February 9, 1989

To Our Clients:

Share Price Protection Preferred Stock
"Protect Preferred"

Since our initial memorandum on the concept of share price protection preferred stock ("protect preferred") in December 1988, we have had discussions with corporate financial officers, investment bankers, lawyers and accountants, who raised a number of questions about how it works. This memorandum summarizes the answers to those questions and the purpose, mechanics and likely effect of issuing protect preferred. It also reflects certain significant modifications based upon these discussions and our further thinking.

Protect preferred can be used as a response to a takeover bid or as a planning and value enhancement strategy before a company becomes a target of a bid. Protect preferred is designed to be an attractive long-term investment for institutional investors and to alleviate the pressure to restructure or be taken over. Protect preferred may be the deciding factor in enabling a company to support a determination that the best interests of the company and its shareholders would be served by the company remaining independent and pursuing its present business plan without subjecting itself to a wrenching and untimely restructuring.

Background

The recent decisions by the Delaware Chancery Court in the Interco and Pillsbury cases have underscored the difficulties faced today by a company whose shares are undervalued in the market. The company's board of directors may believe that the company's value to shareholders will be maximized if the company remains independent and continues to pursue its current business plan. Yet in today's takeover environment, the board of directors often may find that it simply has no time to pursue this value-maximizing alternative. Quite simply, the board is likely to come under enormous pressure either to sell the company or to restructure now, incurring heavy debt which will force the company to abandon its long-term business plan. Indeed, the Interco case suggests that a company often may not even have the opportunity to complete a restructuring begun in the face of a hostile cash tender and thus may have no choice but to sell the company.

Protect preferred is particularly appropriate for successful companies with sound business plans whose shares are undervalued and who are under pressure to restructure. The basic concept of protect preferred is the undertaking by a company to achieve a specified market price (the "target price") for its equity, i.e., the combination of its common stock and the protect preferred, by a specified date (the "target date"). If the target price is not achieved by the target date, the holders of protect preferred are entitled to a special cash dividend in an amount equal to the shortfall.

Protect preferred should alleviate the pressure for an immediate restructuring. It is the practical equivalent of an undertaking by the company to restructure in the future if it fails to reach a stated target price by a predetermined target date. The target price is based upon the expected trading value of the company's stock on the target date assuming that the company meets its growth objectives set forth in its business plan. The target price is not intended to reflect the company's acquisition value on the target date. The expected acquisition value on the target date would be substantially higher than the target price expected to be achieved on that date.

Issuing protect preferred telegraphs to the market a company's confidence in its long-term prospects, while providing assurances to investors that the company will take additional measures in the future to enhance shareholder value if the company fails to meet its growth objectives. As such, protect preferred creates an incentive to shareholders to be long-term investors rather than short-term speculators.

Protect preferred does not burden the operations and financial structure of the company as would an immediate leveraged recapitalization. There are no asset sales, so there are no taxes on such sales. There are no new borrowings, so there is no additional debt service requirement. The company remains free to follow the business and financial strategies set by the board of directors and to revise these strategies as the board determines to be appropriate. Moreover, protect preferred has various features that build in flexibility so that the company may continue to pursue its business plans in the face of changing conditions.

Protect preferred is not a poison pill and is not intended to prevent all takeovers. Nevertheless, the market value enhancement and the capital structure created by protect preferred should deter takeovers at less than the target price set by the board of directors. Unlike the share purchase rights plan (the classic "poison pill"), protect preferred cannot be redeemed at the option of the company's board of directors to facilitate an acquisition approved by the board of directors. Protect preferred does not replace a rights plan, and it is contemplated that a company that issues protect preferred would have a rights plan.

Protect preferred would be issued by a company for planning and value enhancement purposes after the company's board of directors concluded that the company has favorable long-term prospects that would be jeopardized by being forced to change its plans. Essentially, the board of directors is concluding that the restrictive provisions of the protect preferred are justified by the advantages to shareholders of the company having an improved opportunity to realize its long-term goals without being sidetracked by pressure for short-term performance.

Protect preferred can also be used in connection with a plan by a company to recapitalize or liquidate over a six to eighteen month period. In this case the target price would be the estimated liquidation value or recapitalization value and the target date would be the estimated consummation date of the recapitalization or liquidation. The protect preferred could provide additional assurance to shareholders that the company will follow through on its planned recapitalization or liquidation.

Terms of Protect Preferred

Each issue of protect preferred must be specially designed and will require a combined financial and legal effort by the issuing company. The following summary of the terms of the protect preferred and the term sheet attached as Exhibit A give only the basic parameters for that design. Exhibit B contains several examples of the operation of protect preferred. Exhibit C contains a mathematical analysis of the operation of protect preferred.

The protect preferred would be issued to all current holders of the company's common stock as a dividend of one share of protect preferred for each outstanding share of common stock.

The shares of protect preferred would be freely tradeable apart from the common stock, but the company would recommend that shareholders consider trading their shares as units and would establish a mechanism for trading units. The protect preferred would pay a regular preferential dividend in an amount based on the current common stock dividend. In most cases, the preferential dividend would be equal to approximately 10% to 20% of the current common stock dividend. The dividend would be cumulative.

The liquidation preference of the protect preferred would be determined by calculating a current market yield based on the amount of the dividend on the protect preferred. For example, if the dividend were $.50 and the company could issue an ordinary preferred stock at an 8% yield, the liquidation preference for the protect preferred would be $6.25 (i.e., $.50 divided by .08).

Except for two key special elements, the terms of the protect preferred would be essentially similar to the terms of other preferred stocks which are routinely issued by companies for financing and other purposes. These special elements are the special dividend ("put") feature and the conversion ("call") feature. The protect preferred would also contain various covenants designed to prevent evasion of these two special features and provide certain voting rights in the event the special dividend is not paid on time or any of the covenants is breached.

Special Dividend Feature. The special dividend feature embodies the company's commitment to take measures to enhance shareholder value if the company does not meet its target. The company will pay a special dividend to the holders of the protect preferred if the combined trading prices of the company's common stock and the protect preferred does not equal or exceed the target price for a specified period of time prior to the target date. The amount of the special dividend will be equal to the difference between the target price and the average combined market price of one share of common stock and one share of protect preferred (collectively, a "protected equity unit") for a specified number of days prior to the target date. The special dividend would be cumulative with the regular preferential dividend and would accrue interest at a rate equal to the regular dividend rate until paid in full. Holders of the protect preferred would be entitled to receive the special dividend whether or not they also hold shares of common stock.

In an early version of protect preferred the size of the special dividend was determined solely by reference to the value of the common stock, which led to a possible downward ratchet effect on the price of the common. As illustrated in Exhibits B and C, setting the amount of the special dividend based upon the market price of the protected equity units limits the downward pressure on the common stock and permits equilibrium trading values of the common stock and protect preferred to be established.

While the protect preferred is outstanding, the expected amount of the special dividend, if any, would vary with changes in the market value of the protected equity units, which would be difficult to predict. In order to permit a company to eliminate its special dividend obligation prior to the target date, the protect preferred would provide that the special dividend may be paid prior to the target date. In that case, the amount of the dividend would be equal to the difference between the target price and the market price of a protected equity unit for a specified number of days prior to the declaration date of the dividend. Thus, if prior to the target date the market price of a protected equity unit approaches the target price, the company may, by accelerating the payment of the special dividend, eliminate the obligation to pay it on the target date.

In order to protect the company against a deterioration in stock market conditions, the target price could be subject to a stock market or industry group index adjustment. This would provide a hedge against the possibility that the company may successfully achieve its business plan but fail to reach the target price due to a decline in the general level of stock prices, whether in the market as a whole or in the company's industry group. The indexing could also provide that the target price would automatically increase in a period of rising stock market prices. In addition, the target price would be subject to customary antidilution provisions.

In the event of a change of control other than pursuant to an offer for all shares of common stock or protected equity units at a price not less than the target price, the special dividend would be accelerated and would be equal to the difference between the target price and the lowest common stock sales price during the period beginning a specified number of trading days prior to the change of control and ending a specified number of trading days following the change of control. This change of control provision is designed to insure that a holder of one protected equity unit receives an aggregate of not less than the target price for his securities and would have the effect of deterring takeover bids at a price less than the target price. The triggering of the change of control provision may create substantial downward pressure on the common stock during the specified trading-day period before and after the change of control as shareholders sell their common stock to hedge against a substantial deterioration in the value of the common stock after the end of the measurement period. This will lead to a corresponding increase in the special dividend payable on the protect preferred. In extreme situations, the special dividend payable upon a change of control could hypothetically approach the target price. While a bidder would presumably tender for protected equity units, it is unlikely that holders would be willing to tender their units at a price less than the target price achievable after the change of control. Thus, the impact on the trading market for the common stock of triggering the change of control provision if the target price is not paid is unlikely to occur. Moreover, the holders of shares of common stock not acquired in a takeover bid would be protected against a squeeze-out merger at a lower price by fair price charter or statutory provisions as well as by the company maintaining a rights plan. We believe that it is unlikely that a court would order redemption of a rights plan to permit the consummation of a tender offer that does not offer a fair price for all of the common stock and all of the protect preferred.

The definition of "change of control" may be tailored to an individual issuer's needs, but should generally include any acquisition by a single person or group of direct or indirect beneficial ownership of more than a specified threshold amount (in most cases, 50% or more) of the issuer's common stock.

In the event of a merger or other extraordinary transaction in which the common stock is converted into cash, securities or other property having a value less than the target price, the protect preferred would be entitled to receive consideration equal to the greater of (i) any accrued and unpaid special dividend previously determined upon a change of control or (ii) the difference between the target price and the value paid per share of common stock in such transaction. The amount of any special dividend previously paid to holders of protect preferred upon a change of control would be credited against such payment in the transaction. The protect preferred would continue to remain outstanding following such a transaction in order to preserve the value of the conversion feature described below.

Conversion Feature. The protect preferred would be convertible into common stock at the option of the holder upon payment of an amount of cash equal to the target price. Thus, the protect preferred includes features of a long-term call. The conversion price would have customary antidilution adjustments and could be subject to the same index adjustments, if any, as the target price.

Three alternative antidilution adjustments could be provided in the event of a merger. First, as is provided in most publicly issued convertibles, the protect preferred could remain outstanding and could become convertible into the same consideration that the holders of common stock receive in the merger. Thus, in the event of a merger at a price above the target price, the conversion feature would entitle holders of the protect preferred to receive an amount equal to the excess of the merger price over the conversion price, while the conversion feature would have no value in the event of a merger at a price below the target price.

A second alternative would be to provide that the protect preferred remains outstanding and becomes convertible, at an appropriately adjusted price, into the common stock of the ultimate parent of the purchaser. A third would be to make the protect preferred convertible into common stock of the corporation surviving the merger. Precedent for both the second and the third alternatives can be found in private placement convertibles. Furthermore, the second or third alternative could be combined with the first alternative with the holder being given the option of electing between the alternative antidilution adjustments. These alternatives should be coupled with so-called "anti-destruct" provisions which would assure the value of the conversion right by requiring that the underlying common be kept publicly registered and stock exchange listed. Thus, these alternatives may somewhat deter an acquiror which is a private company or which does not wish to have a public subsidiary. The amount of "overhang" arising from the potential conversion of the protect preferred after a merger could be substantial depending upon the number of shares of protect preferred which were acquired by the purchaser prior to the merger.

The protect preferred would be noncallable until some date subsequent to the target date. The longer the noncall period, the more valuable the conversion feature would be. Prior to any call, the company would fix a call date on appropriate notice. The call price would be equal to the liquidation preference plus accrued and unpaid dividends (including the special dividend). There would not be any mandatory redemption of the protect preferred.

As an option, the company could reserve the right to exchange the protect preferred for subordinated debt under certain circumstances. This would enable the company to benefit from the deductibility of interest payments for tax purposes.

Covenants. The protect preferred would be junior to any currently outstanding preferred stock. It would contain covenants prohibiting the issuance of additional senior or parity preferred stock. The protect preferred would also contain limitations on the incurrence of debt and liens, on the payment of common dividends and dividends on other junior stock, on the making of loans to stockholders, as well as other covenants designed to prevent diminution of the value of the protected preferred. There could be a special exception for transactions that, based upon the determination of an independent board, are likely to result in the target price being achieved. The covenants would not apply after the special dividend has been paid or becomes nonpayable because the price of the protected equity units has exceeded the target price for the required period of time. Corporate actions taken in violation of the covenants could be enjoinable. This would likely force a leveraged acquiror to seek to acquire the protect preferred as part of his takeover bid.

Voting Rights. The protect preferred would ordinarily be nonvoting, except for any voting rights required under state law and customary class voting provisions for waivers of financial covenants, with 85% of the outstanding shares of protect preferred being required to approve a waiver. The waiver of covenants could be conditioned upon the approval by holders unaffiliated with the person who triggered a change of control. In the event that there is a default in payment of the special dividend or a breach of a covenant, the holders of the protect preferred would have the right to elect one-third of the board of directors of the issuer. As an option, the protect preferred could provide that in the event of a willful breach of a covenant, the holders of the protect preferred would have the right to elect a majority of the board of directors of the issuer.

Trading Market for the Protect Preferred and Valuation Issues

General. The protect preferred would be freely tradeable apart from the common stock. However, we believe that prior to the target date a separate trading market for the protect preferred would be limited in the absence of a change of control and that as a practical matter the protect preferred and the common stock would principally trade as units. It will be in the interests of most shareholders not to separate the protect preferred from the common stock and most will not. Since the protect preferred acts as a hedge against the company failing to reach the target price, shareholders who separate the securities are at risk to volatile changes in the value of the security they retain, as described below. Accordingly, companies would be expected to advise shareholders to consider carefully the implications of trading the securities separately. The issuance of protect preferred would not interfere with a company's ability to raise additional equity capital since the company could sell protected equity units. Appropriate adjustments to employee stock options and convertible securities would also be made.

Because the protect preferred is a new and unique security, its value will be uncertain until it is tested in the market. In addition to the value of the protect preferred as an ordinary preferred stock, the conversion feature creates the equivalent of a deep-out-of-the-money long-term call for holders, while the special dividend feature creates the equivalent of a deep-in-the-money put that only becomes exercisable in the future. The valuation of these features will be a function of term and liquidity, the market value and volatility of the common stock and protect preferred, and other factors that go into valuation of puts and calls. While the protect preferred will likely increase the volatility of the company's common stock, the volatility of the protected equity units should be significantly less than that of either security separately.

In the view of several investment banking firms, the aggregate value of the company's equity should increase as a result of the issuance of the protect preferred. The issuance of the protect preferred signals the strength of the board of directors' belief in its estimate of the company's future prospects and hence may improve the visibility of those prospects. A company is unlikely to issue protect preferred if its target price reflects a lower growth rate than is anticipated at that time by analysts. The protect preferred will also create an impetus for the future sale or recapitalization of the company if the target price is not achieved. Furthermore, the special dividend feature provides downside protection for the protected equity units, making the units an attractive investment for both institutions and individual investors.

<u>Allocation of Values</u>. The allocation by the market of the total value of the company's equity between the common stock and the protect preferred will depend upon several factors, including the market's assumptions at any given time regarding the amount and timing of the special dividend, if any, and the company's business prospects. Given the market's valuation of the combined equity of the company and the market's assumptions regarding the special dividend, however, the relative valuations

of the common stock and the protect preferred should reach an equilibrium. An example of how this equilibrium of relative valuations is reached is described in Exhibit B.

Earnings Per Share Alternative for Calculating Target Price

As an alternative to setting a target price, the company could set a target for earnings per share as an appropriate measure of the success of its business plan. If the earnings target were not met by the target date, then the company would pay a special dividend calculated on the basis of the shortfall in earnings and a trading multiple established by the company. Thus, the company effectively establishes an "imputed target price" which equals the product of the target earnings per share and the trading multiple.

No special dividend would be payable if either the earnings target were achieved by the target date or the protected equity unit were to trade at or above the imputed target price for a specified period prior to the target date. If a change of control occurred, the special dividend would equal the difference between the imputed target price and the lowest common stock sales price during a specified period beginning prior to the change of control and ending after the change of control. An example of the operation of protect preferred using an earnings per share target is set forth in Exhibit B.

The use of an accounting measure of the business plan's success, such as earnings per share, has both advantages and disadvantages. On the plus side, many managements believe that accounting measures are a better gauge of performance than stock market measures, since the stock market is subject to large fluctuations over which management has no control. In addition, the greater stability of accounting results would allow a board of directors to judge with greater accuracy the likelihood that an accounting target will be met than the possibility of a stock price target being met; especially in the last year or two before the target date, this greater predictability could increase the board's ability to plan for a restructuring or other action to enhance shareholder value in the event the target were not met. On the other hand, many shareholders, especially institutional investors, might believe that a target stock price provides greater assurance that they will receive the expected value for their shares.

Effect on Takeovers

As noted above, the protect preferred will be a deterrent to an acquiror seeking control of the company at a price per share below the target price. The deterrent effect will not be great with respect to bids above the target price. Since the target price is based upon future trading values rather than acquisition values, we recognize that if a company meets its growth plan, a future bid price that includes a control premium on top of an improved market price should exceed the target price earlier than the target date. If a bid were to be made, the company would be free to use its rights plan or any other defense against such a bid as well as seek a white knight or undertake a leveraged recapitalization. And the protect preferred would have served its purpose -- the pressure for an immediate restructuring would have been relieved and the shareholders would have received at least the target price. Because the protect preferred, unlike a rights plan, cannot be redeemed by the board to facilitate a friendly offer, the protect preferred might make it difficult or impossible for the board of directors to negotiate a sale of the company at less than the target price even if the board felt that such a sale would be in the best interests of shareholders. Subject to its fiduciary duties to holders of the common stock, the board could accelerate the payment of the special dividend in connection with a negotiated transaction. Since it is likely that the protect preferred and common stock would be held by substantially the same shareholders, the fiduciary issues raised by an acceleration of the special dividend should not be significant.

Secret accumulations of protect preferred by potential acquirors would be limited by the disclosure requirements of Section 13(d) of the 1934 Act. Because the protect preferred is immediately convertible into common stock (even though it is out-of-the-money), the shares of protect preferred that an acquiror purchases would count as shares of common stock for the purpose of determining whether the acquiror has crossed the 5% threshold at which his ownership of the common stock must be disclosed. In calculating the acquiror's percentage ownership for purposes of Section 13(d), the number of shares of protect preferred held by other persons would not be considered. There would be no separate 5% threshold under Section 13(d) involving the protect preferred as a separate class of securities. The Hart-Scott-Rodino filing and clearance requirement (e.g., $15 million or 15%) would not apply to acquisitions of the protect preferred; it would apply to acquisitions of the common stock through conversion of the protect preferred.

It should be noted that even after an acquiror discloses his accumulation, it could be to his advantage to continue to seek to buy common stock and/or protect preferred in the market, depending on the market price of these securities and his intended bid price. A rights plan would provide protection for shareholders against this sort of creeping acquisition. Ownership of protect preferred by the acquiror (but not by other holders) would be treated as beneficial ownership of the underlying common stock for purposes of determining whether the rights plan's acquisition thresholds have been triggered.

As indicated above, the issuance of the protect preferred should not have the effect of setting a sales price for the company. The target price is designed primarily to reflect the judgment of the board of directors as to the future trading value of the company if it remains independent and unrestructured, although the board in the exercise of its business judgment may consider additional factors in setting the target price. Moreover, even to the extent that the target price reflects the judgment of the board of directors as to the value of the company at the time the target price was set, the board of directors' judgment as to the company's value is subject to continuous re-evaluation and change based on changes in circumstances.

Deferred Recapitalization or Restructuring

If the company's stock price fails to reach the target price, regardless of whether the company has otherwise met its business plan, the company would, at the target date, become subject to the special dividend provisions. In that event, the company would probably have taken steps to implement a restructuring or recapitalization in order to pay the special dividend. It should be noted, however, that the company is not required to pay the entire target price in cash; only the difference between the target price and the market price of a protected equity unit must be paid in cash. Thus, in many cases, the restructuring would not be a dramatic one and would not require the company to leverage itself highly, to sell major assets or to abandon its plans for future investment. Thus, if the protected equity units of a company that set a $100 target price were to reach a market price of only $80, the company would only have to restructure to the extent necessary to pay $20 per share of protect preferred. The company should be able to raise this amount of money without the wrenching corporate changes that would have been required by an immediate restructuring today. Moreover, if the price of the protected equity units reached $80 in an earlier year, the company could elect to pay a $20 special dividend at that time rather than risk the consequences of a possible future market decline.

Finally, as with any preferred stock dividend, the board of directors retains the power, in the exercise of its business judgment, not to pay the special dividend or to pay only a part of the special dividend. The board of directors could determine that under the business, market or economic conditions prevailing at the target date, payment of the special dividend should be deferred until conditions become more attractive for a restructuring or recapitalization. In that event, the holders of the protect preferred would be entitled to elect one-third of the board of directors, the unpaid special dividend would cumulate with interest and dividends on junior stock could not be paid. The board would continue to have the power and the obligation to direct the company in accordance with its independent business judgment of the best interests of the company and all of its shareholders.

The company's financing capacity should not be impaired by the prospect of the special dividend, although lenders would likely insist on provisions that restrict the payment of the special dividend without prior repayment of the borrowings or without the satisfaction of certain financial covenants following payment of the special dividend.

Tax and Accounting Implications

There would be no significant adverse tax or accounting consequences of using protect preferred.

The dividend of protect preferred would be tax-free to the holders of the common stock. The protect preferred would be Section 306 stock, with the principal tax consequence being the recognition of ordinary income on any eventual redemption or sale. Indexing the conversion price would result in additional tax consequences to the holders of the common stock and protect preferred. In all other respects, the tax consequences to a company using protect preferred are the same as would flow from the issuance of an ordinary preferred stock. Thus, there would be no significant tax consequences either to the issuing company or to its shareholders.

Although the accounting treatment of protect preferred has not yet been passed on by the SEC, based on advice we have received from one of the big eight accounting firms, the special dividend would be reported as a dividend in the period it is declared or becomes payable. The special dividend would also be included in primary and fully diluted earnings per share for that period. In financial statements of periods prior to the target date, footnote disclosure would be made of the special dividend that would have been payable, and the related supplementary earnings per share impact, had the special dividend been declared at that date. There would be no effect on earnings per share until the market price of the common stock exceeds the target price and the conversion feature comes into the money.

<u>Other Legal Matters</u>

We believe a dividend of the protect preferred can be declared by a board of directors in the exercise of its business judgment. It is a reasonable response to pressure for an immediate restructuring or recapitalization when the board believes that pursuing the company's business plan is a superior alternative. We think the protect preferred should satisfy some of the concerns raised by the <u>Interco</u> and <u>Pillsbury</u> cases, where the courts expressed skepticism about the management's business plans. By issuing the protect preferred, a board of directors would be demonstrably expressing confidence in its business plan and committing itself to take forceful action to create additional shareholder value if the business plan fails to meet its goals. Accordingly, it is important that a company that issues protect preferred tailor the features of the protect preferred to match its specific business plan.

The protect preferred should bolster the ability of a board of directors to "just say no" to inadequate takeover bids, a question which has not yet been decided by the Delaware Supreme Court. In those states which have adopted statutes requiring or permitting the board of directors to consider the long-term interests of shareholders and other constituencies, the protect preferred should assist the board in carrying out this responsibility.

Companies that have previously obtained shareholder approval for "blank check" preferred stock will not require additional approval for the issuance of protect preferred. Companies which do not have enough authorized preferred stock to issue protect preferred on a one-for-one basis with the common stock could issue fractional shares of protect preferred, with terms designed to make the fractional shares equivalent to full shares of protect preferred. Companies that do not have sufficient authorized common stock to satisfy the full exercise of the conversion feature of the protect preferred could provide that the protect preferred is convertible into a new series of preferred stock (or fractional shares of a new series) which has terms designed to make these new preferred shares equivalent to shares of common stock. We believe that protect preferred will be sufficiently attractive to shareholders, including institutional investors, that it will be feasible to obtain any charter amendments necessary to permit the issuance of protect preferred.

Issuance of the protect preferred as a dividend to holders of the company's common stock would be exempt from registration under the 1933 Act. The protect preferred would have to be registered under the 1934 Act by filing a simple Form 8-A describing its terms. If the common stock is listed on a stock exchange, the listing application for the protect preferred should also be simple and straightforward.

The protect preferred may raise an issue under Rule 19c-4. However, we believe the issuance of protect preferred as a dividend to holders of the common stock should fall within the exemptions to Rule 19c-4, because all current shareholders will receive shares of protect preferred in proportion to their current holdings of common stock, because the class vote, like the class vote provided in other preferred stocks, is tied to the breach of covenants or the failure to pay dividends as contemplated by Rule 19c-4, and because the protect preferred does not otherwise serve to disenfranchise the common shareholders.

Since the "out of the money" conversion right would not be exercised immediately, a registration statement with the SEC covering the issuance of the common stock upon conversion of the protect preferred need not be effective until after issuance of the protect preferred dividend, when and if the conversion feature of the protect preferred comes into the money.

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Term Sheet

Price Protection Preferred Stock

Regular Dividend:	The regular dividend on the protect preferred is set at an amount based on the current common dividend, and in most cases is expected to be equal to approximately 10 to 20% of the common dividend.
Preference on Liquidation:	An amount determined by the regular dividend on the protect preferred so that the regular dividend is a market rate yield. For example, if the regular dividend is $.50 and the company could issue an ordinary preferred at 8%, the liquidation preference for the protect preferred would be $6.25 (i.e., $.50 divided by .08).
Special Cash Dividend:	An amount equal to the difference between the target price and the average combined market prices of one share of common stock and one share of protect preferred (collectively, a "protected equity unit") for a specified number of days prior to the target date. If the market price of a protected equity unit equals or exceeds the target price for a specified period prior to the target date, no special dividend is due. The company may pay the special dividend prior to the target date, in which case the dividend is an amount equal to the difference between the target price and the market prices for a specified period prior to the declaration date. After the target date, until paid in full, the special dividend accrues interest at a rate equal to the regular dividend rate. The target price is subject to customary antidilution adjustments. As an option, the target price could also be subject to a stock market or industry group index

adjustment to protect against the company being successful but the general level of stock market prices declining.

Holders of the protect preferred are not required to hold common stock to receive the special dividend.

If there is a change in control of the company other than pursuant to an offer for all shares of common stock or protected equity units at a price not less than the target price, the special dividend is accelerated and equals the difference between the target price and the lowest sales price of the common stock during the period beginning a specified number of trading days prior to the change of control and ending a specified number of trading days following the change of control. In the event of a merger or other extraordinary transaction, the protect preferred would be entitled to receive consideration equal to the greater of (i) any accrued and unpaid special dividend previously determined upon a change of control or (ii) the difference between the target price and the value paid per share of common stock in such transaction. The amount of any special dividend previously paid to holders of protect preferred upon a change of control would be credited against such payment. The protect preferred would continue to remain outstanding following such transaction.

As an option, rather than setting a target price, the company could set a target for earnings per share. If target earnings are not achieved by the target date, the amount of the special dividend would be calculated using a formula based on the shortfall in earnings and a multiple specified by the company at the time the protect preferred is issued.

Dividends Cumulative: The regular dividend and the special dividend are cumulative.

Conversion into Common: Each share of protect preferred is convertible at the option of the holder into one share of common stock at any time upon payment of an amount in cash equal to the target price. The conversion price would have customary antidilution adjustments and could be subject to the same index adjustments, if any, as the target price.

Three alternative antidilution adjustments can be provided in the event of a merger: (1) the protect preferred could become convertible into the consideration received by the holders of common stock in the merger; (2) the protect preferred could become convertible, at an appropriately adjusted price and conversion ratio, into the common stock of the ultimate parent of the acquiror; and (3) the protect preferred could become convertible into the common stock of the surviving corporation of the merger. The first alternative could be coupled with either of the latter two alternatives, with the holder of the protect preferred being given the option to elect.

Call Provisions: Noncallable until a date subsequent to the target date. Prior to any call, the company will fix a call date on appropriate notice. The call price is equal to the liquidation preference plus accrued and unpaid dividends (including the special dividend) and interest.

As an option, the company could reserve the right to exchange the protect preferred for subordinated debt under certain circumstances.

Mandatory Redemption: None.

Covenants: No issuance of prior or parity preferred. Limitations on incurrence of debt and liens, payment of common dividends and dividends on other junior stock and making of loans to shareholders. Such other covenants as are needed to protect and assure the value of the protect preferred.

The covenants no longer apply after the special dividend has been paid or the target price is achieved for the requisite period of time. There could be a special exception to the covenants to permit a transaction that, in the determination of an independent board, is likely to result in the target price being achieved.

<u>Voting</u>: The protect preferred has a class vote on waiver of covenants, with 85% of the outstanding shares necessary to approve a waiver of financial covenants. As an option, shares of protect preferred held by an interested shareholder can be excluded from this calculation. Otherwise, the protect preferred is nonvoting except as required by state law or in the event of default in payment of the special dividend or a breach of a covenant, in which event the protect preferred as a class has the right to elect one-third of the board of directors. As an option, in the event of a willful breach of covenant, the holders of the protect preferred could have the right to elect a majority of the board of directors of the issuer.

<u>Change of Control</u>: No provisions except as set forth above.

Examples of Operation of Protect Preferred

The following are hypothetical illustrations of how the protect preferred can be used. The prices, time periods, dividend ratio, percentages and discount rates are illustrative and would vary to suit the circumstances of each individual company. Our hypothetical company is named Growth. Growth has a share purchase rights plan, which will continue in effect. Our analysis shows that protect preferred preserves more of the upside for shareholders than an immediate restructuring and acts as a deterrent to takeover offers below the target price.

I. Protect Preferred Issued as Alternative to Immediate Recapitalization. Growth's common stock is selling in the market for $50 per share and is paying a dividend of $2.50 annually. The $50 trading value does not reflect the intrinsic value of Growth's assets and presumably an acquisition premium could be obtained if Growth were sold immediately. Growth's five-year business plan projects a 15% compound annual increase in profits, and the stock price is expected to increase at about the same rate. Therefore, Growth can reasonably expect its common stock price to double to $100 or more by the end of the fifth year without a restructuring or recapitalization. Presumably, the intrinsic value of Growth's underlying assets would grow proportionately and would be substantially greater than $100 at that time.

Growth could undertake an immediate restructuring or recapitalization which would enable Growth to pay shareholders $50 per share in cash immediately -- i.e., to pay out the entire current market value of the common stock in cash -- while still leaving shareholders with a "stub" equity interest in Growth. The value of this "stub" equity is uncertain and difficult to predict. The recapitalization would force Growth to incur a heavy debt load, to sell important assets and to abandon Growth's promising five-year plan, in order to concentrate on maximizing cash flow to repay debt. The increased debt load would make the "stub" equity price more volatile and risky than the common stock price would be in the absence of a restructuring. While the recapitalization would eliminate some of the discount to intrinsic value placed on Growth's assets by the market, it would deprive shareholders of the opportunity eventually to obtain the full value inherent in Growth's assets and long-term prospects.

Instead of implementing an immediate restructuring, the board of directors decides that Growth should distribute a dividend to its shareholders of one share of protect preferred for each share of common stock. Each share of protect preferred has a liquidation preference of $6.25 and an annual preferential dividend of $.50. The board decides to set the target price at $100 per protected equity unit and to fix the target date at five years from the date of issuance. Issuing protect preferred rather than carrying out an immediate recapitalization will preserve the upside potential that Growth's business plan offers -- the possibility that Growth's shares may be worth even more than $100 in five years -- while the special dividend feature decreases the downside risk for investors if the stock price does not increase as fast as expected.

If Growth meets expectations under the business plan, Growth's share price should reach $100 or more by the target date. On the other hand, if Growth restructures immediately, shareholders might have much less than $100 in five years. Moreover, by issuing the protect preferred, Growth is leaving open the option of a future restructuring or alternative transaction designed to eliminate the market discount; a restructuring of Growth or an alternative transaction in the future, after the expected period of 15% compounded annual returns, is likely to have a greater present value than an immediate recapitalization or restructuring.

If Growth is not successful in meeting its target price and the protected equity units are only trading at $80 in the market during the specified period prior to the target date, Growth will pay a $20 special dividend to the holders of the protect preferred. Assuming the market anticipates that the $20 dividend will be paid promptly, the protect preferred should be valued at approximately $26.25 (i.e., the sum of the $20 dividend and the $6.25 value of the stream of preferred dividend payments, assuming no value for the conversion feature). The value of the common stock would then be $53.75, giving effect to the obligation to pay the special dividend. The $80 market value of the protected equity units should reflect the perceived value resulting from the recapitalization necessary to pay the special dividend and presumably the market price of the shares at such time would have been lower absent the issuance of the protect preferred.

II. Growth Receives a Takeover Bid Shortly after Issuing the Protect Preferred. Suppose a person who wishes to acquire Growth makes a takeover bid at a price of $75 per share of common stock shortly after Growth issues the protect preferred. Since the full amount of the special dividend accelerates upon a change of control, the would-be acquiror would have to determine how to price his bid and how to allocate his price between the common stock and the protect preferred. The net effect of the acceleration provision of the protect preferred will be to deter offers below the $100 target price.

Whether the acquiror offers the full $75 for the common stock and does not offer to purchase the protect preferred or makes an offer to buy units consisting of one share of common stock and one share of protect preferred at a purchase price of $75 per unit, a holder of the protect preferred would be entitled to a special dividend upon the change of control equal to the difference between $100 and the lowest sales price of the common stock during the specified period beginning prior to the change of control and ending following the change of control. Thus, the amount of the special dividend would be expected to be at least $25 per share and if the common stock trades below $75 during this period the amount of the special dividend would increase by a like amount. If the acquiror were to decide not to pay the special dividend, the protect preferred holders would be entitled to elect one-third of Growth's board of directors. In addition, the financial covenants of the protect preferred would prohibit the acquiror from receiving dividends or loans from the company and would impair the acquiror's ability to finance the transaction at the company level.

While a takeover bid for protected equity units at less than the target price is unlikely to be successful, since holders who do not tender can lock in at least the target price by selling the common stock shortly before or after the change of control and retaining the protect preferred, a takeover bid for common stock alone could receive the tender of a substantial number of shares. However, the change of control would impose a substantial dividend obligation on Growth that would cause the cost to the acquiror of each protected equity unit to be at least equal to the $100 target price and would restrict the financial flexibility of Growth until the special dividend is paid. If the change of control provision is triggered by a takeover bid at a price below the target price, there could be substantial downward pressure on the common stock during the specified period around the change of control date as holders seek to sell Growth common stock to hedge against further deterioration of the value of the common stock after the measurement period ends and the amount of the special dividend is determined. By selling in the measurement period shareholders can assure that the value they receive for their common stock when added to the amount of the special dividend will equal at least $100. In extreme situations, this selling pressure in the absence of willing buyers of the common stock could cause the amount of the special dividend to approach the target price. The holders of common stock would be protected against a bidder attempting a strategy involving a squeeze-out merger at a low common stock price by fair price charter or statutory provisions as well as by the company's rights plan.

III. Growth Receives a Takeover Bid Three Years after Issuing the Protect Preferred. Suppose that, three years after the issuance of the protect preferred, Growth is on target with its business plan and Growth's common stock price has increased to $75 per share. A would-be acquiror then makes a bid for Growth at a price of $110 per share. The acquiror's difficulty in allocating his purchase price is diminished, since if he makes an offer for all shares of common stock or protected equity units at a price not less than $100 per share, the holders of the protect preferred would not be entitled to a special dividend.

Nevertheless, due to the $.50 preferential dividend, the $6.25 liquidation preference and the conversion feature, the protect preferred would continue to have value even after a takeover bid in excess of the target price. Each holder of a share of protect preferred would be able to convert it into a share of common stock by paying the target price of $100 per share. The acquiror would have to consider these factors in calculating the total cost of the transaction and in allocating his offer price between the common stock and the protect preferred. The value of the conversion feature in a merger will depend upon the particular anti-dilution alternative chosen by Growth in establishing the protect preferred. In any case, Growth would be free to seek a white knight or undertake a leveraged recapitalization at that time to enable shareholders to receive more than $110 per share.

IV. Protect Preferred Using Earnings Per Share for Target. Assume that Growth currently reports earnings per share of $5.00 and has a stock price of $50. As in the earlier examples, Growth's business plan projects a 15% per annum increase in earnings per share compounded annually over the next five years. Under these circumstances, the board of directors might determine to set an earnings per share target of $10.00 for the fifth year and an earnings multiple of 10. Thus, the imputed target price would be $100 (i.e., 10 times the projected fifth year per share earnings of $10). Alternatively, the board could establish a target for aggregate or average earnings during the five year period or some other appropriate performance measure tailored to meet the company's specific needs. In the event that earnings per share do not reach the target amount, the protect preferred could provide that the special dividend would be equal to the difference between the imputed target price and the product of 10 times the fifth year's earnings per share. In that case, if Growth earned only $8.00 per share in the fifth year, the holders of the protect preferred would be entitled to a special dividend of $20.00 per share of protect preferred (*i.e.*, $100 less the product of 10 times the $8.00 per share earnings). The change of control provisions using an earnings target could be similar to the earlier examples involving a target price but would be based upon the imputed target price or could be based upon an acquisition multiple applied to earnings per share at the time of the change of control. There is wide discretion in determining the appropriate formulas for calculating these payments; the formulas could be either simple, like the ones described in this example, or more complex.

V. Protect Preferred Issued in Connection with a Planned Recapitalization or Liquidation. Assume that Growth has determined to undertake a recapitalization that is expected to provide shareholders with $75 per share but is estimated to require twelve months to complete in order to maximize values. In order to provide shareholders with greater assurance of the company's commitment to complete its recapitalization, Growth could issue protect preferred with a $75 target price and a target date of one year. In the event Growth did not effect a recapitalization that provided stockholders with $75 per share, the holders of the protect preferred would be entitled to receive a special dividend equal to the shortfall and, if the special dividend were not paid, to elect one-third of the board of directors of Growth.

Mathematical Illustration

The following is a mathematical illustration of the special dividend based on the combined market prices of the common stock and protect preferred and of the relative allocation of the common and protect preferred market values as of the target date. As illustrated in Case IV below, a cap on the special dividend equal to approximately 50% to 66 2/3% of the current market price may be an attractive option for some companies.

Let d = amount of special dividend
c = common stock market price
p = protect preferred market price
e = combined equity value per share = c + p
$100 = target price
$6.25 = liquidation price (or present value of preferred dividend cash flows)

Assumptions:

(1) the protect preferred market price at the target date equals the special dividend plus the $6.25 liquidation price, _i.e._, p = d + $6.25. The call value in cases where the common stock price is less than the target price is ignored for purposes of this analysis.

(2) the equity value per share of the company is less than the target price so a special dividend is due, _i.e._, $100 > e or $100 > c + p

Case I: Special dividend equals difference between target price and common stock market price, _i.e._, d = $100 - c.

(1) Substituting (p - $6.25) for d:

p - $6.25 = $100 - c
p + c = $106.25

There is no solution for this equation since we have assumed that p + c < $100, _i.e._, there is no market price of common stock that can be stabilized within the constraints that the equity value is less than the target price at the target date.

Case II: Special dividend equals difference between target price and the combined common stock market price and protect preferred market price, _i.e._, d = $100 - (c + p).

(1) Substituting (p - $6.25) for d:

$$p - \$6.25 = \$100 - (c + p)$$
$$p + (c + p) = \$106.25$$
$$2p + c = \$106.25 \qquad \text{(Equation I)}$$

(2) Substituting $(e - c)$ for p in Equation I and solving for c:

$$2(e - c) + c = \$106.25$$
$$2e - 2c + c = \$106.25$$
$$2e - c = \$106.25$$
$$2e - \$106.25 = c \text{ where } \$53.125 < e < 100$$

This equation may be solved for $c > 0$ so long as the combined equity value per share is greater than $53.125.

The graph on Attachment I shows the equilibrium common stock price as a function of the total equity value of the company at the target date. As shown in the graph, the common is worth zero if the total equity value per share is not greater than $53.125. The common stock increases in value by $2 for every $1 increase in equity value per share above $53.125 until the equity value per share reaches the target price, at which point the common stock portion would be $93.75. See discussion of Case III below regarding value of common stock where $e > \$100$.

(3) Substituting $(e - p)$ for c in Equation I and solving for p:

$$2p + e - p = \$106.25$$
$$p + e = \$106.25$$
$$p = \$106.25 - e \text{ where } \$53.125 < e < \$100$$

The graph on Attachment II shows the equilibrium protect preferred stock price as a function of the total equity value of the common at the target date. If the equity value per share is less than $53.125, all of the equity value is contained in the protect preferred since the special dividend plus the liquidation preference would exceed the total equity of the company. As shown in the graph, the protect preferred increases in value by $1 for every $1 increase in equity value per share until $53.125 and then <u>decreases</u> at the rate of $1 for every $1 increase in equity value between $53.125 and $100, at which point the protect preferred portion would be $6.25. See discussion of Case III below regarding value of protect preferred where $e > \$100$.

Case III: Same as Case II but assume no special dividend is due at the target date, *i.e.*, $e > \$100$ or $c + p > \$100$.

A simplifying assumption regarding the valuation of the conversion feature is made by including in the value of the protect preferred only the amount that is in-the-money (excluding any additional call premium). For example, if the common stock price is $105, it is assumed that the value of the protect preferred would be $6.25 + $5, i.e.,

$p = \$6.25 + (c - \$100)$ where $c > \$100$ (Equation II)

(1) Substituting $(e - c)$ for p in Equation II and solving for c:

$$(e - c) = \$6.25 + c - 100$$
$$e + \$93.75 = 2c$$
$$\frac{e + \$93.75}{2} = c \text{ where } e > \$106.25$$

Refer to the graph on Attachment I. The rate of increase in the value of the common stock once the target price is exceeded is $1 for every $1 increase in equity value between $100 and $106.25 and is reduced to $.50 for each $1 increase in equity value beyond $106.25. The reduction occurs when the common stock price exceeds $100 and the conversion price becomes in-the-money.

(2) Substituting $(e - p)$ for c in Equation II and solving for p:

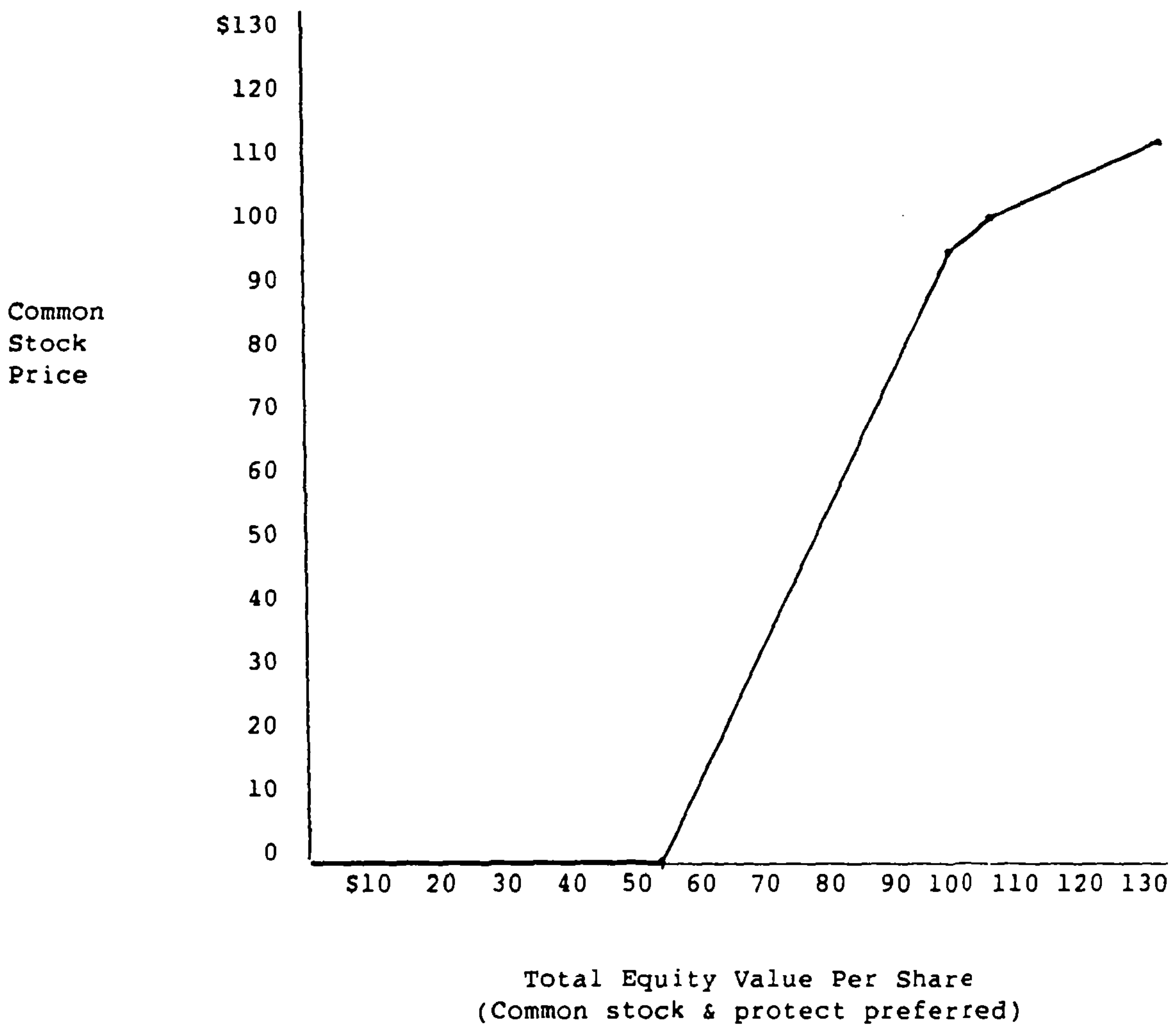
$$p = \$6.25 + ((e - p) - 100)$$
$$2p = e - \$93.75$$
$$p = \frac{e - \$93.75}{2} \text{ where } e > \$106.25$$

Refer to the graph on Attachment II. At total equity values of between $100 and $106.25 per share, the protect preferred is assumed to always have a value of $6.25 per share, disregarding any call premium, since it is neither entitled to special dividend nor is the conversion feature in the money. At equity values per share over $106.25, the protect preferred increases in value by $.50 for each $1 increase in total equity value as a result of the conversion feature.

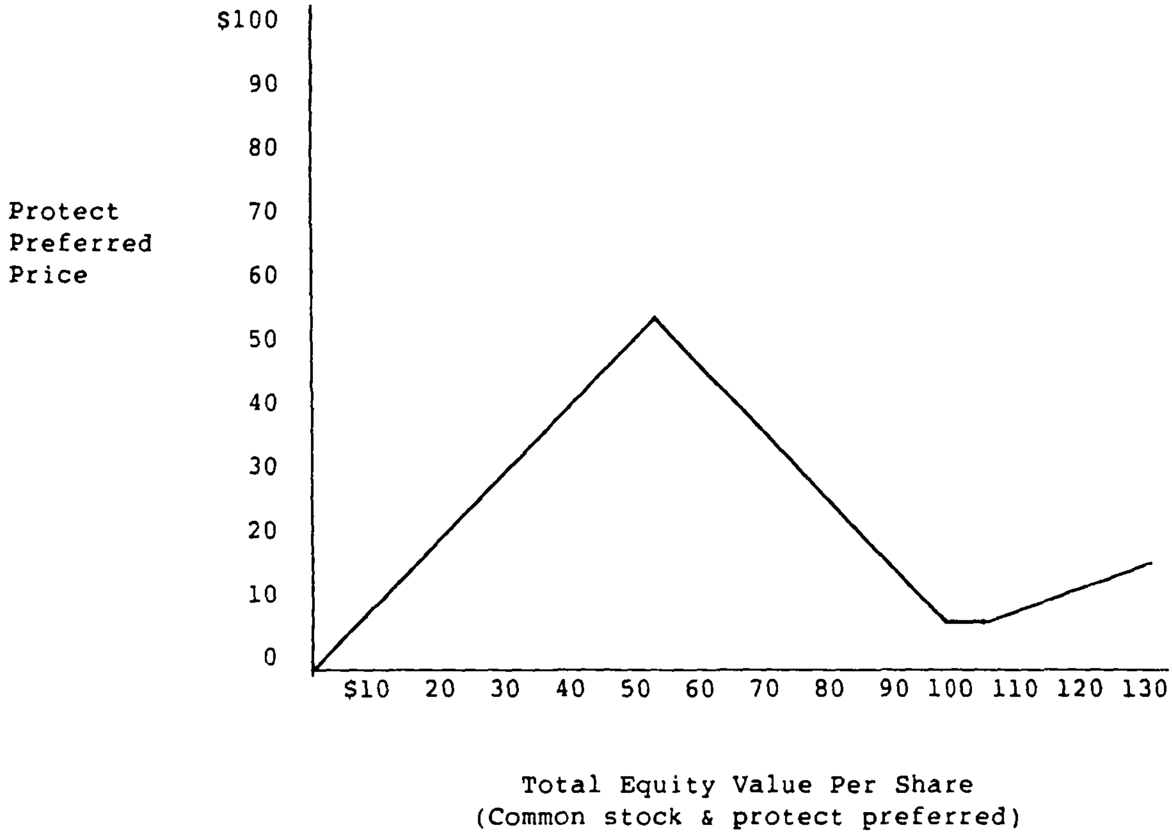
Case IV: Same as Cases II and III but with a $25 cap on the special dividend (i.e., 50% of current market price). The effect of the cap is to shift value from the protect preferred to the common stock when the equity value at the target date is between $31.25 and $75 per share. The common stock would have some value beginning when the equity value exceeded $31.25 (i.e., $25 special dividend + $6.25 liquidation preference yielding a maximum value of $31.25 for protect preferred) rather than $53.125 as was the situation in Case II. The valuation curve for the common stock or protect preferred is unchanged when the equity value exceeds $75 per share or is less than $31.25.

This alternative may be an attractive option. The graph on Attachment III compares the effect on the common stock price of the $25 cap with no cap on the special dividend. The graph on Attachment IV compares the effect on the protect preferred price of the $25 cap with no cap on the special dividend.

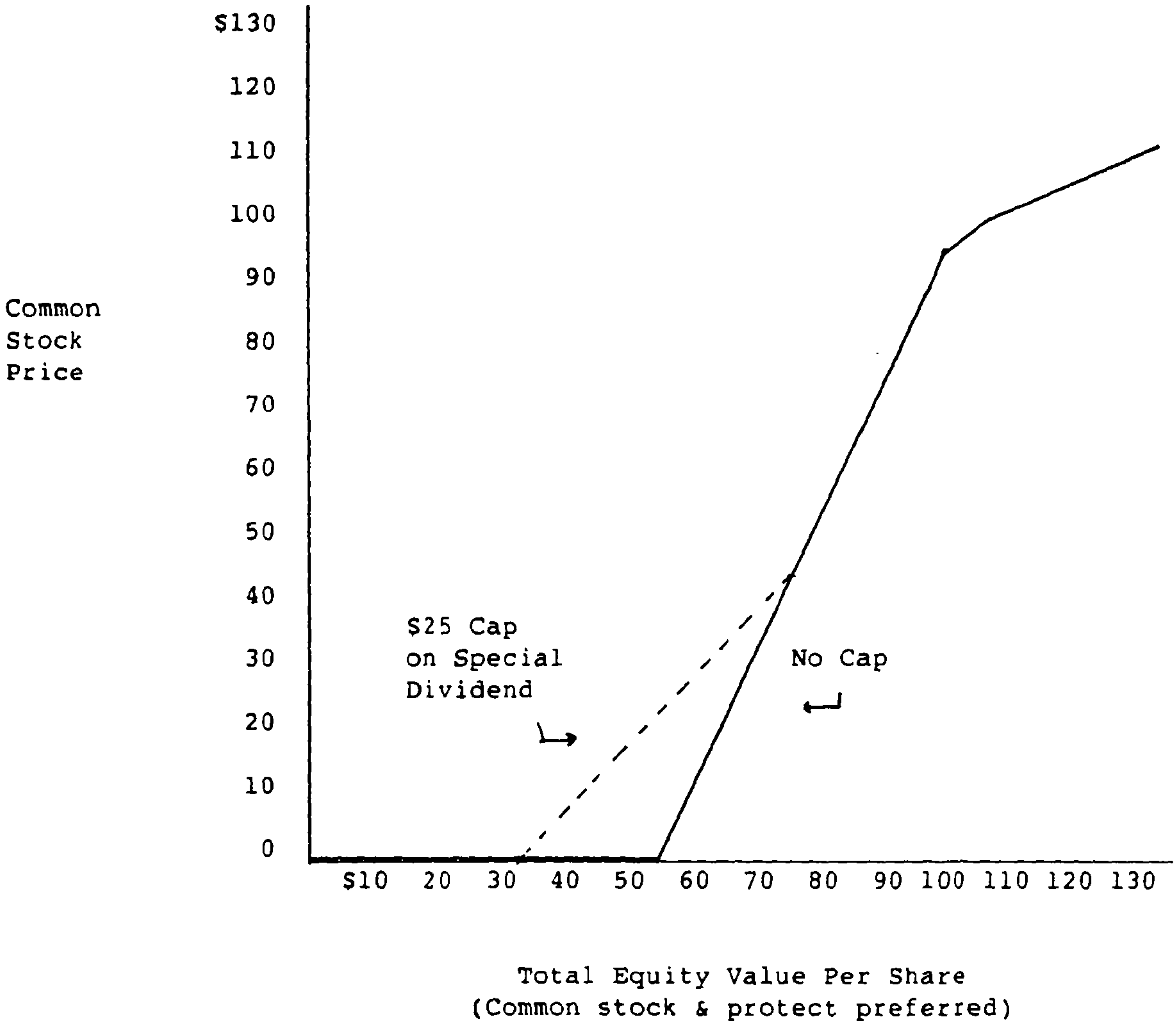
COMMON STOCK PRICE OF GROWTH AT TARGET DATE
AS FUNCTION OF TOTAL EQUITY VALUE



PROTECT PREFERRED PRICE OF GROWTH AT TARGET DATE
AS FUNCTION OF TOTAL EQUITY VALUE



COMMON STOCK PRICE OF GROWTH AT TARGET DATE
AS FUNCTION OF TOTAL EQUITY VALUE



PROTECT PREFERRED PRICE OF GROWTH AT TARGET DATE
AS FUNCTION OF TOTAL EQUITY VALUE