

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15 (d) of the  
Securities Exchange Act of 1934

For the quarterly period ended March 26, 1999

Commission File Number: 001-9249

GRACO INC.

(Exact name of Registrant as specified in its charter)

Minnesota

41-0285640

-----  
(State of incorporation)

-----  
(I.R.S. Employer Identification Number)

4050 Olson Memorial Highway  
Golden Valley, Minnesota

55422

-----  
(Address of principal executive offices)

-----  
(Zip Code)

(612) 623-6000

-----  
(Registrant's telephone number, including area code)

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, and (2) has been subject to such filing requirements for the past 90 days.

Yes        X        No  
-----

20,300,233 common shares were outstanding as of April 29, 1999.

GRACO INC. AND SUBSIDIARIES

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Key Employee Agreement between the Company and one executive officer dated March 1, 1999	Exhibit 10.3
Stock Option Agreement. Form of agreement used for award of non-incentive stock options to one executive officer, dated March 1, 1999.	Exhibit 10.4
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PART I

GRACO INC. AND SUBSIDIARIES

Item I. CONSOLIDATED STATEMENTS OF EARNINGS

(Unaudited)

	Thirteen Weeks Ended	
	March 26, 1999	March 27, 1998
	-----	-----
	(In thousands except per share amounts)	
Net Sales	\$ 103,241	\$ 105,717
Cost of products sold	50,384	53,772
	-----	-----
Gross Profit	52,857	51,945
Product development	4,754	4,782
Selling, marketing and distribution	19,305	22,647
General and administrative	9,524	10,165
	-----	-----
Operating Profit	19,274	14,351
Interest expense	1,953	225
Other (income) expense, net	320	279
	-----	-----
Earnings Before Income Taxes	17,001	13,847
Income taxes	5,800	4,900
	-----	-----
Net Earnings	\$ 11,201	\$ 8,947
	=====	=====
Basic Net Earnings Per Common Share	\$ .56	\$ .35
	=====	=====
Diluted Net Earnings Per Common Share	\$ .54	\$ .34
	=====	=====

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS  
(In thousands)

	March 26, 1999	Dec. 25, 1998
	-----	-----
ASSETS (Unaudited)		
Current Assets:		
Cash and cash equivalents	\$ 4,204	\$ 3,555
Accounts receivable, less allowances of \$4,400 and \$4,400	81,162	80,146
Inventories	34,111	34,018
Deferred income taxes	12,563	12,384
Other current assets	1,135	1,217
	-----	-----
Total current assets	133,175	131,320
Property, Plant and Equipment:		
Cost	199,706	199,122
Accumulated depreciation	(105,355)	(102,756)
	-----	-----
	94,351	96,366
Other Assets	6,046	6,016
	-----	-----
	\$ 233,572	\$ 233,702
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Notes payable to banks	\$ 11,056	\$ 14,560
Current portion of long-term debt	1,715	3,157
Trade accounts payable	12,489	11,965
Salaries, wages & commissions	9,462	14,025
Accrued insurance liabilities	11,193	10,809
Income taxes payable	10,297	5,134
Other current liabilities	20,898	23,316
	-----	-----
Total current liabilities	77,110	82,966
Long-term Debt, less current portion	105,353	112,582
Retirement Benefits and Deferred Compensation	29,133	28,841
Shareholders' Equity:		
Common stock	20,294	20,097
Additional paid-in capital	27,274	23,892
Retained deficit	(26,891)	(35,878)
Other, net	1,299	1,202
	-----	-----
Total shareholders' equity	21,976	9,313
	\$ 233,572	\$ 233,702
	=====	=====

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Thirteen Weeks	
	March 26, 1999	March 27, 1998
CASH FLOWS FROM OPERATING ACTIVITIES:	(In thousands)	
Net Earnings	\$ 11,201	\$ 8,947
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation and amortization	3,773	3,994
Deferred income taxes	(69)	158
Change in:		
Accounts receivable	(2,204)	952
Inventories	(731)	(2,531)
Trade accounts payable	471	1,999
Salaries, wages and commissions	(4,396)	(4,047)
Retirement benefits and deferred compensation	380	(200)
Other accrued liabilities	3,573	2,922
Other	183	839
	----- 12,181 -----	----- 13,033 -----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Property, plant and equipment additions	(2,015)	(2,995)
Proceeds from sale of property, plant and equipment	220	170
	----- (1,795) -----	----- (2,825) -----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings on notes payable and lines of credit	38,992	5,037
Payments on notes payable and lines of credit	(42,397)	(2,772)
Borrowings on long-term debt	2,000	-
Payments on long-term debt	(10,632)	(310)
Common stock issued	3,579	3,822
Retirement of common stock	-	(12)
Cash dividends paid	(2,212)	(2,811)
	----- (10,670) -----	----- 2,954 -----
Effect of exchange rate changes on cash	933	1,698
Net increase (decrease) in cash and cash equivalents	649	14,860
Cash and cash equivalents:		
Beginning of year	3,555	13,523
End of period	\$ 4,204 =====	\$ 28,383 =====

See notes to consolidated financial statements.

GRACO INC. AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. The consolidated balance sheet of Graco Inc. and Subsidiaries (the Company) as of March 26, 1999, and the related statements of earnings and cash flows for the thirteen weeks then ended, have been prepared by the Company without being audited.

In the opinion of management, these consolidated statements reflect all adjustments (consisting of only normal recurring adjustments) necessary to present fairly the financial position of Graco Inc. and Subsidiaries as of March 26, 1999, and the results of operations and cash flows for all periods presented.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. Therefore, these statements should be read in conjunction with the financial statements and notes thereto included in the Company's 1998 Form 10-K.

The results of operations for interim periods are not necessarily indicative of results that will be realized for the full fiscal year.

2. Major components of inventories were as follows (in thousands):

	Mar. 26, 1999	Dec. 25, 1998
	-----	-----
Finished products and components	\$ 27,396	\$ 27,764
Products and components in various stages of completion	22,757	23,024
Raw materials	19,744	18,970
	-----	-----
	69,897	69,758
Reduction to LIFO cost	(35,786)	(35,740)
	-----	-----
	\$ 34,111	\$ 34,018
	=====	=====

## GRACO INC. AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

3. The Company has three reportable segments, Industrial/Automotive, Contractor and Lubrication. Assets of the Company are not tracked along reportable segment lines. Sales and operating profit by segment for the thirteen weeks ended March 26, 1999 and March 25, 1998 are as follows (in thousands):

	Mar. 26, 1999	Mar. 27, 1998
	-----	-----
Net Sales		
Industrial/Automotive	\$ 50,748	\$ 57,428
Contractor	41,694	37,392
Lubrication	10,799	10,897
	-----	-----
Total	\$ 103,241	\$ 105,717
	=====	=====
Operating Profit		
Industrial/Automotive	\$ 9,745	\$ 7,225
Contractor	8,899	7,039
Lubrication	2,288	1,750
Unallocated Corporate expenses	(1,658)	(1,663)
	-----	-----
Consolidated Operating Profit	\$ 19,274	\$ 14,351
	=====	=====

4. In June 1998, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) No. 133, "Accounting for Derivative Instruments and Hedging Activities", which will be effective for the Company in fiscal year 2000. SFAS No. 133 requires that all derivatives are recognized in the financial statements as either assets or liabilities measured at fair value and also specifies new methods of accounting for hedging transactions. The Company has not yet determined the impact of FAS 133, if any.
5. On April 28, 1999 the Company agreed to purchase the assets of Bollhoff Verfahrenstechnik (BV), located in Bielefeld, Germany. BV designs, manufactures and sells fluid application equipment for industrial and automotive markets primarily in Germany, and had 1998 sales of approximately \$20 million.

Item 2.

GRACO INC. AND SUBSIDIARIES  
MANAGEMENT'S DISCUSSION AND ANALYSIS OF  
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

- - - - -

Graco's net earnings of \$11.2 million for the quarter ended March 26, 1999 increased 25 percent from first quarter 1998 earnings of \$8.9 million. Diluted earnings per share of \$0.54 for the quarter were up 59 percent over diluted earnings per share of \$0.34 in the first quarter of 1998. The quarterly performance was driven by reduced expenses and improved gross profit margins, offset by increased interest expense and reduced sales. Diluted earnings per share were higher due to higher earnings and the repurchase of 5.8 million common shares of the Company's common stock during the third quarter of 1998.

The following table sets forth items from the Company's Consolidated Statements of Earnings as percentages of net sales:

	Three Months (13 weeks) Ended	
	March 26, 1999	March 27, 1998
Net Sales	100.0%	100.0%
Cost of products sold	48.8	50.9
Product development	4.6	4.5
Selling, marketing and distribution	18.7	21.4
General and administrative	9.2	9.6
Operating Profit	18.7	13.6
Interest expense	2.0	0.2
Other (income) expense, net	0.3	0.3
Earnings Before Income Taxes	16.4	13.1
Income taxes	5.6	4.6
Net Earnings	10.8%	8.5%

Net Sales

Net sales in the first quarter of \$103.2 million were down 2 percent from the first quarter of 1998. Industrial/Automotive Equipment segment sales of \$50.7 million are down 12 percent, due to slow sales in the Americas and Europe in 1999 and strong sales to automotive companies and automotive feeder plants in Europe in 1998. First quarter Contractor Equipment segment sales of \$41.7 million were 12 percent higher than last year due to strong demand in North America. Lubrication Equipment segment sales decreased 1 percent from the first quarter 1998 to \$10.8 million as improved sales in the Americas were offset by lower demand in Europe and in Asia.



Geographically, sales in the Americas increased 4 percent to \$74.7 million for the quarter primarily due to strong Contractor sales. European quarterly sales of \$19.1 million were 18 percent lower than last year due to weak demand in all segments. Asia Pacific sales of \$9.3 million were 11 percent lower than last year's first quarter due to the weak economy's in Japan.

#### Gross Profit

Gross profit as a percentage of net sales improved to 51.2 percent in the first quarter, up 2.1 percentage points from the same period last year. The increase was due to higher margins on automotive products resulting from the switch from custom designed systems to pre-engineered packages, disciplined cost controls, enhanced pricing, and more favorable exchange rates. The weakening of the US dollar has improved gross margins as a greater proportion of the Company's sales are denominated in currencies other than the US dollar than are costs.

#### Operating Expenses

First quarter operating expenses of \$33.6 million decreased 11 percent from the first quarter of 1998. Selling, marketing and distribution expenses were down 15 percent due primarily to restructuring of the Company's industrial and automotive businesses in 1998. General and administrative expenses were down 6 percent, which included the results of the restructuring of the Company's Asia Pacific operations in 1998. Product development costs were \$4.8 million in both the first quarters of 1999 and 1998.

#### Other Income (Expense)

Other expense was \$0.3 million in the first quarter of 1999 and 1998.

#### Income Taxes

The effective tax rate decreased to 34 percent in the first quarter compared to 35 percent for the same period last year.

#### Liquidity and Capital Resources

The Company generated \$12.1 million of cash flow from operating activities in the first three months of 1999, compared to \$13.0 million for the same period last year. Significant uses of operating cash flow in 1999 included the payment of 1998 sales incentives and bonuses and an increase in accounts receivable balances. Available cash was used to fund short-term operating needs and pay \$12.0 million on net borrowings (notes payable and long-term debt). The Company had unused lines of credit available at March 26, 1999 totaling \$63.3 million. The available credit facilities and internally generated funds provide the Company with the financial flexibility to meet liquidity needs.

Year 2000

The Year 2000 issue is the result of computer programs that were written using two digits rather than four to define the applicable year, which could cause potential failure or miscalculation in date-sensitive software that recognizes "00" as 1900 rather than 2000.

The Company is continuing its program, begun in 1996, to ensure that all information technology systems and non-information technology (non-IT) systems will be Year 2000-compliant. The assessment phase of the Year 2000 Project has been completed. It was determined that the Company needed to modify or upgrade most of its mainframe applications, operating systems, network hardware and software and desktop hardware and software. In addition, many non-IT systems required upgrading or replacement in order to ensure proper functioning beyond the year 1999.

The mainframe modification phase involving the conversion of core business applications was completed in July 1998 and the operating systems' upgrades were completed in November 1998. The network and desktop upgrades involving the replacement of certain hardware and software is scheduled to be completed by July 1999. Further testing of all mainframe applications and databases is scheduled to continue through July 1999.

The Company has incurred costs totaling \$5.1 million, including \$0.6 million in 1999, and estimates a total of an additional \$1.7 million to be spent in the remainder of 1999 to resolve Year 2000 issues. These costs are charged to expense as incurred and include software license fees and cost of persons assigned to the project. Incremental costs associated with Year 2000 compliance are not anticipated to result in significant increases in future operating expenses and are not expected to have a material adverse effect on the results of operations, liquidity and capital resources. Existing resources are being redeployed and other projects are being delayed to accommodate Year 2000 related projects. These delays are not expected to have a material adverse impact on future results of operations or financial condition.

Business continuation plans for critical business processes and applications are being developed. These plans include adequate staffing on-site during the Year 2000 date change to quickly repair any errant applications. In addition, in the event of any problems the Company will follow its current computer outage business continuation plans until such problems are corrected.

Approximately 240 non-IT applications were identified at the Company with approximately 64 percent being Year 2000-compliant as of March 1999. Non-IT applications are primarily microprocessors and other electronic controls embedded in non-computer equipment used by the Company. Teams have been assembled to ensure the successful conversion of the remaining systems. These conversions are continuing in 1999.

The Company has a very limited number of products with embedded controls and does not believe there are any Year 2000 compatibility issues with these products. The Company has very few customers whose loss of business would be material to the Company. It is not aware of any Year 2000 issues with these customers that would have a material adverse impact on the Company's results.

The Company is having discussions with, and has sent questionnaires to, its suppliers to assess their Year 2000 readiness. Information will continue to be gathered from key suppliers until July 1999. At that time, the Company will identify alternative suppliers for those key suppliers unable to supply materials due to Year 2000 issues.

Management believes that sufficient resources have been allocated and project plans are in place to avoid any adverse material impact on operations or operating results. However, there can be no guarantee that the Company's systems will be converted in a timely fashion and Year 2000 problems will not have an adverse effect on the Company. The Year 2000 efforts of third parties are not within the Company's control and their failure to respond to Year 2000 issues successfully could result in business disruption and increased operating costs to the Company. At the present time, it is not possible to determine whether any such events are likely to occur, or to quantify any potential impact they may have on the Company's future results of operations and financial condition.

Readers are cautioned that forward-looking statements contained in the Year 2000 Update should be read in conjunction with the company's disclosures under the heading: "SAFE HARBOR CAUTIONARY STATEMENT" below.

#### Outlook

While the Company expects 1999 to be a difficult year for sales growth, it continues to plan for higher sales and strong earnings per share. Management believes the strategic changes made in 1998 and prior years will allow the Company to deliver higher profits in the turbulent international environment.

#### SAFE HARBOR CAUTIONARY STATEMENT

The information in this 10-Q contains "forward-looking statements" about the Company's expectations of the future, which are subject to certain risk factors that could cause actual results to differ materially from those expectations. These factors include economic conditions in the United States and other major world economies, currency exchange fluctuations, the results of the efforts of the Company, its suppliers and customers, to avoid any adverse effect as a result of the Year 2000 issue, and additional factors identified in Exhibit 99 to the Company's Report on Form 10-K for fiscal year 1998.

PART II

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

1999 Corporate and Business Unit Annual  
Bonus Plan Exhibit 10

Form of Stock Option Agreement under the Long  
Term Stock Incentive Plan Dated December 12,  
1997. Exhibit 10.1

Executive Long Term Incentive Agreement between  
the Company and one executive officer dated  
February 22, 1999 Exhibit 10.2

Key Employee Agreement between the Company  
and one executive officer dated March 1, 1999 Exhibit 10.3

Stock Option Agreement. Form of agreement used  
for award of non-incentive stock options to one  
executive officer, dated March 1, 1999. Exhibit 10.4

Statement on Computation Exhibit 11  
of Per Share Earnings

Financial Data Schedule (EDGAR filing only) Exhibit 27

(b) No reports on Form 8-K have been filed during the quarter for  
which this report is filed.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

GRACO INC.

Date: May 7, 1999

By: /s/James A. Earnshaw  
James A. Earnshaw  
Chief Executive Officer

Date: May 7, 1999

By: /s/James A. Graner  
James A. Graner  
Vice President & Controller  
("duly authorized officer")

GRACO INC.

1999 CORPORATE

&

BUSINESS UNIT

ANNUAL BONUS PLAN

Effective January 1, 1999  
Human Resources

1999 EXECUTIVE CORPORATE & SBU BONUS PLAN

Objectives

- -----

- o To create shareholder value through achievement of annual financial objectives.
- o To motivate and retain those key executives and managers who work in positions where they can impact the Company's annual financial objectives.

Plan Design

- -----

The Plan links the size of each individual's award to specific financial objectives. These objectives are tailored for the Corporation and for each Business Unit. These objectives are:

- o Corporation
  - o Corporate Sales and/or Net Earnings objectives
- o Business Units
  - o Sales and/or Contribution Growth objectives

Eligibility Requirements

- -----

Only those positions which carry clear managerial responsibility for directly contributing to Graco's Corporate Sales and/or Net Earnings objective and Business Unit Sales and/or Contribution Growth objectives are eligible to be included in this Plan.

Only those individuals in eligible positions who have demonstrated and are maintaining a performance level that meets the supervisor's normal expectations for that position are eligible for annual participation in this Plan as well as the receipt of any annual Bonus Payments.

Participation  
- -----

The top executive in each organizational unit may nominate managers for participation in this Plan when the established position and individual eligibility requirements have been met.

The Management Organization and Compensation Committee of the Graco Inc. Board of Directors has sole authority to approve the participation of the Chief Executive Officer in the Plan.

The Chief Executive Officer of Graco Inc. has sole authority to select and approve all other Plan participants.

Bonus Maximum  
- -----

Taken in conjunction with base salary market comparisons, bonus maximum for all positions will be:

- o Commensurate with the position's ability to impact the annual Corporate Sales and/or Net Earnings objective and Business Unit Sales and/or Contribution Growth objectives.
- o Consistent with total compensation levels prevalent for similar positions in the market place.

Based on these criteria, bonus maximums ranging from 10% to 80% have been established for each individual.

Bonus Payment  
- -----

The determination of a participant's annual Bonus Payment will be calculated by adding the bonus results attained for Corporate Sales and/or Net Earnings performance (expressed in percent) to the bonus results attained for any applicable Business Unit's Sales and/or Contribution Growth performance (expressed in percent). These bonus results are then multiplied by the participant's Maximum Bonus Percentage and then multiplied by the participant's Base Salary for the Plan Year, to determine the total Bonus Payment.

Example:

- -----		-----					
Annual		Annual		Participant's	Participant's		
Corporate		Business Unit		Maximum	Annual		
Performance	+	Performance		Bonus	x	Base	= Bonus
Results		Results (if		Salary		Salary	
		applicable)		\$		\$	\$
	%	%					
- -----		-----					

1999 EXECUTIVE CORPORATE & SBU BONUS PLAN

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Administration

- -----

The following rules have been established to ensure equitable administration of Graco's Annual Bonus Plan (the Plan):

1. The Plan will be administered by the Management Organization and Compensation Committee of the Board of Directors. The Committee may cancel the Plan and interpret the Plan.
2. The Management Organization and Compensation Committee shall establish the Annual Corporate Bonus Plan financial objectives. Within the basic framework of the Plan, the Chief Executive Officer may establish the annual bonus plan financial objectives for individual Business Units. The CEO may also establish deadlines for filing administrative forms and adopt other administrative rules.

The CEO has established the Bonus Administrative Committee consisting of the CEO, the Director, Human Resources, and the Compensation Manager. This Committee is responsible for making approval recommendations on all Annual Bonus Program administrative matters, such as participation award payments, performance measures, and performance results. All requests for adjustments or exceptions are to be formally submitted to this Committee for review through the Compensation Manager.

3. Key executives and managers selected to participate in the Plan after its annual effective date (January 1st) may be included on a pro-rata basis.
4. Participation in the Plan one year does not necessarily assure participation in subsequent years. Eligibility requirements for both the position and individual performance must be met continually.
5. Participation continues during any paid time off such as short-term disability (up to six months). Participation ceases with retirement, death, or long-term disability (over six months). In the event participation ceases due to retirement, death, or long term disability, the Participant will be eligible for a Bonus Payment, calculated using the Maximum Bonus Percent and Base Salary up to the time of retirement, death, or long-term disability and the annual performance results for the year in which retirement, death, or long-term disability occurs.
6. A participant who transfers to a position (e.g. through job posting or job elimination) that is not eligible for inclusion in the Plan will be eligible for a pro-rata award based on the actual time employed in the eligible position during the year.



Administration (continued)

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If, due to unique skills possessed by a participant, the company requests that the participant accept a transfer to a non-bonus eligible position, the participant will remain on the Plan. The participant's eligibility will be reviewed annually as noted in Administrative Rule #4.

7. A participant must be an employee in good standing on 1/31 of the Plan Year in order to receive a bonus. A participant who resigns or is terminated effective during the Plan Year is ineligible for a bonus.

Participants must maintain satisfactory performance throughout the Plan year in order to be eligible to receive a bonus award payment.

In addition, a participant whose employment termination has been requested due to job elimination, performance or otherwise for cause will be ineligible for a bonus payment even though the participant is still employed at year-end.

8. All matrix calculations will include such effects as those created by foreign exchange gain/loss translation and income tax rate changes.
9. All matrix calculations will be based on actual exchange rates, not plan rates.
10. Acquisitions and divestitures not included in the annual business plan for the Plan Year will be excluded from the Corporate Sales and/or Net Earnings calculations.
11. Significant changes in historical FASB accounting practices or income tax rates will be included in corporate earnings calculations at the discretion of the Management Organization and Compensation Committee of the Board of Directors.
12. Payments will be made by March 15th of the year following each successive Corporate and Business Unit performance year.

These Administrative Rules indicate Graco's intent. Situations may arise which are not specifically covered by these rules and will require the use of judgment and discretion. Final responsibility for interpretation of these Administrative Rules rests solely with the Director, Human Resources.

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1999

Corporate Performance Results and Awards  
for 100% Corporate Participants

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1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.00%
\$46,400	18.75%
\$50,000	37.50%
\$53,550	56.25%
\$57,100	75.00%

=====

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1999 Corporate Sales Results	Percent of Maximum Bonus Award Earned
-----	-----
\$436,000	0.00%
\$449,100	6.25%
\$462,200	12.50%
\$475,250	18.75%
\$488,300	25.00%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

=====

1999

Corporate Performance Results and Awards  
for 50% Corporate Earnings Participants

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1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.0%
\$46,400	12.5%
\$50,000	25.0%
\$53,550	37.5%
\$57,100	50.0%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

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1999

Corporate Performance Results and Awards  
for 30% Corporate Earnings Participants

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1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.0%
\$46,400	7.5%
\$50,000	15.0%
\$53,500	22.5%
\$57,100	30.0%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

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1999

Corporate Performance Results and Awards  
for 25% Corporate Earnings Participants

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1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.00%
\$46,400	6.25%
\$50,000	12.50%
\$53,550	18.75%
\$57,100	25.00%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

=====

1999

Corporate Performance Results and Awards  
for 20% Corporate Earnings Participants

=====

1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.0%
\$46,400	5.0%
\$50,000	10.0%
\$53,550	15.0%
\$57,100	20.0%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

=====

1999

Corporate Performance Results and Awards

for 15% Corporate Earnings Participants

=====

=====

1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.00%
\$46,400	3.75%
\$50,000	7.50%
\$53,550	11.25%
\$57,100	15.00%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

=====

1999

Corporate Performance Results and Awards  
for 10% Corporate Earnings Participants

=====

1999 Corporate Net Earnings Results	Percent of Maximum Bonus Award Earned
-----	-----
\$42,800	0.0%
\$46,400	2.5%
\$50,000	5.0%
\$53,550	7.5%
\$57,100	10.0%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.



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1999

Corporate Performance Results and Awards  
for 10% Corporate Sales Participants

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=====

1999 Corporate Sales Results	Percent of Maximum Bonus Award Earned
-----	-----
\$436,000	0.0%
\$449,100	2.5%
\$462,200	5.0%
\$475,250	7.5%
\$488,300	10.0%

=====

Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

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1999

Corporate Performance Results and Awards

for 5% Corporate Sales Participants

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1999 Corporate Sales Results	Percent of Maximum Bonus Award Earned
-----	-----
\$436,000	0.00%
\$449,100	1.25%
\$462,200	2.50%
\$475,250	3.75%
\$488,300	5.00%

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Note: Calculations exclude acquisitions and divestitures which were not included in the 1999 Annual Business Plan.

STOCK OPTION AGREEMENT  
(NON-ISO)

THIS AGREEMENT, made this \_\_\_\_\_ day of \_\_\_\_\_, 199\_\_\_\_, by and  
between Graco Inc., a Minnesota corporation (the "Company") and  
(the "Employee").

WITNESSETH THAT:

WHEREAS, the Company pursuant to it's Long-Term Incentive Stock Plan wishes to grant this stock option to Employee;

NOW THEREFORE, in consideration of the premises and of the mutual covenants herein contained, the parties hereto hereby agree as follows:

1. Grant of Option  
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The Company hereby grants to Employee, the right and option (hereinafter called the "option") to purchase all or any part of an aggregate of \_\_\_\_\_ shares of Common Stock of the Company, par value \$1.00 per share, at the price of \$ \_\_\_\_\_ per share on the terms and conditions set forth herein.

2. Duration and Exercisability  
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A. This option may not be exercised by Employee until the expiration of two (2) years from the date of grant, and this option shall in all events terminate ten (10) years after the date of grant. During the first two years from the date of grant of this option, no portion of this option may be exercised. Thereafter this option shall become exercisable in four cumulative installments of 25% as follows:

Date ----	Total Portion of Option Which is Exercisable -----
Two Years after Date of Grant	25%
Three Years after Date of Grant	50%
Four Years after Date of Grant	75%
Five Years after Date of Grant	100%

In the event that Employee does not purchase in any one year the full number of shares of Common Stock of the Company to which he/she is entitled under this option, he/she may, subject to the terms and conditions of Section 3 hereof, purchase such shares of Common Stock in any subsequent year during the term of this option.

B. During the lifetime of the Employee, the option shall be exercisable only by him/her and shall not be assignable or transferable by him/her otherwise than by will or the laws of descent and distribution.

3. Effect of Termination of Employment  
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A. In the event that Employee shall cease to be employed by the Company or its subsidiaries for any reason other than his/her gross and willful misconduct, death, retirement (as defined in Section 3. D. below), or disability (as defined in Section 3. D. below), Employee shall have the right to exercise the option at any time within one month after such termination of employment to the extent of the full number of shares he/she was entitled to purchase under the option on the date of termination, subject to the condition that no option shall be exercisable after the expiration of the term of the option.

B. In the event that Employee shall cease to be employed by the

Company or its subsidiaries by reason of his/her gross and willful misconduct during the course of his/her employment, including but not limited to wrongful appropriation of Company funds or the commission of a felony, the option shall be terminated as of the date of the misconduct.

- C. If the Employee shall die while in the employ of the Company or a subsidiary or within one month after termination of employment for any reason other than gross and willful misconduct and shall not have fully exercised the option, all remaining shares shall become immediately exercisable and such option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.
- D. If the Employee's termination of employment is due to retirement (either after attaining age 55 with 10 years of service, or attaining age 65), or due to disability within the meaning of the provisions of the Graco Long-Term Disability Plan subject to the conditions that no option shall be exercisable after the expiration of the terms of the option, all remaining shares shall become immediately exercisable and the option may be exercised by the Employee at any time within three years of the Employee's retirement, subject to the condition that no option shall be exercisable after the expiration of the term of the option. In the event of the death of the Employee within the three-year period after retirement, the option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, to the extent of the full number of shares he/she was entitled to purchase under the option on the date of death, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.

- E. Notwithstanding anything to the contrary contained in this Section 3, if the Employee chooses to terminate his/her employment by retirement (as defined in Section 3. D. above) and has not given the Company written notice, by correspondence to his/her immediate supervisor and the Chief Executive Officer, of said intention to retire not less than six (6) months prior to the date of his/her retirement, then in such event for purposes of this Agreement said termination of employment shall be deemed to be not a retirement but a termination subject to the provisions of Section 3. A. above, provided, however, that in the event that the Chief Executive Officer, in his/her sole discretion and judgement, determines that termination of employment by retirement of the Employee without six (6) months prior written notice is in the best interests of the Company, then such retirement shall be subject to Section 3. D. above.

4. Manner of Exercise  
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- A. The option can be exercised only by Employee or other proper party within the option period delivering written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the option is being exercised and, except as provided in Section 4. C., accompanied by payment-in-full of the option price for all shares designated in the notice.
- B. The Employee may, at Employee's election, pay the option price either by check (bank check, certified check, or personal check) or by delivering to the Company for cancellation shares of Common Stock of the Company with a fair market value equal to the option price. For these purposes, the fair market value of the Company's Common Stock shall be the closing price of the Common Stock on the date of exercise on the New York Stock Exchange (the "NYSE") or on the principal national securities exchange on which such shares are traded if the shares are not then traded on the NYSE. If there is not a quotation available for such day, then the closing price on the next preceding day for which such a quotation exists shall be determinative of fair market value. If the shares are not then traded on an exchange, the fair market value shall be the average of the closing bid and asked prices of the Common Stock as reported by the National Association of Securities Dealers Automated Quotation System. If the Common Stock is not then traded on NASDAQ or on an exchange, then the fair market value shall be determined in such manner as the Company shall deem reasonable.
- C. The Employee may, with the consent of the Company, pay the option price by arranging for the immediate sale of some or all of the shares issued upon exercise of the option by a securities dealer and the payment to the Company by the securities dealer of the option exercise price.

5. Payment of Withholding Taxes  
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Upon exercise of any portion of this option, Employee shall pay to the Company an amount sufficient to satisfy any federal, state, or local withholding tax requirements which arise as a result of the exercise of the option or provide the Company with satisfactory indemnification for such payment.

6. Change of Control  
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A. Notwithstanding Section 2(a) hereof, the entire option shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by its terms. A "Change of Control" means:

- (1) acquisition by any individual, entity, or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act of 1934), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either
  - (a) the then outstanding shares of Common Stock of the Company (the "Outstanding Company Common Stock") or
  - (b) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

provided, however, that the following acquisitions will not result in a Change of Control:

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 6, a Trust Person shall not be deemed to have

beneficial ownership of the Company common stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,

- (v) an acquisition by the Employee or any group that includes the Employee, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of subsection (4) below; and

provided, further, that if any Person's beneficial ownership of the Outstanding Company Common Stock or Outstanding Company Voting Securities is 25% or more as a result of a transaction described in clause (i) or (ii) above, and such Person subsequently acquires beneficial ownership of additional Outstanding Company Common Stock or Outstanding Company Voting Securities as a result of a transaction other than that described in clause (i) or (ii) above, such subsequent acquisition will be treated as an acquisition that causes such Person to own 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities and be deemed a Change of Control; and provided further, that in the event any acquisition or other transaction occurs which results in the beneficial ownership of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities by any Trust Person, the Incumbent Board may by majority vote increase the threshold beneficial ownership percentage to a percentage above 32% for any Trust Person; or

- (2) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or

- (3) The commencement or announcement of an intention to make a tender offer or exchange offer, the consummation of which would result in the beneficial ownership by a Person of 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities; or
- (4) The approval by the shareholders of the Company of a reorganization, merger, consolidation, or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation) excluding, however, such a Business combination pursuant to which
  - (a) all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of common stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets either directly or through one or more subsidiaries) in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,
  - (b) no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of common stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and
  - (c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial Agreement, or of the action of the Board, providing for such Business Combination; or



- (5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

B. A Change of Control shall not be deemed to have occurred with respect to an Employee if:

- (1) the acquisition of the 25% or greater interest referred to in subparagraph A.(1) of this Section 6 is by a group, acting in concert, that includes the Employee or
- (2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding Company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in subsections (4) or (5) of this section by a group, acting in concert, that includes that Employee.

#### 7. Adjustments

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If there shall be any change in the number or character of the Common Stock of the Company through merger, consolidation, reorganization, recapitalization, dividend in the form of stock (of whatever amount), stock split or other change in the corporate structure of the Company, and all or any portion of the option shall then be unexercised and not yet expired, appropriate adjustments in the outstanding option shall be made by the Company, in order to prevent dilution or enlargement of option rights. Such adjustments shall include, where appropriate, changes in the number of shares of Common Stock and the price per share subject to the outstanding option.

#### 8. Miscellaneous

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- A. This option is issued pursuant to the Company's Long-Term Incentive Stock Plan and is subject to its terms. A copy of the Plan has been given to the Employee. The terms of the Plan are also available for inspection during business hours at the principal offices of the Company.
- B. This Agreement shall not confer on Employee any right with respect to continuance of employment by the Company or any of its subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time. Employee shall have none of the rights of a shareholder with respect to shares subject to this option until such shares shall have been issued to him/her upon exercise of this option.

C. The Company shall at all times during the term of the option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed on the day and year first above written.

GRACO INC.

By Its Chief Executive Officer

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Employee

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AMENDMENT AGREEMENT - GRACO EXECUTIVE LONG TERM INCENTIVE AGREEMENT  
(RESTRICTED STOCK AWARD)

Amendment Agreement, entered into this 22nd day of February, 1999, by and between Graco Inc., a Minnesota corporation (the "Company"), and George Aristides ("Mr. Aristides") which amends the Agreement between the parties entitled "Graco Executive Long Term Incentive Agreement (Restricted Stock Award)", dated May 6, 1998 (the "Agreement").

WHEREAS, the Management Organization and Compensation Committee of the Board of Directors and Mr. Aristides have discussed the transition of management leadership of the Company, and have determined that in connection with such transition it may be appropriate for Mr. Aristides to retire from the Company before the end of 1999.

NOW, THEREFORE, the parties hereto agree as follows:

1. Section 2(a) of the Agreement is amended to change the phrase therein "March 31, 2000" to "December 27, 1999", the effect being that the vesting of the shares designated by the Agreement to vest on March 31, 2000 shall vest on December 27, 1999.
2. This Amendment Agreement fully replaces, and renders null and void, the amendment to the Agreement signed by the parties dated December 11, 1998.

IN WITNESS WHEREOF, the Company and Mr. Aristides have caused this Amendment Agreement to be executed and delivered, all as of the day and year first above written.

George Aristides  
/s/George Aristides

GRACO INC.

By:/s/Robert M. Mattison  
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Robert M. Mattison  
Vice President, General Counsel and Secretary

EXHIBIT A

GRACO INC. KEY EMPLOYEE AGREEMENT

AGREEMENT, by and between Graco Inc., a Minnesota corporation (the "Company") and \_\_\_\_\_ (the "Executive"), dated as of the \_\_\_\_\_ day of \_\_\_\_\_, \_\_\_\_\_.

The Board of Directors of the Company (the "Board"), has determined that it is in the best interests of the Company and its shareholders to assure that the Company will have the continued dedication of the Executive, notwithstanding the possibility, threat or occurrence of a Change of Control (as defined in Section 2 below) of the Company. The Board believes it is imperative to diminish the inevitable distraction of the Executive by virtue of the personal uncertainties and risks created by a pending or threatened Change of Control, to encourage the Executive's full attention and dedication to the Company currently and in the event of any threatened or pending Change of Control, to provide inducement for the Executive to remain an employee of the Company in the event of any threatened or pending Change of Control, and to facilitate an orderly transition in the event of a Change of Control. Therefore, in order to accomplish these objectives, the Board has caused the Company to enter into this Agreement.

NOW, THEREFORE, IT IS HEREBY AGREED AS FOLLOWS:

1. Certain Definitions: "Effective Date;" "Change of Control Period;" "Company;" "Affiliated Companies."
  - (a) The "Effective Date" shall mean the first date during the Change of Control Period (as defined in Section 1(b)) on which a Change of Control (as defined in Section 2) occurs. Anything in this Agreement to the contrary notwithstanding, if a Change of Control occurs and if the Executive's employment with the Company is terminated prior to the date on which the Change of Control occurs, and if it is reasonably demonstrated by the Executive that such termination of employment (i) was at the request of a third party who has taken steps reasonably calculated to effect the Change of Control or (ii) otherwise arose in connection with or anticipation of the Change of Control, then for all purposes of this Agreement the "Effective Date" shall mean the date immediately prior to the date of such termination of employment.
  - (b) The "Change of Control Period" shall mean the period commencing on the date hereof and ending on the second anniversary of such date, provided, however, that commencing on the date one year after the date hereof, and on each annual anniversary of such date (such date and each annual anniversary thereof shall be hereinafter referred to as the "Renewal Date"), the Change of Control Period shall be automatically extended so as to terminate two years from such Renewal Date, unless at least 60 days prior to the Renewal Date the Company shall give notice to the Executive that the Change of Control Period shall not be so extended.
  - (c) The "Company" shall mean the Company as hereinbefore defined and any successor to its business and/or assets which assumes or agrees to perform this Agreement by operation of law or otherwise.
  - (d) As used in this Agreement, the term "affiliated companies" shall include any company controlled by, controlling or under common control with the Company.
2. Change of Control. For the purpose of this Agreement
  - (a) A "Change of Control" means:
    - (i) acquisition by any individual, entity or group (within the meaning of Section 13(d) (3) or 14(d) (2) of the Exchange Act of 1934), (a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either
      - A. the then outstanding shares of Common Stock of the Company (the "Outstanding Company Common Stock") or
      - B. the combined voting power of the then outstanding

voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

provided, however, that the following acquisitions will not result in a Change of Control:

- (1) an acquisition directly from the Company,
- (2) an acquisition by the Company,
- (3) an acquisition by any employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (4) an acquisition by any Person who is deemed to have beneficial ownership of the Company common stock or other Company voting securities owned immediately after said acquisition by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 2, a Trust Person shall not be deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including without limitation the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (5) an acquisition by the Executive or any group that includes the Executive, or
- (6) an acquisition by any corporation pursuant to a transaction that complies with clauses (A), (B) and (C) of Section 2 (a)(iii) below; and

provided, further, that if any Person's beneficial ownership of the Outstanding Company Common Stock or Outstanding Company Voting Securities is 25% or more as a result of a transaction described in clause (1) or (2) above, and such Person subsequently acquires beneficial ownership of additional Outstanding Company Common Stock or Outstanding Company Voting Securities as a result of a transaction other than that described in clause (1) or (2) above, such subsequent acquisition will be treated as an acquisition that causes such Person to own 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities and be deemed a Change of Control; and provided further, that in the event any acquisition or other transaction occurs which results in the beneficial ownership of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities by any Trust Person, the Incumbent Board may by majority vote increase the threshold beneficial ownership percentage to a percentage above 32% for any Trust Person; or

- (ii) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board, or
- (iii) The approval by the shareholders of the Company of a reorganization, merger, consolidation or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or

substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation); excluding, however, such a Business Combination pursuant to which

A. all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of common stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets either directly or through one or more subsidiaries) in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,

B. no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of common stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and

C. at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

(iv) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

3. Employment Period. For purposes of this Agreement, the term "Employment Period" shall mean the period commencing on the Effective Date and ending on the earlier of (i) the termination by the Company or the Executive of the Executive's employment with the Company, or (ii) the second anniversary of the Effective Date." As provided in Section 10(f), nothing stated in this Agreement shall restrict the right of the Company or the Executive at any time to terminate the Executive's employment with the Company, subject to the obligations of the Company provided for in this Agreement in the event of such termination.

4. Terms of Employment.

(a) Position and Duties.

(i) During the Employment Period, (A) the Executive's position (including offices and titles), duties and responsibilities shall be at least commensurate in all material respects with the most significant of those held, exercised and assigned at any time during the 90-day period immediately preceding the Effective Date and (B) the Executive's services shall be performed at the location where the Executive was employed immediately preceding the Effective Date or any office or location less than 50 miles from such location.

(ii) Except as otherwise expressly provided in this Agreement, during the Employment Period, and excluding any periods of vacation and sick leave to which the Executive is entitled, the Executive agrees to devote reasonable attention and time during normal business hours to the business and affairs of the Company. During the Employment Period it shall not be a violation of this Agreement for the Executive to (A) serve on corporate, civic or charitable boards or committees, (B) deliver lectures, fulfill speaking engagements or teach at educational institutions and (C)

manage personal investments, so long as such activities do not significantly interfere with the performance of the Executive's responsibilities as an employee of the Company in accordance with this Agreement. To the extent that any such activities have been conducted by the Executive prior to the Effective Date, the continued conduct of such activities (or the conduct of activities similar in nature and scope thereto) subsequent to the Effective Date shall not thereafter be deemed to interfere with the performance of the Executive's responsibilities to the Company.

(b) Compensation.

- (i) Base Salary. During the Employment Period, the Executive shall receive an annual base salary ("Annual Base Salary") which shall be paid at a monthly rate, at least equal to twelve times the highest monthly base salary paid or payable to the Executive by the Company and its affiliated companies in respect of the twelve-month period immediately preceding the month in which the Effective Date occurs. During the Employment Period, the Annual Base Salary shall be reviewed at least annually and shall be increased at any time and from time to time as shall be substantially consistent with increases in base salary generally awarded in the ordinary course of business to other peer executives of the Company. The term Annual Base Salary as used in this Agreement shall refer to Annual Base Salary as so increased. The Executive's Annual Base Salary shall not be reduced after any such increase. Any increase in Annual Base Salary shall not serve to limit or reduce any other obligation to the Executive under this Agreement.
- (ii) Annual Incentive Payments. In addition to Annual Base Salary, the Executive shall be awarded, for each fiscal year during the Employment Period, an annual bonus ("Annual Bonus") in cash, in accordance with the Company's Annual Bonus Plan, or other plan instituted in lieu of the Annual Bonus Plan which provides for an annual incentive payment in addition to Annual Base Salary ("Substitute Plan"). The Executive shall participate in the Annual Bonus Plan or Substitute Plan at the same level at which the Executive participated immediately prior to the Effective Date, or if more favorable, at the level of other peer executives of the Company and its affiliated companies. Any Substitute Plan instituted by the Company after the Effective Date shall be at least as favorable, in the aggregate, as the most favorable Annual Bonus Plan or Substitute Plan in effect at any time during the 90-day period immediately preceding the Effective Date.
- (iii) Savings and Retirement Plans. During the Employment Period, the Executive shall be entitled to participate in all savings and retirement plans, practices, policies and programs applicable generally to other peer executives of the Company and its affiliated companies, but in no event shall such plans, practices, policies and programs provide the Executive with savings opportunities and retirement benefit opportunities, in each case, less favorable, in the aggregate, than the most favorable of those provided by the Company and its affiliated companies for the Executive under such plans, practices, policies and programs as in effect at anytime during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, those provided generally at any time after the Effective Date to other peer executives of the Company and its affiliated companies.
- (iv) Welfare Benefit Plans. During the Employment Period, the Executive and/or the Executive's family, as the case maybe, shall be eligible for participation in and shall receive all benefits under welfare benefit plans, practices, policies and programs provided by the Company and its affiliated companies (including, without limitation, medical, prescription, dental, disability, salary continuance, employee life, group life, accidental death and travel accident insurance plans and programs) to the extent applicable generally to other peer executives of the Company and its affiliated companies, but in no event shall such plans, practices, policies and programs provide the Executive with benefits which are less favorable,, in the aggregate, than the most favorable of such plans, practices, policies and programs in effect for the Executive at anytime during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, those provided generally at any time after the Effective Date to other peer executives of the Company and its affiliated companies.

- (v) Expenses. During the Employment Period, the Executive shall be entitled to receive prompt reimbursement for all reasonable expenses incurred by the Executive in accordance with the most favorable policies, practices and procedures of the Company and its affiliated companies in effect for the Executive at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer executives of the Company and its affiliated companies.
- (vi) Perquisites. During the Employment Period, the Executive shall be entitled to perquisites in accordance with the most favorable plans, practices, programs and policies of the Company and its affiliated companies in effect for the Executive at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer executives of the Company and its affiliated companies.
- (vii) Office and Support Staff. During the Employment Period, the Executive shall be entitled to an office or offices of a size and with furnishings and other appointments, and to secretarial and other assistance, at least equal to the most favorable of the foregoing provided to the Executive by the Company at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as provided generally at any time thereafter with respect to other peer executives of the Company.
- (viii) Vacation. During the Employment Period, the Executive shall be entitled to paid vacations in accordance with the most favorable plans, policies, programs and practices of the Company and its affiliated companies as in effect for the Executive at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer Executives of the Company and its affiliated companies.

## 5. Termination of Employment.

- (a) Death or Disability. The Executive's employment shall terminate automatically upon the Executive's death during the Employment Period. If the Company determines in good faith that the Disability of the Executive has occurred during the Employment Period (pursuant to the definition of Disability set forth below), it may give to the Executive written notice in accordance with Section 10(b) of this Agreement of its intention to terminate the Executive's employment. In such event, the Executive's employment with the Company shall terminate effective on the 30th day after receipt of such notice by the Executive (the "Disability Effective Date"), provided that, within the 30 days after such receipt, the Executive shall not have returned to full-time performance of the Executive's duties. For purposes of this Agreement, "Disability" shall mean the absence of the Executive from the Executive's duties with the Company on a full-time basis for 180 consecutive days as a result of incapacity due to mental or physical illness which is determined to be total and permanent by a physician selected by the Company or its insurers and acceptable to the Executive or the Executive's legal representative (such agreement as to acceptability not to be withheld unreasonably).
- (b) Cause. The Company may terminate the Executive's employment during the Employment Period for Cause. For purposes of this Agreement, "Cause" shall mean (i) repeated violations by the Executive of the Executive's obligations under Section 4(a) of this Agreement (other than as a result of incapacity due to physical or mental illness) which are demonstrably willful and deliberate on the Executive's part, which are committed in bad faith or without the belief on the part of the Executive that such violations are in the best interests of the Company and which are not remedied in a reasonable period of time after receipt of written notice from the Company specifying such violations or (ii) the conviction of the Executive of a felony involving moral turpitude.
- (c) Good Reason. The Executive's employment may be terminated by the Executive for Good Reason. For purposes of this Agreement, "Good Reason" shall mean:
  - (i) the assignment to the Executive of any duties materially inconsistent in any respect with the Executive's position (including offices and titles), duties or responsibilities as



contemplated by Section 4(a) of this Agreement, or any other action by the Company which results in a material diminution in such position, duties or responsibilities, excluding for this purpose an isolated, insubstantial and inadvertent action not taken in bad faith and which is remedied by the Company promptly after receipt of notice thereof given by the Executive;

- (ii) any failure by the Company to comply with any of the provisions of Section 4(b) of this Agreement, other than an isolated, insubstantial and inadvertent failure not occurring in bad faith and which is remedied by the Company promptly after receipt of notice thereof given by the Executive;
- (iii) the Company's requiring the Executive to be based at any office or location other than that described in Section 4(a)(i)(B) hereof or the Company's requiring the Executive to travel on Company business to a substantially greater extent than required immediately prior to the Effective Date;
- (iv) any purported termination by the Company of the Executive's employment otherwise than as expressly permitted by this Agreement; or
- (v) any failure by the Company to comply with and satisfy Section 9(c) of this Agreement.

For purposes of this Section 5(c), any good faith determination of "Good Reason" made by the Executive shall be conclusive.

- (d) Notice of Termination. Any termination by the Company for Cause, or by the Executive for Good Reason, shall be communicated by Notice of Termination to the other party hereto given in accordance with Section 10(b) of this Agreement. For purposes of this Agreement, a "Notice of Termination" means a written notice which (i) indicates the specific termination provision in this Agreement relied upon, (ii) to the extent applicable, sets forth in reasonable detail the facts and circumstances claimed to provide a basis for termination of the Executive's employment under the provision so indicated and (iii) if the Date of Termination (as defined below) is other than the date of receipt of such notice, specifies the termination date (which date shall be not more than fifteen days after the giving of such notice). The failure by the Executive or the Company to set forth in the Notice of Termination any fact or circumstance which contributes to a showing of Good Reason or Cause shall not waive any right of the Executive or the Company hereunder or preclude the Executive or the Company from asserting such fact or circumstance in enforcing the Executive's or the Company's rights hereunder.
- (e) Date of Termination. "Date of Termination" means (i) if the Executive's employment is terminated by the Company for Cause, or by the Executive for Good Reason, the date of receipt of the Notice of Termination or any later date specified therein, as the case may be, (ii) if the Executive's employment is terminated by the Company other than for Cause or Disability or death, the Date of Termination shall be the date on which the Company notifies the Executive of such termination and (iii) if the Executive's employment is terminated by reason of death or Disability, the Date of Termination shall be the date of death of the Executive or the Disability Effective Date, as the case may be.

## 6. Obligations of the Company upon Termination.

- (a) Good Reason; Other Than for Cause, Death or Disability. If, within two years after the Effective Date, the Company shall terminate the Executive's employment other than for Cause, death or Disability, or the Executive shall terminate employment for Good Reason, in lieu of further payments pursuant to Section 4(b) with respect to periods following the Date of Termination:
  - (i) except as provided in Section 6(e) below, the Company shall pay to the Executive, in a lump sum in cash, within 30 days (except as provided in subsection 6(a)(i)A below) after the Date of Termination, the aggregate of the following amounts (such aggregate shall be hereinafter referred to as the "Special Termination Amount"):
    - A. the sum of (1) the Executive's Annual Base Salary through the Date of Termination to the extent not theretofore paid, and, (2) the product of (x) the higher of (I) the midpoint between the minimum and the maximum bonus payment under the Annual Bonus Plan or Substitute Plan applicable to the

Executive for the fiscal year in which the Date of Termination occurs, or (II) the amount that would be payable to the Executive for the fiscal year in which the Date of Termination occurs under the Annual Bonus Plan or Substitute Plan had the termination not so occurred (which amount shall be payable pursuant to this clause 2 within 30 days after it is calculated), and (y) a fraction, the numerator of which is the number of days in the current fiscal year through the Date of Termination, and the denominator of which is 365 (the sum of the amounts described in clauses (1) and (2) shall be hereinafter referred to as the "Accrued Obligations"); and

B. the amount equal to the product of (1) two and (2) the sum of (x) the Executive's Annual Base Salary and (y) the midpoint between the maximum and minimum bonus payment applicable to the Executive for the fiscal year in which the Date of Termination occurs under the Annual Bonus Plan or Substitute Plan; and

(ii) for two years following the Date of Termination or such longer period as any plan, program, practice or policy may provide, the Company shall continue benefits to the Executive and/or the Executive's family at least equal to those which would have been provided to them in accordance with the plans programs, practices and policies described in Section 4(b)(iv) of this Agreement if the Executive's employment had not been terminated, in accordance with the most favorable plans, practices, programs or policies of the Company and its affiliated companies applicable generally to other peer executives and their families during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive, as in effect generally at any time thereafter with respect to other peer executives of the Company and its affiliated companies and their families, provided, however, that if the Executive becomes re-employed with another employer and is eligible to receive medical or disability welfare benefits under another employer provided plan, the medical and disability welfare benefits described herein shall cease upon the Executive and the Executive's family becoming eligible under such other plan. For purposes of determining eligibility of the Executive for retiree benefits pursuant to such plans, practices, programs and policies, the Executive shall be considered to have remained employed until two years after the Date of Termination and to have retired two years after the Date of Termination.

(b) Death. If the Executive's employment is terminated by reason of the Executive's death within two years after the Effective Date, this Agreement shall terminate without further obligations to the Executive's legal representatives under this Agreement, other than for payment of the Accrued Obligations. The Accrued Obligations shall be paid to the Executive's estate or beneficiary, as applicable, in a lump sum in cash within 30 days of the Date of Termination, or as otherwise provided in Section 6(a)(i)(A). In addition, the Executive's family shall be entitled to receive benefits at least equal to the most favorable benefits provided by the Company and any of its affiliated companies to surviving families of deceased peer executives of the Company and such affiliated companies under such plans, programs, practices and policies relating to family death benefits, if any, as in effect with respect to other deceased peer executives and their families at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive and/or the Executive's family, as in effect on the date of the Executive's death with respect to other deceased peer executives of the Company and its affiliated companies and their families.

(c) Disability. If the Executive's employment is terminated by reason of the Executive's Disability within two years after the Effective Date, this Agreement shall terminate without further obligations to the Executive, other than for payment of the Accrued Obligations. The Accrued Obligations shall be paid to the Executive in a lump sum in cash within 30 days of the Date of Termination or as otherwise provided in Section 6(a)(i)(A). In addition, the Executive shall be entitled after the Disability Effective Date to receive disability and other benefits at least equal to the most favorable of those generally provided by the Company and its affiliated companies to disabled executives and/or their families in accordance with such plans, programs, practices, and policies relating to disability, if any, as in effect generally with respect to other disabled peer executives and their families at any time during the 90-day period immediately preceding the Effective Date or, if more favorable to the Executive and/or the Executive's family, as in effect at any time thereafter

generally with respect to other disabled peer executives of the Company and its affiliated companies and their families.

(d) Cause; Other than for Good Reason. If the Executive's employment shall be terminated for Cause within two years after the Effective Date, this Agreement shall terminate without further obligations to the Executive other than the obligation to pay to the Executive Annual Base Salary through the Date of Termination plus the amount of any compensation previously deferred by the Executive, in each case to the extent theretofore unpaid. If the Executive voluntarily terminates employment within two years after the Effective Date, excluding a termination for Good Reason, this Agreement shall terminate without further obligations to the Executive, other than Annual Base Salary through the Date of Termination plus the amount of any compensation previously deferred by the Executive, in each case to the extent theretofore unpaid, and any payment that may be due under the terms of the Annual Bonus Plan or any Successor Plan. In such case, all such amounts shall be paid to the Executive in a lump sum in cash within 30 days of the Date of Termination or, in the case of any payment under the Annual Bonus Plan or any Successor Plan, pursuant to the terms thereof.

(e) Possible Payment Reduction.

(i) Notwithstanding any provision to the contrary contained in this Agreement, if the lump sum cash payment due and the other benefits to which the Executive shall become entitled under Section 6(a) hereof, either alone or together with other payments in the nature of compensation to the Executive which are contingent on a change in the ownership or effective control of the Company or in the ownership of a substantial portion of the assets of the Company or otherwise, would constitute a "parachute payment" (as defined in Section 280G of the Internal Revenue Code of 1986, as amended (the "Code") or any successor provision thereto), such lump sum payment shall be reduced (but not below zero) to the largest aggregate amount as will result in no portion thereof being subject to the excise tax imposed under Section 4999 of the Code (or any successor provision thereto) or being non-deductible to the Company for Federal Income Tax purposes pursuant to Section 280G of the Code (or any successor provision thereto), provided, however, that no such reduction shall occur, and this Section 6(e) shall not apply, in the event that the amount of such reduction would be more than \$25,000. The Executive in good faith shall determine the amount of any reduction to be made pursuant to this Section 6(e) and shall select from among the foregoing benefits and payments those which shall be reduced. No modification of, or successor provision to, Section 280G or Section 4999 subsequent to the date of this Agreement shall, however, reduce the benefits to which the Executive would be entitled under this Agreement in the absence of this Section 6(e) to a greater extent than they would have been reduced if Section 280G and Section 4999 had not been modified or superseded subsequent to the date of this Agreement, notwithstanding anything to the contrary provided in the first sentence of this Section 6(e) (i).

(f) Certain Additional Payments by the Company.

(i) Anything in this Agreement to the contrary notwithstanding, in the event it shall be determined that Section 6(e) above does not apply and any payment or distribution by the Company to or for the benefit of the Executive (whether paid or payable or distributed or distributable pursuant to the terms of this Agreement, any stock option, restricted stock agreement or otherwise, but determined without regard to any additional payments required under this Section 16(f)) (a "Payment") would be subject to the excise tax imposed by Section 4999 of the Internal Revenue Code of 1986, as amended (the "Code") or any interest or penalties are incurred by the Executive with respect to such excise tax (such excise tax, together with any such interest and penalties, are hereinafter collectively referred to as the "Excise Tax"), then the Executive shall be entitled to receive an additional payment (a "Gross-Up Payment") in an amount such that after payment by the Executive of all taxes (including any interest or penalties imposed with respect to such taxes), including, without limitation, any income taxes (and any interest and penalties imposed with respect thereto) and Excise Tax imposed upon the Gross-Up Payment, the Executive retains an amount of the Gross-Up Payment equal to the Excise Tax imposed upon the Payments.

(ii) Subject to the provisions of Section 6(f)(iii), all determinations required to be made under this Section 6(f), including whether and when a Gross-Up Payment is required and the amount of such Gross-Up Payment and the assumptions to be utilized in arriving at such determination, shall be made by Deloitte and Touche LLP or such other certified public accounting firm as may be designated by the Executive (the "Accounting Firm") which shall provide detailed supporting calculations both to the Company and the Executive within 15 business days of the receipt of notice from the Executive that there has been a Payment, or such earlier time as is requested by the Company. In the event that the Accounting Firm is serving as accountant or auditor for the individual, entity or group effecting the Change of Control, the Executive shall appoint another nationally recognized accounting firm to make the determinations required hereunder (which accounting firm shall then be referred to as the Accounting Firm hereunder). All fees and expenses of the Accounting Firm shall be borne solely by the Company. Any Gross-Up Payment, as determined pursuant to this Section 6(f), shall be paid by the Company to the Executive within five days of the receipt of the Accounting Firm's determination. If the Accounting Firm determines that no Excise Tax is payable by the Executive, it shall furnish the Executive with a written opinion that failure to report the Excise Tax on the Executive's applicable federal income tax return would not result in the imposition of a negligence or similar penalty. Any determination by the Accounting Firm shall be binding upon the Company and the Executive. As a result of the uncertainty in the application of Section 4999 of the Code at the time of the initial determination by the Accounting Firm hereunder, it is possible that Gross-Up Payments which will not have been made by the Company should have been made ("Underpayment"), consistent with the calculations required to be made hereunder. In the event that the Company exhausts its remedies pursuant to Section 6(f)(iii) and the Executive thereafter is required to make a payment of any Excise Tax, the Accounting Firm shall determine the amount of the Underpayment that has occurred and any such Underpayment shall be promptly paid by the Company to or for the benefit of the Executive.

(iii) The Executive shall notify the Company in writing of any claim by the Internal Revenue Service that, if successful, would require the payment by the Company of the Gross-Up Payment. Such notification shall be given as soon as practicable but no later than ten business days after the Executive is informed in writing of such claim (provided that any delay in so informing the Company within such ten business day period shall not affect the obligations of the Company under this Section 6(f) except to the extent that such delay materially and adversely affects the Company) and shall apprise the Company of the nature of such claim and the date on which such claim is requested to be paid. The Executive shall not pay such claim prior to the expiration of the 30-day period following the date on which it gives such notice to the Company (or such shorter period ending on the date that any payment of taxes with respect to such claim is due). If the Company notifies the Executive in writing prior to the expiration of such period that it desires to contest such claim, the Executive shall:

- (A) give the Company any information reasonably requested by the Company relating to such claim,
- (B) take such action in connection with contesting such claim as the Company shall reasonably request in writing from time to time, including, without limitation, accepting legal representation with respect to such claim by an attorney reasonably selected by the Company,
- (C) cooperate with the Company in good faith in order to effectively contest such claim, and
- (D) permit the Company to participate in any proceedings relating to such claim;

provided, however, that the Company shall bear and pay directly all costs and expenses (including additional interest and penalties) incurred in connection with such contest and shall indemnify and hold the Executive harmless, on an after-tax basis, for any Excise Tax or income tax (including interest and penalties with respect thereto) imposed as a result of such representation and payment of costs and expenses. Without limitation on the foregoing provisions of this Section 6(f)(iii), the Company shall control all proceedings taken in connection with such contest and, at its sole option, may pursue or forgo any and all administrative appeals, proceedings, hearings and conferences with the taxing authority in respect of such claim

and may, at its sole option, either direct the Executive to pay the tax claimed and sue for a refund or contest the claim in any permissible manner, and the Executive agrees to prosecute such contest to a determination before any administrative tribunal, in a court of initial jurisdiction and in one or more appellate courts, as the Company shall determine; provided, however, that if the Company directs the Executive to pay such claim and sue for a refund, the Company shall advance the amount of such payment to the Executive, on an interest-free basis, and shall indemnify and hold the Executive harmless, on an after-tax basis, from any Excise Tax or income tax (including interest or penalties with respect thereto) imposed with respect to such advance or with respect to any imputed income with respect to such advance; and further provided that any extension of the statute of limitations relating to payment of taxes for the taxable year of the Executive with respect to which such contested amount is claimed to be due is limited solely to such contested amount. Furthermore, the Company's control of the contest shall be limited to issues with respect to which a Gross-Up Payment would be payable hereunder and the Executive shall be entitled to settle or contest, as the case may be, any other issue raised by the Internal Revenue Service or any other taxing authority.

(iv) If, after the receipt by the Executive of an amount advanced by the Company pursuant to Section 6(f)(iii), the Executive becomes entitled to receive any refund with respect to such claim, the Executive shall (subject to the Company's complying with the requirements of Section 6(f)(iii)) promptly pay to the Company the amount of such refund (together with any interest paid or credited thereon after taxes applicable thereto). If, after the receipt by the Executive of an amount advanced by the Company pursuant to Section 6(f)(iii), a determination is made that the Executive shall not be entitled to any refund with respect to such claim and the Company does not notify the Executive in writing of its intent to contest such denial of refund prior to the expiration of 30 days after such determination, then such advance shall be forgiven and shall not be required to be repaid and the amount of such advance shall offset, to the extent thereof, the amount of Gross-Up Payment required to be paid.

7. Non-exclusivity of Rights. Nothing in this Agreement shall prevent or limit the Executive's continuing or future participation in any plan, program, policy or practice provided by the Company or any of its affiliated companies and for which the Executive may qualify, nor shall anything herein limit or otherwise affect such rights as the Executive may have under any contract or agreement with the Company or any of its affiliated companies. Amounts which are vested benefits or which the Executive is otherwise entitled to receive under any plan, policy, practice or program of or any contract or agreement with the Company or any of its affiliated companies at or subsequent to the Date of Termination shall be payable in accordance with such plan, policy, practice or program or contract or agreement except as explicitly modified by this Agreement.

8. Full Settlement; No Mitigation; Legal Fees. The Company's obligation to make the payments provided for in this Agreement and otherwise to perform its obligations hereunder shall not be affected by any set-off, counterclaim, recoupment, defense or other claim, right or action which the Company may have against the Executive or others. In no event shall the Executive be obligated to seek other employment or take any other action by way of mitigation of the amounts payable to the Executive under any of the provisions of this Agreement and such amounts shall not be reduced whether or not the Executive obtains other employment. The Company agrees to pay, to the full extent permitted by law, all legal fees and expenses which the Executive may reasonably incur as a result of any contest (regardless of the outcome thereof) by the Company, the Executive or others of the validity or enforceability of, or liability under, any provision of this Agreement or any guarantee of performance thereof (including as a result of any contest by the Executive about the amount of any payment pursuant to this Agreement), plus in each case interest on any delayed payment at the applicable Federal rate provided for in Section 7872(f)(2)(A) of the Internal Revenue Code of 1986, as amended (the "Code").

9. Successors.

(a) This Agreement is personal to the Executive and without the prior written consent of the Company shall not be assignable by the

Executive otherwise than by will or the laws of descent and distribution. This Agreement shall inure to the benefit of and be enforceable by the Executive's legal representatives.

- (b) This Agreement shall inure to the benefit of and be binding upon the Company and its successors and assigns.
- (c) The Company will require any successor (whether direct or indirect, by purchase, merger, consolidation or otherwise) to all or substantially all of the business and/or assets of the Company to assume expressly and agree to perform this Agreement in the same manner and to the same extent that the Company would be required to perform it if no such succession had taken place.

10. Miscellaneous.

- (a) This Agreement shall be governed by and construed in accordance with the laws of the State of Minnesota, without reference to principles of conflict of laws. The captions of this Agreement are not part of the provisions hereof and shall have no force or effect. This Agreement may not be amended or modified otherwise than by a written agreement executed by the parties hereto or their respective successors and legal representatives.
- (b) All notices and other communications hereunder shall be in writing and shall be given by hand delivery to the other party or by registered or certified mail, return receipt requested, postage prepaid, addressed as follows:

If to the Executive:

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If to the Company:

Graco Inc.  
4050 Olson Memorial Highway  
Golden Valley, MN 55422  
Attention: Vice President, Human Resources

or to such other address as either party shall have furnished to the other in writing in accordance herewith. Notice and communications shall be effective when actually received by the addressee.

- (c) The invalidity or unenforceability of any provision of this Agreement shall not affect the validity or enforceability of any other provision of this Agreement.
- (d) The Company may withhold from any amounts payable under this Agreement such Federal, state or local taxes as shall be required to be withheld pursuant to any applicable law or regulation.
- (e) The Executive's or the Company's failure to insist upon strict compliance with any provision hereof or any other provision of this Agreement or the failure to assert any right the Executive or the Company may have hereunder, including, without limitation, the right of the Executive to terminate employment for Good Reason pursuant to Section 5(c)(i)(v) of this Agreement, shall not be deemed to be a waiver of such provision or right or any other provision or right of this Agreement.
- (f) The Executive and the Company acknowledge that, except as may otherwise be provided under any other written agreement between the Executive and the Company, the employment of the Executive by the Company may be terminated by either the Executive or the Company at any time prior to the Effective Date or, subject to the obligations of the Company provided for in this Agreement in the event of a termination after the Effective Date, at anytime on or after the Effective Date. Moreover, if prior to the

Effective Date, the Executive's employment with the Company terminates, then the Executive shall have no further rights under this Agreement. From and after the Effective Date, this Agreement shall supersede any other agreement between the parties with respect to the subject matter hereof.

IN WITNESS WHEREOF, the Executive has hereunto set the Executive's hand and, pursuant to the authorization from its Board of Directors, the Company has caused these presents to be executed in its name on its behalf, all as of the day and year first above written.

Executive

Graco Inc.

By

Name

Name and title

STOCK OPTION AGREEMENT  
(NON-ISO)

THIS AGREEMENT, made this \_\_\_\_\_ day of \_\_\_\_\_, 1999, by and between  
-----  
Graco Inc., a Minnesota corporation (the "Company") and James A. Earnshaw (the  
"Employee").

WITNESSETH THAT:

WHEREAS, the Company pursuant to its Long Term Incentive Stock Plan  
wishes to grant this stock option to Employee;

NOW THEREFORE, in consideration of the premises and of the mutual  
covenants herein contained, the parties hereto hereby agree as follows:

1. Grant of Option  
-----

The Company hereby grants to Employee, the right and option  
(hereinafter called the "option") to purchase all or any part of an  
aggregate of 50,000 Common Shares, par value \$1.00 per share, at the  
price of \$ per share on the terms and conditions set forth herein.

2. Duration and Exercisability  
-----

A. Except as otherwise set forth herein, this option may not be  
exercised by Employee until the expiration of two (2) years from  
the date of grant, and this option shall in all events terminate  
ten (10) years after the date of grant. During the first two years  
from the date of grant of this option, no portion of this option  
may be exercised. Thereafter this option shall become exercisable  
in four cumulative installments of 25% as follows:

Date -----	Total Portion of Option Which is Exercisable -----
Two Years after Date of Grant	25%
Three Years after Date of Grant	50%
Four Years after Date of Grant	75%
Five Years after Date of Grant	100%

In the event that Employee does not purchase in any one year the  
full number of shares of Common Stock of the Company to which  
he/she is entitled under this option, he/she may, subject to the  
terms and conditions of Section 3 hereof, purchase such shares of  
Common Stock in any subsequent year during the term of this  
option.

B. During the lifetime of the Employee, the option shall be  
exercisable only by him/her and shall not be assignable or  
transferable by him/her otherwise than by will or the laws of  
descent and distribution.

3. Effect of Termination of Employment  
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A. In the event that Employee shall cease to be employed by the  
Company or its subsidiaries for any reason other than his/her  
gross and willful misconduct (as set forth on subparagraph B  
below), death, retirement (as defined in Section 3(d) below), or  
disability (as defined in Section 3(d) below): (i) If such  
termination is voluntary, or involuntary and occurs after the  
second anniversary of the first day of employment of the Employee  
by the Company, the Employee shall have the right to exercise the  
option at any time within one month after such termination of  
employment to the extent of the full number of shares he/she was  
entitled to purchase under the option on the date of termination,  
subject to the condition that no option shall be exercisable  
after the expiration of the term of the option; (ii) If such  
termination is involuntary and occurs before the second  
anniversary of the first day of employment of the Employee by the  
Company, notwithstanding Section 2(A) hereof, the entire option  
granted hereunder shall become immediately and fully exercisable  
for a period of six (6) months after the date of such



termination.

- B. In the event that Employee shall cease to be employed by the Company or its subsidiaries by reason of his/her gross and willful misconduct during the course of his/her employment, including but not limited to wrongful appropriation of Company funds, violation of Company policy or the commission of a felony, the option shall be terminated as of the date of the misconduct.
- C. If the Employee shall die while in the employ of the Company or a subsidiary or within one month after termination of employment for any reason other than gross and willful misconduct and shall not have fully exercised the option, all remaining shares shall become immediately exercisable and such option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.
- D. If the Employee's termination of employment is due to retirement (either after attaining age 55 with 10 years of service, or attaining age 65, or due to disability within the meaning of the provisions of the Graco Long Term Disability Plan), all remaining shares shall become immediately exercisable and the option may be exercised by the Employee at any time within three years of the employee's retirement, or in the event of the death of the Employee within the three-year period after retirement, the option may be exercised at any time within twelve months after his/her death by the executors or administrators of the Employee or by any person or persons to whom the option is transferred by will or the applicable laws of descent and distribution, to the extent of the full number of shares he/she was entitled to purchase under the option on the date of death, and subject to the condition that no option shall be exercisable after the expiration of the term of the option.

#### 4. Manner of Exercise

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- A. The option can be exercised only by Employee or other proper party within the option period delivering written notice to the Company at its principal office in Minneapolis, Minnesota, stating the number of shares as to which the option is being exercised and, except as provided in Section 4(c), accompanied by payment-in-full of the option price for all shares designated in the notice.
- B. The Employee may, at Employee's election, pay the option price either by check (bank check, certified check, or personal check) or by delivering to the Company for cancellation Common Shares of the Company with a fair market value equal to the option price. For these purposes, the fair market value of the Company's Common Shares shall be the closing price of the Common Shares on the date of exercise on the New York Stock Exchange (the "NYSE") or on the principal national securities exchange on which the shares are traded if the shares are not then traded on the NYSE. If there is not a quotation available for such day, then the closing price on the next preceding day for which such a quotation exists shall be determinative of fair market value. If the shares are not then traded on an exchange, the fair market value shall be the average of the closing bid and asked prices of the Common Shares as reported by the National Association of Securities Dealers Automated Quotation System. If the Common Shares are not then traded on NASDAQ or on an exchange, then the fair market value shall be determined in such manner as the Company shall deem reasonable.
- C. The Employee may, with the consent of the Company, pay the option price by arranging for the immediate sale of some or all of the shares issued upon exercise of the option by a securities dealer and the payment to the Company by the securities dealer of the option exercise price.

#### 5. Payment of Withholding Taxes

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Upon exercise of any portion of this option, Employee shall pay to the Company an amount sufficient to satisfy any federal, state, or local withholding tax requirements which arise as a result of the exercise

of the option or provide the Company with satisfactory indemnification for such payment.

6. Change of Control

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A. Notwithstanding Section 2(a) hereof, the entire option shall become immediately and fully exercisable on the day following a "Change of Control" and shall remain fully exercisable until either exercised or expiring by its terms. A "Change of Control" means:

(1) acquisition by any individual, entity, or group (within the meaning of Section 13(d)(3) or 14(d)(2) of the Exchange Act of 1934),

(a "Person"), of beneficial ownership (within the meaning of Rule 13d-3 under the 1934 Act) which results in the beneficial ownership by such Person of 25% or more of either

(a) the then outstanding shares of Common Stock of the Company (the "Outstanding Company Common Stock") or

(b) the combined voting power of the then outstanding voting securities of the Company entitled to vote generally in the election of directors (the "Outstanding Company Voting Securities");

provided, however, that the following acquisitions will not result in a Change of Control:

- (i) an acquisition directly from the Company,
- (ii) an acquisition by the Company,
- (iii) an acquisition by an employee benefit plan (or related trust) sponsored or maintained by the Company or any corporation controlled by the Company,
- (iv) an acquisition by any Person who is deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by the Trust Under the Will of Clarissa L. Gray ("Trust Person"), provided that such acquisition does not result in the beneficial ownership by such Person of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities, and provided further that for purposes of this Section 6, a Trust Person shall not be deemed to have beneficial ownership of the Company common stock or other Company voting securities owned by The Graco Foundation or any employee benefit plan of the Company, including, without limitations, the Graco Employee Retirement Plan and the Graco Employee Stock Ownership Plan,
- (v) an acquisition by the Employee or any group that includes the Employee, or
- (vi) an acquisition by any corporation pursuant to a transaction that complies with clauses (a), (b), and (c) of subsection (4) below; and

provided, further, that if any Person's beneficial ownership of the Outstanding Company Common Stock or Outstanding Company Voting Securities is 25% or more as a result of a transaction described in clause (i) or (ii) above, and such Person subsequently acquires beneficial ownership of additional Outstanding Company Common Stock or Outstanding Company Voting Securities as a result of a transaction other than that described in clause (i) or (ii) above, such subsequent acquisition will be treated as an acquisition that causes such Person to own 25% or more of the Outstanding Company Common Stock or

Outstanding Company Voting Securities and be deemed a Change of Control; and provided further, that in the event any acquisition or other transaction occurs which results in the beneficial ownership of 32% or more of either the Outstanding Company Common Stock or the Outstanding Company Voting Securities by any Trust Person, the Incumbent Board may by majority vote increase the threshold beneficial ownership percentage to a percentage above 32% for any Trust Person; or

- (2) Individuals who, as of the date hereof, constitute the Board of Directors of the Company (the "Incumbent Board") cease for any reason to constitute at least a majority of said Board; provided, however, that any individual becoming a director subsequent to the date hereof whose election, or nomination for election by the Company's shareholders, was approved by a vote of at least a majority of the directors then comprising the Incumbent Board will be considered as though such individual were a member of the Incumbent Board, but excluding, for this purpose, any such individual whose initial membership on the Board occurs as a result of an actual or threatened election contest with respect to the election or removal of directors or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board; or
- (3) The commencement or announcement of an intention to make a tender offer or exchange offer, the consummation of which would result in the beneficial ownership by a Person of 25% or more of the Outstanding Company Common Stock or Outstanding Company Voting Securities; or
- (4) The approval by the shareholders of the Company of a reorganization, merger, consolidation, or statutory exchange of Outstanding Company Common Stock or Outstanding Company Voting Securities or sale or other disposition of all or substantially all of the assets of the Company ("Business Combination") or, if consummation of such Business Combination is subject, at the time of such approval by stockholders, to the consent of any government or governmental agency, the obtaining of such consent (either explicitly or implicitly by consummation) excluding, however, such a Business combination pursuant to which
  - (a) all or substantially all of the individuals and entities who were the beneficial owners of the Outstanding Company Common Stock or Outstanding Company Voting Securities immediately prior to such Business Combination beneficially own, directly or indirectly, more than 80% of, respectively, the then outstanding shares of common stock and the combined voting power of the then outstanding voting securities entitled to vote generally in the election of directors, as the case may be, of the corporation

resulting from such Business Combination (including, without limitation, a corporation that as a result of such transaction owns the Company or all or substantially all of the Company's assets either directly or through one or more subsidiaries) in substantially the same proportions as their ownership, immediately prior to such Business Combination of the Outstanding Company Common Stock or Outstanding Company Voting Securities,

(b) no Person [excluding any employee benefit plan (or related trust) of the Company or such corporation resulting from such Business Combination] beneficially owns, directly or indirectly, 25% or more of the then outstanding shares of common stock of the corporation resulting from such Business Combination or the combined voting power of the then outstanding voting securities of such corporation except to the extent that such ownership existed prior to the Business Combination, and

(c) at least a majority of the members of the board of directors of the corporation resulting from such Business Combination were members of the Incumbent Board at the time of the execution of the initial agreement, or of the action of the Board, providing for such Business Combination; or

(5) approval by the stockholders of the Company of a complete liquidation or dissolution of the Company.

B. A Change of Control shall not be deemed to have occurred with respect to an Employee if:

(1) the acquisition of the 25% or greater interest referred to in subparagraph A.(1) of this Section 6 is by a group, acting in concert, that includes the Employee or

(2) if at least 25% of the then outstanding common stock or combined voting power of the then outstanding company voting securities (or voting equity interests) of the surviving corporation or of any corporation (or other entity) acquiring all or substantially all of the assets of the Company shall be beneficially owned, directly or indirectly, immediately after a reorganization, merger, consolidation, statutory share exchange, disposition of assets, liquidation or dissolution referred to in subparagraph (4) and (5) of this section by a group, acting in concert, that includes that Employee.

7. Adjustments

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If Employee exercises all or any portion of the option subsequent to any change in the number or character of the Common Shares of the Company (through merger, consolidation, reorganization, recapitalization, stock dividend, or otherwise), Employee shall then receive for the aggregate price paid by him/her on such exercise of the option, the number and type of securities or other consideration which he/she would have received if such option had been exercised prior to the event changing the number or character of outstanding shares.

8. Miscellaneous

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- A. This option is issued pursuant to the Company's Long-Term Incentive Stock Plan and is subject to its terms. A copy of the Plan has been given to the Employee. The terms of the Plan are also available for inspection during business hours at the principal offices of the company.
- B. This Agreement shall not confer on Employee any right with respect to continuance of employment by the Company or any of its subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time. Employee shall have none of the rights of a shareholder with respect to shares subject to this option until such shares shall have been issued to him upon exercise of this option.
- C. The Company shall at all times during the term of the option reserve and keep available such number of shares as will be sufficient to satisfy the requirements of this Agreement.

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed on the day and year first above written.

Employee

Graco Inc.

Name

By

Name and title

## GRACO INC. AND SUBSIDIARIES

## COMPUTATION OF NET EARNINGS PER COMMON SHARE

(Unaudited)

	Thirteen Weeks Ended	
	Mar. 26, 1999	Mar. 27, 1998
Net earnings applicable to common shareholders for basic and diluted earnings per share	\$ 11,201	\$ 8,947
Weighted average shares outstanding for basic earnings per share	20,104	25,635
Dilutive effect of stock options computed using the treasury stock method and the average market price	502	604
Weighted average shares outstanding for diluted earnings per share	20,606	26,239
Basic earnings per share	\$ 0.56	\$ 0.35
Diluted earnings per share	0.54	0.34

This schedule contains summary financial information extracted from Graco Inc. and subsidiaries consolidated balance sheets for the quarterly period ending March 25, 1999 and is qualified in its entirety by reference to such statements.

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GRACO INC.

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U.S. DOLLARS

3-MOS

DEC-31-1999

DEC-25-1998

MAR-25-1999

1

4,204

0

85,562

4,400

34,111

133,175

199,706

105,355

233,572

77,110

107,068

0

0

20,294

1,299

233,572

103,241

103,241

50,384

50,384

33,903

148

1,953

17,001

5,800

11,201

0

0

0

11,201

.56

.54