustments: (a) benefits payable under the company's employee incentive compensation plans for the applicable performance period to employees of that entity (other than employees who participate in this Plan for that performance period) shall be deducted, but any cash benefits payable under this Plan shall not be deducted unless otherwise expressly provided by the Administrator at the time of grant of the Award; (b) any income or loss derived from discontinued operations shall be excluded (unless the Administrator expressly provides in the applicable award agreement that such income or loss shall not be excluded with respect to the related award); and (c) any income or loss derived from new or acquired operations shall be excluded (unless the Administrator expressly provides in the applicable award agreement that such income or loss shall not be excluded with respect to the related award).

Cash Flow. Cash Flow means cash and cash equivalents derived from either: (a) net cash flow from operations, or (b) net cash flow from operations, financings and investing activities, as determined by the Administrator at the time of grant and set forth in the applicable award agreement.

Corporate Overhead Costs. Corporate Overhead Costs means an entity's allocable share of the company's corporate overhead shared services including human resources, accounting, legal, information technology and compliance services.

Delinquency Rates. Delinquency Rates means the percentage of borrowers whose loans are serviced by the company who have not made a payment on or before its due date.

Earnings Per Share. Earnings Per Share means earnings per share of Common Stock on a fully diluted basis (giving effect to the dilutive effects of stock options, restricted stock, and other dilutive instruments) determined by dividing: (a) net earnings, by (b) the weighted average number of common shares and common share equivalents outstanding.

Economic Profit. Economic Profit means the company's net operating profit after tax less a capital charge. The capital charge is calculated by multiplying the company's operating capital by the company's weighted average cost of capital.

Employees. Employees means the entity's aggregate number of employees, or the number performing a specific function (such as loan officers, account executives, telemarketers, etc.).

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Gain on Sale of Loans. Gain on Sale of Loans means the total gain recognized on loans sold through whole loan transactions or through securitizations, net of premiums paid to acquire such loans and net of expenses associated with the sale of such loans.

Liquidity Management. Liquidity Management means the company's cash and borrowing capacity under its credit commitments.

Loan Losses. Loan Losses means sales of loans for less than the loan amount or sales of REOs for less than the loan amount at the time of foreclosure plus expenses and other advances in maintaining and selling the REO.

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Loan Production Volume. Loan Production Volume means the aggregate volume of loans funded during any given period or the volume of a type or category of loans funded during any given period, as specified by the Administrator in the award agreement.

Loan Quality. Loan Quality means a mathematical score based on the number of loans originated in accordance with the company's underwriting policies and procedures, loans sold, either individually, through bulk sales transactions, or through securitizations, at a premium price as a percentage of total loans sold, and various other measures.

Operating Margin. Operating Margin means, on a percentage basis, the net execution of all whole loan sales during the performance period, plus net interest earned on unsold inventory, less loan acquisition costs.

Origination Expenses. Origination Expenses means the aggregate points and fees paid to mortgage brokers or correspondents, commission expenses and other direct origination-related expenses paid by an entity in connection with loan originations over a specified period.

Origination Revenues. Origination Revenues means the aggregate points and fees and other revenues received by an Entity from borrowers in connection with loan originations over a specified period.

Residual Performance. Residual Performance means the performance of residual interests in the company's loan securitization transactions as compared with the projected performance used by the company in recording the book value of the residual interests.

Return on Assets. Return on Assets means the company's consolidated net income (less any preferred dividends), divided by the company's average assets.

Return on Capital Invested. Return on Capital Invested means the company's consolidated net income (less any preferred dividends), divided by the company's invested capital.

Return on Equity. Return on Equity means consolidated net income of the company (less any preferred dividends), divided by the average consolidated common stockholders equity.

Return on Sales/Revenue. Return on Sales/Revenue means the company's consolidated net income (less any preferred dividends), divided by the company's total sales or revenue, as applicable.

Stock Price. Stock Price means the stock price or market value of the Common Stock of the Corporation.

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Total Stockholders Equity. Total Stockholders Equity means the company's total stockholders equity as shown on the company's audited financial statements as of the first day of a performance period, increased for equity issued during the performance period and decreased for equity reacquired during the performance period in the manner described in the next two sentences. The amount of any such increase shall be equal to the amount of equity issues during the performance period multiplied by a fraction, the numerator of which is the number of days remaining in the performance period and the denominator of which is the total number of days is 365. The amount of any such decrease shall be equal to the amount of equity reacquired by the company during the performance period multiplied by a fraction, the numerator of which is the number of days remaining in the performance period and the denominator of which is the total number of days is 365.

Total Stockholder Return. Total Stockholder Return means, with respect to the Corporation or other entities (if measured on a relative basis): (a) the change in the market price of its common stock (as quoted on the principal market on which it is traded as of the beginning and ending of the period) plus dividends and other distributions paid, divided by (b) the beginning quoted market price for the common stock, all of which is adjusted for any changes in equity structure, including but not limited to stock splits and stock dividends.

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