

AMREP CORP.
Form 10-Q
March 15, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended January 31, 2016

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 1-4702

AMREP Corporation
(Exact name of Registrant as specified in its charter)

Oklahoma

59-0936128

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(State or other jurisdiction of (IRS Employer
incorporation or organization) Identification No.)

300 Alexander Park, Suite 204, Princeton, New Jersey 08540
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (609) 716-8200

Not Applicable
(Former name or former address, if changed since last report)

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 (the "Exchange Act") during the preceding 12 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes No

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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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

Number of Shares of Common Stock, par value \$.10 per share, outstanding at February 29, 2016 – 8,059,454.

AMREP CORPORATION AND SUBSIDIARIES

INDEX

	PAGE NO.
<u>PART I. FINANCIAL INFORMATION</u>	
<u>Item 1. Financial Statements</u>	
<u>Consolidated Balance Sheets January 31, 2016 (Unaudited) and April 30, 2015</u>	1
<u>Consolidated Statements of Operations and Retained Earnings (Unaudited) Three Months Ended January 31, 2016 and 2015</u>	2
<u>Consolidated Statements of Comprehensive Income (Loss) (Unaudited) Three Months Ended January 31, 2016 and 2015</u>	3
<u>Consolidated Statements of Operations and Retained Earnings (Unaudited) Nine Months Ended January 31, 2016 and 2015</u>	4
<u>Consolidated Statements of Comprehensive Income (Loss) (Unaudited) Nine Months Ended January 31, 2016 and 2015</u>	5
<u>Consolidated Statements of Cash Flows from Continuing Operations (Unaudited) Nine Months Ended January 31, 2016 and 2015</u>	6
<u>Notes to Consolidated Financial Statements (Unaudited)</u>	7
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	16
<u>Item 4. Controls and Procedures</u>	22
<u>PART II. OTHER INFORMATION</u>	
<u>Item 6. Exhibits</u>	23
<u>SIGNATURE</u>	24
<u>EXHIBIT INDEX</u>	25

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

AMREP CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets

(Amounts in thousands, except par value and share amounts)

	January 31, 2016 (Unaudited)	April 30, 2015
ASSETS		
Cash and cash equivalents	\$ 13,857	\$ 12,050
Receivables, net	8,053	11,265
Real estate inventory	63,583	66,321
Investment assets, net	15,241	15,364
Property, plant and equipment, net	15,547	15,763
Intangible and other assets, net	8,470	10,440
Taxes receivable, net	1,718	-
Deferred income taxes, net	6,578	5,837
Assets of discontinued operations	-	1,689
TOTAL ASSETS	\$ 133,047	\$ 138,729
LIABILITIES AND SHAREHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable and accrued expenses	\$ 8,708	\$ 10,284
Notes payable:		
Amounts due within one year	454	128
Amounts due beyond one year	3,859	3,959
Amounts due to related party	12,491	14,003
	16,804	18,090
Taxes payable, net	-	653
Other liabilities and deferred revenue	4,601	4,827
Accrued pension cost	12,022	11,259
Liabilities of discontinued operations	-	295
TOTAL LIABILITIES	42,135	45,408
SHAREHOLDERS' EQUITY:		

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Common stock, \$.10 par value; shares authorized – 20,000,000; shares issued – 8,284,704 at January 31, 2016 and 8,281,704 at April 30, 2015	828	828
Capital contributed in excess of par value	50,553	50,538
Retained earnings	54,579	57,003
Accumulated other comprehensive loss, net	(10,833)	(10,833)
Treasury stock, at cost; 225,250 shares at January 31, 2016 and April 30, 2015	(4,215)	(4,215)
TOTAL SHAREHOLDERS' EQUITY	90,912	93,321
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 133,047	\$ 138,729

The accompanying notes to consolidated financial statements are an integral part of these consolidated financial statements.

AMREP CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations and Retained Earnings (Unaudited)

Three Months Ended January 31, 2016 and 2015

(Amounts in thousands, except per share amounts)

	2016	2015
REVENUES:		
Fulfillment services	\$8,759	\$10,832
Real estate land sales	3,197	1,861
Other	242	527
	12,198	13,220
COSTS AND EXPENSES:		
Real estate land sales	2,781	822
Operating expenses:		
Fulfillment services	7,888	9,727
Real estate selling expenses	54	51
Other	360	237
General and administrative expenses:		
Fulfillment services	707	1,395
Real estate operations and corporate	872	1,048
Interest expense	342	472
	13,004	13,752
Loss from continuing operations before income taxes	(806)	(532)
Benefit for income taxes	(237)	(228)
Loss from continuing operations	(569)	(304)
Discontinued operations (Note 2)		
Income from discontinued operations before income taxes	-	35
Provision for income taxes	-	40
Loss from discontinued operations	-	(5)
Net loss	(569)	(309)
Retained earnings, beginning of period	55,148	52,201
Retained earnings, end of period	\$54,579	\$51,892
Loss per share – continuing operations – basic and diluted	\$(0.07)	\$(0.04)
Earnings per share – discontinued operations – basic and diluted	\$-	\$-
Loss per share, net - basic and diluted	\$(0.07)	\$(0.04)
Weighted average number of common shares outstanding	8,038	8,026

The accompanying notes to consolidated financial statements are an integral part of these consolidated financial statements.

AMREP CORPORATION AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss) (Unaudited)

Three Months Ended January 31, 2016 and 2015

(Amounts in thousands)

	2016	2015
Net loss	\$(569)	\$(309)
Other comprehensive income, net of tax:		
Change in pension liability, net of tax (\$320 in 2015)	-	543
Other comprehensive income	-	543
Total comprehensive income (loss)	\$(569)	\$234

The accompanying notes to consolidated financial statements are an integral part of these consolidated financial statements.

AMREP CORPORATION AND SUBSIDIARIES

Consolidated Statements of Operations and Retained Earnings (Unaudited)

Nine Months Ended January 31, 2016 and 2015

(Amounts in thousands, except per share amounts)

	2016	2015
REVENUES:		
Fulfillment services	\$26,666	\$34,544
Real estate land sales	5,487	4,758
Other	841	596
	32,994	39,898
COSTS AND EXPENSES:		
Real estate land sales	4,699	3,232
Operating expenses:		
Fulfillment services	24,535	28,684
Real estate selling expenses	162	178
Other	1,040	1,006
General and administrative expenses:		
Fulfillment services	2,452	3,614
Real estate operations and corporate	2,837	2,693
Impairment of assets	-	925
Interest expense	1,085	1,234
	36,810	41,566
Loss from continuing operations before income taxes	(3,816)	(1,668)
Benefit for income taxes	(1,392)	(631)
Loss from continuing operations	(2,424)	(1,037)
Discontinued operations (Note 2)		
Income from discontinued operations before income taxes	-	11,446
Provision for income taxes	-	4,200
Income from discontinued operations	-	7,246
Net income (loss)	(2,424)	6,209
Retained earnings, beginning of period	57,003	45,683
Retained earnings, end of period	\$54,579	\$51,892
Loss per share – continuing operations – basic and diluted	\$(0.30)	\$(0.13)
Earnings per share – discontinued operations – basic and diluted	\$-	\$0.92
Earnings (loss) per share, net - basic and diluted	\$(0.30)	\$0.79
Weighted average number of common shares outstanding	8,035	7,884

The accompanying notes to consolidated financial statements are an integral part of these consolidated financial statements.

AMREP CORPORATION AND SUBSIDIARIES

Consolidated Statements Of Comprehensive Income (Loss) (Unaudited)

Nine Months Ended January 31, 2016 and 2015

(Amounts in thousands)

	2016	2015
Net income (loss)	\$(2,424)	\$6,209
Other comprehensive income, net of tax:		
Change in pension liability, net of tax (\$320 in 2015)	-	543
Other comprehensive income	-	543
Total comprehensive income (loss)	\$(2,424)	\$6,752

The accompanying notes to consolidated financial statements are an integral part of these consolidated financial statements.

AMREP CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows from Continuing Operations (Unaudited)

Nine Months Ended January 31, 2016 and 2015

(Amounts in thousands)

	2016	2015
CASH FLOWS FROM OPERATING ACTIVITIES:		
Loss from continuing operations	\$(2,424)	\$(1,037)
Adjustments to reconcile loss from continuing operations to net cash provided by (used in) operating activities:		
Depreciation and amortization	2,168	2,434
Impairment of assets	-	925
Non-cash credits and charges:		
Allowance for doubtful accounts	57	19
Stock-based compensation	52	95
Loss on disposal of fixed assets	5	-
Pension settlement accounting	-	431
Changes in assets and liabilities, net of effects of discontinued operations:		
Receivables	(445)	2,917
Real estate inventory and investment assets	2,536	2,675
Intangible and other assets	958	567
Accounts payable and accrued expenses	(1,576)	(1,545)
Taxes receivable and payable	(2,373)	9
Deferred income taxes and other liabilities	(967)	2,823
Accrued pension costs	763	360
Total adjustments	1,178	11,710
Net cash provided by (used in) operating activities	(1,246)	10,673
CASH FLOWS FROM INVESTING ACTIVITIES:		
Capital expenditures - property, plant and equipment	(655)	(731)
Proceeds from line of credit receivable	2,000	-
Proceeds from note receivable	1,600	-
Net cash provided by (used in) investing activities	2,945	(731)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from debt financing	-	949
Principal debt payments	(1,286)	(1,941)
Net transfers from (advances to) discontinued operations	1,394	(1,544)
Net cash provided by (used in) financing activities	108	(2,536)
Increase in cash and cash equivalents	1,807	7,406
Cash and cash equivalents, beginning of period	12,050	7,571
Cash and cash equivalents, end of period	\$13,857	\$14,977

SUPPLEMENTAL CASH FLOW INFORMATION:

Interest paid	\$1,061	\$1,259
Income taxes paid, net	\$1,862	\$7
Non-cash transactions:		
Issuance of common stock in settlement	\$-	\$4,274

The accompanying notes to consolidated financial statements are an integral part of these consolidated financial statements.

AMREP CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

Nine Months Ended January 31, 2016 and 2015

(1) BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements have been prepared by AMREP Corporation (the “Company”) pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”) for interim financial information, and do not include all the information and footnotes required by accounting principles generally accepted in the United States of America for complete financial statements. The Company, through its subsidiaries, is primarily engaged in two business segments: the Fulfillment Services business operated by Palm Coast Data LLC and its subsidiary and the real estate business operated by AMREP Southwest Inc. (“AMREP Southwest”) and its subsidiaries. The Company’s foreign sales are insignificant. All significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, these unaudited consolidated financial statements include all adjustments, which are of a normal recurring nature, considered necessary to reflect a fair presentation of the results for the interim periods presented. The results of operations for such interim periods are not necessarily indicative of what may occur in future periods. Unless otherwise qualified, all references to 2016 and 2015 are to the fiscal years ending April 30, 2016 and 2015 and all references to the third quarter and first nine months of 2016 and 2015 mean the fiscal three and nine month periods ended January 31, 2016 and 2015.

The unaudited consolidated financial statements herein should be read in conjunction with the Company’s annual report on Form 10-K for the year ended April 30, 2015, which was filed with the SEC on July 29, 2015 (the “2015 Form 10-K”). As described in Note 13 to the financial statements included in the 2015 Form 10-K, the Company revised its previously reported results for the third quarter and first nine months of 2015 as reported in the Company’s Form 10-Q for the quarter ended January 31, 2015 to reflect an adjustment to pension expense which should have been reported in the third quarter of 2015 under generally accepted accounting principles.

Recently Issued Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, Revenue from Contracts with Customers. This guidance defines how companies report revenues from contracts with customers and also requires enhanced disclosures. In July 2015, the Financial Accounting Standards

Board voted to defer the effective date by one year, with early adoption on the original effective date permitted. The Company will be required to adopt the standard as of May 1, 2018 and early adoption is permitted as of May 1, 2017. The Company has not determined the transition approach that will be utilized nor has it estimated the impact of adopting the new accounting standard.

In February 2016, the FASB issued ASU 2016-02, Leases. ASU 2016-01 requires that a lessee recognize the assets and liabilities that arise from operating leases. A lessee should recognize in its balance sheet a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. For leases with a term of 12 months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. In transition, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period presented using a modified retrospective approach. The amendments in the ASU are effective for the Company in fiscal year and interim periods beginning on May 1, 2019.

(2) DISCONTINUED OPERATIONS

Prior to February 9, 2015, the Company had been engaged in the Newsstand Distribution Services business and the Product Packaging and Fulfillment Services business. On February 9, 2015, the Newsstand Distribution Services business and the Product Packaging and Fulfillment Services business were sold. In addition, prior to April 10, 2015, the Company had also been engaged in the Staffing Services business. On April 10, 2015, the Staffing Services business was sold. The Newsstand Distribution Services business, the Product Packaging and Fulfillment Services business and the Staffing Services business have been classified as “discontinued operations” in the Company’s financial statements. Financial information from prior periods has been reclassified to conform to this presentation. Refer to Item 1 of Part I of the 2015 Form 10-K for more detail about the sale of the Newsstand Distribution Services business, the Product Packaging and Fulfillment Services business and the Staffing Services business. The following table provides a reconciliation of the carrying amounts of the major classes of assets and liabilities of the discontinued operations in the accompanying balance sheet (in thousands):

	April 30, 2015
Carrying amounts of major classes of assets included as part of discontinued operations:	
Cash and cash equivalents	\$1,241
Receivables, net	431
Intangible and other assets, net	17
Total assets classified as discontinued operations in the accompanying balance sheets	\$1,689
Carrying amounts of major classes of liabilities included as part of discontinued operations:	
Accounts payable and accrued expenses	\$150
Deferred and income taxes payable	145
Total liabilities classified as discontinued operations in the accompanying balance sheets	\$295

The following tables provide a reconciliation of the carrying amounts of components of income or loss of the discontinued operations to the amounts reported in the accompanying statement of operations (in thousands):

	January 31, 2015
For the three months ended:	
Components of pretax income from discontinued operations:	
Revenues	\$5,645
Operating expenses	(5,071)
General and administrative expenses	(599)
Interest income	60

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Income from discontinued operations before income taxes	35
Provision for income taxes	40
Loss from discontinued operations	\$(5)

For the nine months ended:

Components of pretax income from discontinued operations:	
Revenues	\$16,342
Operating expenses	(14,273)
General and administrative expenses	(1,746)
Gain from settlement (Note 13)	11,155
Interest expense	(32)
Income from discontinued operations before income taxes	11,446
Provision for income taxes	4,200
Income from discontinued operations	\$7,246

The following table provides the total operating and investing cash flows of the discontinued operations for the nine-month period in which the results of operations of the discontinued operations are presented in the accompanying statement of operations (in thousands):

For the nine months ended:	January 31, 2015
Cash flows from discontinued operating activities:	
Income from discontinued operations	\$7,246
Adjustments to reconcile net income to net cash provided by (used in) operating activities:	
Gain on settlement	(11,155)
Depreciation and amortization	300
Non-cash credits and charges:	
Allowance for doubtful accounts	(1,488)
Changes in assets and liabilities:	
Receivables	7,666
Intangible and other assets	271
Accounts payable and accrued expenses	(4,898)
Other	1,710
Total adjustments	(7,594)
Net cash used in operating activities	\$(348)
Cash flows from investing activities:	
Capital expenditures - property, plant and equipment	\$(25)
Net cash used in investing activities	\$(25)

(3) RECEIVABLES

Receivables, net consist of the following (in thousands):

	January 31, 2016	April 30, 2015
Fulfillment Services	\$ 8,153	\$ 7,993
Buyer promissory note	-	1,600
Line of credit receivable	-	2,000
Real estate operations and corporate	322	116
	8,475	11,709
Less allowance for doubtful accounts	(422)	(444)
	\$ 8,053	\$ 11,265

Refer to Item 1 of Part I of the 2015 Form 10-K for detail about the buyer promissory note and line of credit issued in connection with the sale of the Newsstand Distribution Services business and the Product Packaging and Fulfillment Services business. In January 2016, American Republic Investment Co. (“Lender”), a subsidiary of AMREP Corporation, entered into a letter agreement with each of DFI Holdings, LLC, KPS Holdco, LLC and their respective subsidiaries (collectively, “Borrowers”), which resolved certain events of default of the Borrowers. Among other things, the letter agreement provided the following:

Payment to Lender of approximately \$1,600,000, representing the full amount of principal and interest outstanding under the buyer promissory note executed by DFI Holdings, LLC and KPS Holdco, LLC in favor of Lender;

Termination of the line of credit provided by Lender to certain Borrowers. No amount of principal was outstanding under the line of credit promissory note as of the termination date;

Termination of the security agreement provided by Borrowers in favor of Lender pursuant to which Borrowers had pledged and granted a security interest in substantially all of their personal property to Lender in order to secure the obligations of Borrowers; and

A release and indemnity in favor of Lender and its affiliates with respect to the events of default and the resolution thereof.

During the third quarter and first nine months of 2016, revenues from one major customer of the Company’s Fulfillment Services business totaled \$1,297,000 and \$4,084,000, or 10.6% and 12.4% of total revenues of the

Company for those periods. As of February 29, 2016, the Company's Fulfillment Services business had \$469,000 of outstanding accounts receivable from this customer. This major customer has given notice to the Company that it will no longer use certain services the Company currently provides beginning in the second quarter of fiscal 2017. It is expected that revenues from this major customer could be reduced by more than 50% from its current business levels.

(4) INVESTMENT ASSETS

Investment assets consist of (in thousands):

	January 31, 2016	April 30, 2015
Land held for long-term investment	\$ 9,718	\$ 9,733
Warehouse facility	6,572	6,572
Less accumulated depreciation	(1,049)	(941)
	5,523	5,631
	\$ 15,241	\$ 15,364

Refer to Item 7 of Part II of the 2015 Form 10-K for detail about the warehouse facility in Fairfield, Ohio leased to Kable Product Services, Inc. In February 2016, El Dorado Utilities, Inc. (“El Dorado”), a subsidiary of AMREP Corporation, sold the warehouse facility to a third party. All of the accumulated depreciation noted above is associated with the warehouse facility.

(5) PROPERTY, PLANT AND EQUIPMENT

Property, plant and equipment, net consist of the following (in thousands):

	January 31, 2016	April 30, 2015
Land, buildings and improvements	\$ 20,513	\$ 20,000
Furniture and equipment	19,077	19,098
	39,590	39,098
Less accumulated depreciation	(24,043)	(23,335)
	\$ 15,547	\$ 15,763

(6) INTANGIBLE AND OTHER ASSETS

Intangible and other assets, net consist of the following (in thousands):

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	January 31, 2016		April 30, 2015	
	Cost	Accumulated Amortization	Cost	Accumulated Amortization
Customer contracts and relationships	\$16,986	\$ 11,820	\$16,986	\$ 10,757
Prepaid expenses	2,155	-	2,520	-
Deferred order entry costs	884	-	961	-
Other	265	-	730	-
	\$20,290	\$ 11,820	\$21,197	\$ 10,757

Customer contracts and relationships are amortized on a straight line basis over twelve years. Deferred order entry costs represent costs incurred in connection with the data entry of customer subscription information to database files and are charged directly to operations generally over a twelve month period.

(7) ACCOUNTS PAYABLE AND ACCRUED EXPENSES

Accounts payable and accrued expenses consist of the following (in thousands):

	January 31, 2016	April 30, 2015
Fulfillment Services	\$ 7,204	\$ 8,910
Real estate operations and corporate	1,504	1,374
	\$ 8,708	\$ 10,284

The January 31, 2016 accounts payable and accrued expenses total consists of customer postage deposits of \$4,105,000, accrued expenses of \$1,242,000, trade payables of \$1,234,000 and other of \$2,127,000. The April 30, 2015 accounts payable and accrued expenses total consists of customer postage deposits of \$4,832,000, accrued expenses of \$1,142,000, trade payables of \$1,641,000 and other of \$2,669,000.

(8) NOTES PAYABLE

Notes payable consist of the following (in thousands):

	January 31, 2016	April 30, 2015
Credit facilities:		
Real estate operations - due to related party	\$ 12,491	\$ 14,003
Real estate operations - other	320	-
Other notes payable	3,993	4,087
	\$ 16,804	\$ 18,090

Real Estate Loan

AMREP Southwest has a loan from a company owned by Nicholas G. Karabots, a significant shareholder of the Company and in which another director of the Company has a 20% participation. The loan had an outstanding principal amount of \$12,491,000 at January 31, 2016, is scheduled to mature on December 1, 2017, bears interest payable monthly at 8.5% per annum and is secured by a mortgage on all real property of AMREP Southwest in Rio Rancho, New Mexico and by a pledge of the stock of its subsidiary, Outer Rim Investments, Inc. The total book value

of the real property collateralizing the loan was approximately \$61,281,000 as of January 31, 2016. No payments of principal are required until maturity, except that the following amounts are required to be applied to the payment of the loan: (a) 25% of the net cash proceeds from any sales of real property by AMREP Southwest and (b) 25% of any royalty payments received by AMREP Southwest under the oil and gas lease described in Note 9.

Other Notes Payable

Other notes payable includes a mortgage note payable with an outstanding principal balance of \$3,993,000 on a warehouse facility with a maturity date of February 2018 and an interest rate of 6.35%. The amount due within one year related to this mortgage note payable is \$134,000. In February 2016, the warehouse facility was sold to a third party and this mortgage note payable was paid in full.

US Bank Facility

During November 2015, Las Fuentes Village, LLC (“LFV”), a subsidiary of AMREP Southwest, entered into a loan agreement with U.S. Bank National Association to permit the borrowing from time to time by LFV of a maximum principal amount of \$933,000 for the construction of a 2,200 square foot, single tenant retail building in Rio Rancho, New Mexico. The construction loan is scheduled to mature on October 31, 2016, bears interest payable monthly on the outstanding principal amount at 0.5% plus the prime rate, is secured by a mortgage on the real property of approximately 1 acre where construction of the building is to occur, contains customary events of default and representations, warranties and covenants and is guaranteed by AMREP Southwest. As of January 31, 2016, the outstanding principal balance of the loan was \$320,000 and the book value of the real property collateralizing the loan was approximately \$217,000. No payments of principal are required until maturity.

PNC Credit Facility

The Company’s Fulfillment Services business had a revolving credit and security agreement with PNC Bank, N.A., which expired by its terms on August 12, 2015. There were no borrowings under this agreement at the time of its expiration.

(9) DEFERRED REVENUE

Refer to Item 7 of Part II of the 2015 Form 10-K for detail about the Oil and Gas Lease and the Addendum thereto with Thrust Energy, Inc. and Cebolla Roja, LLC. No royalties under the Lease were received during the first nine months of 2016. Deferred revenue of approximately \$910,000 from this transaction is being recorded over the four-year lease term. Approximately \$57,000 and \$171,000 of such deferred revenue was recognized during the third quarter and first nine months of 2016 and \$57,000 and \$95,000 for the third quarter and first nine months of 2015, which is included in Other revenues in the accompanying financial statements. At January 31, 2016, there was \$587,000 of deferred revenue remaining to be recognized in future periods.

Refer to Item 7 of Part II of the 2015 Form 10-K for detail about a lease agreement for the warehouse facility in Fairfield, Ohio leased to Kable Product Services, Inc. The amount of deferred rent revenue in connection with this lease totaled \$955,000 and \$1,042,000 at January 31, 2016 and April 30, 2015. The credit related to the amortization of the deferred rent revenue has been accounted for as a reduction of general and administrative expenses for real estate operations and corporate in the accompanying financial statements and totaled \$29,000 and \$87,000 for the three and nine month periods ended January 31, 2016 and also for the same periods ended January 31, 2015. In February 2016, the warehouse facility was sold to a third party and, as a result of the sale, the Company is expected to recognize a pretax gain of \$251,000 during its fiscal quarter ending April 30, 2016.

(10) FAIR VALUE MEASUREMENTS

The Financial Instruments Topic of the Financial Accounting Standards Board Accounting Standards Codification requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet, for which it is practicable to estimate that value. The Topic excludes all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company. The following methods and assumptions are used in estimating fair value disclosure for financial instruments: the carrying amounts of cash and cash equivalents, trade receivables and trade payables approximate fair value because of the short maturity of these financial instruments.

The Company did not have any long-term, fixed-rate notes receivables at January 31, 2016 or April 30, 2015. The estimated fair values of the Company's long-term, fixed-rate notes payable were \$15,194,000 and \$16,365,000 compared with carrying amounts of \$16,484,000 and \$18,090,000 at January 31, 2016 and April 30, 2015.

(11) BENEFIT PLANS

Retirement plan

The Company has a defined benefit retirement plan for which accumulated benefits were frozen and future service credits were curtailed as of March 1, 2004. The Company has secured \$5,019,000 of accrued pension-related obligations with first lien mortgages on certain real property in favor of the Pension Benefit Guaranty Corporation (the "PBGC"). On an annual basis, the Company is required to provide updated appraisals on each mortgaged property and, if the appraised value of the mortgaged properties is less than two times the amount of the accrued pension-related obligations secured by the mortgages, the Company is required to make a payment to its pension plan in an amount equal to one-half of the amount of the shortfall. During the first quarter of 2016, the Company substituted certain real property subject to the first lien mortgage in favor of the PBGC. During the first nine months of 2016, there was no change in the appraised value of the mortgaged property that required the Company to make any additional payments to its pension plan.

Equity compensation plan

The Company issued 3,000 shares of restricted common stock under the AMREP Corporation 2006 Equity Compensation Plan (the "Equity Plan") during the first nine months of 2016. During the first nine months of 2016, 10,000 shares of common stock previously issued under the Equity Plan vested leaving 21,000 shares issued under the Equity Plan that had not vested as of January 31, 2016. For the third quarter and first nine months of 2016, the Company recognized \$15,000 and \$52,000 of compensation expense related to the restricted shares of common stock issued, and \$29,000 and \$95,000 for the same periods of 2015. As of January 31, 2016, there was \$44,000 of total unrecognized compensation expense related to shares of common stock issued under the Equity Plan which had not vested as of that date, which expense is expected to be recognized over the remaining vesting term not to exceed three years.

(12) INCOME TAXES

Taxes receivable, net was \$1,718,000 at January 31, 2016. In February 2016, the Company received a refund of \$1,056,000 following the filing of its federal income tax return for 2015. The remaining taxes receivable balance is

expected to be recoverable from the carryback of current year tax losses.

(13) GAIN FROM SETTLEMENT

During the first quarter of 2015, the Company and certain of its subsidiaries entered into a settlement agreement with a significant customer, Heinrich Bauer (USA) LLC. As a result of the settlement agreement, the Company recognized a pretax gain of \$11,155,000, which is included in the results of discontinued operations in the accompanying financial statements for the nine months ended January 31, 2015. Refer to Item 7 of Part II of the 2015 Form 10-K for additional detail about the settlement agreement.

(14)

IMPAIRMENT OF ASSETS

During the first quarter of 2015, the Company's Fulfillment Services business recognized a \$925,000 impairment charge relating to the discontinuance of the development of certain software. The impairment charge included previously capitalized software costs, internal labor costs and third party consulting costs.

(15) INFORMATION ABOUT THE COMPANY'S OPERATIONS IN DIFFERENT INDUSTRY SEGMENTS

The following tables set forth summarized data relative to the industry segments in which the Company operated (other than with respect to discontinued operations) for the three and nine month periods ended January 31, 2016 and 2015 (in thousands):

	Fulfillment Services	Real Estate Operations	Corporate and Other	Consolidated
Three months ended January 31, 2016 (a):				
Revenues	\$ 8,759	\$ 3,254	\$ 185	\$ 12,198
Net income (loss) from continuing operations	\$ (440)	\$ (468)	\$ 339	\$ (569)
Provision (benefit) for income taxes	(258)	(287)	308	(237)
Interest expense (income), net	263	577	(498)	342
Depreciation and amortization	599	23	93	715
EBITDA (b)	\$ 164	\$ (155)	\$ 242	\$ 251
Capital expenditures	\$ 384	\$ -	\$ -	\$ 384
Three months ended January 31, 2015 (a):				
Revenues	\$ 10,832	\$ 1,996	\$ 392	\$ 13,220
Net income (loss) from continuing operations	\$ (489)	\$ (166)	\$ 351	\$ (304)
Provision (benefit) for income taxes	(291)	(107)	170	(228)
Interest expense (income), net	179	687	(394)	472
Depreciation and amortization	733	23	36	792
EBITDA (b)	\$ 132	\$ 437	\$ 163	\$ 732
Capital expenditures	\$ 176	\$ -	\$ -	\$ 176
Nine months ended January 31, 2016 (a):				
Revenues	\$ 26,666	\$ 5,678	\$ 650	\$ 32,994
Net income (loss) from continuing operations	\$ (1,722)	\$ (1,825)	\$ 1,123	\$ (2,424)
Provision (benefit) for income taxes	(1,011)	(1,088)	707	(1,392)
Interest expense (income), net	612	1,844	(1,371)	1,085

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Depreciation and amortization	1,992	68	108	2,168
EBITDA (b)	\$ (129) \$ (1,001) \$ 567	\$ (563
Capital expenditures	\$ 655	\$ -	\$ -	\$ 655

	Fulfillment Services	Real Estate Operations	Corporate and Other	Consolidated
Nine months ended January 31, 2015 (a):				
Revenues	\$ 34,544	\$ 5,105	\$ 249	\$ 39,898
Net income (loss) from continuing operations	\$ (786)	\$ (1,463)	\$ 1,212	\$ (1,037)
Provision (benefit) for income taxes	(282)	(973)	624	(631)
Interest expense (income), net	531	2,075	(1,372)	1,234
Depreciation and amortization	2,257	68	109	2,434
Impairment of assets	925	-	-	925
EBITDA (b)	\$ 2,645	\$ (293)	\$ 573	\$ 2,925
Capital expenditures	\$ 731	\$ -	\$ -	\$ 731

(a) Revenue information provided for each segment includes amounts grouped as Other in the accompanying consolidated statements of operations. Corporate and Other is net of intercompany eliminations.

(b) The Company uses EBITDA (which the Company defines as income before net interest expense, income taxes, depreciation and amortization, and non-cash impairment charges from continuing operations) in addition to net income (loss) from continuing operations as a key measure of profit or loss for segment performance and evaluation purposes.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

INTRODUCTION

AMREP Corporation (the "Company"), through its subsidiaries, is primarily engaged in two business segments: the real estate business operated by AMREP Southwest Inc. ("AMREP Southwest") and its subsidiaries and the Fulfillment Services business operated by Palm Coast Data LLC and its subsidiary. Data concerning industry segments is set forth in Note 15 of the notes to the consolidated financial statements included in this report on Form 10-Q. All significant intercompany accounts and transactions have been eliminated in consolidation. The Company's foreign sales and activities are not significant.

Prior to February 9, 2015, the Company had been engaged in the Newsstand Distribution Services business and the Product Packaging and Fulfillment Services business. On February 9, 2015, the Newsstand Distribution Services business and the Product Packaging and Fulfillment Services business were sold. In addition, prior to April 10, 2015, the Company had also been engaged in the Staffing Services business. On April 10, 2015, the Staffing Services business was sold. The Newsstand Distribution Services business, the Product Packaging and Fulfillment Services business and the Staffing Services business have been classified as "discontinued operations" in the Company's financial

statements. Financial information from prior periods has been reclassified to conform to this presentation. Refer to Item 1 of Part I of the Company's annual report on Form 10-K for the year ended April 30, 2015, which was filed with the Securities Exchange Commission on July 29, 2015 (the "2015 Form 10-K"), for more detail about the sale of the Newsstand Distribution Services business, the Product Packaging and Fulfillment Services business and the Staffing Services business.

The following provides information that management believes is relevant to an assessment and understanding of the Company's consolidated results of operations and financial condition. The information contained in this section should be read in conjunction with the unaudited consolidated financial statements and related notes thereto appearing elsewhere in this quarterly report on Form 10-Q and with the 2015 Form 10-K. Many of the amounts and percentages presented in this section have been rounded for convenience of presentation. Unless otherwise qualified, all references to 2016 and 2015 are to the fiscal years ending April 30, 2016 and 2015 and all references to the third quarter and first nine months of 2016 and 2015 mean the fiscal three and nine month periods ended January 31, 2016 and 2015.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis of financial condition and results of operations is based on the accounting policies used and disclosed in the 2015 consolidated financial statements and accompanying notes that were prepared in accordance with accounting principles generally accepted in the United States of America and included as part of the 2015 Form 10-K. The preparation of those consolidated financial statements required management to make estimates and assumptions that affected the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual amounts or results could differ from those estimates.

The critical accounting policies, assumptions and estimates are described in Item 7 of Part II of the 2015 Form 10-K. There have been no changes in these accounting policies.

The significant accounting policies of the Company are described in Note 1 to the consolidated financial statements contained in the 2015 Form 10-K. Information concerning the Company's implementation and the impact of recent accounting standards issued by the Financial Accounting Standards Board is included in the notes to the consolidated financial statements contained in the 2015 Form 10-K and the unaudited consolidated financial statements and related notes thereto appearing elsewhere in this quarterly report on Form 10-Q. The Company did not adopt any accounting policy in the first nine months of 2016 that had a material impact on its consolidated financial statements.

RESULTS OF OPERATIONS

Continuing Operations

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For the third quarter of 2016, the Company's continuing operations recorded a net loss of \$569,000, or \$0.07 per share, compared to a net loss of \$304,000, or \$0.04 per share, for the third quarter of 2015. For the first nine months of 2016, the Company's continuing operations recorded a net loss of \$2,424,000, or \$0.30 per share, compared to a net loss of \$1,037,000, or \$0.13 per share, for the same period of 2015. Revenues from continuing operations were \$12,198,000 and \$32,994,000 for the third quarter and first nine months of 2016 compared to \$13,220,000 and \$39,898,000 for the same periods of the prior year.

Revenues from the Company's Fulfillment Services operations decreased from \$10,832,000 and \$34,544,000 for the third quarter and first nine months of 2015 to \$8,759,000 and \$26,666,000 for the same periods in 2016. The decrease for the first nine months of 2016 was due in part to lower revenues of \$2,720,000 from a significant customer that changed fulfillment service providers, and the revenues from this customer in the first nine months of 2015 consisted largely of contract termination fees that had little or no operating expenses associated with them. Magazine publishers are the principal customers of the Company's Fulfillment Services operations, and these customers have continued to be negatively impacted by increased competition from new media sources, alternative technologies for the distribution, storage and consumption of media content, weakness in advertising revenues and increases in paper costs, printing costs and postal rates. The result has been reduced subscription sales, which has caused publishers to close some magazine titles, change subscription fulfillment providers and seek more favorable terms from the Company's Fulfillment Services business and its competitors when contracts are up for bid or renewal. Operating expenses for Fulfillment Services decreased from \$9,727,000 and \$28,684,000 for the third quarter and first nine months of 2015 to \$7,888,000 and \$24,535,000 for the same periods in 2016, primarily reflecting lower payroll and benefits, as well as lower facilities and equipment expenses, including depreciation. In addition, during the first quarter of 2015, the Fulfillment Services business recorded a non-cash impairment charge of \$925,000 due to the discontinuance of the development of certain software. This impairment charge included previously capitalized software costs, internal labor costs and third party consulting costs. Should the adverse Fulfillment Services business conditions continue, the Fulfillment Services business may experience future impairment charges related to its long-lived assets.

Revenues from the Company's real estate land sales were \$3,197,000 and \$5,487,000 for the third quarter and first nine months of 2016 compared to \$1,861,000 and \$4,758,000 for the same periods of 2015. For the third quarter and first nine months of 2016 and 2015, the Company's land sales in New Mexico were as follows (dollars in thousands):

	Ended January 31, 2016			Ended January 31, 2015		
	Acres Sold	Revenues	Revenues Per Acre	Acres Sold	Revenues	Revenues Per Acre
Three months:						
Developed						
Residential	7.8	\$ 3,045	\$ 390	2.3	\$ 861	\$ 374
Commercial	-	-	-	-	-	-
Total Developed	7.8	3,045	390	2.3	861	374
James F. Gero (1)(6)	443,818	3.7	60,000	27.3	-	-
Donald M. Johnston (7)	38,858	*	-	-	-	-
Garry L. Hemphill (8)	212,760	*	-	-	-	-
Michael L. Paxton (1)(9)	2,266,888	18.8	-	-	-	-
Julie Paxton Puckett (1)(10)	1,967,250	16.8	-	-	-	-
Mark A. Paxton(1)(11)	1,603,888	13.7	-	-	-	-
Titan Capital Management (1) (12)	1,060,345	9.1	-	-	-	-
Marshall B. Payne (1)(13)	126,597	1.1	20,000	9.1	-	-
Donald W. Hodges (1)(14)	843,022	7.2	-	-	-	-
	5,037,802	36.3	200,000	91.0	-	-

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All directors and executive officers
as a group (7 persons) (15)

* Represents beneficial ownership of less than 1% of the outstanding shares of Common Stock.

- (1) The addresses of the persons or entities shown in the foregoing table who are beneficial owners of more than 5% of the Common Stock or Preferred Stock are as follows: G. Ward Paxton, T. Joe Head, James F. Gero, Michael L. Paxton, Mark A. Paxton and Julie Paxton Puckett, 1101 East Arapaho Road, Suite 200, Richardson, Texas 75081; Titan Capital Management, L.L.C., 7 Century Drive, Suite 201, Parsippany, NJ 07054; Marshall B. Payne, 500 Crescent Court, Suite 250, Dallas, TX 75201; and Donald W. Hodges, 2905 Maple Avenue, Dallas, TX 75201.
- (2) Beneficial ownership is calculated in accordance with the rules of the SEC in accordance with Rule 13d-3(d)(1) of the Exchange Act. Percentage of beneficial ownership is based on 11,704,535 shares of Common Stock and 220,000 shares of 5% Preferred Stock outstanding as of April 2, 2010. In computing the number of shares beneficially owned by a person and the percentage ownership of that person, shares of Common Stock subject to options or warrants held by that person that are currently exercisable or will become exercisable within 60 days following April 2, 2010 are deemed outstanding. However, these shares are not deemed outstanding for the purpose of computing the percentage ownership of any other person. Unless otherwise indicated in the footnotes to this table, the persons and entities named in the table have sole voting and sole investment power with respect to all shares beneficially owned, subject to community property laws where applicable.

Certain shares of Common Stock shown as beneficially owned are issuable upon conversion of the 5% Preferred Stock the Company issued in a private placement on March 25, 2004. Under the terms of these shares of 5% Preferred Stock, the shares of 5% Preferred Stock are convertible only to the extent that the number of shares of Common Stock issuable pursuant to those securities, together with the number of shares of Common Stock owned by the relevant person and its affiliates (but not including shares of Common Stock underlying unconverted portions of the 5% Preferred Stock) would not exceed 9.9% of the then outstanding Common Stock, as determined in accordance with Section 13(d) of the Exchange Act. In addition, certain shares of Common Stock shown as beneficially owned are issuable upon the conversion of Series 2 5% Preferred Stock issued in a private placement

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on March 28, 2005. Under the terms of the Series 2 5% Preferred Stock, the shares are convertible only to the extent that the number of shares of Common Stock issuable upon conversion thereof and upon the exercise of the warrants issued in such private placement, together with the number of shares of Common Stock owned the relevant person and its affiliates (but not including shares of Common Stock underlying unconverted portions of the Series 2 preferred stock or unexercised portions of the warrants) would not exceed 4.99% of the then outstanding Common Stock as determined in accordance with Section 13(d) of the Exchange Act. However, this restriction does not apply to any holder of the Series 2 Preferred Stock who is one of the Company's directors or officers. Similar restrictions apply to the conversion of the Series 3 5% Preferred Stock and Private Placement Warrants.

- (3) Includes the equivalent of approximately 4,400 shares held by Mr. G. Ward Paxton in the Intrusion Stock Fund in the Intrusion 401(k) Savings Plan. Includes the equivalent of 123,853 shares that may be issued upon conversion of Series 3 5% Preferred Stock, 260,000 shares that may be issued upon conversion of Series 2 5% Preferred Stock, 222,646 shares that may be issued upon conversion of 5% Preferred Stock and 107,523 shares that Mr. Paxton may acquire upon the exercise of warrants that are currently exercisable or exercisable within 60 days of April 2, 2010. Also includes 211,668 shares that Mr. Paxton may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (4) Includes 365,001 shares that Mr. Head may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (5) Includes 32,501 shares that Mr. Bucy may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (6) Includes the equivalent of 27,523 shares that may be issued upon conversion of Series 3 5% Preferred Stock, the equivalent of 60,000 shares that may be issued upon conversion of Series 2 5% Preferred Stock, 95,419 shares that may issued upon conversion of 5% Preferred Stock and 43,762 shares that Mr. Gero may acquire upon exercise of warrants that are currently exercisable or exercisable within 60 days of April 3, 2009. Also includes 27,501 shares that Mr. Gero may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (7) Includes 32,501 shares that Mr. Johnston may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (8) Includes 206,876 shares that Mr. Hemphill may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (9) Includes 598,222 shares held by trusts of Mr. Paxton's children of which Michael Paxton and Kathryn Paxton are co-trustees. Includes the equivalent of 68,808 shares that may be issued upon conversion of Series 3 5% Preferred Stock and 100,000 shares that may be issued upon conversion of Series 2 5% Preferred Stock. In addition, it includes 182,501 shares that Mr. Paxton may acquire upon exercise of options that are currently exercisable or will become exercisable within 60 days of April 2, 2010.
- (10) Includes 620,000 shares held by Julie Paxton Puckett and Mark Puckett, and 1,140,000 held by trusts of Mrs. Puckett's children of which Julie Puckett and Mark Puckett are co-trustees.
- (11) Includes 855,000 shares held by trusts of Mr. Paxton's children of which Mark Paxton and Barbara Paxton are co-trustees.
- (12) Includes the equivalent of 46,000 shares that may be issued upon the conversion of Series 3 5% Preferred Stock, and 53,600 shares that Titan Capital Management, L.L.C. may acquire upon exercise of warrants that are currently exercisable or exercisable within 60 days of April 2, 2010. Walter Schenker and Steven Slawson have shared voting and/or investment control over the shares held by Titan Capital Management, L.L.C. and affiliates.
- (13) Includes the equivalent of 23,194 shares that may be issued upon the conversion of Series 3 5% Preferred Stock, the equivalent of 40,000 shares that may be issued upon conversion of Series 2 5% Preferred Stock, 31,806 shares that may be issued upon conversion of 5% Preferred Stock and 31,597 shares that Mr. Payne may acquire upon exercise of warrants that are currently exercisable or exercisable within 60 days of April 2, 2010.
- (14) Includes the beneficial holdings of First Dallas Holdings, Inc., First Dallas Securities, Inc., Hodges Capital Management, Inc. and Hodges Fund.
- (15) Includes an aggregate of 1,058,549 shares that may be acquired upon exercise of options of officers and directors that are currently exercisable or will become exercisable within 60 days of April 2, 2010. Includes the equivalent of 220,184 shares that may be issued upon conversion of Series 3 5% Preferred Stock, the equivalent of 420,000 shares that may be issued upon conversion of Series 2 5% Preferred Stock, 318,065 shares that may be issued upon conversion of 5% Preferred Stock and 151,285 shares that may be acquired upon exercise of warrants that are currently exercisable or exercisable within 60 days of April 2, 2010.

Executive Officers

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The following table sets forth the names and ages of all executive officers of the Company, their respective positions with the Company, and the period during which each has served as an officer.

Name of Officer	Age	Position(s)	Served as Officer Since
G. Ward Paxton	74	Chairman, President, Chief Executive Officer and Director	2001
T. Joe Head	53	Vice Chairman, Vice President and Director	2003
Garry L. Hemphill	61	Vice President, Operations	2003
Michael L. Paxton	49	Vice President, Chief Financial Officer, Treasurer and Corporate Secretary	2002

Garry L. Hemphill joined the Company on February 14, 2003 as Vice President of Operations and was named as Vice President of Sales in 2006. Mr. Hemphill was previously employed with the Company from 1987 to 2000 as Vice President of Operations and 1984 to 1987 as Director of Operations. From 2002 to 2003, Mr. Hemphill acted as an independent consultant to contract manufacturers in the area of business development. From 2000 to 2001, Mr. Hemphill was President and Chief Executive Officer of VHB Technologies, Inc., a Richardson, Texas based start-up. Mr. Hemphill's background covers over 20 years in data networking, engineering and operation management. Mr. Hemphill holds an Associate Degree in Business Administration from the University of Texas at Dallas.

Michael L. Paxton joined the Company on August 13, 2002 as Vice President, Chief Financial Officer, Secretary and Treasurer. He was also employed by the Company from 1986 until May 1998. Mr. Paxton previously held positions with the Company as Vice President and Secretary from 1995 to 1998, Controller of Finance and Accounting from 1987 to 1995 and Accounting Manager from 1986 to 1987. From 1998 to August 2002, Mr. Paxton served as General Partner for Paxton Ventures, L.P. Mr. Paxton holds a B.B.A. degree from the University of Oklahoma.

The biographies of G. Ward Paxton and T. Joe Head are provided in *Proposal One Election of Directors*.

All executive officers of the Company are elected annually by the Board and serve at the discretion of the Board. There are no family relationships between any director or executive officer and any other such person except for Michael L. Paxton, Vice President, Chief Financial Officer, Secretary and Treasurer, who is the son of G. Ward Paxton, Chairman, President and Chief Executive Officer.

Summary Compensation Information

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The following table sets forth certain summary information regarding all cash compensation earned by the Company's Chief Executive Officer, Chief Financial Officer and each of the Company's other two executive officers for the last three fiscal years in all capacities in which they served the Company and its subsidiaries for such period. The individuals listed below shall be referred to as the Named Executive Officers.

2009 SUMMARY COMPENSATION TABLE (4)

Name and Principal Position	Year	Salary (1)	Option Awards (2)	All Other Compensation (3)	Total
G. Ward Paxton, Chairman, President, and Director	2009	\$137,000	\$25,740	\$1,225	\$163,965
	2008	122,500	8,297	1,225	132,022
	2007	122,500	15,155	1,225	138,880
Michael L. Paxton, Vice President, Chief Financial Officer, Treasurer and Secretary	2009	137,000	12,870	1,225	151,095
	2008	122,500	8,297	1,225	132,022
	2007	122,500	15,155	1,225	138,880
T. Joe Head, Vice-Chairman, Vice President and Director	2009	190,000	26,057	1,750	217,807
	2008	175,000	17,140	1,750	193,890
	2007	175,000	31,330	1,750	208,080
Garry L. Hemphill, Vice President of Sales	2009	125,000	13,028	1,100	139,128
	2008	110,000	8,570	1,100	119,670
	2007	110,000	15,665	1,100	126,765

- (1) Represents bonus compensation and/or commission earned during the fiscal year indicated, a portion of which may have been or will be paid during the subsequent fiscal year.
- (2) Represents the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. The FASB ASC Topic 718 full grant date fair value and will be expensed and reported as the option vests for each Named Executive Officer. A complete discussion of the assumptions used to calculate such values can be found in the Company's 2009 Annual Report on Form 10-K, which accompanies this Proxy Statement.
- (3) This amount includes the annual employer matching contributions under the Company's tax qualified Section 401(k) Savings Plan for Mr. G. Ward Paxton, Mr. Michael L. Paxton, T. Joe Head and Garry L. Hemphill, respectively.
- (4) No stock awards were paid, no non-equity incentive plan compensation was paid, and no pension or non-qualified deferred compensation earnings were charged to the Named Executive Officers for the last three fiscal years. These columns have been omitted from the table.

Base Salary

The salaries of the executive officers, including the Chief Executive Officer, are determined annually by the Compensation Committee with reference to the following without specific weighting:

- salaries paid to executives with similar responsibilities at companies of a comparable size and sales volume, primarily in the high technology industry;
- each officer's performance; and
- the Company's overall financial results.

The Compensation Committee believes that other companies likely compete with the Company for executive talent and that the Company must offer salaries within a competitive market range to attract and retain talented executives. However, the Compensation Committee manages salaries for the executive group as a whole in a conservative fashion in order to place more emphasis on incentive compensation. Compensation paid to our executive officers is low compared to industry averages; therefore, as a result of positive Company performance, the Compensation Committee increased the base salaries of the executive officers by 8% to 14% during 2009. As a result, the Company believes the base salary of its executive officers is lower than the median compensation in effect for comparable positions in the surveyed data. The Company does not consider the performance of the comparison group in determining compensation of its executive officers.

Bonus

To reinforce the attainment of corporate objectives, the Compensation Committee believes that a substantial portion of the potential annual compensation of each executive officer should be in the form of short-term variable incentive pay. The incentive cash bonus program for executives is established annually by the Compensation Committee based upon the Company's achievement of sales and/or net income targets established at the beginning of the fiscal year. The incentive plan for executives requires a threshold level of Company financial performance before any incentives are awarded. Once the threshold objective for sales and/or net income of a fiscal year is reached, specific formulas are in place to calculate the actual incentive payment for each executive for such year.

At the beginning of fiscal year 2009, the Compensation Committee adopted the 2009 management incentive plan. Under the terms of the 2009 management incentive plan, the bonus payable to each executive officer was based on sales targets.

Bonuses Awarded

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In fiscal year 2009, the Company did not achieve its threshold level of sales; thus, non-sales executives, including the Named Executive Officers, did not receive any incentive bonus awards. Certain employees in the sales organization, received incentive sales commission in fiscal 2009 based upon the Company's sales.

Stock Option and Equity Incentive Programs

The goal of the Company's equity-based incentive awards is to align the interests of executive officers with the Company's stockholders. The Compensation Committee determines the value allocated to equity-based incentives according to each executive's position within the Company, individual performance, contributions to achievement of corporate objectives and related factors, and grants stock options to create a meaningful opportunity for stock ownership. Because of the direct relationship between stock option value and the market price, it is believed that granting options is the best method to motivate executives to mirror the concerns of other stockholders.

Stock Options Granted

The Company grants stock option awards to the executive officers and key employees in order to retain their services and increase their performance potential to help attain long-term goals of the Company. However, there is no set formula for the granting of awards to individual executives or employees. In each of the past three fiscal years, 2009, 2008 and 2007, the Company has granted stock options to purchase 496,000, 445,000 and 346,000 shares of the Company's Common Stock, respectively. Of this amount, 300,000, 250,000 and 320,000 shares have been granted to the Named Executive Officers, and the balance has been granted to other key employees and non-employee directors in 2009, 2008 and 2007 respectively. During fiscal year 2009, a total of twenty-two employees, three non-employees, and three non-employee directors received stock options to purchase an aggregate of 4.07% of the outstanding shares of Common Stock, including all of the four Named Executive Officers, who received stock options to acquire an aggregate of 300,000 shares or 60% of the total options granted in fiscal 2009.

Timing of Grants

Stock awards to executive officers and other key employees are typically granted annually in conjunction with the review of the individual performance. This review typically takes place in January. Stock option awards are granted to non-employee directors on the date of the annual meeting of stockholders, in accordance with the terms of the 2005 Plan. Grants to newly hired employees are effective on the first Compensation Committee meeting following the employee's first day of employment, after approval by the committee. The exercise price of all stock options is set at the current day's closing price of the Common Stock.

Stock Ownership Guidelines

The Company does not have any standard stock ownership guidelines. However, all executives are encouraged to retain stock options and other shares that they directly own.

Perquisites

The Company limits the perquisites that are made available to executive officers. The Company does not have a pension program for executives or employees.

The perquisites provided by the Company in fiscal year 2009 are as follows. All employees who participated in the Company's 401(k) plan received up to \$1,750 in matching funds. All of the Named Executive Officers who participated in the 401(k) plan received matching funds. The health and life insurance plans are the same for all employees. In general, all employees' base health premiums are paid 100% and the employee pays approximately 40% of the health premiums for dependents. All employees are also provided life insurance up to \$10,000. This policy is the same for all employees, including executive officers.

Grants of Plan-Based Awards During Fiscal Year 2009

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The following table provides information related to options to acquire shares of Common Stock granted to the Named Executive Officers during fiscal year 2009. The Company did not grant any stock awards or non-equity incentive plan units during fiscal year 2009.

Employment Agreements

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Neither the Company nor its subsidiaries has any employment agreements with any of its Named Executive Officers.

2009 GRANTS OF PLAN-BASED AWARDS TABLE

Name	Grant Date	Estimated future payouts under non-equity incentive plan awards			Estimated future payouts under equity incentive plan awards			All other stock awards: number of shares of stock or units (#)	All other option awards: number of securities underlying options (#)	Exercise base price of option awards (\$ / Sh)	Grant date fair value of stock and option awards (\$)(1)(2)
		Threshold (#)	Target (#)	Maximum (#)	Threshold (#)	Target (#)	Maximum (#)				
G. Ward Paxton	02/04/09								100,000	\$0.31	\$25,740
Michael L. Paxton	02/04/09								50,000	0.31	12,870
T. Joe Head	02/04/09								100,000	0.28	26,057
Garry L. Hemphill	02/04/09								50,000	0.28	13,028

(1) Refer to Note 9, "Stock Options", in the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K filed on March 29, 2010 for the relevant assumptions used to determine the valuation of the option awards.

(2) Represents the grant-date fair value of equity compensation awarded in the year. Refer to Note 9, "Stock Options", in the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K filed on March 29, 2010 for the relevant assumptions used to determine the valuation of the stock option awards.

Outstanding Equity Awards at the End of Fiscal Year 2009

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The following table sets forth information with respect to the options outstanding by the Named Executive Officers held at fiscal year end.

2009 OUTSTANDING EQUITY AWARDS AT FISCAL YEAR-END TABLE

Name	Number of Securities Underlying Unexercised Options (#) Exercisable	Number of Securities Underlying Unexercised Options (#) (1) Unexercisable	Option Exercise Price (\$)	Option Expiration Date (2)	
G. Ward Paxton	25,000		\$3.20	01/31/15	
	40,000		3.08	06/14/15	
	30,000		0.33	11/09/11	
	33,334	16,666	0.44	05/30/12	
	16,667	33,333	0.24	01/23/13	
			100,000	0.31	02/04/14
Michael L. Paxton	12,500		3.20	01/31/15	
	40,000		3.08	06/14/15	
	30,000		0.33	11/09/11	
	33,334	16,666	0.44	05/30/12	
	16,667	33,333	0.24	01/23/13	
			50,000	0.31	02/04/14
T. Joe Head	25,000		3.20	01/31/15	
	40,000		3.08	06/14/15	
	100,000		0.30	11/09/16	
	66,667	33,333	0.40	05/30/17	
	33,334	66,666	0.22	01/23/18	
			100,000	0.28	02/04/19
Garry L. Hemphill	2,500		1.12	02/14/13	
	2,500		1.08	05/01/13	
	2,500		2.68	08/20/13	
	1,250		4.04	11/05/13	
	3,125		2.72	01/29/14	
	17,500		1.36	08/12/14	
	7,500		3.20	01/31/15	
	40,000		3.08	06/14/15	
	30,000		0.30	11/09/16	
	33,334	16,666	0.40	05/30/17	
	16,667	33,333	0.22	01/23/18	
			50,000	0.28	02/04/19

(1) Options become exercisable in three equal annual installments beginning on the first anniversary date of grant.

- (2) The expiration date of each option occurs between five to ten years after the date of grant of each option.

DIRECTOR COMPENSATION

Name	Fees Earned or Paid in Cash (\$)	Option Awards (\$)(2)(3)(4)	Total (\$)
G. Ward Paxton, (1) Chairman of the Board			
T. Joe Head, (1) Vice Chairman of the Board			
J. Fred Bucy, Jr., (2) Member	\$18,000	\$1,949	\$19,949
James F. Gero, (2) Member	18,000	1,949	19,949
Donald M. Johnston, (2) Member	18,000	1,949	19,949

(1) Mr. G. Ward Paxton and Mr. Head are employee directors of the Company. All compensation paid to them is paid for their services as employee executives of the Company, which are detailed in the 2009 Summary Compensation Table. No additional fees were paid to Mr. Paxton or Mr. Head for their services as a Director of the Company as noted above.

(2) Mr. Bucy, Mr. Gero and Mr. Johnston were each granted 5,000 stock options with an exercise price of \$0.41, the closing fair market value on such date.

(3) Represents the aggregate grant date fair value computed in accordance with FASB ASC Topic 718. The FASB ASC Topic 718 full grant date fair value of \$1,949 which will be expensed and reported as the option vests for each non employee director. Refer to Note 9, Stock Options, in the Notes to Consolidated Financial Statements included in the Annual Report on Form 10-K filed on March 29, 2010 for the relevant assumptions used to determine the valuation of the stock option awards.

(4) The following are the aggregate number of option awards outstanding that have been granted to each of the non-employee directors as of December 31, 2009: Mr. Bucy 37,500; Mr. Gero 32,500; and Mr. Johnston 37,500.

Overview of Compensation and Procedures

The Compensation Committee reviews the level of compensation of non-employee Directors on an annual basis. The Company has historically used data from a number of different sources to determine the compensation for non-employee Directors. Some examples of the data used include:

- publicly available data describing director compensation in peer companies; and
- survey data collected by the Company.

We compensate non-employee members of the Board through a mixture of cash and equity-based compensation. Each non-employee Director receives a cash retainer fee of \$1,200 per month. Each non-employee Director also receives a fee of \$1,200 for each meeting of the Board attended (excluding telephonic meetings) and for each meeting of a committee of the Board attended (exclusive of committee meetings held on the same day as Board meetings). Each non-employee Director also receives a fee of \$600 for each telephonic meeting attended. Each non-employee Director is also reimbursed for all reasonable expenses incurred in attending such meetings. No Director who is an employee of the Company receives any fees for service as a Director. However, G. Ward Paxton and T. Joe Head each earned compensation for his services to the Company as an employee as set forth in the Summary Compensation Table. Mr. G. Ward Paxton received a stock option grant for 100,000 shares at a price of \$0.31 per share during 2009. Mr. T. Joe Head received a stock option grant for 100,000 shares at a price of \$0.28 per share during 2009. The options are detailed on the 2009 Grants of Plan-Based Awards Table in this proxy statement. Neither Mr. Paxton nor Mr. Head received any additional fees for his services as a Director.

Under the Automatic Option Grant Program of the 2005 Plan, each non-employee Director will automatically be granted an option to purchase 10,000 shares of Common Stock upon joining the Board and an option to purchase 5,000 shares of Common Stock on the date of each annual stockholder meeting as long as the director has served at least six months prior to the date of grant.

CERTAIN TRANSACTIONS WITH MANAGEMENT

February 4, 2010 Promissory Note

On January 30, 2008 and extended on October 24, 2008 and February 4, 2010, the Company entered into a revolving promissory note to borrow up to \$700,000 from G. Ward Paxton, the Company's Chairman, President and Chief Executive Officer. Under the terms of the note, the Company may borrow, repay and reborrow on the loan as needed up to an outstanding principal amount of \$700,000 at any date. Amounts the Company borrows under the note accrue interest a floating rate per annum equal to the announced prime rate of Silicon Valley Bank plus 1% and are unsecured. All outstanding principal and accrued but unpaid interest are due on March 31, 2011. At December 31, 2009, there was a principal balance due to Mr. Paxton of \$700,000 under the terms of the promissory note.

February 4, 2010 Written Commitment

On March 20, 2008 and extended on November 7, 2008 and February 4, 2010, we received a written commitment from our Chief Executive Officer to invest up to an additional \$1,500,000 in the Company until March 2011, should such funding be required by the Company, on terms and conditions yet to be determined. Under this agreement, the Company borrowed and repaid funds during the year 2009 with similar terms as the \$700,000 note described above. At December 31, 2009, there was a balance borrowed against this commitment of \$270,000.

During 2009 and up until March 31, 2010, there have been no other transactions, or currently proposed transactions, between the Company and any of its executive officers, directors or 5% beneficial holders, or member of the immediate family of the foregoing persons, in which one of the foregoing individuals or entities had an interest of more than \$120,000.

COMPLIANCE WITH SECTION 16 REPORTING REQUIREMENTS

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Section 16(a) of the Exchange Act requires the Company's directors and officers, and persons who own more than 10% of a registered class of the Company's equity securities, to file initial reports of ownership and reports of changes in ownership with the SEC. Such persons are required by SEC regulation promulgated pursuant to the Exchange Act to furnish the Company with copies of all Section 16(a) report forms they file with the SEC.

Based solely on its review of the copies of such report forms received by it with respect to fiscal year 2009, the Company believes that all filing requirements applicable to its directors, officers and persons who own more than 10% of a registered class of the Company's equity securities have been timely complied with in accordance with Section 16(a) of the Exchange Act except for late Form 4 filings for four company officers, G. Ward Paxton, T. Joe Head, Garry L. Hemphill and Michael L. Paxton, and late Form 3 filings for two 10% shareholders, Mark A. Paxton and Julie Paxton Puckett. The late Form 4 filings were filed on February 26, 2010 and originally due on February 6, 2010. The late Form 3 filings were filed on March 22, 2010, originally due on January 14, 2010.

STOCKHOLDER PROPOSALS

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Stockholders may submit proposals on matters appropriate for stockholder action at subsequent annual meetings of the stockholders consistent with Rule 14a-8 promulgated under the Exchange Act. For such proposals to be considered for inclusion in the Proxy Statement and Proxy relating to the 2011 Annual Meeting of Stockholders, such proposals must be received by the Company not later than December 16, 2010. Such proposals should be directed to Intrusion Inc., 1101 East Arapaho Road, Suite 200, Richardson, Texas 75081, Attention: Secretary (telephone: (972) 234-6400; telecopy: (972) 234-1467).

Pursuant to Rule 14a-4(c) of the Exchange Act of 1934, if a stockholder who intends to present a proposal at the 2010 Annual Meeting of Stockholders does not notify the Company of such proposal on or prior to March 4, 2010, then management proxies would be allowed to use their discretionary voting authority to vote on the proposal when the proposal is raised at the annual meeting, even though there is no discussion of the proposal in the 2010 proxy statement.

EXPENSES OF SOLICITATION

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All costs incurred in the solicitation of Proxies for the Meeting will be borne by the Company. In addition to the solicitation by mail, officers and employees of the Company may solicit Proxies by telephone, telefax or personally, without additional compensation. The Company may also make arrangements with brokerage houses and other custodians, nominees and fiduciaries for the forwarding of solicitation materials to the beneficial owners of shares of Common Stock held of record by such persons, and the Company may reimburse such brokerage houses and other custodians, nominees and fiduciaries for their out-of-pocket expenses incurred in connection therewith. In addition, Mellon Investor Services LLC has been retained by the Company to aid in the solicitation of Proxies and will solicit Proxies by mail, telephone, internet, telefax and personal interview and may request brokerage houses and nominees to forward soliciting material to beneficial owners of Common Stock. For these services, Mellon Investor Services LLC will be paid fees not to exceed approximately \$3,000, plus reasonable incidental expenses.

ADDITIONAL INFORMATION AVAILABLE

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Upon the written request of any stockholder, the Company will furnish, without charge, a copy of the Company's 2009 Annual Report on Form 10-K, as filed with the SEC, including the financial statements and schedules thereto. The request should be directed to the Secretary at the Company's offices indicated above.

The Company's 2009 Annual Report on Form 10-K accompanies this Proxy Statement. The Annual Report on Form 10-K, which includes financial statements, does not form and is not to be deemed part of this Proxy Statement.

OTHER BUSINESS

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As of the date of this Proxy Statement, the Board and management are not aware of any other matter, other than those described herein, which will be presented for consideration at the Meeting. Should any other matter requiring a vote of the stockholders properly come before the Meeting or any adjournment thereof, the enclosed Proxy confers upon the persons named in and entitled to vote the shares represented by such Proxy discretionary authority to vote the shares represented by such Proxy in accordance with their best judgment in the interest of the Company on such matters. The persons named in the enclosed Proxy also may, if it is deemed advisable, vote such Proxy to adjourn the Meeting from time to time.

Please sign, date and return promptly the enclosed Proxy at your earliest convenience in the enclosed envelope, which requires no postage if mailed in the United States.

By Order of the Board of Directors

*G. WARD PAXTON
Chairman, President and Chief Executive Officer*

Richardson, Texas
April 16, 2010

Appendix A

Amended 2005 Incentive Stock Plan

INTRUSION INC.

AMENDED 2005 STOCK INCENTIVE PLAN

ARTICLE ONE

GENERAL PROVISIONS

I. PURPOSE OF THE PLAN

This Plan is intended to promote the interests of the Corporation by providing eligible persons, who are employed by or serving the Corporation or any Parent or Subsidiary, with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in the Corporation as an incentive for them to remain in such service and to continue contributing to the on-going success of the Corporation.

Capitalized terms shall have the meanings assigned to such terms in the attached Appendix.

II. STRUCTURE OF THE PLAN

A. The Plan shall be divided into three separate equity incentive programs:

1. the Discretionary Option Grant Program under which eligible persons may, at the discretion of the Plan Administrator, be granted options to purchase shares of Common Stock;

2. the Stock Issuance Program under which eligible persons may, at the discretion of the Plan Administrator, be issued shares of Common Stock directly, either through the immediate purchase of such shares or as a bonus for services rendered the Corporation (or any Parent or Subsidiary); and

3. the Automatic Option Grant Program under which eligible non-Employee Board members shall automatically receive option grants at designated intervals over their period of continued Board service.

B. The provisions of Articles One and Five shall apply to all equity programs under the Plan and shall govern the interests of all persons under the Plan.

III. ADMINISTRATION OF THE PLAN

A. The Primary Committee and the Board shall have concurrent authority to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders. Grants made by the entire Board will be not be exempt from the million dollar compensation deduction limitation of Code Section 162(m). Administration of the Discretionary Option Grant and Stock Issuance Programs with respect to all other persons eligible to participate in those programs may, at the Board's discretion, be vested in the Primary Committee or a Secondary Committee, or the Board may retain the power to administer those programs with respect to all such persons. However, any discretionary option grants or stock issuances for members of the Primary Committee should be authorized by a disinterested majority of the Board.

B. Members of the Primary Committee or any Secondary Committee shall serve for such period of time as the Board may determine and may be removed by the Board at any time. The Board may also at any time terminate the functions of any Secondary Committee and reassume all powers and authority previously delegated to such committee.

C. Each Plan Administrator shall, within the scope of its administrative functions under the Plan, have full power and authority (subject to the provisions of the Plan) to establish such rules and procedures as it may deem appropriate for proper administration of the Discretionary Option Grant and Stock Issuance Programs and to make such determinations under, and issue such interpretations of, the provisions of those programs and any outstanding options or stock issuances thereunder as it may deem necessary or advisable. Decisions of the Plan Administrator within the scope of its administrative functions under the Plan shall be final on all parties who have an interest in the Discretionary Option Grant and Stock Issuance Programs under its jurisdiction or any option or stock issuance thereunder.

D. Service on the Primary Committee or the Secondary Committee shall constitute service as a Board member, and members of each such committee shall accordingly be entitled to full indemnification and reimbursement as Board members for their service on such committee. No member of the Primary Committee or the Secondary Committee shall be liable for any act or omission made in good faith with respect to the Plan or any option grants or stock issuances under the Plan.

E. Administration of the Automatic Option Grant Program shall be self-executing in accordance with the terms of that program, and no Plan Administrator shall exercise any discretionary functions with respect to any option grants or stock issuances made under that program.

IV. ELIGIBILITY

A. The persons eligible to participate in the Discretionary Option Grant and Stock Issuance Programs are as follows:

1. Employees,
2. non-Employee members of the Board or the board of directors of any Parent or Subsidiary, and

3. independent contractors who provide services to the Corporation (or any Parent or Subsidiary).

B. Each Plan Administrator shall, within the scope of its administrative jurisdiction under the Plan, have full authority to determine, (1) with respect to the option grants made pursuant to the Discretionary Option Grant Program, which eligible persons are to receive such grants, the time or times when those grants are to be made, the number of shares to be covered by each such grant, the status of the granted option as either an Incentive Option or a Non-Statutory Option, the time or times when each option is to become exercisable, the exercise price, the vesting schedule (if any) applicable to the option shares and the maximum term for which the option is to remain outstanding and (2) with respect to stock

issuances pursuant to the Stock Issuance Program, which eligible persons are to receive such issuances, the time or times when the issuances are to be made, the number of shares to be issued to each Participant, the vesting schedule (if any) applicable to the issued shares and the consideration for such shares.

C. The Plan Administrator shall have the absolute discretion either to grant options in accordance with the Discretionary Option Grant Program or to effect stock issuances in accordance with the Stock Issuance Program.

D. The individuals who shall be eligible to participate in the Automatic Option Grant Program shall be limited to (1) those individuals who first become non-Employee Board members on or after the Plan Effective Date, whether through appointment by the Board or election by the Corporation's stockholders, and (2) those individuals who continue to serve as non-Employee Board members at one or more Annual Stockholders' Meetings held on or after the Plan Effective Date, provided that individual has been a non-Employee Board member for at least six months.

V. STOCK SUBJECT TO THE PLAN

A. The stock issuable under the Plan shall be shares of authorized but unissued or reacquired Common Stock, including shares repurchased by the Corporation on the open market. The number of shares of Common Stock reserved for issuance over the term of the Plan shall not exceed 3,000,000 shares.

B. No one person participating in the Plan may receive options and direct stock issuances pursuant to the Plan for more than 100,000 shares of Common Stock in the aggregate per calendar year.

C. Shares of Common Stock subject to outstanding options granted under the Plan shall be available for subsequent issuance under the Plan to the extent (1) those options expire or terminate for any reason prior to exercise in full or (2) the options are cancelled in accordance with the cancellation-regrant provisions of the Discretionary Option Grant Program. Unvested shares issued under the Plan and subsequently cancelled or repurchased by the Corporation pursuant to the Corporation's repurchase rights under the Plan shall be added back to the number of shares of Common Stock reserved for issuance under the Plan and shall accordingly be available for reissuance through one or more subsequent option grants or direct stock issuances under the Plan. However, should the exercise price of an option granted pursuant to the Plan be paid with shares of Common Stock or should shares of Common Stock otherwise issuable pursuant to the Plan be withheld by the Corporation in satisfaction of the withholding taxes incurred in connection with the exercise of an option or the vesting of a stock issuance made pursuant to the Plan, then the number of shares of Common Stock available for issuance pursuant to the Plan shall be reduced by the gross number of shares for which the option is exercised or which vest under the stock issuance, and not by the net number of shares of Common Stock issued to the holder of such option or stock issuance.

D. If any change is made to the Common Stock by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration,

A-3

appropriate adjustments shall be made by the Plan Administrator to (1) the maximum number and/or class of securities issuable pursuant to the Plan, (2) the maximum number and/or class of securities for which any one person may be granted options and direct stock issuances pursuant to the Plan per calendar year, (3) the number and/or class of securities for which grants are subsequently to be made pursuant to the Automatic Option Grant Program to new and continuing non-Employee Board members, and (4) the number and/or class of securities and the exercise price per share in effect under each outstanding option granted pursuant to the Plan. Such adjustments to the outstanding options are to be effected in a manner that shall preclude the enlargement or dilution of rights and benefits under such options. The adjustments determined by the Plan Administrator shall be final.

E. Outstanding awards granted pursuant to the Plan shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

ARTICLE TWO

DISCRETIONARY OPTION GRANT PROGRAM

I. OPTION TERMS

Each option shall be evidenced by one or more documents in the form approved by the Plan Administrator; *provided, however*, that each such document shall comply with the terms specified below. Each document evidencing an Incentive Option shall, in addition, be subject to the provisions of the Plan applicable to such options.

A. Exercise Price.

1. The exercise price per share shall be fixed by the Plan Administrator but shall not be less than 100% of the Fair Market Value per share of Common Stock on the date of grant.

2. The exercise price shall become immediately due upon exercise of the option and shall, subject to the provisions of Section I of Article Five and the documents evidencing the option, be payable in one or more of the forms specified below:

- (i) cash or check made payable to the Corporation,

- (ii) shares of Common Stock held for the requisite period necessary to avoid a charge to the Corporation's earnings for financial reporting purposes and valued at Fair Market Value on the Exercise Date, or

- (iii) to the extent the option is exercised for vested shares, through a special sale and remittance procedure pursuant to which the Optionee shall concurrently provide irrevocable instructions to (a) a Corporation-designated brokerage firm to effect the immediate sale of the purchased shares and remit to the Corporation, out of the sale proceeds available on

the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable income and employment taxes required to be withheld by the Corporation by reason of such exercise and (b) the Corporation to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale.

Except to the extent such sale and remittance procedure is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

B. **Exercise and Term of Options.** Each option shall be exercisable at such time or times, during such period and for such number of shares as shall be determined by the Plan Administrator and set forth in the documents evidencing the option. However, no option shall have a term in excess of ten years measured from the date the option is granted.

C. **Effect of Termination of Service.**

1. The following provisions shall govern the exercise of any options granted pursuant to the Discretionary Option Grant Program that are outstanding at the time of the Optionee's cessation of Service:

(i) Immediately upon the Optionee's cessation of Service, the option shall terminate with respect to the unvested shares subject to the option.

(ii) Should the Optionee's Service be terminated for Misconduct or should the Optionee otherwise engage in Misconduct, then the option shall terminate immediately with respect to all shares subject to the option.

(iii) Should the Optionee's Service terminate for reasons other than Misconduct, then the option shall remain exercisable during such period of time after the Optionee's Service ceases as shall be determined by the Plan Administrator and set forth in the documents evidencing the option, but no option shall be exercisable after its Expiration Date. During the applicable post-Service exercise period, the option may not be exercised in the aggregate for more than the number of vested shares for which the option is exercisable on the date of the Optionee's Service ceased. Upon the expiration of the applicable exercise period or (if earlier) upon the Expiration Date, the option shall terminate with respect to any vested shares subject to the options.

2. Among its discretionary powers, the Plan Administrator shall have complete discretion, exercisable either at the time an option is granted or at any time while the option remains outstanding, to:
- (i) extend the period of time for which the option is to remain exercisable following the Optionee's cessation of Service, but in no event beyond the Expiration Date, and/or

(ii) permit the option to be exercised, during the applicable post-Service exercise period, not only with respect to the number of vested shares of Common Stock for which such option is exercisable at the time of the Optionee's cessation of Service but also with respect to one or more additional installments in which the Optionee would have vested had the Optionee continued in Service.

D. **Stockholder Rights**. The holder of an option shall have no stockholder rights with respect to the shares subject to the option until such person shall have exercised the option, paid the exercise price and become a holder of record of the purchased shares.

E. **Repurchase Rights**. The Plan Administrator shall have the discretion to grant options that are exercisable for unvested shares of Common Stock. Should the Optionee cease Service while such shares are unvested, the Corporation shall have the right to repurchase any or all of those unvested shares at the exercise price paid per share. The terms upon which such repurchase right shall be exercisable (including the period and procedure for exercise and the appropriate vesting schedule for the purchased shares) shall be established by the Plan Administrator and set forth in the document evidencing such repurchase right.

F. **Limited Transferability of Options**. During the lifetime of the Optionee, options shall be exercisable only by the Optionee and shall not be assignable or transferable other than by will or by the laws of inheritance following the Optionee's death. However, a Non-Statutory Option may be assigned in whole or in part during the Optionee's lifetime to one or more members of the Optionee's family or to a trust established exclusively for one or more such family members or to the Optionee's former spouse, to the extent such assignment is in connection with the Optionee's estate plan or pursuant to a domestic relations order. The assigned portion may only be exercised by the person or persons who acquire a proprietary interest in the option pursuant to the assignment. The terms applicable to the assigned portion shall be the same as those in effect for the option immediately prior to such assignment and shall be set forth in such documents issued to the assignee as the Plan Administrator may deem appropriate. Notwithstanding the foregoing, the Optionee may also designate one or more persons as the beneficiary or beneficiaries of his or her outstanding options granted pursuant to the Plan, and those options shall, in accordance with such designation, automatically be transferred to such beneficiary or beneficiaries upon the Optionee's death prior to the Expiration Date of those options. Such beneficiary or beneficiaries shall take the transferred options subject to all the terms and conditions of the applicable agreement evidencing each such transferred option, including (without limitation) the limited time period during which the option may be exercised following the Optionee's death.

II. INCENTIVE OPTIONS

The terms specified below shall be applicable to all Incentive Options. Except as modified by the provisions of this Section II, all the provisions of Articles One, Two and Five shall be applicable to Incentive Options. Options that are specifically designated as Non-Statutory Options when issued pursuant to the Plan shall *not* be subject to the terms of this Section II.

A. **Eligibility.** Incentive Options may only be granted to Employees.

A-6

B. **Dollar Limitation.** The aggregate Fair Market Value of the shares of Common Stock (determined as of the respective date or dates of grant) for which one or more options granted to any Employee pursuant to the Plan (or any other option plan of the Corporation or any Parent or Subsidiary) may for the first time become exercisable as Incentive Options during any one calendar year shall not exceed \$100,000. To the extent that an Optionee's options exceed that limit, they will be treated as Non-Statutory Options (but all of the other provisions of the option shall remain applicable), with the first options that were awarded to the Optionee to be treated as Incentive Options.

C. **10% Stockholder.** If any Employee to whom an Incentive Option is granted is a 10% Stockholder, then the exercise price per share shall not be less than 110% of the Fair Market Value per share of Common Stock on the date the option is granted, and the Expiration Date shall not be more than five years from the date the option was granted.

III. CORPORATE TRANSACTIONS

A. In the event a Change in Control occurs, the shares of Common Stock at the time subject to each outstanding option granted pursuant to this Discretionary Option Grant Program shall automatically vest in full so that each such option shall, immediately prior to the effective date of the Change in Control, become exercisable for all the shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully vested shares of Common Stock. However, an outstanding option shall not become vested on such an accelerated basis if and to the extent: (1) such option is to be assumed by the successor corporation (or parent thereof) or is otherwise to continue in full force pursuant to the terms of transaction or (2) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing at the time of the Change in Control on any shares for which the option is not otherwise at that time exercisable and provides for subsequent payout of that spread no later than the time the Optionee would vest in those option shares or (3) the acceleration of such option is subject to other limitations imposed by the Plan Administrator at the time of the option grant.

B. All outstanding repurchase rights under the Discretionary Option Grant Program shall automatically terminate, and the shares of Common Stock subject to those terminated rights shall immediately vest in full, immediately prior to the occurrence of a Change in Control, except to the extent: (1) those repurchase rights are to be assigned to the successor corporation (or parent thereof) or are otherwise to continue in full force pursuant to the terms of the transaction or (2) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

C. Immediately following the consummation of the transactions contemplated by the Change in Control documentation, all outstanding options granted pursuant to the Discretionary Option Grant Program shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof) or otherwise continued in full force and effect pursuant to the terms of the transaction.

D. Each option granted pursuant to the Discretionary Option Grant Program which is assumed or otherwise continued in effect in connection with a Change in Control shall

A-7

be appropriately adjusted, immediately after such Change in Control, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Change in Control had the option been exercised immediately prior to such Change in Control. Appropriate adjustments to reflect such Change in Control shall also be made to (1) the exercise price payable per share under each outstanding option, provided the aggregate exercise price payable for such securities shall remain the same, (2) the maximum number and/or class of securities available for issuance over the remaining term of the Plan and (3) the maximum number and/or class of securities for which any one person may be granted options and direct stock issuances pursuant to the Plan per calendar year. To the extent the holders of Common Stock receive cash consideration for their Common Stock in consummation of the Change in Control, the successor corporation may, in connection with the assumption of the outstanding options granted pursuant to the Discretionary Option Grant Program, substitute one or more shares of its own common stock with a fair market value equivalent to the cash consideration paid per share of Common Stock in such transaction.

E. Among its discretionary powers, the Plan Administrator shall have the ability to structure an option (either at the time the option is granted or at any time while the option remains outstanding) so that the option shall become immediately exercisable and some or all of the shares subject to that option shall automatically become vested (and some or all of the repurchase rights of the Corporation with respect to the unvested shares subject to that option shall immediately terminate) upon the occurrence of a Change in Control, the consummation of a Proxy Contest or any other specified event or the Optionee's Involuntary Termination within a designated period of time following any of these events. In addition, the Plan Administrator may provide that one or more of the Corporation's repurchase rights with respect to some or all of the shares held by the Optionee at the time of such a Change in Control, Proxy Contest, or any other specified event or the Optionee's Involuntary Termination within a designated period of time following such an event shall immediately terminate and all of the shares shall become vested.

F. The portion of any Incentive Option accelerated in connection with a Change in Control or Proxy Contest shall remain exercisable as an Incentive Option only to the extent the \$100,000 limitation described in Section II.B. above is not exceeded. To the extent such dollar limitation is exceeded, the accelerated portion of such option shall be exercisable as a Non-Statutory Option under the federal tax laws.

ARTICLE THREE

STOCK ISSUANCE PROGRAM

I. STOCK ISSUANCE TERMS

Shares of Common Stock may be issued pursuant to the Stock Issuance Program through direct and immediate issuances without any intervening option grants. Each such stock issuance shall be evidenced by a Stock Issuance

Agreement that complies with the terms specified below. Shares of Common Stock may also be issued pursuant to the Stock Issuance Program pursuant to awards that entitle the recipients to receive those shares upon the attainment of designated performance goals or the satisfaction of specified Service requirements.

A. **Purchase Price.**

1. The purchase price per share shall be fixed by the Plan Administrator, but shall not be less than 100% of the Fair Market Value per share of Common Stock on the date of grant.

2. Subject to the provisions of Section I of Article Five, shares of Common Stock may be issued pursuant to the Stock Issuance Program for any of the following items of consideration which the Plan Administrator may deem appropriate in each individual instance:

- (i) cash or check made payable to the Corporation, or
- (ii) past services rendered to the Corporation (or any Parent or Subsidiary).

B. **Vesting Provisions.**

1. Shares of Common Stock issued pursuant to the Stock Issuance Program may, in the discretion of the Plan Administrator, be fully and immediately vested upon issuance or may vest in one or more installments over the Participant's period of Service or upon attainment of specified performance objectives. The elements of the vesting schedule applicable to any unvested shares of Common Stock issued pursuant to the Stock Issuance Program shall be determined by the Plan Administrator and incorporated into the Stock Issuance Agreement. Shares of Common Stock may also be issued pursuant to the Stock Issuance Program pursuant to awards that entitle the recipients to receive those shares upon the attainment of designated performance goals or the satisfaction of specified Service requirements.

2. Any new, substituted or additional securities or other property (including money paid other than as a regular cash dividend) which the Participant may have the right to receive with respect to the Participant's unvested shares of Common Stock by reason of any stock dividend, stock split, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration shall be issued subject to such escrow arrangements as the Plan Administrator shall deem appropriate and shall be vested to the same extent the Participant's shares of Common Stock are vested.

3. The Participant shall have full stockholder rights with respect to any shares of Common Stock issued to the Participant pursuant to the Stock Issuance Program, whether or not the Participant's interest in those shares is vested. Accordingly, the Participant shall have the right to vote such shares and to receive any regular cash dividends paid on such shares. Cash dividends constitute taxable compensation to the Participant are deductible by the Corporation (unless the Participant has made an election under Section 83(b) of the Code).

4. Should the Participant cease to remain in Service while one or more shares of Common Stock issued pursuant to the Stock Issuance Program are unvested or should the performance objectives not be attained with respect to one or more such unvested shares of Common Stock, then those shares shall be immediately surrendered to the

Corporation for cancellation, and the Participant shall have no further stockholder rights with respect to those shares. To the extent the surrendered shares were previously issued to the Participant for consideration paid in cash or cash equivalent (including the Participant's purchase-money indebtedness), the Corporation shall repay to the Participant the cash consideration paid for the surrendered shares without interest and/or shall cancel the unpaid principal balance of any outstanding purchase-money note of the Participant attributable to the surrendered shares.

5. The Plan Administrator may in its discretion waive the surrender and cancellation of one or more unvested shares of Common Stock that would otherwise occur upon the cessation of the Participant's Service or the non-attainment of the performance objectives applicable to those shares. Such waiver shall result in the immediate vesting of the Participant's interest in the shares of Common Stock as to which the waiver applies. Such waiver may be effected at any time, whether before or after the Participant's cessation of Service or attainment of the applicable performance objectives.

6. Outstanding share right awards granted pursuant to the Stock Issuance Program shall automatically terminate, and no shares of Common Stock shall actually be issued in satisfaction of those awards, if the performance goals or Service requirements established for such awards are not attained or satisfied. The Plan Administrator, however, shall have the discretionary authority to issue shares of Common Stock under one or more outstanding share right awards as to which the designated performance goals or Service requirements have not been attained or satisfied.

II. CORPORATE TRANSACTIONS

A. All of the Corporation's outstanding repurchase rights under the Stock Issuance Program shall terminate automatically, and all the shares of Common Stock subject to those terminated rights shall immediately vest in full, immediately prior to the occurrence of a Change in Control, except to the extent (1) those repurchase rights are to be assigned to the successor corporation (or parent thereof) or are otherwise to continue in full force and effect pursuant to the terms of the transaction or (2) such accelerated vesting is precluded by other limitations imposed in the Stock Issuance Agreement.

B. The Plan Administrator shall have the discretionary authority to structure one or more of the Corporation's repurchase rights under the Stock Issuance Program so that those rights shall automatically terminate in whole or in part, and some or all of the shares of Common Stock subject to those terminated rights shall immediately vest, upon the occurrence of a Change in Control, the consummation of a Proxy Contest or any other event, or the Participant's Involuntary Termination within a designated period of time following any of these events.

ARTICLE FOUR

AUTOMATIC OPTION GRANT PROGRAM

I. OPTION TERMS

A. **Grant Dates.** Option grants shall be made on the dates specified below:

1. Each individual who is first elected or appointed as a non-Employee Board member at any time on or after the Plan Effective Date shall automatically be granted, on the date of such initial election or appointment, a Non-Statutory Option to purchase 10,000 shares of Common Stock; *provided, however*, such individual has not been employed by the Corporation in the preceding six months.

2. On the date of each annual stockholders meeting (beginning with the first annual stockholders meeting occurring on or after the Plan Effective Date), each individual who is to continue to serve as a non-Employee Board member shall automatically be granted a Non-Statutory Option to purchase 5,000 shares of Common Stock, provided such individual has served as a non-Employee Board member for at least six months. There shall be no limit on the number of such annual option grants any one non-Employee Board member may receive over his or her period of Board service, and non-Employee Board members who have previously been in the employ of the Corporation (or any Parent or Subsidiary) or who have otherwise received one or more option grants from the Corporation prior to the Plan Effective Date shall be eligible to receive one or more such annual option grants over their period of continued Board service.

B. **Exercise Price.** The exercise price per share shall be equal to 100% of the Fair Market Value per share of Common Stock on the date the option is granted.

C. **Option Term.** Each option shall have a term of ten years measured from the date the option is granted.

D. **Exercisability.** Each option shall become exercisable in a series of three successive equal annual installments upon the Optionee's completion of each year of Service as a Board member over the three-year period measured from the date the option is granted.

E. **Termination of Board Service.** The following provisions shall govern the exercise of any options granted to the Optionee pursuant to the Automatic Option Grant Program that are outstanding at the time the Optionee ceases to serve as a Board member:

1. The option shall be exercisable until the earlier to occur of (a) the Expiration Date or (b) the one-year anniversary of the date the Optionee's Board service terminated.

2. During the post-Service exercise period, the option may not be exercised in the aggregate for more than the number of vested shares of Common Stock for which the option is exercisable at the time of the Optionee's cessation of Board service.

3. Should the Optionee's Board service cease due to death or Permanent Disability, then all shares at the time subject to the option shall immediately vest so that such option may be exercised for any or all of those shares as fully vested shares of Common Stock.

4. Upon the expiration of the one year exercise period or (if earlier) upon the Expiration Date, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Board service for any reason other than death or Permanent Disability, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

II. CORPORATE TRANSACTION

A. In the event a Change in Control occurs while the Optionee remains a Board member, the shares of Common Stock at the time subject to each outstanding option that was granted pursuant to this Automatic Option Grant Program shall automatically vest in full so that each such option shall, immediately prior to the effective date of the Change in Control, become exercisable for all the shares subject to the option at that time as fully vested shares of Common Stock and may be exercised for any or all of those vested shares. Immediately following the consummation of the transactions contemplated by the Change in Control documentation, each automatic option grant shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof) or otherwise continued in effect pursuant to the terms of the Change in Control transaction.

B. In the event a Proxy Contest occurs while the Optionee remains a Board member, the shares of Common Stock at the time subject to each outstanding option granted pursuant to this Automatic Option Grant Program shall automatically vest in full so that each such option shall, upon the consummation of the Proxy Contest, become exercisable for all the option shares as fully vested shares of Common Stock and may be exercised for any or all of those vested shares. Such option shall remain exercisable until the *earliest* to occur of (1) the Expiration Date, (2) the expiration of the one-year period measured from the date of the Optionee's cessation of Board service, or (3) the termination of the option in connection with a Change in Control transaction.

C. Each option which is assumed or otherwise continued in effect in connection with a Change in Control shall be appropriately adjusted, immediately after such Change in Control, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Change in Control had the option been exercised immediately prior to such Change in Control. Appropriate adjustments shall also be made to the exercise price payable per share under each outstanding option, *provided* the aggregate exercise price payable for such securities shall remain the same. To the extent the holders of Common Stock receive cash consideration for their Common Stock in consummation of the Change in Control, the successor corporation may, in connection with the assumption of the outstanding options granted pursuant to the Automatic Option Grant Program, substitute one or more shares of its own common stock with a fair market value equivalent to the cash consideration paid per share of

Common Stock in such transaction.

A-12

III. REMAINING TERMS

The remaining terms of each option granted pursuant to the Automatic Option Grant Program shall be the same as the terms in effect for option grants made pursuant to the Discretionary Option Grant Program.

ARTICLE FIVE

MISCELLANEOUS

I. FINANCING

To the extent permissible under applicable law and regulations (including any prohibitions on the Corporation's ability to make personal loans to Section 16 Insiders), the Plan Administrator may permit any Optionee or Participant to pay the option exercise price under the Discretionary Option Grant Program or the purchase price of shares issued pursuant to the Stock Issuance Program by delivering a full-recourse, interest bearing promissory note payable in one or more installments. The terms of any such promissory note (including the interest rate and the terms of repayment) shall be established by the Plan Administrator in its sole discretion. In no event may the maximum credit available to the Optionee or Participant exceed the sum of (A) the aggregate option exercise price or purchase price payable for the purchased shares (less the par value of such shares) plus (B) any applicable income and employment tax liability incurred by the Optionee or the Participant in connection with the option exercise or share purchase. Prior to permitting the use of promissory notes as payment, the Plan Administrator may wish to consider the restrictions on doing so imposed by Regulation U.

II. TAX WITHHOLDING

A. The Corporation's obligation to deliver shares of Common Stock upon the exercise of options or the issuance or vesting of such shares granted pursuant to the Plan shall be subject to the satisfaction of all applicable income and employment tax withholding requirements.

B. The Plan Administrator may, in its discretion, provide any or all holders of Non-Statutory Options or unvested shares of Common Stock issued pursuant to the Plan (other than the options granted to non-Employee Board members or independent contractors) with the right to use shares of Common Stock in satisfaction of all or part of the

Withholding Taxes to which such holders may become subject in connection with the exercise of their options or the vesting of their shares. Such right may be provided to any such holder in either or both of the following formats:

1. **Stock Withholding**: The election to have the Corporation withhold, from the shares of Common Stock otherwise issuable upon the exercise of such Non-Statutory Option or the vesting of such shares, a portion of those shares. So as to avoid adverse accounting treatment, the number of shares that may be withheld for this purpose shall not exceed the minimum number needed to satisfy the applicable income and employment tax withholding rules.

2. Stock Delivery: The election to deliver to the Corporation, at the time the Non-Statutory Option is exercised or the shares vest, one or more shares of Common Stock previously acquired by such holder (other than in connection with the option exercise or share vesting triggering the Withholding Taxes). So as to avoid adverse accounting treatment, the number of shares that may be withheld for this purpose shall not exceed the minimum number needed to satisfy the applicable income and employment tax withholding rules.

III. SHARE ESCROW/LEGENDS

Unvested shares may, in the Plan Administrator's discretion, be held in escrow by the Corporation until the Participant's or the Optionee's interest in such shares vests or may be issued directly to the Participant or the Optionee with restrictive legends on the certificates evidencing those unvested shares.

IV. CANCELLATION AND REGRANT OF OPTIONS

The Plan Administrator shall have the authority to effect, at any time and from time to time, with the consent of the affected option holders, the cancellation of any or all outstanding options granted pursuant to the Plan and to grant in substitution new options covering the same or a different number of shares of Common Stock with an exercise price equal to the Fair Market Value at the time of grant.

V. EFFECTIVE DATE AND TERM OF THE PLAN

A. The Plan shall become effective immediately on the Plan Effective Date. Options may be granted pursuant to the Discretionary Option Grant at any time on or after the Plan Effective Date, and the initial option grants made pursuant to the Automatic Option Grant Program shall also be made on the Plan Effective Date to any non-Employee Board members eligible for such grants at that time.

B. Unless terminated by the Board prior to such time, the Plan shall terminate upon the tenth anniversary of the Plan's adoption by the Board. Should the Plan terminate when options and/or unvested shares are outstanding, such awards shall continue in effect in accordance with the provisions of the documents evidencing such grants or issuances.

VI. AMENDMENTS

The Board shall have complete and exclusive power and authority to amend or modify the Plan or any awards made hereunder. However, no such amendment or modification of the Plan shall adversely affect the rights and obligations with respect to options or unvested stock issuances at the time outstanding under the Plan unless the Optionee or the Participant consents in writing to such amendment or modification. In addition, certain amendments to the Plan, including amendments increasing the maximum aggregate number of shares of Common Stock that may be issued under the Plan or changing the class of persons eligible to receive Incentive Options, shall required approval of the Corporation s stockholders.

VII. USE OF PROCEEDS

Any cash proceeds received by the Corporation from the sale of shares of Common Stock pursuant to the Plan shall be used for any corporate purpose.

VIII. REGULATORY APPROVALS

A. The implementation of the Plan, the granting of any option pursuant to the Plan and the issuance of any shares of Common Stock (1) upon the exercise of any granted option or (2) pursuant to the Stock Issuance Program shall be subject to the Corporation's procurement of all approvals and permits required by regulatory authorities having jurisdiction over the Plan, the options granted pursuant to it and the shares of Common Stock issued pursuant to it.

B. No shares of Common Stock or other assets shall be issued or delivered pursuant to the Plan unless and until there shall have been compliance with all applicable requirements of applicable securities laws, including the filing and effectiveness of the Form S-8 registration statement for the shares of Common Stock issuable pursuant to the Plan, and all applicable listing requirements of any stock exchange or trading system, including the Nasdaq Stock Market, on which Common Stock is then traded.

IX. NO EMPLOYMENT/SERVICE RIGHTS

Nothing in the Plan shall confer upon the Optionee or the Participant any right to continue in Service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining such person) or of the Optionee or the Participant, which rights are hereby expressly reserved by each, to terminate such person's Service at any time for any reason, with or without cause.

APPENDIX

The following definitions shall be in effect under the Plan:

- A. **Automatic Option Grant Program** shall mean the automatic option grant program in effect under Article Four of the Plan.
- B. **Board** shall mean the Corporation's Board of Directors.
- C. **Change in Control** shall mean a change in ownership or control of the Corporation effected through any of the following transactions:
1. a merger, consolidation or other reorganization approved by the Corporation's stockholders, *unless* securities possessing more than 50% of the total combined voting power of the voting securities of the successor corporation are immediately thereafter beneficially owned, directly or indirectly, by the persons who beneficially owned the Corporation's outstanding voting securities immediately prior to such transaction;
 2. the sale, transfer or other disposition of all or substantially all of the Corporation's assets; or
 3. the acquisition, directly or indirectly by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation), of beneficial ownership (within the meaning of Rule 13d-3 of the Exchange Act) of securities possessing more than 50% of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders.
- D. **Code** shall mean the Internal Revenue Code of 1986, as amended.
- E. **Common Stock** shall mean the Corporation's common stock, par value \$0.01 per share.

F. **Corporation** shall mean Intrusion Inc., a Delaware corporation, and any corporate successor to all or substantially all of the assets or voting stock of Intrusion Inc. which has by appropriate action assumed the Plan.

G. **Discretionary Option Grant Program** shall mean the discretionary option grant program in effect under Article Two of the Plan.

H. **Employee** shall mean an individual who is in the employ of the Corporation (or any Parent or Subsidiary), subject to the control and direction of the employer entity as to both the work to be performed and the manner and method of performance.

I. **Exchange Act** shall mean the Securities Exchange Act of 1934, as amended.

J. **Exercise Date** shall mean the date on which the option shall have been exercised in accordance with the appropriate option documentation.

K. **Expiration Date** shall mean the 5:00 p.m. Central Time on the date the option expires as set forth in the Optionee's Notice of Stock Option Grant.

L. **Fair Market Value** per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:

1. If the Common Stock is at the time traded on the Nasdaq Stock Market, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question, as such price is reported by the National Association of Securities Dealers on the Nasdaq Stock Market and published in *The Wall Street Journal*. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

2. If the Common Stock is at the time listed on any stock exchange, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question on the stock exchange determined by the Plan Administrator to be the primary market for the Common Stock, as such price is officially quoted in the composite tape of transactions on such exchange and published in *The Wall Street Journal*. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

3. If the Common Stock is at the time neither listed on any stock exchange or the Nasdaq Stock Market, then the Fair Market Value shall be determined by the Plan Administrator after taking into account such factors as the Plan Administrator shall deem appropriate.

M. **Incentive Option** shall mean an option that satisfies the requirements of Code Section 422.

N. **Involuntary Termination** shall mean the termination of the Service of any individual which occurs by reason of:

1. such individual's involuntary dismissal or discharge by the Corporation (or any Parent or Subsidiary) for reasons other than Misconduct, or

2. such individual's voluntary resignation following (a) a change in his or her position with the Corporation (or any Parent or Subsidiary) which materially reduces his or her duties and responsibilities, (b) a reduction in his or her base salary by more than 15%, unless the base salaries of all similarly situated individuals are reduced by the Corporation (or any Parent or Subsidiary) employing the individual or (c) a relocation of such individual's place of employment by more than fifty miles, provided and only if such change, reduction or relocation is effected by the Corporation (or any Parent or Subsidiary) without the individual's consent.

O. **Misconduct** shall mean the commission of any act of fraud, embezzlement or dishonesty by the Optionee or Participant, any unauthorized use or disclosure by such person of confidential information or trade secrets of the Corporation (or any Parent or Subsidiary), or any other intentional misconduct by such person adversely affecting the business or affairs of the Corporation (or any Parent or Subsidiary) in a material manner. The foregoing definition shall not in any way preclude or restrict the right of the Corporation (or any Parent or Subsidiary) to discharge or dismiss any Optionee, Participant or other person in the Service of the Corporation (or any Parent or Subsidiary) for any other acts or omissions but such other acts or omissions shall not be deemed, for purposes of the Plan, to constitute grounds for termination for Misconduct.

P. **Non-Statutory Option** shall mean an option not intended to satisfy the requirements of Code Section 422.

Q. **Optionee** shall mean any person to whom an option is granted pursuant to the Discretionary Option Grant or Automatic Option Grant Program.

R. **Parent** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations ending with the Corporation, provided each corporation in the unbroken chain (other than the Corporation) owns, at the time of the determination, stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

S. **Participant** shall mean any person who is issued shares of Common Stock under the Stock Issuance Program.

T. **Permanent Disability or Permanently Disabled** shall mean the inability of the Optionee or the Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or has lasted or can be expected to last for a continuous period of twelve months or more. However, solely for purposes of the Automatic Option Grant Program, Permanent Disability or Permanently Disabled shall mean the inability of the non-Employee Board member to perform his or her usual duties as a Board member by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve months or more.

U. **Plan** shall mean the Intrusion Inc. 2005 Stock Incentive Plan, as set forth in this document.

V. **Plan Administrator** shall mean the particular entity, whether the Primary Committee, the Board or the Secondary Committee, which is authorized to administer the Discretionary Option Grant and Stock Issuance Programs with respect to one or more classes of eligible persons, to the extent such entity is carrying out its administrative functions under those programs with respect to the persons under its jurisdiction.

W. **Plan Effective Date** shall mean the date the Corporation's stockholders approve the Plan.

X. **Primary Committee** shall mean the committee comprised of one or more directors designated by the Board. To obtain the benefits of Rule 16b-3, there must be at least two members on the Primary Committee and *all* of the members must be non-employee directors as that term is defined in the Rule *or* the entire Board must approve the grant(s).

Similarly, to be exempt from the million dollar compensation deduction limitation of Code Section 162(m), there must be at least two members on the Primary Committee and all of the members must be outside directors as that term is defined in Code Section 162(m). The Primary Committee may be the Corporation's Compensation Committee so long as it meets the requirements of this paragraph (Y).

Y. **Proxy Contest** shall mean a change in ownership or control of the Corporation effected through a change in the composition of the Board over a period of thirty-six consecutive months or less such that a majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (a) have been Board members continuously since the beginning of such period or (b) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (a) who were still in office at the time the Board approved such election or nomination.

Z. **Secondary Committee** shall mean a committee of one or more Board members appointed by the Board (including the Corporation's Compensation Committee) to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons other than Section 16 Insiders.

AA. **Section 16 Insider** shall mean an officer or director of the Corporation subject to the short-swing profit liabilities of Section 16 of the Exchange Act.

BB. **Service** shall mean the performance of services for the Corporation (or any Parent or Subsidiary) by a person in the capacity of an Employee, a non-Employee member of the board of directors or an independent contractor, except to the extent otherwise specifically provided in the documents evidencing the option grant or stock issuance.

CC. **Stock Issuance Agreement** shall mean the agreement entered into by the Corporation and the Participant at the time of issuance of shares of Common Stock under the Stock Issuance Program.

DD. **Stock Issuance Program** shall mean the stock issuance program in effect under Article Three of the Plan.

EE. **Subsidiary** shall mean any corporation (other than the Corporation) in an unbroken chain of corporations beginning with the Corporation, provided each corporation (other than the last corporation) in the unbroken chain owns, at the time of the determination, stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

FF. **10% Stockholder** shall mean the owner of stock (as determined under Code Section 424(d)) possessing more than 10% of the total combined voting power of all classes of stock of the Corporation (or any Parent or Subsidiary).

GG. **Withholding Taxes** shall mean the applicable income and employment withholding taxes to which the holder of Non-Statutory Options or unvested shares of Common Stock may become subject in connection with the exercise of those options or the vesting of those shares.

INTRUSION INC.

70433

FOLD AND DETACH HERE

This Proxy, when properly executed will be voted as directed herein by the undersigned.

Please mark your votes as indicated in this example

X

IF NO DIRECTION IS GIVEN, THIS PROXY WILL BE VOTED FOR PROPOSALS 1, 2 and 3.

	FOR WITHHOLD EXCEPTIONS				FOR	AGAINST	ABSTAIN
	ALL	FOR ALL	EXCEPTIONS				
1. ELECTION OF DIRECTORS	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>				
Nominees:							
01 G. Ward Paxton							
02 T. Joe Head							
03 J. Fred Bucy, Jr.							
04 James F. Gero							
05 Donald M. Johnston							
				2. To approve the amendment to the 2005 Stock Incentive Plan, to change the authorized aggregate number of shares issuable under the plan from 2,500,000 to 3,000,000 shares, as described in the accompanying proxy statement and set forth in Appendix A thereto.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
				3. Ratification at the appointment of Whitley Penn LLP as independent auditors of the Company for the fiscal year ending December 31, 2010.	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

(INSTRUCTIONS: To withhold authority to vote for any individual nominee, mark the Exceptions box above and write that nominee's name in the space provided below.)

*Exceptions

In their discretion, such attorneys-in-fact and proxies are authorized to vote upon such other business as properly may come before the meeting.

Will be attending the meeting YES

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Mark Here for
Address Change
or Comments
SEE REVERSE

Signature

Signature

Date

, 2010

NOTE: Please sign as name appears hereon. Joint owners should each sign. When signing as attorney, executor, administrator, trustee or guardian, please give full title as such.

You can now access your Intrusion Inc. account online.

Access your Intrusion Inc. account online via Investor ServiceDirect® (ISD).

BNY Mellon Shareowner Services, the transfer agent for Intrusion Inc., now makes it easy and convenient to get current information on your shareholder account.

- View account status
- View certificate history
- View book-entry information
- View payment history for dividends
- Make address changes
- Obtain a duplicate 1099 tax form

***Visit us on the web at <http://www.bnymellon.com/shareowner/isd>
For Technical Assistance Call 1-877-978-7778 between 9am-7pm
Monday-Friday Eastern Time***

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Available 24 hours per day, 7 days per week
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Choose **MLinkSM** for fast, easy and secure 24/7 online access to your future proxy materials, investment plan statements, tax documents and more. Simply log on to **Investor ServiceDirect®** at www.bnymellon.com/shareowner/isd where step-by-step instructions will prompt you through enrollment.

FOLD AND DETACH HERE

**PROXY
INTRUSION Inc.
1101 East Arapaho Road, Suite 200
Richardson, Texas 75081
Annual Meeting of Stockholders May 20, 2010
THIS PROXY IS SOLICITED BY THE BOARD OF DIRECTORS OF THE COMPANY**

The undersigned stockholder(s) of Intrusion Inc., a Delaware corporation (the Company), hereby appoints G. Ward Paxton and Michael L. Paxton, and each of them, attorneys-in-fact and proxies of the undersigned, with full power of substitution, to represent and to vote all shares of common stock of the Company which the undersigned is entitled to vote at the Annual Meeting of Stockholders to be held at the Doubletree Hotel-Richardson, 1981 North Central Expressway, Richardson, Texas 75080, at 10:00 A.M., Local Time, on Thursday, May 20, 2010, and at any adjournment thereof.

Address Change/Comments
(Mark the corresponding box on the reverse side)

BNY MELLON SHAREOWNER SERVICES
P.O. BOX 3550
SOUTH HACKENSACK, NJ 07606-9250

(Continued and to be marked, dated and signed, on the other side)

