

CINCINNATI BELL INC
Form 10-Q
August 07, 2007
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED JUNE 30, 2007

.. **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: 1-8519

CINCINNATI BELL INC.

Ohio
(State of Incorporation)

31-1056105
(I.R.S. Employer Identification No.)

221 East Fourth Street, Cincinnati, Ohio 45202

(Address of principal executive offices) (Zip Code)

(513) 397-9900

(Registrant's telephone number, including area code)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 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 is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act:

Large accelerated filer Accelerated filer Non-accelerated filer

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

At July 31, 2007, there were 248,106,340 common shares outstanding and 155,250 shares of 6³/₄% Cumulative Convertible Preferred Stock outstanding.

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Form 10-Q Part I

Cincinnati Bell Inc.

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Form 10-Q Part I

Cincinnati Bell Inc.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(Dollars in millions, except per share amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2007	2006	2007	2006
Revenue				
Services	\$ 288.7	\$ 275.5	\$ 570.6	\$ 545.4
Products	40.4	47.8	73.8	76.2
Total revenue	329.1	323.3	644.4	621.6
Costs and expenses				
Cost of services, excluding depreciation	103.0	93.6	199.6	188.4
Cost of products sold, excluding depreciation	42.3	51.9	78.8	85.2
Selling, general and administrative	65.8	61.7	131.3	120.0
Depreciation	36.0	34.3	71.5	68.1
Amortization	0.8	1.4	1.7	2.0
Shareholder claim settlement				6.3
Gain on sale of broadband assets		(2.9)		(2.9)
Restructuring charges	0.1	0.1	2.6	0.2
Total operating costs and expenses	248.0	240.1	485.5	467.3
Operating income	81.1	83.2	158.9	154.3
Minority interest expense				0.4
Interest expense	39.0	40.3	79.1	79.8
Other income, net	(0.2)	(0.1)	(2.2)	(0.2)
Income before income taxes	42.3	43.0	82.0	74.3
Income tax expense	18.1	18.7	35.3	35.9
Net income	24.2	24.3	46.7	38.4
Preferred stock dividends	2.6	2.6	5.2	5.2
Net income applicable to common shareowners	\$ 21.6	\$ 21.7	\$ 41.5	\$ 33.2
Basic earnings per common share	\$ 0.09	\$ 0.09	\$ 0.17	\$ 0.13
Diluted earnings per common share	\$ 0.08	\$ 0.09	\$ 0.16	\$ 0.13
Weighted average common shares outstanding (in millions)				
Basic	247.3	246.8	247.2	246.7
Diluted	257.6	252.4	256.4	251.9

The accompanying notes are an integral part of the condensed consolidated financial statements.

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Form 10-Q Part I

Cincinnati Bell Inc.

CONDENSED CONSOLIDATED BALANCE SHEETS

(Dollars in millions, except share amounts)

(Unaudited)

	June 30, 2007	December 31, 2006
Assets		
Current assets		
Cash and cash equivalents	\$ 26.7	\$ 79.4
Receivables, less allowances of \$15.7 and \$15.2	155.9	161.9
Materials and supplies	29.5	24.9
Deferred income tax benefits, net	78.4	63.3
Prepaid expenses and other current assets	23.5	17.9
Total current assets	314.0	347.4
Property, plant and equipment, net	856.6	818.8
Goodwill	55.4	53.3
Intangible assets, net	113.2	112.9
Deferred income tax benefits, net	565.7	631.4
Other noncurrent assets	47.8	50.0
Total assets	\$ 1,952.7	\$ 2,013.8
Liabilities and Shareowners Deficit		
Current liabilities		
Current portion of long-term debt	\$ 7.4	\$ 7.3
Accounts payable	90.9	74.1
Unearned revenue and customer deposits	45.3	42.9
Accrued taxes	42.0	52.8
Accrued interest	50.4	52.1
Accrued payroll and benefits	39.0	43.8
Other current liabilities	40.9	45.9
Total current liabilities	315.9	318.9
Long-term debt, less current portion	1,956.7	2,065.9
Accrued pension and postretirement benefits	362.6	359.6
Other noncurrent liabilities	61.5	61.0
Total liabilities	2,696.7	2,805.4
Shareowners deficit		
Preferred stock, 2,357,299 shares authorized, 155,250 shares (3,105,000 depository shares) of 6 ³ / ₄ % Cumulative Convertible Preferred Stock issued and outstanding at June 30, 2007 and December 31, 2006; liquidation preference \$1,000 per share (\$50 per depository share)	129.4	129.4
Common shares, \$.01 par value; 480,000,000 shares authorized; 256,387,368 and 255,669,983 shares issued; 248,097,440 and 247,471,538 outstanding at June 30, 2007 and December 31, 2006	2.6	2.6
Additional paid-in capital	2,923.7	2,924.9

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Accumulated deficit	(3,485.6)	(3,527.2)
Accumulated other comprehensive loss	(166.9)	(174.5)
Common shares in treasury, at cost: 8,289,928 and 8,198,445 shares at June 30, 2007 and December 31, 2006	(147.2)	(146.8)
Total shareowners' deficit	(744.0)	(791.6)
Total liabilities and shareowners' deficit	\$ 1,952.7	\$ 2,013.8

The accompanying notes are an integral part of the condensed consolidated financial statements.

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Form 10-Q Part I

Cincinnati Bell Inc.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Dollars in millions)

(Unaudited)

	Six Months Ended June 30, 2007	2006
Cash flows from operating activities		
Net income	\$ 46.7	\$ 38.2
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	71.5	68.2
Amortization	1.7	2.1
Gain on sale of fixed assets		(2.1)
Provision for doubtful accounts	7.4	7.1
Change in cash		
Interest expense	2.6	2.1
Minority interest expense		0.1
Deferred income tax expense, including revaluation allowance		
Change in pension and other retirement expense in excess of payments	14.9	16.0
Other, net	1.0	0.0
Changes in operating assets and liabilities, net	32.6	32.6

Effects of acquisitions (increase)		
Increase in receivables	(0.7)	9
Increase in prepaid expenses and other current assets	(14.8)	(21)
Increase in accounts payable	10.7	8
Increase in accrued and other current liabilities	(16.8)	(5)
Change in other assets and liabilities,	(1.7)	1
Net cash provided by operating activities	155.1	157
Cash flows from investing activities		
Capital expenditures	(90.3)	(74)
Acquisitions of businesses		
Net remaining interest in W	(4.6)	(86)
Other, net	0.1	2
Net cash used in investing activities	(94.8)	(159)
Cash flows from financing activities		
Increase of long-term debt	75.0	
Increase in corporate credit facility,		12
Payment of debt	(183.2)	(5)
Increase of common shares -	2.3	0

Exercise of		
Stock options		
Preferred stock		
Dividends	(5.2)	(5)
Debt issuance	(1.3)	
Assets	(0.6)	0
Other, net		

The statute containing this law and the applicable proposed Treasury regulations offer a number of transitional exceptions to this deduction limit for pre-existing compensation plans, arrangements and binding contracts. As a result, the compensation committee believes that at the present time it is quite unlikely that the compensation paid to any executive officer in a taxable year which is subject to the deduction limit will exceed \$1 million. Therefore, the compensation committee has not yet established a policy for determining which forms of incentive compensation awarded to its executive officers shall be designed to qualify as "performance-based compensation." The compensation committee intends to continue to evaluate the effects of the statute and any final Treasury regulations and to comply with Code Section 162(m) in the future to the extent consistent with the best interests of the Company.

Compensation Committee Report

The compensation committee of the Board (the "Committee") is composed of Mr. Parker and Mr. Dullum, neither of whom is currently an officer or employee of the Company. The Committee is responsible for establishing the Company's compensation programs for the Company's executives and other key employees by evaluating their performance and determining compensation policies and levels.

Compensation Philosophy

The goals of the compensation program are to align compensation with business objectives and performance and to enable the Company to attract, retain and reward executive officers and other key employees who contribute to the long-term success of the Company and to motivate them to enhance long-term stockholder value. Key elements of this philosophy are:

The Company pays competitively with leading finance companies with which the Company competes for talent. To ensure that pay is competitive, the Company regularly compares its pay practices with these companies and sets its pay parameters based on this review.

The Company maintains annual incentive opportunities sufficient to provide motivation to achieve specific operating goals and to generate rewards that bring total compensation to competitive levels.

The Company provides significant equity-based incentives for executives and other key employees to ensure that they are motivated over the long-term to respond to the Company's business challenges and opportunities as owners and not just as employees.

Base Salary. The Committee annually reviews each executive officer's base salary. When reviewing base salaries, the Committee considers individual and corporate performance, levels of responsibility, prior experience, breadth of knowledge and competitive pay practices.

Annual Incentives. The Company maintains an annual incentive award program for executive officers and other key employees of the Company to earn additional annual compensation. The actual incentive award earned depends on the extent to which Company and individual performance objectives are achieved. The Committee and the full Board review and approve the annual performance objectives for the Company and individual officers. No incentive bonuses were accrued or paid to the Company's executive officers for the fiscal year ended September 30, 2002.

The Company's objectives consist of operating, strategic and financial goals that are considered to be critical to the Company's fundamental long-term goal building stockholder value. For fiscal 2002, these goals were:

identifying a sufficient number of prospective investment opportunities;

managing the existing investments to provide for a good portfolio; and

increasing the dividends to stockholders each year.

After the end of the fiscal year, the Committee evaluates the degree to which the Company has met its goals and establishes a total incentive award pool. Individual awards are determined by evaluating each participant's performance against objectives and allocating a portion of the award pool based on the participant's contributions during the year. Awards are paid in cash and distributions are made in the October following the performance year.

Long-Term Incentives. The Company's long-term incentive program consists of the 2001 Plan. The option program utilizes vesting periods to encourage key employees to continue in the employ of the Company. Through option grants, executives receive significant equity incentives to build long-term stockholder value. Grants are made at 100% of fair market value on the date of grant. Executives receive value from these grants only if the Company's common stock appreciates over the long-term. The size of option grants is determined based on competitive practices at leading companies in the finance industry and the Company's philosophy of significantly linking executive compensation with stockholder interests. In 2002 the Committee granted stock options that will vest over a one-year period to certain of its executive officers. Such grants were intended to provide the incentive to successfully maximize stockholder value over the next several years. The Committee believes this approach creates an appropriate focus on longer term objectives and promotes executive retention.

Corporate Performance and Chief Executive Officer Compensation

Mr. Gladstone's base salary for the fiscal year ended September 30, 2002 was \$200,000. He was not paid a bonus for the year. In setting this amount, the Committee took into account (i) its belief that Mr. Gladstone is one of the leading CEOs of finance companies who has significant and broad-based experience in the finance industry; (ii) the scope of Mr. Gladstone's responsibilities; and (iii) the Board's confidence in Mr. Gladstone's ability to lead the Company's continued development.

During the fiscal year ended September 30, 2002, the Company achieved some, but not all, of its corporate objectives. The Committee rated Mr. Gladstone's individual performance as above average for this difficult economic period.

Conclusion

Through the plans described above, a significant portion of the Company's compensation program and Mr. Gladstone's compensation are contingent on Company performance, and realization of benefits is closely linked to increases in long-term stockholder value. The Company remains committed to this philosophy of pay for performance, recognizing that the competitive market for talented executives and the volatility of the Company's business may result in highly variable compensation for a particular time period.

Compensation Committee of the Board of Directors

David A.R. Dullum, Chairman

Anthony W. Parker

Compensation Committee Interlocks and Insider Participation

The Company's compensation committee consists of Mr. Parker and Mr. Dullum, both of whom are independent directors.

Performance Measurement Comparison(1)

The following graph shows the total stockholder return of an investment of \$100 in cash on August 24, 2001 for (i) the Company's common stock, (ii) the Standards & Poor's 500 Index (the "S&P 500") and (iii) the Company's peer group². All values assume reinvestment of the full amount of all dividends and are calculated as of September 30, 2001 and September 30, 2002:

	August 24, 2001	September 30, 2001	September 30, 2002
Gladstone Capital Corporation	\$ 100.00	\$ 96.13	\$ 110.68
S&P 500	\$ 100.00	\$ 87.84	\$ 68.80
Peer Group	\$ 100.00	\$ 96.67	\$ 93.10

- (1) This Section is not "soliciting material," is not deemed "filed" with the SEC and is not to be incorporated by reference in any filing of the Company under the Securities Act or the Exchange Act whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

- (2) The Company's peer group is composed of Allied Capital Corporation and American Capital Strategies, Ltd. The returns of each company assume reinvestment of dividends and have been weighted according to their respective stock market capitalization for purposes of arriving at a peer group average.

Certain Transactions

At September 30, 2002, the Company had loans outstanding in the principal amount of \$5,900,010 to Mr. Gladstone, \$1,400,010 to Mr. Brubaker and \$150,000 to Mr. Brill, each of whom is an executive officer of the Company. These loans were extended in connection with the exercise of stock options by each of the executive officers. Each such loan is evidenced by a full recourse

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promissory note secured by the shares of common stock purchased upon the exercise of the options. The interest rate on each such loan is 4.9% per annum. Interest is due quarterly and each of the executive officers has made each of his quarterly interest payments to date. The outstanding principal amount of each loan is due and payable in cash on August 23, 2010.

During the fiscal year ended September 30, 2002, the Company paid an aggregate of \$31,750 in personnel referral fees to Medical Funding Corporation which operates a franchise of Snelling Personnel Agency. Anthony Parker, a non-employee director of the Company, is the founder, president and chairman of Medical Funding Corporation. The Company believes that the terms of the arrangement between the Company and Medical Funding Corporation are no less favorable than the Company would be able to obtain from a disinterested third party. The rates that Medical Funding Corporation charges to the Company are the same as it charges to its unaffiliated clients.

In its Articles of Incorporation and Bylaws, the Company has agreed to indemnify certain officers and directors by providing, among other things, that the Company will indemnify such officer or director, under the circumstances and to the extent provided for therein, for expenses, damages, judgments, fines and settlements he or she may be required to pay in actions or proceedings in which he or she is or may be made a party by reason of his or her position as a director, officer or other agent of the Company, and otherwise to the fullest extent permitted under Maryland law and the Company's Bylaws. Notwithstanding the foregoing, the indemnification provisions shall not protect any officer or director from liability to the Company or its stockholders as a result of any action that would constitute willful misfeasance, bad faith or gross negligence in the performance of such officer's or director's duties, or reckless disregard of his or her obligations and duties.

Other Matters

The Board knows of no other matters that will be presented for consideration at the Annual Meeting. If any other matters are properly brought before the meeting, it is the intention of the persons named in the accompanying proxy to vote on such matters in accordance with their best judgment.

By Order of the Board of Directors

/s/ TERRY BRUBAKER

Terry Brubaker
Secretary
January 17, 2003

A copy of the Company's Annual Report to the Securities and Exchange Commission on Form 10-K for the fiscal year ended September 30, 2002 is available without charge upon written request to: Corporate Secretary, Gladstone Capital Corporation, 1616 Anderson Road, Suite 208, McLean, Virginia 22102.

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APPENDIX A

GLADSTONE CAPITAL CORPORATION

THIRD AMENDMENT TO

AMENDED AND RESTATED 2001 EQUITY INCENTIVE PLAN

Approved By Board of Directors: December 5, 2002
Presented to Stockholders for Approval: February 24, 2003

1. *Section 4(a)* of the Plan shall be amended and restated in its entirety to read as follows:

(a) **Share Reserve.** Subject to the provisions of Section 11(a) relating to Capitalization Adjustments, the capital stock that may be issued pursuant to Stock Awards shall be two million (2,000,000) shares of capital stock. Stock Awards shall be comprised of Common Stock or Preferred Stock as determined by the Board in its discretion.

2. Except as set forth in this Third Amendment, the Plan shall be unaffected hereby and shall remain in full force and effect.

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GLADSTONE CAPITAL CORPORATION

AMENDED AND RESTATED 2001 EQUITY INCENTIVE PLAN

Adopted: June 2, 2001

Amended and Restated: July 23, 2001

Approved By Stockholders: July 23, 2001

Termination Date: June 1, 2011

1. Purposes.

(a) **Eligible Stock Award Recipients.** The persons eligible to receive Stock Awards are the Employees and Directors of the Company and its Affiliates. Stock Awards to Non-Employee Directors must be approved by order of the Commission as provided by Section 61(a)(3)(B)(I)(II) of the Investment Company Act.

(b) **Available Stock Awards.** The purpose of the Plan is to provide a means by which eligible recipients of Stock Awards may be given an opportunity to benefit from increases in value of the Company's capital stock through the granting of the following Stock Awards: (i) Incentive Stock Options, (ii) Nonstatutory Stock Options, and (iii) rights to acquire restricted stock.

(c) **General Purpose.** The Company, by means of the Plan, seeks to retain the services of the group of persons eligible to receive Stock Awards, to secure and retain the services of new members of this group and to provide incentives for such persons to exert maximum efforts for the success of the Company and its Affiliates.

2. Definitions.

(a) **"Affiliate"** means any parent corporation or subsidiary corporation of the Company, whether now or hereafter existing, as those terms are defined in Sections 424(e) and (f), respectively, of the Code.

(b) **"Board"** means the Board of Directors of the Company.

(c) **"Capitalization Adjustment"** has the meaning ascribed to that term in Section 11(a).

(d) **"Change in Control"** means the occurrence, in a single transaction or in a series of related transactions, of any one or more of the following events:

(i) any Exchange Act Person becomes the Owner, directly or indirectly, of securities of the Company representing more than fifty percent (50%) of the combined voting power of the Company's then outstanding securities other than by virtue of a merger, consolidation or similar transaction;

(ii) there is consummated a merger, consolidation or similar transaction involving (directly or indirectly) the Company and, immediately after the consummation of such merger, consolidation or similar transaction, the stockholders of the Company immediately prior thereto do not Own, directly or indirectly, outstanding voting securities representing more than

fifty percent (50%) of the combined outstanding voting power of the surviving Entity in such merger, consolidation or similar transaction or more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving Entity in such merger, consolidation or similar transaction;

(iii) the stockholders of the Company approve or the Board approves a plan of complete dissolution or liquidation of the Company, or a complete dissolution or liquidation of the Company shall otherwise occur;

(iv) there is consummated a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its Subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its Subsidiaries to an Entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are Owned by stockholders of the Company in substantially the same proportions as their Ownership of the Company immediately prior to such sale, lease, license or other disposition; or

(v) individuals who, on the date this Plan is adopted by the Board, are members of the Board (the "Incumbent Board") cease for any reason to constitute at least a majority of the members of the Board; (*provided, however*, that if the appointment or election (or nomination for election) of any new Board member was approved or recommended by a majority vote of the members of the Incumbent Board then still in office, such new member shall, for purposes of this Plan, be considered as a member of the Incumbent Board).

Notwithstanding the foregoing, a Change in Control shall not be deemed to occur solely because the level of Ownership held by any Exchange Act Person (the "Subject Person") exceeds the designated percentage threshold of the outstanding voting securities as a result of a repurchase or other acquisition of voting securities by the Company reducing the number of shares outstanding, provided that if a Change in Control would occur (but for the operation of this sentence) as a result of the acquisition of voting securities by the Company, and after such share acquisition, the Subject Person becomes the Owner of any additional voting securities that, assuming the repurchase or other acquisition had not occurred, increases the percentage of the then outstanding voting securities Owned by the Subject Person over the designated percentage threshold, then a Change in Control shall be deemed to occur.

Notwithstanding the foregoing or any other provision of this Plan, the definition of Change in Control (or any analogous term) in an individual written agreement between the Company or any Affiliate and the Participant shall supersede the foregoing definition with respect to Stock Awards subject to such agreement (it being understood, however, that if no definition of Change in Control or any analogous term is set forth in such an individual written agreement, the foregoing definition shall apply).

(e) "*Code*" means the Internal Revenue Code of 1986, as amended.

(f) "*Committee*" means a committee of one or more members of the Board appointed by the Board in accordance with Section 3(c).

(g) "*Common Stock*" means the common stock of the Company.

(h) "*Company*" means Gladstone Capital Corporation, a Maryland corporation.

(i) "*Continuous Service*" means that the Participant's service with the Company or an Affiliate, whether as an Employee or Director, is not interrupted or terminated. A change in the capacity in which the Participant renders service to the Company or an Affiliate as an Employee or Director or a change in the entity for which the Participant renders such service, provided that there is no interruption or termination of the Participant's service with the Company or an Affiliate, shall not terminate a Participant's Continuous Service. For example, a change in status from an Employee of the Company to an Employee of an Affiliate or a Director shall not constitute an interruption of Continuous Service. The Board or the chief executive officer of the Company, in that party's sole discretion, may determine whether Continuous Service shall be considered interrupted in the case of any leave of absence approved by that party, including sick leave, military leave or any other personal

leave. Notwithstanding the foregoing, a leave of absence shall be treated as Continuous Service for purposes of vesting in a Stock Award only to such extent as may be provided in the Company's leave of absence policy or in the written terms of the Participant's

leave of absence.

(j) **"Corporate Transaction"** means the occurrence, in a single transaction or in a series of related transactions, of any one or more of the following events:

(i) a sale or other disposition of all or substantially all, as determined by the Board in its discretion, of the consolidated assets of the Company and its Subsidiaries;

(ii) a sale or other disposition of at least fifty percent (50%) of the outstanding securities of the Company;

(iii) a merger, consolidation or similar transaction following which the Company is not the surviving corporation; or

(iv) a merger, consolidation or similar transaction following which the Company is the surviving corporation but the shares of Common Stock outstanding immediately preceding the merger, consolidation or similar transaction are converted or exchanged by virtue of the merger, consolidation or similar transaction into other property, whether in the form of securities, cash or otherwise.

(k) **"Covered Employee"** means the chief executive officer and the four (4) other highest compensated officers of the Company for whom total compensation is required to be reported to stockholders under the Exchange Act, as determined for purposes of Section 162(m) of the Code.

(l) **"Director"** means a member of the Board of Directors of the Company.

(m) **"Disability"** means the permanent and total disability of a person within the meaning of Section 22(e)(3) of the Code.

(n) **"Employee"** means any person employed by the Company or an Affiliate. Service as a Director or payment of a director's fee by the Company or an Affiliate shall not be sufficient to constitute "employment" by the Company or an Affiliate.

(o) **"Entity"** means a corporation, partnership or other entity.

(p) **"Exchange Act"** means the Securities Exchange Act of 1934, as amended.

(q) **"Exchange Act Person"** means any natural person, Entity or "group" (within the meaning of Section 13(d) or 14(d) of the Exchange Act), except that "Exchange Act Person" shall not include (A) the Company or any Subsidiary of the Company, (B) any employee benefit plan of the Company or any Subsidiary of the Company or any trustee or other fiduciary holding securities under an employee benefit plan of the Company or any Subsidiary of the Company, (C) an underwriter temporarily holding securities pursuant to an offering of such securities, or (D) an Entity Owned, directly or indirectly, by the stockholders of the Company in substantially the same proportions as their Ownership of stock of the Company.

(r) **"Fair Market Value"** means, as of any date, the value of the capital stock determined as follows:

(i) If the class of capital stock is listed on any established stock exchange or traded on the Nasdaq National Market or the Nasdaq SmallCap Market, the Fair Market Value of a share of such capital stock shall be the closing sales price for such stock (or the closing bid, if no sales were reported) as quoted on such exchange or market (or the exchange or market with the greatest volume of trading in the capital stock) on the last market trading day prior to the day of determination, as reported in *The Wall Street Journal* or such other source as the Board deems reliable.

(ii) In the absence of such markets for the capital stock, the Fair Market Value shall be determined in good faith by the Board.

(s) **"Incentive Stock Option"** means an Option intended to qualify as an incentive stock option within the meaning of Section 422 of the Code and the regulations promulgated thereunder.

(t) **"Investment Company Act"** means the Investment Company Act of 1940.

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(u) **"Non-Employee Director"** means a Director who either (i) is not a current Employee or Officer of the Company or its parent or a subsidiary, does not receive compensation (directly or indirectly) from the Company or its parent or a subsidiary for services rendered as a consultant or in any capacity other than as a Director (except for an amount as to which disclosure would not be required under Item 404(a) of Regulation S-K promulgated pursuant to the Securities Act ("Regulation S-K")), does not possess an interest in any other transaction as to which disclosure would be required under Item 404(a) of Regulation S-K and is not engaged in a business relationship as to which disclosure would be required under Item 404(b) of Regulation S-K; or (ii) is otherwise considered a "non-employee director" for purposes of Rule 16b-3.

(v) **"Nonstatutory Stock Option"** means an Option not intended to qualify as an Incentive Stock Option.

(w) **"Officer"** means a person who is an officer of the Company within the meaning of Section 16 of the Exchange Act and the rules and regulations promulgated thereunder.

(x) **"Option"** means an Incentive Stock Option or a Nonstatutory Stock Option granted pursuant to the Plan.

(y) **"Option Agreement"** means a written agreement between the Company and an Optionholder evidencing the terms and conditions of an individual Option grant. Each Option Agreement shall be subject to the terms and conditions of the Plan.

(z) **"Optionholder"** means a person to whom an Option is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Option.

(aa) **"Outside Director"** means a Director who either (i) is not a current employee of the Company or an "affiliated corporation" (within the meaning of Treasury Regulations promulgated under Section 162(m) of the Code), is not a former employee of the Company or an "affiliated corporation" receiving compensation for prior services (other than benefits under a tax-qualified pension plan), was not an officer of the Company or an "affiliated corporation" at any time and is not currently receiving direct or indirect remuneration from the Company or an "affiliated corporation" for services in any capacity other than as a Director or (ii) is otherwise considered an "outside director" for purposes of Section 162(m) of the Code.

(bb) **"Own," "Owned," "Owner," or "Ownership"** means that a person or Entity shall be deemed to "Own," to have "Owned," to be the "Owner" of, or to have acquired "Ownership" of securities if such person or Entity, directly or indirectly, through any contract, arrangement, understanding, relationship or otherwise, has or shares voting power, which includes the power to vote or to direct the voting, with respect to such securities.

(cc) **"Participant"** means a person to whom a Stock Award is granted pursuant to the Plan or, if applicable, such other person who holds an outstanding Stock Award.

(dd) **"Plan"** means this Gladstone Capital Corporation Amended and Restated 2001 Equity Incentive Plan.

(ee) **"Preferred Stock"** means the preferred stock of the Company.

(ff) **"Rule 16b-3"** means Rule 16b-3 promulgated under the Exchange Act or any successor to Rule 16b-3, as in effect from time to time.

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(gg) **"Securities Act"** means the Securities Act of 1933, as amended.

(hh) **"Stock Award"** means any right granted under the Plan, including an Option or a right to acquire restricted stock.

(ii) **"Stock Award Agreement"** means a written agreement between the Company and a holder of a Stock Award evidencing the terms and conditions of an individual Stock Award grant. Each Stock Award Agreement shall be subject to the terms and conditions of the Plan.

(jj) **"Subsidiary"** means, with respect to the Company, (i) any corporation of which more than fifty percent (50%) of the outstanding capital stock having ordinary voting power to elect a majority of the board of directors of such corporation (irrespective of whether, at the time, stock of any other class or classes of such corporation shall have or might have voting power by reason of the happening of any contingency) is at the time, directly or indirectly, Owned by the Company, and (ii) any partnership in which the

Company has a direct or indirect interest (whether in the form of voting or participation in profits or capital contribution) of more than fifty percent (50%).

(kk) "Ten Percent Stockholder" means a person who Owns (or is deemed to Own pursuant to Section 424(d) of the Code) stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or of any of its Affiliates.

3. Administration.

(a) Administration by Board. The Board shall administer the Plan unless and until the Board delegates administration to a Committee, as provided in Section 3(c).

(b) Powers of Board. The Board shall have the power, subject to, and within the limitations of, the express provisions of the Plan:

(i) To determine from time to time which of the persons eligible under the Plan shall be granted Stock Awards; when and how each Stock Award shall be granted; what type or combination of types of Stock Award shall be granted; the provisions of each Stock Award granted (which need not be identical), including the time or times when a person shall be permitted to receive Common Stock or Preferred Stock pursuant to a Stock Award; and the number of shares of capital stock with respect to which a Stock Award shall be granted to each such person.

(ii) To construe and interpret the Plan and Stock Awards granted under it, and to establish, amend and revoke rules and regulations for its administration. The Board, in the exercise of this power, may correct any defect, omission or inconsistency in the Plan or in any Stock Award Agreement, in a manner and to the extent it shall deem necessary or expedient to make the Plan fully effective.

(iii) To amend the Plan or a Stock Award as provided in Section 12.

(iv) To terminate or suspend the Plan as provided in Section 13.

(v) Generally, to exercise such powers and to perform such acts as the Board deems necessary or expedient to promote the best interests of the Company and that are not in conflict with the provisions of the Plan.

(c) Delegation to Committee.

(i) General. The Board may delegate administration of the Plan to a Committee or Committees of one (1) or more members of the Board, and the term "Committee" shall apply to any person or persons to whom such authority has been delegated. If administration is delegated to a Committee, the Committee shall have, in connection with the administration of the Plan, the powers theretofore possessed by the Board, including the power to delegate to a subcommittee any of the administrative powers the Committee is authorized to exercise (and references in this Plan to the Board shall thereafter be to the Committee or subcommittee), subject, however, to such

resolutions, not inconsistent with the provisions of the Plan, as may be adopted from time to time by the Board. The Board may abolish the Committee at any time and revert in the Board the administration of the Plan.

(ii) Section 162(m) and Rule 16b-3 Compliance. In the discretion of the Board, the Committee may consist solely of two or more Outside Directors, in accordance with Section 162(m) of the Code, and/or solely of two or more Non-Employee Directors, in accordance with Rule 16b-3. Within the scope of such authority, the Board or the Committee may (1) delegate to a committee of one or more members of the Board who are not Outside Directors the authority to grant Stock Awards to eligible persons who are either (a) not then Covered Employees and are not expected to be Covered Employees at the time of recognition of income resulting from such Stock Award or (b) not persons with respect to whom the Company wishes to comply with Section 162(m) of the Code and/or (2) delegate to a committee of one or more members of the Board who are not Non-Employee Directors the authority to grant Stock Awards to eligible persons who are not then subject to Section 16 of the Exchange Act.

(d) Effect of Board's Decision. All determinations, interpretations and constructions made by the Board in good faith shall not be subject to review by any person and shall be final, binding and conclusive on all persons.

4. Shares Subject to the Plan.

(a) Share Reserve. Subject to the provisions of Section 11(a) relating to Capitalization Adjustments, the capital stock that may be issued pursuant to Stock Awards shall be six hundred thousand (600,000) shares, subject to increase by 4.5% of the number of shares sold pursuant to the exercise of the underwriter's over-allotment option in the initial public offering and any upsizing of the offering up to 20%, for a maximum share reserve of eight hundred twenty-eight thousand (828,000) shares of capital stock. Stock Awards shall be comprised of Common Stock or Preferred Stock as determined by the Board in its discretion.

(b) Reversion of Shares to the Share Reserve. If any Stock Award shall for any reason expire or otherwise terminate, in whole or in part, without having been exercised in full, the shares of capital stock not acquired under such Stock Award shall revert to and again become available for issuance under the Plan.

(c) Source of Shares. The shares of capital stock subject to the Plan may be unissued shares or reacquired shares, bought on the market or otherwise.

5. Eligibility.

(a) Eligibility for Specific Stock Awards. Incentive Stock Options may be granted only to Employees. Stock Awards other than Incentive Stock Options may be granted to Employees and Directors.

(b) Ten Percent Stockholders. A Ten Percent Stockholder shall not be granted an Incentive Stock Option unless the exercise price of such Option is at least one hundred ten percent (110%) of the Fair Market Value of the capital stock on the date of grant and the Option is not exercisable after the expiration of five (5) years from the date of grant.

(c) Section 162(m) Limitation on Annual Grants. Subject to the provisions of Section 11(a) relating to Capitalization Adjustments, no Employee shall be eligible to be granted Options covering more than three hundred thousand (300,000) shares of capital stock during any calendar year.

6. Option Provisions.

Each Option shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. All Options shall be separately designated Incentive Stock Options or Nonstatutory Stock Options at the time of grant, and, if certificates are issued, a separate certificate or certificates shall be issued for shares of capital stock purchased on exercise of each type of Option. The provisions of separate Options need not be identical, but each Option shall include (through incorporation of provisions hereof by reference in the Option or otherwise) the substance of each of the following provisions:

(a) Term. Subject to the provisions of Section 5(b) regarding Ten Percent Stockholders, no Incentive Stock Option shall be exercisable after the expiration of ten (10) years from the date on which it was granted.

(b) Exercise Price of an Incentive Stock Option. Subject to the provisions of Section 5(b) regarding Ten Percent Stockholders, the exercise price of each Incentive Stock Option shall be not less than one hundred percent (100%) of the Fair Market Value of the capital stock subject to the Option on the date the Option is granted. Notwithstanding the foregoing, an Incentive Stock Option may be granted with an exercise price lower than that set forth in the preceding sentence if such Option is granted pursuant to an assumption or substitution for another option in a manner satisfying the provisions of Section 424(a) of the Code.

(c) Exercise Price of a Nonstatutory Stock Option. The exercise price of each Nonstatutory Stock Option shall be not less than the Fair Market Value of the capital stock subject to the Option on the date the Option is granted. Notwithstanding the foregoing, a Nonstatutory Stock Option may be granted with an exercise price lower than that set forth in the preceding sentence if such Option is granted pursuant to an assumption or substitution for another option in a manner satisfying the provisions of Section 424(a) of the Code.

(d) Consideration. The purchase price of capital stock acquired pursuant to an Option shall be paid, to the extent permitted by applicable statutes and regulations, either (i) in cash at the time the Option is exercised or (ii) at the discretion of the Board at the time of the grant of the Option (or subsequently in the case of a Nonstatutory Stock Option) (1) by delivery to the Company of other capital stock, (2) according to a deferred payment or other similar arrangement with the Optionholder which satisfies the requirements of Section 62 of the Investment Company Act, or (3) in any other form of legal consideration that may be acceptable to the Board. Unless otherwise specifically provided in the Option, the purchase price of capital stock acquired pursuant to an Option that is paid by delivery to the Company of other capital stock acquired, directly or indirectly from the Company, shall be paid only by shares of the capital stock of the Company that have been held for more than six (6) months (or such longer or shorter period of time required to avoid a charge to earnings for financial accounting purposes). In the case of any deferred payment arrangement, interest shall be compounded at least annually and shall be charged at the minimum rate of interest necessary to avoid (1) the treatment as interest, under any applicable provisions of the Code, of any amounts other than amounts stated to be interest under the deferred payment arrangement, and (2) the treatment of the Option as a variable award for financial accounting purposes.

(e) Transferability of an Incentive Stock Option. An Incentive Stock Option shall not be transferable except by will or by the laws of descent and distribution and shall be exercisable during the lifetime of the Optionholder only by the Optionholder. Notwithstanding the foregoing, the Optionholder may, by delivering written notice to the Company, in a form satisfactory to the Company, designate a third party who, in the event of the death of the Optionholder, shall thereafter be entitled to exercise the Option.

(f) Transferability of a Nonstatutory Stock Option. A Nonstatutory Stock Option shall be transferable by gift, by will, or by the laws of descent and distribution to the extent provided in the

Option Agreement. The Nonstatutory Stock Option shall be exercisable during the lifetime of the Optionholder only by the Optionholder. Notwithstanding the foregoing, the Optionholder may, by delivering written notice to the Company, in a form satisfactory to the Company, designate a third party who, in the event of the death of the Optionholder, shall thereafter be entitled to exercise the Option.

(g) Vesting Generally. The total number of shares of capital stock subject to an Option may, but need not, vest and therefore become exercisable in periodic installments that may, but need not, be equal. The Option may be subject to such other terms and conditions on the time or times when it may be exercised (which may be based on performance or other criteria) as the Board may deem appropriate. The vesting provisions of individual Options may vary. The provisions of this Section 6(g) are subject to any Option provisions governing the minimum number of shares of capital stock as to which an Option may be exercised.

(h) Termination of Continuous Service. In the event that an Optionholder's Continuous Service terminates (other than upon the Optionholder's death or Disability), the Optionholder may exercise his or her Option (to the extent that the Optionholder was entitled to exercise such Option as of the date of termination) but only within such period of time ending on the earlier of (i) the date three (3) months following the termination of the Optionholder's Continuous Service (or such longer or shorter period specified in the Option Agreement) or (ii) the expiration of the term of the Option as set forth in the Option Agreement. If, after termination, the Optionholder does not exercise his or her Option within the time specified in the Option Agreement, the Option shall terminate.

(i) Extension of Termination Date. An Optionholder's Option Agreement may also provide that if the exercise of the Option following the termination of the Optionholder's Continuous Service (other than upon the Optionholder's death or Disability) would be prohibited at any time solely because the issuance of shares of capital stock would violate the registration requirements under the Securities Act, then the Option shall terminate on the earlier of (i) the expiration of the term of the Option set forth in Section 6(a) or (ii) the expiration of a period of three (3) months after the termination of the Optionholder's Continuous Service during which the exercise of the Option would not be in violation of such registration requirements.

(j) Disability of Optionholder. In the event that an Optionholder's Continuous Service terminates as a result of the Optionholder's Disability, the Optionholder may exercise his or her Option (to the extent that the Optionholder was entitled to exercise such Option as of the date of termination), but only within such period of time ending on the earlier of (i) the date twelve (12) months following such termination (or such longer or shorter period specified in the Option Agreement) or (ii) the expiration of the term of the Option as set forth in the Option Agreement. If, after termination, the Optionholder does not exercise his or her Option within the time specified herein, the Option shall terminate.

(k) Death of Optionholder. In the event that (i) an Optionholder's Continuous Service terminates as a result of the Optionholder's death or (ii) the Optionholder dies within the period (if any) specified in the Option Agreement after the termination of the Optionholder's Continuous Service for a reason other than death, then the Option may be exercised (to the extent the Optionholder was entitled to exercise such Option as of the date of death) by the Optionholder's estate, by a person who acquired the right to exercise

the Option by bequest or inheritance or by a person designated to exercise the Option upon the Optionholder's death pursuant to Section 6(e) or 6(f), but only within the period ending on the earlier of (1) the date eighteen (18) months following the date of death (or such longer or shorter period specified in the Option Agreement) or (2) the expiration of the term of such Option as set forth in the Option Agreement. If, after death, the Option is not exercised within the time specified herein, the Option shall terminate.

(l) Early Exercise. The Option may, but need not, include a provision whereby the Optionholder may elect at any time before the Optionholder's Continuous Service terminates to exercise the Option as to any part or all of the shares of capital stock subject to the Option prior to the full vesting of the Option. Any unvested shares of capital stock so purchased may be subject to a repurchase option in favor of the Company or to any other restriction the Board determines to be appropriate. The Company will not exercise its repurchase option until at least six (6) months (or such longer or shorter period of time required to avoid a charge to earnings for financial accounting purposes) have elapsed following exercise of the Option unless the Board otherwise specifically provides in the Option.

(m) Re-Load Options.

(i) Without in any way limiting the authority of the Board to make or not to make grants of Options hereunder, the Board shall have the authority (but not an obligation) to include as part of any Option Agreement a provision entitling the Optionholder to a further Option (a "Re-Load Option") in the event the Optionholder exercises the Option evidenced by the Option Agreement, in whole or in part, by surrendering other shares of capital stock in accordance with this Plan and the terms and conditions of the Option Agreement. Unless otherwise specifically provided in the Option, the Optionholder shall not surrender shares of capital stock acquired, directly or indirectly from the Company, unless such shares have been held for more than six (6) months (or such longer or shorter period of time required to avoid a charge to earnings for financial accounting purposes).

(ii) Any such Re-Load Option shall (1) provide for a number of shares of capital stock equal to the number of shares of capital stock surrendered as part or all of the exercise price of such Option; (2) have an expiration date which is the same as the expiration date of the Option the exercise of which gave rise to such Re-Load Option; and (3) have an exercise price which is equal to one hundred percent (100%) of the Fair Market Value of the capital stock subject to the Re-Load Option on the date of exercise of the original Option. Notwithstanding the foregoing, a Re-Load Option shall be subject to the same exercise price and term provisions heretofore described for Options under the Plan.

(iii) Any such Re-Load Option may be an Incentive Stock Option or a Nonstatutory Stock Option, as the Board may designate at the time of the grant of the original Option; provided, however, that the designation of any Re-Load Option as an Incentive Stock Option shall be subject to the one hundred thousand dollar (\$100,000) annual limitation on the exercisability of Incentive Stock Options described in subsection 10(d) and in Section 422(d) of the Code. There shall be no Re-Load Options on a Re-Load Option. Any such Re-Load Option shall be subject to the availability of sufficient shares of capital stock under subsection 4(a) and the "Section 162(m) Limitation" on the grants of Options under subsection 5(c) and shall be subject to such other terms and conditions as the Board may determine which are not inconsistent with the express provisions of the Plan regarding the terms of Options.

7. Restricted Stock Award Provisions.

Each restricted stock purchase agreement shall be in such form and shall contain such terms and conditions as the Board shall deem appropriate. The terms and conditions of the restricted stock purchase agreements may change from time to time, and the terms and conditions of separate restricted stock purchase agreements need not be identical, but each restricted stock purchase agreement shall include (through incorporation of provisions hereof by reference in the agreement or otherwise) the substance of each of the following provisions:

(a) Purchase Price. The purchase price of restricted stock awards shall not be less than the capital stock's Fair Market Value on the date such award is made or at the time the purchase is

consummated and shall be above the current net asset value as defined in rule 2a-4 of the Investment Company Act.

(b) Consideration. The purchase price of capital stock acquired pursuant to the restricted stock purchase agreement shall be paid either: (i) in cash at the time of purchase; (ii) at the discretion of the Board, according to a deferred payment or other similar arrangement with the Participant which satisfies the requirements of Section 62 of the Investment Company Act; or (iii) in any other form of legal consideration that may be acceptable to the Board in its discretion; *provided, however*, that at any time that the Company is incorporated in Delaware, then payment of the Common Stock's "par value," as defined in the Delaware General Corporation Law, shall not be made by deferred payment.

(c) Vesting. Shares of capital stock acquired under the restricted stock purchase agreement may, but need not, be subject to a share repurchase option in favor of the Company in accordance with a vesting schedule to be determined by the Board.

(d) Termination of Participant's Continuous Service. In the event that a Participant's Continuous Service terminates, the Company may repurchase or otherwise reacquire any or all of the shares of capital stock held by the Participant that have not vested as of the date of termination under the terms of the restricted stock purchase agreement.

(e) Transferability. Rights to acquire shares of capital stock under the restricted stock purchase agreement shall be transferable by the Participant only upon such terms and conditions as are set forth in the restricted stock purchase agreement, as the Board shall determine in its discretion, so long as capital stock awarded under the restricted stock purchase agreement remains subject to the terms of the restricted stock purchase agreement.

8. Covenants of the Company.

(a) Availability of Shares. During the terms of the Stock Awards, the Company shall keep available at all times the number of shares of capital stock required to satisfy such Stock Awards.

(b) Securities Law Compliance. The Company shall seek to obtain from each regulatory commission or agency having jurisdiction over the Plan such authority as may be required to grant Stock Awards and to issue and sell shares of capital stock upon exercise of the Stock Awards; *provided, however*, that this undertaking shall not require the Company to register under the Securities Act the Plan, any Stock Award or any capital stock issued or issuable pursuant to any such Stock Award. If, after reasonable efforts, the Company is unable to obtain from any such regulatory commission or agency the authority which counsel for the Company deems necessary for the lawful issuance and sale of capital stock under the Plan, the Company shall be relieved from any liability for failure to issue and sell capital stock upon exercise of such Stock Awards unless and until such authority is obtained.

9. Use of Proceeds from Stock.

Proceeds from the sale of capital stock pursuant to Stock Awards shall constitute general funds of the Company.

10. Miscellaneous.

(a) Acceleration of Exercisability and Vesting. The Board shall have the power to accelerate the time at which a Stock Award may first be exercised or the time during which a Stock Award or any part thereof will vest in accordance with the Plan, notwithstanding the provisions in the Stock Award stating the time at which it may first be exercised or the time during which it will vest.

(b) Stockholder Rights. No Participant shall be deemed to be the holder of, or to have any of the rights of a holder with respect to, any shares of capital stock subject to such Stock Award unless

and until such Participant has satisfied all requirements for exercise of the Stock Award pursuant to its terms.

(c) No Employment or other Service Rights. Nothing in the Plan or any instrument executed or Stock Award granted pursuant thereto shall confer upon any Participant any right to continue to serve the Company or an Affiliate in the capacity in effect at the time the Stock Award was granted or shall affect the right of the Company or an Affiliate to terminate (i) the employment of an Employee with or without notice and with or without cause or (ii) the service of a Director pursuant to the Bylaws of the Company or an Affiliate, and any applicable provisions of the corporate law of the state in which the Company or the Affiliate is incorporated, as the case may be.

(d) Incentive Stock Option \$100,000 Limitation. To the extent that the aggregate Fair Market Value (determined at the time of grant) of capital stock with respect to which Incentive Stock Options are exercisable for the first time by any Optionholder during any calendar year (under all plans of the Company and its Affiliates) exceeds one hundred thousand dollars (\$100,000), the Options or portions thereof that exceed such limit (according to the order in which they were granted) shall be treated as Nonstatutory Stock Options.

(e) Investment Assurances. The Company may require a Participant, as a condition of exercising or acquiring capital stock under any Stock Award, (i) to give written assurances satisfactory to the Company as to the Participant's knowledge and experience in financial and business matters and/or to employ a purchaser representative reasonably satisfactory to the Company who is knowledgeable and experienced in financial and business matters and that he or she is capable of evaluating, alone or together with the purchaser representative, the merits and risks of exercising the Stock Award; and (ii) to give written assurances satisfactory to the Company stating that the Participant is acquiring capital stock subject to the Stock Award for the Participant's own account and not with any present intention of selling or otherwise distributing the capital stock. The foregoing requirements, and any assurances given pursuant to such requirements, shall be inoperative if (1) the issuance of the shares of capital stock upon the exercise or acquisition of capital stock under the Stock Award has been registered under a then currently effective registration statement under the Securities Act or (2) as to any particular requirement, a determination is made by counsel for the Company that such requirement need not be met in the circumstances under the then applicable securities laws. The Company may, upon advice of counsel to the Company, place legends on stock certificates issued under the Plan as such counsel deems necessary or appropriate in order to comply with applicable securities laws, including, but not limited to, legends restricting the transfer of the capital stock.

(f) Withholding Obligations. To the extent provided by the terms of a Stock Award Agreement, the Participant may satisfy any federal, state or local tax withholding obligation relating to the exercise or acquisition of capital stock under a Stock Award by any of the following means (in addition to the Company's right to withhold from any compensation paid to the Participant by the Company) or by a combination of such means: (i) tendering a cash payment; (ii) authorizing the Company to withhold shares of capital stock from the shares of capital stock otherwise issuable to the Participant as a result of the exercise or acquisition of capital stock under the Stock Award; *provided, however*, that no shares of capital stock are withheld with a value exceeding the minimum amount of tax required to be withheld by law (or such lesser amount as may be necessary to avoid variable award accounting); or (iii) delivering to the Company owned and unencumbered shares of capital stock.

11. Adjustments upon Changes in Stock.

(a) Capitalization Adjustments. If any change is made in, or other event occurs with respect to, the capital stock subject to the Plan or subject to any Stock Award without the receipt of consideration by the Company (through merger, consolidation, reorganization, recapitalization, reincorporation, stock dividend, dividend in property other than cash, stock split, liquidating dividend, combination of shares, exchange of shares, change in corporate structure or other transaction not involving the receipt of

consideration by the Company (each a "Capitalization Adjustment"), the Plan will be appropriately adjusted in the class(es) and maximum number of securities subject to the Plan pursuant to Sections 4(a) and 4(b) and the maximum number of securities subject to award to any person pursuant to Section 5(c), and the outstanding Stock Awards will be appropriately adjusted in the class(es) and number of securities and price per share of capital stock subject to such outstanding Stock Awards. The Board shall make such adjustments, and its determination shall be final, binding and conclusive. (The conversion of any convertible securities of the Company shall not be treated as a transaction "without receipt of consideration" by the Company.)

(b) Dissolution or Liquidation. In the event of a dissolution or liquidation of the Company, then all outstanding Stock Awards shall terminate immediately prior to the completion of such dissolution or liquidation.

(c) Corporate Transaction. In the event of a Corporate Transaction, any surviving corporation or acquiring corporation may assume any or all Stock Awards outstanding under the Plan or may substitute similar stock awards for Stock Awards outstanding under the Plan (it being understood that similar stock awards include, but are not limited to, awards to acquire the same consideration paid to the stockholders or the Company, as the case may be, pursuant to the Corporate Transaction). In the event that any surviving corporation or acquiring corporation does not assume any or all such outstanding Stock Awards or substitute similar stock awards for such outstanding Stock Awards, then with respect to Stock Awards that have been neither assumed nor substituted and that are held by Participants whose Continuous Service has not terminated prior to the effective time of the Corporate Transaction, the vesting of such Stock Awards shall (contingent upon the effectiveness of the Corporate Transaction) be accelerated in full to a date prior to the effective time of such Corporate Transaction as the Board shall determine (or, if the Board shall not determine such a date, to the date that is five (5) days prior to the effective time of the Corporate Transaction), and the Stock Awards shall terminate if not exercised (if applicable) at or prior to such effective time. With respect to any other Stock Awards outstanding under the Plan that have been neither

assumed nor substituted, the vesting of such Stock Awards shall not be accelerated unless otherwise provided in a written agreement between the Company or any Affiliate and the holder of such Stock Award, and such Stock Awards shall terminate if not exercised (if applicable) prior to the effective time of the Corporate Transaction.

(d) Change in Control. A Stock Award held by any Participant whose Continuous Service has not terminated prior to the effective time of a Change in Control may be subject to additional acceleration of vesting and exercisability as may be provided in the Stock Award Agreement for such Stock Award or as may be provided in any other written agreement between the Company or any Affiliate and the Participant, but in the absence of such provision, no such acceleration shall occur.

12. Amendment of the Plan and Stock Awards.

(a) Amendment of Plan. The Board at any time, and from time to time, may amend the Plan. However, except as provided in Section 11(a) relating to Capitalization Adjustments, no amendment shall be effective unless approved by the stockholders of the Company to the extent stockholder approval is necessary to satisfy the requirements of Section 422 of the Code.

(b) Stockholder Approval. The Board, in its sole discretion, may submit any other amendment to the Plan for stockholder approval, including, but not limited to, amendments to the Plan intended to satisfy the requirements of Section 162(m) of the Code and the regulations thereunder regarding the exclusion of performance-based compensation from the limit on corporate deductibility of compensation paid to Covered Employees.

(c) Contemplated Amendments. It is expressly contemplated that the Board may amend the Plan in any respect the Board deems necessary or advisable to provide eligible Employees with the maximum benefits provided or to be provided under the provisions of the Code and the regulations

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promulgated thereunder relating to Incentive Stock Options and/or to bring the Plan and/or Incentive Stock Options granted under it into compliance therewith.

(d) No Impairment of Rights. Rights under any Stock Award granted before amendment of the Plan shall not be impaired by any amendment of the Plan unless (i) the Company requests the consent of the Participant and (ii) the Participant consents in writing.

(e) Amendment of Stock Awards. The Board at any time, and from time to time, may amend the terms of any one or more Stock Awards; *provided, however*, that the rights under any Stock Award shall not be impaired by any such amendment unless (i) the Company requests the consent of the Participant and (ii) the Participant consents in writing.

13. Termination or Suspension of the Plan.

(a) Plan Term. The Board may suspend or terminate the Plan at any time. Unless sooner terminated, the Plan shall terminate on the day before the tenth (10th) anniversary of the date the Plan is adopted by the Board or approved by the stockholders of the Company, whichever is earlier. No Stock Awards may be granted under the Plan while the Plan is suspended or after it is terminated.

(b) No Impairment of Rights. Suspension or termination of the Plan shall not impair rights and obligations under any Stock Award granted while the Plan is in effect except with the written consent of the Participant.

14. Effective Date of Plan.

The Plan shall become effective as determined by the Board, but no Stock Award shall be exercised unless and until the Plan has been approved by the stockholders of the Company, which approval shall be within twelve (12) months before or after the date the Plan is adopted by the Board.

15. Choice of Law.

The law of the Commonwealth of Virginia shall govern all questions concerning the construction, validity and interpretation of this Plan, without regard to such state's conflict of laws rules.

16. Investment Company Act.

No provision of this Equity Incentive Plan will contravene any portion of the Investment Company Act. In the event of any conflict between the provisions of the Plan and the Investment Company Act, the applicable section of the Investment Company Act shall control and all Stock Awards under the Plan shall be so modified. All participants holding such modified Stock Awards shall be notified of the change to their Stock Awards and such change shall be binding on such Participants.

GLADSTONE CAPITAL CORPORATION

FIRST AMENDMENT TO
AMENDED AND RESTATED 2001 EQUITY INCENTIVE PLAN

Approved By Board of Directors: August 8, 2001
Approved By Stockholders: August 8, 2001

1. *Section 4(a)* of the Plan shall be amended and restated in its entirety to read as follows:

(a) **Share Reserve.** Subject to the provisions of Section 11(a) relating to Capitalization Adjustments, the capital stock that may be issued pursuant to Stock Awards shall be one million two hundred fifty thousand (1,250,000) shares, subject to increase by 20% of the number of shares sold pursuant to the exercise of the underwriter's over-allotment option in the initial public offering and any upsizing of the offering up to 20%, for a maximum share reserve of one million five hundred thousand (1,500,000) shares of capital stock. Stock Awards shall be comprised of Common Stock or Preferred Stock as determined by the Board in its discretion.

2. *Section 5(c)* of the Plan shall be amended to increase the maximum number of Options that an Employee shall be eligible to be granted during any calendar year to Options covering no more than eight hundred thousand (800,000) shares of capital stock.

3. Except as set forth in this First Amendment, the Plan shall be unaffected hereby and shall remain in full force and effect.

GLADSTONE CAPITAL CORPORATION

SECOND AMENDMENT TO
AMENDED AND RESTATED 2001 EQUITY INCENTIVE PLAN

Approved By Board of Directors: September 23, 2002

1. *Section 2(r)* of the Plan shall be amended and restated in its entirety to read as follows:

(r) "**Fair Market Value**" or "**Current Market Value**" means, as of any date, the value of the capital stock determined as follows:

(i) If the class of capital stock is listed on any established stock exchange or traded on the Nasdaq National Market or the Nasdaq SmallCap Market, the Fair Market Value of a share of such capital stock shall be the closing sales price for such stock (or the closing bid, if no sales were reported) as quoted on such exchange or market (or the exchange or market with the greatest volume of trading in the capital stock) on the day of grant, as reported in

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The Wall Street Journal or such other source as the Board deems reliable.

(ii) In the absence of such market value, the Fair Market Value shall be determined in good faith by the Board, but shall in no event be less than the current net asset value per share of such stock.

2. Except as set forth in this Second Amendment, the Plan shall be unaffected hereby and shall remain in full force and effect.

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DETACH PROXY CARD HERE

0 Please vote, date and promptly return this proxy in the enclosed return envelope which is postage prepaid if mailed in the United States. **ý** Votes must be indicated (x) in Black or Blue ink.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR EACH NOMINEE FOR DIRECTOR LISTED BELOW.

Proposal 1: To elect two directors to hold office until the 2006 Annual Meeting of Stockholders.

FOR all nominees listed **0** **WITHHOLD AUTHORITY** to vote for all nominees listed **0** ***FOR** all except **0**

Nominee: Terry Lee Brubaker
Nominee: David A.R. Dullum

To withhold authority to vote in favor of either nominee, mark "For all except" and write the name of the nominee below:

*Exceptions _____

In their discretion, the proxies are authorized to vote on any other business as may properly come before the meeting or any adjournment or postponement thereof.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR PROPOSAL 2.

	FOR	AGAINST	ABSTAIN
Proposal 2: To approve an amendment to the Company's Amended and Restated 2001 Equity Incentive Plan, as amended, to increase the aggregate number of shares of common stock authorized for issuance under such plan by 500,000 shares.	0	0	0

THE BOARD OF DIRECTORS RECOMMENDS A VOTE FOR PROPOSAL 3.

	FOR	AGAINST	ABSTAIN
Proposal 3: To ratify the selection of PricewaterhouseCoopers LLP as independent auditors of the Company for its fiscal year ending September 30, 2003.	0	0	0

SCANLINE

Please sign exactly as your name or names appear hereon. If the stock is registered in the names of two or more persons, each should sign. Executor, administrator, trustee, guardian and attorneys-in-fact should add their titles. If signer is a corporation, please give full corporate name and have a duly authorized officer sign, stating title. If signer is a partnership, please sign in partnership name by authorized person.

Date	Share Owner sign here	Co-Owner sign here
_____	_____	_____
_____	_____	_____

**GLADSTONE CAPITAL CORPORATION
PROXY SOLICITED BY THE BOARD OF DIRECTORS
FOR THE ANNUAL MEETING OF STOCKHOLDERS
TO BE HELD ON FEBRUARY 24, 2003**

The undersigned hereby appoints David Gladstone and Terry Brubaker, and each of them, as attorneys and proxies of the undersigned, with full power of substitution, to vote all of the shares of stock of Gladstone Capital Corporation which the undersigned may be entitled to vote at the Annual Meeting of Stockholders of Gladstone Capital Corporation to be held at the Third Floor Conference Room of the company's principal executive office at 1616 Anderson Road, McLean, VA 22102 on Monday, February 24, 2003 at 10:00 a.m. (local time), and at any and all postponements, continuations and adjournments thereof, with all powers that the undersigned would possess if personally present, upon and in respect of the following matters and in accordance with the following instructions, with discretionary authority as to any and all other matters that may properly come before the meeting.

Unless a contrary direction is indicated, this proxy will be voted in favor of each of the nominees listed in Proposal 1, for Proposal 2 and for Proposal 3, as more specifically described in the proxy statement. If specific instructions are indicated, this proxy will be voted in accordance therewith.

(Continued and to be signed on reverse side)

To change your address, please mark this box

GLADSTONE CAPITAL CORPORATION
P.O. BOX 11046
NEW YORK, N.Y. 10203-0046

QuickLinks

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