

## SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-QSB

X Quarterly report pursuant to Section 13 or 15(d)  
of the  
Securities  
Exchange  
Act of

1934

For the quarterly period ended September 30, 1997 or

Transition report pursuant to Section 13 or 15(d) of the  
Securities Exchange Act 1934For the transition period from  
to .

Commission File Number 0-16106

APA Optics, Inc.

(exact name of small business issuer as specified in its  
charter)

Minnesota

41-1347235

(State or other jurisdiction of  
(I.R.S. Employer Identification No.)  
incorporation or organization)

2950 N.E. 84th Lane, Blaine, Minnesota 55449

(Address of principal executive offices and zip code)

Issuer's telephone number, including area code: (612)  
784-4995

Indicate whether the issuer (1) has filed all reports  
required to be filed by Section 13 or 15 (d) of the  
Securities Exchange Act of 1934 during the preceding 12  
months (or for such shorter period that the issuer was  
required to file such reports), and (2) has been subject to  
the filing requirement for the past 90 days.

Yes      X      No

Indicate the number of shares outstanding of each of the  
issuer's classes of common stock, as of the latest  
practicable date:

Class:

Outstanding at September 30, 1997

Common stock, par value \$.01

8,308,124

## PART 1, FINANCIAL INFORMATION

## ITEM 1, FINANCIAL STATEMENTS

APA OPTICS, INC.  
CONDENSED BALANCE SHEETS

ASSETS	September 30 1997	March 31 1997
CURRENT ASSETS:	(Unaudited)	(Audited)
Cash and short-term investments	\$3,167,286	\$3,875,205
Accounts receivable	344,838	355,981

Inventories:			
Raw materials		19,037	15,666
Work-in-process & finished goods		121,740	132,697
Prepaid expenses		13,403	27,408
Bond reserve funds		42,917	70,000
TOTAL CURRENT ASSETS		3,709,221	4,476,957
PROPERTY AND EQUIPMENT, NET		2,577,828	2,107,755
OTHER ASSETS		2,798,728	2,834,686
		\$	\$
		9,085,777	9,419,398
LIABILITIES AND SHAREHOLDERS' EQUITY			
CURRENT LIABILITIES:			
Current portion of long-term debt		\$	\$
Accounts payable		223,021	158,021
Accrued expenses		92,277	59,210
TOTAL CURRENT LIABILITIES		117,167	118,216
		432,465	335,447
LONG-TERM DEBT		3,476,532	3,670,983
SHAREHOLDERS' EQUITY			
Undesignated shares; 5,000,000 shares authorized; none issued		---	---
Common stock, \$.01 par value; 15,000,000 shares authorized; 8,308,124 & 8,306,624 issued		83,081	83,066
Paid-in-capital		8,215,970	8,244,423
Retained earnings (deficit)		(3,122,271)	(2,914,521)
		5,176,780	5,412,968
		\$	\$
		9,085,777	9,419,398

\* Derived from audited financial statements

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APA OPTICS, INC.  
CONDENSED STATEMENTS OF OPERATIONS  
(UNAUDITED)

	Three months ended		Six months ended	
	September 30		September 30	
	1997	1996	1997	
REVENUES	\$	\$	\$	\$1,211,054
	653,385	672,66	1,315,0	

## COSTS AND EXPENSES:

Cost of sales and services	675,651	442,328	1,209,710	799,068
Selling, general & administrative	118,339	157,263	240,398	306,489
Research & development	76,625	117,650	135,054	226,006
	870,615	717,241	1,585,162	1,331,563
Gain/loss from operations:	(217,230)	(44,575)	(270,137)	(120,509)
INTEREST INCOME & EXPENSE:				
Interest income	86,020	94,355	156,148	115,543
Interest expense	(47,306)	(56,293)	(93,162)	(64,814)
	38,714	38,062	62,986	50,729
INCOME (LOSS) BEFORE INCOME TAXES	(178,516)	(6,513)	(207,151)	(69,780)
(BENEFIT)	300	250	600	500
NET INCOME (LOSS)	\$ (178,816)	\$ (6,763)	\$ (207,751)	\$ (70,280)
EARNINGS (LOSS) PER COMMON & COMMON EQUIVALENT SHARE (EXHIBIT 11)	\$ (.02)	\$ (.00)	\$ (.03)	\$ (.01)
WEIGHTED AVERAGE SHARES OUTSTANDING	8,307,831	8,160,736	8,307,384	8,081,197

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APA OPTICS, INC.  
CONDENSED STATEMENTS OF CASH FLOWS  
(UNAUDITED)

Six Months Ended

September 30

1997 1996

## OPERATING ACTIVITIES

Net income (loss) \$ (207,751) \$ (70,280)

Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	213,541	219,768
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	11,143	(418,109)
Decrease in inventories and prepaid expenses	48,674	32,897
Costs in excess of billings on research contracts	---	210,658
Increase in accounts payable and accrued expenses	97,018	16,004
Other	(1,695)	19,682
Net cash provided by operating activities	160,930	10,620
INVESTING ACTIVITIES		
Purchases of property and equipment	(635,614)	(272,505)
Net cash (used in) investing activities	(635,614)	(272,505)
FINANCING ACTIVITIES		
Proceeds from the sale of common stock	3,438	1,281,263
Long-term debt proceeds	---	3,722,483
Earnest money deposit on bond financing	---	(315,000)
Debt placement costs	---	(286,869)
Bond reserve funds	(42,222)	(1,780,269)
Repayment of long-term debt	(194,451)	(116,909)
Net cash provided by (used in) financing activities	(233,235)	2,504,699
Increase (decrease) in cash	(707,919)	2,242,814
Cash at Beginning of Period	3,875,205	2,256,309
Cash at end of Period	\$3,167,286	\$4,499,123
Supplemental schedule of non-cash transactions:		
Land and corresponding deferred revenue	\$ 250,000	\$ 250,000

#### NOTE TO CONDENSED FINANCIAL STATEMENTS

1. In the opinion of management, the information furnished reflects all adjustments which are necessary to a fair statement of the results of the interim periods presented. All adjustments were of a normal recurring nature. The result of any interim period are not necessarily indicative of results for the full year.

Revenues for the second quarter of fiscal 1998 ended September 30, 1997 were \$653,385, a decrease of three percent from the second quarter of fiscal 1997 ended September 30, 1996. The second quarter revenues of fiscal 1998 are also down one percent as compared to the first quarter of fiscal 1998. Revenues for the first two quarters of fiscal 1998 are up nine percent as compared to the first two quarters of fiscal 1997. The slight change in revenues can be attributed to work shifted from government contracts to internal research and development. The Company continues to devote personnel toward product development associated with the Aberdeen facility.

For the second quarter of fiscal 1998, the Company is reporting a loss of \$178,816 as compared to a loss of \$6,763 in the second quarter of fiscal 1997. For the first six months of fiscal 1998, the Company is reporting a loss of \$207,751 as compared to a loss of \$70,280 for the first six months of fiscal 1997. The Company's increased loss for the first six months of fiscal 1998, as compared to the first six months of fiscal 1997 is mainly due to the decreased gross profit margin, from thirty-four percent for the first six months of fiscal 1997 to eight percent for the first six months of 1998. The decreased gross profit margin is a result of the hiring of 11 employees in our Aberdeen facility. As yet there has been no production and no sales generated from Aberdeen. The Company expects the losses to continue in the next quarters, until the Aberdeen sales develop. The Company's backlog of uncompleted contracts is down to \$2,000,000, at September 30, 1997 as compared to \$3,200,000 at March 31, 1997.

Liquidity and Capital Resources:

The Company's cash balance at September 30, 1997 is \$3,167,286 compared to \$3,875,205 at March 31, 1997. The primary use of cash during the first six months ended September 30, 1997 was for payments on the building in Aberdeen, S.D. and purchases of equipment for that facility. The Company's cash balance will increase during the next two quarters, following a draw on the South Dakota Bond funds which was projected to be drawn in the second quarter but was delayed.

Forward-looking statements contained herein are made pursuant to the safe harbor provisions of the Private Litigation Reform Act of 1995. These statements are based upon the Company's current expectations and judgments about future developments in the Company's business. Certain important factors could have a material impact on the Company's performance, including, without limitation, delays in or increased costs of production, delays in or increased costs of production, delays in or lower than anticipated sales of the Company's new products, and other factors discussed from time to time in the Company's filings with the Securities and Exchange Commission. Readers are cautioned not to place undue reliance on forward-looking statements. The Company undertakes no obligation to update such statements to reflect actual events.

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PART II. OTHER INFORMATION

ITEMS 1 - 3. Not Applicable.

Item 4. Submission of Matters to a Vote of Security-Shareholders.

(a.) The Company held its Annual Meeting of Shareholders on August 20, 1997.

c.) 1. The Shareholders voted for four directors, each to serve a one year term. The vote was as follows for each of the nominees:

Name	Affirmative	Authority Withheld
Anil K. Jain	7,466,506	0
Kenneth Olsen	7,466,506	0
Grgory Von Wald	7,466,506	0
Lincoln Hudson	7,214,472	252,034

2. The shareholders also considered adoption of the 1997 Stock Compensation Plan. Voting on approval of the Plan was as follows: 5,283,567 shares in favor, 94,310 opposed, 46,450 abstentions, and 2,042,179 broker nonvotes.

Item 5. Not Applicable

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ITEM 6. Exhibits and Reports on Form 8-K.

(a) 10.1 Form of Agreement Regarding Repurchase of Stock upon Change in control Event with Anil K. Jain and Kenneth A. Olsen.

10.2 Form of Agreement Regarding Employment/Compensation upon Change in Control entered into with Anil K. Jain and Kenneth A. Olsen.

b) Reports on Form 8-K

There were no reports on Form 8-K filed during the three months ended September 30, 1997.

(c) Exhibit 27: Financial Data Schedules.

Signatures

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

APA OPTICS, INC.

November 13, 1997  
/s/ Anil K. Jain

Date  
Anil K. Jain

President

Principal Executive Officer

Treasurer & Principal Financial  
Officer

November 13, 1997  
/s/ Randal J. Becker

Date  
Randal J. Becker

Principal Accounting Officer



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FORM OF AGREEMENT  
REGARDING REPURCHASE OF STOCK UPON  
CHANGE IN CONTROL EVENT

THIS AGREEMENT is entered into as of August 20, 1997, by and between APA OPTICS, INC., a Minnesota corporation (herein called the "Company"), and \_\_\_\_\_ (herein called the "Executive").

WHEREAS, Executive has been employed by the Company for several years and is currently its \_\_\_\_\_; and

WHEREAS, Executive owns \_\_\_\_\_ shares (the "Shares") of the Company's Common Stock, par value \$.01 per share (the "Common Stock"), which represents \_\_\_\_\_% of the Common Stock outstanding as of the date hereof; and

WHEREAS, Executive has refrained from selling Shares for his own account, having been advised that such sales might have an adverse impact on the public market for the Common Stock; and

WHEREAS, the Company desires to provide Executive an opportunity to dispose of a reasonable number of his Shares of Common Stock in the event of a "Change in Control Event" as defined herein;

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

1. Change in Control Event. For the purposes of this Agreement, "Change in Control Event" shall mean:

(a) the consummation of any consolidation or merger of the Company in which the Company is the continuing or surviving corporation, other than a merger of the Company in which the holders of the Company's Common Stock immediately prior to the merger have the same proportionate ownership immediately after the merger, or

(b) any person (as such term is used in Sections 13(d) and 14(d)(2) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) shall become the beneficial owner (within the meaning of Rule 13d-3 under the Exchange Act) of 30% or more of the Company's outstanding stock; or

(c) during any period of two consecutive years, individuals who at the beginning of such period constitute the entire Board of Directors shall cease for any reason to constitute a majority thereof unless the election, or the nomination for election by the Company's shareholders, of each new director was approved by a vote of at least two-thirds of the directors then still in office who were directors at the beginning of the two-year period; or

(d) an event described in Paragraph 1(a), (b) or (c) has occurred and an individual other than the Executive holds the position held by Executive as of the date hereof or as of the date of the Change in Control Event or other changes have been made to the terms and conditions of Executive's employment without Executive's consent; provided, however, that a Change in Control shall not be deemed to have occurred if Executive has voluntarily resigned from or changed his position with the Company prior to or following a Change in Control.

2. Effective Date of Change in Control. A Change in Control Event shall be deemed to have occurred,

(a) in the case of a transaction requiring Board or shareholder approval, on the date of such approval;

(b) in the case of acquisition of shares, on the date of the acquisition of the shares resulting in the

acquirer's becoming the holder of the stated amount;

(c) in the case of board membership, on the date of election of the director(s) that results in a Change in Control Event as defined in Section 1(c) hereof; and

(d) in the case of a change in the terms of Executive's employment, on the date the notice of such change is given to Executive.

3. Purchase of Stock. In the event of a Change in Control Event, and at the option of Executive, the Company shall purchase from Executive a number of Shares equal to up to 4% of the shares of Common Stock outstanding immediately prior to the Change in Control Event (or, if greater, 4% of the shares of Common Stock outstanding at the time this option is exercised) at a price per share equal to the highest per share price paid in connection with the Change in Control Event or the highest price paid in the public market within the twelve months preceding the exercise of this option (as adjusted to reflect any stock split, reverse stock split, stock dividend or similar event occurring during such period). This option shall be exercised by Executive by delivery of written notice of the intent to exercise, indicating the number of Shares to be purchased (if less than the full amount permitted hereunder) and the purchase price (as determined by Executive). The Company shall complete such purchase within 30 days of receipt of such notice, at which time the purchase price shall be paid in full, in cash.

4. Term of Option. The option granted herein to Executive shall be exercisable for a period of twelve months from the Effective Date of the Change in Control.

5. Aggregate Shares to be Sold. This option may be exercised more than one time during its term, but the total number of Shares purchased by the Company shall not exceed the maximum stated in Paragraph 3 hereof. If the Executive has sold Shares within the twelve months preceding the Effective Date of the Change in Control, the number of Shares subject to this option shall be reduced by 150% of the number of Shares sold. To the extent the full number of Shares subject to this option is not tendered to the Company pursuant hereto during the twelve months during which this option is effective, Executive may sell such number of Shares in the open market.

6. Determination of Price. The price per Share to be paid hereunder shall be the highest of the following (in each case, as adjusted to reflect any stock split, reverse stock split, stock dividend, or similar event occurring during the twelve-month period):

(a) (i) If the Company's Common Stock is traded on an exchange or is quoted on The Nasdaq Stock Market ("Nasdaq"), the highest sale price reported during the twelve months immediately preceding the date of exercise of the option, or

(ii) If the Company's Common Stock is not traded on an exchange or on Nasdaq, but is traded in the over-the-counter market, then the highest asked price reported during the twelve months immediately preceding the date of exercise of the option; or

(b) The highest price per share paid or offered in any bona fide transaction related to the Change in Control Event at any time during the twelve-month period immediately preceding the Effective Date of the Change in Control.

7. Resolution of Disputes. Any dispute or claim arising out of this Agreement, or breach thereof, shall be decided by arbitration, under the commercial arbitration rules of the American Arbitration Association (the "AAA"), and shall be conducted in the Minneapolis, Minnesota metropolitan area. Demand for arbitration hereunder may be made by either party hereto upon written notification to the other party. The arbitration shall be by a single arbitrator mutually selected by Executive and the Company. If the parties do not agree upon an arbitrator within 20 days after the date of a demand for arbitration, the

selection of the single arbitrator shall be made in accordance with the rules of the AAA. This agreement to arbitrate shall be specifically enforceable. Any decision rendered by the arbitrator shall be final and binding, and judgment may be entered upon it by any court having jurisdiction. The arbitrator shall assess arbitration fees, expenses, attorneys' fees, and compensation in accordance with the applicable AAA rules. Nothing herein contained shall bar either party from seeking equitable remedies in a court of appropriate jurisdiction.

8. Entire Agreement; Headings. This Agreement is the entire agreement between the parties on its subject matter and shall be deemed to supersede any other agreements allegedly made between the parties regarding the subject matter. The parties represent that no other such agreements or understandings exist. Headings shall not be utilized in any interpretation of this Agreement.

9. Notices. Any notice or other communication provided for herein or given hereunder shall be in writing and shall be delivered in person or, in the case of the Company, to its Chairman, or mailed by first class registered or certified mail, postage prepaid, addressed to the Company at its registered office in the State of Minnesota and addressed to the Executive or any other person at the last known address of such person appearing on the books of the Company.

10. Amendment. This Agreement may not be changed, modified or amended except in writing signed by both parties.

11. Invalidity of Any Provision. The provisions of this Agreement are severable, it being the intention of the parties hereto that should any provisions hereof be invalid or unenforceable, such invalidity or unenforceability of any provision shall not affect the remaining provisions hereof, but the same shall remain in full force and effect as if such invalid or unenforceable provision or provisions were omitted.

12. Successors and Assigns. This Agreement shall be binding upon, and inure to the benefit of, the Company, its successors and assigns, and Executive, his heirs, legal representatives and assigns.

13. Governing Law. This Agreement is being delivered and is intended to be performed in the State of Minnesota and shall be construed and enforced in accordance with the laws of such state.

14. Counterparts. This Agreement may be executed simultaneously in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute but one and the same instrument.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

APA Optics, Inc.

By

\_\_\_\_\_  
Its \_\_\_\_\_

EXECUTIVE

\_\_\_\_\_  
\_\_\_\_\_

FORM OF AGREEMENT  
REGARDING EMPLOYMENT/COMPENSATION UPON  
CHANGE IN CONTROL

THIS AGREEMENT is entered into as of August 20, 1997, by and between APA OPTICS, INC., a Minnesota corporation (herein called the "Company"), and \_\_\_\_\_ (herein called the "Executive").

WHEREAS, Executive has been employed by the Company for several \_\_\_\_\_ years and is currently its \_\_\_\_\_; and

WHEREAS, Executive is a very important and valuable employee and the Company desires to keep Executive in its service; and

WHEREAS, the Company desires to provide suitable compensation to the Executive should his employment be terminated or substantially changed as a result of a "Change in Control" as defined herein; and

WHEREAS, Executive acknowledges that this is not an employment agreement, but is solely intended to provide for employment security and compensation in the event of any Change in Control of the Company in accordance with the terms and conditions of this Agreement.

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

1. Definitions. For the purposes of this Agreement, the following words and phrases shall have the following meanings:

(a) "Change in Control" shall mean:

(i) the consummation of any consolidation or merger of the Company in which the Company is not the continuing or surviving corporation or pursuant to which shares of the Company's common stock would be converted into cash, securities, or other property, other than a merger of the Company in which the holders of the Company's common stock immediately prior to the merger have the same proportionate ownership of common stock of the surviving corporation immediately after the merger; or

(ii) any sale, lease, exchange, or other transfer (in one transaction or a series of related transactions) of all, or substantially all, of the assets of the Company; or

(iii) approval by the shareholders of the Company of any plan or proposal for the liquidation or dissolution of the Company; or

(iv) any person (as such term is used in Sections 13(d) and 14(d)(2) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) shall become the beneficial owner (within the meaning of Rule 13d-3 under the Exchange Act) of 30% or more of the Company's outstanding stock; or

(v) during any period of two consecutive years, individuals who at the beginning of such period constitute the entire Board of Directors shall cease for any reason to constitute a majority thereof unless the election, or the nomination for election by the Company's shareholders, of each new director was approved by at least two-thirds of the directors then still in office who were directors at the beginning of the two-year period.

(b) "Cause" shall mean clear and convincing evidence of:

(i) material dishonesty by Executive

involving the employer;

(ii) willful violation of any law, rule, or regulation;

(iii) failure or refusal to perform a material requirement of Executive's duties, or failure or refusal to comply with a reasonable, important general policy of the Company or its Board of Directors, after receipt by Executive of written notice specifying in detail the failure or refusal, and a reasonable time in which to perform;

(iv) breach of fiduciary duty to the employer, or

(v) Executive's (a) death or (b) disability (by reason of physical or mental disease, defect, accident or illness) such that Executive is or, in the opinion of two independent physicians, one selected by the Company and one by Executive or his representative, for purposes of making this determination, will be unable for an aggregate of 180 or more days during any continuous 12-month period to render the services required of him in his then current position with the Company.

(c) "Competitive Activities" shall mean:

(i) directly or indirectly engaging in, continuing in, or carrying on any business which substantially competes with the business conducted by the Company;

(ii) soliciting or accepting orders for business on behalf of an entity other than the Company from any persons (whether individuals or entities) who were customers or bona fide prospects of the Company during the one-year period prior to Executive's termination of employment or inducing or attempting to induce such persons to terminate or modify their relationship with the Company for such business; or

(iii) offering, soliciting or agreeing to employ an employee of the Company, or inducing or attempting to induce such an employee to quit his or her employ with the Company, without the prior written consent of the Company;

Provided, however, that the term "Competitive Activities" shall not include the ownership of securities of corporations, which are listed on a national securities exchange or quoted on a national over-the-counter market, by the Executive in an amount not exceeding 2% of the outstanding shares of any such corporation.

(d) "Date of Termination" shall mean:

(i) if Executive's employment is terminated by the Company for disability, 90 days after Notice of Termination is given to Executive (provided that Executive shall not have returned to the performance of Executive's duties on a full-time basis during such 90 day period); or

(ii) if Executive's employment is terminated by the Company for any other reason, 90 days after Notice of Termination is given; provided, however, that if within 90 days after any Notice of Termination is given to Executive by the Company Executive notifies the Company that a dispute exists concerning the termination, the Date of Termination shall be the date the dispute is finally determined, whether by mutual agreement by the parties or upon final judgment, order, or decree of a court of competent jurisdiction (the time for appeal therefrom having expired and no appeal having been perfected).

(e) "Good Reason" shall mean any of the following (without Executive's express written consent):

(i) Assignment to Executive by the Company of duties inconsistent with Executive's position, duties, responsibilities, and status with the Company immediately prior to a Change in Control of the Company, or a change in Executive's titles or offices as in effect immediately prior to a Change in Control of the Company, or any removal of Executive from or any failure to reelect or reappoint Executive to any of such positions, except in connection with the termination of his employment for disability, Retirement, or Cause or as a result of Executive's death or by Executive other than for Good Reason;

(ii) A reduction by the Company of Executive's base salary as in effect on the date hereof or as the same may be increased from time to time during the term of this Agreement or the Company's failure to increase Executive's base salary (within 12 months of Executive's last increase in base salary) after a Change in Control of the Company in an amount which at least equals, on a percentage basis, the average percentage increase in base salary for all executive officers of the Company effected during the preceding 12 months;

(iii) Any failure by the Company to continue in effect, or to provide a comparable substitute for, any benefit plan or arrangement (including, without limitation, any profit sharing plan, executive supplemental medical plan, group life insurance plan, and medical, dental, accident, and disability plans) in which Executive is participating at the time of a Change in Control of the Company (or any other plans providing Executive with substantially similar benefits) (hereinafter referred to as "Benefit Plans"), the taking of any action by the Company that would adversely affect Executive's participation in or materially reduce Executive's benefits under any such Benefit Plan or deprive Executive of any material fringe benefit enjoyed by Executive at the time of a Change in Control of the Company;

(iv) Any failure by the Company to continue in effect, or to provide a comparable substitute for, any incentive plan or arrangement (including, without limitation, any incentive compensation plan, long-term incentive plan, bonus or contingent bonus arrangements or credits, the right to receive performance awards, or similar incentive compensation benefits) in which Executive is participating, or is eligible to participate, at the time of a Change in Control of the Company (or any other plans or arrangements providing him with substantially similar benefits) (hereinafter referred to as "Incentive Plans") or the taking of any action by the Company which would adversely affect Executive's participation in any such Incentive Plan, expressed as a percentage of his base salary, by more than ten percentage points in any fiscal year as compared to the immediately preceding fiscal year;

(v) Any failure by the Company to continue in effect, or to provide a comparable substitute for, any plan or arrangement to receive securities of the Company (including, without limitation, any stock option plan or any other plan or arrangement to receive and exercise stock options, stock appreciation rights, restricted stock, or grants thereof) in which Executive is participating, or is eligible to participate, at the time of a Change in Control of the Company (or plans or arrangements providing him with substantially similar benefits) (hereinafter referred to as "Securities Plans") or the taking of any action by the Company which would adversely affect Executive's participation in or materially reduce Executive's benefits under any such Securities Plan;

(vi) If at the time of a Change in Control of

the Company Executive is employed at the Company's principal executive offices, a relocation of such principal executive offices to a location more than fifty miles outside of the Minneapolis-St. Paul Metropolitan Area or, if Executive is not employed at the Company's principal executive offices, Executive's relocation to any place other than the location at which the Executive performed Executive's duties prior to a Change in Control of the Company, except for required travel by Executive on the Company's business to an extent substantially consistent with Executive's business travel obligations at the time of a Change in Control of the Company;

(vii) Any failure by the Company to provide Executive with at least the number of paid vacation days to which the Executive is entitled at the time of a Change in Control of the Company;

(viii) Any material breach by the Company of any provision of this Agreement;

(ix) Any failure by the Company to obtain the assumption of this Agreement by any successor or assign of the Company; or

(x) Any purported termination of Executive's employment which is not effected pursuant to a Notice of Termination satisfying the requirements of Section 1(f) hereof.

(f) "Notice of Termination" shall mean a written notice which shall indicate those specific termination provisions in this Agreement relied upon and which sets forth in reasonable detail the facts and circumstances claiming to provide a basis for termination of Executive's employment under the provisions so indicated. Any termination by the Company pursuant to this Agreement shall be communicated by Notice of Termination. For purposes of this Agreement, no such purported termination by the Company shall be effective without such Notice of Termination.

(g) "Retirement" shall mean termination by the Company or Executive of Executive's employment based on Executive's having reached age 65 or such other age or upon such other terms as shall have been fixed in any arrangement established with Executive's consent.

2. Separate Employment Arrangements. Executive is, and shall be, employed by the Company solely upon the existing arrangements which are separate from this Agreement, as those employment arrangements hereafter may be amended by the parties. The parties expressly acknowledge and agree that this Agreement is not intended to be an employment agreement.

3. Participation in Other Executive Benefit Plans. Nothing in this Agreement shall in any manner modify, impair, or affect the existing or future rights or interests of Executive (a) to receive any employee benefits from the Company to which he would otherwise be entitled or (b) as a participant in any incentive, profit-sharing or bonus plan, stock option plan or pension plan of the Company. The rights and interests of Executive to any employee benefits or as a participant or beneficiary in or under any or all such plans shall continue in full force and effect. Executive shall have the right at any future time to become a participant or beneficiary under or pursuant to any and all such plans. Any compensation payable under this Agreement shall not be deemed salary or other compensation to Executive for purposes of any retirement plans maintained by the Company or for purposes of any other fringe benefit obligations of the Company.

4. Nonassignability of Benefits. Executive shall not transfer, assign, encumber, or otherwise dispose of his right to receive payments hereunder and, in the event of any attempted transfer or assignment, the Company shall have no further liability to Executive under this Agreement.

5. Payments and Benefits upon a Change in Control.

If Executive is employed by the Company upon the occurrence of a Change in Control, the following provisions shall govern:

- (a) Executive shall continue to be employed for at least thirty-six (36) months with substantially the same duties, compensation, and benefits in the same geographic location as existed just prior to the Change in Control.
- (b) Executive may terminate his employment during the thirty-six (36) months following the Change in Control for Good Reason, as defined herein, and, upon such termination, shall receive from the Company in a lump sum, in cash, on the fifth (5th) day following the Date of Termination, an amount equal to two and one-half (2-1/2) times Executive's "annualized includible compensation for the base period" (as defined in Section 280G(d) of the Internal Revenue Code of 1986, as amended (the "Code")), and shall not engage in any Competitive Activities for one year following the Date of Termination.
- (c) If Executive's employment is terminated within thirty-six (36) months following the Change in Control, other than for Cause as defined herein or as a result of his Retirement, disability, or death, the Executive shall receive as severance pay in a lump sum, in cash, on the fifth (5th) day following the Date of Termination, an amount equal to two and one-half (2-1/2) times Executive's "annualized includible compensation for the base period" (as defined in Section 280G(d) of the Code), and shall not engage in any Competitive Activities for one year following the Date of Termination.
- (d) Executive may terminate his employment other than for Good Reason upon at least three months' notice following the Change in Control, thereby waiving any further benefits hereunder except a severance benefit of three months' salary and a prorated portion of any annual bonus, provided that Executive then agrees not to engage in any Competitive Activities for six months following the Date of Termination.
- (e) If Executive terminates his employment otherwise than under any of paragraphs (b) or (d) of this Section 5, Executive shall not be entitled to any payments for any period after the end of the employment and shall not receive any severance benefit.
- (f) If the Executive holds any options to purchase stock of the Company after a Change in Control, Executive shall be entitled, upon involuntary termination except for Cause during the thirty-six (36) month period, to demand payment of the current value of such options (fair market value as of the Date of Termination less the then effective exercise price).
- (g) If the lump sum severance payment provided for under this Section 5, calculated as set forth above, either alone or together with other payments which Executive has the right to receive from the Company, would constitute an "excess parachute payment" (as defined in Section 280G of the Code), such lump sum severance payment shall be reduced to the largest amount as will result in no portion of the lump sum severance payment under this Section 5 being subject to the excise tax imposed by Section 4999 of the Code. The determination of any reduction in the lump sum severance payment under this Section 5(g) pursuant to the foregoing sentence shall be made by Executive in good faith, and such determination shall be conclusive and binding on the Company.
- (h) In the event of termination of Executive's employment for any reason, Executive shall be entitled to continue to participate in the Company's group health plan for employees



following such termination. Executive shall be responsible for payment of premiums. This benefit shall be available until Executive's death or his election not to continue such participation.

6. No Obligation to Mitigate Damages; No Effect on Other Contractual Rights.

- (a) Executive shall not be required to mitigate damages or the amount of any payment provided for under Section 5 hereof by seeking other employment or otherwise, nor shall the amount of any payment provided for under Section 5 be reduced by any compensation earned by Executive as the result of employment by another employer after the Date of Termination, or otherwise.
- (b) The provisions of Section 5, and any payment provided for thereunder, shall not reduce any amounts otherwise payable, or in any way diminish Executive's existing rights, or rights which would accrue solely as a result of the passage of time, under any Benefit Plan, Incentive Plan, Securities Plan, employment agreement, or other contract, plan, or arrangement.

7. Entire Agreement; Headings. This Agreement is the entire Agreement between the parties on its subject matter and shall be deemed to supersede any other agreements allegedly made between the parties regarding the subject matter. The parties represent that no other such agreements or understandings exist. Headings shall not be utilized in any interpretation of this Agreement.

8. Notices. Any notice or other communication provided for herein or given hereunder shall be in writing and shall be delivered in person or, in the case of the Company, to the Board of Directors, or mailed by first class registered or certified mail, postage prepaid, addressed to the Company at its registered office in the State of Minnesota and addressed to the Executive or any other person at the last known address of such person appearing on the books of the Company.

9. Amendment. This Agreement may not be changed, modified or amended except in writing signed by both parties.

10. Waiver of Breach. The waiver by either party of the breach of any provision of this Agreement shall not operate or be construed as a waiver of any subsequent breach by either party.

11. Invalidity of Any Provision. The provisions of this Agreement are severable, it being the intention of the parties hereto that should any provision hereof be invalid or unenforceable, such invalidity or unenforceability of any provision shall not affect the remaining provisions hereof, but the same shall remain in full force and effect as if such invalid or unenforceable provision or provisions were omitted.

12. Resolution of Disputes. Any dispute or claim arising out of this Agreement, or breach thereof, shall be decided by arbitration, under the commercial arbitration rules of the American Arbitration Association (the "AAA"), and shall be conducted in the Minneapolis, Minnesota metropolitan area. Demand for arbitration hereunder may be made by either party hereto upon written notification to the other party. The arbitration shall be by a single arbitrator mutually selected by Executive and the Company. If the parties do not agree upon an arbitrator within 20 days after the date of a demand for arbitration, the selection of the single arbitrator shall be made in accordance with the rules of the AAA. This agreement to arbitrate shall be specifically enforceable. Any decision rendered by the arbitrator shall be final and binding, and judgment may be entered upon it by any court having jurisdiction. The arbitrator shall assess arbitration fees, expenses, attorneys' fees, and compensation in accordance with the applicable AAA rules. Nothing herein contained shall bar either party from seeking equitable remedies in a court of appropriate jurisdiction.

13. Successors and Assigns. This Agreement shall be

binding upon, and inure to the benefit of, the Company, its successors and assigns, and Executive, his heirs, legal representatives and assigns.

14. Governing Law. This Agreement is being delivered and is intended to be performed in the State of Minnesota and shall be construed and enforced in accordance with the laws of such state.

15. Counterparts. This Agreement may be executed simultaneously in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute but one and the same instrument.

IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the day and year first above written.

APA OPTICS, INC.

By

\_\_\_\_\_

Its \_\_\_\_\_

EXECUTIVE

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