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IRS Issues Additional Guidance on Valuation of Stock Options Under the New Proposed Regulations on Golden Parachute Payments

Overview

Since the release of our recent alert letter[1] describing the amendments and clarifications to the new proposed regulations on golden parachute payments, the Internal Revenue Service ("IRS") has provided additional guidance on the valuation of stock options under Sections 280G and 4999 of the Internal Revenue Code (IRC). On June 13, 2002, the IRS released an advance copy of Revenue Procedure 2002-45[2], that clarifies that a stock option will not be considered properly valued if the option is valued solely using the intrinsic value (i.e., the spread between the exercise price and the value of the stock, not less than zero) at the time of a "change in control" (CIC). A stock option will now be considered properly valued if the value is determined in accordance with generally accepted accounting principles (such as FAS 123[3]).

> ***For purposes of IRC Sections 280G and 4999, stock options will no longer be considered properly valued if the option is valued solely using the option's spread at the time of the CIC. As of April 26, 2002, stock option values now must be based on the fair value of the option calculated using a Black-Scholes or similar option pricing model. This additional guidance has significant implications for the design of stock option provisions in the event of a CIC.***

This revenue procedure also modifies portions of Rev. Proc. 2002-13[4] that was released earlier this year in conjunction with the newly proposed regulations that apply to golden parachute payments. Unlike the other amendments and clarifications issued with the new proposed regulations, we believe this additional guidance has significant implications for the design of stock option provisions in the event of a CIC. Rev. Proc. 2002-45 is effective June 13, 2002 and the stock option valuation rules in this procedure apply on or after April 26, 2002.

Background

Under IRC Section 280G, if a corporation undergoes a CIC, no tax deduction is allowed to the corporation for an "excess parachute payment" paid to a "disqualified individual". In addition, under IRC Section 4999, a "disqualified individual" is subject to a 20% nondeductible excise tax on all excess parachute payments received by such individual. Under the so-called golden parachute rules, compensatory payments that may be treated as parachute payments include a

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1 IRS Issues Long-Awaited Proposed Regulations on Golden Parachute Payments, April 8, 2002.

2 Rev. Proc. 2002-45, will appear in Internal Revenue Bulletin 2002-27 dated July 8, 2002.

3 In FAS 123, the Financial Accounting Standards Board established financial accounting and reporting standards for stock-based employee compensation plans.

4 Rev. Proc. 2002-13, 2002-8 IRB 549 was effective April 26, 2002.

transfer of property as well as cash, the right to receive cash and other payments (such as health and welfare benefits) arising out of an employment relationship. Under Q&A-13 of the new proposed regulations, both nonstatutory stock options (NQSOs) and statutory stock options (ISOs for which Section 421 applies), which vest at a CIC, are treated as property transferred and their payment amounts must be included as a parachute payment at the time at which the options become "substantially vested". Q&A-24(c) of the 1989 proposed regulations provides a special rule for compensation that normally vests based upon continued service, but is accelerated upon a change in control. Under this rule, the parachute payment amount can be limited to a value based on the sum of (i) the amount by which the accelerated payment exceeds the present value of the payment based on its normal (i.e., absent a CIC) vesting or payment schedule plus (ii) an additional amount reflecting the lapse of the obligation to perform future employment services (calculated as 1% of the accelerated payment for each full month of services no longer required to be performed).

However, previous guidance had not been clear on how options should be valued for purposes of determining the accelerated payment amount under Q&A-24(c). Based upon the 1989 proposed regulations, practitioners have interpreted the valuation methodologies to include intrinsic value (i.e., spread method), or a Black-Scholes or similar (e.g. binomial) value, which in most cases results in a significantly higher value than the option spread. As such, practitioners have invariably used the spread method to value options. In Rev. Proc. 2002-13, the IRS provided a safe harbor valuation approach based on a modified Black-Scholes option pricing model as an alternative to the spread method. With the issuance of Rev. Proc. 2002-45, the IRS has now clarified that options must be valued for parachute tax purposes using a Black-Scholes or a similar option pricing model, such as the binomial model, and that the spread method is no longer considered appropriate.

Summary of Rev. Proc. 2002-45

A summary outline of the clarifications and modifications under this revenue procedure follows:

- Valuation of Stock Options

  — Rev. Proc. 2002-45 clarifies that a stock option will not be considered properly valued if the option is valued solely using the option's intrinsic value (i.e., the spread between the exercise price and the value of the stock, but not less than zero) at the time of the change in control

  — In general, a stock option will be considered properly valued if the value is based on any valuation method that is consistent with generally accepted accounting principles and takes into account the factors provided in Q&A-13 of both the new and old (i.e., 1989) proposed golden parachute regulations

    ⇒ These factors include but are not limited to: the option spread; the fair market value of the underlying stock (i.e., the stock price) at the time of vesting; the probability of the value of the underlying stock increasing or decreasing; and the length of period during which the option can be exercised (i.e., the term of the option)

⇒ Such factors are the typical inputs for Black-Scholes-based option pricing models used to calculate an option's fair value under generally accepted accounting principles (such as FAS 123)

— As a simplifying alternative in Rev. Proc. 2002-13, the IRS included a safe harbor approach to value stock options modeled after the Black-Scholes option pricing model

⇒ The safe harbor valuation table provided in the Appendix of Rev. Proc. 2002-45 (see **Exhibit I**) supercedes the table provided in Rev. Proc. 2002-13

⇒ Note that unlike traditional Black-Scholes option pricing models, expected dividends on the underlying stock and the risk-free interest rate over the option term are not used as specific valuation factors in the safe harbor table, but the IRS has indicated that these factors are "included in the table"

⇒ The new table has been modified to include an additional column for use when the remaining term of the option is 3 months (if the remaining term is less than 12 months, taxpayers may round down to the 3-month interval)

- Please refer to **Attachment A** for detail on the proper valuation methodologies for stock options for publicly traded stock and stock options for stock that is not publicly traded

Comments Requested

Comments are requested by the IRS regarding the methods described in Rev. Proc. 2002-45 as well as Rev. Proc. 2002-13. Comments must be received by August 12, 2002.

Discussion of Rev. Proc. 2002-45

With the issuance of new guidance stipulating the use of a Black-Scholes method to value stock options that vest upon a change in control, the IRS has radically changed the required approach. In most cases, the use of a Black-Scholes valuation method relative to the spread method would result in unfavorable additional tax liabilities for excess parachute payments. This result occurs because the Black-Scholes value reflects an option's intrinsic value (i.e., spread) at a minimum plus any remaining time value (i.e., the value for future stock price increases) that the option may have. From a theoretical point of view, given that a Black-Scholes-based option value already reflects an option's time value, the application of the special valuation rules of Q&A-24(c) to incorporate a calculation of the option's present value would seem to result in a "double counting" of the option's time value and thereby overstate the value of the option. Typically, the Black-Scholes value of options significantly exceeds the intrinsic value of options. For example, the illustration in **Exhibit II** shows that the Black-Scholes safe harbor value is approximately three times greater than the intrinsic value using the spread method. As such, the optionee in this example will be subject to substantial parachute penalties if the payments are considered to be excess parachute payments. Moreover, if the company in this case agreed to protect the optionee from the excise tax penalty through a tax gross-up, the cost to the company

will be significant since the gross-up payment itself is subject to additional excise and income taxes.

In general, option values calculated under the Black-Scholes method relative to the spread method increase the higher the volatility, the longer the remaining option term and the smaller the option spread. Furthermore, options that are underwater (up to a spread factor of –60%) on the date of a CIC have a positive value if the Black-Scholes method is employed. This could potentially result in a tax payment for an option that may never have value to an employee. In many cases, taxpayers may be able to support lower valuations using their own Black-Scholes calculation based on their company's FAS 123 assumptions rather than using the safe harbor value. This is mainly due to the fact that the expected life of the option for FAS 123 assumptions is generally less than the maximum option term that must be used to calculate the safe harbor value. Last, since the new guidance does not contain a consistency rule, it appears that taxpayers will be permitted to "cherry pick" among the allowable Black-Scholes methods in order to minimize individual option values.

The table below shows an illustration of the differences in option value produced by the intrinsic value under the previous spread method approach, the safe harbor method under the new guidance and a Black-Scholes value using FAS 123 assumptions. The illustration shows the safe harbor value is approximately 3.4 times greater than the intrinsic value and approximately 1.5 times greater than the Black-Scholes value using typical FAS 123 assumptions, including an expected term versus the actual remaining term. Note, that once the value of the stock option is determined, the parachute payment amount is calculated based on the present value of the accelerated benefit and the lapse in service obligation amounts using the special valuation rules under Q&A-24(c).

	Intrinsic Value	**Safe Harbor Value**	**Black-Scholes Value Under FAS 123**
Stock Price at CIC	$12	$12	$12
Exercise Price	$10	$10	$10
Spread/Factor	$2/option	20% Factor ($12/$10-1)	-
Volatility	-	30.1% (Medium)	30.1%
Remaining Term (Years)	-	7	5
Dividend Yield	-	-	1.00%
Risk-Free Interest Rate	-	-	4.75%
Value Per Option	$2.00	$6.78 (56.5% x $12)	$4.65
Number of Options	10,000	10,000	10,000
Total Option Value	$20,000	$67,800	$46,500

Planning Implications

As a result of this new guidance, companies should assess the likely consequences and potential impact of their current CIC provisions on stock options. Companies, especially those with tax gross-up provisions, should evaluate the cost of potential tax liabilities in terms of a possible loss of corporate tax deductions, increase in tax gross-up payments and parachute excise taxes paid by its executives. Unfortunately, the alternative option design strategies to mitigate the adverse consequences under the new guidance inevitably involve a trade-off between accounting cost, corporate governance principles, retention considerations and post-CIC protection of executives. In addition, some strategies should be implemented as soon as possible because, in many cases, the changes can only apply to new, rather than outstanding, stock option grants. In any event, companies must carefully weigh these trade-offs in relation to their own particular situation in order to make an appropriate response.

The following outlines some of the possible strategies to address the new guidance and identifies the relevant attributes of each in terms of the trade-offs discussed above.

- Automatic Cash Out of Option Gains at CIC

  — Unvested options that become vested and are exercised at a CIC would generally not be subjected to Black-Scholes valuation under either Rev. Proc. 2002-13 or Rev. Proc. 2002-45

    ⇒ Unvested options that become vested at a CIC and are converted into options of the acquiring company's stock are generally subject to the new Black-Scholes valuation rules

    ⇒ This would effectively establish the intrinsic value (i.e., option spread) as the parachute payment amount rather than the potentially larger Black-Scholes value

    ⇒ As such, options cashed out at their intrinsic value would generally be valued in the same manner as under the old spread method and be subjected to the special valuation rules of Q&A-24(c)

  — Note that implementation of this feature results in the option being accounted for as a limited SAR (i.e., an option with a contingently exercisable stock appreciation right feature)

    ⇒ This approach should not result in any adverse accounting consequences (i.e., variable plan accounting) until a cash settlement is considered likely to occur

    ⇒ Any expense that occurs due to a cash settlement would be recognized on the target company's books and should have no direct post-merger expense implications

⇒ But, the successor company would lose the potential retention of any option awards that would be converted at the CIC

- Double Trigger Vesting of Options Upon a CIC

  — Unvested options at a CIC become vested only on the occurrence of a CIC and a subsequent involuntary termination

    ⇒ Unvested options become subject to the new Black-Scholes valuation rules only if the executive is involuntarily terminated post-CIC

    ⇒ Although this approach does not totally eliminate the potential of a excess parachute payment penalty, the size of the parachute payment is reduced to the extent that executive is not terminated involuntarily or vesting is further delayed (i.e., the longer vesting is delayed the smaller the Black-Scholes value will be)

  — Note that while implementation of this feature to outstanding awards would not result in adverse accounting treatment, it may be difficult to implement a feature that is viewed as a take-away if the current provision is single trigger vesting

- Grant Options with Shorter Vesting Schedules

  — This effectively reduces the number of options that will be unvested at a CIC subject to the new Black-Scholes valuation rules

    ⇒ This also decreases the Black-Scholes value of any unvested options with shorter vesting schedules relative to those with longer vesting schedules since the portion of the option's value that is considered a parachute payment depends on the amount of time that the vesting is accelerated under the special valuation rules of Q&A-24(c)

  — Also, consider options with monthly, rather than yearly, vesting schedules to avoid a situation in which a large number of options are close to being vested at any point in time

- Grant Options With No Accelerated Vesting Provision at CIC

  — Grant options without an accelerated vesting provision so long as the options are assumed or converted upon a CIC

    ⇒ If options are not assumed/converted, then accelerate vesting

  — This eliminates any unvested options from being considered as parachute payments so long as assumed or converted upon a CIC

— This does however result in a loss of protection for the acquired company's executives due to the potential they may be terminated post-CIC and the exercise period of their converted options is truncated

⇒ This may be appropriate in a situation where the acquired company's executives are critical to the company's ongoing success and the likelihood they may be terminated is small

- Prospectively Add a Reload Feature to Options

— Early exercise of stock options decreases the extent of the parachute payments in the event of a change in control of the Company

⇒ Early exercise increases an individual's W-2 income to effectively increase the average W-2 base amount used to determine the Section 280G limit (i.e., three times the individual's base amount)

— Note, adding a reload feature to outstanding option awards retrospectively results in variable accounting treatment (i.e., mark-to-market accounting) until the award is exercised, assuming the reload stock option does not itself have a reload feature

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Specific questions concerning this topic should be addressed to appropriate tax counsel. General questions may be addressed to Robert Timmerman in our New York office at (212) 986-6330. Copies of this letter and other published material are available on our website at www.fwcook.com.

Attachment A

Outline of Stock Option Valuation Methodology Under Revenue Procedure 2002-45

The following provides detail on the proper valuation methodology for stock options under Rev. Proc. 2002-45:

- Rev. Proc. 2002-45 provides guidance on the proper valuation of stock options for publicly traded stock and stock options for stock that is not publicly traded

- For purposes of Sections 280G and 4999, a stock option will not be considered properly valued if the option is valued solely using the option's intrinsic value (i.e., the spread between the exercise price and the value of the stock, but not less than zero) at the time of the change in control, or without regard to the factors provided in Q&A-13 of both the new and proposed section 280G regulations

- Stock Options For Publicly Traded Stock:

  — A stock option for stock that is publicly traded (i.e., an option that is a Compensatory Stock Option as defined in Rev. Proc. 98-34[5]) is considered properly valued for purposes of Sections 280G and 4999 if the value is determined using:

    ⇒ The safe harbor valuation table provided in the Appendix of Rev. Proc. 2002-45 (see **Exhibit I**)

      ➢ Note the table provided in the Appendix of Rev. Proc. 2002-45 supercedes the table provided in Rev. Proc. 2002-13. The new table has been modified to include an additional column for use when the remaining term of the option is 3 months (if the remaining term is less than 12 months, taxpayers may round down to the 3-month interval)

      ➢ The valuation table is based on the following factors[6]: (1) the volatility of the underlying stock; (2) the option spread at the valuation date and; (3) the option's remaining term

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[5] Rev. Proc. 2002-13 extended the valuation rules contained in Rev. Proc. 98-34, 1998-1 CB 983, to values calculated for purposes of Sections 280G and 4999. In Rev. Proc. 98-34, the IRS provided a methodology for valuing certain nonpublicly traded compensatory stock options on stock that, on the valuation date is publicly traded on an established securities market, for purposes of gift, estate, and generation-skipping transfer tax purposes. Under Rev. Proc. 98-34, the value of compensatory stock options is based on a generally recognized option pricing model (for example, the Black-Scholes model or an accepted version of the binomial model) that takes into account as of the valuation date the following factors: (1) the exercise price of the option; (2) the expected life of the option; (3) the current trading price of the underlying stock; (4) the expected volatility of the underlying stock; (5) the expected dividends on the underlying stock and; (6) the risk-free interest rate over the remaining option term.

[6] Note that unlike traditional Black-Scholes option pricing models, expected dividends on the underlying stock and the risk-free interest rate over the option term are not used as specific valuation factors under this

→ The volatility factor is determined using three volatility rankings[7] (i.e., low, medium and high) and is based on the volatility of the underlying stock used for purposes of FAS 123 and disclosed in the most recent financial statement of the corporation

→ The option spread at the valuation date is calculated as a percentage of the stock's exercise price on the date of valuation (equal to the stock's FMV at CIC divided by the exercise price and subtracting 1) to determine a "spread factor" of between –60% and 220% (the resulting percentage may be rounded to the next lowest interval, but if the factor exceeds 220%, the safe harbor valuation method can not be used to value the stock option)

→ The remaining term of the option is based on the <u>maximum</u> remaining term of the option (in general, the number of full months may be rounded down to the next lowest 12-month interval)

⇒ The value determined in accordance with Rev. Proc. 98-34

⇒ A method that is consistent with generally accepted accounting principles (such as FAS 123[8]) and takes into account the factors provided in Q&A-13 of the proposed golden parachute regulations

- <u>Stock Options For Stock That Is Not Publicly Traded</u>:

— A stock option for stock that is not publicly traded (i.e., an option that is not a Compensatory Stock Option as defined in Rev. Proc. 98-34) is considered properly valued for purposes of Sections 280G and 4999 if the value is determined using any valuation that:

⇒ Is consistent with generally accepted accounting principles (such as FAS 123), <u>and</u>

⇒ Takes into account the factors provided in Q&A-13 of the proposed golden parachute regulations

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method. However, Section 4.01 of Rev. Proc. 2002-13 indicates that these factors are "included in the table".

7 "Low" volatility covers a stock with an annual standard deviation of 30% or less, "medium" volatility covers a stock with an annual standard deviation of between 30% to 70% and "high" volatility covers a stock with an annual standard deviation of 70% or more.

8 In FAS 123, the Financial Accounting Standards Board established financial accounting and reporting standards for stock-based employee compensation plans. The stock option valuation factors used in Rev. Proc. 98-34 outlined above (see *footnote 5*) are similar to those used in FAS 123.

⇒ Note, the safe harbor valuation method provided in Section 4 of Rev. Proc. 2002-13 is considered consistent with generally accepted accounting principles and takes into account the relevant factors of Q&A-13

- If the underlying stock is registered but is not publicly traded, the volatility is assumed to be the volatility of a "comparable corporation" (determined by industry, corporate size, earnings, market capitalization and debt-equity structure) that is publicly traded

- If the underlying stock is not registered, the taxpayer must assume medium volatility

- Illustration of Stock Option Valuation Process:

— See **Exhibit II** for an illustration of the calculation process for determining the parachute payment for unvested options under the new safe harbor Black-Scholes method versus the old spread method for unvested options

⇒ Note that once the value of the stock option is determined, the parachute payment amount is calculated based on the present value of the accelerated benefit and the lapse in service obligation amounts using the special valuation rules under Q&A-24(c)[9]

⇒ The example shows that for a stock of medium volatility (i.e., 50%) with a five-year remaining term, and a 20% spread factor (i.e., an option spread of 16.67%[10] of the stock price at the CIC), the Rev. Proc. 2002-45 safe harbor value is 50.8% of the stock price at the CIC or approximately three times greater than the option spread

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[9] Under Q&A-24(c) of the 1989 and new proposed regulations, the portion of the payment that becomes vested as a result of acceleration under a CIC is the lesser of (1) the accelerated payment or (2) the sum of the (i) difference between the present value of the payment and the accelerated payment value and (ii) an additional amount reflecting the lapse of the obligation to perform future employment services (calculated as 1% of the accelerated payment for each full month of services no longer required to be performed).

[10] Option spread in the example is equal to ($12-$10)/$12, or 16.67%, of the stock price at the CIC.

Exhibit I

Safe Harbor Valuation Table Under Rev. Proc. 2002-45

	Term (months)	3	12	24	36	48	60	72	84	96	108	120
Volatility	Spread Factor*											
Low Volatility (30% or lower)	*200%*	66.8%	67.3%	67.9%	68.4%	69.0%	69.5%	69.9%	70.3%	70.7%	71.0%	71.2%
	180%	64.5%	65.0%	65.7%	66.4%	67.1%	67.7%	68.3%	68.8%	69.3%	69.6%	69.9%
	160%	61.8%	62.4%	63.3%	64.1%	65.0%	65.8%	66.5%	67.1%	67.7%	68.1%	68.5%
	140%	58.6%	59.4%	60.4%	61.5%	62.5%	63.5%	64.4%	65.1%	65.8%	66.4%	66.9%
	120%	54.9%	55.8%	57.1%	58.4%	59.7%	60.9%	62.0%	62.9%	63.7%	64.5%	65.1%
	100%	50.4%	51.5%	53.2%	54.8%	56.4%	57.9%	59.1%	60.3%	61.3%	62.2%	63.0%
	80%	44.9%	46.3%	48.5%	50.6%	52.6%	54.3%	55.9%	57.3%	58.5%	59.6%	60.5%
	60%	38.0%	40.0%	42.9%	45.6%	48.0%	50.1%	52.0%	53.7%	55.2%	56.5%	57.6%
	40%	29.3%	32.3%	36.3%	39.7%	42.6%	45.2%	47.4%	49.4%	51.2%	52.7%	54.1%
	20%	18.1%	23.3%	28.5%	32.7%	36.2%	39.3%	41.9%	44.3%	46.4%	48.2%	49.9%
	0%	6.4%	13.6%	19.9%	24.7%	28.8%	32.3%	35.4%	38.1%	40.5%	42.7%	44.7%
	-20%	0.6%	5.4%	11.2%	16.1%	20.4%	24.2%	27.6%	30.6%	33.4%	35.9%	38.1%
	-40%	0.0%	0.9%	4.1%	7.9%	11.6%	15.2%	18.5%	21.7%	24.6%	27.3%	29.9%
	-60%	0.0%	0.0%	0.6%	2.0%	4.0%	6.4%	9.0%	11.6%	14.3%	16.8%	19.3%
Medium Volatility (30% to 70%)	*200%*	66.8%	67.4%	68.6%	69.9%	71.1%	72.2%	73.1%	73.9%	74.5%	75.0%	75.4%
	180%	64.5%	65.2%	66.7%	68.2%	69.6%	70.9%	71.9%	72.8%	73.5%	74.1%	74.6%
	160%	61.8%	62.7%	64.5%	66.3%	68.0%	69.4%	70.6%	71.6%	72.5%	73.2%	73.7%
	140%	58.6%	59.8%	62.0%	64.2%	66.1%	67.7%	69.1%	70.3%	71.2%	72.0%	72.7%
	120%	54.9%	56.4%	59.2%	61.7%	63.9%	65.8%	67.4%	68.8%	69.9%	70.8%	71.6%
	100%	50.4%	52.5%	55.9%	58.9%	61.5%	63.7%	65.5%	67.0%	68.3%	69.4%	70.3%
	80%	44.9%	47.9%	52.2%	55.7%	58.7%	61.2%	63.2%	65.0%	66.5%	67.7%	68.8%
	60%	38.2%	42.6%	47.8%	52.0%	55.4%	58.3%	60.6%	62.7%	64.3%	65.8%	67.0%
	40%	30.0%	36.3%	42.7%	47.6%	51.6%	54.8%	57.6%	59.9%	61.8%	63.5%	64.9%
	20%	20.3%	29.1%	36.8%	42.5%	47.0%	50.8%	53.9%	56.5%	58.8%	60.7%	62.3%
	0%	10.4%	21.2%	30.0%	36.4%	41.6%	45.8%	49.4%	52.4%	55.0%	57.2%	59.1%
	-20%	3.0%	13.0%	22.2%	29.2%	34.9%	39.7%	43.7%	47.2%	50.2%	52.8%	55.0%
	-40%	0.3%	5.7%	13.8%	20.8%	26.8%	32.0%	36.4%	40.4%	43.8%	46.8%	49.5%
	-60%	0.0%	1.2%	5.9%	11.4%	16.9%	22.1%	26.7%	31.0%	34.8%	38.3%	41.4%
High Volatility (70% or higher)	*200%*	66.8%	68.1%	70.7%	73.1%	75.0%	76.6%	77.8%	78.8%	79.5%	80.0%	80.4%
	180%	64.5%	66.1%	69.1%	71.7%	73.9%	75.6%	77.0%	78.1%	78.9%	79.5%	79.9%
	160%	61.8%	63.8%	67.3%	70.3%	72.7%	74.6%	76.1%	77.3%	78.2%	78.9%	79.4%
	140%	58.6%	61.3%	65.3%	68.6%	71.3%	73.4%	75.1%	76.4%	77.4%	78.2%	78.8%
	120%	54.9%	58.3%	63.0%	66.8%	69.7%	72.1%	73.9%	75.4%	76.6%	77.4%	78.1%
	100%	50.6%	55.0%	60.4%	64.6%	67.9%	70.6%	72.6%	74.3%	75.6%	76.6%	77.3%
	80%	45.3%	51.1%	57.4%	62.2%	65.9%	68.8%	71.1%	73.0%	74.4%	75.6%	76.5%
	60%	39.1%	46.6%	54.0%	59.4%	63.5%	66.8%	69.4%	71.4%	73.1%	74.4%	75.4%
	40%	31.7%	41.4%	50.0%	56.1%	60.7%	64.4%	67.3%	69.6%	71.5%	73.0%	74.2%
	20%	23.2%	35.4%	45.3%	52.1%	57.4%	61.5%	64.8%	67.4%	69.6%	71.3%	72.7%
	0%	14.3%	28.5%	39.6%	47.4%	53.3%	57.9%	61.6%	64.7%	67.1%	69.1%	70.8%
	-20%	6.4%	20.8%	32.9%	41.5%	48.1%	53.4%	57.6%	61.1%	64.0%	66.4%	68.3%
	-40%	1.5%	12.7%	24.8%	34.0%	41.4%	47.3%	52.2%	56.3%	59.7%	62.5%	64.8%
	-60%	0.1%	5.2%	15.2%	24.3%	32.1%	38.8%	44.4%	49.1%	53.2%	56.6%	59.5%

* Spot (market) price/Exercise price -1 or (S/X -1)

Exhibit II

Illustration of Stock Option Valuation Under the Spread Method Versus Safe Harbor Black-Scholes Method

The illustration shown below assumes:

- 10,000 options
- Exercise price of $10/share
- CIC stock price - $12/share
- Volatility of 50%
- Remaining term of 60 months
- Due to vest in 12 months

	Spread Method	Safe Harbor Black-Scholes
A. Value of option payment • *Note increase of the safe harbor Black-Scholes method versus the spread method = $60,096 / $20,000 = 3.05 or approximately 3 times higher*	• Value of option payment (**A.**) = 10,000 x ($12 - $10) = $20,000	• Spread factor = $12 / $10 – 1 = 20% • Black-Scholes value (as a percent of FMV) in IRS table based on a 20% spread factor, remaining term of 60 months (based on full term to expiration) and a volatility of 50% = 50.8% • Value of option payment **(A.)** = number of options multiplied by the FMV/share at CIC multiplied by the table value provided in Appendix of IRS Rev. Proc. 2002-45 = 10,000 x $12 x 50.8% = $60,960
B. Present value[11] (PV) of accelerated benefit	**B.** = $20,000 / ((1 + 0.0347/12) ^ 12) = $20,000 / 1.03526 = $19,319	**B.** = $60,960 / ((1 + 0.0347/12) ^ 12) = $60,960 / 1.03526 = $58,884
C. Difference between **A.** and **B.**	**C.** = $20,000 - $19,319 = $681	**C.** = $60,960 - $58,884 = $2,076
D. Lapse of service obligation (1% for each full month of service lapse)	**D.** = $20,000 x (0.01 x 12) = $2,400	**D.** = $60,960 x (0.01 x 12) = $7,315
E. Sum of **C.** and **D.**	**E.** = $681 + $2,400 = $3,081	**E.** = $2,076 + $7,315 = $9,391
F. Parachute payment is the lesser of **A.** and **E.**	**F.** = Lesser of $20,000 and $3,081 = $3,081	**F.** = Lesser of $60,960 and $9,391 = $9,391

[11] The interest rate for determining the present value (3.47%) is based on Revenue Ruling 2002-36 and is equal to 120% of the semiannual short-term applicable federal rate (short-term 120% AFR) for June 2002.