

Carbonite Inc  
Form 10-K  
March 06, 2013  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2012

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: 001-35264

**CARBONITE, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation)

177 Huntington Avenue

33-1111329  
(I.R.S. Employer Identification No.)

02115

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**Boston, Massachusetts**  
(Address of principal executive offices)

(Zip Code)

**(617) 587-1100**

(Registrant's telephone number, including area code)

**Securities Registered pursuant to Section 12(b) of the Act:**

<b>Title of Each Class</b>	<b>Name of Exchange on Which Registered</b>
Common Stock, par value \$0.01 per share	The NASDAQ Stock Market LLC

**Securities Registered pursuant to Section 12(g) of the Act:**

None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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 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 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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 the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer

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

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

As of June 29, 2012, the last business day of the registrant's most recently completed second quarter, the aggregate market value of the voting stock held by non-affiliates of the registrant was \$132,139,842.

As of March 1, 2013, there were 25,913,579 shares of the registrant's common stock, par value \$0.01 per share, outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

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Portions of the registrant's definitive proxy statement for its 2013 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K.

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**PART I**

**SPECIAL NOTE REGARDING FORWARD LOOKING STATEMENTS**

This Annual Report on Form 10-K (the "Annual Report"), including the sections entitled "Business," "Risk Factors," and "Management's Discussion and Analysis of Financial Condition and Results of Operations," includes forward-looking statements. The words "believe," "may," "will," "estimate," "continue," "anticipate," "intend," "expect," "predict," "potential," and similar expressions, as well as the negatives thereof, as they relate to us, our business, our management, and our industry, are intended to identify forward-looking statements. In light of risks and uncertainties discussed in this Annual Report, the forward-looking events and circumstances discussed in this Annual Report may not occur and actual results could differ materially from those anticipated or implied in the forward-looking statements. We have based these forward-looking statements on our current expectations and projections about future events and financial trends affecting the financial condition of our business. Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at or by which such performance or results will be achieved. Forward-looking statements are based on information available at the time those statements are made and/or management's good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in or suggested by the forward-looking statements. Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time and it is not possible for our management to predict all risks, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements we may make. Important factors that could cause such differences include, but are not limited to:

our ability to accurately forecast revenue and appropriately plan our expenses and working capital requirements;

our ability to generate additional revenue;

our ability to retain existing customers and attract new customers;

our ability to protect our customers' stored files and adequately address privacy concerns;

the impact of actual or threatened litigation, including intellectual property infringement claims, involving us or our industry;

the impact of increased competition in our business;

interruptions in service and any related impact on our reputation;

our ability to maintain, protect, and enhance our brand; and

other risk factors included under "Risk Factors" in this Annual Report.

Forward-looking statements speak only as of the date of this Annual Report. We may not actually achieve the plans, intentions, or expectations disclosed in our forward-looking statements, and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions, and expectations disclosed in the forward-looking statements we make. In addition, our forward-looking statements do not reflect the potential impact of any future acquisitions, mergers, dispositions, joint ventures, or investments that we may make.

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You should read this Annual Report completely and with the understanding that our actual future results may be materially different from what we expect. We do not assume any obligation to update any forward-looking statements, whether as a result of new information, future events, or otherwise, except as required by law. If we update one or more forward-looking statements, no inference should be drawn that we will make additional updates with respect to those or other forward-looking statements.

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Unless otherwise indicated, information contained in this Annual Report concerning our industry and the market in which we operate, including our general expectations and market position, market opportunity, and market size, is based on information from various sources, on assumptions that we have made that are based on such data, and on our knowledge of the markets for our solutions. Such data involves a number of assumptions and limitations, and you are cautioned not to give undue weight to such estimates. In addition, projections, assumptions, and estimates of our future performance and the future performance of the industry in which we operate, whether made by us or by third parties, are necessarily subject to a high degree of uncertainty and risk due to a variety of factors, including those described in Risk Factors and elsewhere in this Annual Report. These and other factors could cause results to differ materially from those expressed in the estimates made by the independent parties and by us.

### **ITEM 1. BUSINESS**

#### **Overview**

Carbonite, Inc. (together with its subsidiaries, Carbonite, the Company, our, we, or us ) was incorporated on February 10, 2005 and is a Delaware corporation. We are a leading provider of cloud backup solutions for consumers and small and medium sized businesses, or SMBs. We provide easy-to-use, affordable, and secure cloud backup solutions with anytime, anywhere access to files stored on our servers. We believe that we are the best known brand in the cloud backup market.

We founded Carbonite on one simple idea: all computers need to be backed up, and in this always-connected and highly-mobile world, cloud backup is the ideal approach. Our set and forget automated solution requires little effort and protects our customers stored files even if their computers are lost, stolen, or destroyed.

Our backup solutions work quietly in the background, automatically and continuously uploading encrypted copies of our customers files to Carbonite servers. Our customers can browse and share their photos, videos, and documents anytime, anywhere using a web browser or our free iPad, iPhone, BlackBerry, and Android apps. We charge consumers a \$59 flat fee for one year of unlimited cloud backup with our Carbonite Home solution. Our Carbonite HomePlus solution provides consumers with additional features, including backup and restore for external hard drives, for an annual flat fee of \$99. The Carbonite HomePremier solution also includes automatic cloud backup for video files as well as a recovery-by-mail feature for an annual flat fee of \$149. The pricing of all of our consumer solutions is discounted for multi-year subscriptions. Our SMB solutions, Carbonite Business and Carbonite BusinessPremier, allow for an unlimited number of users, subject to storage limits, and are priced starting at \$229 and \$599 per year, respectively.

As of December 31, 2012, we had subscribers in more than 100 countries, with subscribers based in the U.S. representing 94% of our total revenue for 2012. Since 2005, we have backed up over 300 billion files and have restored nearly 20 billion files that might otherwise have been permanently lost. We currently back up more than 350 million files each day.

We have developed a highly predictable subscription revenue model, with a consistently high customer retention rate and a scalable infrastructure to support our growth. We generated revenue of \$84.0 million in 2012. We continue to invest heavily in customer acquisition, principally through advertising, and as a result we recorded a net loss of \$18.9 million in 2012. Our bookings have grown from \$32.9 million in 2009 to \$98.5 million in 2012. For a reconciliation of bookings to revenue for the last five years, see Selected Consolidated Financial and Other Data.

#### **Industry Trends**

Cloud backup is gaining increasing acceptance as the best way to store copies of valuable data off-premise, where they are safe from equipment failure, theft, loss, viruses, and accidental deletion.

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Several trends are helping to fuel the growth of the cloud backup industry:

*Your life is on your computer.* Computers and mobile devices have transformed the way people work, communicate, and lead their daily personal and professional lives. People store a plethora of information on their computers and mobile devices, from photos, music, videos, and school work, to financial records, correspondence, passwords, work files, and tax returns. These files could be permanently destroyed due to equipment failure, theft, loss, viruses, and accidental deletions. Often these files are accumulated over time and are irreplaceable, making their loss devastating for the owner.

*Rapid growth in unprotected data drives demand for backup services.* According to IDC, an independent research firm, the proportion of information in the digital universe that requires data protection is growing faster than the digital universe itself.\* From 2005 to 2020, the digital universe is expected to grow by a factor of 300, from 130 exabytes to 40,000 exabytes, or 40 trillion gigabytes (more than 5,200 gigabytes for every man, woman, and child in 2020) and, from 2013 to 2020, the digital universe will about double every two years, according to IDC. Further, while less than a third of the digital universe required data protection in 2010, that proportion is expected to exceed 40% by 2020. According to IDC, only about half the information that should be protected from loss is currently protected.

*Smartphones and tablets drive demand for anytime, anywhere access.* The growing popularity of smartphones, tablet computers, and other mobile devices is driving the demand for instant access to information regardless of a user's location. According to IDC, worldwide tablet shipments reached a record total of 52.5 million units and the tablet market grew 74.3% in the fourth quarter of 2012 up from the third quarter's total of 30.1 million units. Approximately 712.6 million smartphones were shipped globally in 2012, which was 44.1% more than in 2011. IDC predicts that these factors will drive demand for data protection and mobile access.

*Plummeting storage and bandwidth costs.* The cost of providing cloud backup is highly dependent on the cost of storage and bandwidth. According to IDC, between 2012 and 2020, the cost per gigabyte (GB) is expected to drop from \$2.00 to \$0.20. In 2005, the average wholesale cost of bandwidth was approximately \$75 per megabits per second (Mbps) as compared to \$5 per Mbps in 2010, according to an August 2010 study done by DrPeering International. This study projects that the wholesale cost of bandwidth will further decline to approximately \$0.94 per Mbps in 2014.\*\*

\* IDC information was derived from the following reports dated December 2012 and January 2013: IDC Digital Universe Study, Sponsored by EMC, Tablet Shipments Soar to Record Levels During Strong Holiday Quarter; The Digital Universe in 2020: Big Data, Bigger Digital Shadows and Biggest Growth in the Far East, Sponsored by EMC; Strong Demand for Smartphones and Heated Vendor Competition Characterize the Worldwide Mobile Phone Market at the End of 2012, IDC Says.

\*\* DrPeering International: Internet Transit Prices - Historical and Projected, August 2010.



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There are multiple alternatives currently available for backing up data, such as external hard disk drives, flash memory drives, CDs, DVDs, and tape backup drives. However, these traditional alternatives are limited by drive capacity, cumbersome to scale, prone to failure, not secure, and not accessible from a remote location. Traditional hardware solutions for storing data have the following limitations:

<b>Limitation</b>	<b>Key Problems</b>
Limited Capacity	Users must select which files to back up
	Cumbersome to add incremental capacity
Susceptible to failure	Unable to protect files in the event of equipment failure, theft, loss, viruses, and accidental deletions
Overly complex	Time consuming and labor intensive to manually manage backup
	Confusing software and processes
Lack of mobile access	Do not provide anytime, anywhere access from computers, smartphones, tablets, and other mobile devices

As a result of these limitations, consumers and SMBs are increasingly searching for simple, affordable solutions that provide reliable and secure cloud backup and anytime, anywhere access to their stored files. We believe that cloud backup effectively addresses the limitations of traditional solutions and will be the predominant backup solution in the future.

**Our Solution**

We provide cloud backup solutions for consumers and SMBs. We believe that our customers buy our solutions because they are easy to use, affordable, and secure, and provide anytime, anywhere access to their stored files. We make it easy for customers to restore their files and we provide high quality customer support to those customers who need assistance.

We believe that our solution provides the following benefits to all of our customers:

*Easy to install and use.* We offer our customers automatic backup, eliminating the need to manually pick and choose which files to back up. Installation requires just an email address and password. Once installed, our set and forget solution works continuously in the background backing up new and changed files.

*Easy to restore files.* In the event of data loss, our restore wizard guides customers through the process of restoring their files. If customers accidentally delete or overwrite files on their Carbonite protected devices, they can quickly restore files from any device with an internet connection.

*Anytime, anywhere access.* We enable customers to access stored files from Carbonite servers anytime, anywhere using a web browser or from any internet-connected device using one of our free iPad, iPhone, BlackBerry, or Android apps. Customers can browse their photos, play music and videos, and view documents, spreadsheets and presentations. Unlike traditional remote desktop applications, we allow our customers to access their stored files even if their computers are turned off, lost, stolen, or destroyed.

*Affordability.* We believe that we were one of the first companies to offer consumers unlimited cloud backup for a fixed price. Our Carbonite Home subscription costs \$59 for one year, with discounts for multi-year plans. Our SMB solutions allows for an unlimited number of users with tiered pricing based on the total amount of data backed up.

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*Security.* We encrypt all of our customers' files before they are transmitted to our data centers, guarding against unauthorized access to stored files and ensuring a high level of data security. In addition, we employ state-of-the-art data center security measures intended to prevent intrusions.

*Reliability.* Our proprietary Carbonite Communications System and Carbonite File System manage our customers' stored files and are designed to ensure high levels of reliability and accessibility.

### **Our Key Competitive Strengths**

We believe that our key competitive strengths include the following:

*Brand awareness.* We believe that we have among the highest brand awareness in the cloud backup market. According to our research surveys, our unaided brand awareness is more than one and a half times that of our nearest competitor. We promote our brand through our multi-channel marketing program, which includes a broad presence in television, radio, online display advertising, print advertising, paid and natural search, and an affiliate and reseller network.

*Scale.* Since 2005, we have backed up over 300 billion files, and we currently back up more than 350 million files each day. We believe that our large scale infrastructure, built over the last seven years, enables us to store additional files at lower incremental cost than our smaller competitors. In addition, we are able to purchase national advertising at advantageous rates, access advertising opportunities that may be unavailable to smaller businesses, and take advantage of sophisticated analytical marketing systems.

*Optimized backup architecture.* Our entire infrastructure is optimized for backup, which is a low transaction speed, high volume, write mostly application. We believe that our average storage costs per subscriber are lower than those realized by typical general purpose data center storage systems.

*Comprehensive customer support.* We believe that our U.S.-based customer support is more comprehensive than that offered by our primary competitors in the cloud backup market and aids in our customer retention. We provide free telephone, live chat, and email customer support in our basic subscription fee.

*Significant intellectual property portfolio.* We have a significant intellectual property portfolio relating to our cloud backup solutions. CARBONITE is a registered trademark in the U.S. and in over 30 other countries, including countries in the European Union. Carbonite also has additional registrations and pending applications for additional marks in the U.S. and other countries, including but not limited to Carbonite The Better Backup Plan, Green Dot Logo, Back it up. Get it back, Because Your Life is On Your Computer, Carbonite and the Green Dot Logo, Carbonite Lock Logo and Chinese character representations for Carbonite. In addition, we have four issued patents and 18 pending patent applications in the U.S. and internationally that cover both our technical infrastructure and our key usability and design concepts.

### **Our Offerings**

We offer backup solutions to our customers with anytime, anywhere access to their stored files. We charge consumers a flat fee for one year of unlimited cloud backup at three different service levels, each with discounts for multi-year subscriptions. We offer SMB customers cloud backup for an unlimited number of computers for an annual flat fee based on the total amount of data backed up, with the option to purchase additional incremental storage capacity.

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The following table sets forth key features of our Carbonite Home, Carbonite HomePlus, and Carbonite HomePremier consumer offerings:

	<b>Carbonite Home</b>	<b>Carbonite HomePlus</b>	<b>Carbonite HomePremier</b>
Number of computers		One per subscription	
Supported operating systems	Windows, Mac		Windows
Pricing	\$59/year; unlimited storage	\$99/year; unlimited storage, external hard drive backup and restore	\$149/year; unlimited storage, external hard drive backup and restore, automatic backup for video files, recovery-by-mail feature
Subscription Period		Annual or multi-year	
Customer support		U.S.-based telephone, live chat, and email	
Remote file access	Anytime, anywhere using a web browser or our free iPad, iPhone, Blackberry, or Android apps		

The following table sets forth key features of our Carbonite Business and Carbonite BusinessPremier SMB offerings:

	<b>Carbonite Business</b>	<b>Carbonite BusinessPremier</b>
Number of computers		Unlimited
Supported operating systems	Windows	Windows and Windows Server
Pricing	\$229/year; 250 GB of backup storage space	\$599/year; 500 GB of backup storage space
Subscription Period		Annual
Customer support		U.S.-based telephone, live chat, and email
Remote file access	Anytime, anywhere using a web browser or our free iPad, iPhone, Blackberry, or Android apps	

We use sophisticated encryption technology to ensure the privacy of our customers' stored files. We encrypt files using a secure key before the files leave the customer's computer and transmit the encrypted files over the internet to one of our secure data centers. Customers' files remain encrypted on our servers to guard against unauthorized access. We employ outside security analysis firms, including anti-hacking specialists, to review and test our defenses and internal procedures.

**Our Proprietary Server Software**

At the core of our offerings is our proprietary server software designed specifically for cloud backup. The server software is comprised of two major components: the Carbonite Communications System (CCS) and the Carbonite File System (CFS). These components work together to move and store vast amounts of customer data—more than 350 million files every day. CCS moves customer data between our software installed on our customers' computers and CFS running on our storage servers. CCS also balances loads across our server network. CFS manages the write-mostly database of stored files with the flexibility to operate on a wide variety of readily available third-party storage hardware.

We invest heavily in the development of our technologies. In 2012, 2011, and 2010, we spent \$19.9 million, \$16.5 million, and \$10.9 million, respectively, on research and development. Our proprietary technologies are fundamental to our value proposition as they enable us to deliver the following benefits:

*Scalability.* We add storage capacity at the rate of approximately one petabyte every two weeks. CCS allows us to automatically balance processing and storage capacity across our large and expanding server network. CFS allows us to easily add storage capacity across multiple physical locations by automatically integrating new storage servers into our existing infrastructure.

*Reliability.* We designed CCS and CFS to eliminate all single points of failure. The modular design of these components uses well-defined protocols intended to ensure that our customers' stored files are accurate and free from errors. CFS provides proprietary disk error detection for errors that can occur over years of storage. Our software also incorporates checks and balances to verify data integrity.

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*Cost effectiveness.* Storage cost is the biggest component of our cost of revenue. CCS enables us to dynamically load balance among servers to allow higher overall utilization. CFS enables us to reduce storage costs by utilizing almost every block of physical disk space to store our customers' files. We can choose the most cost-effective hardware solutions for our data centers because CFS allows us to operate in a heterogeneous hardware environment.

### **Marketing and Sales**

Our marketing efforts are focused on three primary goals: building brand awareness, acquiring customers at a low cost, and retaining existing customers. Our advertising reinforces our brand image by emphasizing ease of use, affordability, security, reliability, and anytime, anywhere access to stored files. We use television and radio advertising, online display advertising, print advertising, paid search, direct marketing, and affiliate and reseller marketing. Our public relations efforts include engaging the traditional press, new media, and social networks.

*Marketing.* Most of our revenue is from consumers who sign up for Carbonite backup on our website in response to our direct marketing campaigns. Direct sales from our websites accounted for 96% of our total revenue during 2012. Our marketing efforts are designed to attract prospects to our website and enroll them as paying customers, usually after a 15-day free trial that we offer to consumers. Our SMB sales team responds to inbound qualified SMB leads, communicates the benefits of our solutions to the SMB market and assists our SMB customers to enroll in free trial versions and purchase subscriptions to our SMB offering.

*Channel distribution and reseller strategy.* In January 2012, we launched a new distribution strategy designed to sell large volumes of our solutions through our sales channel relationships including major retailers and resellers.

*Retention.* Our customer retention efforts are focused on establishing and maintaining long-term relationships with our customers by delivering a compelling customer experience and superior value, communicating regularly with customers through email, on-site messaging, and other media, and creating positive interactions with our customer support team. We monitor developing trends in subscription durations, renewals, and customer satisfaction to maximize our customer retention. We offer incentives to customers to purchase multi-year subscriptions, which we believe helps to increase our customer retention. As of December 31, 2012, 2011, and 2010, 29%, 30%, and 24%, respectively, of our customers had multi-year subscriptions.

### **Intellectual Property**

We believe that the strength of our brand and the functionality of our software help differentiate us from our competitors. As such, our success depends upon our ability to protect our technologies and intellectual property, including our proprietary server software, which allows us to move and store vast amounts of customer data. To protect our intellectual property, we rely on a combination of trademark, patent, copyright, and trade secret laws, as well as confidentiality procedures and contractual restrictions. CARBONITE is a registered trademark in the U.S. and in over 30 other countries, including countries in the European Union. Carbonite also has additional registrations and pending applications for additional marks in the U.S. and other countries, including but not limited to Carbonite The Better Backup Plan, Green Dot Logo, Back it up. Get it back, Because Your Life is On Your Computer, Carbonite and the Green Dot Logo, Carbonite Lock Logo and Chinese character representations for Carbonite. In addition, we have four issued patents and 18 pending patent applications in the U.S. and internationally that cover both our technical infrastructure and our key usability and design concepts.

The steps we have taken may not adequately protect our intellectual property or prevent unauthorized use of our technologies. Others may independently develop technologies that are competitive to ours or infringe our intellectual property. In addition, costly and time consuming litigation may be necessary to protect and enforce our intellectual property rights.

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If we become more successful, we believe that competitors will be more likely to try to develop products and services that are similar to ours, and that may infringe our proprietary rights. It may also be more likely that competitors or other third parties will claim that our solutions infringe their proprietary rights.

### **Competition**

We compete with both cloud backup providers and providers of traditional hardware-based backup systems. The market for cloud backup solutions is competitive and rapidly changing. We directly compete with CrashPlan, Mozy (a division of VMWare), SOS Online Backup, and others. Certain of our features, including our mobile backup and remote access service, also compete with current or potential services offered by Apple, Google, Microsoft, Amazon, and others. Certain of our planned features, including the ability to share data with third parties, compete with current or potential services offered by DropBox, SugarSync, Box, and others. With the introduction of new technologies and market entrants, we expect competition to intensify in the future. Many of our actual and potential competitors enjoy competitive advantages over us, such as greater name recognition, longer operating histories, more varied services, and larger marketing budgets, as well as greater financial, technical, and other resources. In addition, many of our competitors have established marketing relationships and major distribution agreements with computer manufacturers, internet service providers, and resellers, giving them access to larger customer bases.

We believe that the key competitive factors in the consumer and SMB backup industry include:

ease of installation and use;

affordability;

remote access;

storage capacity;

security of customers' stored files;

rapid recovery of lost files;

reliability and redundancy;

automated file backup; and

reputation of the provider.

We believe that we compete favorably with respect to each of these factors by providing easy to use, affordable, unlimited, secure cloud backup solutions with anytime, anywhere access to stored files.

Some of our competitors have made or may make acquisitions or enter into partnerships or other strategic relationships to offer a more comprehensive service than we do. These combinations may make it more difficult for us to compete effectively, including on the basis of price, sales and marketing programs, technology, or service functionality. We expect these trends to continue as companies attempt to strengthen or maintain their market positions.

**Employees**

As of December 31, 2012, we had 367 full-time and 11 part-time employees. Of our full-time employees, 195 were in operations and support, 45 were in sales and marketing, 105 were in research and development, and 22 were in general and administrative functions. None of our employees are covered by collective bargaining agreements.

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### **Available Information**

We file reports with the Securities and Exchange Commission ( SEC ), including annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and other filings required by the SEC. We make available on our website (www.carbonite.com) our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. These materials are available free of charge on or through our website via the Investor Relations page at www.carbonite.com. References to our website address in this report are intended to be inactive textual references only, and none of the information contained on our website is part of this Annual Report or incorporated in this Annual Report by reference.

The public may read and copy any materials that we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. The public may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. The SEC maintains an internet site (<http://www.sec.gov>) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC.

### **ITEM 1A. RISK FACTORS**

*An investment in our common stock involves a high degree of risk. You should carefully consider the risks described below and the other information in this Annual Report on Form 10-K before making an investment decision. Our business, prospects, financial condition, or operating results could be harmed by any of these risks, as well as other risks not currently known to us or that we currently consider immaterial. The trading price of our common stock could decline due to any of these risks, and, as a result, you may lose all or part of your investment.*

#### **Risks Related to Our Business**

*We have experienced losses and negative cash flow since our inception, and we may not be able to achieve or sustain profitability or positive cash flow in the future.*

We experienced net losses of \$25.8 million for 2010, \$23.5 million for 2011, and \$18.9 million for 2012, respectively, and have an accumulated deficit of \$119.4 million as of December 31, 2012. We do not expect to be profitable for the foreseeable future. We expect to continue making significant expenditures to develop and expand our business, including for advertising, customer acquisition, technology infrastructure, storage capacity, product development, and international expansion, in an effort to increase and service our customer base. In 2012, we incurred increased expenses associated with the relocation of one of our data centers to a new facility. We also expect that our quarterly results may fluctuate due to a variety of factors described elsewhere in this Annual Report on Form 10-K, including the timing and amount of our advertising expenditures, which are seasonal, as well as the timing and amount of expenditures related to the development of technologies and solutions and to defend intellectual property infringement and other claims. In addition, as a public company, we incur significant legal, accounting, and other expenses, including increased costs for director and officer liability insurance that we did not incur as a private company. We may also incur increased losses and negative cash flow in the future for a number of reasons, and we may encounter unforeseen expenses, difficulties, complications, delays, and other unknown events. For these reasons, we expect to continue to record net losses for the next several years and we may not be able to achieve or maintain positive cash flow from operations or profitability.

*Any significant disruption in our service or loss or misuse of our customers' data could damage our reputation and harm our business and operating results.*

Our brand, reputation, and ability to attract, retain, and serve our customers are dependent upon the reliable performance of our service and our customers' ability to readily access their stored files. Our customers rely on our cloud backup solution to store digital copies of their valuable data files, including financial records, business

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information, photos, and other personally meaningful content. Our data centers are vulnerable to damage or interruption from human error, intentional bad acts, computer viruses or hackers, earthquakes, hurricanes, floods, fires, war, terrorist attacks, power losses, hardware failures, systems failures, telecommunications failures, and similar events, any of which could limit our customers' ability to access their files and could prevent us from being able to continuously back up our customers' files. Prolonged delays or unforeseen difficulties in connection with adding storage capacity or upgrading our network architecture when required may cause our service quality to suffer. A breach of our network security and systems could also cause the loss or public disclosure of, or access by third parties to, our customers' stored files. Any event that significantly disrupts our service or exposes our customers' stored files to misuse could damage our reputation and harm our business and operating results, including reducing our revenue, causing us to issue credits to customers, subjecting us to potential liability, harming our renewal rates, or increasing our cost of acquiring new customers.

*The market for cloud backup solutions is competitive, and if we do not compete effectively, our operating results could be harmed.*

We compete with both cloud backup providers and providers of traditional hardware-based backup systems. The market for cloud backup solutions is competitive and rapidly changing. We directly compete with CrashPlan, Mozy (a division of VMWare), SOS Online Backup, and others. Certain of our features, including our mobile backup and remote access service, also compete with current or potential services offered by Apple, Google, Microsoft, Amazon, and others. Certain of our planned features, including the ability to share data with third parties, compete with current or potential services offered by DropBox, SugarSync, Box, and others. With the introduction of new technologies and market entrants, we expect competition to intensify in the future. Many of our actual and potential competitors benefit from competitive advantages over us, such as greater name recognition, longer operating histories, more varied services, and larger marketing budgets, as well as greater financial, technical, and other resources. In addition, many of our competitors have established marketing relationships and major distribution agreements with computer manufacturers, internet service providers, and resellers, giving them access to larger customer bases. Some of our competitors may make acquisitions or enter into strategic relationships to offer a more comprehensive service than we do. These combinations may make it more difficult for us to compete effectively. We expect these trends to continue as competitors attempt to strengthen or maintain their market positions.

Demand for our cloud backup solutions is sensitive to price. Many factors, including our advertising, customer acquisition and technology costs, and our current and future competitors' pricing and marketing strategies, can significantly affect our pricing strategies. Certain of our competitors offer, or may in the future offer, lower-priced or free products or services that compete with our solutions. Similarly, certain competitors may use internet-based marketing strategies that enable them to acquire customers at a lower cost than us. There can be no assurance that we will not be forced to engage in price-cutting initiatives, or to increase our advertising and other expenses to attract and retain customers in response to competitive pressures, either of which could have a material adverse effect on our revenue and operating results.

*Our limited operating history makes it difficult to evaluate our current business and future prospects.*

We have been in existence since 2005, and our revenue has grown rapidly from \$8.2 million in 2008 to \$84.0 million in 2012, representing a compound annual growth rate of 79% over that period. We do not expect that this growth rate will continue in future periods and you should not rely on the revenue growth of any prior quarterly or annual periods as an indication of our future performance. In addition, because we recognize revenue from customers over the terms of their subscriptions, a large portion of our revenue for each quarter reflects deferred revenue from subscriptions entered into during previous quarters, and downturns or upturns in subscription sales or renewals may not be reflected in our operating results until later periods. We may not achieve sufficient revenue to achieve or maintain positive cash flow from operations or profitability, and our limited operating history may make it difficult for you to evaluate our current business and our future prospects. We have encountered and will continue to encounter risks and difficulties frequently experienced by growing



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companies in rapidly changing industries, including increasing expenses as we continue to grow our business. If we do not manage these risks successfully, our business will be harmed. If our future growth fails to meet investor or analyst expectations, it could have a negative effect on our stock price. If our growth rate were to decline significantly or become negative, it could adversely affect our financial condition and operating results.

*A decline in demand for our solutions or for cloud backup solutions in general could cause our revenue to decline.*

We derive, and expect to continue to derive, substantially all of our revenue from the sale of our cloud backup solutions, a relatively new and rapidly changing market. As a result, widespread acceptance and use of cloud backup solutions is critical to our future growth and success. If the market for cloud backup solutions fails to grow or grows more slowly than we currently anticipate, demand for our solutions could be negatively affected.

Changes in customer preferences for cloud backup solutions may have a disproportionately greater impact on us than if we offered multiple products and services. The market for cloud backup solutions is subject to rapidly changing customer demand and trends in preferences. Some of the potential factors that could affect interest in and demand for cloud backup solutions include:

awareness of our brand and the cloud backup solutions category generally;

the appeal and reliability of our solutions;

the price, performance, features, and availability of products and services that compete with ours;

public concern regarding privacy and data security;

our ability to maintain high levels of customer satisfaction; and

the rate of growth in online solutions generally.

In addition, substantially all of our revenue is currently derived from customers in the U.S. Consequently, a decrease of interest in and demand for cloud backup solutions in the U.S. could have a disproportionately greater impact on us than if our geographic mix of revenue was less concentrated.

*If we are unable to attract new customers to our solutions on a cost-effective basis, our revenue and operating results would be adversely affected.*

We generate substantially all of our revenue from the sale of subscriptions to our solutions. In order to grow, we must continue to attract a large number of customers on a cost-effective basis, many of whom have not previously used cloud backup solutions. We use and periodically adjust a diverse mix of advertising and marketing programs to promote our solutions. Significant increases in the pricing of one or more of our advertising channels would increase our advertising costs or cause us to choose less expensive and perhaps less effective channels. As we add to or change the mix of our advertising and marketing strategies, we may need to expand into channels with significantly higher costs than our current programs, which could adversely affect our operating results. We may incur advertising and marketing expenses significantly in advance of the time we anticipate recognizing any revenue generated by such expenses, and we may only at a later date, or never, experience an increase in revenue or brand awareness as a result of such expenditures. We have made in the past, and may make in the future, significant investments to test new advertising, and there can be no assurance that any such investments will lead to the cost-effective acquisition of additional customers. If we are unable to maintain effective advertising programs, our ability to attract new customers could be adversely affected, our advertising and marketing expenses could increase substantially, and our operating results may suffer.

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A portion of our potential customers locate our website through search engines, such as Google, Bing, and Yahoo!. Our ability to maintain the number of visitors directed to our website is not entirely within our control. If

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search engine companies modify their search algorithms in a manner that reduces the prominence of our listing, or if our competitors' search engine optimization efforts are more successful than ours, fewer potential customers may click through to our website. In addition, the cost of purchased listings has increased in the past and may increase in the future. A decrease in website traffic or an increase in search costs could adversely affect our customer acquisition efforts and our operating results.

A significant portion of our customers first try our cloud backup solutions through free trials. We seek to convert these free trial users to paying customers of our solutions. If our rate of conversion suffers for any reason, our revenue may decline and our business may suffer.

***If we are unable to retain our existing customers, our revenue and operating results would be adversely affected.***

If our efforts to satisfy our existing customers are not successful, we may not be able to retain them, and as a result, our revenue and ability to grow would be adversely affected. We may not be able to accurately predict future trends in customer renewals. Customers choose not to renew their subscriptions for many reasons, including if customer service issues are not satisfactorily resolved, a desire to reduce discretionary spending, or a perception that they do not use the service sufficiently, that the solution is a poor value, or that competitive services provide a better value or experience. If our customer retention rate decreases, we may need to increase the rate at which we add new customers in order to maintain and grow our revenue, which may require us to incur significantly higher advertising and marketing expenses than we currently anticipate, or our revenue may decline. A significant decrease in our customer retention rate would therefore have an adverse effect on our business, financial condition, and operating results.

***Our relationships with our partners may be terminated or may not continue to be beneficial in generating new customers, which could adversely affect our ability to increase our customer base.***

We maintain a network of active partners, which refer customers to us through links on their websites and outbound promotion to their customers. If we are unable to maintain our contractual relationships with existing partners or establish new contractual relationships with potential partners, we may experience delays and increased costs in adding customers, which could have a material adverse effect on us. The number of customers that we are able to add through these relationships is dependent on the marketing efforts of our partners, over which we have very little control.

***We have recently introduced additional solutions for mobile devices and, if users of these devices do not widely adopt our solutions, our revenue and operating results could be adversely affected.***

The number of people who access the internet through devices other than personal computers, including smartphones and handheld tablets or computers, has increased dramatically in the past few years and is projected to continue to increase. In addition, people are increasingly using their mobile devices to create and store data and other content that is important to them. We recently introduced our mobile backup solutions for the iPhone and Android smartphones; however, these solutions have not yet achieved widespread adoption. If one or more of our competitors were to launch similar services, or if we are unsuccessful in achieving widespread adoption of our mobile solutions, our competitive position could be materially harmed. As new devices and new platforms are continually being released, it is difficult to predict the problems that we may encounter in developing versions of our solutions for use on these mobile devices, and we may need to devote significant resources to the creation, support, and maintenance of such solutions, which could adversely affect our operating results.

***If we are unable to expand our base of SMB customers, our business could be adversely affected.***

In 2010, we introduced the first version of our backup solution targeted toward SMBs, which are generally companies that are too small to have a dedicated in-house IT staff. We have committed and continue to commit

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substantial resources to the expansion and increased marketing of our SMB offerings. If we are unable to market and sell our solutions to SMBs with competitive pricing and in a cost-effective manner, our ability to grow our revenue and achieve profitability will be harmed. We believe that it is more difficult and expensive to attract and retain SMB customers than consumers, because SMBs:

are difficult to reach without using more expensive, targeted sales campaigns;

may have different or much more complex needs than those of individual consumers, such as archiving, version control, enhanced security requirements, and other forms of encryption and authentication, which our solutions may not adequately address; and

frequently cease operations due to the sale or failure of their business.

In addition, SMBs frequently have limited budgets and are more likely to be signiat such time or times and subject to such restrictions as determined by the Compensation Committee. However, SARs granted in tandem with stock options may be exercised only with respect to the shares of Class A Common Stock for which their related stock options are then exercisable. The exercise of either options or SARs that are granted in tandem will result in the termination of the other to the extent of the number of shares of Class A Common Stock with respect to which such options or SARs are exercised.

If an individual s service with the Company terminates, SARs then held by such individual will terminate on the same terms and conditions that apply to stock options as described above, unless otherwise provided by the Compensation Committee.

SARs generally may not be transferred other than by will or the laws of descent and distribution and SARs generally may be exercised during the lifetime of the recipient only by the recipient. However, the Compensation Committee, in its discretion, may permit the transfer of SARs, without consideration, to certain family members or family-related trusts, foundations or other entities, subject to limitations determined by the Compensation Committee.

## **Restricted Stock and Restricted Stock Units**

Restricted stock is an award of shares of Sonic s Class A Common Stock that is subject to restrictions and such other terms and conditions as the Compensation Committee determines. Restricted stock units represent the right to receive shares of Class A Common Stock or the value of shares of Class A Common Stock in the future, but no shares are actually awarded to recipients on the date of grant. Once applicable restrictions lapse or have been satisfied, restricted stock units may be payable in cash, shares of Class A Common Stock or a combination thereof, as determined by the Compensation Committee.

The Compensation Committee will determine the type of restrictions applicable to the award, which can include restrictions based on achievement of financial or other business objectives (including objective performance goals as described below), the occurrence of a specific event, continued service for a period of time or other time-based restrictions. The Compensation Committee also will determine the purchase price, if any, to be paid for the restricted stock or restricted stock units. Restricted stock units are not transferable and restricted stock generally may not be transferred until all restrictions applicable to the award have lapsed or been satisfied.

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If the recipient of restricted stock or restricted stock units ceases to perform services for the Company, all shares of Class A Common Stock or restricted stock units, as the case may be, that are still subject to restrictions generally will be forfeited unless the Compensation Committee waives such restrictions.

A recipient of restricted stock generally will have certain rights and privileges of a stockholder, including the right to vote such shares of restricted stock and to receive dividends, if any (although the Compensation Committee may require that any dividends be reinvested in additional shares of restricted stock). A recipient of restricted stock units will not have any voting or other stockholder rights, but if a dividend is declared on the Class A Common Stock, the Compensation Committee may, in its discretion, determine that recipients receive dividend equivalents with respect to restricted stock units and the form thereof.

### **Stock Awards**

The Compensation Committee may grant other types of stock awards that involve the issuance of shares of Class A Common Stock or that are valued by reference to shares of Class A Common Stock. The terms and conditions applicable to such stock awards will be determined by the Compensation Committee in its discretion.

## Performance Awards

The Stock Incentive Plan allows the Compensation Committee to designate a grant of restricted stock, restricted stock units or a stock award as a performance award intended to qualify as performance-based compensation under Section 162(m) of the Code. Section 162(m) of the Code generally limits Sonic's annual federal income tax deduction for compensation paid to certain covered employees (generally, the Chief Executive Officer and the four other highest paid officers) to \$1 million with respect to each such officer. However, compensation that qualifies as performance-based compensation under Section 162(m) is not subject to this deduction limit. Compensation qualifies as performance-based only if it satisfies certain requirements, including that the material terms of the plan and performance goals under which the awards will be paid are disclosed to and approved by the stockholders. Accordingly, the Board of Directors is seeking stockholder approval of the Stock Incentive Plan in part to satisfy the requirements of Section 162(m) of the Code.

For performance awards, the Compensation Committee will establish in writing the performance goals upon which the performance award is contingent, the period over which such goals will be measured and any other applicable conditions. These terms must be established within 90 days after the beginning of the applicable period (or, if earlier, by the date on which 25% of the period has been completed).

The performance goals established by the Compensation Committee must be objectively determinable and will be based on one or more of the following: stock price; earnings per share; net earnings; operating or other earnings; profits; revenues; net cash flow; financial return ratios; stockholder return; return on equity; return on investment; return on net assets; debt rating; sales; expense reduction levels; growth in assets, sales, or market share; or strategic business objectives based on meeting specified revenue goals, market penetration goals, customer satisfaction goals, geographic business expansion goals, cost targets or goals relating to acquisitions or divestitures. Performance goals may be based on the performance of Sonic, based on the individual's division, business unit or employing subsidiary, based on the performance of one or more divisions, business units or subsidiaries, based on the performance of the Company as a whole or based on any combination of the foregoing. Performance goals may be either absolute in their terms or relative. Performance goals may provide for the inclusion or exclusion of items such as the effect of unusual charges or income items or other events, including acquisitions or dispositions of businesses or assets, restructurings, reductions in force, or changes in accounting principles or tax laws. The Compensation Committee also may establish subjective performance goals, provided that subjective performance goals generally may be used only to reduce, and not increase, an award. The Compensation Committee generally cannot waive the performance goal requirements except in its discretion in the case of the death or disability of the recipient or as otherwise provided under the Stock Incentive Plan in the event of a change in control (as described below).

As noted previously, no individual may be granted restricted stock, restricted stock units or stock awards with respect to an aggregate of more than 250,000 shares of Class A Common Stock during any calendar year. In addition, the maximum cash payment that may be paid to an award recipient during a calendar year pursuant to a performance award is \$2,000,000.

The Compensation Committee may, in its discretion, grant awards to covered officers that are not intended to qualify as performance-based compensation under Section 162(m) of the Code.

## Change in Control

Under the Stock Incentive Plan, a change in control generally means any merger or consolidation in which Sonic is not the surviving corporation and which results in the holders of the outstanding voting securities of Sonic (determined immediately prior to such merger or consolidation) owning less than a majority of the outstanding voting securities of the surviving corporation, any sale or transfer by Sonic of all or substantially all of its assets or any tender offer or exchange offer for, or the acquisition, directly or indirectly, by any person or group of, all or a majority of the then-outstanding voting securities of Sonic.

Upon either the consummation of a tender or exchange offer that constitutes a change in control or the third business day prior to the effective date of any other change in control, as the case may be, all outstanding stock options, SARs and stock awards generally will become fully vested and exercisable and all outstanding restricted stock and restricted stock units generally will become fully vested with all restrictions and conditions related thereto being deemed satisfied. Any outstanding awards that have been designated as performance awards will be accelerated and deemed to have been fully earned as of the date of the change in control, with a pro rata payment to be made within 30 days following the change in control based upon an assumed achievement of the applicable performance goals and the extent to which the performance period has elapsed prior to the change in control.

### **Amendment, Suspension or Termination**

The Board of Directors may at any time amend, suspend or terminate the Stock Incentive Plan in whole or in part for any purpose, provided that such action may be subject to stockholder approval if (1) it is necessary, or the Board determines that it is desirable, to comply with the Code, the Securities Exchange Act of 1934, as amended, securities exchange listing requirements or other legal or regulatory requirements or (2) the action is intended to allow the exercise price of outstanding stock options to be reduced by repricing or replacing such options. Unless terminated earlier, the Stock Incentive Plan will terminate ten years from its adoption by the Board of Directors. The Compensation Committee also may amend the terms of an outstanding award. However, no amendment, suspension or termination of the Stock Incentive Plan (or amendment of an outstanding award) may adversely affect in any material way the rights of the holder of any outstanding award without his or her consent.

### **Federal Income Tax Consequences**

The following is a brief summary of the federal income tax consequences that generally apply with respect to awards that may be granted under the Stock Incentive Plan. This summary is based on current laws and regulations that may change in the future. This summary is not intended to be exhaustive and does not describe a number of special tax rules, including any foreign, state or local tax consequences, wage withholding requirements or various other rules that could apply to a particular individual or to the Company under certain circumstances.

#### *Nonstatutory Stock Options*

The grant of nonstatutory stock options has no federal income tax consequences to the Company or the option holder. Upon the exercise of a nonstatutory stock option, the option holder will recognize ordinary income equal to the excess of the fair market value of the acquired shares on the date of exercise over the exercise price paid for the shares. The Company generally will be allowed a federal income tax deduction equal to the same amount that the option holder recognizes as ordinary income. In the event of the disposition of the acquired shares of Common Stock, any additional gain (or loss) generally will be taxed to the option holder as either short-term or long-term capital gain (or loss) depending on how long the shares were held.

#### *Incentive Stock Options*

The grant and exercise of incentive stock options have no federal income tax consequences to the Company. The grant and exercise of incentive stock options generally have no ordinary income tax consequences to the option holder. However, upon the exercise of an incentive stock option, the option holder has to treat the excess of the fair market value on the date of exercise over the exercise price as an item of tax adjustment for alternative minimum tax purposes, which may result in alternative minimum tax liability.

If the option holder retains the shares of Class A Common Stock acquired upon the exercise of an incentive stock option for at least two years following the grant date of the option and one year following exercise of the option, the subsequent disposition of such shares will ordinarily result in long-term capital gains or losses to the option holder equal to the difference between the amount realized on disposition of the shares and the exercise price. The Company will not be entitled to any deduction in such case. If the holding period requirements described above are not met, the option holder will recognize ordinary income upon disposition of the Class A Common Stock equal to the excess of the fair market value of the shares on the date of exercise (or, if less, the amount received on disposition of the shares) over the exercise price. The Company will be entitled to a corresponding tax deduction in the same amount. Any additional gain (or loss) realized by the option holder on the disposition of the Class A Common Stock will be taxed as short-term or long-term capital gain (or loss), as applicable.



*Stock Appreciation Rights*

The grant of SARs has no federal income tax consequences to the Company or the recipient. Upon the exercise of SARs, the recipient will recognize ordinary income equal to the amount of cash received and the fair market value of any shares of Class A Common Stock received. The Company generally will be allowed a federal income tax deduction equal to the same amount that the recipient recognizes as ordinary income.

### *Restricted Stock*

There generally should not be any federal income tax consequences to the Company or the recipient upon the grant of restricted stock. The recipient normally will recognize ordinary income when shares of the restricted stock vest (which means that the shares are no longer subject to a substantial risk of forfeiture) or become transferable, whichever occurs first. However, a recipient instead may elect to recognize ordinary income at the time the restricted stock is granted by making an election under Section 83(b) of the Code within 30 days after the grant date. In either case, the recipient will recognize ordinary income equal to the fair market value of such shares of stock at the time the income is recognized (reduced by the amount, if any, the recipient paid for the stock) and the Company generally will be entitled to a corresponding tax deduction (subject to Section 162(m) limitations). If the recipient subsequently disposes of the shares of Class A Common Stock, any additional gain (or loss) should be eligible for short-term or long-term capital gain tax treatment, depending on how long the shares were held after the ordinary income was recognized. If a recipient makes an 83(b) election and then forfeits the shares of Class A Common Stock, the recipient normally will not be entitled to any tax deduction or refund with respect to the tax already paid.

### *Restricted Stock Units*

The grant of restricted stock units has no federal income tax consequences to the Company or the recipient. When the restricted stock units vest and become payable, the recipient will recognize ordinary income equal to the amount of cash received and the fair market value of any shares of Class A Common Stock received. The Company generally will be allowed a federal income tax deduction equal to the same amount that the recipient recognizes as ordinary income (subject to Section 162(m) limitations).

### *Other Stock Awards*

The federal income tax consequences of other stock awards will depend on the form of such awards.

### *Section 162(m)*

As discussed above, Section 162(m) of the Code generally limits the Company's annual federal income tax deduction for compensation paid to certain covered employees (generally, the Chief Executive Officer and the four other most highly compensated officers) to \$1 million with respect to each such officer. However, compensation that qualifies as performance-based compensation under Section 162(m) is not subject to this deduction limit. If the Stock Incentive Plan is approved by Sonic's stockholders, Sonic intends that stock options, stock appreciation rights and performance awards granted to covered employees generally should qualify as performance-based compensation that will not be subject to the Section 162(m) deduction limit.

### **Stock Incentive Plan Benefits**

As of the date of this Proxy Statement, no awards have been granted under the Stock Incentive Plan. Since the Stock Incentive Plan is subject to stockholder approval and all future awards under the Stock Incentive Plan will be made at the discretion of the Compensation Committee, awards that may be received by any particular person or group pursuant to the Stock Incentive Plan are not presently determinable.

**SELECTION OF INDEPENDENT ACCOUNTANTS**

The Audit Committee has selected the firm of Deloitte & Touche LLP to serve as the principal independent accountants of Sonic for the fiscal year ending December 31, 2004. Deloitte & Touche LLP has acted in such capacity for Sonic since its organization in 1997.

Representatives of Deloitte & Touche LLP will attend the Annual Meeting. They will have an opportunity to make a statement if they so desire, and to respond to appropriate questions.

Stockholder ratification of the Audit Committee's selection of Deloitte & Touche LLP as our independent accountants is not required by our Bylaws or otherwise. The Board is submitting the selection of Deloitte & Touche LLP to the stockholders for ratification and will reconsider whether to retain Deloitte & Touche LLP if the stockholders fail to ratify the

Audit Committee's selection. In addition, even if the stockholders ratify the selection of Deloitte & Touche LLP, the Audit Committee may in its discretion appoint a different independent accounting firm at any time during the year if the Audit Committee determines that a change is in the best interests of Sonic.

*Fees and Services*

For the fiscal years ended December 31, 2002 and 2003, fees for services provided by Deloitte & Touche LLP were as follows:

	<u>2002</u>	<u>2003</u>
<b>Audit Fees(1)</b>		
Recurring Audit and Quarterly Reviews	\$ 623,000	\$ 613,000
Registration Statements and Related Services	170,000	310,000
<b>Audit-Related Fees(2)</b>		
Audits of Acquired Businesses	740,000	0
<b>Tax Fees(3)</b>		
Tax Compliance Services	9,000	10,500
Tax Planning and Advice	72,000(4)	64,000
<b>All Other Fees (5)</b>	<b>0</b>	<b>0</b>

- (1) Audit fees consist of fees for professional services rendered in connection with or related to the audit of our consolidated annual financial statements, for the review of interim consolidated financial statements in Form 10-Qs and for services normally provided in connection with statutory and regulatory filings or engagements, including registration statements. Certain of these fees will be billed in 2004 as services are rendered in connection with the audit of Sonic's financial statements for the fiscal year ended December 31, 2003.
- (2) Audit-related fees consist of fees billed for assurance and related services reasonably related to the performance of the audit or review of our audited or interim consolidated financial statements and are not reported under the heading Audit Fees.
- (3) Tax fees consist of fees billed for professional services rendered for tax compliance, tax advice and tax planning.
- (4) Includes fees in 2003 primarily related to property tax assessments and payroll tax assistance services.
- (5) All other fees consist of fees billed for products and services other than the services reported in other categories.

The Audit Committee considers the provision of these non-audit services to be compatible with maintaining Deloitte & Touche LLP's independence.

*Pre-approval of Audit and Non-Audit Services of Independent Auditor*

The Audit Committee is responsible for pre-approving all audit and non-audit services provided by Sonic's independent auditors, and pre-approved all of the services provided in 2003. These services may include audit services, audit-related services, tax services and other services. The Audit Committee has delegated its pre-approval authority to its chairman. The chairman in turn reports to the Audit Committee at least quarterly on audit and non-audit services he pre-approved since his last report.



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## EXECUTIVE COMPENSATION

### Compensation Committee Report on Executive Compensation

#### *2003 Executive Officer Compensation Program*

The policy of the Compensation Committee is to:

link executive compensation to Sonic's business strategy and performance in order to attract, retain and reward key executive officers;

provide performance incentives and equity-based compensation to align the long-term interests of executive officers with those of Sonic's stockholders; and

offer salaries and incentive performance pay opportunities that are competitive in the marketplace.

Sonic's executive compensation program is comprised of two components: annual cash compensation, paid in the form of annual salary and performance-based bonuses, and long-term compensation, paid principally in the form of options to purchase the Company's Class A Common Stock. Prior to 2003, the Compensation Committee typically adjusted the base salaries of and awarded cash bonuses and stock options to executive officers early in the fourth quarter of each fiscal year. However, in early 2003, the Compensation Committee decided to shift this schedule so that adjustments of base salaries and awards of cash bonuses and stock options would be made by the Committee early in the first quarter of each year, commencing with the 2004 calendar year.

The Board of Directors has determined that each member of the Compensation Committee is independent as defined in the current listing standards of the New York Stock Exchange.

#### **Annual Cash Compensation**

Annual cash compensation for Sonic's executive officers consists of a base salary and the potential for an annual cash bonus. The annual cash compensation paid by Sonic to its executive officers during 2003 was targeted to be competitive principally in relation to other automotive retailing companies (such as those included in the Peer Group Index in the performance graph elsewhere herein), although the Compensation Committee also considered the compensation of executives of some retailing companies not included in the Peer Group Index because the Compensation Committee considered those other companies to be in relatively comparable industries. Analysis of the competitiveness of annual cash compensation paid by Sonic to its executives was provided to the Compensation Committee in October 2002 by an independent consulting firm specializing in executive compensation.

The base salaries of Sonic's executive officers (other than Messrs. Wright and Wyatt, as discussed below) and adjustments to executive officers base salaries (including adjustments to the base salaries of Messrs. Wright and Wyatt) are based upon a subjective evaluation of the executive's performance by the Compensation Committee and recommendations submitted to the Committee by the Chief Executive Officer. The

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Compensation Committee's evaluation is based upon non-quantitative factors such as positions of responsibility and authority, years of service and annual performance evaluations. Mr. Wright's base salary was initially established in an employment agreement he entered into with Sonic in October 2000, which base salary is subject to adjustment as provided in the employment agreement. Mr. Wyatt's base salary was initially established in an employment agreement he entered into with Sonic on March 31, 2003, which base salary is subject to adjustment as provided in the employment agreement. The Compensation Committee did not make any adjustments to the base salaries of any of Sonic's executive officers during the 2003 calendar year.

None of Sonic's executive officers received an annual cash bonus during the 2003 calendar year. Prior to 2003, Sonic's executive officers traditionally had been awarded annual cash bonuses in October of each year based on subjective evaluations of each executive officer's performance by the Compensation Committee. For the 2003 calendar year, however, the Compensation Committee determined that each of Sonic's executive officers would participate in the Sonic Automotive, Inc. Incentive Compensation Plan (the "Incentive Plan"), and would have their respective annual cash bonuses determined based upon attainment of objective, performance based goals established by the Committee pursuant to the terms of the Incentive Plan. The Committee established objective, performance based goals and target bonus awards for each executive officer (not including Mr. Wyatt, who commenced employment with the Company on April 7, 2003) for the performance

period beginning January 1, 2003 and ending December 31, 2003, with annual cash bonuses to be paid in February 2004 following the Committee's determination of achievement of the specified performance goals. The Committee established four categories of performance objectives to be measured for each of the executive officers: return on net assets, EBITDA margin, market share improvement for the Company's dealerships in specified major brands, and customer satisfaction performance for the Company's dealerships in specified major brands. The Committee also established targeted award amounts for each of the executive officers for specified levels of achievement within each of the four performance categories, subject to a reduction in the event the Committee determined that subjective or other factors warranted a reduction. On February 19, 2004, the Committee determined that certain of the specified performance goals had been met for the respective executive officers, and that certain of the other specified performance goals had not been met, resulting in awards under the Incentive Plan of \$195,000 to Mr. Scott Smith, \$195,000 to Mr. Wright, \$195,000 to Mr. Rachor and \$157,500 to Mr. Iuppenlatz. The Compensation Committee further determined that no subjective or other factors warranted a reduction in the awards to each of these executive officers, and approved payment of these respective awards in lump sum cash bonuses to these executive officers in February 2004. The Committee also awarded Mr. Iuppenlatz an additional cash bonus of \$10,000 on February 19, 2004. Pursuant to the terms of Mr. Wyatt's employment agreement with Sonic, the Committee awarded Mr. Wyatt a cash bonus of \$200,000 on February 19, 2004.

### **Long-term Compensation**

Sonic's long-term compensation program is based principally upon awards of options to purchase shares of its Class A Common Stock under the Stock Option Plan. The Compensation Committee believes that equity-based compensation is the most effective means of aligning the long-term interests of Sonic's executive officers with those of its stockholders. Awards of stock options (other than to the Chief Executive Officer) are based upon a subjective evaluation of the executive's performance by the Compensation Committee and recommendations submitted to the Committee by the Chief Executive Officer. The Compensation Committee's evaluation considers a number of non-quantitative factors, including the responsibilities of the individual officers for and contribution to Sonic's operating results (in relation to Sonic's other optionees), their expected future contributions and the levels of stock options currently held by the executive officers individually and in the aggregate. With the exception of Mr. Wyatt (as discussed below), none of Sonic's executive officers were awarded stock options under the Stock Option Plan by the Compensation Committee during the 2003 calendar year. Pursuant to the terms of Mr. Wyatt's employment agreement with Sonic entered into on March 31, 2003, Mr. Wyatt was awarded options to purchase 75,000 shares of Sonic's Class A Common Stock on April 21, 2003 at an exercise price of \$15.90 per share (the closing price of Sonic's Class A Common Stock on the day preceding the award), with such options vesting in three equal installments on the first, second and third anniversaries of the date of grant. For additional details concerning the options granted to and held by the executive officers during 2003, see "Option Grants in 2003" and "Fiscal Year-End Option Values."

Executive officers of Sonic (including the Chief Executive Officer) were also eligible to participate in the Sonic Automotive, Inc. Deferred Compensation Plan (the "Deferred Plan") during the 2003 calendar year. Under the Deferred Plan, eligible employees were able to elect to defer a portion of their annual cash compensation, up to a maximum of 20% or \$50,000, whichever was lower. Sonic makes cash matching contributions of 20% of the amount deferred by the employee, not to exceed \$10,000 per year in matching contributions. Sonic may also make supplemental contributions for eligible employees to make up for the additional matching contributions the employees would have received under Sonic's 401(k) plan in the absence of legal limitations on the amount of compensation that can be considered under the 401(k) plan (e.g., \$200,000 for 2003). Sonic's contributions generally vest pro rata over a five year period. Participation in the Deferred Plan is offered annually to a select group of our management and highly compensated employees.

Executive officers of Sonic (including the Chief Executive Officer) were also eligible in 2003 to participate in various benefit plans similar to those provided to other employees of Sonic. These benefit plans are intended to provide a safety net of coverage against various events, such as death, disability and retirement.

#### *Chief Executive Officer Compensation*

The Compensation Committee annually reviews and approves the compensation of O. Bruton Smith, Sonic's Chief Executive Officer. For the 2003 calendar year, Mr. Smith's annual base salary was not adjusted by the Compensation Committee, remaining the same amount as had been



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approved by the Compensation Committee in October 2002. The Committee's adjustment of Mr. Smith's base salary in October 2002 was based upon non-quantitative factors such as his position of responsibility and authority, years of service and a qualitative performance evaluation. Mr. Smith's annual salary

is targeted to be competitive principally in relation to other automotive retailing companies (such as those included in the Peer Group Index in the performance graph elsewhere herein), although the Compensation Committee also considered the compensation of executives of some retailing companies not included in the Peer Group Index because the Compensation Committee considered those other companies to be in relatively comparable industries. Analysis of the competitiveness of the annual compensation paid to Mr. Smith was provided to the Compensation Committee in October 2002 by an independent consulting firm specializing in executive compensation.

The Compensation Committee considers annual stock option awards to Mr. Smith based upon a subjective evaluation of his performance as Chief Executive Officer. The Compensation Committee's evaluation is based upon a number of non-quantitative factors, including his responsibility for and contribution to Sonic's operating results (in relation to Sonic's other optionees), his expected future contributions and the number of stock options currently held by Mr. Smith individually and by all executive officers in the aggregate. During the 2003 calendar year, Mr. Smith was not awarded any grant of stock options by the Compensation Committee. For additional details concerning the stock options held by Mr. Smith as of December 31, 2003, see Fiscal Year-End Option Values.

Mr. Smith did not receive an annual cash bonus from the Company during the 2003 calendar year. With respect to Mr. Smith's annual cash bonus for 2003, the Compensation Committee determined that Mr. Smith would again participate in the Incentive Plan and would have his annual cash bonus determined based upon attainment of objective, performance based goals established by the Committee pursuant to the terms of the Incentive Plan. The Committee established objective, performance based goals and target bonus awards for Mr. Smith for the performance period beginning January 1, 2003 and ending December 31, 2003, with Mr. Smith's annual cash bonus to be paid in February 2004 following the Committee's determination of achievement of the specified performance goals. The Committee established four categories of performance objectives to be measured for Mr. Smith: return on net assets, EBITDA margin, market share improvement for the Company's dealerships in specified major brands, and customer satisfaction performance for the Company's dealerships in specified major brands. The Committee also established targeted award amounts for Mr. Smith for specified levels of achievement within each of the four performance categories, subject to a reduction in the event the Committee determined that subjective or other factors warranted a reduction. On February 19, 2004, the Committee determined that certain of the specified performance goals had been met for Mr. Smith, and that certain of the other specified performance goals had not been met, resulting in an award under the Incentive Plan to Mr. Smith of \$492,187. The Compensation Committee further determined that no subjective or other factors warranted a reduction in the award to Mr. Smith, and approved payment of the award in a lump sum cash bonus to Mr. Smith in February 2004.

#### *Federal Income Tax Considerations*

As noted above, Sonic's compensation policy is primarily performance-based. Section 162(m) of the Internal Revenue Code of 1986, as amended (the Code), imposes a limitation on the deductibility of annual compensation in excess of \$1 million that is not performance-based. It is intended that compensation attributable to the exercise of stock options granted under the Stock Option Plan generally should qualify as deductible performance-based compensation. The Compensation Committee currently intends to continue to manage Sonic's executive compensation program in a manner that will preserve federal income tax deductions. However, the Compensation Committee also must approach executive compensation in a manner which will attract, motivate and retain key personnel whose performance increases the value of Sonic. Accordingly, the Compensation Committee may from time to time exercise its discretion to award compensation that may not be deductible under Section 162(m) of the Code when in its judgment such award would be in the interests of Sonic.

*William P. Benton, Chairman*

*H. Robert Heller*

*William I. Belk*

*Robert L. Rewey*



## Compensation of Executive Officers

The following table sets forth compensation paid by or on behalf of Sonic to the Chief Executive Officer of Sonic and to its other named executive officers for services rendered during Sonic's fiscal years ended December 31, 2001, 2002 and 2003:

### Summary Compensation Table

Name and Principal Position(s)	Year	Annual Compensation			Long-Term Compensation Awards	All Other Compensation (4)
		Salary (1)	Bonus (2)	Other Annual Compensation (3)	Number of Shares Underlying Options	
O. Bruton Smith Chairman, Chief Executive Officer and Director	2003	\$ 1,050,000	\$ 492,187		-0-	
	2002	830,956	750,000		100,000	
	2001	800,000	200,000		100,000	
B. Scott Smith Vice Chairman and Chief Strategic Officer and Director	2003	\$ 800,000	\$ 195,000		-0-	\$ 7,385
	2002	588,200	500,000		50,000	10,000
	2001	550,000	350,000		50,000	
Theodore M. Wright President and Director	2003	\$ 800,000	\$ 195,000	\$ 74,901(5)	300	\$ 16,000
	2002	503,846	425,000	58,050(5)	50,300	15,500
	2001	450,000	300,000	52,109(5)	40,300	1,700
Jeffrey C. Rachor Executive Vice President and Chief Operating Officer and Director	2003	\$ 802,564	\$ 195,000		-0-	\$ 15,231
	2002	316,591	622,438		50,000	15,500
	2001	285,000	683,103		40,000	1,700
Mark J. Iuppenlatz Senior Vice President of Corporate Development	2003	\$ 350,000	\$ 167,500		300	\$ 6,000
	2002	307,692	300,000		30,300	5,500
	2001	279,038	225,000		30,300	1,700

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- (1) Does not include the dollar value of perquisites and other personal benefits.
- (2) The amounts shown are cash bonuses paid in the specified year.
- (3) Excludes perquisites and other personal benefits that, in the aggregate, did not exceed the lesser of \$50,000 or 10% of the total annual salary and bonus reported for such executive officer.
- (4) Includes company match to 401(k) plan and company contributions to Deferred Plan.
- (5) Includes interest imputed to a non-interest bearing advance to Mr. Wright under the terms of his employment agreement based on the applicable federal rate that was in effect on the date of the advance. The amount of this imputed interest was \$40,250 in 2001, 2002 and 2003. Sonic also provides Mr. Wright with automobiles for personal use, the annual cost of which was \$34,651 in 2003, \$17,800 in 2002 and \$11,859 in 2001.

### **Employment Agreements**

Sonic has an employment agreement with Mr. Wright (the Employment Agreement), which provides for an annual base salary and certain other benefits. Mr. Wright's base salary may be increased annually as determined by the Compensation Committee. The Employment Agreement also provides for the payment of an annual performance-based cash bonus. Mr. Wright will be eligible to receive bonuses under the Incentive Plan.

Under the terms of the Employment Agreement, Sonic will employ Mr. Wright through November 2005. Under the Employment Agreement, Mr. Wright received a \$700,000 non-interest bearing advance from Sonic in November 2000, which advance is payable towards any severance due to him under the Employment Agreement. Mr. Wright is entitled to retain the advance in lieu of any other severance to which he would otherwise be entitled if Sonic terminates his employment without cause before the expiration of the term of the Employment Agreement, or in the event of his death or disability before such time. Mr. Wright is required to repay the advance in full to Sonic if he voluntarily resigns his employment with, or is terminated for cause by, Sonic before the expiration of the term of the Employment Agreement, or if he remains employed with Sonic at the expiration of the term. Mr. Wright's Employment Agreement also provides that he may voluntarily resign his employment within thirty days following a change of control of Sonic, whereupon Sonic is required to pay him a lump sum amount in cash equal to the aggregate salary and annual cash bonus that he would have received for the remainder of the term of the Employment Agreement.

The Employment Agreement contains non-competition provisions. These provisions, during the term of the Employment Agreement (i) prohibit the disclosure or unauthorized use of confidential Sonic information, and (ii) prohibit competition with Sonic for Sonic's employees and its customers, interference with Sonic's relationships with its vendors, and employment with any competitor of Sonic. The provisions referred to in (ii) above also apply for a period of two years following the expiration or termination of the Employment Agreement, and prohibit competition in specified geographic areas during this period. For Mr. Wright, the geographic restrictions apply in any Standard Metropolitan Statistical Area (SMSA) or county in which Sonic has a place of business at the time his employment ends.

Mr. Rachor has entered into an agreement with Sonic that contains non-competition provisions similar to those contained in the Employment Agreement. This agreement with Mr. Rachor will expire in November 2004. The geographic restrictions in this agreement with Mr. Rachor apply to any SMSA in Houston, Texas; Charlotte, North Carolina; Chattanooga, Tennessee; and Nashville, Tennessee.

#### **Option Grants in 2003**

No options to acquire shares of Class A Common Stock were granted to the named executive officers during 2003.

**Fiscal Year-End Option Values**

The following table sets forth information concerning outstanding options to purchase Class A Common Stock held by the named executive officers of Sonic as of December 31, 2003:

Name	Shares		Number of Securities		Value of Unexercised	
	Acquired	Realized	Underlying Unexercised		In-the-Money	
			Options at FY-End (#)		Options at FY-End (\$) (1)	
	on Exercise (#)	(\$)	Exercisable	Unexercisable	Exercisable	Unexercisable
O. Bruton Smith			750,000		\$ 7,697,125	\$ 0
B. Scott Smith			569,750	20,000	\$ 7,052,795	\$ 149,650
Theodore M. Wright	191,676	\$ 2,201,261	170,000	20,000	\$ 1,191,000	\$ 149,650
Jeffrey C. Rachor			223,333	20,000	\$ 1,739,853	\$ 149,650
Mark J. Iuppenlatz			120,000		\$ 1,229,100	\$ 0

(1) Value based on market price as of December 31, 2003.

**EQUITY COMPENSATION PLAN INFORMATION**

The following table sets forth information concerning shares of our Class A Common Stock that may be issued under our equity compensation plans as of December 31, 2003.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants, and rights	(b)	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
		Weighted-average exercise price of outstanding options, warrants, and rights	
Equity compensation plans approved by security holders(1)	5,498,339	\$ 22.46(2)	2,710,339
Equity compensation plans not approved by security holders(3)	58,261	\$ 11.87(4)	917,388

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Total	5,556,600	\$	17.26(2)(4)	3,627,727
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- (1) Includes the Sonic Automotive, Inc, 1997 Stock Option Plan, the Formula Stock Option Plan for Independent Directors (the Directors Plan ) and the Employee Stock Purchase Plan (the Employee Plan ), but does not include the Stock Incentive Plan that is being submitted for stockholder approval at the Annual Meeting. If the Stock Incentive Plan is approved by the stockholders at the Annual Meeting, 2,000,000 shares of our Class A Common Stock will be available for issuance thereunder.
- (2) Does not include the exercise price of options outstanding under the Employee Plan because the exercise price is indeterminable as of the date of this Proxy Statement. The exercise price of these options equals the lesser of 85% of the fair market value per share of our Class A Common Stock on the date of grant or 85% of the fair market value per share of our Class A common Stock on the date of exercise.
- (3) Includes the FirstAmerica Automotive, Inc. 1997 Stock Option Plan, as amended and restated as of December 10, 1999 (the FirstAmerica Plan ) and the Nonqualified Employee Stock Purchase Plan (the Nonqualified ESPP ).
- (4) Does not include the exercise price of options outstanding under the Nonqualified ESPP because the exercise price is indeterminable as of the date of this Proxy Statement. The exercise price of these options equals the lesser of 85% of the fair market value per share of our Class A Common Stock on the date of grant or 85% of the fair market value per share of our Class A common Stock on the date of exercise.



### **FirstAmerica Plan**

We assumed the FirstAmerica Plan in connection with our acquisition of FirstAmerica Automotive, Inc. ( FAA ). The FirstAmerica Plan has not been approved by Sonic's stockholders. Upon completion of the acquisition of FAA on December 10, 1999, the FirstAmerica Plan was amended and restated to provide that each outstanding option to purchase a share of FAA Class A Common Stock was converted into the right to purchase 0.32232 shares of Sonic's Class A Common Stock. The following summary of the FirstAmerica Plan is qualified in its entirety by reference to the FirstAmerica Plan, a copy of which has been filed with the SEC.

The FirstAmerica Plan provides for the grant of incentive stock options to certain employees, within the meaning of Section 422 of the Code, and for the grant of nonstatutory stock options to certain employees, non-employee directors and consultants. Generally, options granted under the FirstAmerica Plan vest over five years, and expire if unexercised within ten years of the date of grant. Options may expire earlier due to termination of employment with the Company. Certain of the options outstanding under the FirstAmerica Plan may provide for partial acceleration upon a change of control.

The total number of shares of Class A Common Stock that have been reserved for issuance under the FirstAmerica Plan is 966,960. Options to purchase a total of approximately 58,261 shares of our Class A Common Stock were outstanding under the FirstAmerica Plan as of December 31, 2003. We have not granted any new options under the FirstAmerica Plan since we assumed it on December 10, 1999 and do not currently intend to grant options to purchase our Class A Common Stock under the FirstAmerica Plan in the future.

### **Nonqualified Employee Stock Purchase Plan**

The Nonqualified Employee Stock Purchase Plan (the Nonqualified ESPP ) was adopted by the Board of Directors of Sonic on December 11, 1998. The Nonqualified ESPP has not been approved by Sonic's stockholders. The purpose of the Nonqualified ESPP is to provide employees of certain subsidiaries that are not able to participate in Sonic's Employee Plan with a similar opportunity to acquire an ownership interest in Sonic. Both the Nonqualified ESPP and the Employee Plan permit eligible employees to purchase shares of Class A Common Stock at a discount from the market price. The terms of the Nonqualified ESPP are substantially similar to the terms of the Employee Plan, which has been approved by Sonic's stockholders.

The total number of shares of Class A Common Stock that have been reserved for issuance under the Nonqualified ESPP is 300,000. For 2004, there are 124 eligible employees who elected to participate in the Nonqualified ESPP and they each were granted an option to purchase 300 shares of Class A Common Stock. At present, no options to acquire shares have been exercised to date in 2004, options to acquire 37,200 shares remain outstanding (subject to any cancellations during the year) and approximately 191,624 additional shares remain available for future option grants under the Nonqualified ESPP.

Employees of participating subsidiaries generally are eligible for the Nonqualified ESPP if they work for Sonic and its subsidiaries on a full-time or part-time basis, are regularly scheduled to work more than twenty hours per week, are customarily employed more than five months in a calendar year and have completed one year of continuous service. Employees who are officers or directors of Sonic or any participating employer are not eligible to participate in the Nonqualified ESPP. In addition, employees who own or hold options to purchase (or who are treated under certain tax rules as owning or holding options to purchase) 5% or more of the total combined voting power or value of all classes of stock of Sonic or any subsidiary also are not eligible to participate in the Nonqualified ESPP.

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Options generally are granted under the Nonqualified ESPP as of each January 1 to all eligible employees who elect to participate. The Compensation Committee designates the number of shares of Class A Common Stock that can be purchased under each option, which number will be the same for each option granted on the same date and which also will be the same number of shares available under an option granted on the same date pursuant to the Employee Plan. The options have an exercise price per share equal to the lesser of (i) 85% of the fair market value per share of the Class A Common Stock on the date of grant or (ii) 85% of such fair market value on the date of exercise. No option can be granted which would permit a participant to purchase more than \$25,000 worth of stock under the Nonqualified ESPP during the calendar year.

A participant can make contributions to the Nonqualified ESPP by after-tax payroll deduction or direct payment. To the extent that a participant has made contributions to the Nonqualified ESPP, his or her option will be exercised automatically

to purchase Class A Common Stock on each exercise date during the calendar year in which the option is granted. The exercise dates generally are the last business day of March, June, September and December on which the NYSE is open for trading. The participant's accumulated contributions as of each exercise date will be used to purchase whole shares of Class A Common Stock at the applicable option price, limited to the number of shares available for purchase under the option. The exercisability of options may accelerate in the event of a change in control of Sonic.

Options granted under the Nonqualified ESPP expire on the last exercise date of the calendar year in which granted. However, if a participant withdraws from the Nonqualified ESPP or terminates employment, the option may expire earlier.

In the event of certain changes in the capital stock of Sonic due to a reorganization, stock split, stock dividend, merger or other similar event, appropriate adjustments generally will be made to the shares of Class A Common Stock available for issuance under the Nonqualified ESPP, the shares of Class A Common Stock covered by outstanding options and the exercise price per share.

The Board of Directors of Sonic generally can amend, suspend or terminate the Nonqualified ESPP at any time. However, no amendment, suspension or termination may adversely affect the rights of the participant under an outstanding option without the participant's consent.

#### **Compensation Committee Interlocks and Insider Participation**

During 2003, the Compensation Committee was comprised of the following independent directors: Messrs. Benton, Belk, Rewey and Heller.

#### **Director Compensation**

Non-employee directors are paid a \$25,000 annual retainer that is paid quarterly, and a \$1,500 stipend for each Board of Directors meeting attended and are reimbursed for their expenses incurred in connection with their activities as directors of Sonic. In addition, each chairman of a Committee and the Lead Independent Director of Sonic's Board of Directors will also receive a \$5,000 annual retainer that will be paid quarterly. All Committee members who are not employees of Sonic will also receive a \$1,500 stipend for each Committee meeting attended. Directors who are also employees of Sonic receive no additional compensation for serving on the Board of Directors or its Committees.

Members of the Board of Directors who are not employees of Sonic are also compensated for their services under the the Directors Plan. The Directors Plan authorizes the issuance of options to purchase up to an aggregate of 600,000 shares of Class A Common Stock. Under the Directors Plan, each outside director is awarded on or before March 31st of each year an option to purchase 10,000 shares at an exercise price per share equal to the fair market value per share of the Class A Common Stock at the date of grant. Options granted under the Directors Plan become exercisable six months from the date of grant and generally expire ten years from the date of grant.

### **Stockholder Performance Graph**

Set forth below is a line graph comparing the cumulative stockholder return on Sonic's Class A Common Stock against the cumulative total return of each of the Standard and Poor's 500 Stock Index and a Peer Group Index for the time period commencing December 31, 1998 and ending December 31, 2003. The companies used in the Peer Group Index consist of AutoNation, Group 1 Automotive, United Auto Group, Car Max and Lithia Motors, which are all publicly traded companies known by Sonic to be involved in the automobile industry. The graph assumes that \$100 was invested on December 31, 1998 in each of Sonic's Class A Common Stock, the Standard & Poor's 500 Stock Index and the Peer Group Index companies and that all dividends were reinvested.

### **CERTAIN TRANSACTIONS**

#### **Registration Rights Agreement**

When Sonic acquired Town & Country Ford, Lone Star Ford, Fort Mill Ford, Town & Country Toyota and Frontier Oldsmobile-Cadillac in 1997, Sonic signed a Registration Rights Agreement dated as of June 30, 1997 with SFC, O. Bruton Smith, B. Scott Smith and William S. Egan (collectively, the "Class B Registration Rights Holders"). SFC currently owns 8,881,250 shares of Class B Common Stock; Bruton Smith, 2,171,250 shares; and Scott Smith, 976,875 shares; all of which are covered by the Registration Rights Agreement. Egan Group, LLC, an assignee of Mr. Egan, also owns certain shares of Class A Common Stock to which the Registration Rights Agreement applies. If, among other things provided in Sonic's Charter, offers and sales of shares Class B Common Stock are registered with the SEC, then such shares will automatically convert into a like number of shares of Class A Common Stock.

The Class B Registration Rights Holders have certain limited piggyback registration rights under the Registration Rights Agreement. These rights permit them to have their shares of Sonic's Common Stock included in any Sonic registration statement registering Class A Common Stock, except for registrations on Form S-4, relating to exchange offers and certain other transactions, and Form S-8, relating to employee stock compensation plans. The Registration Rights Agreement expires in November 2007. SFC is controlled by O. Bruton Smith.

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### Subordinated Smith Loan

As a condition to increasing Sonic's borrowing limits under its secured lending facility (the Revolving Facility), Ford Motor Credit Company (Ford Motor Credit) required that Bruton Smith make a loan to Sonic in December 1997 in the amount of \$5.5 million (the Smith Subordinated Loan). This loan was repaid in full in 2003.

### The SFC Pledge

Before Sonic's acquisition of FirstAmerica in December 1999, Bruton Smith guaranteed the obligations of FirstAmerica under FirstAmerica's new acquisition line of credit with Ford Motor Credit. FirstAmerica obtained this new financing to enable it to complete its then pending acquisitions. The borrowing limit under this credit facility was approximately \$138 million prior to FirstAmerica's acquisition by Sonic. Mr. Smith guaranteed approximately \$107 million of this amount, which guarantee was secured by a pledge of 5 million shares of SMI Common Stock owned by SFC. Sonic assumed FirstAmerica's obligations to Ford Motor Credit under the Revolving Facility when it acquired FirstAmerica. In connection with the refinancing and replacement of the Revolving Facility with a new secured lending facility between Sonic, Ford Motor Credit and Chrysler Financial Company, LLC in August 2000 (as amended, the Revolving Facility), Ford Motor Credit released Mr. Smith from his secured guarantee under the replaced Revolving Facility. However, the lenders under the Revolving Facility required that the SFC Pledge remain in place, and it now secures Sonic's obligations under the Revolving Facility. The SFC Pledge remains in place as collateral security for Sonic's obligations under its current secured lending facility with Ford Motor Credit, DaimlerChrysler Services North America, L.L.C., Toyota Motor Credit Corporation and Bank of America, N.A. which was entered into in February 2003 to replace the Revolving Facility.

### Other Transactions

Sonic leases office space in Charlotte from a subsidiary of SFC for a majority of its headquarters personnel. Annual aggregate rent under this lease was approximately \$466,400 in 2003.

Sonic rents various aircraft owned by SFC, subject to their availability, for business-related travel by Sonic executives. Sonic incurred costs in an aggregate amount of approximately \$1,464,169 for the use of these aircraft during 2003.

Certain of Sonic's dealerships purchase the Z-Max oil additive product from Oil Chem Research Company, a subsidiary of SMI, for resale to service customers of the dealerships in the ordinary course of business. Total purchases by Sonic dealerships either directly through Oil Chem or indirectly through an Oil Chem distributor totaled approximately \$1,849,822 in 2003.

Sonic and its dealerships frequently purchase apparel items (such as hats, shirts, jackets, etc.), which are screen-printed with Sonic and dealership logos, for its employees as part of internal marketing and sales promotions. Sonic and its dealerships purchase such items from several companies, including Speedway Systems, LLC, a company owned by SMI. Total purchases from Speedway Systems by Sonic and its dealerships totaled approximately \$222,585 in 2003.

### SECTION 16(a) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE

Section 16(a) of the Securities Exchange Act of 1934, as amended, requires Sonic's executive officers, directors and persons who own more than 10% of Sonic's Voting Stock to file reports on ownership and changes in ownership with the SEC. Additionally, SEC regulations require that Sonic identify in its proxy statements any individuals for whom one of the referenced reports was not filed on a timely basis during the most

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recent fiscal year or prior fiscal years. To Sonic's knowledge, based solely on review of reports furnished to it, all Section 16(a) filing requirements applicable to its executive officers, directors and more than 10% beneficial owners were complied with except for one Form 4 filing for each of Messrs. Brooks, Belk, Benton, Capo, Heller and Rewey and Ms. Keller reflecting stock options granted on March 31, 2003 pursuant to our Directors Plan.

## ADDITIONAL INFORMATION

### Other Matters that May Be Considered at the Annual Meeting

In the event that any matters other than those referred to in the accompanying Notice of Meeting should properly come before and be considered at the Annual Meeting, it is intended that proxies in the accompanying form will be voted thereon in accordance with the judgment of the person or persons voting such proxies.

### Expenses of Solicitation

Sonic will pay the cost of solicitation of proxies, including the cost of assembling and mailing this Proxy Statement and the enclosed materials. In addition to the use of the mails, proxies may be solicited personally, or by telephone or email, by corporate officers and employees of Sonic without additional compensation. Sonic intends to request brokers and banks holding stock in their names or in the names of nominees to solicit proxies from their customers who own our stock, where applicable, and will reimburse them for their reasonable expenses of mailing proxy materials to their customers.

### 2005 Stockholder Proposals

The deadline for submission of stockholder proposals to be considered for inclusion in the proxy materials relating to the 2005 annual stockholders meeting is November 22, 2004. Any such proposal received after this date will be considered untimely and may be excluded from the proxy materials.

The deadline for submission of stockholder proposals to be presented at the 2005 annual stockholders meeting, but for which we may not be required to include in the proxy materials relating to such meeting, is February 5, 2005. Any such proposal received after this date will be considered untimely and the persons named in the proxy for such meeting may exercise their discretionary voting power with respect to such proposal.

Proposals should be addressed to the attention of the Secretary of Sonic at the address set forth on the cover of this Proxy Statement.

### Delivery of Proxy Statements

As permitted by the 1934 Act, only one copy of this Proxy Statement is being delivered to stockholders residing at the same address, unless such stockholders have notified Sonic of their desire to receive multiple copies of the Proxy Statement.

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Sonic will promptly deliver, upon oral or written request, a separate copy of the Proxy Statement to any stockholder residing at an address to which only one copy was mailed. Requests for additional copies of this year's Proxy Statement, requests to receive multiple copies of future proxy statements and requests to receive only one copy of future proxy statements should be directed to Stephen K. Coss, Vice President, General Counsel and Secretary, at Sonic's principal executive offices.



**APPENDIX A**

**SONIC AUTOMOTIVE, INC.**

**CHARTER OF THE AUDIT COMMITTEE OF THE BOARD OF DIRECTORS**

**AMENDED AND RESTATED FEBRUARY 19, 2004**

**I. Purpose**

The Audit Committee is appointed by the Board of Directors to assist the Board in fulfilling its oversight responsibilities relating to the Company's accounting policies, reporting policies, internal controls, compliance with legal and regulatory requirements, and the integrity of the Company's financial reports. The Audit Committee's primary duties and responsibilities are to:

Monitor the integrity of the Company's financial reporting process and systems of internal controls regarding finance, accounting, and legal compliance.

Monitor the independence and performance of the Company's independent auditors and internal auditing department.

Review the proposed form, quality and adequacy of the Company's financial statements and disclosures included therein.

Provide an avenue of communication among the independent auditors, management, the internal auditing department and the Board of Directors.

Review areas of potential significant financial risk to the Company.

Report the Board of Directors regarding each of the matters listed above.

The Audit Committee has the authority to conduct any investigation appropriate to fulfilling its responsibilities, and it has direct access to the independent auditors as well as anyone in the organization. The Audit Committee has the ability to retain, at the Company's expense, special legal, accounting, or other consultants or experts it deems necessary in the performance of its duties.

**II. Composition and Meetings**

The Audit Committee shall consist of three or more directors, each of whom is independent (as defined by applicable New York Stock Exchange ( NYSE ) and Securities and Exchange Commission ( SEC ) rules in effect from time to time). Each Audit Committee member must also be financially literate (as such qualification is interpreted by the Board in its business judgment) or must become financially literate within a

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reasonable period of time after his or her appointment to the Audit Committee. At least one member of the Audit Committee must have accounting or related financial management expertise (as the Board interprets such qualification in its business judgment), and at least one member shall be an audit committee financial expert (as determined under the rules promulgated by the SEC).

Audit Committee members, and the Chairman of the Audit Committee, shall be appointed by the Board on the recommendation of the Nominating and Corporate Governance Committee. The Chairman shall meet the experience requirements of the NYSE.

No Audit Committee member may receive compensation, directly or indirectly, from the Company other than director's fees. As used in this Audit Committee Charter, the term "director's fees" includes normal fees (including equity-based awards) or reimbursement of expenses paid to directors for service on the Board of Directors or Committees thereof, or attendance at meetings thereof, which fees have previously been approved by the Board of Directors. In addition, no Audit Committee member may simultaneously serve on the Audit Committee of more than two (2) other public companies unless the Board of Directors shall affirmatively determine that such simultaneous service would not impair the ability of such member to effectively serve on the Company's Audit Committee and the Company affirmatively discloses such determination in the Company's annual proxy statement.

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The Audit Committee shall meet at least four times annually, or more frequently as circumstances dictate. One-third of the members, but not less than two, will constitute a quorum of the Audit Committee, and a majority of the members present at any meeting at which a quorum is present may act on behalf of the Audit Committee. The Audit Committee may meet by telephone or video conference, and may take action by unanimous written consent of its members.

The Audit Committee should meet privately in executive session at least quarterly with management, with the director of the internal auditing department, with the independent auditors, and as a committee to discuss any matters that the Audit Committee or any of these groups believe should be discussed. In addition, the Audit Committee, or at least its Chairman, should communicate with management and the independent auditors quarterly to review the Company's financial statements and significant findings based upon the auditors' limited review procedures.

### **III. Responsibilities and Duties**

1. The independent auditors are ultimately accountable to the Audit Committee. The Audit Committee shall review the independence and performance of the auditors and shall have the sole authority to appoint the independent auditors, subject to shareholder ratification, or approve any discharge of auditors when circumstances warrant.
2. Review and reassess the adequacy of this Charter at least annually. Submit the charter to the Board of Directors for approval and have the document published at least every three years in accordance with SEC regulations.
3. Review the Company's annual audited financial statements, including disclosures in the Annual Report on Form 10-K under Management's Discussion and Analysis of Financial Condition and Results of Operation, prior to filing or distribution. Review should include discussion with management and the independent auditors of significant issues regarding accounting principles, practices, and judgments made in connection with the preparation of the Company's financial statements, including an analysis of the effect on the financial statements of applying alternative methods under generally accepted accounting principles and a description of any transactions as to which management obtained letters prepared in accordance with AICPA Statement on Auditing Standards No. 50. Recommend, if appropriate, to the Board of Directors that the audited financial statements be included in the Annual Report on Form 10-K.
4. Review with financial management and the independent auditors the Company's quarterly financial results prior to the release of earnings and the Company's quarterly financial statements (including the Company's disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operation) prior to filing or distribution, including the results of the independent auditors' review of the quarterly financial statements. Discuss any significant changes to the Company's accounting principles and any items required to be communicated by the independent auditors in accordance with AICPA Statement of Auditing Standards No. 61 (see Item 11 below). The Chairman of the Audit Committee may represent the entire Audit Committee for purposes of this review.
5. In consultation with management, the independent auditors, and the internal auditors, review the adequacy and effectiveness of the Company's internal accounting and financial controls. Discuss significant financial risk exposures and the processes management has implemented to monitor, control, and report such exposures. Review significant findings prepared by the independent auditors and the internal auditing department together with management's responses.
6. Discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

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7. Review the appropriateness of the Company's accounting policies, and the effect of regulatory and accounting initiatives as well as any off-balance sheet structures as they apply to the Company's financial statements.

8. The Audit Committee shall review and pre-approve the audit services to be provided to the Corporation by the independent auditors, and shall review and approve the fees to be paid to the independent auditors for such audit services. The Audit Committee shall also review and pre-approve the retention of the independent auditors for any non-audit services to be provided to the Corporation, and shall review and approve the fees to be paid to the independent auditors for such non-audit services. The Audit Committee may delegate to one or more of its members the authority to pre-approve audit and non-audit services, and to approve the fees to be paid for such audit and non-audit services. The decision of any member of the Audit Committee to whom authority is delegated pursuant to the preceding sentence shall be presented to the full Audit Committee at its next meeting.

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9. On at least an annual basis, the Audit Committee will obtain and review a report by the independent auditors on: (a) the auditing firm's internal quality-control procedures; (b) any material issues raised by the auditing firm's most recent internal quality-control review, or peer review, of the auditing firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five (5) years, respecting one or more independent audits carried out by the auditing firm, and any steps taken to deal with any such issues; and (c) all relationships between the independent auditing firm and the Company. The Audit Committee should discuss with the independent auditors any significant issues regarding the auditors' qualifications, performance or independence. As to the issue of independence, the Audit Committee shall consider whether the provision of non-audit services is compatible with maintaining the auditors' independence and take appropriate action to satisfy itself of the independence of the auditors. The Audit Committee shall present its conclusions with respect to the independent public accountants to the full Board of Directors.

10. Review the independent auditors' audit plan, discuss scope, staffing, locations, reliance upon management, and internal audit and general audit approach. Review the experience and qualifications of the senior members of the independent auditors' team and the quality control procedures of the independent auditors.

11. Prior to releasing the year-end earnings, discuss the results of the audit with the independent auditors. Discuss certain matters required to be communicated to audit committees in accordance with AICPA Statement of Auditing Standards 61.

12. Consider the independent auditors' judgments about the quality and appropriateness of the Company's accounting principles as applied in its financial reporting.

13. Establish clear guidelines for the Company's hiring of employees or former employees of the independent auditors who were engaged on the Company's account.

14. Review with the independent auditors any audit problems or difficulties that arise from the audits as well as management's response thereto.

15. Review the budget, plan, changes in plan, activities, organizational structure, and qualifications of the internal audit department, as needed.

16. Review and concur in the appointment, performance, and replacement of the senior internal audit executive, and the structure of the internal audit staff.

17. Review significant reports prepared by the internal audit department together with management's response and follow-up to these reports.

18. On at least an annual basis, review with the Company's counsel any legal matters that could have a significant impact on the organization's financial statements, and the Company's compliance with applicable laws and regulations.

19. Review with management and the independent auditors any correspondence with regulators or governmental agencies, which raise material issues regarding the Company's financial statements, internal controls or accounting policies.

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20. Establish and periodically review procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters, and the confidential, anonymous submission by any employee of concerns regarding questionable accounting or auditing matters.
  
21. Obtain from the independent auditors assurance that Section 10A of the Securities Exchange Act of 1934 has not been implicated.
  
22. Annually prepare a report to stockholders as required by the SEC to be included in the Company's annual proxy statement.
  
23. Annually prepare a performance evaluation of the Audit Committee, and report the findings of such evaluation to the Nominating and Corporate Governance Committee of the Board of Directors.

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24. Perform any other activities consistent with this Charter, the Company's by-laws, and governing law, as the Audit Committee or the Board deems necessary or appropriate.

25. Maintain minutes of meetings and circulate such minutes to the entire Board of Directors.

The Audit Committee is responsible for the duties set forth in this Charter, but the Audit Committee is not responsible for (i) preparing the financial statements or certifying that the Company's financial statements are complete, accurate and prepared in accordance with generally accepted accounting principles, or implementing and maintaining internal controls, or (ii) auditing the Company's financial statements. Management has the responsibility for preparing the financial statements, certifying that the Company's financial statements are complete, accurate and prepared in accordance with generally accepted accounting principles, and implementing and maintaining internal controls. The independent public accountants have the responsibility for auditing the financial statements.

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**Appendix B**

**SONIC AUTOMOTIVE, INC.**

**2004 STOCK INCENTIVE PLAN**

**ARTICLE 1. PURPOSE AND EFFECTIVE DATE**

1.1 Purposes of the Plan. Sonic Automotive, Inc. (the Company) has established this Sonic Automotive, Inc. 2004 Stock Incentive Plan (the Plan) to promote the interests of the Company and its stockholders. The purposes of the Plan are to provide key employees and consultants providing services to the Company and its Subsidiaries with incentives to contribute to the Company's performance and growth, to offer such persons stock ownership in the Company or other compensation that aligns their interests with those of the Company's stockholders and to enhance the Company's ability to attract, reward and retain such persons upon whose efforts the Company's success and future growth depends.

1.2 Effective Date. The Plan was adopted by the Board of Directors on February 19, 2004 and shall be effective as of such date, subject to the requisite approval of the Company's stockholders at the 2004 Annual Meeting of Stockholders. Awards may be granted prior to stockholder approval of the Plan, provided that all such Awards must be subject to stockholder approval of the Plan. This means that no Option or SAR may be exercised prior to such approval, and all Awards must be subject to forfeiture if such approval is not obtained.

**ARTICLE 2. DEFINITIONS**

2.1 Definitions. As used in the Plan, the following capitalized terms shall have the meanings set forth below:

(a) Award means, individually or collectively, a grant under this Plan of Incentive Stock Options, Nonqualified Stock Options, Stock Appreciation Rights, Restricted Stock, Restricted Stock Units, Performance Awards or Stock Awards.

(b) Award Agreement means an agreement entered into by a Participant and the Company, setting forth the terms and conditions applicable to an Award granted to the Participant under this Plan.

(c) Board or Board of Directors means the Board of Directors of the Company.

(d) Cause means any act, action or series of acts or actions or any omission, omissions, or series of omissions which result in, or which have the effect of resulting in, (i) the commission by the Participant of a crime involving moral turpitude, which crime has a material adverse impact on the Company or a Subsidiary or which is intended to result in the personal enrichment of the Participant at the expense of the Company or a Subsidiary; (ii) the Participant's material violation of his responsibilities, or the Participant's gross negligence or willful misconduct; or (iii) the continuous and willful failure by the Participant to follow the reasonable directives of the Board of Directors. In any event, the existence of Cause shall be determined by the Committee.



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(e) **Change in Control** means any merger or consolidation in which the Company is not the surviving corporation and which results in the holders of the outstanding voting securities of the Company (determined immediately prior to such merger or consolidation) owning less than a majority of the outstanding voting securities of the surviving corporation (determined immediately following such merger or consolidation), or any sale or transfer by the Company of all or substantially all of its assets or any tender offer or exchange offer for, or the acquisition, directly or indirectly, by any person or group of, all or a majority of the then-outstanding voting securities of the Company.

(f) **Code** means the Internal Revenue Code of 1986, as amended from time to time, or any successor act thereto.

(g) **Committee** means (i) the committee appointed by the Board to administer the Plan or (ii) in the absence of such appointment, the Board itself. Notwithstanding the foregoing, to the extent required for Awards to be exempt from Section 16 of the Exchange Act pursuant to Rule 16b-3, the Committee shall consist of two or more Directors who are **non-employee directors** within the meaning of such Rule 16b-3, and to the extent required for Awards to satisfy the requirements for **performance-based compensation** within the meaning of Section 162(m) of the Code and the regulations thereunder, the Committee shall consist of two or more Directors who are **outside directors** within the

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meaning of Section 162(m) of the Code. The Compensation Committee of the Board of Directors shall constitute the Committee until otherwise determined by the Board of Directors.

(h) **Common Stock** means the Class A common stock of the Company, par value \$0.01 per share.

(i) **Company** means Sonic Automotive, Inc., a Delaware corporation, or any successor thereto.

(j) **Director** means any individual who is a member of the Board of Directors of the Company.

(k) **Disability** means a permanent and total disability as described in Section 22(e)(3) of the Code and determined by the Committee.

(l) **Employee** means any employee of the Company or any Subsidiary. Directors who are not otherwise employed by the Company or a Subsidiary are not considered Employees under this Plan.

(m) **Exchange Act** means the Securities Exchange Act of 1934, as amended from time to time, or any successor act thereto.

(n) **Fair Market Value** means, as of a particular date, the value of the Common Stock determined as follows:

(i) If the Common Stock is traded on a national or regional securities exchange or on the Nasdaq National Market System ( **Nasdaq** ), Fair Market Value shall be determined on the basis of the closing sale price on the principal securities exchange on which the Common Stock may then be traded on the last trading day prior to the date of reference or, if there is no such sale on the relevant date, then on the last previous day on which a sale was reported;

(ii) If the Common Stock is not listed on any securities exchange or traded on Nasdaq, but nevertheless is publicly traded and reported on Nasdaq without closing sale prices for the Common Stock being customarily quoted, Fair Market Value shall be determined on the basis of the mean between the closing high bid and low asked quotations in such other over-the-counter market as reported by Nasdaq on the last trading day prior to the date of reference; but, if there are no bid and asked quotations in the over-the-counter market as reported by Nasdaq on that date, then the mean between the closing bid and asked quotations in the over-the-counter market as reported by Nasdaq on the immediately preceding day such bid and asked prices were quoted; and

(iii) If the Common Stock is not publicly traded as described in (i) or (ii) above, Fair Market Value shall be determined by the Committee in good faith.

(o) **Family Members** means the Participant's child, stepchild, grandchild, parent, stepparent, grandparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law or sister-in-law, including adoptive relationships, or any

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person sharing the Participant's household (other than a tenant or employee).

(p) Incentive Stock Option or ISO means an option to purchase shares of Common Stock granted under Article 6 which is designated as an Incentive Stock Option and is intended to meet the requirements of Section 422 of the Code.

(q) Involuntary Termination Without Cause means the dismissal, or the request for the resignation, of a Participant by either (i) a court order, order of any court-appointed liquidator or trustee of the Company, or the order or request of any creditors' committee of the Company constituted under the federal bankruptcy laws, provided that such order or request contains no specific reference to actions or omissions that would constitute Cause; or (ii) a duly authorized corporate officer of the Company or any Subsidiary, or by the Board, for any reason other than for Cause.

(r) Named Executive Officer means a Participant who is considered a covered employee within the meaning of Section 162(m) of the Code.

(s) Nonqualified Stock Option or NSO means an option to purchase shares of Common Stock granted under Article 6, and which is not intended or otherwise fails to meet the requirements of Section 422 of the Code.

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(t) **Option** means an Incentive Stock Option or a Nonqualified Stock Option.

(u) **Option Price** means the price at which a share of Common Stock may be purchased by a Participant pursuant to an Option, as determined by the Committee in accordance with Article 6.

(v) **Participant** means an Employee or consultant who performs services for the Company or a Subsidiary who has been granted an Award under the Plan which is outstanding.

(w) **Performance Award** means an Award granted under Article 10 which is subject to the attainment of one or more Performance Goals during a Performance Period, as established by the Committee in its discretion.

(x) **Performance Goals** means the criteria and objectives designated by the Committee that must be met during the Performance Period as a condition of the Participant's receipt of a Performance Award, as described in Section 10.1(b) hereof.

(y) **Performance Period** means the period designated by the Committee during which the Performance Goals with respect to a Performance Award will be measured.

(z) **Plan** means this Sonic Automotive, Inc. 2004 Stock Incentive Plan, as amended from time to time.

(aa) **Restricted Period** means the period beginning on the grant date of an Award of Restricted Stock and ending on the date the shares of Common Stock subject to such Award are no longer restricted and subject to forfeiture.

(bb) **Restricted Stock** means a share of Common Stock granted in accordance with the terms of Article 8, which Common Stock is nontransferable and subject to a substantial risk of forfeiture and such other restrictions as determined by the Committee.

(cc) **Restricted Stock Unit** means the right to receive a share of Common Stock (or the value of a share of Common Stock) in the future granted in accordance with the terms of Article 8, which right is nontransferable and subject to a substantial risk of forfeiture and such other restrictions as determined by the Committee.

(dd) **SAR** means a stock appreciation right granted pursuant to Article 7.

(ee) **Stock Award** means an equity-based award granted pursuant to Article 9.

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(ff) **Subsidiary** means a corporation, partnership, limited liability company, joint venture or other entity in which the Company directly or indirectly controls more than 50% of the voting power or equity or profits interests; provided, that for purposes of Incentive Stock Options, Subsidiary means a subsidiary corporation within the meaning of Section 424(f) of the Code.

(gg) **Ten Percent Stockholder** means a Participant who owns (directly or by attribution within the meaning of Section 424(d) of the Code) stock possessing more than 10% of the total combined voting power of all classes of stock of the Company, any Subsidiary or a parent of the Company.

(hh) **Termination of Service** means the termination of a Participant's service with the Company and its Subsidiaries as an Employee or consultant for any reason other than a change in the capacity in which the Participant renders service to the Company or a Subsidiary or a transfer between or among the Company and its Subsidiaries. Unless otherwise determined by the Committee, an Employee shall be considered to have incurred a Termination of Service if his or her employer ceases to be a Subsidiary. All determinations relating to whether a Participant has incurred a Termination of Service and the effect thereof shall be made by the Committee in its discretion, including whether a leave of absence shall constitute a Termination of Service, subject to applicable law.

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### ARTICLE 3. ADMINISTRATION

3.1 Authority of the Committee. Subject to the provisions of the Plan, the Committee shall have full and exclusive power to select the individuals to whom Awards may from time to time be granted under the Plan; determine the size and types of Awards; determine the terms, restrictions and conditions of Awards in a manner consistent with the Plan (including, but not limited to, the number of shares of Common Stock subject to an Award, vesting or other exercise conditions applicable to an Award, the duration of an Award, and restrictions on transferability of an Award and any shares of Common Stock issued thereunder); construe and interpret the Plan and any agreement or instrument entered into under the Plan; establish, amend or waive rules and regulations for the Plan's administration; delegate administrative responsibilities under the Plan and (subject to the provisions of Article 12) amend the terms and conditions of any outstanding Award to the extent such terms and conditions are within the discretion of the Committee, including accelerating the time any Option or SAR may be exercised, waiving restrictions and conditions on Awards and establishing different terms and conditions relating to the effect of a Termination of Service. The Committee also shall have the absolute discretion to make all other determinations which may be necessary or advisable in the Committee's opinion for the administration of the Plan.

3.2 Decisions Binding. All determinations, decisions and interpretations made by the Committee pursuant to the provisions of the Plan and all related resolutions of the Board shall be final, conclusive and binding on all persons, including the Company, the Company's stockholders, and Participants and their estates and beneficiaries.

3.3 Indemnification. In addition to such other rights they may have as Directors or members of the Committee, each person who is or shall have been a member of the Committee shall be indemnified and held harmless by the Company against any loss, cost, liability or expense (including settlement amounts paid with the approval of the Committee) that may be imposed upon or reasonably incurred by the Committee member in connection with or resulting from any claim, action, suit or proceeding in which the member may be a party or otherwise involved by reason of any action taken or failure to act under or in connection with the Plan or any Award, except with respect to matters as to which the Committee member has been grossly negligent or engaged in willful misconduct; provided, however, that the member shall give the Company an opportunity, at its own expense, to handle and defend the same before the member undertakes to handle and defend it on the member's own behalf.

### ARTICLE 4. STOCK SUBJECT TO THE PLAN

4.1 Stock Available Under the Plan. Subject to adjustments as provided in Section 4.3, the aggregate number of shares of Common Stock that may be issued pursuant to Awards under the Plan is 2,000,000 shares. Shares of Common Stock issued under the Plan may be shares of original issuance, shares held in the treasury of the Company or shares purchased in the open market or otherwise. Shares of Common Stock covered by Awards which expire or are forfeited or canceled for any reason or which are settled in cash shall be available for further Awards under the Plan.

4.2 Award Limits. Notwithstanding any provision in the Plan to the contrary, the following limitations shall apply (subject to adjustment as provided in Section 4.3):

(a) Individual Option and SAR Limit. No Participant shall be granted, during any one calendar year, Options and/or SARs (whether such SARs may be settled in shares of Common Stock, cash or a combination thereof) covering in the aggregate more than 500,000 shares of Common Stock.

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(b) Individual Limit on Other Awards. With respect to any Awards other than Options and SARs, no Participant shall be granted, during any one calendar year, such Awards (whether such Awards may be settled in shares of Common Stock, cash or a combination thereof) consisting of, covering or relating to in the aggregate more than 250,000 shares of Common Stock.

4.3 Adjustments. In the event of a reorganization, recapitalization, stock split, stock dividend, combination of shares, merger, consolidation or similar transaction or other change in corporate capitalization affecting the Common Stock, unless the Committee should determine otherwise, corresponding adjustments or substitutions, as applicable, shall be made to the maximum number and kind of shares of Common Stock which may be issued under the Plan set forth in Section 4.1, the number of shares of Common Stock subject to the Award limits set forth in Section 4.2 and in the number, kind and price of shares of Common Stock subject to outstanding Awards granted under the Plan. In addition, the Committee, in its discretion, shall make such similar adjustments as described above in the event of any corporate transaction to which Section 424(a) of

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the Code applies or such other event which in the judgment of the Committee necessitates an adjustment as may be determined to be appropriate and equitable by the Committee. Notwithstanding the foregoing, the number of shares of Common Stock subject to any Award shall always be a whole number and the Committee, in its discretion, shall make such adjustments as are necessary to eliminate fractional shares that may result from any adjustments made pursuant hereto. Except as expressly provided herein, the issuance by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall not affect, and no adjustment by reason thereof shall be made with respect to, the number or price of shares of Common Stock subject to an outstanding Award.

## ARTICLE 5. ELIGIBILITY AND PARTICIPATION

Awards under the Plan may be granted to Employees and consultants providing services to the Company or a Subsidiary (provided such consultants render bona fide services not in connection with the offer and sale of securities in a capital-raising transaction) as selected by the Committee. In determining the individuals to whom such an Award shall be granted and the terms and conditions of such Award, the Committee may take into account any factors it deems relevant, including the duties of the individual, the Committee's assessment of the individual's present and potential contributions to the success of the Company or its Subsidiaries and such other factors as the Committee shall deem relevant in connection with accomplishing the purposes of the Plan. Subject to the Award limits set forth in Section 4.2, a Participant may be granted more than one Award under the Plan.

## ARTICLE 6. STOCK OPTIONS

6.1 Stock Options. Subject to the provisions of the Plan, the Committee may grant Options upon the following terms and conditions:

(a) Award Agreement. Each grant of an Option shall be evidenced by an Award Agreement in such form as the Committee may from time to time approve. The Award Agreement shall specify the number of shares of Common Stock to which the Option pertains, whether the Option is an ISO or a NSO, the Option Price, the term of the Option, the conditions upon which the Option shall become vested and exercisable, and such additional terms and conditions, not inconsistent with the provisions of the Plan, as the Committee shall determine. ISOs may be granted only to Employees of the Company or a Subsidiary.

(b) Option Price. The Option Price per share of Common Stock shall be determined by the Committee, but shall not be less than the Fair Market Value per share of Common Stock on the date of grant of the Option. In the case of an ISO granted to a Ten Percent Stockholder, the Option Price per share of Common Stock shall not be less than 110% of the Fair Market Value per share of Common Stock on the date of grant of the Option. Notwithstanding the foregoing, an Option may be granted with an Option Price per share of Common Stock less than that set forth above if such Option is granted pursuant to an assumption of, or substitution for, another option in a manner satisfying the provisions of Section 424(a) of the Code.

(c) Exercise of Options. An Option shall be exercisable in whole or in part (including periodic installments) at such time or times, and subject to such restrictions and conditions, as the Committee shall determine. Except as otherwise provided in the Award Agreement, the right to purchase shares of Common Stock under the Option that become exercisable in periodic installments shall be cumulative so that such shares of Common Stock (or any part thereof) may be purchased at any time thereafter until the expiration or termination of the Option.

(d) Option Term. The term of an Option shall be determined by the Committee, but in no event shall an ISO be exercisable more than ten years from the date of its grant or in the case of any ISO granted to a Ten Percent Stockholder, more than five years from the date of its grant.



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(e) Termination of Service. Except to the extent an Option remains exercisable as provided below or as otherwise set forth in the Award Agreement, an Option shall immediately terminate upon the Participant's Termination of Service with the Company and its Subsidiaries for any reason.

(i) General Rule. In the event that a Participant incurs a Termination of Service for any reason other than Cause, Involuntary Termination Without Cause, or his death or Disability, the Participant may exercise an Option to the extent that the Participant was entitled to exercise such Option as of the date of termination, but only within

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such period of time ending on the earlier of (1) 60 days following such Termination of Service or (2) the expiration of the term of the Option as set forth in the Award Agreement.

(ii) Involuntary Termination Without Cause. In the event that a Participant incurs a Termination of Service that constitutes an Involuntary Termination Without Cause, the Participant may exercise an Option to the extent that the Participant was entitled to exercise such Option as of the date of termination, but only within such period of time ending on the earlier of (1) 90 days following such Termination of Service or (2) the expiration of the term of the Option as set forth in the Award Agreement.

(iii) Disability. In the event that a Participant incurs a Termination of Service as a result of the Participant's Disability, the Participant may exercise an Option to the extent that the Participant was entitled to exercise such Option as of the date of termination, but only within such period of time ending on the earlier of (1) one year following such Termination of Service or (2) the expiration of the term of the Option as set forth in the Award Agreement.

(iv) Death. In the event that a Participant's Termination of Service is caused by the Participant's death, or in the event of the Participant's death following the Participant's Termination of Service but during the exercise period following termination described in subparagraph (i), (ii) or (iii) above, as applicable, then an Option may be exercised to the extent the Participant was entitled to exercise such Option as of the date of death by the person or persons to whom the Participant's rights to exercise the Option passed by will or the laws of descent and distribution (or by the executor or administrator of the Participant's estate), but only within the period ending on the earlier of (1) one year following the date of death or (2) the expiration of the term of the Option as set forth in the Award Agreement.

(f) ISO Limitation. To the extent that the aggregate Fair Market Value (determined as of the date of grant) of the shares of Common Stock with respect to which ISOs are exercisable for the first time during any calendar year (under all plans of the Company and its Subsidiaries) exceeds \$100,000 or such other applicable limitation set forth in Section 422 of the Code or any regulations thereunder, such ISOs shall be treated as NSOs. The determination of which ISOs shall be treated as NSOs generally shall be based on the order in which such ISOs were granted and shall be determined by the Committee in accordance with applicable rules and regulations.

(g) Payment. Options shall be exercised by the delivery of a written notice of exercise to the Company, specifying the number of shares of Common Stock with respect to which the Option is to be exercised, accompanied by the aggregate Option Price for the shares of Common Stock. The aggregate Option Price shall be payable to the Company in full in cash or cash equivalent acceptable to the Company, or if approved by the Committee, by tendering previously acquired shares of Common Stock (or delivering a certification of ownership of such shares) having an aggregate Fair Market Value at the time of exercise equal to the total Option Price (provided that the shares of Common Stock either were purchased on the open market or have been held by the Participant for a period of at least six months (unless such six-month period is waived by the Committee)), a combination of the foregoing, or by any other means which the Company determines to be consistent with the Plan's purpose and applicable law (including the tendering of Awards having an aggregate Fair Market Value at the time of exercise equal to the total Option Price, as determined by the Committee).

(h) Transfer Restrictions. Except as otherwise set forth herein, Options may not be sold, transferred, pledged, assigned, alienated, hypothecated or disposed of in any manner other than by will or the laws of descent and distribution, and Options shall be exercisable during the Participant's lifetime only by the Participant (or, to the extent permitted by applicable law, the Participant's guardian or legal representative in the event of the Participant's legal incapacity). Notwithstanding the foregoing, the Committee, in its absolute discretion, may permit a Participant to transfer NSOs, in whole or in part, for no consideration to (1) one or more Family Members; (2) a trust in which Family Members have more than 50% of the beneficial interest; (3) a foundation in which Family Members (or the Participant) control the management of assets; or (4) any other entity in which Family Members (or the Participant) own more than 50% of the voting interests; provided, that such transfer is permitted under applicable tax laws and Rule 16b-3 of the Exchange Act as in effect from time to time. In all cases, the Committee must be notified in advance in writing of the terms of any proposed transfer to a permitted transferee and such transfers may occur only with the consent of and subject to the rules and conditions imposed by the Committee. The transferred NSOs shall continue to be subject to the



same terms and conditions in the hands of the transferee as were applicable immediately prior to the transfer (including the provisions of the Plan and Award Agreement relating to the expiration or termination of the NSOs). The NSOs shall be exercisable by the permitted transferee only to the extent and for the periods specified herein and in any applicable Award Agreement.

(i) No Stockholder Rights. No Participant shall have any rights as a stockholder with respect to shares of Common Stock subject to the Participant's Option until the issuance of such shares to the Participant pursuant to the exercise of such Option.

## **ARTICLE 7. STOCK APPRECIATION RIGHTS**

7.1 Grants of SARs. Subject to the provisions of the Plan, the Committee may grant SARs upon the following terms and conditions:

(a) Award Agreement. Each grant of a SAR shall be evidenced by an Award Agreement in such form as the Committee may from time to time approve. The Award Agreement shall specify the number of shares of Common Stock to which the SAR pertains, the term of the SAR, the conditions upon which the SAR shall become vested and exercisable, and such additional terms and conditions, not inconsistent with the provisions of the Plan, as the Committee shall determine. The Committee may grant SARs in tandem with or independently from Options.

(b) Initial Value of SARs. The Committee shall assign an initial value to each SAR, provided that the initial value may not be less than the aggregate Fair Market Value on the date of grant of the shares of Common Stock to which the SAR pertains.

(c) Exercise of SARs. A SAR shall be exercisable in whole or in part (including periodic installments) at such time or times, and subject to such restrictions and conditions, as the Committee shall determine. Notwithstanding the foregoing, in the case of a SAR that is granted in tandem with an Option, the SAR may be exercised only with respect to the shares of Common Stock for which its related Option is then exercisable. The exercise of either an Option or a SAR that are granted in tandem shall result in the termination of the other to the extent of the number of shares of Common Stock with respect to which such Option or SAR is exercised.

(d) Term of SARs. The term of a SAR granted independently from an Option shall be determined by the Committee, but in no event shall such a SAR be exercisable more than ten years from the date of its grant. A SAR granted in tandem with an Option shall have the same term as the Option to which it relates.

(e) Termination of Service. In the event that a Participant incurs a Termination of Service, the Participant's SARs shall terminate in accordance with the provisions specified in Article 6 with respect to Options.

(f) Payment of SAR Value. Upon the exercise of a SAR, a Participant shall be entitled to receive (i) the excess of the Fair Market Value on the date of exercise of the shares of Common Stock with respect to which the SAR is being exercised, over (ii) the initial value of the SAR on the date of grant, as determined in accordance with Section 7.1(b) above. Notwithstanding the foregoing, the Committee may specify in an Award Agreement that the amount payable upon the exercise of a SAR shall not exceed a designated amount. At the Committee's discretion, the amount payable as a result of the exercise of a SAR may be settled in cash, shares of Common Stock of equivalent value, or a combination of cash and Common Stock. A fractional share of Common Stock shall not be deliverable upon the exercise of a SAR, but a cash payment shall be made in lieu thereof.

(g) Nontransferability. Except as otherwise set forth herein, SARs granted under the Plan may not be sold, transferred, pledged, assigned, alienated, hypothecated or disposed of in any manner other than by will or the laws of descent and distribution, and SARs shall be exercisable during the Participant's lifetime only by the Participant (or, to the extent permitted by applicable law, the Participant's guardian or legal representative in the event of the Participant's legal incapacity). Notwithstanding the foregoing, the Committee, in its absolute discretion, may permit a Participant to transfer SARs, in whole or in part, for no consideration to (i) one or more Family Members; (ii) a trust in which Family Members have more than 50% of the beneficial interest; (iii) a foundation in which Family Members (or the Participant) control the management of assets; or (iv) any other entity in which Family Members (or the Participant) own more than

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50% of the voting interests; provided, that such transfer is permitted under applicable tax laws and Rule 16b-3 of the Exchange Act as in effect from time to time. In all cases, the Committee must be notified in advance in writing of the terms of any proposed transfer to a permitted transferee and such transfers may occur only with the consent of and subject to the rules and conditions imposed by the Committee. The transferred SARs shall continue to be subject to the same terms and conditions in the hands of the transferee as were applicable immediately prior to the transfer (including the provisions of the Plan and Award Agreement relating to the expiration or termination of the SARs). The SARs shall be exercisable by the permitted transferee only to the extent and for the periods specified herein and in any applicable Award Agreement.

(h) No Stockholder Rights. No Participant shall have any rights as a stockholder of the Company with respect to shares of Common Stock subject to a SAR until the issuance of shares (if any) to the Participant pursuant to the exercise of such SAR.

## ARTICLE 8. RESTRICTED STOCK AND RESTRICTED STOCK UNITS

8.1 Grants of Restricted Stock and Restricted Stock Units. Subject to the provisions of the Plan, the Committee may grant Restricted Stock and/or Restricted Stock Units upon the following terms and conditions:

(a) Award Agreement. Each grant of Restricted Stock or Restricted Stock Units shall be evidenced by an Award Agreement in such form as the Committee may from time to time approve. The Award Agreement shall specify the number of shares with respect to which the Restricted Stock or Restricted Stock Units are granted, the Restricted Period, the conditions upon or the time at which the Restricted Period shall lapse, and such additional terms and conditions, not inconsistent with the provisions of the Plan, as the Committee shall determine.

(b) Purchase Price. The Committee shall determine the purchase price, if any, to be paid for each share of Restricted Stock or each Restricted Stock Unit, subject to such minimum consideration as may be required by applicable law.

(c) Nontransferability. Except as otherwise set forth in the Award Agreement, shares of Restricted Stock and Restricted Stock Units may not be sold, transferred, pledged, assigned, alienated, hypothecated or disposed of in any manner until the end of the Restricted Period applicable to such shares and the satisfaction of any and all other conditions prescribed by the Committee.

(d) Other Restrictions. The Committee may impose such conditions and restrictions on the grant or vesting of Restricted Stock and Restricted Stock Units as it determines, including but not limited to restrictions based upon the occurrence of a specific event, continued service for a period of time or other time-based restrictions, or the achievement of financial or other business objectives (including the Performance Goals described in Section 10.1(b)). The Committee may provide that such restrictions may lapse separately or in combination at such time or times and with respect to all shares of Restricted Stock and Restricted Stock Units or in installments or otherwise as the Committee may deem appropriate.

(e) Settlement of Restricted Stock Units. After the expiration of the Restricted Period and all conditions and restrictions applicable to Restricted Stock Units have been satisfied or lapsed, the Participant shall be entitled to receive the then Fair Market Value of the shares of Common Stock with respect to which the Restricted Stock Units were granted. Such amount shall be paid in cash, shares of Common Stock or a combination thereof as determined by the Committee.

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(f) Section 83(b) Election. If a Participant makes an election pursuant to Section 83(b) of the Code with respect to Restricted Stock, the Participant shall be required to promptly file a copy of such election with the Company as required under Section 83(b) of the Code.

(g) Termination of Service. Notwithstanding anything herein to the contrary and except as otherwise determined by the Committee, in the event of the Participant's Termination of Service prior to the expiration of the Restricted Period, all shares of Restricted Stock and Restricted Stock Units with respect to which the applicable restrictions have not yet lapsed shall be forfeited.

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(h) Stockholder Rights.

(i) Restricted Stock. Except to the extent otherwise provided by the Committee, a Participant that has been granted Restricted Stock shall have the rights and privileges of a stockholder as to such Restricted Stock, including the right to vote such Restricted Stock and the right to receive dividends, if and when declared by the Board of Directors, provided, that the Committee may require that any cash dividends shall be automatically reinvested in additional shares of Restricted Stock.

(ii) Restricted Stock Units. A Participant shall have no voting or other stockholder rights or ownership interest in shares of Common Stock with respect to which Restricted Stock Units are granted. Notwithstanding the foregoing, if the Board of Directors declares a dividend with respect to the Common Stock, the Committee may, in its discretion, determine that Participants receive dividend equivalents with respect to their Restricted Stock Units. The Committee may determine the form of such dividend equivalents, which may include cash or Restricted Stock Units.

(iii) Adjustments and Dividends Subject to Plan. With respect to any shares of Restricted Stock or Restricted Stock Units received as a result of adjustments under Section 4.3 hereof and also any shares of Common Stock, Restricted Stock or Restricted Stock Units that result from dividends declared on the Common Stock, the Participant shall have the same rights and privileges, and be subject to the same restrictions, as are set forth in this Article 8 except to the extent the Committee otherwise determines.

(i) Issuance of Restricted Stock. A grant of Restricted Stock may be evidenced in such manner as the Committee shall deem appropriate, including without limitation, book-entry registration or the issuance of a stock certificate (or certificates) representing the number of shares of Restricted Stock granted to the Participant, containing such legends as the Committee deems appropriate and held in custody by the Company or on its behalf, in which case the grant of Restricted Stock shall be accompanied by appropriate stop-transfer instructions to the transfer agent for the Common Stock, until (1) the expiration or termination of the Restricted Period for such shares of Restricted Stock and the satisfaction of any and all other conditions prescribed by the Committee or (2) the forfeiture of such shares of Restricted Stock. The Committee may require a Participant to deliver to the Company a stock power, endorsed in blank, relating to the shares of Restricted Stock to be held in custody by or for the Company.

## **ARTICLE 9. STOCK AWARDS**

The Committee may grant other types of Stock Awards that involve the issuance of shares of Common Stock or that are valued by reference to shares of Common Stock, including but not limited to the grant of shares of Common Stock or the right to acquire or purchase shares of Common Stock. Stock Awards shall be evidenced by an Award Agreement in such form as the Committee may from time to time approve. The Award Agreement shall specify the number of shares of Common Stock to which the Stock Award pertains, the form in which the Stock Award shall be paid and such additional terms and conditions, not inconsistent with the provisions of the Plan, as the Committee shall determine.

## **ARTICLE 10. PERFORMANCE AWARDS**

10.1 Performance Awards. Subject to the terms of the Plan, the Committee may designate an Award of Restricted Stock or Restricted Stock Units or a Stock Award as a Performance Award based upon a determination that the Participant is or may become a Named Executive Officer and the Committee wishes such Awards to qualify for the exemption from the limitation on deductibility imposed by Section 162(m) of the Code. Performance Awards shall be contingent upon the attainment of one or more Performance Goals. The provisions of this Article 10 shall control to the extent inconsistent with Articles 8 and 9 and such Performance Awards shall be subject to the following terms and conditions:



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(a) Award Agreement. Each grant of a Performance Award shall be evidenced by an Award Agreement in such form as the Committee may from time to time approve. The Award Agreement shall specify the number of shares of Common Stock to which the Performance Award pertains, the Performance Goals applicable to such Performance Award, the length of the Performance Period, and such additional terms and conditions, not inconsistent with the provisions of the Plan, as the Committee shall determine.

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(b) Performance Goals. The Committee shall establish one or more Performance Goals for the Participant that are objectively determinable (i.e., such that a third party with knowledge of the relevant facts could determine whether the goals have been met). Such Performance Goals must be established in writing by the Committee within ninety (90) days after the beginning of the Performance Period (or, if earlier, by the date on which 25% of the Performance Period has elapsed) or within such other time period prescribed by Section 162(m) of the Code and the regulations thereunder; provided, that achievement of the Performance Goals must be substantially uncertain at the time they are established. The Performance Goals shall be based on one or more of the following, as determined in the sole discretion of the Committee: stock price; earnings per share; net earnings; operating or other earnings; profits; revenues; net cash flow; financial return ratios; stockholder return; return on equity; return on investment; return on net assets; debt rating; sales; expense reduction levels; growth in assets, sales, or market share; or strategic business objectives based on meeting specified revenue goals, market penetration goals, customer satisfaction goals, geographic business expansion goals, cost targets, or goals relating to acquisitions or divestitures. Performance Goals may be based on the performance of the Company, based on the Participant's division, business unit or employing Subsidiary, based on the performance of one or more divisions, business units or Subsidiaries, based on the performance of the Company and its Subsidiaries as a whole, or based on any combination of the foregoing. Performance Goals may be either absolute in their terms or relative. Performance Goals may provide for the inclusion or exclusion of items such as the effect of unusual charges or income items or other events, including acquisitions or dispositions of businesses or assets, restructurings, reductions in force, or changes in accounting principles or tax laws. The Committee also may establish subjective Performance Goals for Participants, provided that for Named Executive Officers, the subjective Performance Goals may be used only to reduce, and not increase, the Performance Award otherwise payable under the Plan.

(c) Payment. Prior to the vesting, payment or delivery, as the case may be, of a Performance Award, the Committee shall certify in writing the extent to which the applicable Performance Goals and any other material terms of the Performance Award have been achieved or exceeded for the applicable Performance Period. In no event may the Committee waive achievement of the Performance Goal requirements for a Named Executive Officer except in its discretion in the case of the death or Disability of the Participant or as otherwise provided in Article 11 with respect to a Change in Control. Notwithstanding anything herein to the contrary, the maximum cash payment that may be paid during a calendar year to a Participant pursuant to a Performance Award shall be \$2,000,000.

(d) Code Section 162(m). The Committee shall have the power to impose such other restrictions on Performance Awards as it may deem necessary or appropriate to ensure that such Performance Awards satisfy all requirements for performance-based compensation within the meaning of Section 162(m) of the Code and the regulations thereunder.

## ARTICLE 11. CHANGE IN CONTROL

11.1 Impact on Options, SARs and Stock Awards. Notwithstanding any other provision of the Plan, all outstanding Options, SARs and Stock Awards (other than Stock Awards that have been designated as Performance Awards) shall become fully vested and exercisable on and after (a) the date of consummation of a tender offer or exchange offer that constitutes a Change in Control or (b) the third business day prior to the effective date of any other Change in Control.

11.2 Impact on Restricted Stock and Restricted Stock Units. Notwithstanding any other provision of the Plan, all Awards of Restricted Stock and Restricted Stock Units (other than those that have been designated as Performance Awards) shall be deemed vested, all restrictions shall be deemed lapsed, all terms and conditions shall be deemed satisfied and the Restricted Period with respect thereto shall be deemed to have ended as of (a) the date of consummation of a tender offer or exchange offer that constitutes a Change in Control or (b) the third business day prior to the effective date of any other Change in Control.

11.3 Performance Awards. All Performance Awards earned and outstanding as of the date of the Change in Control shall be payable in full within 30 days following the Change in Control. Any remaining Performance Awards shall be accelerated and deemed to have been fully earned as of the date of the Change in Control, with a pro rata settlement of the Performance Award to be made within 30 days following the Change in Control based upon an assumed achievement of the applicable Performance Goals and the length of time within the Performance Period that has elapsed prior to the Change in Control.



## ARTICLE 12. AMENDMENT, SUSPENSION AND TERMINATION

12.1 Amendment, Suspension and Termination of Plan. The Board may at any time, and from time to time, amend, suspend or terminate the Plan in whole or in part; provided, that no amendment, suspension or termination shall be effective unless approved by the stockholders of the Company (a) to the extent stockholder approval is necessary to satisfy the applicable requirements of the Code (including, but not limited to, Sections 162(m) and 422 thereof), the Exchange Act or Rule 16b-3 thereunder, any New York Stock Exchange, Nasdaq or securities exchange listing requirements or any other law or regulation; (b) if such amendment is intended to allow the Option Price of outstanding Options to be reduced by repricing or replacing such Options; or (c) to the extent the Board determines, in its discretion, that stockholder approval is desirable even if such stockholder approval is not expressly required by the Plan or applicable law or regulation. Unless sooner terminated by the Board, the Plan shall terminate ten years from the date the Plan is adopted by the Board. No further Awards may be granted after the termination of the Plan, but the Plan shall remain effective with respect to any outstanding Awards previously granted. No amendment, suspension or termination of the Plan shall adversely affect in any material way the rights of a Participant under any outstanding Award without the Participant's consent.

12.2 Amendment of Awards. Subject to Section 12.1 above, the Committee may at any time amend the terms of an Award previously granted to a Participant, but no such amendment shall adversely affect in any material way the rights of the Participant without the Participant's consent.

## ARTICLE 13. WITHHOLDING

13.1 Tax Withholding in General. The Company shall have the power and the right to deduct or withhold from cash payments or other property to be paid to the Participant, or require a Participant to remit to the Company or a Subsidiary, an amount sufficient to satisfy federal, state and local taxes (including the Participant's FICA obligation) required by law to be withheld with respect to any taxable event arising in connection with an Award under this Plan. The Company shall not be required to issue any shares of Common Stock or settle any Awards payable hereunder until such withholding requirements have been satisfied.

13.2 Share Withholding and Remittance. With respect to withholding required upon the exercise of Options, or upon any other taxable event arising as a result of Awards granted hereunder which are to be paid in the form of shares of Common Stock, the Company may withhold from an Award, or the Participant may remit, subject to applicable law (including Rule 16b-3 under the Exchange Act), shares of Common Stock having a Fair Market Value on the date the tax is to be determined of no more than the minimum statutory total tax which could be imposed on the transaction. All such elections shall be made in accordance with procedures established by the Committee and/or the Company. Notwithstanding the foregoing, the Committee and/or the Company shall have the right to restrict a Participant's ability to satisfy tax obligations through share withholding as they may deem necessary or appropriate.

## ARTICLE 14. GENERAL PROVISIONS

14.1 Restrictions on Stock Ownership/Legends. The Committee, in its discretion, may establish guidelines applicable to the ownership of any shares of Common Stock acquired pursuant to the exercise of an Option or SAR or in connection with any other Award under this Plan as it may deem desirable or advisable, including, but not limited to, time-based or other restrictions on transferability regardless of whether or not the Participant is otherwise vested in such Common Stock. All stock certificates representing shares of Common Stock issued pursuant to this Plan shall be subject to such stock transfer orders and other restrictions as the Committee may deem advisable and the Committee may cause any such certificates to have legends affixed thereto to make appropriate references to any applicable restrictions.

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14.2 No Employment Rights. Nothing in the Plan or any Award Agreement shall confer upon any Participant any right to continue in the employ or service of the Company or a Subsidiary nor interfere with or limit in any way the right of the Company or a Subsidiary to terminate any Participant's employment by, or performance of services for, the Company or Subsidiary at any time for any reason.

14.3 No Participation Rights. No person shall have the right to be selected to receive an Award under this Plan and there is no requirement for uniformity of treatment among Participants.

14.4 Unfunded Plan. To the extent that any person acquires a right to receive Common Stock or cash payments under the Plan, such right shall be only contractual in nature unsecured by any assets of the Company or a Subsidiary.

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Neither the Company nor any Subsidiary shall be required to segregate any specific funds, assets or other property with respect to any Awards under this Plan.

14.5 Restrictions on Transferability. Except as otherwise provided herein or in an Award Agreement, no Award or any shares of Common Stock subject to an Award which have not been issued, or as to which any applicable restrictions have not lapsed, may be sold, transferred, pledged, assigned, alienated, hypothecated or disposed of in any manner. Any attempt to transfer an Award or such shares of Common Stock in violation of the Plan or an Award Agreement shall relieve the Company and its Subsidiaries from any obligations to the Participant thereunder.

14.6 Requirements of Law. The granting of Awards and the issuance of shares of Common Stock under the Plan shall be subject to all applicable laws, rules and regulations, and to such approvals by any governmental agencies or national securities exchanges as may be required. With respect to Participants who are subject to Section 16 of the Exchange Act, this Plan is intended to comply with all provisions of Rule 16b-3 or any successor rule under the Exchange Act, unless determined otherwise by the Committee.

14.7 Approvals and Listing. The Company shall not be required to grant, issue or settle any Awards or issue any certificate or certificates for shares of Common Stock under the Plan prior to (a) obtaining any required approval from the stockholders of the Company; (b) obtaining any approval from any governmental agency which the Company shall, in its discretion, determine to be necessary or advisable; (c) the admission of such shares of Common Stock to listing on any national securities exchange on which the Company's Common Stock may be listed; and (d) the completion of any registration or other qualification of such shares of Common Stock under any state or federal law or ruling or regulation of any governmental body which the Company shall, in its sole discretion, determine to be necessary or advisable. The Company may require that any recipient of an Award make such representations and agreements and furnish such information as it deems appropriate to assure compliance with the foregoing or any other applicable legal requirement. Notwithstanding the foregoing, the Company shall not be obligated at any time to file or maintain a registration statement under the Securities Act of 1933, as amended, or to effect similar compliance under any applicable state laws with respect to the Common Stock that may be issued pursuant to this Plan.

14.8 Compliance with Code Section 162(m). It is intended that the Plan comply fully with and meet all of the requirements of Section 162(m) of the Code with respect to Options and SARs granted hereunder. At all times when the Committee determines that compliance with the performance-based compensation exception under Section 162(m) of the Code is required or desired, all Performance Awards granted under this Plan also shall comply with the requirements of Section 162(m) of the Code, and the Plan must be resubmitted to the stockholders of the Company as necessary to enable Performance Awards to qualify as performance-based compensation thereunder (which rules currently require that the stockholders reapprove the Plan no later than the first stockholders meeting that occurs in the fifth year following the year in which the stockholders previously approved the Plan). In addition, in the event that changes are made to Section 162(m) of the Code to permit greater flexibility with respect to any Award or Awards under the Plan, the Committee may make any adjustments it deems appropriate. The Committee may, in its discretion, determine that it is advisable to grant Awards that shall not qualify as performance-based compensation and may grant Awards without satisfying the requirements of Section 162(m) of the Code.

14.9 Other Corporate Actions. Nothing contained in the Plan shall be construed to limit the authority of the Company to exercise its corporate rights and powers, including, but not by way of limitation, the right of the Company to adopt other compensation arrangements or the right of the Company to authorize any adjustment, reclassification, reorganization, or other change in its capital or business structure, any merger or consolidation of the Company, the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its business or assets.

14.10 Gender and Number. Except where otherwise indicated by the context, any masculine term used herein shall also include the feminine, and the plural shall include the singular and the singular shall include the plural.

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14.11 Severability. The invalidity or unenforceability of any particular provision of this Plan shall not affect the other provisions hereof, and the Committee may elect in its discretion to construe such invalid or unenforceable provision in a manner which conforms to applicable law or as if such provision was omitted.

14.12 Governing Law. To the extent not preempted by federal law, the Plan, and all Award Agreements hereunder, shall be construed in accordance with and governed by the laws of the State of North Carolina (excluding the principles of conflict of law thereof).

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**Appendix C**

**SONIC AUTOMOTIVE, INC.**

**P R O X Y**

**Charlotte, North Carolina**

**THIS PROXY IS BEING SOLICITED ON BEHALF OF THE BOARD OF DIRECTORS OF SONIC AUTOMOTIVE, INC.**

The undersigned hereby appoints Mr. O. Bruton Smith and Mr. William I. Belk as proxies, each with the power to appoint his Substitute, and hereby authorizes them to represent and vote, as designated below, all shares of the Voting Stock of Sonic Automotive, Inc. held of record by the undersigned on February 26, 2004, at the Annual Meeting of Stockholders to be held on April 22, 2004 or any adjournment thereof.

The Board of Directors recommends a vote **FOR ALL** nominees in Item 1 and **FOR** Items 2 and 3.

**1. ELECTION OF DIRECTORS**

Nominees: B. Scott Smith, William P. Benton and William I. Belk (Mark only one of the following boxes.)

**VOTE FOR ALL** nominees listed above, except  
vote withheld as to the following nominee  
(if any): \_\_\_\_\_  
\_\_\_\_\_

**VOTE WITHHELD** as to all nominees

**2. APPROVAL OF THE SONIC AUTOMOTIVE, INC. 2004 STOCK INCENTIVE PLAN**



**FOR**

**AGAINST**

**ABSTAIN**

**3. RATIFICATION OF APPOINTMENT OF DELOITTE & TOUCHE LLP AS THE COMPANY S INDEPENDENT ACCOUNTANTS**

**FOR**

**AGAINST**

**ABSTAIN**

In their discretion, the Proxies are authorized to vote upon such other business as may properly come before the meeting.

**PLEASE MARK, SIGN BELOW, DATE AND RETURN THIS  
PROXY PROMPTLY IN THE ENVELOPE FURNISHED.**

Please sign exactly as name appears below.

When shares are held by joint tenants, both should sign. When signing as attorney, as executor, administrator, trustee or guardian, please give full title as such. If a corporation, please sign in full corporate name by President or other authorized officer. If a partnership, please sign in partnership name by authorized person.

Class A Common Stock Shares: \_\_\_\_\_

Class B Common Stock Shares: \_\_\_\_\_

Dated: \_\_\_\_\_, 2004

Signature: \_\_\_\_\_

Printed Name: \_\_\_\_\_

Signature, if held jointly: \_\_\_\_\_

Printed Name: \_\_\_\_\_

“ Please mark here if you intend to attend the Meeting of Stockholders.