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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 8-K

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### CURRENT REPORT

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

February 14, 2006 (Date of earliest event reported)

Commission file number: 0-23329

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## Charles & Colvard, Ltd.

(Exact name of registrant as specified in its charter)

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**North Carolina**  
(State or other jurisdiction of  
incorporation or organization)

**56-1928817**  
(I.R.S. Employer  
Identification No.)

**300 Perimeter Park Drive, Suite A**  
**Morrisville, North Carolina 27560**  
(Address of principal executive offices)  
(Zip code)

**(919) 468-0399**  
(Registrant's telephone number, including area code)

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Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions (see General Instruction A.2. below):

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
  - Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
  - Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
  - Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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## **Item 1.01 Entry into a Material Definitive Agreement**

### **Management Incentive Plan (2006) and the Quarterly & Annual Incentive Plan for Non-Officer Employees (2006)**

On February 14, 2006, the Board of Directors (the "Board") of Charles & Colvard, Ltd. (the "Company") approved two incentive plans for 2006, the Management Incentive Plan (2006) (the "Management Plan") and the Quarterly & Annual Incentive Plan for Non-Officer Employees (2006) (the "Non-Officer Employees Plan").

The principal purpose of each of the plans is to provide incentives to meet or exceed certain Company goals for 2006. Both plans provide for cash and equity awards. All equity awards, if any, will be made pursuant to the Company's 1997 Omnibus Stock Plan (as amended). The specific criteria used to determine whether any eligible participant will receive an award include the Company's net sales and net income and, for participants under the Management Plan and for certain director level employees under the Non-Officer Employee Plan, other key objectives as set by the Company.

Persons eligible to receive awards under the Management Plan are the CEO, CFO & Vice President, Executive Vice President and Chief Marketing Officer, and Senior Vice President – Manufacturing (the "Executives"). The Board, or, upon the Board's delegation, a committee, may determine that other executives of the Company may also be eligible to participate in the Management Plan. Pursuant to the terms of the Management Plan, each Executive is eligible to receive (i) a cash bonus of up to 40% of his or her annual salary for 2006, which shall be prorated among the Board approved goals for (x) key objectives (20%), (y) net sales (60%), and (z) net income (20%) (the "Cash Award"); and (ii) restricted stock awards based on the Company's attainment of its net income goal for 2006. The Cash Award may be increased by up to a 100% if the Company exceeds its net income goal.

All other full time Company employees are eligible to receive awards under the Non-Officer Employees Plan. If operating income and revenue goals are met for a given quarter, each full time employee, who is not a participant in another annual incentive plan, generally will receive a cash bonus equal to five days' pay and a stock option award for either 60 or 100 shares of common stock of the Company, depending on position. An additional cash bonus equal to five days' pay and a stock option award for either 60 or 100 shares of common stock (again depending on position) will be paid if operating income and revenue goals are met for the entire year. Sales staff employees are eligible for the equity portion of these awards but not the cash portion, because cash bonuses are paid to sales staff based on their individual and team sales results. Certain director level employees are also eligible to receive a cash bonus of up to 25% of their annual base salary if certain net income goals and performance tasks are achieved.

Copies of the Management Plan and Non-Officer Employees Plan are attached as Exhibit 10.87 and Exhibit 10.88, respectively, and the descriptions above are qualified in their entirety by reference to such documents.

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**Director Compensation**

On February 14, 2006, the Board approved, after approval of and recommendation by the Compensation Committee, changes to the compensation to be paid to non-employee members of the Board. A summary of such compensation is attached as Exhibit 10.89.

**Executive Compensation**

On February 14, 2006, the Board approved, after approval of and recommendation by the Compensation Committee, base salary increases for Robert S. Thomas, the CEO, James Braun, the CFO & Vice President, and Dennis Reed, the Executive Vice President and Chief Marketing Officer. Effective as of March 1, 2006, Mr. Thomas' annual base salary will increase from \$250,000 to \$300,000. Mr. Braun's annual base salary will increase from \$190,000 to \$215,000 and Mr. Reed's annual base salary will increase from \$200,000 to \$225,000.

**2005 Bonuses**

On February 14, 2006, the Board approved, after approval of and recommendation by the Compensation Committee, certain cash incentive payments and equity awards to executive officers and other management employees, under the Company's Management Incentive Plan (2005). A list of the cash and equity awards to be paid is attached as Exhibit 99.1. All equity awards are being made pursuant to the Company's 1997 Omnibus Stock Plan, as amended. All equity awards vest in full after three years.

**Item 9.01 Financial Statements and Exhibits****(d) Exhibits**

Exhibit 10.87	Management Incentive Plan (2006)
Exhibit 10.88	Quarterly & Annual Incentive Plan for Non-Officer Employees (2006)
Exhibit 10.89	Director Compensation Structure, effective May 22, 2006
Exhibit 99.1	Cash and Equity Performance Awards for 2005

**SIGNATURE**

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.

Charles & Colvard, Ltd.

By: /s/ James R. Braun

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James R. Braun  
Vice President of Finance & Chief Financial Officer

Date: February 21, 2006

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**EXHIBIT INDEX**

<u>Exhibit No.</u>	<u>Exhibit Description</u>
Exhibit 10.87	Management Incentive Plan (2006)
Exhibit 10.88	Quarterly & Annual Incentive Plan for Non-Officer Employees (2006)
Exhibit 10.89	Director Compensation Structure, effective May 22, 2006
Exhibit 99.1	Cash and Equity Performance Awards for 2005

MANAGEMENT INCENTIVE PLAN  
(2006)

The purpose of the Management Incentive Plan (the "Plan") is to provide management with incentives for the successful execution of both short- and long-term plans that:

1. Provide significant revenue growth,
2. Maintain and increase the profitability of Charles & Colvard, Ltd. (the "Corporation"),
3. Increase the public market valuation of the Corporation, and
4. Develop the human, fiscal, and physical capacity to enable the Corporation to accelerate and maintain growth into the indefinite future.

The Board of Directors of the Corporation ("Board") recognizes that there are currently four senior officer positions within the senior management that will play important roles in achieving the stated goals. The Board has established specific goals for 2006 net sales, and net income, and has set strategic objectives for the Corporation. The Board has tasked the senior managers with the responsibility and accountability for meeting both the annual goals and the strategic objectives.

As tangible incentives to the officers, the Board has determined that a short-term incentive consisting of an annual cash bonus and a long-term incentive consisting of restricted stock awards should be offered to those executives for attaining the defined goals.

Upon the completion of the annual audit by the Corporation's outside accountants, each of the identified officers shall be eligible to receive cash bonuses and restricted stock awards as defined in this Plan. Earning of the restricted stock awards will be subject to the executive's continuing service to the Corporation as an employee, consultant, or member of the Board for a minimum of three years following the date of grant of the restricted stock, and as further defined in the documents that accompany the restricted stock awards. The restricted stock awards are intended to be a reward for the continuing achievement and success of the Corporation due to the executive's service and contributions. The base number of shares of the Corporation's common stock which may be earned through a restricted stock awarded will be determined based on the closing price of the Corporation's common stock on December 30, 2005 (as adjusted for any stock splits or dividends prior to the issuance of a restricted stock award) and the restriction shall terminate on the third anniversary of the award date. Unless the Committee determines otherwise, if the executive terminates employment, prior to the third anniversary of the restricted stock award, the stock award shall be forfeited and the executive shall have no right to the shares subject to the restricted stock award.

The individuals and titles of the individuals currently eligible for inclusion in the Plan are:

<u>Name</u>	<u>Title</u>
Robert S. Thomas	CEO
James Braun	CFO & Vice President
Dennis Reed	Executive Vice President and Chief Marketing Officer
Earl Hines	Senior Vice President – Manufacturing

The Committee, in its discretion, may determine that other executives of the Corporation may also be eligible to participate in the Plan. Participation in the Plan in any one year does not guarantee the right to participate in any other year.

### I. Short-Term Incentive Opportunity

The short-term incentive portion of the Plan shall provide each eligible executive with the opportunity to earn up to 40% of their total 2006 salary (excluding bonuses) for achieving goals for three separate components of the Corporation's approved plans as approved by the Board. The maximum opportunity of 40% shall be prorated among the approved goals for: (i) Key Objectives – 20%; (ii) Net Sales – 60%; and (iii) Net Income – 20% as shown on Table A below:

**Table A - Short Term Incentive Opportunities**

<b>Executive A – Short-term Incentive Opportunity</b>		
Base Salary		\$200,000
STI (%)		40%
STI (\$)		\$ 80,000
<b>Short-term Incentive Weighting</b>		
Key Objectives	20%	\$ 16,000
Net Sales	60%	\$ 48,000
Net Income	20%	\$ 16,000
	100%	\$ 80,000

Based upon management's recommendation, the Committee has approved specific Key Objectives for each executive with an appropriate weighting. The portion of the short-term incentive determined by the "Key Objectives" criteria shall be awarded based upon management's recommendations, and the Committee's determination, as to the success of the executive in achieving the specific key objectives for that executive during 2006. An example is provided below:

**Table B – Short-Term Incentive for Attaining Key Objectives**

<b>Award Opportunity</b>	
Base Salary	\$200,000
Total Award Opportunity at Target (%)	40%
Total Award Opportunity at Target (\$)	\$ 80,000
Key Objectives as a % of Award	20%
Key Objectives at Target (\$)	\$ 16,000

**Calculation of Key Objectives**

<u>Goals</u>	<u>Approved Weighting</u>	<u>Gate = 50%</u>	<u>Target = 100%</u>	<u>Performance Achieved</u>	<u>Payout</u>
Individual Goal #1	50%	<u>A</u> \$ 4,000	<u>B</u> \$ 8,000	"A"	\$ 4,000
Individual Goal #1	30%	<u>A</u> \$ 2,400	<u>B</u> \$ 4,800	Above "B"	\$ 4,800
Individual Goal #1	20%	<u>A</u> \$ 1,600	<u>B</u> \$ 3,200	Between "A" and "B"	\$ 2,400
Totals	100%	<u>\$ 8,000</u> 50%	<u>\$ 16,000</u> 100%		<u>\$ 11,200</u> 70%

No short-term incentive for the Net Sales component shall be paid unless the Corporation attains 80% of the approved Net Sales goal. Upon reaching 80% of the approved goal, the portion of the short-term incentive earned from "Net Sales" shall be determined as provided below:

**Table C – Short-Term Incentive for Attaining Net Sales Goal**

<u>Goal Achieved (% of Net Sales)</u>	<u>Percent of Maximum Payment</u>	<u>Incentive Dollars Earned</u>
80%	25%	\$12,000
81%	28.75%	\$13,800
82%	32.50%	\$15,600
83%	36.25%	\$17,400
84%	40.00%	\$19,200
85%	43.75%	\$21,000
86%	47.50%	\$22,800
87%	51.25%	\$24,600
88%	55.00%	\$26,400
89%	58.75%	\$28,200
90%	62.5%	\$30,000
91%	66.25%	\$31,800
92%	70.00%	\$33,600
93%	73.75%	\$35,400
94%	77.50%	\$37,200
95%	81.25%	\$39,000
96%	85.00%	\$40,800
97%	88.75%	\$42,600
98%	92.50%	\$44,400
99%	96.25%	\$46,200
100%	100.00%	\$48,000



No short-term incentive shall be paid for the Net Income component unless the Corporation attains 80% of the approved Net Income goal. Upon reaching 80% of the approved goal, the portion of the short term incentive from Net Income shall be determined as provided below. Net Income will include an accrual for both the total cash bonus under the Plan and an accrual for the current year portion, if any, of compensation expense relating to the restricted stock awards.

**Table D – Short-Term Incentive for Attaining Net Income Goal**

<b>Goal Achieved (% of Net Income)</b>	<b>Percent of Maximum Payment</b>	<b>Incentive Dollars Earned</b>
80%	25%	\$4,000
81%	28.75%	\$4,600
82%	32.50%	\$5,200
83%	36.25%	\$5,800
84%	40.00%	\$6,400
85%	43.75%	\$7,000
86%	47.50%	\$7,600
87%	51.25%	\$8,200
88%	55.00%	\$8,800
89%	58.75%	\$9,400
90%	62.5%	\$10,000
91%	66.25%	\$10,600
92%	70.00%	\$11,200
93%	73.75%	\$11,800
94%	77.50%	\$12,400
95%	81.25%	\$13,000
96%	85.00%	\$13,600
97%	88.75%	\$14,200
98%	92.50%	\$14,800
99%	96.25%	\$15,400
100%	100.00%	\$16,000

In the event the Net Income goal is exceeded, the total dollar value of the short-term incentive award will be calculated, and the total short-term incentive payment shall be modified to increase the total amount of the award up to a maximum of 200% as set out on Table E below:

**Table E - Calculation of Short Term Incentive and Application of Modifier for Exceeding the Goal**

<u>% of Net Income Goal Achieved</u>	<u>Modifier applied to STI dollar value</u>	
101%	101.00%	
102%	102.00%	
103%	103.00%	
104%	104.00%	
105%	105.00%	
106%	106.00%	
107%	107.00%	
108%	108.00%	
109%	109.00%	
>110%	110.00%	
>115%	121.25%	
>120%	132.50%	
>125%	143.75%	
>130%	155.00%	
>135%	166.25%	
>140%	177.50%	
>145%	188.75%	
>150%	200.00%	
		<b>Amount Earned</b>
Key Objectives		\$ 11,200
Net Sales		\$ 44,400
Net Income		\$ 16,000
		<hr/>
		\$ 71,600
		<hr/>
<b>Net Income Modifier</b>		
Net Income at 108% of Goal		108%
		<hr/>
		\$ 77,328
		<hr/>

**II. Long-Term Incentive Opportunity**

As additional incentive and motivation, and to provide for stability and continuity of service among the senior leadership of the Corporation, the Board hereby establishes a long-term incentive opportunity for the indicated executives of the Corporation to earn restricted stock awards. The restricted stock awards shall be awarded based on the Corporation's attainment of its Net Income goal for 2006. The base number of restricted shares available to each executive shall be determined based on 75% of the executive's 2006 total salary (excluding any bonuses otherwise earned) divided by the closing price of the Corporation's common stock on December 30, 2005 (as adjusted for any stock splits or dividends prior to the issuance of a restricted stock award). Table F below provides an example of the base number of restricted shares available to each executive in the long-term incentive portion of the Plan.

**Table F – Example of Calculation of Restricted Stock**

<b>Long-term Incentive Opportunity</b>	
Executive's Total 2006 Salary	\$200,000
LTI (%)	75%
LTI (\$)	\$150,000
12/30/05 Stock Price (example only)	\$ 25.00
# Restricted Shares available	6,000
<b>Long-term Incentive Weighting</b>	
Net Income	100%

Based on the actual Net Income of the Corporation for 2006, the Corporation will make a restricted stock award to each executive with the base number of restricted shares modified as set out in Table G below.

**Table G – Determination of the Number of Restricted Shares to be Awarded**

<b>Percent of Goal Achieved</b>	<b>% of LTI Value to be Awarded</b>	<b>Percent of Goal Achieved</b>	<b>% of LTI Value to be Awarded</b>
80%	50.0%	101%	105.0%
81%	52.5%	102%	110.0%
82%	55.0%	103%	115.0%
83%	57.5%	104%	120.0%
84%	60.0%	105%	125.0%
85%	62.5%	106%	130.0%
86%	65.0%	107%	135.0%
87%	67.5%	108%	140.0%
88%	70.0%	109%	145.0%
89%	72.5%	110%	150.0%
90%	75.0%	111%	155.0%
91%	77.5%	112%	160.0%
92%	80.0%	113%	165.0%
93%	82.5%	114%	170.0%
94%	85.0%	115%	175.0%
95%	87.5%	116%	180.0%
96%	90.0%	117%	185.0%
97%	92.5%	118%	190.0%
98%	95.0%	119%	195.0%
99%	97.5%	120%	200.0%
100%	100.0%		

<b>Examples of Percent of Goal Accomplished</b>			
Net Income	79%	80%	108%
<b>Long-term Incentive Opportunity</b>			
Number of Restricted Shares at Net Income Goal	6,000	6,000	6,000
Percentage Earned	0	50%	140%
LTI (#)	0	3,000	8,400

Each award shall require the executive to remain in service to the Corporation as an executive, consultant or Director for three full years from the date of the award. Unless the Committee determines otherwise, upon termination of employment prior to the third anniversary of the restricted stock award, the stock award will be forfeited and the executive shall have no right to the shares subject to the restricted stock award.

### III. Terms and Conditions of the Plan

Unless otherwise stated, the following terms and conditions apply to any incentives awarded under the Plan:

#### A. Administration of the Plan

1. The Plan shall be administered by the Board or, upon its delegation, by the Committee. For the purposes of the Plan, the term “Committee” shall, unless otherwise required by applicable law, refer to the Board and, upon its delegation to the Committee of all or part of its authority to administer the Plan, to the Committee.

2. In addition to action by meeting in accordance with applicable law, any action of the Committee with respect to the Plan may be taken by a written instrument signed by all of the members of the Committee and any such action so taken by written consent shall be as fully effective as if it had been taken by a majority of the members at a meeting duly held and called. Subject to the provisions of the Plan, the Committee shall have full and final authority in its discretion to take any action with respect to the Plan including, without limitation, the authority (a) to determine all matters relating to any awards under the Plan, including selection of individuals to be granted awards, the types of awards, the number of shares of Common Stock, if any, subject to an award, and all terms, conditions, restrictions and limitations of an award; (b) to prescribe the form or forms of any agreements, if any, evidencing any awards granted under the Plan; (c) to establish, amend and rescind rules and regulations for the administration of the Plan; and (d) to construe and interpret the Plan and any agreements evidencing awards granted under the Plan, to establish and interpret rules and regulations for administering the Plan and to make all other determinations deemed necessary or advisable for administering the Plan. In addition, except to the extent otherwise required under Internal Revenue Code (“Code”) Section 409A, related regulations or other guidance, the Committee shall have authority, in its sole discretion, to accelerate the date that any award that was not otherwise exercisable or vested shall become exercisable or vested in whole or in part without any obligation to accelerate such date with respect to any other awards granted to any recipient. In addition, the Committee shall have the authority and discretion to establish terms and conditions of awards (including but not limited to the establishment of subplans) as the Committee determines to be necessary or appropriate to conform to the applicable requirements or practices of jurisdictions outside of the United States.

#### B. Board Authority to Reduce or Eliminate Awards

The Committee shall have full authority to reduce or eliminate all awards hereunder. Unless the Committee determines otherwise, a participant who terminates employment for any reason prior to the completion of the time period on which an award is based or vesting period applicable to the award shall not be eligible for the award.

#### C. Source of Restricted Stock Awards

Any restricted stock awards made under the Plan are issued under and pursuant to the 1997 Omnibus Stock Plan of Charles & Colvard, Ltd. as amended ("Omnibus Plan"). With respect to any restricted stock awards made under the Plan, all terms, conditions, and requirements of the Omnibus Plan are incorporated into the Plan by reference. For any restricted stock awards, to the extent that there is a contradiction between the Plan and the Omnibus Plan or an ambiguity as to the provisions of the Plan, the terms of the Omnibus Plan shall control. All shares issued under the Plan are drawn from the shares reserved under the Omnibus Plan for issuance of awards (see section 4 of the Omnibus Plan).

#### D. Compliance with Code Section 409A

1. Notwithstanding any other provision in the Plan or an award to the contrary, if and to the extent that Section 409A of the Code is deemed to apply to the Plan or any award granted under the Plan, it is the general intention of the Corporation that the Plan and all such awards shall comply with Code Section 409A, related regulations or other guidance, and the Plan and any such award shall, to the extent practicable, be construed in accordance therewith. Deferrals of shares issued under the Plan in a manner that would cause Code Section 409A to apply shall not be permitted. Without in any way limiting the effect of the foregoing, in the event that Code Section 409A, related regulations or other guidance require that any special terms, provisions or conditions be included in the Plan or any award, then such terms, provisions and conditions shall, to the extent practicable, be deemed to be made a part of the Plan or award, as applicable. Further, in the event that the Plan or any award shall be deemed not to comply with Code Section 409A or any related regulations or other guidance, then neither the Corporation, the Board nor its or their designees or agents shall be liable to any participant or other person for actions, decisions or determinations made in good faith.

2. Without limiting the effect of Section D.1., herein, except to the extent otherwise required or permitted under Code Section 409A, related regulations or other guidance, distributions of awards under the Plan must be made no later than the later of (a) the date that is 2 1/2 months from the end of the employee's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or (b) the date that is 2 1/2 months from the end of the Corporation's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

#### E. Applicable Law

The Plan shall be governed by and construed in accordance with the laws of the State of North Carolina, without regard to the conflicts of laws provisions of any state, and in accordance with applicable federal laws of the United States.

#### F. Amendment and Termination of the Plan

1. The Plan and any award may be amended or terminated at any time by the Board or the Committee. No action to amend or terminate the Plan or an award shall permit the acceleration of the time or schedule or any payment of amounts deemed to involve the deferral of compensation under Code Section 409A, except as may be otherwise permitted under Section 409A, related regulations or other guidance.

2. Without limiting the effect of Section F.1., herein, the Board shall have unilateral authority to amend the Plan and any award (without participant consent) to the extent necessary to comply with applicable laws, rules or regulations or changes to applicable laws, rules or regulations (including but not limited to Code Section 409A, federal securities laws or related regulations or other guidance).

#### G. No Right or Obligation of Continued Employment

Nothing contained in the Plan shall require the Corporation or a related corporation to continue the employment or service of an employee, nor shall any such individual be required to remain in the employment or service of the Corporation or a related corporation.

#### H. Compliance with Laws

The Board may impose such restrictions on any shares or other payments or awards hereunder as it may deem advisable, including without limitation restrictions under the Securities Act of 1933, as amended (the "Securities Act"), under the requirements of any stock exchange or similar organization and under any blue sky, state or foreign securities laws applicable to such shares. Notwithstanding any other Plan provision to the contrary, the Corporation shall not be obligated to issue, deliver or transfer shares of Common Stock under the Plan, make any other distribution of benefits under the Plan or take any other action, unless such delivery, distribution or action is in compliance with all applicable laws, rules and regulations (including but not limited to the requirements of the Securities Act). The Corporation may cause a restrictive legend to be placed on any certificate issued hereunder in such form as may be prescribed from time to time by applicable laws and regulations or as may be advised by legal counsel.

#### I. Unfunded Plan; No Effect on Other Plans

1. The Plan shall be unfunded, and the Corporation shall not be required to create a trust or segregate any assets that may at any time be represented by awards under the Plan. The Plan shall not establish any fiduciary relationship between the Corporation and any employee or other person. Neither an employee nor any other person shall, by reason of the Plan, acquire any right in or title to any assets, funds or property of the Corporation or any related corporation, including, without limitation, any specific funds, assets or other property that the Corporation or any related corporation, in their discretion, may set aside in anticipation of a liability under the Plan. A participant shall have only a contractual right to the Common Stock or other amounts, if any, payable under the Plan, unsecured by any assets of the Corporation or any related corporation. Nothing contained in the Plan shall constitute a guarantee that the assets of such entities shall be sufficient to pay any benefits to any person.

2. The amount of any compensation deemed to be received by a participant pursuant to an award shall not constitute compensation with respect to which any other employee

benefits of such participant are determined, including, without limitation, benefits under any bonus, pension, profit sharing, life insurance or salary continuation plan, except as otherwise specifically provided by the terms of such plan or as may be determined by the Board or Committee.

3. The adoption of the Plan shall not affect any other compensation plans in effect for the Corporation or any related corporation, nor shall the Plan preclude the Corporation from establishing any other forms of compensation for employees or service providers of the Corporation or any related corporation.

J. Withholding; Tax Matters

1. The Corporation shall withhold, or shall require the participant to pay the Corporation in cash, the amount of any local, state, federal, foreign or other tax or other amount required by any governmental authority to be withheld and paid over by the Corporation to such authority for the account of the participant.

2. The Corporation makes no warranties or representations with respect to the tax consequences (including but not limited to, income tax consequences) related to the transactions contemplated by this Plan. A participant should consult with his or her own attorney, accountant, and/or tax advisor regarding the decision to participate in the Plan and the consequences thereof. The Corporation has no responsibility to take or refrain from taking any actions in order to achieve a certain tax result for any participant.

QUARTERLY & ANNUAL INCENTIVE PLAN FOR NON-OFFICER EMPLOYEES  
(2006)

The Board of Directors (the "Board") recognizes that each employee plays an important role in the growth and financial success of Charles & Colvard, Ltd. (the "Corporation") and wishes to provide each of those employees with meaningful incentives to work to accomplish the goals established by the Board on an annual basis. This Quarterly & Annual Incentive Plan for Non-Officer Employees Plan (the "Plan") outlines the provisions of those incentives.

### **I. General Incentives**

Effective January 1, 2006, each full time employee, including the employees of the Hong Kong subsidiary, who is not a participant in another annual incentive plan, shall be eligible to receive five days' pay and a stock option award for 60 shares of the common stock of the Corporation ("Common Stock") for each fiscal quarter when both the operating income and revenue goals of the Corporation are achieved. Should the Corporation achieve the quarterly operating income goal, but fail to meet the quarterly revenue target, each employee shall receive three days' pay and a stock option award for 30 shares of Common Stock. Sales staff employees are eligible to receive the stock option awards, but shall not be eligible for the cash portion of this incentive because they are eligible to receive other cash bonuses based on their individual and team sales results. For purposes of this incentive plan, the Hong Kong employees will be judged on the results of the Hong Kong subsidiary budget only.

Additionally, each employee shall be eligible to receive an additional incentive based on the annual results of the Corporation. Should the Corporation attain the annual goals for operating income and revenue, irrespective of whether one or more of the quarterly goals are not attained, the employee shall receive five days' pay and a stock option award for 60 shares of Common Stock. Should the Corporation reach the operating income for the year, but fail to reach the revenue goal, the employee shall be awarded three days' pay and a stock option award for 30 shares of Common Stock.

The restrictions on the stock awarded under this incentive program will require the individual to remain an employee on a continuous basis, and shall vest over a three-year period, one third each on the anniversary date of the award, so that the award will vest in full on the third anniversary of the date of grant and have an expiration date on the tenth anniversary of the award date. Unless the Committee determines otherwise, if the employment of the employee is terminated for any reason (whether by the Corporation or the employee) prior to vesting of his stock option award, the unvested portion(s) of his stock option award shall be forfeited and the employee shall have no right to the shares subject to the unvested portion of the award.

### **II. Director Level Incentives**

There are several key positions representing important leadership roles in the Corporation; the contributions of the individuals occupying these positions are critical to the success of the Corporation. For 2006, these positions are: Sales Directors; Director of Manufacturing; Director of Information Technology; Director of Engineering Services; Comptroller; and Managing Director, Asia. For purposes of the Plan, the Managing Director, Asia will be judged On the results of the Hong Kong subsidiary budget only.



The Committee, in its discretion, may determine that individuals occupying other positions within the Corporation may also be eligible to participate in the Plan. Participation in the Plan in any one year does not guarantee the right to participate in any other year.

The Committee wishes to provide each of the employees in these positions with meaningful incentives to work to accomplish the goals established by the Board on an annual basis. The following outlines the provisions of those incentives.

Effective January 1, 2006, each of those employees shall be eligible to receive five days' pay and a stock option award for 100 shares of Common Stock for each fiscal quarter when both the operating income and revenue goals of the Corporation are achieved. Should the Corporation achieve the operating income goal, but fail to meet the revenue target, each employee shall receive three days' pay and a stock option award for 50 shares of Common Stock. The Sales Directors are eligible for the stock option awards, but shall not be eligible for the cash portion of this incentive because they are eligible to receive other cash bonuses based on their individual and team sales results.

Additionally, each of these employees shall be eligible to receive an additional incentive based on the annual results of the Corporation. Should the Corporation attain the annual goals for operating income and revenue, irrespective of whether one or more of the quarterly goals is not attained, the employee shall receive five days' pay and a stock option award for 100 shares of Common Stock. Should the Corporation reach the operating income for the year, but fail to reach the revenue goal, the employee shall be awarded three days' pay and a stock option award for 50 shares of Common Stock. The Sales Directors are eligible for the stock option awards, but shall not be eligible for the quarterly cash portion of this incentive because they are eligible to receive other cash bonuses based on their individual and team sales results.

The restrictions on the stock options awarded under this incentive program will require the individual to remain an employee on a continuous basis and shall vest over a three-year period, one third each on the anniversary date of the award, so that the award will vest in full on the third anniversary of the date of grant. Unless the Committee determines otherwise, if the employment of the employee is terminated for any reason (whether by the Corporation or the employee), the unvested portion(s) of his stock option award shall be forfeited and the employee shall have no right to the shares subject to the unvested portion of the award.

#### Director Level Employees – Additional Cash Incentives

Additionally, each director level employee as defined above (excluding Sales Directors) shall be eligible to receive up to 25% of their actual base salary for the year as a further incentive to accomplish the goals established for the Company by the Board of Directors and Senior Management.

The opportunity for each such director will be defined for each director and the award shall be granted based on the successful execution of the operating and strategic plan as adopted by the Company Board of Directors.

Should the Company reach or exceed the budgeted goal for net income, each director level employee shall receive 10% of their base salary. If the Company exceeds its Net Income goal these directors will be paid an additional 15% of their salary (for a total of 25% as defined in the first paragraph above) if they complete a minimum of three specific and measurable tasks that will be defined at the beginning of the plan year. These tasks will be weighted at 5% each, or at the corresponding percentage based on the number of tasks assigned to that specific employee.

### III. Terms and Conditions of the Plan

Unless otherwise stated, the following terms and conditions apply to any incentives awarded under the Plan:

#### A. Administration of the Plan

1. The Plan shall be administered by the Board or, upon its delegation, by the Committee. For the purposes of the Plan, the term “Committee” shall, unless otherwise required by applicable law, refer to the Board and, upon its delegation to the Committee of all or part of its authority to administer the Plan, to the Committee.

2. In addition to action by meeting in accordance with applicable law, any action of the Committee with respect to the Plan may be taken by a written instrument signed by all of the members of the Committee and any such action so taken by written consent shall be as fully effective as if it had been taken by a majority of the members at a meeting duly held and called. Subject to the provisions of the Plan, the Committee shall have full and final authority in its discretion to take any action with respect to the Plan including, without limitation, the authority (a) to determine all matters relating to any awards under the Plan, including selection of individuals to be granted awards, the types of awards, the number of shares of Common Stock, if any, subject to an award, and all terms, conditions, restrictions and limitations of an award; (b) to prescribe the form or forms of any agreements evidencing any awards granted under the Plan; (c) to establish, amend and rescind rules and regulations for the administration of the Plan; and (d) to construe and interpret the Plan and any agreements evidencing awards granted under the Plan, to establish and interpret rules and regulations for administering the Plan and to make all other determinations deemed necessary or advisable for administering the Plan. In addition, except to the extent otherwise required under Internal Revenue Code (“Code”) Section 409A, related regulations or other guidance, the Committee shall have authority, in its sole discretion, to accelerate the date that any award that was not otherwise exercisable or vested shall become exercisable or vested in whole or in part without any obligation to accelerate such date with respect to any other awards granted to any recipient. In addition, the Committee shall have the authority and discretion to establish terms and conditions of awards (including but not limited to the establishment of subplans) as the Committee determines to be necessary or appropriate to conform to the applicable requirements or practices of jurisdictions outside of the United States.

#### B. Board Authority to Reduce or Eliminate Awards

The Board shall have full authority to reduce or eliminate all awards hereunder. Unless the Committee determines otherwise, a participant who terminates employment for any reason prior to the completion of the time period on which an award is based or vesting period applicable to the award shall not be eligible for the award.

#### C. Source of Stock option Awards

Any stock option awards made under the Plan are issued under and pursuant to the 1997 Omnibus Stock Plan of Charles & Colvard, Ltd. as amended (“Omnibus Plan”). With respect to any stock option awards made under the Plan, all terms, conditions, and requirements of the

Omnibus Plan are incorporated into the Plan by reference. For any stock option awards, to the extent that there is a contradiction between the Plan and the Omnibus Plan or an ambiguity as to the provisions of the Plan, the terms of the Omnibus Plan shall control. All shares issued under the Plan are drawn from the shares reserved under the Omnibus Plan for issuance of awards (see section 4 of the Omnibus Plan).

D. Compliance with Code Section 409A

1. Notwithstanding any other provision in the Plan or an award to the contrary, if and to the extent that Section 409A of the Code is deemed to apply to the Plan or any award granted under the Plan, it is the general intention of the Corporation that the Plan and all such awards shall comply with Code Section 409A, related regulations or other guidance, and the Plan and any such award shall, to the extent practicable, be construed in accordance therewith. Deferrals of shares issued under the Plan in a manner that would cause Code Section 409A to apply shall not be permitted. Without in any way limiting the effect of the foregoing, in the event that Code Section 409A, related regulations or other guidance require that any special terms, provisions or conditions be included in the Plan or any award, then such terms, provisions and conditions shall, to the extent practicable, be deemed to be made a part of the Plan or award, as applicable. Further, in the event that the Plan or any award shall be deemed not to comply with Code Section 409A or any related regulations or other guidance, then neither the Corporation, the Board nor its or their designees or agents shall be liable to any participant or other person for actions, decisions or determinations made in good faith.

2. Without limiting the effect of Section D.1., herein, except to the extent otherwise required or permitted under Code Section 409A, related regulations or other guidance, distributions of Awards under the Plan must be made no later than the later of (a) the date that is 2 1/2 months from the end of the employee's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture; or (b) the date that is 2 1/2 months from the end of the Corporation's first taxable year in which the amount is no longer subject to a substantial risk of forfeiture.

E. Applicable Law

The Plan shall be governed by and construed in accordance with the laws of the State of North Carolina, without regard to the conflicts of laws provisions of any state, and in accordance with applicable federal laws of the United States.

F. Amendment and Termination of the Plan

1. The Plan and any award may be amended or terminated at any time by the Board or the Committee. No action to amend or terminate the Plan or an award shall permit the acceleration of the time or schedule or any payment of amounts deemed to involve the deferral of compensation under Code Section 409A, except as may be otherwise permitted under Section 409A, related regulations or other guidance.

2. Without limiting the effect of Section F.1., herein, the Board shall have unilateral authority to amend the Plan and any award (without Participant consent) to the extent necessary to comply with applicable laws, rules or regulations or changes to applicable laws, rules or regulations (including but not limited to Code Section 409A, federal securities laws or related regulations or other guidance).

#### G. No Right or Obligation of Continued Employment

Nothing contained in the Plan shall require the Corporation or a related corporation to continue the employment or service of an employee, nor shall any such individual be required to remain in the employment or service of the Corporation or a related corporation.

#### H. Compliance with Laws

The Board may impose such restrictions on any shares or other payments or awards hereunder as it may deem advisable, including without limitation restrictions under the Securities Act of 1933, as amended (the "Securities Act"), under the requirements of any stock exchange or similar organization and under any blue sky, state or foreign securities laws applicable to such shares. Notwithstanding any other Plan provision to the contrary, the Corporation shall not be obligated to issue, deliver or transfer shares of Common Stock under the Plan, make any other distribution of benefits under the Plan or take any other action, unless such delivery, distribution or action is in compliance with all applicable laws, rules and regulations (including but not limited to the requirements of the Securities Act). The Corporation may cause a restrictive legend to be placed on any certificate issued hereunder in such form as may be prescribed from time to time by applicable laws and regulations or as may be advised by legal counsel.

#### I. Unfunded Plan; No Effect on Other Plans

1. The Plan shall be unfunded, and the Corporation shall not be required to create a trust or segregate any assets that may at any time be represented by awards under the Plan. The Plan shall not establish any fiduciary relationship between the Corporation and any employee or other person. Neither an employee nor any other person shall, by reason of the Plan, acquire any right in or title to any assets, funds or property of the Corporation or any related corporation, including, without limitation, any specific funds, assets or other property that the Corporation or any related corporation, in their discretion, may set aside in anticipation of a liability under the Plan. A participant shall have only a contractual right to the Common Stock or other amounts, if any, payable under the Plan, unsecured by any assets of the Corporation or any related corporation. Nothing contained in the Plan shall constitute a guarantee that the assets of such entities shall be sufficient to pay any benefits to any person.

2. The amount of any compensation deemed to be received by a participant pursuant to an award shall not constitute compensation with respect to which any other employee benefits of such participant are determined, including, without limitation, benefits under any bonus, pension, profit sharing, life insurance or salary continuation plan, except as otherwise specifically provided by the terms of such plan or as may be determined by the Board or Committee.

3. The adoption of the Plan shall not affect any other compensation plans in effect for the Corporation or any related corporation, nor shall the Plan preclude the Corporation from establishing any other forms of compensation for employees or service providers of the Corporation or any related corporation.

#### J. Withholding; Tax Matters

1. The Corporation shall withhold, or shall require the participant to pay the Corporation in cash, the amount of any local, state, federal, foreign or other tax or other amount required by any governmental authority to be withheld and paid over by the Corporation to such authority for the account of the participant.

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2. The Corporation makes no warranties or representations with respect to the tax consequences (including but not limited to, income tax consequences) related to the transactions contemplated by this Plan. A participant should consult with his or her own attorney, accountant, and/or tax advisor regarding the decision to participate in the Plan and the consequences thereof. The Corporation has no responsibility to take or refrain from taking any actions in order to achieve a certain tax result for any participant.

**Summary of Non-Employee Director Compensation, effective May 22, 2006****Cash Compensation**

Annual Retainer for the Lead Director	\$25,000
Annual Retainer for Directors	\$ 18,000
Fee per Board Meeting*	\$ 750
Fee per Committee Meeting*	
Audit Committee	
Chairperson	\$ 2,000
Member	\$ 750
Compensation Committee	
Chairperson	\$ 1,000
Member	\$ 750
Nominating and Corporate Governance Committee	
Chairperson	\$ 1,000
Member	\$ 750

\* Board and Committee Meeting Fees are capped at a maximum of \$2,750 per day for each Director who serves on multiple committees.

***Payment of Cash Compensation***

The Annual Retainer will be paid in two installments in May and November. Board and Committee Meeting Fees will be paid in arrears for the prior quarter's meetings.

***Equity Compensation***

The Lead Director will be granted restricted stock awards with a grant date value of \$55,000. All other Directors will be granted restricted stock awards with a grant date value of \$50,000. The restricted stock awards will vest upon completion of service on the Board from the 2006 annual shareholders meeting until the 2007 annual shareholders meeting.

**Cash and Equity Performance Awards for 2005**

Approved February 14, 2006 by the Board of Directors of Charles &amp; Colvard, Ltd.

<u>Executive</u>	<u>Cash</u>	<u>Stock Options</u>
Robert Thomas	\$203,095	26,250
James Braun	\$143,620	21,500
Dennis Reed	\$141,521	25,750
Earl Hines	\$115,277	15,750

In addition, the Board of Directors approved cash bonuses and equity awards for additional management employees totaling \$171,020 in cash and covering an aggregate of 15,750 shares of the Company's common stock.