FRESH BRANDS INC
Form SC 13G/A
February 12, 2004

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Schedule 13G
Under the Securities Exchange Act of 1934
(Amendment No. 7)

Fresh Brands Inc.

(Name of Issuer)

Common Stock

(Title of Class of Securities)

35803U108

(CUSIP Number)

December 31, 2003
(Date of Event Which Requires Filing of this Statement)

Check the appropriate box to designate the rule pursuant to which this Schedule is filed:

[X] Rule 13d-1(b)
[ ] Rule 13d-(c)
[ ] Rule 13d-1(d)

*The remainder of this cover page shall be filled out for a reporting person's initial filing on this form with respect to the subject class of securities, and for any subsequent amendment containing information which would alter the disclosures provided in a prior cover page.

Check the following box if a fee is being paid with this statement. (A fee is not required only if the filing person: (1) has a previous statement on file reporting beneficial ownership of more than five percent of the class of securities described in Item 1; and (2) has filed no amendment subsequent thereto reporting beneficial ownership of five percent or less of such class.) (See Rule 13d-7.) [ ]

The information required in the remainder of this cover page shall not be deemed to be "filed" for the purpose of Section 18 of the Securities Exchange Act of 1934 ("Act") or otherwise subject to the liabilities of that section of the Act but shall be subject to all other provisions of the Act (however, see the Notes).

1) Name of Reporting Person
S.S. or I.R.S. Identification No. of Reporting Person:

MARSHALL & ILSLEY CORPORATION, I.D. No. 39-0452805

2) Check the Appropriate Box if a Member of a Group (See Instructions):
(a) [ ]
(b) [ ]

3) SEC Use Only

4) Citizenship or Place of Organization: Wisconsin

Number of Shares Beneficially Owned by Each Reporting Person With:

5) Sole Voting Power: 0

6) Shared Voting Power: 388,343*

7) Sole Dispositive Power: 0

8) Shared Dispositive Power: 388,343*

9) Aggregate Amount Beneficially Owned by Each Reporting Person: 388,343*

*Beneficial ownership of 388,343 shares is specifically disclaimed.
See Item 4.

10) Check if the Aggregate Amount in Row (9) Excludes Certain Shares
(See Instructions): N/A

11) Percent of Class Represented by Amount in Row 9: 7.79%

12) Type of Reporting Person (See Instructions): HC

Item 1(a). Name of Issuer: Fresh Brands Inc.

Item 1(b). Address of Issuer's Principal Executive Offices:

2215 Union Avenue
Sheboygan, WI 53081

Item 2(a). Name of Person Filing:

Marshall & Ilsley Corporation

Item 2(b). Address or Principal Business Office or, if none, Residence:

770 North Water Street
Milwaukee, Wisconsin 53202

Item 2(c). Citizenship: Wisconsin Corporation

Item 2(d). Title of Class of Securities: Common Stock

Item 2(e). CUSIP Number: 35803U108

Item 3. If this statement is filed pursuant to rules 13d-1 (b) (1), or 13d-2 (b), check whether the person filing is a:

(a) [ ] Broker or dealer registered under Section 15 of the Act
(b) [ ] Bank as defined in Section 3 (a) (6) of the Act
(c) [ ] Insurance Company as defined in Section 3 (a) (19) of the Act
(d) [ ] Investment Company registered under Section 8 of the Investment Company Act
(e) [ ] Investment Adviser registered under Section 203 of the Investment Advisers Act of 1940
(f) [ ] Employee Benefit Plan, Pension fund which is subject to the provisions of the Employee Income Security Act of 1974 or Endowment fund: see Sec. 240.13d-1(b)(1)(ii)(F)
(g) [XX] Parent Holding Company, in accordance with Sec. 240.13d-1 (b)(1)(ii)(G) (Note: See Item 7)
(h) [ ] Group, in accordance with Sec. 240.13d-1 (b) (1) (h) (H)

Item 4. Ownership.

(a) Amount Beneficially Owned: 388,343*
(b) Percent of Class: 7.79%
(c) Number of shares as to which such person has:
(i) Sole power to vote or to direct the vote: 0
(ii) Shared power to vote or to direct the vote: 388,343*
(iii) Sole power to dispose or to direct the disposition of: 0
(iv) Shared power to dispose or to direct the disposition of: 388,343*

*Includes 388,343 shares held in one or more employee benefit plans, where the Marshall & Ilsley Trust Company N.A., as custodian, may be viewed as having voting or dispositive authority in certain situations pursuant to Department of Labor regulations or interpretations or federal case law. Pursuant to SEC Rule 13d-4, inclusion of such shares in this statement shall not be construed as an admission that the Reporting Person or its subsidiaries are, for purposes of Sections 13(d) or 13(g) of the Act, the beneficial owners of such securities.

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Item 5. Ownership of Five Percent or Less of a Class.

If this statement is being filed to report the fact that as of the date hereof the reporting person has ceased to be the beneficial owner of more than five percent of the class of securities, check the following [ ].

Item 6. Ownership of More than Five Percent on Behalf of Another Person.

The following person is believed to have the right to receive or the power to direct the receipt of dividends from, or the proceeds from the sale of more than 5% of the subject securities:

Fresh Brands Distributing, Inc. Retirement Savings Plan

Item 7. Identification and Classification of the Subsidiary which Acquired the Security Being Reported on by the Parent Holding Company.

The parent holding company has filed this schedule pursuant to Rule 13d-1(b)(1)(ii)(g) and each relevant subsidiary hereby consents to the filing of this statement on its behalf by the parent company:

Marshall & Ilsley Trust Company N.A.
a national banking association
(successor to Marshall & I-width: 1">1.Title of Security
(Instr. 3)

2. Transaction Date (Month/Day/Year)
2A. Deemed Execution Date, if any (Month/Day/Year)
3. Transaction Code
(Instr. 8)
4. Securities Acquired (A) or Disposed of (D)
(Instr. 3, 4 and 5)
5. Amount of Securities Beneficially Owned Following Reported Transaction(s)
(Instr. 3 and 4)
6. Ownership Form: Direct (D) or Indirect (I)
(Instr. 4)
7. Nature of Indirect Beneficial Ownership
(Instr. 4)

Code
V
Amount
(A) or (D)
Price

Common Stock

1,949.799
(1)
(2)

D

Reminder: Report on a separate line for each class of securities beneficially owned directly or indirectly.

Persons who respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB control number.

SEC 1474 (9-02)

Table II - Derivative Securities Acquired, Disposed of, or Beneficially Owned (*e.g.*, puts, calls, warrants, options, convertible securities)

1. Title of Derivative Security (Instr. 3)	2. Conversion or Exercise Price of Derivative Security	3. Transaction Date (Month/Day/Year)	3A. Deemed Execution Date, if any (Month/Day/Year)	4. Transaction Code (Instr. 8)		5. Number of Derivative Securities Acquired (A) or Disposed of (D) (Instr. 3, 4, and 5)		6. Date Exercisable and Expiration Date (Month/Day/Year)		7. Title and Amount of Underlying Securities (Instr. 3 and 4)		8 D S (I
				Code	V	(A)	(D)	Date Exercisable	Expiration Date	Title	Amount or Number of Shares	
Phantom Stock	$ 0 (3)	03/28/2011		A		140.526		(4)	(4)	Common Stock	140.526	$

Reporting Owners

Reporting Owner Name / Address	Relationships			
	Director	10% Owner	Officer	Other
SAMPSON A PATRICIA 3385 SYCAMORE LANE PLYMOUTH, MN 55402	X			

Signatures

Tara M. Heine, Attorney in Fact for A. Patricia Sampson — 03/30/2011

**Signature of Reporting Person — Date

Explanation of Responses:

- * If the form is filed by more than one reporting person, *see* Instruction 4(b)(v).
- ** Intentional misstatements or omissions of facts constitute Federal Criminal Violations. *See* 18 U.S.C. 1001 and 15 U.S.C. 78ff(a).
- **(1)** Includes 18.812 shares of stock acquired pursuant to reinvestment of dividends.
- **(2)** This total reflects 150 benefically held shares that were inadvertantly omitted from the reporting persons initial Form 3.
- **(3)** Security converts to common stock on a one-for-one basis.
- **(4)** Shares of phantom stock are payable in shares of common stock following termination of a reporting person's service. Partial shares are payable in cash.
- **(5)** Includes 823.185 shares of stock acquired pursuant to reinvestment of dividends.

Note: File three copies of this Form, one of which must be manually signed. If space is insufficient, *see* Instruction 6 for procedure.
Potential persons who are to respond to the collection of information contained in this form are not required to respond unless the form displays a currently valid OMB number.

(3) Includes the maximum number of ordinary shares expected to be issued or delivered to U.S. security holders pursuant to the conversion. This number is based on an estimated 6,954,322 preference shares, including preference

shares in the form of ADSs, currently held by U.S. persons that are eligible to be converted into ordinary shares in the conversion offer and transformed in the transformation, and up to 350,000 additional preference shares that may be acquired by U.S. persons between the effective date of the registration statement and the expiration of the conversion offer upon exercise of outstanding options that would be eligible to be converted. (4) The Proposed Maximum Aggregate Offering Price (estimated solely for the purpose of computing the amount of the registration fee pursuant to Rule 457(f)(1) and (f)(3) under the Securities Act) is the sum of (i) $624,289,458.94, the proposed maximum offering price of 6,954,322 ordinary shares covered by the registration statement as originally filed on October 7, 2005, determined at then prevailing share prices and exchange rates, plus (ii) $35,280,803.60, the proposed maximum offering price of the additional 350,000 shares being registered pursuant to this amendment. The maximum offering price of such additional 350,000 shares is based on the sum of (i) a price of 75.56 per preference share of Fresenius Medical Care AG plus (ii) the conversion premium of 9.75 per preference share. The price per preference share is based on a market value of 75.56 per preference share, calculated pursuant to Rule 457(c) by taking the average of the high and low prices of preference shares as reported on the Frankfurt Stock Exchange on December 18, 2005. The price per preference share was converted into U.S. dollars based on an exchange rate of 1.00 equals U.S.$1.1816 the Noon Buying Rate on December 21, 2005. (5) A registration fee of $73,478.87 was paid on October 7, 2005 in connection with the original registration of 6,954,322 ordinary shares, based on then prevailing preference share prices and exchange rates. The registration fee of $3,775.05 set forth above is the additional fee for the registration of 350,000 additional ordinary shares being effected pursuant to this Amendment No. 2.

The Registrant hereby amends this Registration Statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment which specifically states that this Registration Statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, or until this Registration Statement shall become effective on such date as the Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and we are not soliciting an offer to buy these securities in any state or jurisdiction where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED DECEMBER 23, 2005

PRELIMINARY PROSPECTUS U.S. CONVERSION OFFER

Conversion Offer
To U.S. holders of the non-voting preference shares
without par value, including preference shares represented by
American Depositary Shares, of Fresenius Medical Care AG

We are offering holders of our non-voting preference shares, including preference shares represented by American Depositary Shares, the opportunity to convert their preference shares into voting ordinary shares in the ratio of:

one preference share without par value for one ordinary share without par value of Fresenius Medical Care AG; and

one preference American Depositary Share (ADS) (each preference share ADS representing one-third of a preference share of Fresenius Medical Care AG) for one ordinary share ADS of Fresenius Medical Care AG (each ordinary share ADS representing one-third of an ordinary share of Fresenius Medical Care AG).

Preference shares tendered for conversion must be accompanied by payment of a conversion premium of 9.75 per preference share, or 3.25 per preference share ADS. *Holders of preference share ADSs must pay the conversion premium in U.S. dollars. Each preference share ADS tendered for conversion of the underlying preference shares must be accompanied by payment of a conversion premium of $_____ per preference share ADS.* That amount equals approximately 110% of the U.S. dollar equivalent of 3.25, based on an exchange rate of 1 equals $___ at January l, 2006 (the day before the date of this prospectus). The additional 10% U.S. dollar premium payment is required to cover possible currency exchange rate fluctuations, and any excess premium payment of more than $10.00 will be returned to converting preference share ADS holders. Holders of preference share ADSs will not be charged any depositary fees for the surrender of their preference ADSs for conversion or for the issuance of ADSs representing the ordinary shares held upon consummation of the conversion.

The U.S. offer will expire at __ p.m., New York City time, on February l, 2006, unless it is extended prior to that time. You may withdraw any preference shares or preference shares ADSs tendered in the U.S. offer at any time prior to the expiration time.

On August 30, 2005, the shareholders of Fresenius Medical Care AG approved a resolution for the transformation of Fresenius Medical Care AG from a stock corporation *(Aktiengesellschaft)* under German law into a partnership limited by shares *(Kommanditgesellschaft auf Aktien)* under German law to be called Fresenius Medical Care AG & Co. KGaA (Fresenius Medical Care KGaA). Upon registration of the transformation, the share capital of Fresenius Medical Care AG will become the share capital of Fresenius Medical Care KGaA, and shareholders in Fresenius Medical Care AG will become shareholders of Fresenius Medical Care KGaA. We intend to arrange for the registration of the transformation immediately following completion of the conversion offer, and we will not register the conversion of preference shares into ordinary shares pursuant to the conversion offer unless we are satisfied that the transformation of legal form will occur. Upon registration of the transformation of legal form, the ordinary shares of Fresenius Medical Care AG offered in this conversion offer will be transformed into ordinary shares of Fresenius Medical Care KGaA. Accordingly, holders of Fresenius Medical Care AG preference shares (including preference shares represented by ADSs) who elect to convert their shares in the conversion offer will receive ordinary shares of Fresenius Medical Care KGaA. Holders of Fresenius Medical Care AG preference shares (including preference shares represented by ADSs) who do not elect to convert their shares in the conversion offer will become preference shareholders of Fresenius Medical Care KGaA.

Fresenius Medical Care AG is making the conversion offer to all holders of its outstanding preference shares through two separate offers. See The U.S. Offer The U.S. Offer and the German Offer. Together, these offers are being made for the conversion of all issued and outstanding preference shares, including preference shares represented by preference share ADSs, and all preference shares that are or may become issuable prior to the expiration of the offers due to the exercise of outstanding preference share options or the conversion of outstanding convertible bonds issued under our employee participation programs. Depending on the level of acceptance of the offers, up to approximately 27,762,179 preference shares (including preference shares represented by ADSs) will be converted into ordinary shares pursuant to the offers. The completion of the offers is subject to certain conditions, as described under The U.S. Offer Conditions to the U.S. Offer. Subject to applicable law and regulations, we reserve the right to modify or waive any of such conditions in our discretion.

For a discussion of the risk factors that you should consider carefully in evaluating the U.S. offer, see Risk Factors beginning on page 20.

Fresenius Medical Care AG ordinary shares are listed on the Frankfurt Stock Exchange and trade on the Xetra system under the symbol FME and Fresenius Medical Care AG ordinary share ADSs are listed on the New York Stock Exchange, or NYSE, and trade under the symbol FMS. Fresenius Medical Care AG preference shares are listed on the Frankfurt Stock Exchange and trade on the Xetra system under the symbol FME3 and Fresenius Medical Care AG preference share ADSs are listed on the New York Stock Exchange, and trade under the symbol FMS p. We intend to list both the ordinary shares and preference shares of Fresenius Medical Care KGaA on the Frankfurt Stock Exchange, and we expect the shares to be traded on the Xetra system, under the symbols l and l, respectively. American Depositary Shares representing Fresenius Medical Care KGaA ordinary shares and preference shares have been approved for listing on the New York Stock Exchange, subject to official notice of issuance and, in the case of preference share ADSs, satisfaction of New York Stock Exchange distribution criteria. However, we cannot assure holders of Fresenius Medical Care AG preference ADSs that, after the conversion and the transformation, the preference ADSs of Fresenius Medical Care KGaA will be eligible for listing on the New York Stock Exchange or that we will be able to maintain an American Depositary Receipt facility for the preference shares of Fresenius Medical Care KGaA. See Stock Exchange Listing and Trading.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved the securities to be issued under this prospectus or determined if this prospectus is accurate or complete. Any representation to the contrary is a criminal offense.

The Information Agent for the U.S. Offer is:

D.F. King & Co., Inc.

This prospectus is dated January l, 2006.

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INFORMATION INCORPORATED BY REFERENCE

This prospectus incorporates important information about Fresenius Medical Care AG by reference and, as a result, this information is not included in or delivered with this prospectus. For a list of those documents that are incorporated by reference into this prospectus, see Where You Can Find More Information on page 1.

Documents incorporated by reference are available from us upon oral or written request without charge. You may also obtain documents incorporated by reference into this prospectus from the Internet site of the Securities and Exchange Commission, or SEC, at the URL (or uniform resource locator) *http://www.sec.gov* or by requesting them in writing or by telephone from the information agent for these offers:

D.F. King & Co., Inc.
48 Wall Street, 22nd Floor
New York, NY 10005
212-269-5550
or
Call Toll-Free (888) 542-7446
Email: webmaster@dfking.com

In deciding whether to convert your preference shares in the conversion offer described in this prospectus, you should rely only on the information contained or incorporated by reference into this prospectus and the ADS letter of transmittal (collectively referred to herein as the related U.S. offer documents). Fresenius Medical Care AG has not authorized any person to provide you with any information that is different from, or in addition to, the information that is contained in this prospectus or in the related offer documents.

The information contained in this prospectus speaks only as of the date indicated on the cover of this prospectus unless the information specifically indicates that another date applies.

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REGULATORY STATEMENT

The conversion offers described in this prospectus are subject to the applicable laws and regulations of the Federal Republic of Germany, including the Securities Prospectus Act (*Wertpapierprospektgesetz*) and of the United States, including the tender offer rules applicable to equity securities registered under Section 12 of the United States Securities Exchange Act of 1934, as amended, or the Exchange Act. This U.S. offer document constitutes a prospectus under Section 5 of the United States Securities Act of 1933, as amended, or the Securities Act, with respect to the ordinary shares offered in connection with the U.S. offer.

This prospectus does not constitute an offer to sell, or a solicitation of an offer to purchase, the securities offered by this prospectus in any jurisdiction in which such offer, solicitation or sale is not permitted or would be unlawful prior to registration or qualification under the laws of any such jurisdiction.

This prospectus has not been reviewed by the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* or *BaFin*). Accordingly, this prospectus may not be used to make offers or sales in Germany in connection with any offer described herein.

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WHERE YOU CAN FIND MORE INFORMATION

We file annual reports on Form 20-F and furnish periodic reports on Form 6-K to the United States Securities and Exchange Commission (the SEC). You may read and copy any of these reports at the SEC s public reference room at 100 F Street, N.E., Washington, D.C., 20549, U.S.A., and its public reference rooms in New York, New York, U.S.A. and Chicago, Illinois, U.S.A. Please call the SEC at 1-800-SEC-0330 for further information on the public reference rooms. The reports may also be obtained from the website maintained by the SEC at http://www.sec.gov, which contains reports and other information regarding registrants that file electronically with the SEC. The New York Stock Exchange currently lists American Depositary Shares representing our ordinary shares and American Depositary Shares representing our preference shares. Our periodic reports, registration statements and other information that we file with the SEC are also available for inspection and copying at the offices of the New York Stock Exchange, 20 Broad Street, New York, New York 10005, U.S.A. Our SEC filings are also available to the public from commercial document retrieval services.

We prepare annual and quarterly reports, which are then distributed to our shareholders. Our annual reports contain financial statements examined and reported upon, with opinions expressed by, our independent auditors. The consolidated financial statements of Fresenius Medical Care AG included in these annual reports are prepared in conformity with U.S. generally accepted accounting principles. Our annual and quarterly reports to our shareholders are posted on our website at www.fmc-ag.com. In furnishing our website address in this prospectus, however, we do not intend to incorporate any information on our website into this prospectus, and you should not consider any information on our website to be part of this prospectus.

We will also furnish JP Morgan Chase Bank, N.A., the depositary for our American Depositary Receipts, with all notices of general meetings of shareholders and other reports and communications that are made generally to our shareholders. Such documents will be available for inspection by appointment by registered holders of American Depositary Receipts at the principal office of the depositary, presently located at 4 New York Plaza, New York, New York, 10004 U.S.A.

This prospectus is a part of a registration statement on Form F-4 that we are filing with the SEC to register the offer of ordinary shares in connection with the conversion of our preference shares in the conversion offer. As allowed by SEC rules, this prospectus does not contain all the information included in the registration statement or the exhibits to the registration statement.

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The SEC allows us to incorporate by reference information into this prospectus, which means that we can disclose important information to you by referring you to another document filed separately with the SEC. The information incorporated by reference is deemed to be part of this prospectus, except for any information superseded by information in, or incorporated by reference in, this prospectus through the date hereof. This prospectus incorporates by reference the documents set forth below that we have previously filed with or furnished to the SEC. These documents contain important information about our company and its finances.

SEC Filings (File No. 001-14444)	Period/Filing Date
Annual Report on Form 20-F	Fiscal Year ended December 31, 2004 (filing date March 1, 2005)
Form 6-K Report	July 2005 (furnished to the SEC July 5, 2005)
Amended Annual Report on Form 20-F	Fiscal year ended December 31, 2004 (filing date July 13, 2005)
Form 6-K Report	November 2005 (furnished to the SEC November 3, 2005 and containing the Company s financial statements as of and for the nine months ended September 30, 2005).
Form 6-K Report	November 2005 (furnished to the SEC on November 29, 2005)
Form 6-K Report	December 2005 (furnished to the SEC on December 1, 2005)
Form 6-K Report	December 2005 (furnished to the SEC on December 22, 2005)
Form 6-K Report	December 2005 (furnished to the SEC on December 23, 2005).

If you are a shareholder, we may have sent you some of the documents incorporated by reference, but you can obtain any of them through us or the SEC. Documents incorporated by reference are available from us without charge, excluding all exhibits unless we have specifically incorporated by reference an exhibit in this prospectus. **Shareholders may obtain documents incorporated by reference in this prospectus by requesting them in writing or by telephone from the appropriate party at the following address:**

In North America	Elsewhere
Fresenius Medical Care North America Investor Relations 95 Hayden Avenue Lexington, MA 02420 Attn: Heinz Schmidt Toll Free: 1(800)662-1237	Fresenius Medical Care AG Investor Relations Else-Kröner-Strasse 1 D. 61352 Bad Homburg, Germany Attn: Oliver Maier ++ 49 6172 609-2601
D.F. King & Co., Inc. 48 Wall Street New York, NY 10005 Toll Free: 1 (888) 542-7446 Banks and Brokers 1(212) 269-5550	D.F. King & Co., Inc. No. 2 London Wall Buildings London Wall, London EC2M 5PP Toll Free, Germany 0 800 182 0227 Toll Free, U.K.: 0 800 917 8414 Call Collect: +(44) 20 7920 9700

In addition, the articles of association of Fresenius Medical Care AG, the proposed articles of association of Fresenius Medical Care KGaA and the historical financial information of Fresenius Medical Care AG and its subsidiaries for each of the two financial years prior to the date of this prospectus are available for inspection for the duration of the offers during normal business hours at the above address of Fresenius Medical Care AG in Bad Homburg, Germany. Future annual reports and interim reports issued by the Company will also be available at that office.

This prospectus does not constitute an offer to sell, or a solicitation of an offer to purchase, the securities offered by this prospectus in any jurisdiction to or from any person to whom or from whom it is unlawful to make such offer or solicitation of an offer in such jurisdiction.

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You should rely only on the information contained or incorporated by reference in this prospectus or in the related U.S. offer documents. We have not authorized anyone to provide you with information that is different from what is contained in this prospectus or in the related U.S. offer documents.

This prospectus is dated January l, 2006. You should not assume that the information contained in this prospectus is accurate as of any date other than this date. Neither the delivery of this prospectus nor any distribution of securities pursuant to this prospectus will, under any circumstances, create any implication that there has been no change in the information set forth or incorporated into this prospectus by reference or in our affairs since the date of this prospectus.

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QUESTIONS AND ANSWERS ABOUT THE U.S. OFFER

Q: Why is Fresenius Medical Care AG making the U.S. Offer? (See page 46)

A: We are making the U.S. offer and the concurrent German offer because we believe that the conversion of our outstanding preference shares into ordinary shares, in addition to the transformation of the legal form of our company from an AG to a KGaA, will increase our financial and operative flexibility by increasing the number of publicly held ordinary shares (which we refer to as our free float). We expect that this increase in free float will increase the liquidity of our ordinary shares and strengthen our position on the DAX, the index of 30 major German stocks, while enabling us to substantially maintain our existing corporate governance.

We also believe that increased liquidity for our ordinary shares will allow us to attract equity financing so that we may pursue our long-term growth objectives and strategies, which will help us maintain and improve our position as a leading global integrated provider of dialysis products and services. There can be no assurance, however, that the anticipated benefits will be realized. For a discussion of the risk factors that you should consider carefully in evaluating the U.S. offer, see Risk Factors.

Q: Why are there two offers? (See page 34)

A: We are making two offers so that we can comply with the Exchange Act and the rules and regulations under that Act in connection with the conversion offer to U.S. residents and holders of ADSs and with the somewhat different provisions of German law in connection with the German Offer. Making two offers also enables us to offer and issue our ordinary shares to U.S. residents in compliance with the Securities Act in connection with the U.S. offer and with German securities regulations in connection with the German offer.

Q: What are the differences between the German offer and the U.S. offer? (See page 34)

A: Subject to statutory requirements, the German offer and the U.S. offer are being made on substantially similar terms and completion of the offers is subject to the same conditions. The U.S. offer is open to all holders of preference shares who are residents of the United States, and to all holders of preference share ADSs, wherever located. The German offer is a public offer in Germany open to all holders of our preference shares (other than preference shares represented by ADSs) who are residents of Germany and, subject to applicable local laws and regulations, to all holders of our preference shares (other than preference shares represented by ADSs) who reside outside of Germany and the United States. Participants in the U.S. offer are entitled to withdrawal rights under the Securities Exchange Act of 1934 and the rules of the SEC thereunder. German law, which governs the German offer, does not require withdrawal rights in connection with the conversion, but such rights will be available in the German offer. See The U.S. Offer Withdrawal Rights. The U.S. offer and the German offer will each commence on January l, 2006 and will each expire on February l, 2006, subject to extension in each case.

Q: May I participate in the German offer? (See page 34)

A: No. Holders of preference shares who are United States residents, and all holders of preference share ADSs, wherever located, must follow the procedures set forth in this prospectus to tender your preference shares or preference share ADSs pursuant to the U.S. offer.

Q: Must I pay a premium in order to convert my preference shares to ordinary shares?

A: Yes. Conversion of preference shares requires payment of a premium of 9.75 per preference share or 3.25 per preference share ADS. The premium must be paid at the time you tender your preference shares or preference share ADSs. *If you hold ADSs (each ADS representing one-third of one preference share), you must pay the conversion premium in U.S. dollars and your preference share ADSs must be accompanied by payment of $ per ADS.* That amount is approximately 110% of the U.S. dollar equivalent of 3.25, based on an exchange rate of 1 equals $ on January l, 2006 (the day before the date of this prospectus). The additional 10% U.S. dollar conversion premium payment is required to cover possible currency exchange rate fluctuations between the date of your payment and the date on which the depositary converts your payment into Euro for payment to Fresenius Medical Care. Your payment and 10% deposit will be held in a separate non-interest bearing account pending completion of the offer period and converted into Euro upon expiration of the U.S. offer, based on the Euro-dollar exchange rate then in effect. At the end of the offer period, after payment of your aggregate conversion premium in Euro, any deposit amount remaining of more than ten U.S. dollars ($10.00) will be returned to you without interest. If, however, the offering is not completed, both your payment and deposit will be returned to you without interest. Any amount returned to you will be paid in U.S. dollars and will depend on the prevailing exchange rate at the time funds in the possession of the depositary are converted from Euro to U.S. dollars.

Q: How was the amount of the premium I must pay to convert my preference shares to ordinary shares determined?

A: The amount of the conversion premium corresponds to approximately one-half of the difference between the weighted average German stock exchange price of our ordinary shares and the weighted average German stock exchange price of our preference shares for the three months through and including May 3, 2005, the last trading day before our first announcement of the proposed conversion and transformation, determined by using the stock exchange prices reported on the official website of the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* or *BaFin*). See The Conversion and Transformation; Effects Structure of the Conversion and Transformation.

Q: If my preference shares are represented by American Depositary Shares, are there additional depositary s fees that I must pay in connection with the conversion of any preference shares?

A: No. Holders of preference American Depositary Shares who elect to convert the preference shares represented by their American Depositary Shares will not be required to pay any depositary fees for the surrender of their preference American Depositary Shares of Fresenius Medical Care AG for conversion or for the issuance of ADSs representing the ordinary shares held upon consummation of the conversion.

Q: What will I receive in the U.S. offer? (See page 35)

A: For each preference share validly tendered, not withdrawn and accompanied by payment of 9.75 in cash, you will receive one ordinary share. For each preference share ADS (each representing one-third of a preference share) validly tendered, not withdrawn and accompanied by the conversion premium payment of $ in cash, you will receive one ordinary share ADS (each representing one-third of an ordinary share).

Q: How long will the U.S. offer be open? (See page 37)

A: Unless we extend the U.S. offer, it will expire at p.m., New York City time, on February l, 2006.

Q: Under what circumstances will you extend the U.S. offer? (See page 37)

A: If we believe that for specific reasons an extension of the conversion period would be beneficial for us or if SEC rules require us to extend the conversion offer, we may extend such period. In any event, we expect that the conversion period will not be longer than six weeks.

Q: How will you let me know if you extend the U.S. offer? (See page 36)

A: If we extend the U.S. offer we will issue a press release. Our press release will set forth the expiration date and time of the extended U.S. offer and inform holders of our preference shares that they may tender, or withdraw their tendered, preference shares at any time until the expiration of the offer period, as extended.

Q: Are there any conditions to your obligation to accept the preference shares that I tender? (See page 36)

A: Yes. Our obligation to complete the offers is subject to the condition, which must be satisfied or waived prior to expiration of the offers, that we are satisfied that the transformation of legal form will be registered immediately following registration of the conversion.

Q: After I tender my preference shares in the U.S. offer, may I change my mind and withdraw them? (See page 39)

A: Yes. You may withdraw your preference shares or preference ADSs, tendered in the U.S. offer at any time until the expiration date without charge. Your withdrawn preference share ADSs and conversion premium will be returned to you promptly upon withdrawal.

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Q: I hold American Depositary Receipts for preference share ADSs or my ADSs are held through the Direct Registration System maintained by the Depositary. How do I accept the U.S. offer? (See page 37)

A: If you hold American Depositary Receipts, or ADRs, for preference share ADSs, complete and sign the ADS letter of transmittal included with this document and send it, together with your ADRs and any other required documents, to the U.S. ADS exchange agent before the expiration of the U.S. offer. ***Do not send your certificates to Fresenius Medical Care AG or the Information Agent.***

Q: I hold preference share ADSs through a bank, broker or other nominee. How do I accept this U.S. offer? (See page 37)

A: If you hold preference share ADSs in book-entry form through a bank, broker or other nominee, instruct such bank, broker or other nominee to complete the confirmation of a book-entry transfer of your preference share ADSs into the account of the U.S. ADS exchange agent at The Depository Trust Company, commonly known as DTC, and send either an agent s message or an ADS letter of transmittal and any other required documents to the U.S. ADS exchange agent before the expiration of the U.S. offer.

Q: I hold preference shares through a U.S. custodian, such as a broker, bank or trust company. How do I accept this U.S. offer? (See page 39)

A: If you hold your preference shares through a U.S. custodian, you do not need to complete the ADS letter of transmittal. Instead, your U.S. custodian should either forward to you the transmittal materials and instructions sent by the German financial intermediary that holds the shares on behalf of the U.S. custodian as record owner or send you a separate form prepared by the U.S. custodian. If you have not yet received instructions from your U.S. custodian, please contact your U.S. custodian directly.

Q: I hold preference shares through a German financial intermediary, such as a German broker or bank. How do I accept this U.S. offer? (See page 39)

A: If you hold preference shares through a German financial intermediary, you do not need to complete the ADS letter of transmittal. Instead, your German financial intermediary should send you transmittal materials and instructions for accepting the U.S. offer. If you have not yet received instructions from your German financial intermediary, please contact the information agent or your German financial intermediary directly.

Q: What will happen to my preference share options and convertible bonds if these offers are completed? (See page 44)

A: Holders of convertible bonds or stock options entitling them to preference shares under our employee participation programs will be separately offered the opportunity to receive convertible bonds or stock options entitling them to receive ordinary shares. The number of convertible bonds or options and the conversion or exercise prices will be adjusted. No conversion premium will be payable in connection with such adjustments.

Q: Do I need to do anything if I want to retain my preference shares? (See page 45)

A: No. If you want to retain your preference shares, you do not need to take any action. Upon registration of the transformation your preference shares will become preference shares of Fresenius Medical Care KGaA.

Q: When will I know the outcome of the offers?

A: We will issue a press release regarding the results of the offers promptly after they expire. We intend to file those press releases with the SEC under Form 6-K. We will also file an amendment to our Schedule TO with the SEC setting forth the final results of the offers.

Q: Is Fresenius Medical Care making any recommendation with respect to the conversion offer?

A: We believe that the conversion offer is in the best interest of the Company and its shareholders. However, preference shareholders should determine for themselves, in consultation with their tax and financial advisors, whether to accept the conversion offer with respect to all or any part of their preference shares or to retain their preference shares.

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SUMMARY

The following summary does not contain all the information that may be important to investors. As an investor, you should base your investment decision on the entire prospectus, including the incorporated documents.

In this prospectus, (1) the Company refers to both Fresenius Medical Care AG prior to the transformation and Fresenius Medical Care KGaA after the transformation; (2) we and our refers either to the Company or the Company and its subsidiaries on a consolidated basis both before and after the transformation, as the context requires; and (3) Management AG refers to a newly formed entity that will serve as the general partner of Fresenius Medical Care KGaA and that is wholly owned by Fresenius AG.

General Information on the Company and its Business

Fresenius Medical Care AG has operated as a stock corporation *(Aktiengesellschaft)* organized under the laws of Germany since August 5, 1996. On August 30, 2005, our shareholders approved the transformation of the Company s legal form from an AG, to a KGaA, which is a German partnership limited by shares. Fresenius Medical Care AG is registered with the commercial register of the local court *(Amtsgericht)* of Hof an der Saale, Germany, under HRB 2460. Our registered office *(Sitz)* is Hof an der Saale, Germany.

Our business address is Else-Kröner-Strasse 1, 61352 Bad Homburg v.d.H., Germany, telephone ++49-6172-609-0. Our fiscal year is the calendar year.

We operate both in the field of dialysis products and in the field of dialysis services. Based on publicly reported sales and number of patients treated, we are the largest dialysis company in the world. (Source: *Nephrology News & Issues*, July 2005; company data of significant competitors.) Our dialysis business is vertically integrated, providing dialysis treatment at our own dialysis clinics and supplying these clinics with a broad range of products. In addition, we sell dialysis products to other dialysis service providers. At September 30, 2005, we provided dialysis treatment to approximately 130,400 patients in 1,670 clinics worldwide located in 27 countries. In the U.S. we also perform clinical laboratory testing and provide inpatient dialysis services, therapeutic aphaeresis, hemoperfusion and other services under contract to hospitals. In 2004, we provided 18.8 million dialysis treatments, an increase of approximately 5% compared to 2003. In the first nine months of 2005, we provided approximately 14.7 million dialysis treatments, an increase of approximately 5% compared to the first nine months of 2004. We also develop and manufacture a full range of equipment, systems and disposable products, which we sell to customers in over 100 countries. For the year ended December 31, 2004, we had net revenues of $6.2 billion, an increase of 13% over 2003 revenues. We derived 68% of our revenues in 2004 from our North America operations and 32% from our international operations. In the first nine months of 2005, we had net revenues of $5.0 billion, an increase of 9% over our net revenues for the first nine months of 2004.

Dialysis is the artificial means of removing toxic metabolic end products and excess liquid from the body. Dialysis is the most widespread method to treat chronic renal failure, which is also called end-stage renal disease or ESRD. ESRD is the stage of progressed chronic renal disease characterized by the irreversible loss of the renal function. Keeping the patient alive requires regular dialysis treatment or kidney transplantation. The number of possible transplantations is restricted by the lack of suitable donor kidneys. For these reasons, the majority of ESRD patients depend on dialysis. There are two methods of dialysis treatment: hemodialysis and peritoneal dialysis. Approximately 89% of patients worldwide are treated by hemodialysis.

Competitive Strengths, the Renal Care Industry and Our Strategy

We believe that our size and our activities in both dialysis care and dialysis products allow us to operate more cost-effectively than many of our competitors.

We use the insight we gain when treating patients in developing new and improved products.

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Comprehensive renal therapy solutions

Dialysis treatment. For the year 2004, dialysis services accounted for 72% of our total revenue. We offer dialysis services for outpatient treatment in its own centers as well as inpatient treatment in hospitals on a contractual basis.

Due to our large number of patients, we are able to compile our own databases with patient statistics which enable us to improve the results of our dialysis treatments as well as the quality and efficiency of our dialysis products and thus to decrease mortality rates in the long run. We believe that in addition to our patient databases physicians in private practices, hospitals and managed care organizations determine to have their ESRD patients treated in our centers for the following reasons:

Our reputation for high quality treatment and support of patients;

Our extensive network of dialysis centers, which enables medical specialists to refer their patients to a conveniently located center; and

Our reputation as a provider of technically advanced dialysis products.

Dialysis products. For the year 2004, dialysis products accounted for 28% of our total revenue. We are currently the world s largest manufacturer and distributor of equipment and related products for hemodialysis and the second largest manufacturer of peritoneal dialysis products. (Source: internal estimates, publicly available market data and company data of significant competitors.) We sell our dialysis products in over 100 countries. The majority of our customers are dialysis centers. Fresenius Medical Care produces a wide range of equipment and accessories for hemodialysis and peritoneal dialysis. These products include hemodialysis equipment, peritoneal dialysis cyclers, dialyzers, solutions for peritoneal dialysis in flexible plastic bags, hemodialysis concentrates and solutions, blood lines and disposable tubes as well as systems for water treatment in dialysis centers.

The dialysis market

We offer life-sustaining and life-saving treatments in markets characterized by favorable demographic trends.

Based on our own estimates, approximately 1.8 million ESRD patients were being treated worldwide as of year-end 2004. Of these patients, approximately 1,375,000 were receiving dialysis treatment, of which 1,225,000 were receiving hemodialysis and just under 150,000 were receiving peritoneal dialysis. More than 400,000 kidney patients were living with donated kidneys. In 2004, the number of dialysis patients grew by approximately 6% over 2003.

The growth in patient numbers has not been uniform across all regions. For example, in the United States, Japan and Western and Central Europe, patient growth rates tend to be below average. This is because the percentage of ESRD patients treated is already high and access to appropriate treatment, primarily dialysis, is generally available in these countries and regions. On the other hand, significantly higher growth rates of approximately 10% were recorded in economically less-developed regions. Of all dialysis patients worldwide, approximately 24% were treated in the United States, approximately 18% in Japan and approximately 18% in the 25 countries of the European Union. The remaining 40% of all dialysis patients were spread across 90 countries throughout the rest of the world.

Strategy

Our objective is generating revenue growth that exceeds market growth of the dialysis industry, measured by growth in the patient population, while maintaining our leading position in the market and increasing earnings at a faster pace than revenues. In the past five years revenues from dialysis services and products have increased more rapidly than the total market and we believe that we are well positioned to meet our objectives by focusing on the following strategies:

Maintenance of high-quality dialysis treatment;

Patient care programs which distinguish themselves from those of our competitors; in particular, in single-use high flux polysulfone dialyzers and related services;

Worldwide strengthening of the presence in attractive growth markets;

Expansion of the range of dialysis services that we offer;

Continuing to offer a complete product range for dialysis, ensuring a constant flow of revenues from disposable products; and

Strengthening our position as an innovator in product and process technologies.

Acquisition of Renal Care Group, Inc.

On May 3, 2005, we entered into a definitive merger agreement for the acquisition of Renal Care Group, Inc. (RCG) for an all cash purchase price of approximately $3.5 billion. RCG is a Delaware corporation that provides dialysis and other ancillary services to patients with ESRD. RCG was on May 1, 2005 the fourth largest provider of out-patient renal care and ancillary services in the United States. (Source: *Nephrology News and Issues*, July 2005, based on patients treated.) In 2004 RCG had revenue of approximately $1.35 billion and net income of approximately $122 million. As of September 30, 2005, RCG provided dialysis and ancillary services to over 32,000 patients through more than 450 outpatient dialysis centers in 34 states in the United States, in addition to providing acute dialysis services to more than 200 hospitals. RCG generates a large share of its revenue from private insurers and other private payors. We believe that RCG has an attractive portfolio of patients.

RCG s stockholders have approved the acquisition. Completion of the acquisition remains subject to governmental approvals (including termination or expiration of the waiting period under the Hart-Scott Rodino Antitrust Improvements Act of 1976, as amended). On June 15, 2005, we announced that we had received a request for additional information from the United States Federal Trade Commission (FTC) relating to the RCG acquisition. We intend to continue to cooperate with the FTC and to respond promptly to the request so as to enable us to complete the acquisition in early 2006, but we cannot offer any assurance that the acquisition will be completed during this time.

The following sets forth selected unaudited *pro forma* financial data illustrating the *pro forma* effects of the acquisition of RCG. The *pro forma* income statement data are based on the income statements of FMC AG and RCG for the year ended December 31, 2004 and the nine-month period ended September 30, 2005, and assume that the merger occurred as of January 1, 2004. The *pro forma* balance sheet data are based on the balance sheets of FMC AG and RCG as of September 30, 2005, and assume that the merger occurred as of September 30, 2005. The selected *pro forma* financial data should be read together with the *pro forma* financial statements of FMC AG contained in Appendix A-1 to this prospectus. THE SELECTED *PRO FORMA* FINANCIAL DATA DO NOT PURPORT TO REPRESENT WHAT THE FINANCIAL POSITION OR RESULTS OF OPERATIONS OF FMC AG OR RCG WOULD ACTUALLY HAVE BEEN IF THE MERGER HAD IN FACT OCCURRED AS OF JANUARY 1, 2004 OR TO PROJECT THE FINANCIAL POSITION OR RESULTS OF OPERATIONS FOR ANY FUTURE DATE OR PERIOD.

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		Year ended December 31, 2004		Nine Months Ended September 30, 2005
	(in millions, except per share amounts)			
Summary of *Pro Forma* Operating Information				
Net Revenues	$	7,523	$	6,115
Earnings before income taxes		613		566
Net earnings		371		320
Earnings per share	$	3.83	$	3.31

		September 30, 2005
***Pro Forma* Balance Sheet Information**		
Total assets	$	12,481
Total borrowings		6,469
Total liabilities		8,661
Total shareholders equity		3,820

In connection with the proposed acquisition, we have entered into a commitment letter pursuant to which Bank of America, N.A. and Deutsche Bank AG New York Branch have agreed, subject to certain conditions, to underwrite an aggregate of $5.0 billion in principal amount of term and revolving loans to be syndicated to other financial institutions. See Recent Developments Acquisition of Renal Care Group, Inc. and The New Senior Credit Facilities.

Structure of the Conversion and Transformation

Conversion of preference shares into ordinary shares

We are offering our preference shareholders the opportunity voluntarily to convert their preference shares into ordinary shares on a one-to-one basis pursuant to a conversion offer approved by shareholder meetings held on August 30, 2005. Preference shareholders who decide to convert their shares will be required to pay a premium of 9.75 per preference share ($____ per American Depositary Share) and will lose their preferential dividend rights under the articles of association and under German law. The right to convert preference shares into ordinary shares is available only through the expiration date of the conversion offer. See The Conversion and Transformation; Effects Structure of the Conversion and Transformation. *Conversion premium payments made by holders of preference American Depositary Shares must be made in U.S. dollars*. The ADS conversion premium of $_____ per ADS includes an additional deposit of approximately 10% of the aggregate premium payment to cover possible currency exchange rate fluctuations. At the end of the offer period, after payment of the aggregate conversion premium to Fresenius Medical Care in Euro, any deposit amount of more than ten U.S. dollars ($10.00) remaining will be returned to converting shareholders without interest. Holders of preference American Depositary Shares who decide to convert their shares will not be required to pay any depositary fees for the surrender of their preference American Depositary Shares of Fresenius Medical Care AG or for the issuance of ADSs representing the ordinary shares into which the preference shares were converted. In this prospectus, we refer to this conversion of our preference shares into ordinary shares as the conversion.

Transformation into a partnership limited by shares

On August 30, 2005, our shareholders also approved the transformation of the Company s legal form, from an AG, which is a German stock corporation, to a KGaA, which is a German partnership limited by shares. The transformation will become effective upon registration with the commercial register of the local court *(Amtsgericht)*, in Hof an der Saale. Upon registration of the transformation, the Company s legal form will be changed by operation of law to a partnership limited by shares, and it will continue to exist in that legal form. The Company as a KGaA will be the same legal entity under German law, rather than a successor to the stock corporation. Our share capital will become the share capital of the Company in its new legal form after

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the transformation. Shareholders in Fresenius Medical Care AG at the time of the registration of the transformation of legal form in the commercial register will be shareholders in Fresenius Medical Care KGaA. Fresenius Medical Care Management AG, a subsidiary of Fresenius AG, will be the general partner of the Company. In this prospectus, we refer to this transformation of our legal form as the transformation. For more information, see The Conversion and Transformation Structure of the Conversion and Transformation and The Legal Structure of Fresenius Medical Care KGaA.

Immediately following completion of the offering and registration of the ordinary shares into which our preference shares are converted, we intend to arrange for the registration of the transformation of legal form with the commercial register. Our board of management was instructed by the shareholders meeting on August 30, 2005 to register the changes in the articles of association connected with the implementation of the conversion offer only when they are convinced that the transformation into a KGaA will take place. For that reason holders of preference shares who accept the conversion offer will not receive ordinary shares of the Company in the legal form of a stock corporation. In effect, they will receive ordinary shares of Fresenius Medical Care KGaA. Holders of preference shares who do not accept the conversion offer will hold preference shares of Fresenius Medical Care KGaA.

Reasons for the conversion and transformation

We believe that the conversion and transformation will improve our financial and operative flexibility, and that the conversion will increase the number of publicly held ordinary shares (which we refer to as our free float), which we expect will increase the liquidity of our ordinary shares and strengthen our position on the DAX, the index of 30 major German stocks. We also believe that our increased liquidity will allow us to attract equity financing so that we may pursue our long-term growth objectives and strategies.

Additional Information on the Company

Management Board	The management board of the Company as a stock corporation consists, as of the date of this prospectus, of Dr. Ben J. Lipps (Chief Executive Officer), Dr. Emanuele Gatti, Roberto Fusté, Dr. Rainer Runte, Lawrence A. Rosen, Robert M. Powell and Mats L. Wahlstrom. Upon registration of the transformation of legal form, the Company, as a KGaA will be represented by its general partner, Fresenius Medical Care Management AG, which is also responsible for the management of the Company. On the prospectus date, the general partner is represented by a management board whose members are identical to the present management board of the Company. In addition, we expect that, subject to formal appointment by the supervisory board of the general partner, Gary Brukardt, currently president of RCG, will become a member of the management board after the closing of the merger with RCG.
Supervisory Board	The supervisory board of the Company presently consists, as of the date of this prospectus, of Dr. Gerd Krick (chairman of the supervisory board), Dr. Dieter Schenk (deputy chairman), Prof. Dr. Bernd Fahrholz, Dr. Ulf M. Schneider, Walter L. Weisman and John Gerhard Kringel. On the prospectus date, all of the members of the Company s supervisory board are also members of the supervisory board of the general partner. They will also be members of the supervisory board of the company as a partnership limited by shares except for Dr. Ulf M. Schneider, who will resign from the supervisory board of the Company in the legal form of a partnership limited by

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	shares. In accordance with German law, we intend to apply for court appointment of a sixth member of the supervisory board to replace Dr. Schneider.
Share capital	The share capital of the Company as of the date of this prospectus is 250,271,178.24 consisting of 70,000,000 ordinary bearer shares and 27,762,179 preference bearer shares. The relative breakdown between preference shares and ordinary shares will change in connection with the conversion. Our share capital will not be affected by the transformation.
Listing	All of the Company s ordinary shares and preference shares in the legal form of a stock corporation are listed on the Frankfurt Stock Exchange on the official market with simultaneous listing in the sub-segment of the official market with additional post-admission obligations (Prime Standard). American Depositary Shares (ADSs) are listed on the New York Stock Exchange. All of the Company s shares in its KGaA legal form will again be listed on the Frankfurt Stock Exchange on the official market with simultaneous listing in the sub-segment of the official market with additional post-admission obligations (Prime Standard) upon effectiveness of the transformation. American Depositary Shares representing the Company s shares in KGaA form have been approved for listing on the New York Stock Exchange.
Current auditors	The Company s auditor is KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, Frankfurt am Main, Germany.
Principal shareholder	Approximately 50.8% of the voting ordinary bearer shares of the Company are held by Fresenius AG. All other ordinary shares as well as the preference shares of the Company are publicly held. Fresenius AG holds approximately 36% of the total share capital of all classes of the Company. The participation of Fresenius AG in the voting ordinary shares will be reduced by the conversion offer. Fresenius AG also holds 100% of the shares of the general partner, Fresenius Medical Care Management AG.
Business with related parties	In connection with our foundation and the combination of the dialysis business of Fresenius AG with that of W.R. Grace & Co. in 1996, Fresenius Medical Care AG and Fresenius AG entered into several agreements to implement restructuring measures on terms which we believe are not less favorable than would be available under contracts with unaffiliated third parties. The agreement relating to trademarks and other intellectual property entered into does not necessarily correspond to the conditions of contracts between unaffiliated parties.
Employees	At September 30, 2005, the Company had 47,030 employees, as compared to 44,526 employees on December 31, 2004.

The U.S. Offer and the German Offer

We are offering holders of our preference shares the opportunity to convert their outstanding preference shares through two separate offers a U.S. offer and a German offer. We are utilizing two separate offers as permitted by Rule 13e-4 under the Exchange Act so that we can comply with the Exchange Act and the rules and regulations under that Act in connection with the conversion offer to U.S. residents and holders of ADSs and with the somewhat different provision of German law in connection with the German Offer. Conducting two separate offers also enables us to conduct the U.S. portion of the offers in accordance with U.S. practices for such transactions and the German offer in accordance with German market practices. We are also able to offer and issue our ordinary shares to U.S. residents in compliance with the Securities Act in connection with the U.S. offer and with German securities regulations in connection with the German offer. The U.S. offer and the German offer are being made on substantially similar terms and completion of the offers is subject to the same conditions. The U.S. offer is open to all holders of our preference shares who are residents of the United States and to all holders of our preference share ADSs, wherever located. The German offer is a public offer in Germany addressed to all holders of our preference shares who are residents of Germany and, subject to local laws and regulations, to all holders of our preference shares who reside outside of Germany and the United States (other than, in each case, holders of our preference ADSs).

Terms of the U.S. Offer

Upon the terms and subject to the conditions set forth in this prospectus, we are offering holders of our preference shares, including preference shares represented by American Depositary Shares, the opportunity to convert their preference shares into ordinary shares on the following terms:

one preference share without par value for one ordinary share without par value of Fresenius Medical Care AG; and

one preference American Depositary Share (ADS) (each preference share ADS representing one-third of a preference share of Fresenius Medical Care AG) for one ordinary share ADS of Fresenius Medical Care AG (each ordinary share ADS representing one-third of an ordinary share of Fresenius Medical Care AG).

Preference shares tendered for conversion must be accompanied by payment of a conversion premium of 9.75 per preference share. Each preference share ADS tendered for conversion of the underlying preference shares must be accompanied by payment *in U.S. dollars* of a conversion premium of $ per preference share ADS. That amount equals approximately 110% of the U.S. dollar equivalent of 3.25. The additional 10% U.S. dollar premium payment is required to cover possible exchange rate fluctuations, and any excess premium payment of more than $10.00 will be returned to converting preference ADS holders. The conversion premium of 9.75 per preference share corresponds to approximately one-half of the difference between the weighted average stock exchange price of the ordinary shares and the weighted average German stock exchange price of the preference shares for the three months through and including May 3, 2005, the last trading day before our announcement of the proposed conversion and transformation, determined using the prices reported on the official website of the German Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht,* or *BaFin*).

Conditions to the U.S. Offer

Our obligation to complete the offers is subject to the condition, which must be satisfied or waived prior to expiration of the offers, that we are satisfied that the transformation of legal form will be registered immediately following registration of the conversion.

Expiration Date

The U.S. offer will expire at p.m., New York City time on February l, 2006, unless it is extended prior to such time. We do not currently plan to extend the conversion offer. However, if we believe that for specific reasons an extension of the conversion period would be beneficial for us or if SEC rules require us to extend the conversion offer, we may extend such period both in Germany and in the U.S. In any event, we expect that the conversion period will not be longer than six weeks.

Procedures for Tendering Preference Shares

The procedure for tendering preference shares varies depending on a number of factors, including:

whether you hold preference shares or preference share ADSs;

whether you hold your preference share ADSs in book-entry form; and

whether you hold your preference shares through a financial intermediary in the United States or Germany.

You should read carefully the procedures for tendering your preference shares beginning on page 37 of this prospectus as well as the related transmittal materials enclosed with this prospectus.

Withdrawal Rights

You have the right to withdraw any preference shares that you have tendered in the U.S. offer at any time prior to and including the expiration date.

For a withdrawal to be effective, the German financial intermediary, the U.S. custodian or the U.S. ADS exchange agent, as applicable, must receive a written notice of withdrawal prior to the expiration date of the offer or the subsequent offering period, as applicable. For a withdrawal of preference shares to be effective, the German financial intermediary must have arranged for a timely book-entry re-transfer of the preference shares submitted for conversion on the bank working day following the end of the conversion period by 11:30 a.m. New York City time. Withdrawn preference share ADSs and conversion premiums will be returned promptly upon withdrawal.

Withdrawn preference shares may be retendered for conversion prior to the expiration of the offer period by following appropriate tender procedures.

Delivery of Ordinary Shares and Ordinary Share ADSs

In accordance with German corporate practice, we intend to deliver ordinary shares or ordinary share ADSs in Fresenius Medical Care KGaA to tendering holders within two to three German banking days following the registration of the conversion with the commercial register, which will occur approximately one week after expiration of the offers.

Comparison of the Rights of Holders of Preference Shares and Ordinary Shares

There are differences between the rights of a preference shareholder and the rights of an ordinary shareholder. We urge you to review the discussion under The Conversion and Transformation; Effects and Description of the Shares of the Company for a discussion of these differences.

Effects on Securities Holders

Preference shareholders who do not choose to convert their shares will retain their preference rights but may suffer financial disadvantages due to the overall reduced liquidity of their preference shares. After the conversion and the transformation, the current holders of our ordinary shares and ADSs representing our ordinary shares will continue to have substantially similar rights, but will experience a dilution of their voting rights due to the increase in the number of outstanding ordinary shares. Moreover, they will experience some economic dilution as the preference shareholders who convert their shares are required to pay a conversion

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premium of only 9.75, which is approximately one-half of the difference between the weighted average German stock exchange price of our ordinary shares and the weighted average German stock exchange price of our preference shares for the three months through and including May 3, 2005, the last trading day before our first announcement of the proposed conversion and transformation. Preference shareholders who choose to convert their shares into ordinary shares will no longer have preference rights. For more information, see Description of the Shares of the Company, Descriptions of American Depositary Receipts, Description of the Proposed Pooling Arrangements, The Conversion and Transformation; Effects and Stock Exchange Listing and Trading.

Tax Consequences of the Conversion

Under German tax law, the conversion and premium payments will be tax neutral to Fresenius Medical Care. Shareholders who convert their shares and pay the conversion premium will not recognize any gain or loss for German tax purposes.

Under U.S. federal income tax law, the conversion of preference shares into ordinary shares will constitute a reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended (the Code), in which case (i) the Company will not recognize any gain or loss upon issuance of ordinary shares in exchange for preference shares; (ii) U.S. holders of preference shares that participate in the conversion will not recognize gain or loss upon their receipt of ordinary shares; and (iii) U.S. holders of preference shares who do not participate in the conversion as well as U.S. holders of ordinary shares will not recognize gain or loss upon such conversion. See Material Tax Consequences of the Conversion.

Interests of Certain Persons in the Conversion and Transformation

Currently, Fresenius AG owns approximately 50.8% of our ordinary shares and, therefore, controls the management of the Company. Fresenius AG also consolidates the Company in its financial statements. In connection with the transformation, Fresenius Medical Care Management AG, a wholly-owned subsidiary of Fresenius AG, will assume the management of the Company through its position as general partner. Therefore, Fresenius AG will continue to control the Company and consolidate the Company in its financial statements after the transformation, notwithstanding the likely loss of its majority ownership of our ordinary shares due to the increased number of ordinary shares expected to be outstanding as a result of the offers.

At the prospectus date, the members of our management board are also the members of the management board of the general partner. They will enter into service contracts and compensation arrangements on the same terms after the transformation as are currently in effect. We expect that Gary Brukardt, currently the President and Chief Executive Officer of RCG, will also become a member of our management board after the closing of the RCG merger. At the prospectus date, all of the members of our supervisory board are also the members of the general partner s supervisory board and (other than Dr. Ulf M. Schneider) will also become the members of the supervisory board of the Company in its KGaA form after the transformation. For more information, see Interests of Certain Persons in the Conversion and Transformation.

Stock Exchange Listing and Trading; Market for Preference Shares after the Offers.

The ordinary shares into which our preference shares will be converted, will, together with the other ordinary and preference shares of the Company in its new legal form as a KGaA, be admitted to the Frankfurt Stock Exchange on the official market and at the same time to the Prime Standard listing section. The Company will continue to be included in the electronic trading system Xetra and, if the relevant criteria are fulfilled, on the German Index DAX. We expect that the listing will take place on February 13, 2006, unless the conversion offers are extended.

We expect that in accordance with German market practice, preference shares submitted for conversion will continue to be traded on the official market of the Frankfurt Stock Exchange during the conversion period, i.e. from January l, 2006 until February l, 2006, and until registration of the conversion (ISIN: DE000A0HN438). No guarantee can be given that active trading in the preference shares submitted for conversion will develop on the Frankfurt Stock Exchange or that sufficient liquidity will be available

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throughout the entire trading period for the preference shares submitted for conversion. ADSs submitted for conversion cannot be traded on the New York Stock Exchange, but can be traded if the tendered ADSs are withdrawn.

American Depositary Shares representing Fresenius Medical Care KGaA ordinary shares and preference shares have been approved for listing on the New York Stock Exchange, subject to official notice of issuance and, in the case of preference share ADSs, satisfaction of the exchange s distribution criteria. However, a U.S. trading market for the preference ADSs may cease to be available if: (i) the preference ADSs are not eligible for New York Stock Exchange listing due to a substantial decrease in the number of outstanding preference shares; (ii) the depositary resigns as depositary for the preference shares and we are unable to designate a replacement depositary; or (iii) we otherwise terminate the preference share deposit agreement. **We cannot assure holders of preference ADSs that we will be able to maintain an American Depositary Receipt facility for our preference shares or that preference ADSs will continue to be eligible for listing on the New York Stock Exchange after the offers.** For more information, see Stock Exchange Listing and Trading.

On December 22, 2005, the closing price per share in Euro for our ordinary shares was 86.65 and the closing price per share in Euro for our preference shares was 76.60, as reported by the Frankfurt Stock Exchange Xetra system. On the same date, the closing price per American Depositary Share, or ADS, for ADSs representing our ordinary shares was $34.37, as reported by the New York Stock Exchange, and the last reported sale price per ADS for ADSs representing our preference shares was $29.25, as reported by the New York Stock Exchange. Three ordinary share ADSs represent one ordinary share, and three preference share ADSs represent one preference share.

Appraisal Rights

Holders of preference shares do not have any appraisal rights under German law in connection with the conversion.

The U.S. ADS Exchange Agent

JPMorgan Chase Bank, N.A. has been appointed the U.S. ADS exchange agent in connection with the U.S. offer. An ADS letter of transmittal (or a manually executed facsimile copy thereof) should be sent by each tendering preference shareholder or his or her broker, dealer, bank or other nominee to the U.S. ADS exchange agent at the addresses set forth on the back cover of this prospectus.

Costs of the Transaction/ Use of Proceeds

We estimate the costs for the conversion to be approximately $5.4 million and the costs for the transformation to be approximately $8.9 million. We plan to use the net proceeds of the conversion offers to reduce outstanding indebtedness and for general corporate purposes.

Summary Consolidated Financial Information

The following table summarizes the consolidated financial information for our company for each of the years 2002 through 2004 and for the nine months ended September 30, 2005 and 2004. We derived the selected financial information as of and for the years ended December 31, 2002 through December 31, 2004 from our consolidated financial statements. We prepared our financial statements in accordance with U.S. generally accepted accounting principles and KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftsprüfungsgesellschaft, independent registered public accounting firm audited these financial statements. We derived the selected consolidated financial data as of September 30, 2005 and for the nine months ended September 30, 2005 and 2004 from our unaudited interim consolidated financial statements which are prepared in accordance with U.S. generally accepted accounting principles. Our unaudited condensed consolidated financial statements have been prepared on a basis substantially consistent with our audited consolidated financial statements. You should read this information together with our consolidated financial statements and the notes to those statements contained in our amended Annual Report on Form 20-F for the year ended December 31, 2004, which has been incorporated by reference into this prospectus and Item 5, Operating and Financial Review and Prospects, contained in that report.

	Nine Months Ended September 30,		Year Ended December 31,		
	2005	2004	2004	2003	2002
	(unaudited)				
	(In millions USD, except share and per share date)				
Statement of Operations Data:					
Net revenues	$ 4,999	$ 4,588	$ 6,228	$ 5,528	$ 5,084
Cost of revenues	3,280	3,064	4,142	3,699	3,428
Gross profit	1,719	1,524	2,086	1,829	1,656
Selling, general and administrative	984	861	1,183	1,022	914
Research and development	40	38	51	50	47
Operating income	695	625	852	757	695
Interest expense, net	127	137	183	211	226
Income before income taxes and minority interest	568	488	669	546	469
Net income	$ 339	$ 294	$ 402	$ 331	$ 290
Weighted average of:					
Preference shares outstanding	26,421,404	26,231,287	26,243,059	26,191,011	26,185,178
Ordinary shares outstanding	70,000,000	70,000,000	70,000,000	70,000,000	70,000,000
Basic income per Ordinary share	$ 3.50	$ 3.04	$ 4.16	$ 3.42	$ 3.00
Fully diluted income per Ordinary share	3.48	3.02	4.14	3.42	3.00

Basic income per Preference share	3.56	3.09	4.23	3.49	3.06
Fully diluted income per Preference share	3.53	3.07	4.21	3.49	3.06
Ratio of Earnings to Fixed Charges	4.64	3.96	4.03	3.16	2.62
Dividends declared per Ordinary share( )(a)			1.12	1.02	0.94
Dividends declared per Preference share( )(a)			1.18	1.08	1.00
Dividends declared per Ordinary share($)(a)			1.41	1.25	1.10
Dividends declared per Preference share($)(a)			1.48	1.32	1.17
Balance Sheet Data					
Working capital	$ 868	$ 690	$ 508	$ 794	$ 526
Current Assets	2,526	2,428	2,446	2,206	1,822
Total assets	7,969	7,721	7,962	7,503	6,780
Current Liabilities	1,658	1,738	1,938	1,412	1,295
Non-Current Liabilities	2,467	2,530	2,371	2,833	2,655
Total long-term debt(b)	1,962	2,049	1,824	2,354	2,234
Minority Interest	14	17	18	14	23

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	Nine Months Ended September 30,		Year Ended December 31,		
	2005	2004	2004	2003	2002
	(unaudited)				
	(In millions USD, except share and per share date)				
Shareholders equity (net assets)	3,830	3,436	3,635	3,244	2,807
Total liabilities and shareholders equity	7,969	7,723	7,962	7,503	6,780
Capital Stock Preference shares Nominal Value	73	70	70	70	70
Capital Stock Ordinary shares Nominal Value	229	229	229	229	229
Book value per share	39.4	37.8	37.7	33.7	29.2
Summary of sources and uses of cash					
Net cash provided by operations	$ 470	$ 560	$ 828	$ 754	$ 550
Net cash used in investing activities	(248)	(217)	(365)	(369)	(281)
Net cash used in financing activities	(198)	(332)	(452)	(416)	(265)

(a) Amounts shown for each year from 2002 to 2004 represent dividends paid with respect to such year. The actual declaration and payment of the dividend was made in the following year, after approval of the dividend at our Annual General Meeting.

(b) Total long-term debt represents long-term debt and capital lease obligations, less current portions and the mandatorily redeemable preferred securities Fresenius Medical Care Capital Trust II, Fresenius Medical Care Capital Trust III, Fresenius Medical Care Capital Trust IV, and Fresenius Medical Care Capital Trust V.

Summary of Risk Factors

The risk factors that are relevant to our business and an investment in our shares can be summarized as follows:

Our operations in both our provider business and our products business are subject to extensive governmental regulation in virtually every country in which we operate. If we do not comply with the health care or other governmental regulations applicable to our business or with the corporate integrity agreement between us and the U.S. government, we could be excluded from government health care reimbursement programs or our authority to conduct business could be terminated.

Changes in U.S. government reimbursement for dialysis care could materially decrease our revenues and operating profit.

A reduction in reimbursement for or a change in the utilization of EPO could materially reduce our revenue and operating profit. An interruption of supply or our inability to obtain satisfactory purchase terms for EPO could reduce our revenues from, or increase our costs in connection with, the administration of EPO.

Creditors of W.R. Grace & Co. Conn. have asserted claims against us in connection with the merger transactions of 1996 between us and W.R. Grace & Co. Our 2003 settlement agreement with W.R. Grace & Co. s creditors provides for a settlement payment from us in the amount of US$115 million upon confirmation of a final plan of reorganization of W.R. Grace & Co. If a plan of reorganization including the settlement is not approved, the creditors claims against us could be reinstated, and W.R. Grace & Co. s indemnification against such claims may not be available.

Managed care plans usually negotiate lower reimbursement rates than other health insurers. As such plans grow, amounts paid for our services and products by non-governmental payors could decrease.

Proposals for health care reform could decrease our revenues and operating profit.

The recent acquisition of the third largest provider of dialysis services in the United States, (Gambro Healthcare, Inc.) by the second largest provider of dialysis services in the United States, (DaVita Inc.) could foreclose certain sales of dialysis products to an important customer.

Our growth depends, in part, on our ability to continue to make acquisitions.

The RCG merger and other acquisitions and their financing expose us to risks that could have an adverse affect on our business, financial condition and results of operation.

Numerous competitors are active in our businesses. Our competitors could develop superior technology or otherwise impact our product sales.

We face products liability and other claims which could result in significant costs and liability which we might not be able to insure on acceptable terms in the future.

We are exposed to additional risks from our international operations, including the worsening of the economic situation in Latin America, difficulties in collecting accounts receivable under some countries legal systems and restrictions on our ability to obtain ownership of local companies under local laws.

If physicians and other referral sources cease referring patients to our dialysis clinics or cease purchasing our dialysis products, our revenues would decrease.

If we are unable to attract and retain skilled medical, technical and engineering personnel, we may be unable to manage our growth or continue our technical development.

Diverging views of the financial authorities could require us to make additional tax payments.

As the capital markets may be unfamiliar with the KGaA form, this may adversely affect our share price.

ADSs representing our preference shares may not be eligible for listing on the New York Stock Exchange after the conversion and transformation. Even if listed, the public market for such ADSs and for our preference shares is likely to be limited and illiquid due to the reduced public float after the conversion.

Our significant indebtedness may limit our ability to pay dividends or to implement certain elements of our business strategy.

Fresenius AG will continue to be able to control our management and strategy even after the transformation of legal form and the consummation of the conversion offers, notwithstanding the resulting loss of Fresenius AG s voting majority.

Because we are not organized under U.S. Law, we are subject to certain less detailed disclosure requirements under U.S. federal securities laws.

See Risk Factors.

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RISK FACTORS

You should carefully consider the risk factors set forth below, as well as the other information contained in this prospectus, any supplement to this prospectus and the documents incorporated by reference in this prospectus. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially and adversely affect our business operations.

Risks Relating to Litigation and Regulatory Matters

If we do not comply with the health care or other governmental regulations applicable to our business or with the corporate integrity agreement between us and the U.S. government, we could be excluded from government health care reimbursement programs in the United States and other countries, or our authority to conduct business could be terminated, either of which would result in a material decrease in our revenue.

Our operations in both our provider business and our products business are subject to extensive governmental regulation in virtually every country in which we operate. We are also subject to other laws of general applicability, including antitrust laws. The applicable regulations, which differ from country to country, cover areas that include:

- the quality, safety and efficacy of medical and pharmaceutical products and supplies;
- the operation of manufacturing facilities, laboratories and dialysis clinics;
- the rate of, and accurate reporting and billing for, government and third-party reimbursement; and
- compensation of medical directors and other financial arrangements with physicians and other referral sources.

If we fail to comply with one or more of these laws or regulations, this may give rise to a number of legal consequences. These include, in particular, monetary and administrative penalties, increased costs for compliance with government orders or a complete or partial exclusion from government reimbursement programs or complete or partial curtailment of our authority to conduct business. Any of these consequences could have a material adverse impact on our business, financial condition and results of operations.

Fresenius Medical Care Holdings, Inc. (FMCH), our principal North American subsidiary, is party to a corporate integrity agreement with the U.S. government. This agreement, which was signed in conjunction with a settlement of claims previously asserted against FMCH, requires that FMCH staff and maintain a comprehensive compliance program, including a written code of conduct, training programs, regulatory compliance policies and procedures, annual audits and periodic reporting to the government. The corporate integrity agreement permits the U.S. government to exclude FMCH and its subsidiaries from participation in U.S. federal health care programs (in particular, Medicare and Medicaid) if there is a material breach of the agreement that FMCH does not cure within thirty days after FMCH receives written notice of the breach. We derive approximately 38% of our consolidated revenue from U.S. federal health care benefit programs. Consequently, if FMCH commits a material breach of the corporate integrity agreement that results in the exclusion of FMCH or its subsidiaries from continued participation in those programs, it would significantly decrease our revenue and have a material adverse effect on our business, financial condition and results of operations.

We rely upon our management structure, regulatory and legal resources and the effective operation of our compliance programs to direct, manage and monitor our operations to comply with government regulations and the corporate integrity agreement. If employees were to deliberately or inadvertently fail to adhere to these regulations, then our authority to conduct business could be terminated and our operations could be significantly curtailed. Such actions could also lead to claims for repayment or other sanctions. Any such terminations or reductions could materially reduce our sales, with a resulting material adverse effect on our business, financial condition and results of operations.

In October 2004, FMCH and its Spectra Renal Management subsidiary received subpoenas from the U.S. Department of Justice, Eastern District of New York, in connection with a civil and criminal investigation, which requires production of a broad range of documents relating to our operations, with specific attention to documents relating to laboratory testing for parathyroid hormone (PTH) levels and vitamin D therapies. We are cooperating with the government s requests for information. While we believe that we have complied with applicable laws relating to PTH testing and use of vitamin D therapies, an adverse determination in this investigation could have a material adverse effect on our business, financial condition, and results of operations.

On April 1, 2005, FMCH was served with a subpoena from the office of the United States Attorney for the Eastern District of Missouri in connection with a joint civil and criminal investigation of our company. The subpoena requires production of a broad range of documents relating to our operations, including documents related to, among other things, clinical quality programs, business development activities, medical director compensation and physician relations, joint ventures and our anemia management program. The subpoena covers the period from December 1, 1996 through the present. We are unable to predict whether proceedings might be initiated against us, when the investigation might be concluded or what the impact of this joint investigation might be on our business, financial condition and results of operations.

A change in U.S. government reimbursement for dialysis care could materially decrease our revenues and operating profit.

For the twelve months ended December 31, 2004, approximately 38% of our consolidated revenues resulted from Medicare and Medicaid reimbursement. Legislative changes or changes in government reimbursement practice may affect the reimbursement rates for the services we provide, as well as the scope of Medicare and Medicaid coverage. A decrease in Medicare or Medicaid reimbursement rates or covered services could have a material adverse effect on our business, financial condition and results of operations. In December 2003, the Medicare Prescription Drug Modernization and Improvement Act was enacted. For information regarding the effects of this legislation on reimbursement rates, see Business Overview Regulatory and Legal Matters Reimbursement in our Annual Report on Form 20-F for the year ended December 31, 2004, as amended (our 2004 Form 20-F), which has been incorporated by reference into this prospectus.

A reduction in reimbursement for or a change in the utilization of EPO could materially reduce our revenue and operating profit. An interruption of supply or our inability to obtain satisfactory terms for EPO could reduce our revenues from, or increase our costs in connection with, the administration of EPO.

Reimbursement and revenue from the administration of erythropoietin, or EPO, accounted for approximately 24% of dialysis care revenue in our North America segment for the nine months ended September 30, 2005. EPO is produced by a single source manufacturer, Amgen Inc. Our new contract with Amgen covers the period from January 1, 2006 to December 31, 2007. A reduction of the current overfill amount in EPO vials which we currently use, an interruption of supply or our inability to obtain satisfactory purchase terms for EPO after our current contract expires could reduce our revenues from, or increase our costs in connection with, the administration of EPO, which could materially adversely affect our business, financial condition and results of operations.

Beginning April 1, 2006, the Centers for Medicare and Medical Services (CMS) will begin monitoring EPO dosages administered by ESRD facilities. Specifically, CMS will monitor any claim for Epogen and Aranesp (another drug used to treat anemia) if the patient s hematocrit level reaches 39.0 percent (or hemoglobin of 13.0). See Recent Developments Recent Actions by CMS. A decrease in EPO reimbursement or a clear reduction in EPO utilization, caused, for example, by CMS new anemia management policy, could have a material adverse effect on our business, financial condition, and results of operations.

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Creditors of W.R. Grace & Co. Conn. have asserted claims against us.

We were formed in 1996 as a result of a series of transactions with W.R. Grace & Co. that we refer to as the merger. At the time of the merger, a W.R. Grace & Co. subsidiary known as W.R. Grace & Co.-Conn. had, and continues to have, significant liabilities arising out of product-liability related litigation (including asbestos), pre-merger tax claims and other claims unrelated to its dialysis business. In connection with the merger, W.R. Grace & Co.-Conn. and other Grace entities agreed to indemnify Fresenius Medical Care AG and its subsidiaries against all liabilities of W.R. Grace & Co., whether relating to events occurring before or after the merger, other than liabilities arising from or relating to the operations of National Medical Care, a subsidiary of W.R. Grace & Co. which became our subsidiary in the merger. W.R. Grace & Co. and certain of its subsidiaries filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code (the Grace Chapter 11 Proceedings) on April 2, 2001.

Pre-merger tax claims or tax claims that would arise if events were to violate the tax-free nature of the merger could ultimately be our obligation. In particular, W.R. Grace & Co. has disclosed in its filings with the SEC that: its tax returns for the 1993 to 1996 tax years are under audit by the Internal Revenue Service (the Service); W.R. Grace & Co. has received the Service s examination report on tax periods 1993 to 1996; that during those years W.R. Grace & Co. deducted approximately $122 million in interest attributable to corporate owned life insurance (COLI) policy loans; and that a U.S. District Court ruling has denied interest deductions of a taxpayer in a similar situation. W.R. Grace & Co. has already paid $21 million in tax and interest related to COLI deductions made in tax years prior to 1993.

In October 2004, W.R. Grace & Co. obtained bankruptcy court approval to settle its COLI claims with the Service. In January 2005, W.R. Grace and Co., FMCH and Sealed Air Corporation executed a settlement agreement with respect to the Service s COLI related claims and other tax claims. On April 14, 2005, W.R. Grace & Co. paid the Service approximately $90 million in connection with taxes owed for the tax periods 1993 to 1996 pursuant to a bankruptcy court order directing W.R. Grace & Co. to make such payment. Subject to certain representations made by W.R. Grace & Co., the Company and Fresenius AG, W.R. Grace & Co. and certain of its affiliates agreed to indemnify us against this and other pre-merger and merger-related tax liabilities.

Prior to and after the commencement of the Grace Chapter 11 Proceedings, class action complaints were filed against W.R. Grace & Co. and FMCH by plaintiffs claiming to be creditors of W.R. Grace & Co.-Conn., and by the asbestos creditors committees on behalf of the W.R. Grace & Co. bankruptcy estate in the Grace Chapter 11 Proceedings, alleging among other things that the merger was a fraudulent conveyance, violated the uniform fraudulent transfer act and constituted a conspiracy. All such cases have been stayed and transferred to or are pending before the U.S. District Court as part of the Grace Chapter 11 Proceedings.

In 2003, we reached an agreement with the asbestos creditors committees and W.R. Grace & Co. in the Grace Chapter 11 Proceedings to settle all fraudulent conveyance and tax claims related to us that arise out of the Grace Chapter 11 Proceedings. The settlement agreement has been approved by the U.S. District Court. The proposed settlement is subject to confirmation of a final plan of reorganization of W.R. Grace & Co. that meets the requirements of the settlement agreement or is otherwise satisfactory to us. At December 31, 2004 our provision for special charges for legal matters was $122 million, including a provision for payment of $115 million pursuant to the settlement agreement. If the proposed settlement with the asbestos creditors committees and W.R. Grace & Co. is not confirmed in such a final plan of reorganization, the claims could be reinstated. If the claims are reinstated and the merger is determined to be a fraudulent transfer and if material damages are proved by the plaintiffs and we are not able to collect, in whole or in part, on the indemnity from any of our indemnitors, a judgment could have a material adverse effect on our business, financial condition and results of operations. See Note 6 to our consolidated financial statements in our amended 2004 Form 20-F. For additional information concerning the Grace Chapter 11 Proceedings and the settlement agreement see Legal Proceedings in our Form 6-K furnished to the SEC on August 5, 2005.

Managed care plans usually negotiate lower reimbursement rates than other health plans. As such plans grow, amounts paid for our services and products by non-governmental payors could decrease.

We obtain a significant portion of our revenues from reimbursement provided by non-governmental third-party payors, such as private medical insurers. Although non-governmental payors generally pay at higher reimbursement rates than governmental payors, managed care plans generally negotiate lower reimbursement rates than indemnity insurance plans. Some managed care plans and indemnity plans also utilize a capitated fee structure or limit reimbursement for ancillary services.

The increasing consolidation in the health care sector in the United States has put us under increasing pressure to reduce the prices for our services and products. These trends will accelerate if future changes to the U.S. Medicare ESRD program require private payors to assume a greater percentage of the total cost of care given to dialysis patients over the term of their illness, or if managed care plans otherwise significantly increase their enrollment of renal patients.

If managed care plans in the United States reduce reimbursements, our sales could decrease. This could have a material adverse effect on our financial condition and results of operations.

Proposals for health care reform could decrease our revenues and operating profit.

A number of governments, in particular, the U.S. federal and certain U.S. state governments and the German government, have been considering proposals to modify their current health care systems to improve access to health care and control costs. See Regulatory and Legal Matters Reimbursement U.S. in our 2004 Form 20-F for a discussion of the Medicare Prescription Drug Modernization and Improvement Act of 2003. Other countries, especially those in Western Europe, are also considering health care reform proposals that could materially alter their government-sponsored health care programs by reducing reimbursement payments. Any reduction could affect the pricing of our products and the profitability of our services, especially as we intend to expand our international business. We cannot predict whether and when these reform proposals will be adopted in countries in which we operate or what impact they might have on us. Any decrease in spending or other significant changes in state funding in countries in which we operate, particularly significant changes in the U.S. Medicare and Medicaid programs, could reduce our sales and profitability and have a material adverse effect on our business, financial condition and results of operations.

Risks Relating to our Business

Our competitors recent combination could foreclose certain sales to an important customer.

We are engaged in both manufacturing dialysis products and providing dialysis services. We compete in the dialysis services business with many customers of our products business. As a result, independent dialysis clinics, those operated by other chains and dialysis centers acquired by other products manufacturers may elect to limit or terminate their purchases of our dialysis products so as to avoid purchasing products manufactured by a competitor. In addition, as consolidation in the dialysis services business continues and other vertically integrated dialysis companies expand, the external market for our dialysis products could be reduced. Possible purchase reductions could decrease our product revenues, with a material adverse effect on our business, financial condition and results of operations.

On October 5, 2005, DaVita Inc. (DaVita), the second largest provider of dialysis services in the U.S. and an important customer of ours, completed its acquisition of Gambro Healthcare, Inc. (Gambro Healthcare), the third largest provider of dialysis services in the U.S., and agreed to purchase a substantial portion of its dialysis product supply requirements from Gambro Renal Products, Inc. during the next ten years. This product supply contract between our customer and our competitor could result in the future in substantial reductions of DaVita s purchases of our dialysis products. Any such reduction in DaVita s purchases will decrease our product revenues and could result in a material adverse effect on our business, financial condition and results of operations.

The risks associated with the Renal Care Group merger and other acquisitions could have an adverse effect on our financial condition and results of operation.

On May 3, 2005, we entered into a definitive merger agreement for the acquisition of Renal Care Group, Inc., or RCG, for an all cash purchase price of approximately $3.5 billion. The acquisition is subject to certain conditions, including expiration or termination of the applicable waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and other regulatory approvals. See Recent Developments Acquisition of Renal Care Group, Inc.

The RCG merger and other potential future acquisitions present challenges for the financing and management of our business. Following an acquisition, the infrastructure of an acquired company (including its management information systems) must be integrated into our own infrastructure; legal issues (including regulatory issues and contractual matters) arising from the acquisition must be resolved; marketing, patient services and logistical procedures must be harmonized; and, in some cases, divergent corporate and management cultures need to be reconciled. There is also the risk that key managers may leave the company during the integration process. These departures could affect the company s day-to-day business and relations with customers and employees. The integration process could also turn out to be more difficult, time-consuming and costly than expected. If there are delays in the receipt of required governmental approvals for an acquisition, it may not be possible to consummate the acquisition and to recover costs that have been incurred in connection with the acquisition. In addition, difficulties regarding the acquisition or the newly acquired company s business activities that we may have failed to identify could materialize or that we had regarded as immaterial could turn out to be material in the end. In addition, potential benefits of an acquisition may fail to materialize or may not materialize as anticipated. If we are unable to successfully meet the challenges associated with one or more of our acquisitions, particularly, the acquisitions of RCG, this could have an adverse effect on our business, financial condition and results of operations.

On October 25, 2004, RCG received a subpoena from the office of the United States Attorney for the Eastern District of New York. The subpoena requires the production of documents related to numerous aspects of their business and operations, including those of RenaLab, Inc., their laboratory. The subpoena includes specific requests for documents related to testing for parathyroid hormone (PTH) levels and vitamin D therapies. RCG has announced that it intends to cooperate with the government s investigation.

On August 9, 2005, RCG was served with a subpoena from the office of the United States Attorney for the Eastern District of Missouri in connection with a joint civil and criminal investigation. The subpoena requires the production of documents related to numerous aspects of RCG s business and operations from January 1, 1996. The areas covered by the subpoena include RCG s supply company, pharmaceutical and other services that RCG provides to patients, RCG s relationships to pharmaceutical companies, RCG s relationships with physicians, medical director compensation and joint ventures with physicians. RCG has announced that it intends to cooperate with the government s investigation.

Our growth depends, in part, on our ability to continue to make acquisitions.

The health care industry has experienced significant consolidation in recent years, particularly in the dialysis services sector. Our ability to make future acquisitions depends, in part, on our available financial resources and limitations imposed under our credit agreements. If we make future acquisitions, we may issue ordinary shares for non-cash consideration without first offering the shares to our existing shareholders, which could dilute the holdings of these shareholders. We may also need to borrow additional debt, assume significant liabilities or create additional expenses relating to intangible assets, any of which might reduce our reported earnings or our earnings per share and cause our stock price to decline. In addition, any financing that we might need for future acquisitions might be available to us only on terms that restrict our business. Acquisitions that we complete are also subject to the risk that we might not successfully integrate the acquired businesses or that we might not realize anticipated synergies from the combination. If we are not able to effect acquisitions on reasonable terms, there could be an adverse effect on our business, financial condition and results of operations.

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We also compete with other dialysis products and services companies in seeking suitable acquisition targets. If we are not able to continue to effect acquisitions on reasonable terms, especially in the international area, this could have an adverse effect on our business, financial condition and results of operations.

Our competitors could develop superior technology or otherwise impact our product sales.

We face numerous competitors in both our dialysis services business and our dialysis products business, some of which may possess substantial financial, marketing or research and development resources. Competition could materially adversely affect the future pricing and sale of our products and services. In particular, technological innovation has historically been a significant competitive factor in the dialysis products business. The introduction of new products by competitors could render one or more of our products less competitive or even obsolete.

We are exposed to products liability and other claims which could result in significant costs and liability which we may not be able to insure on acceptable terms in the future.

Health care companies are subject to claims alleging negligence, products liability, breach of warranty, malpractice and other legal theories that may involve large claims and significant defense costs whether or not liability is ultimately imposed. Health care products may also be subject to recalls and patent infringement claims. We cannot assure you that significant claims will not be asserted against us, that significant adverse verdicts will not be reached against us for patent infringements or that large scale recalls of our products will not become necessary. In addition, some of the countries in which we operate have legal protections relating to pharmaceutical products that could increase the risk of product liability claims. Product liability and patent infringement claims, other actions for negligence or breach of contract and product recalls or related sanctions could result in significant costs. These costs could have a material adverse effect on our business, financial condition and results of operations. See Legal Proceedings in our 2004 Form 20-F.

While we have been able to obtain liability insurance in the past, to cover our business risks, we cannot assure you that such insurance will be available in the future either on acceptable terms or at all. A successful claim in excess of the limits of our insurance coverage could have a material adverse effect on our business, results of operations and financial condition. Liability claims, regardless of their merit or eventual outcome, also may have a material adverse effect on our business and reputation, which could in turn reduce our sales and profitability.

If physicians and other referral sources cease referring patients to our dialysis clinics or cease purchasing our dialysis products, our revenues would decrease.

Our dialysis services business is dependent upon patients choosing our clinics as the location for their treatments. Patients may select a clinic based, in whole or in part, on the recommendation of their physician. We believe that physicians and other clinicians typically consider a number of factors when recommending a particular dialysis facility to an end-stage renal disease patient, including, but not limited to, the quality of care at a clinic, the competency of a clinic s staff, convenient scheduling, and a clinic s location and physical condition. Physicians may change their facility recommendations at any time, which may result in the movement of our existing patients to competing clinics, including clinics established by the physicians themselves. At most of our clinics, a relatively small number of physicians account for the referral of all or a significant portion of the patient base. Our dialysis care business also depends on recommendations by hospitals, managed care plans and other health care institutions. If a significant number of physicians, hospitals or other health care institutions cease referring their patients to our clinics, this would reduce our dialysis care revenue and could materially adversely affect our overall operations.

The decision to purchase our dialysis products and other services or competing dialysis products and other services will be made in some instances by medical directors and other referring physicians at our dialysis clinics and by the managing medical personnel and referring physicians at other dialysis clinics, subject to applicable regulatory requirements. A decline in physician recommendations or recommendations from other sources or purchases of our products or ancillary services would reduce our dialysis product and other services revenue, and could materially adversely affect our business, financial condition and results of operations.

If we are unable to attract and retain skilled medical, technical and engineering personnel, we may be unable to manage our growth or continue our technological development.

Our continued growth in the provider business will depend upon our ability to attract and retain skilled employees, such as highly skilled nurses and other medical personnel. Competition for those employees is intense and the current nursing shortage in North America has increased our personnel and recruiting costs. Moreover, we believe that future success in the provider business will be significantly dependent on our ability to attract and retain qualified physicians to serve as medical directors of our dialysis clinics. If we are unable to achieve that goal or if doing so requires us to bear increased costs this could adversely impact our growth and results of operations.

Our dialysis products business depends on the development of new products, technologies and treatment concepts to be competitive. Competition is also intense for skilled engineers and other technical research and development personnel. If we are unable to obtain and retain the services of key personnel, the ability of our officers and key employees to manage our growth would suffer and our operations could suffer in other respects. These factors could preclude us from integrating acquired companies into our operations, which could increase our costs and prevent us from realizing synergies from acquisitions. Lack of skilled research and development personnel could impair our technological development, which would increase our costs and impair our reputation for production of technologically advanced products.

We face additional risks from international operations.

We operate dialysis clinics in 27 countries and sell a range of equipment, products and services to customers in over 100 countries. Our international operations are subject to a number of risks, including the following:

The economic situation in Latin America could deteriorate;

Fluctuations in exchange rates could adversely affect profitability;

We could face difficulties in enforcing and collecting accounts receivable under some countries legal systems;

Local regulations could restrict our ability to obtain a direct ownership interest in dialysis clinics or other operations;

Political and economic instability, especially in developing and newly industrializing countries, could disrupt our operations;

Some customers and governments could have longer payment cycles, with resulting adverse effects on our cash flow; and

Some countries could impose additional taxes or restrict the import of our products.

Any one or more of these factors could increase our costs, reduce our revenues, or disrupt our operations, with possible material adverse effects on our business, financial condition and results of operations.

Diverging views of the financial authorities could require us to make additional tax payments.

We are subject to ongoing tax audits in the U.S., Germany and other jurisdictions. We have received notices of unfavorable adjustments and disallowances in connection with certain of these audits. We are contesting, and in some cases appealing certain of these unfavorable determinations. We may be subject to additional unfavorable adjustments and disallowances in connection with ongoing audits. If our objections and any final audit appeals are unsuccessful, we could be required to make additional tax payments. We are not currently able to determine the timing of these potential additional tax payments. If all potential additional tax payments were to become due contemporaneously, it could have a material adverse impact on our operating cash flow in the relevant reporting period.

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Risks Relating to our Securities

Capital markets may be unfamiliar with the KGaA form, which may adversely affect our share price.

We are presently aware of only a few companies organized in KGaA form in Germany whose shares are publicly traded, and no such companies shares are listed on any national stock exchange in the United States or quoted in the Nasdaq Stock Market. The lack of familiarity of capital markets with the KGaA form, plus other factors, such as the lesser degree of shareholder influence on management and the inability to effect a takeover without the consent of Fresenius AG, could adversely affect the price of our shares after the conversion and the transformation. We will apply to list the shares of Fresenius Medical Care KGaA on the Frankfurt Stock Exchange and ADSs representing such shares have been approved for listing, subject to notice of issuance, on the New York Stock Exchange. We cannot give any assurances as to the level of capital market acceptance of our securities after the transformation or the prices at which our shares or ADSs representing shares will trade after the conversion and the transformation.

ADSs representing our preference shares may not be eligible for listing on the New York Stock Exchange after the conversion and transformation. Moreover, the public market for such ADSs may be limited and highly illiquid.

We intend to apply to list the preference shares of Fresenius Medical Care KGaA on the Frankfurt Stock Exchange and ADSs representing the preference shares of Fresenius Medical Care KGaA have been approved for listing on the New York Stock Exchange, subject to notice of issuance and satisfaction of that exchange s distribution criteria. However, if most of our preference shares are converted into ordinary shares in the conversion offers, the number of preference shares of Fresenius Medical Care KGaA that would remain outstanding after completion of the transformation and the distribution of ownership of those shares might not satisfy the listing criteria of the New York Stock Exchange in relation to the ADSs representing those preference shares. Without a New York Stock Exchange or a Nasdaq Stock Market listing, we might not be able to maintain an American Depositary Receipt facility for the preference shares of Fresenius Medical Care KGaA. In addition, if substantially all of the preference shares are converted, we may terminate the deposit agreement for the preference shares, or the depositary may resign due to the substantially reduced compensation it is likely to receive for its services in such circumstances and we may not be able to find a suitable replacement. If there is a high acceptance rate of the conversion offer, any public market that may be available for the preference shares of Fresenius Medical Care KGaA after the transformation is likely to be limited and highly illiquid.

Our significant indebtedness may limit our ability to pay dividends or implement certain elements of our business strategy.

We have a substantial amount of debt. At September 30, 2005, we have consolidated debt of $2.26 billion, including $1.20 billion of our trust preferred securities, and consolidated total shareholders equity of $3.83 billion, resulting in a ratio of total debt to equity of 0.59. After the completion of the RCG acquisition (see Recent Developments Acquisition of Renal Care Group, Inc.), our debt will increase (on a pro forma basis as of September 30, 2005) to approximately $6.47 billion and our pro forma total shareholders equity will be approximately $3.82 billion, resulting in a pro forma ratio of total debt to equity of 1.69. Our substantial level of debt and the higher level of debt to be incurred in connection with the RCG acquisition present the risk that we might not generate sufficient cash to service our indebtedness or that our leveraged capital structure could limit our ability to finance acquisitions and develop additional projects, to compete effectively or to operate successfully under adverse economic conditions.

Our 2003 senior credit agreement and the indentures relating to our trust preferred securities include, and the new senior credit agreements that we will enter into in connection with the acquisition of RCG will include, covenants that require us to maintain certain financial ratios or meet other financial tests. Under our senior credit agreement, we are obligated to maintain a minimum consolidated net worth and a minimum consolidated interest coverage ratio (ratio of consolidated earnings before interest, taxes, depreciation and amortization (EBITDA) to consolidated net interest expense) and a certain consolidated leverage ratio (ratio of consolidated funded debt to EBITDA).

Our 2003 senior credit agreement and our indentures include, and the new senior credit agreements that we will enter into in connection with the acquisition of RCG will include other covenants which, among other

things, restrict or have the effect of restricting our ability to dispose of assets, incur debt, pay dividends, create liens or make capital expenditures, investments or acquisitions. These covenants may otherwise limit our activities. The breach of any of the covenants could result in a default and acceleration of the indebtedness under the credit agreement or the indentures, which could, in turn, create additional defaults and acceleration of the indebtedness under the agreements relating to our other long-term indebtedness which would have an adverse effect on our business, financial condition and results of operations.

Fresenius AG will own 100% of the shares in the general partner of the Company after the transformation and will continue to be able to control our management and strategy.

Fresenius AG currently holds approximately 50.8% of our voting securities. Accordingly, Fresenius AG currently possesses the ability to elect the members of the supervisory board *(Aufsichtsrat)* of the Company and, through its voting power, to approve many actions requiring the vote of the shareholders of the Company. This controlling ownership has the effect of, among other things, preventing a change in control and precluding a declaration or payment of dividends without the consent of Fresenius AG.

After the conversion and transformation, Fresenius AG will no longer possess a majority of the outstanding ordinary shares with voting power of the Company and will be precluded from voting on certain matters that will be submitted to the shareholders of the Company. See The Conversion and Transformation; Effects. However, Fresenius AG will own 100% of the outstanding shares of the general partner of the Company and will have the sole right to elect the supervisory board of the general partner which, in turn, will elect the management board of the general partner. The management board of the general partner will be responsible for the management of the Company, but the actions and decisions of the general partner s management board will be fully reviewable by the supervisory board of the general partner and by the supervisory board of the Company in its KGaA form. However, actions of the management board that currently require the consent or approval of the supervisory board of Fresenius Medical Care AG, elected by all of the shareholders, will require only the approval of the supervisory board of the general partner, although the pooling agreement (see Description of Proposed Pooling Arrangements) that we will enter into for the benefit of minority ordinary shareholders and preference shareholders (including holders of ADSs representing ordinary shares and preference shares) of Fresenius Medical Care KGaA is applicable to the supervisory board of the general partner. Accordingly, through its ownership of the general partner, Fresenius AG will be able to exercise substantially the same degree of control over the management and strategy of Fresenius Medical Care KGaA as it currently exercises over Fresenius Medical Care AG, notwithstanding that it will no longer own a majority of the outstanding voting shares. In addition, Fresenius AG will continue to consolidate the Company in its financial statements.

Because we are not organized under U.S. law, we are subject to certain less detailed disclosure requirements under U.S. federal securities laws.

Under pooling agreements that we have entered into for the benefit of minority holders of our ordinary shares and holders of our preference shares (including, in each case, holders of American Depositary Receipts representing beneficial ownership of such shares), we have agreed to file quarterly reports with the SEC, to prepare annual and quarterly financial statements in accordance with U.S. generally accepted accounting principles, and to file information with the SEC with respect to annual and general meetings of our shareholders. These pooling agreements also require that the supervisory board of Fresenius Medical Care AG include at least two members who do not have any substantial business or professional relationship with Fresenius AG, Fresenius Medical Care AG and its affiliates and require the consent of those independent directors to certain transactions between us and Fresenius AG and its affiliates. We intend to enter into similar arrangements with Fresenius AG in connection with the transformation, including requirements that the supervisory board of the general partner include independent directors.

We are a foreign private issuer, as defined in the SEC s regulations, and consequently we are not subject to all of the same disclosure requirements applicable to domestic companies. We are exempt from the SEC s proxy rules, and our annual reports contain less detailed disclosure than reports of domestic issuers regarding such matters as management, executive compensation and outstanding options, beneficial ownership

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of our securities and certain related party transactions. Also, our officers, directors and beneficial owners of more than 10% of our equity securities are exempt from the reporting requirements and short-swing profit recovery provisions of Section 16 of the Securities Exchange Act of 1934. We are not obligated to comply with the SEC s rules regarding internal control over financial reporting until our fiscal year ending December 31, 2006 and we are also generally exempt from most of the governance rule revisions recently adopted by the New York Stock Exchange, other than the obligation to maintain an audit committee in accordance with Rule 10A-3 under the Securities Exchange Act of 1934, as amended. These limits on available information about our company and exemptions from many governance rules applicable to domestic issuers may adversely affect the market prices for our securities.

RECENT DEVELOPMENTS

Acquisition of Renal Care Group, Inc.

On May 3, 2005, we entered into a definitive merger agreement for the acquisition of RCG for an all cash purchase price of approximately $3.5 billion. Renal Care Group, Inc. is a Delaware corporation and provides dialysis services and ancillary services to patients with chronic kidney failure, or ESRD. RCG was, on May 1, 2005, the fourth largest provider of out-patient renal care and ancillary services in the United States (Source: *Nephrology News and Issues*, July, 2005, based on patients treated). As of September 30, 2005, RCG provided dialysis and ancillary services to over 32,000 patients through more than 450 outpatient dialysis centers in 34 states in the United States, in addition to providing acute dialysis services to more than 200 hospitals. Through a subsidiary, RCG also offers clinical laboratory services in the field of dialysis. RCG generates a large share of its revenues from private insurers and other private payors. We believe RCG has an attractive portfolio of patients. In the first nine months of 2005, RCG provided 3,587,959 dialysis treatments. In 2004, RCG had revenue of approximately $1.35 billion and net income of $122 million. In addition to out-patient dialysis in dialysis centers, home dialysis and in-patient dialysis in hospitals, RCG provides a number of ancillary services for the treatment of ESRD patients. The following table provides information for the years ended December 31, 2004, 2003 and 2002 regarding the sources of RCG s revenues:

	Fiscal Year Ended December 31,		
	2004	**2003**	**2002**
U.S. Medicare Program	49%	49%	50%
U.S. Medicaid Program	4%	6%	7%
Insurance companies and other private payors	42%	40%	38%
Acute dialysis services	5%	5%	5%

RCG s stockholders approved the merger on August 24, 2005. Completion of the acquisition remains subject to governmental approvals (including termination or expiration of the waiting period under the Hart-Scott Rodino Antitrust Improvements Act of 1976, as amended). On June 15, 2005, we announced that we had received a request for additional information from the United States Federal Trade Commission (FTC) relating to the RCG acquisition. We intend to continue to cooperate with the FTC and to respond promptly to the request so as to enable us to complete the acquisition in early 2006. However, our ability to complete the acquisition is dependent on the FTC review process, and there can be no assurance that we will complete the acquisition of RCG during this time. In addition, RCG has been served with a complaint in a purported shareholder class action seeking to enjoin and prevent RCG and Fresenius Medical Care from completing the merger. RCG believes that the allegations are without merit. See Note 2 of the notes to condensed consolidated financial statements of RCG for the nine months ended September 30, 2005 in Appendix A-2.

We have included unaudited *pro forma* combined financial statements showing the pro forma effects of the RCG merger in Appendix A-1 to this prospectus. The consolidated financial statements of RCG as of December 31, 2004 and 2003 and for each of the years in the three-year period ended December 31, 2004, and the unaudited condensed consolidated financial statements of RCG as of September 30, 2005 and for the nine-month periods ended

September 30, 2005 and September 30, 2004, are contained in Appendix A-2 to this prospectus.

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On October 25, 2004, RCG received a subpoena from the office of the United States Attorney for the Eastern District of New York. The subpoena requires the production of documents related to numerous aspects of their business and operations, including those of RenaLab, Inc., their laboratory. The subpoena includes specific requests for documents related to testing for parathyroid hormone (PTH) levels and vitamin D therapies. RCG has announced that it intends to cooperate with the government s investigation.

On August 9, 2005, RCG was served with a subpoena from the office of the United States Attorney for the Eastern District of Missouri in connection with a joint civil and criminal investigation. The subpoena requires the production of documents related to numerous aspects of RCG s business and operations from January 1, 1996. The areas covered by the subpoena include RCG s supply company, pharmaceutical and other services that RCG provides to patients, RCG s relationships to pharmaceutical companies, RCG s relationships with physicians, medical director compensation and joint ventures with physicians. RCG has announced that it intends to cooperate with the government s investigation.

The New Senior Credit Facilities

In connection with our proposed acquisition of RCG, we have entered into a commitment letter pursuant to which Bank of America, N.A. (BofA) and Deutsche Bank AG New York Branch (DB) have agreed, subject to the satisfaction of certain conditions, to underwrite an aggregate of $5.0 billion in principal amount of term and revolving loans (the Senior Credit Facilities) for syndication to other financial institutions by Banc of America Securities LLC and Deutsche Bank Securities Inc., as joint lead arrangers and joint book running managers, and BofA has agreed to act as administrative agent. The loans under the Senior Credit Facilities will be available to us, among other things, to pay the purchase price and related expenses for the acquisition of RCG, to refinance the outstanding indebtedness under our existing 2003 senior credit facility and certain indebtedness of RCG, and to utilize for working capital purposes. The Senior Credit Facilities will consist of a 5-year $1.0 billion revolving credit facility, a 5-year $2.0 billion term loan A facility, and a 7-year $2.0 billion term loan B facility. The syndication of the revolving credit facility and the term loan A facility have already been completed. Interest on the Senior Credit Facilities will be at the option of the borrowers at a rate equal to either (i) LIBOR plus an applicable margin, or (ii) the higher of BofA s prime rate or the Federal Funds rate plus 0.5% plus the applicable margin. The applicable margin is variable and depends on the consolidated leverage ratio of the borrowers.

The Senior Credit Facilities will include financial covenants that require us to maintain a certain consolidated leverage ratio and a certain consolidated fixed charge coverage ratio. The Senior Credit Facilities will also include covenants that are substantially the same as those under our existing 2003 senior credit facility, with modifications as required in the context of the transaction. Among other covenants, there will be limitations on liens, mergers, consolidations, sale of assets, incurrence of debt and capital expenditures, prepayment of certain other debt, investments and acquisitions, and transactions with affiliates.

The Senior Credit Facilities will be guaranteed by the Company and FMCH and certain of their respective subsidiaries and secured by pledges of the stock of certain of the Company s material subsidiaries. The borrowers and guarantors under the Senior Credit Facilities will provide liens on substantially all of their personal property and material real property if the non-credit enhanced senior secured debt rating of the borrowers falls below a certain level, to the extent a grant of security interests is determined appropriate by a cost-benefit analysis.

The closing of the Senior Credit Facilities will be subject, among other things, to the execution of definitive documents, the non-occurrence of a material adverse effect in relation to RCG, and the refinancing of the indebtedness under our existing 2003 senior credit facility and certain indebtedness of RCG. DB and BofA also have the right to approve any material modification to the merger agreement and any waiver of any material conditions precedent under that agreement. The commitment letter for the Senior Credit Facilities expressly permits us to consummate the conversion and the transformation.

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Recent Actions by CMS

On November 2, 2005, CMS released its final rule for reimbursement of medications administered by ESRD facilities for calendar year 2006. Among other things, the rule provides for the following: (1) payment for separately billable drugs and biologicals furnished by ESRD facilities will be based on 106% of average sales price; (2) a 14.7% drug add-on to the ESRD composite rate; and (3) certain modifications of the geographic and wage index based adjustments of the ESRD composite rate. We expect that the final rule will have a small positive impact on our 2006 operating results.

On November 9, 2005, CMS announced a new national monitoring policy for claims for Epogen and Aranesp for ESRD patients treated in renal dialysis facilities. Previously, claims for Epogen reimbursement were subject to focused CMS review when the ESRD patient s hematocrit level reached 37.5 or more. In the new monitoring policy, CMS recognized that there is considerable natural variability in individual patient response to the drug which makes it difficult to maintain a hematocrit within a narrow range. Consequently, CMS will not initiate monitoring of claims until the patient s hematocrit level reaches 39.0 (hemoglobin of 13.0). Under the new monitoring policy, for services furnished on or after April 1, 2006, CMS will expect a 25 percent reduction in the dosage of Epogen or Aranesp administered to ESRD patients whose hematocrit exceeds 39.0 (or hemoglobin exceeds 13.0). If the dosage is not reduced by 25 percent, payment will be made by CMS as if the dosage reduction had occurred. This payment reduction may be appealed under the normal appeal process. In addition, effective April 1, 2006, CMS will limit Epogen and Aranesp reimbursement to a maximum per patient per month aggregate dose of 500,000 IU for Epogen and 1500 mcg for Aranesp. We are in the process of analyzing CMS s new Epogen and Aranesp monitoring policy and any impact it may have on our operating results.

CAUTIONARY STATEMENT CONCERNING FORWARD-LOOKING STATEMENTS

This prospectus includes certain forward-looking statements. Forward-looking statements include statements about: our future business, financial condition and results of operations; our strategy, plans, expectations, and targets; and future developments and possible regulatory changes in our existing or future markets. The words should, may, will, believe, assume, expect, estimate, plan, intend, be of the opinion, anticipate, according to, other variations, or similar formulations and statements regarding matters that are not based on historical or current facts, are or may constitute forward-looking statements.

We have based these forward-looking statements on current estimates and assumptions made to the best of our knowledge. By their nature, such forward-looking statements involve risks, uncertainties, assumptions and other factors which could cause actual results, including our financial condition and profitability, to differ materially and be more negative than the results expressly or implicitly described in or suggested by these statements. Moreover, forward-looking estimates or predictions derived from third parties studies or information may prove to be inaccurate. Consequently, we cannot give any assurance regarding the future accuracy of the opinions set forth in this prospectus or the actual occurrence of the predicted developments. In addition, even if our future results meet the expectations expressed here, those results may not be indicative of our performance in future periods. These risks, uncertainties, assumptions, and other factors include, among others, the following:

dependence on government reimbursements for dialysis services;

a possible decline in EPO utilization or EPO reimbursement;

creditors claims and tax risks relating to the merger with W.R. Grace & Co.;

the influence of managed care organizations and healthcare reforms;

our ability to remain competitive in our markets;

product liability risks;

risks relating to the integration of acquisitions and our dependence on additional acquisitions;

the impact of currency fluctuations; and

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other factors described in this prospectus, including the documents incorporated by reference into this prospectus.

You should read the more complete description of factors that could influence our business performance and our industry sectors under the heading Risk Factors in this prospectus and under the headings Information on the Company and Operating and Financial Review and Prospects in our 2004 form 20-F. Prospective investors should not place undue reliance on forward-looking statements due to these risks, uncertainties and assumptions. We do not undertake any obligation to update any forward-looking statements to reflect future events or developments.

This prospectus contains or incorporates by reference patient and other statistical data related to end-stage renal disease and treatment modalities, including estimates regarding the size of the patient population and growth in that population. These data have been included in reports published by organizations such as the Centers for Medicare and Medicaid Services of the U.S. Department of Health and Human Services, the Japanese Society for Dialysis Therapy, the German non-profit entity Quasi-Niere gGmbH and the journal *Nephrology News & Issues*. Investors are advised to consider the information quoted from these reports with caution. Market studies are often based on information or assumptions that might not be accurate or appropriate, and their methodology is inherently predictive and speculative. Investors should be aware that some of our estimates are based on such third party market analyses. We have not independently verified the data or any assumptions on which the estimates they contain are based and therefore accept no liability for the information quoted from such data. All information not attributed to a source is derived from internal documents of the Company or publicly available information such as annual reports of other companies in the healthcare industry and is unaudited. Market data not attributed to a specific source are the Company s estimates.

Our business is also subject to other risks and uncertainties that we describe from time to time in our public filings. Developments in any of these areas could cause our results to differ materially from the results that we or others have projected or may project.

USE OF PROCEEDS

The amount of net proceeds we receive as a result of the conversion offers is not determinable at the date of this prospectus. Such proceeds will consist of the conversion premium of 9.75 per preference share converted pursuant to the terms of the offers. If 100% of our outstanding preference shares are converted, we will receive net proceeds of approximately $302,510,000; if 50% of our outstanding preference shares are converted, we will receive net proceeds of approximately $148,589,000. The actual net proceeds we receive will depend solely on the number of preference shares converted pursuant to the offers. In connection with the conversion offer, we will bear expenses in the amount of approximately $5.4 million.

We plan to use the net proceeds of the conversion offers to reduce outstanding indebtedness and for general corporate purposes.

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CAPITALIZATION AND INDEBTEDNESS

The following table presents our capitalization as of September 30, 2005, on a *pro forma* basis to reflect the acquisition of RCG as if the acquisition had been consummated on September 30, 2005, and on a *pro forma* adjusted basis to reflect the hypothetical conversion of (i) 50% and (ii) 100% of our outstanding preference shares at September 30, 2005 in the conversion offers, after deducting estimated offering expenses. The actual net proceeds we receive will depend on the number of preference shares converted pursuant to the offers. See Use of Proceeds. You should read this table in conjunction with our Operating Review and Prospects and the financial statements contained in our 2004 Form 20-F and our Management s Discussion and Analysis of Financial Condition and Results of Operations and the financial statements contained in our Form 6-K for the nine months ended September 30, 2005, furnished to the SEC on November 3, 2005.

	September 30, 2005			
	Actual	**Pro forma**	**Pro forma adjusted (50% conversion)**	**Pro forma adjusted (100% conversion)**
	(Dollars in millions)			
Debt (Including current portion):				
Short Term borrowings	300	506	352	192
Long Term Debt and capital lease obligations	757	4,758	4,758	4,758
Company-Obligated mandatorily redeemable preferred securities of Fresenius Medical Care Capital Trusts holding solely Company debentures and Company-guaranteed debentures of subsidiary	1,205	1,205	1,205	1,205
Minority Interest	14	71	71	71
Total debt and minority interest	2,276	6,540	6,386	6,226
Total Shareholders Equity	3,830	3,820	3,974	4,134
Total capitalization	6,106	10,360	10,360	10,360

Subsequent to September 30, 2005, we have reduced our outstanding indebtedness utilizing our positive cash flows generated from our ongoing operations. However, year-end cash requirements resulted in some increase in indebtedness. In addition, as indicated in the pro forma financial information contained in Appendix I, the Company expects to incur $4 billion of additional debt in conjunction with the closing of the RCG acquisition.

We believe that our existing and our new credit facilities, cash from operations, the net cash proceeds of the conversion and other sources of liquidity will be sufficient to cover our foreseeable liquidity needs during the next 12 months following the date of this prospectus.

The conversion of preference shares into ordinary shares pursuant to the conversion will not change the total number of issued shares of both classes or our total share capital. Dilution of the capital of our shareholders will not occur. The increase in the number of outstanding voting ordinary shares will dilute the voting rights of current ordinary shareholders, which may affect the price of our ordinary shares.

The conversion as proposed, with a conversion premium of 9.75, will not dilute income per share, but will have a non-recurring effect on the allocation of income used to determine earnings per share. Based upon the market value of our ordinary shares at September 30, 2005 and assuming 100% acceptance of the conversion offer, the benefit for the preference shareholders would be $19.96 and the reduction to ordinary shareholders would be $7.76, with no effect on net income or total shareholders equity. See the discussion of Nonrecurring Charges in the pro forma financial statements in Appendix A-1. Under the assumption that the proceeds of the conversion will be used to reduce our outstanding debt, our net income would increase due to the reduced interest payments. Additionally, and depending on the acceptance rate of the conversion offer, the total amount payable as preference dividend would be reduced.

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THE U.S. OFFER

The U.S. Offer and the German Offer

We are offering our preference shareholders the opportunity to convert their preference shares into ordinary shares through two separate offers:

a U.S. offer open to all holders of preference shares who are residents of the United States and to all holders of preference share ADSs, wherever located; and

a German offer as a public offer in Germany open to all holders of preference shares who are residents of Germany and, subject to local laws and regulations, to all holders of preference shares who are located outside of Germany and the United States, other than, in each case, holders of preference share ADSs.

Taken together, the German offer and the U.S. offer provide the opportunity to convert all of our outstanding preference shares, including preference shares represented by ADSs, and all preference shares that are or may become issuable prior to the expiration of the offers due to the exercise of outstanding preference share options or the conversion of preference share convertible bonds. As of November 30, 2005, there were 27,762,179 preference shares outstanding and 5,835,521 preference shares issuable upon exercise of currently exercisable options and convertible bonds. Of these, we estimate that 763,506 preference shares are represented by preference share ADSs and, in addition, based on the best available information, we estimate that up to approximately 6,954,322 preference shares are held by holders who are located in the United States.

Subject to statutory requirements, the German offer and the U.S. offer are being made on substantially similar terms and completion of the offers is subject to the same conditions. Participants in the U.S. offer are entitled to withdrawal rights under the Securities Exchange Act of 1934 and the rules of the SEC thereunder. German law does not require withdrawal rights in connection with the conversion, but such rights will be available in the German offer. See Withdrawal Rights, below. The U.S. offer will commence by the mailing of this prospectus and the ADS letter of transmittal on January l, 2006 and will expire on February l, 2006. The German offer will also commence on January l, 2006 and expire on February l, 2006. Both offers are subject to extension. Holders of preference shares who are residents of the United States and holders of preference share ADSs do not have the right to tender their preference shares or preference share ADSs in the German offer and holders of preference shares who are not U.S. residents do not have the right to tender their preference shares in the U.S. offer. Holders of preference share ADSs, wherever located, must tender their ADSs to the U.S. ADS exchange agent in accordance with the procedures described below under Procedures for Tendering Preference Share ADSs. This prospectus covers only the U.S. offer to holders of preference shares and preference share ADSs.

In separating our offers into the U.S. offer and the German offer and in conducting the U.S. offer on the terms described in this prospectus, we are relying on Rule 13e-4(i) under the Exchange Act which provides exemptive relief from otherwise applicable rules to persons conducting a tender offer under certain conditions. In order to qualify for exemptive relief under Rule 13e-4(i), or Tier II relief, among other conditions, less than 40% of the preference shares, including preference shares represented by preference share ADSs, must be held by holders who are resident in the United States, or U.S. holders. Our preference shares are held in bearer form, which significantly limits our ability to determine beneficial ownership. In testing our entitlement to Tier II relief (i) we assumed (though not required to do so) that all preference shares represented by ADSs are held by U.S. residents, and (ii) with the assistance of a shareholder relations consultant retained for such purpose who made inquiries on our behalf, we identified the holders of approximately 75% of our preference shares, of which approximately 6,954,322 shares are held by U.S. residents. We do not have any other information regarding U.S. ownership of our preference shares. Under Securities Act Release No. 33-7759, where a foreign private issuer does not know or have reason to know that its bearer shares are held by U.S. residents, the shares will not be treated as held by U.S. residents. After excluding holders of more than 10% of our preference shares, as required by SEC Rule 13e-4(i), the 6,954,322 preference shares we identified as held by U.S. residents represent less than 30% of our preference shares, as a result of which Tier II relief is available.

The German offer is not being made, directly or indirectly, in or into, and may not be accepted in or from, the United States. Copies of the offer documentation being used in the German offer and any related materials are not being and should not be mailed or otherwise distributed or sent in or into the United States.

The distribution of this prospectus and the making of this U.S. offer may, in some jurisdictions, be restricted by law. The U.S. offer is not being made, directly or indirectly, in or into, and may not be accepted from within, any jurisdiction in which the making of the U.S. offer or the acceptance thereof would not be in compliance with the laws of that jurisdiction. Persons who come into possession of this prospectus should inform themselves of and observe any and all of these restrictions. Any failure to comply with these restrictions may constitute a violation of the securities laws of that jurisdiction. We do not assume any responsibility for any violation by any person of any of these laws or restrictions.

Terms of the U.S. Offer; Conversion Premium

Upon the terms and subject to the conditions of the U.S. Offer, we are offering holders of our preference shares, including preference shares represented by ADSs, the opportunity to convert their preference shares into ordinary shares in the ratio of:

one preference share without par value for one ordinary share without par value of Fresenius Medical Care AG; and

one preference American Depositary Share (ADS) (each preference share ADS representing one-third of a preference share of Fresenius Medical Care AG) for one ordinary share ADS of Fresenius Medical Care AG (each ordinary share ADS representing one-third of an ordinary share of Fresenius Medical Care AG).

Preference shares tendered for conversion must be accompanied by payment of a conversion premium of 9.75 per preference share, equivalent to 3.25 per preference share ADS. Each preference share ADS tendered for conversion of the underlying preference shares must be accompanied by payment of a conversion premium of $_____ per preference share ADS. *Holders of preference share ADSs must pay the conversion premium in U.S. dollars.* The U.S. dollar conversion premium payment includes an additional payment of approximately 10 percent to cover possible currency exchange rate fluctuations between the time of payment by converting preference ADS Holders and the time of conversion of such payments into Euro for payment to Fresenius Medical Care. For information regarding the return of any excess U.S. dollar conversion premium payment, see Procedure for Tendering Shares.

The conversion premium corresponds to approximately one-half of the difference between the weighted average stock exchange price of the ordinary shares and the weighted average German stock exchange price of the preference shares on the Frankfurt Stock Exchange (64.28 and 45.78, respectively) as calculated for the three months through and including May 3, 2005, the last trading day before our first announcement of the proposed conversion and transformation. On January l, 2006 (the day prior to the date of this prospectus), the closing price per share in euro for our ordinary shares was and the closing price per share in euro for our preference shares was , as reported by the Frankfurt Stock Exchange Xetra system. On the same date, the closing price per ADS for ADSs representing our ordinary shares was $ and the closing price per ADS for ADSs representing our preference shares was $, as reported by the New York Stock Exchange. (Three ordinary ADSs represent one ordinary share, and three preference ADSs represent one preference share.) Additional information regarding the market prices of our preference shares, preference ADSs, ordinary shares and ordinary ADSs is contained in Item 9 of our Annual Report on Form 20-F/A for the year ended December 31, 2004. On January l, 2006 , the noon buying rate for euro was 1.00 = $. At that rate, the conversion premium would equal $ per preference share and $ per preference ADS if the conversion premium were paid on January l, 2006. However, the ADS exchange agent will convert US dollars received in payment of the conversion premium upon expiration of the U.S. offering, so that the actual exchange rate for conversion of U.S. dollar conversion premium payments into euro will be

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the rate in effect at that time. Holders of preference shares and preference ADSs who choose to convert their shares will no longer have preferential dividend rights (see Loss of Preferred Share Dividends, below). For information regarding dividends paid on our preference shares and our ordinary shares during the preceding three years, see Summary Summary Consolidated Financial Information.

On August 30, 2005, the shareholders of Fresenius Medical Care AG approved a resolution for the transformation of Fresenius Medical Care AG from a stock corporation under German law into a partnership limited by shares under German law. Upon registration of the transformation with the commercial register in Hof an der Saale, Germany, the share capital of Fresenius Medical Care AG will become the share capital of Fresenius Medical Care KGaA, and shareholders in Fresenius Medical Care AG will become shareholders of Fresenius Medical Care KGaA. At the time they approved the transformation of legal form, our shareholders also approved the resolutions authorizing the conversion of our preference shares into ordinary shares. We intend to arrange for the registration of the transformation immediately following completion of the conversion offer, and we will not register the conversion of preference shares into ordinary shares pursuant to the conversion offers unless we are satisfied that the transformation of legal form will occur. Upon registration of the transformation of legal form, the ordinary shares of Fresenius Medical Care AG offered in this conversion offer will be transformed into ordinary shares of Fresenius Medical Care KGaA. Accordingly, holders of Fresenius Medical Care AG preference shares (including preference shares represented by ADSs) who elect to convert their shares in the conversion offer will as a result receive ordinary shares of Fresenius Medical Care KGaA. Holders of Fresenius Medical Care AG preference shares (including preference shares represented by ADSs) who do not elect to convert their shares in the conversion offer will become preference shareholders of Fresenius Medical Care KGaA.

No Fractional Shares

No fractional ordinary shares will be issued upon conversion of preference shares. In addition, no fractional ordinary shares ADSs will be issued upon conversion of preference share ADSs. However, preference share ADSs are not required to be tendered for conversion in integral multiples of three.

Loss of Preferred Share Dividends

Holders of preference shares or preference share ADSs who choose to convert their shares will lose their preferential dividend rights provided for in our articles of association and under German law, but will thereafter be entitled to receive any dividends paid on ordinary shares or ordinary share ADSs after the share conversion and subsequent transformation of the Company s legal form have occurred, effective as of January 1, 2005.

Conditions to the U.S. Offer

Our obligation to complete the U.S. offer is subject to the condition, which must be satisfied or waived prior to expiration of the offers, that we are satisfied that the transformation of legal form will be registered immediately following registration of the conversion.

Completion of the U.S. offer is not an express condition to completion of the German offer and completion of the German offer is not an express condition to completion of the U.S. offer. However, completion of the German offer is subject to the same conditions as completion of the U.S. offer, and any waiver of or determination not to waive a condition precedent will apply to both offers. As a result, we will not complete one offer without completing the other. We will also not terminate one offer without also terminating the other.

If we determine in our reasonable discretion that the foregoing condition has not been or will not be satisfied we may, subject to applicable law, terminate the U.S. offer and the German offer, regardless of whether we have accepted preference shares for conversion before termination or we may waive the condition or otherwise amend the terms of the conversion offers in any respect. Our own acts or omissions cannot be used to preclude satisfaction of a condition to the offers. If we amend the conversion offers in a manner we determine constitutes a material change to their terms, or if we waive a material condition of or extend the

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conversion offers, we will promptly disclose the amendment or waiver by issuing a press release and amending our Schedule TO filed with the SEC and filing and distributing a supplement to this prospectus. If on the date that we announce a material amendment there are less than five business days until the expiration date of the U.S. offer, we will extend both conversion offers so that the expiration date of the U.S. offer will be not less than five business days following such date. We will not amend the U.S. offer or the German offer to decrease the number of preference shares that may be converted or to change the conversion ratio or the conversion premium.

Expiration Date; Extension of the Offer

The U.S. offer will expire at ___ p.m., New York City time on February l, 2006, unless it is extended prior to such time. We will not extend the German offer without also extending the U.S. offer by the same number of business days.

If we believe that for specific reasons an extension of the conversion period would be beneficial for us or if SEC rules require us to extend the conversion offer, we may extend such period. In any event, we expect that the conversion period will not be longer than six weeks.

Procedures for Tendering Preference Share ADSs

Preference Share American Depositary Receipts

If you hold certificates, commonly known as American depositary receipts, or ADRs, evidencing your preference share ADSs or your ADSs are held on the books of the depository through the Direct Registration System, you may tender your preference share ADSs by delivering the following materials to the U.S. ADS exchange agent prior to the expiration date at one of its addresses set forth on the back cover of this prospectus:

your preference share ADRs, if held in certificated form;

a properly completed and duly executed ADS letter of transmittal, or a facsimile copy with an original manual signature, with any required signature guarantees;

payment of the conversion premium in the amount of $_____ per preference share ADS ($_____ for every three preference share ADSs evidenced by the tendered ADRs). *Payment of the conversion premium accompanying preference share ADSs must be made in U.S. dollars*; and

any other documents required by the ADS letter of transmittal.

To provide for possible exchange rate fluctuations between the time of payment by ADS holders and the time such payments are converted into Euro for payment to Fresenius Medical Care, the U.S. dollar conversion premium is equal to approximately 110% of the U.S. dollar equivalent of 3.25 per preference share ADS tendered for conversion, based on an exchange rate of 1 equals $____ on January l, 2006 (the day before the date of this prospectus). At the end of the offer period, after payment of the aggregate conversion premium to Fresenius Medical Care in Euro, any deposit amount of more than $10.00 remaining will be converted back to U.S. dollars and returned to you in U.S. dollars without interest.

If a preference share ADR is registered in the name of a person other than the signatory of the ADS letter of transmittal, the preference share ADR must be endorsed or accompanied by the appropriate stock powers. The stock powers must be signed exactly as the name or names of the registered owner or owners appear on the preference share ADR, with the signature(s) on the certificates or stock powers guaranteed as described below. See ADS letter of transmittal Signature Guarantees .

Holders of preference shares ADSs who remit premium payments via check are required to use checks drawn on U.S. banks. Holders of preference share ADSs will not be charged any depositary fees for the surrender of their preference ADSs for conversion or for the issuance of ADSs representing ordinary shares held upon consummation of the conversion.

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Preference Share ADSs held in book-entry form through a bank, broker or other nominee

If you hold your preference share ADSs in book-entry form through a bank, broker or other nominee, you may tender your preference share ADSs by taking, or causing to be taken, the following actions prior to the expiration date:

a book-entry transfer of your preference share ADSs into the account of the U.S. ADS exchange agent at The Depository Trust Company, or DTC, pursuant to the procedures described below;

sending an agent s message (as defined below) through The Depository Trust Company s ATOP System to the U.S. ADS exchange agent;

the delivery to the U.S. ADS exchange agent of payment of the conversion premium in the amount of $_____ per preference share ADS ($_____ for every three preference share ADSs) evidenced by the tendered ADRs. *Payment of the conversion accompanying preference share ADSs must be made in U.S. dollars*; and

delivery to the U.S. ADS exchange agent at one of its addresses set forth on the back cover of this prospectus of any other documents required by the ADS letter of transmittal.

To provide for possible exchange rate fluctuations between the time of payment by ADS holders and the time such payments are converted into Euro for payment to Fresenius Medical Care, the U.S. dollar conversion premium is equal to approximately 110% of the U.S. dollar equivalent of 3.25 per preference share ADS tendered for conversion, based on an exchange rate of 1 equals $____ on January l, 2006 (the day before the date of this prospectus). At the end of the offer period, after payment of the aggregate conversion premium to Fresenius Medical Care in Euro, any deposit amount of more than $10.00 remaining will be converted back to U.S. dollars and returned to you in U.S. dollars without interest.

Within two business days after the date of this prospectus, the U.S. ADS exchange agent will establish an account at DTC with respect to preference share ADSs for purposes of the U.S. offer. Any financial institution that is a participant in DTC s systems may make book-entry delivery of preference share ADSs by causing DTC to transfer such preference share ADSs into the account of the U.S. ADS exchange agent in accordance with DTC s procedure for the transfer. An agent s message delivered in lieu of the ADS letter of transmittal is a message transmitted by DTC to, and received by, the U.S. ADS exchange agent as part of a confirmation of a book-entry transfer. The message states that DTC has received an express acknowledgment from the DTC participant tendering the preference share ADSs that such participant has received and agrees to be bound by the terms of the ADS letter of transmittal and that we may enforce such agreement against such participant.

Holders of preference shares ADSs who remit premium payments via check are required to use checks drawn on U.S. banks. Holders of preference share ADSs will not be charged any depositary fees for the surrender of their preference ADSs for conversion or for the issuance of ADSs representing ordinary shares held upon consummation of the conversion.

Preference Share ADSs held in street name

If you are not the registered holder of your preference share ADSs but hold your preference share ADSs in street name through a broker, bank or custodian, you should contact your broker, bank or custodian to discuss the appropriate procedures for tendering.

ADS letter of transmittal

Signature Guarantees. In general, signatures on letters of transmittal must be guaranteed by a firm that is a member of the Medallion Signature Guarantee Program, or by any other eligible guarantor institution, as such term is defined in Rule 17Ad-15 under the Exchange Act, each of which we refer to as an eligible institution. However, signature guarantees are not required in cases where preference share ADSs are tendered:

- by a registered holder of preference share ADSs who has not completed either the box entitled Special Transfer Instructions or the box entitled Special Mailing Instructions on the ADS letter of transmittal; or
- for the account of an eligible institution.

Partial Conversions. If you wish to tender for conversion fewer than all of the preference share ADSs evidenced by any ADRs delivered to the U.S. ADS exchange agent, you must indicate this in the ADS letter of transmittal by filling in the number of ADSs you wish to convert in box number 3 of the form.

Treatment of Tendered Preference Share ADSs. The ADS letter of transmittal authorizes the U.S. ADS exchange agent, as agent and attorney-in-fact for tendering holders of preference share ADSs, among other things, to surrender tendered preference share ADSs to the ADS depositary and instruct the ADS depositary to deliver the underlying ordinary shares even before we accept the tendered preference share ADSs for conversion. We intend to instruct the U.S. ADS exchange agent to take these actions promptly after the expiration of these offers. We will agree under the ADS letter of transmittal that if we do not accept the tendered preference share ADSs for conversion, we will cause the preference shares underlying those preference share ADSs to be re-deposited under the deposit agreement and preference share ADSs representing those preference shares to be delivered to the U.S. ADS exchange agent. The U.S. ADS exchange agent will then return the preference share ADSs to you. You will retain beneficial ownership of tendered preference share ADSs unless and until we accept the tendered preference share ADSs for conversion. After acceptance, you will only have a right to receive ordinary share ADSs of Fresenius Medical Care KGaA from us in accordance with the U.S. offer.

Guaranteed delivery

Guaranteed delivery procedures will not be available in connection with the U.S. offer.

Procedures for Tendering Preference Shares for Conversion

Preference shares held through German financial intermediaries

If you hold your preference shares through a German financial intermediary, you should not complete the ADS letter of transmittal. Instead, your German financial intermediary should send you transmittal materials and instructions for participating in the U.S. offer. If you have not yet received instructions from your German financial intermediary, please contact your German financial intermediary directly. You may be required to arrange for payment of the conversion premium in Euro.

Preference shares held through U.S. custodians

If you hold your preference shares through a U.S. custodian, you should not complete an ADS letter of transmittal. Instead, your U.S. custodian should either forward you the transmittal materials and instructions sent by the German financial intermediary that holds the preference shares on behalf of your U.S. custodian as record owner or send a separate form prepared by your U.S. custodian. If you have not yet received instructions from your U.S. custodian, please contact your U.S. custodian directly. You may be required to arrange for payment of the conversion premium in Euro.

Effects of Tender

By tendering your preference shares or preference share ADS for conversion, you elect to convert such preference shares (or the preference shares underlying such preference share ADSs) into ordinary shares. You also represent and warrant that you have the power and authority to tender, exchange and convert the preference shares or preference share ADSs tendered and to acquire the ordinary shares or ordinary share ADSs. You also agree to pay the conversion premium and the charges of the ADS depositary (subject to reimbursement by Fresenius Medical Care AG if the offer is cancelled or withdrawn), and you warrant that

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you will, upon request, execute and deliver any additional documents deemed by us or our agents to be necessary or desirable to complete the conversion, exchange, sale, assignment and transfer of the tendered preference shares and preference share ADSs.

Other Requirements

If the ADS letter of transmittal, form of acceptance, or any certificates or stock powers are signed by trustees, executors, administrators, guardians, attorneys-in-fact, officers of corporations or other persons acting in a fiduciary or representative capacity, such persons should so indicate when signing. Proper evidence of authority to act must be submitted by such persons, although we may waive this requirement.

If any preference share ADR has been mutilated, destroyed, lost or stolen, you must contact the preference share ADS depositary and comply with the requirements under the deposit agreement to obtain a replacement preference share ADR before you will be able to tender those preference share ADSs in this U.S. offer.

If any evidence of ownership of a preference share has been mutilated, destroyed, lost or stolen, you must:

- furnish to your German financial intermediary or U.S. custodian satisfactory evidence of ownership and of the destruction, loss or theft or such document;
- indemnify your German financial intermediary or U.S. custodian against loss; and
- comply with any other reasonable requirements.

Your tender of preference share ADSs or preference shares pursuant to any of the procedures described above in Procedures for Tendering Preference Share ADSs and Procedures for Tendering Preference Shares will constitute your binding agreement with us to the terms and conditions of the U.S. offer.

Determination of Validity

We will determine, in our sole discretion, all questions as to the validity, form and eligibility for conversion of any tendered preference shares and preference share ADSs. Our determination will be final and binding on the holders of preference shares and preference share ADSs. We reserve the absolute right to reject any and all tenders that we determine are not in proper form. We also reserve the right to waive any defect or irregularity in the tender of any preference shares and preference share ADSs of any particular holder, whether or not similar defects or irregularities are waived in the case of other securityholders. Unless otherwise waived by us, your tender of preference shares and preference share ADSs will not be valid until all defects or irregularities have been cured or waived. None of us, the U.S. ADS exchange agent, the information agent or any other person will be under any duty to give notification of any defects or irregularities in the tender of any preference shares and preference share ADSs, or incur any liability for failure to give any such notification. Our interpretation of the terms and conditions of the U.S. offer will be final and binding on the holders of preference shares and preference share ADSs.

In addition, in tendering preference shares and preference share ADSs for conversion, you will represent and warrant that you have the power and authority to tender, exchange and convert the preference shares or preference share ADSs tendered and to acquire the ordinary shares or ordinary share ADSs. We reserve the right to reject any preference shares and preference share ADSs that we determine do not satisfy these conditions.

Withdrawal Rights

You may withdraw preference shares or preference share ADSs tendered to us pursuant to the U.S. offer at any time prior to its expiration. You may also withdraw preference shares or preference ADSs tendered to us for conversion after the expiration of forty business days from the commencement of the conversion offer (i.e., forty business days from January l, 2006) if we have not accepted them for conversion by that date.

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For a withdrawal to be effective, the German financial intermediary, the U.S. custodian or the U.S. ADS exchange agent, as applicable, must receive in a timely manner the written or facsimile transmission notice of withdrawal. Any such notice must specify the name of the person who tendered the preference shares and preference share ADSs being withdrawn, the number of preference shares and preference share ADSs being withdrawn and the name of the registered holder, if different from that of the person who tendered such preference shares and preference share ADSs. For a withdrawal of preference shares to be effective, the German financial intermediary must have arranged for a timely book-entry re-transfer of the preference shares submitted for conversion on the bank working day following the end of the conversion period by 11:30 a.m. New York City time. Withdrawn preference share ADSs and conversion premiums will be returned promptly upon withdrawal.

If preference share ADRs being withdrawn have been delivered or otherwise identified to the U.S. ADS exchange agent, then, prior to the physical release of such ADRs, (1) the U.S. ADS exchange agent also must receive the name of the registered holder and the serial numbers of the particular preference share ADRs and (2) the signature(s) on the notice of withdrawal must be guaranteed by an eligible institution unless such preference share ADSs have been tendered for the account of an eligible institution. If preference share ADSs have been tendered pursuant to the procedure for book-entry transfer, any notice of withdrawal must specify the name and number of the account at DTC to be credited with the withdrawal of preference share ADSs.

We will determine, in our sole discretion, all questions as to the form and validity (including time of receipt) of any notice of withdrawal. Our determination shall be final and binding on the holders of the preference shares and preference share ADSs.

None of us, the U.S. ADS exchange agent, the information agent or any other person will be under any duty to give notification of any defects or irregularities in any notice of withdrawal or incur any liability for failure to give any such notification. Any preference shares and preference share ADSs properly withdrawn will be deemed not to have been validly tendered for purposes of the U.S. offer (or any subsequent offering period, as the case may be) and will not be converted into ordinary shares or ordinary share ADSs. However, withdrawn preference shares and preference share ADSs may be re-tendered for conversion at any time prior to the expiration date by following the procedures described above under Procedures for Tendering Preference Share ADSs or Procedures for Tendering Preference Shares, as applicable.

We expect that preference shares (but not preference share ADSs) that have been tendered for conversion will continue to trade in Germany under a separate securities identification number. A holder of preference shares tendered for conversion (but not preference share ADSs) who wishes to sell such preference shares may do so without withdrawing the tendered shares, and should contact his or her bank or broker for instructions how to do so. No guarantee can be given that active trading in the preference shares submitted for conversion will develop on the Frankfurt Stock Exchange or that sufficient liquidity will be available throughout the entire trading period for the preference shares submitted for conversion. Holders of preference share ADSs tendered for conversion who wish to sell their ADSs must first withdraw such ADSs in accordance with the procedures described above.

Acceptance and Return of Preference Shares and Preference Share ADSs

Subject to the terms and conditions of the U.S. offer, we will accept any and all preference shares and preference share ADSs validly tendered, not properly withdrawn and accompanied by payment of the conversion premium, for conversion into ordinary shares or our ordinary share ADSs, as applicable, as promptly as practicable under German practice after the expiration date. As permitted by the applicable rules of the SEC, we will accept for conversion, or return, as applicable, all preference shares and preference share ADSs in accordance with applicable German law and tender offer practice.

Acceptance of tendered preference shares and preference share ADSs

We will be deemed to have accepted for conversion all preference shares and preference share ADSs validly tendered and accompanied by the required conversion premium and not properly withdrawn on the expiration date, for which such conversion was registered with the commercial register. Subject to the terms and conditions of the offers, the ordinary shares into which preference shares are converted will be transferred to the account of the financial intermediary who tendered the preference shares and preference share ADSs. *Holders of preference share ADSs must submit the conversion premium in U.S. dollars* and are required to submit a conversion premium in the amount of $_____ per preference share ADS. This amount is equal to approximately 110% of the U.S. dollar equivalent of 3.25 per preference share ADS (or 9.75 per three preference share ADSs). The additional 10% payment is required to take into account possibly currency fluctuations between the time such payments are submitted by ADS holders and the time the payments are converted into Euro for payment to Fresenius Medical Care. After conversion of the preference share ADSs tendered by such shareholders, the ADS exchange agent will return, without interest, any U.S. dollar amount remaining after payment of the conversion premium, provided such amount exceeds $10.00.

Under no circumstances will interest be paid on the conversion of preference shares and preference share ADSs into our ordinary shares or our ordinary share ADSs, as applicable, regardless of any delay in effecting the conversion.

Return of tendered preference shares, preference share ADSs and conversion premiums

In case any preference shares and preference share ADSs tendered in accordance with the instructions set forth in the offer materials are not accepted for conversion pursuant to the terms and conditions of this U.S. offer, we will cause these preference shares and preference share ADSs, together with the applicable conversion premium, to be returned promptly following the registration of the conversion with the commercial register. Preference shares underlying such withdrawn preference shares ADSs will be redeposited against the issuance of the preference share ADSs to be returned. Shareholders who withdraw their preference share ADSs will not be required to pay any Depositary s charges for the reissuance of their withdrawn preference share ADSs.

Delivery of our Ordinary Shares and our Ordinary Share ADSs; Settlement Date

Upon expiration of the conversion period, our ordinary shares or our ordinary share ADSs, as applicable, will be delivered to the tendering holders of preference shares and preference share ADSs promptly following the registration of the conversion with the commercial register. We expect that if the offers are consummated, registration of the conversion will take place approximately one week after expiration of the offers and the final settlement date for the offers is currently expected to be within approximately two to three German banking days following such registration. If your ordinary share ADSs will be evidenced by ADRs registered in your name, you may not receive a confirmation of book entry registration of the ADRs until approximately two weeks after the settlement date.

Fees and Expenses

Except as set forth below, we will not pay any fees or commissions to any broker or other person soliciting tenders of preference shares and preference share ADSs pursuant to the U.S. offer or the German offer.

In the event the conversion offers are not consummated, we will pay the fees charged by the ADS depositary for preference share ADSs tendered into the offer, including any fees charged by the ADS depositary to redeposit preference shares underlying tendered preference share ADSs that have been previously withdrawn from deposit with the ADS depositary.

We have retained JPMorgan Chase Bank, N.A. to act as U.S. ADS exchange agent in connection with the U.S. offer. We will pay the U.S. ADS exchange agent reasonable and customary compensation for its services in connection with the U.S. offer, plus reimbursement of its out-of-pocket expenses. We will also reimburse brokers, dealers, commercial banks and trust companies for customary mailing and handling expenses incurred by them in forwarding material to their customers.

We have retained D.F. King & Co., Inc. to act as information agent in connection with the U.S. offer. We will pay the information agent reasonable and customary compensation for its services in connection with the U.S. offer, plus reimbursement of its out-of-pocket expenses.

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We will indemnify the information agent and the U.S. ADS exchange agent against specified liabilities and expenses in connection with the U.S. offer, including liabilities under the U.S. federal securities laws. Indemnification for liabilities under the U.S. federal securities laws may be unenforceable as against public policy.

We have retained Deutsche Bank Aktiengesellschaft as our financial advisor with respect to the conversion and the transformation. We have also retained Deutsche Bank in connection with the admission of the shares of Fresenius Medical Care KGaA to the Frankfurt Stock Exchange. Deutsche Bank s services do not include acting as dealer-manager for the conversion offers. Pursuant to our agreement with Deutsche Bank and the related fee arrangements, we have agreed to pay Deutsche Bank a total fee of up to 4.0 million for its services in connection with the transformation of legal form and the conversion. We have also agreed to indemnify Deutsche Bank against certain liabilities. Deutsche Bank s obligations are subject to certain conditions, such as the receipt of standard legal opinions satisfactory to Deutsche Bank. Deutsche Bank acted as our financial advisor in connection with the RCG acquisition and is also a lender to the Company and a counterparty in connection with foreign currency transactions and interest rate swaps.

The cash expenses to be incurred in connection with the U.S. offer and the German offer will be paid by us and are estimated in the aggregate to be approximately $5.4 million. Such expenses include registration fees, the fees and expenses of the U.S. ADS exchange agent and the information agent, accounting and legal fees and printing costs.

Listing of our Ordinary Shares and our Ordinary Share ADSs

The existing shares in Fresenius Medical Care AG will be delisted from the Frankfurt Stock Exchange on registration of the transformation of legal form in the commercial register. We will admit both the ordinary shares and the preference shares in Fresenius Medical Care KGaA again to stock exchange trading on the Frankfurt Stock Exchange on the official market, with trading on the Prime Standard, the sub-segment of the official market with additional post-admission obligations, directly after the transformation of legal form has become effective. We will then endeavor to ensure that the new admission takes place immediately after the transformation of legal form becomes effective and therefore that the usual stock exchange tradability both of the ordinary and the preference shares of the Company is secured at all times. See Stock Exchange Listing and Trading for more information.

Effect of the Offers on the Market for our Preference Shares and Preference Shares ADSs

American Depositary Shares representing Fresenius Medical Care KGaA ordinary shares and preference shares have been approved for listing on the New York Stock Exchange subject to official notice of issuance and, in the case of preference shares ADSs, satisfaction of that exchange s distribution criteria. We cannot assure you that the preference ADSs of Fresenius Medical Care KGaA will be eligible for listing on that exchange if the number of outstanding preference shares decreases substantially due to conversion of preference shares into ordinary shares. In addition, if substantially all of the preference shares are converted, we may terminate the deposit agreement for the preference shares, or the depositary may resign due to the substantially reduced compensation it is likely to receive for its services in such circumstances. While we will endeavor to provide for continuation of a U.S. trading market for the preference shares of Fresenius Medical Care KGaA, if they are not eligible for New York Stock Exchange listing, if the depositary resigns as depositary for the preference shares and we are unable to designate a replacement depositary, or if we otherwise terminate the preference share deposit agreement, it is likely that a U.S. trading market for the preferences ADSs will cease to be available.

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Treatment of Preference Share Options and Convertible Bonds

Those persons who hold convertible bonds or stock options entitling them to preference shares under our employee participation programs will be separately offered the opportunity to receive convertible bonds or stock options entitling them to receive ordinary shares. The number of convertible bonds or options and the conversion or exercise prices will be adjusted. No conversion premium will be payable in connection with such adjustments.

Appraisal Rights

Holders of preference shares and preference ADSs do not have any appraisal rights under German laws in connection with the conversion.

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THE CONVERSION AND TRANSFORMATION; EFFECTS

Structure of the Conversion and Transformation

On August 30, 2005, the shareholders of Fresenius Medical Care AG approved a resolution for the transformation of Fresenius Medical Care AG from a stock corporation under German law into a partnership limited by shares under German law. Fresenius Medical Care KGaA will not be formed as a separate entity but will be established by registering the transformation resolution with the commercial register in Hof an der Saale, Germany. Upon registration of the transformation resolution, the share capital of Fresenius Medical Care AG will become the share capital of Fresenius Medical Care KGaA, and shareholders in Fresenius Medical Care AG will become shareholders of Fresenius Medical Care KGaA.

At the time they approved the transformation of legal form, our shareholders also approved the resolutions authorizing the conversion of our preference shares into ordinary shares. The conversion resolution was also approved by a special meeting of our preference shareholders held on the same day. We intend to arrange for the registration of the transformation immediately following registration of the changes to the articles of association in connection with the completion of the conversion offers. However, we will not register the conversion of preference shares into ordinary shares pursuant to the conversion offers unless we are satisfied that the transformation of legal form will occur. Accordingly, no shares of Fresenius Medical Care AG will be issued as a result of the conversion offer. Holders of Fresenius Medical Care AG preference shares (including preference shares represented by ADSs) who elect to convert their shares in the conversion offers will receive ordinary shares of Fresenius Medical Care KGaA. Holders of Fresenius Medical Care AG preference shares (including preference shares represented by ADSs) who do not elect to convert their shares in the conversion offers will become preference shareholders of Fresenius Medical Care KGaA.

The conversion premium originally proposed to our shareholders by our management board and our supervisory board was 12.25 per preference share submitted for conversion. However, as permitted by applicable German law, a counter proposal was submitted by a shareholder that provided for a reduced conversion premium of 9.75 per preference share. This counter proposal was submitted to and approved by our ordinary shareholders and our preference shareholders at the meetings held on August 30, 2005. Because the counter proposal was approved, the conversion premium payable in the conversion offer being made by the prospectus was fixed at 9.75 per preference share.

Currently, our outstanding share capital consists of ordinary shares and non-voting preference shares that are issued only in bearer form. Fresenius AG owns approximately 50.8% of our ordinary shares. Fresenius AG s ordinary shares represent approximately 36% of our total share capital of all classes. In connection with the transformation, Management AG will assume the management of the Company through its position as general partner. Fresenius AG, which currently controls the Company as holder of a majority of our ordinary shares, will continue to do so after the transformation as sole shareholder of the general partner.

The Conversion

Prior to registration of the transformation, we are offering our preference shareholders the opportunity to convert their preference shares into ordinary shares on a one-to-one basis pursuant to two conversion offers. Preference shareholders who elect to convert their shares into ordinary shares will be required to pay a premium of 9.75 per converted share (3.25 per preference share ADS) for the conversion.

In the conversion process, preference shares submitted for conversion will lose the preferential dividend right provided for under our articles of association and German law. Details of the conversion offer being made to U.S. residents are set out above under The U.S. Offer. We are also making a separate conversion offer to our preference shareholders who are not U.S. residents pursuant to the German offer. The conversion will increase the number of ordinary shares outstanding held by persons other than Fresenius AG, which we refer to in this prospectus as the outside shareholders or free float of our ordinary shares, as the context requires.

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Persons who hold convertible bonds or stock options entitling them to preference shares under our employee participation programs will be separately offered the opportunity to receive convertible bonds or stock options entitling them to receive ordinary shares upon conversion of their bonds or exercise of their options.

In connection with registration of the conversion we will amend our articles of association for the purpose of allotting shares as between ordinary and preference. The final version of the articles of association can be determined, however, only upon final determination of the number of preference shares submitted to, and accepted by, the Company for conversion in proper form prior to expiration of the conversion offer, together with the applicable conversion premium. As a result, when our shareholders approved the resolutions authorizing the conversion and the transformation, they also authorized our supervisory board to amend the wording of the articles of association after the conversion offer has been completed to reflect the final allocation between classes of shares resulting from the conversion offers.

Preference shareholders who do not convert their shares in the conversion process will retain their preference rights. Preference rights will be cancelled only for those preference shareholders who participate in the conversion offer, i.e., on a voluntary basis. Preference shares that remain on the Frankfurt Stock Exchange may be adversely affected due to the overall reduced liquidity of the preference shares, so that preference shareholders who do not participate may suffer financial disadvantages. Holders of ADSs representing our preference shares may also be adversely affected if ADSs representing preference shares of Fresenius Medical Care KGaA are not eligible for listing on the New York Stock Exchange. In such event, the sole market for the preference shares would be the Frankfurt Stock Exchange. United States holders of preference shares could incur additional costs and delays in effecting transactions in the preference shares on the Frankfurt Stock Exchange. In addition, if we determine to discontinue the preference share ADR facility due to the reduced number of preference shares outstanding after the conversion and the transformation, or if the depositary resigns and we are unable to appoint a successor, holders of ADSs representing the preference shares would no longer have the benefits of that facility, such as receipt of dividends in U.S. dollars.

The Transformation

The transformation will become effective upon registration with the commercial register of the local court (*Amtsgericht*) in Hof an der Saale. Upon registration of the transformation, the Company s legal form will be changed by operation of law from an AG, which is a German stock corporation, to a KGaA, which is a German partnership limited by shares, and it will continue to exist in that legal form. In connection with the transformation, the Company will not transfer any assets to another entity, merge into or with or consolidate with any entity, or acquire the shares of any other entity. The Company as a KGaA will be the same legal entity under German law, rather than a successor to the stock corporation. Upon effectiveness of the transformation, Management AG, a subsidiary of Fresenius AG, will become the general partner of the Company. Legal relationships existing between the Company and third parties will continue unchanged. If public registers become inaccurate by the change of name, they will be amended on the application of the entity in its new legal form.

The offices of the members of the management board of Fresenius Medical Care AG will terminate by operation of law but the service agreements of the members of the management board will continue in force after effectiveness of the transformation. The members of the management board, however, have declared that their service agreements will be rescinded by agreement without compensation. At the prospectus date, the members of our management board are also the members of the management board of the general partner, Management AG. We expect that Gary Brukardt, currently President and Chief Executive Officer of RCG, will become a member of our management board after the closing of the RCG merger. We expect that they will enter into new service agreements with the general partner on the same terms as they had with Fresenius Medical Care AG before the transformation. The service agreements of the members of the management board will thereby in effect pass to Management AG on the same conditions.

Under German law, after a transformation of legal form the members of a company s supervisory board remain in office for the remainder of their terms as members of its supervisory board if the supervisory board of the company in its new legal form is formed in the same way and with the same composition. Dr. Ulf M.

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Schneider, chairman of the management board of Fresenius AG, has notified us, however, that he will resign from the supervisory board effective upon entry of the transformation in the commercial register. Fresenius Medical Care KGaA will apply for a court appointment of a sixth member of the supervisory board to replace Dr. Schneider after the transformation has become effective in accordance with German law.

We intend that our management board shall not register the conversion of preference shares into ordinary shares pursuant to the conversion offers unless we are satisfied that the transformation of legal form will occur.

The Shareholders

Our share capital will become the share capital of the Company in its new legal form after the transformation. Shareholders in Fresenius Medical Care AG at the time of the registration of the transformation of legal form in the commercial register will be shareholders in Fresenius Medical Care KGaA. They will participate in all economic respects, including profits and capital, to the same extent and with the same number of shares in Fresenius Medical Care KGaA as they did in Fresenius Medical Care AG prior to the transformation becoming effective. Ordinary shareholders will hold the same number of voting ordinary shares which they had in Fresenius Medical Care AG prior to the transformation. Holders of non-voting preference shares who elect to convert their shares will receive an equal number of ordinary shares of Fresenius Medical Care KGaA. Non-voting preference shareholders who elect not to convert their shares into ordinary shares will hold the same number of non-voting preference shares as they had in Fresenius Medical Care AG prior to the transformation.

Holders of convertible bonds and stock options issued under the Company s employee participation programs will not experience any change in their legal position due to the transformation of legal form, but will have the opportunity to exchange their bonds or options for adjusted convertible bonds or options convertible into or exercisable for ordinary shares in connection with the conversion.

As a result of the adjustment of the employee participation programs, future exercise of stock options will principally result in issuance of ordinary shares. A slight dilutive effect on the voting rights of the ordinary shareholders, which did not previously exist, will result from the adjustment. This dilutive effect will occur because the issuance of ordinary shares pursuant to the employee participation programs is not subject to statutory pre-emption rights. Such adjustments are within the scope permitted by German law, and we believe that such dilution is justified in light of the benefits to be derived from the new capital structure and the motivational effects of our employee participation programs on our employees. There are no adverse effects from the adjustment of the employee participation programs for preference shareholders.

Reasons for the Conversion and Transformation

Our management board and supervisory board believe that the conversion of our outstanding preference shares into ordinary shares and the transformation of the legal form of the Company are in the overall interest of the Company and its shareholders, taking into account the existing rights of our shareholders. We believe the conversion and transformation (as well as the transformation alone) will improve our financial and operative flexibility, which will allow us to pursue our long-term growth objectives and strategies. We believe that the transformation and conversion are in the interests of the Company and its shareholders overall for the following reasons:

Ability to Issue New Ordinary Shares. Our current articles of association provide only for the issuance of new non-voting preference shares. Fresenius AG, which holds approximately 50.8% of our voting ordinary shares, has advised us that it will not approve an issuance of new ordinary shares that would dilute its ownership below 50%, which would cause Fresenius AG to lose its control over the management of the Company and would preclude Fresenius AG from consolidating our financial statements with its own. Therefore, our ability to issue additional equity capital is generally limited to the issuance of preference shares, which are not as attractive to investors as ordinary shares. In our new legal form as a partnership limited by shares under German law, or a KGaA. Fresenius AG will own the general partner of the Company and, therefore, will continue to control the management of the Company after the transformation, notwithstanding the likely decrease in Fresenius AG s percentage

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ownership of our ordinary shares. Therefore, our new capital structure will allow us to issue ordinary shares without causing Fresenius AG to lose control over the management of the Company. We believe that our ability to issue new ordinary shares will help us attract equity financing so that we may pursue our long-term growth objectives and strategies.

Improved Liquidity. We anticipate that the conversion of the preference shares into ordinary shares will lead to an increase in the free float of our ordinary shares due to the increase in ordinary shares outstanding. If all preference shares are converted, the free float would increase by approximately 27.76 million shares from approximately 34.47 million shares to approximately 62.23 million shares, an increase of approximately 80%. We believe that the new free float of our ordinary shares will lead to an increase in the daily trading volume of our ordinary shares and will improve the liquidity of our ordinary shares, which will create more value for our existing ordinary shareholders and make our ordinary shares more attractive to large investors. We also believe that the increased free float and liquidity will allow us to raise future capital on more attractive terms because the market will be more receptive to new ordinary shares from future capital increases. Equity financing opportunities will allow us to pursue our long-term growth objectives and strategies, including pursuit of acquisitions using ordinary shares as consideration.

Improved DAX Position. We expect that the conversion of our outstanding preference shares into ordinary shares will improve our position on DAX, the German share index. Under the rules of the Frankfurt Stock Exchange, only one class of a company s shares (the larger and more liquid class) may be considered in determining order book volume and market capitalization for purposes of DAX position. We believe that the conversion of our outstanding preference shares into ordinary shares will increase our order book volume and our market capitalization as described above and, therefore, our position on DAX. We believe that a stronger position on DAX will allow us to attract more institutional investors.

Maintenance of the Existing Levels of Corporate Governance and Transparency. Our new structure will include corporate governance arrangements that are substantially similar to our current corporate governance arrangements. At the prospectus date, the current members of the supervisory board of Fresenius Medical Care AG and all members of its management board are also members of the supervisory board or the management board of the general partner. In addition, we expect that Gary Brukardt, currently the President and Chief Executive Officer of RCG, will become a member of our management board after the closing of the RCG merger. Also, Fresenius AG will continue to be obligated to elect to the supervisory board of the general partner at least two persons who have no significant business relationships with Fresenius AG. As a result, we believe that Fresenius AG s ability to control the Company through its ownership of the general partner will not differ significantly from its ability to control the Company through ownership of a majority of our ordinary shares.

Acquisition of New Capital. We will acquire new capital when preference shareholders convert their preference shares into ordinary shares because the terms of the conversion offers require payment of a premium in the amount of 9.75 per share to us in connection with the conversion. We plan to use the net proceeds of the conversion offers to reduce outstanding indebtedness and for general corporate purposes. See Use of Proceeds and Capitalization and Indebtedness, above.

Benefits to our Ordinary Shareholders. Ordinary shareholders will experience dilution of their voting rights and possibly a dilution of the value of their shares as a result of the conversion of preference shares into ordinary shares. We believe, however, that the conversion and the transformation will also produce benefits for our ordinary shareholders. First, approximately one-half of the difference in value between the ordinary shares and the preference shares will be covered by the conversion premium which will strengthen our capital base. Further, the ordinary shares will become more attractive investments due to the increased liquidity which we expect and stronger DAX position. Finally, the preference dividend that is paid to preference shareholders will be cancelled in connection with the preference shares that are converted into ordinary shares, which will allow us to retain more capital.

Benefits to our Preference Shareholders That Choose to Convert Their Preference Shares. Holders of our outstanding preference shares are being offered the opportunity to convert their shares into ordinary shares, but are not required to do so. Although acceptance of the conversion offer requires payment of a premium per share of 9.75 to us for the conversion, the premium consists of approximately one-half of the difference between the weighted average German stock exchange price of the preference shares and the weighted average stock exchange price of the ordinary shares for the three months prior to our announcement of the conversion offer and transformation, determined using the prices reported on the official website of the German Financial Supervisory Authority (German version of the website). Based on such prices, holders of preference shares who elect to convert will acquire ordinary shares at a discount of 8.75 per ordinary share or approximately 13.6% of the weighted average stock exchange price of the ordinary shares for the three-months prior to the announcement. We believe this discount is justified by the need to provide an incentive to as many preference shareholders as possible to convert their preference shares into ordinary shares despite the cost and thereby achieve the highest possible rate of conversion. *Holders of preference share ADSs must pay the conversion premium in U.S. dollars. See The U.S. Offer-Procedures for Tendering Preference Share ADSs.* Holders of preference American Depositary Shares who elect to convert the preference shares represented by their American Depositary Shares will not be required to pay any depositary fees for the surrender of their Fresenius Medical Care AG preference share ADSs or for the issuance of ADSs representing the ordinary shares to be issued on conversion.

Holders of preference shares who do not choose to convert their preference shares into ordinary shares will continue to hold preference shares in the KGaA after the transformation and will continue to be entitled to receive preference dividends. However, holders of preference shares will likely experience reduced liquidity of their shares. Based on our analysis of similar cases, we expect that the preference shares will continue to trade on the Frankfurt Stock Exchange after the conversion and transformation but we cannot offer any assurances that the preference ADSs will continue to be eligible for listing on the New York Stock Exchange if the number of outstanding preference shares decreases substantially due to the conversion of preference shares into ordinary shares. If substantially all of the preference shares are converted, we may terminate the deposit agreement for the preference shares or the depositary may resign due to the substantially reduced compensation it is likely to receive for its services in such circumstances. Our management board and supervisory board have considered the disadvantages to the holders of preference shares that do not choose to convert their shares into ordinary shares as a result of the conversion and transformation but have concluded that the conversion and transformation are nevertheless in the interest of the Company and its shareholders overall.

We believe that the conversion offer is in the interest of the Company and its shareholders. However, preference shareholders should determine for themselves, in consultation with their tax and financial advisors, whether to accept the conversion offer with respect to all or any part of their preference shares or to retain their preference shares.

The Legal Structure of Fresenius Medical Care KGaA

A partnership limited by shares (KGaA) is a mixed form of entity under German corporate law, which has elements of both a partnership and a corporation. Like a stock corporation, the share capital of the KGaA is held by shareholders. The KGaA and the stock corporation are the only legal forms provided by German law for entities having shares tradable on the stock exchange. The KGaA is similar to a limited partnership because there are two groups of owners, the general partner on the one hand, and the KGaA shareholders on the other hand.

A KGaA s corporate bodies are its general partner, supervisory board and the general meeting of shareholders. A KGaA may have one or more general partners who conduct the business of the KGaA. They are appointed as executive bodies on the basis of their corporate position and, therefore, are so-called inherent executive bodies of the partnership under German law. However, in contrast to the appointment of the management board of a stock corporation, the supervisory board of a KGaA has no influence on appointment of the general partner. Likewise, the removal of the general partner from office is subject to very strict conditions, including the necessity of a court decision. The general partners may, but are not required to, purchase shares of the KGaA. The general partners are personally liable for the liabilities of the KGaA in relations with third parties subject, in the case of corporate general partners, to applicable limits on liability of corporations generally.

The status of the members of the two groups of owners, i.e., the group of KGaA shareholders on the one hand, and the general partner or partners, on the other hand, varies within the KGaA due to the structure of a KGaA. The KGaA shareholders exercise influence in the general meeting through their voting rights but, in contrast to a stock corporation, the general partner of a KGaA has a veto right with regard to material resolutions. The members of the supervisory board of a KGaA are elected by the general meeting as in a stock corporation. However, since the supervisory board of a KGaA has less power than the supervisory board of a stock corporation, the indirect influence exercised by the KGaA shareholders on the KGaA via the supervisory board is also less significant than in a stock corporation. For example, the supervisory board is not usually entitled to issue rules of procedure for management or to specify business management measures that require the supervisory board s consent. The status of the general partner or partners in a KGaA is stronger than that of the shareholders based on: (i) the management powers of the general partners, (ii) the existing veto rights regarding material resolutions adopted by the general meeting and (iii) the independence of the general partner from the influence of the KGaA shareholders as a collective body.

In the articles of association of a KGaA, the relationship between the general partners and the KGaA shareholders can be structured to a certain extent without restrictions. This means that the articles of association of a KGaA can be adjusted to the specific needs of the partners at the time the KGaA is founded or at the time a company is transformed into such a partnership limited by shares. Since the articles of association of a KGaA may be amended subsequently only through a resolution of the general meeting adopted by a qualified 75% majority and with the consent of the general partner, neither group of owners (i.e., the KGaA shareholders and the general partners) can unilaterally amend the articles of association without the consent of the other group. Fresenius AG will, however, continue to be able to exert significant influence over amendments to the articles of association of Fresenius Medical Care KGaA through its ownership of a significant percentage of our ordinary shares after the transformation, since such amendments require a 75% vote of the shares present at the meeting rather than three quarters of the outstanding shares.

We intend to ensure that Fresenius AG s controlling position is conditioned upon ownership of a substantial amount of our share capital. Therefore, under the proposed articles of association, Management AG has to withdraw as general partner if Fresenius AG s holdings decrease to 25% or less of our share capital. Alternatively, Fresenius AG may sell its interest in Management AG to a third party if the sale also includes more than 25% of our share capital. At the same time, we intend to ensure that our business operations remain unaffected by the transformation of legal form as much as possible.

Management and Oversight of Fresenius Medical Care KGaA

The management structure of Fresenius Medical Care KGaA is illustrated as follows:

General Partner

A wholly owned subsidiary of Fresenius AG, Management AG, a stock corporation, will be the sole general partner of Fresenius Medical Care KGaA. We chose a stock corporation as the legal form of the general partner principally because it enables us to maintain a management structure substantially similar to Fresenius Medical Care AG s existing management structure by means of the general partner entity. The internal corporate governance structure of the general partner will be substantially similar to the current structure at Fresenius Medical Care AG. In particular, the general partner has substantially the same provisions in its articles of association concerning the relationship between the management board and the supervisory board and, subject to applicable statutory law, substantially the same rules of procedure for its executive bodies. At the prospectus date, the current members of the management board and all members of the supervisory board of Fresenius Medical Care AG are also members of the management board or supervisory board of the general partner. In addition, we expect that Gary Brukardt, currently the President and Chief Executive of RCG, will become a member of our management board after the closing of the RCG merger. The registered capital of Management AG is 1,500,000.

The general partner will not make a capital contribution and, therefore, will participate in neither the assets nor the profits and losses of the KGaA. However, the general partner will be compensated for all outlays in connection with conducting the business of the partnership, including the remuneration of members of the management board and the supervisory board. See The Conversion and Transformation; Effects The Legal Structure of Fresenius Medical Care KGaA The Articles of Association of Fresenius Medical Care KGaA Organization of the Company below. Fresenius Medical Care KGaA itself is to bear all expenses of its administration. Management AG is to devote itself exclusively to the management of Fresenius Medical Care KGaA. In addition, the general partner will receive annual compensation amounting to 4% of its capital for assuming the liability and the management of the KGaA. This payment constitutes a guaranteed return on Fresenius AG s investment in the share capital of Management AG, and will amount to 60,000 per annum. This payment is required for tax reasons, to avoid a constructive dividend by the general partner to Fresenius AG in the amount of reasonable compensation for undertaking liability for the obligations of the KGaA. The KGaA will also reimburse the general partner for the remuneration paid to the members of its management board and its supervisory board. Management AG was incorporated on April 8, 2005 and registered with the commercial register in Hof an der Saale on May 10, 2005.

The statutory provisions governing a partnership, including a KGaA, provide in principle that the consent of the KGaA shareholders at a general meeting is required for transactions that are not in the ordinary course of business. However, as permitted by statute, the articles of association of Fresenius Medical Care KGaA permit such decisions to be made by Management AG as general partner without the consent of the KGaA shareholders primarily to retain the current level of operating flexibility for the management board of the general partner after the transformation.

The negation of the statutory restrictions on the authority of Management AG as general partner is intended to replicate governance arrangements in Fresenius Medical Care AG, in which the shareholders of Fresenius Medical Care AG do not presently have any such veto right regarding determinations of the management board. This does not affect the general meeting s right of approval with regard to measures of unusual significance, such as a sale of a substantial part of a company s assets, as developed in German Federal Supreme Court decisions.

The relationship between the supervisory board and management board of Management AG is substantially similar to the existing governance provisions at Fresenius Medical Care AG. In particular, under the articles of association of Management AG, the same transactions are subject to the consent of the supervisory board of Management AG as currently require the consent of the supervisory board of Fresenius Medical Care AG. These transactions include, among others:

The acquisition, disposal and encumbrance of real property if the value or the amount to be secured exceeds a specified threshold (5,000,000);

The acquisition, formation, disposal or encumbrance of an equity participation in other enterprises if the value of the transaction exceeds a specified threshold (5,000,000);

The adoption of new or the abandonment of existing lines of business or establishments;

Conclusion, amendment and termination of affiliation agreements; and

Certain inter-company legal transactions.

At the date of this prospectus, the members of the management board of Fresenius Medical Care AG are also the members of the management board of Management AG. We expect that Gary Brukardt, currently President and Chief Executive Officer of RCG, will join the management board after the RCG merger. The supervisory boards of Fresenius Medical Care KGaA and of Management AG shall consist to a large extent of the same persons, and therefore consist principally of the same persons as our present supervisory board.

Supervisory Board

The supervisory board of a KGaA is similar in certain respects to the supervisory board of a stock corporation. Like the supervisory board of a stock corporation, the supervisory board of a KGaA is under an obligation to oversee the management of the business of the Company. The supervisory board is elected by the KGaA shareholders at the general meeting. Shares in the KGaA held by the general partner or its affiliated companies are not entitled to vote for the election of the supervisory board members of the KGaA. Accordingly, Fresenius AG will not be entitled to vote its shares for the election of Fresenius Medical Care KGaA s supervisory board. In theory, this means that Fresenius AG will have no influence on the composition of the supervisory board of Fresenius Medical Care KGaA, and that the change in legal form into Fresenius Medical Care KGaA entails an increase in the control rights for the outside shareholders.

However, under the articles of association of Fresenius Medical Care KGaA, a resolution for the election of members of the supervisory board will require the affirmative vote of 75% of the votes cast at the general meeting. Such a high vote requirement could be difficult to achieve, which could result in the court appointment of members to the supervisory board after the end of the terms of the members initially in office at the time the transformation becomes effective. In addition, because (i) the current members of the Fresenius Medical Care AG supervisory board will initially continue as the members of the supervisory board of Fresenius Medical Care KGaA (except for Dr. Ulf M. Schneider) and (ii) in the future, the Fresenius Medical Care KGaA supervisory board will propose future nominees for election to its supervisory board (subject to the right of shareholders to make nominations), Fresenius

AG is likely to retain some influence over the selection of the supervisory board of Fresenius Medical Care KGaA. The supervisory board of

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Fresenius Medical Care KGaA will have less power and scope for influence than the supervisory board of the Company as a stock corporation. The supervisory board of Fresenius Medical Care KGaA is not entitled to appoint the general partner or its executive bodies. Nor may the supervisory board subject the management measures of the general partner to its consent, or issue rules of procedure for the general partner. Management of the Company will be conducted by the management board of the general partner and only the supervisory board of the general partner (all of whose members will be elected solely by Fresenius AG) has the authority to appoint or remove them.

The KGaA shareholders will approve Fresenius Medical Care KGaA s annual financial statements at the general meeting. Except for making a recommendation to the general meeting regarding such approval, this matter is not within the competence of the supervisory board.

General Meeting

The general meeting is the resolution body of the KGaA shareholders. Among other matters, the general meeting of a KGaA will approve its annual financial statements. The internal procedure of the general meeting corresponds to that of the general meeting of a stock corporation. The agenda for the general meeting is fixed by the general partner and the KGaA supervisory board except that the general partner cannot propose nominees for election as members of the KGaA supervisory board or proposals for the Company auditors.

The supervisory board of a KGaA is, in principle, elected by all shareholders of the KGaA at the general meeting. The shares of the KGaA held by the general partner or its affiliates, however, have no vote on the election or removal of members of the supervisory board. Accordingly, Fresenius AG, as sole shareholder in the general partner of our Company will not be entitled to vote its shares in the election of the supervisory board of Fresenius Medical Care KGaA. Theoretically, this means that, in contrast to its power to elect the supervisory board of Fresenius Medical Care AG, Fresenius AG will have no influence on the composition or election of the supervisory board of Fresenius Medical Care KGaA. The Articles of Association of Fresenius Medical Care KGaA provide that a resolution electing members of the supervisory board requires a majority of 75% of the votes cast at the general meeting, in contrast to the simple majority that would otherwise be required. Such a high majority may be difficult to achieve. This could have the result that, on the expiration of the term of office of the first supervisory board members after the effectiveness of the transformation of legal form, the court may have to nominate the next supervisory board members. In addition, (i) the present supervisory board members of Fresenius Medical Care AG will comprise the initial supervisory board of Fresenius Medical Care KGaA (with the exception of Dr. Ulf M. Schneider) and (ii) the supervisory board of Fresenius Medical Care KGaA will propose future supervisory board members for election after expiration of the terms of office of the initial supervisory board (taking into account the right of the shareholders to make proposals for supervisory board membership). Accordingly Fresenius AG will retain a degree of influence on the composition of the supervisory board of Fresenius Medical Care KGaA.

The transformation itself will not affect voting rights or required votes at the general meeting. However, even if only a relative small number of preference shares is converted into ordinary shares, Fresenius AG will lose its voting majority at the general meeting of Fresenius Medical Care KGaA. It is possible, therefore, that after the transformation and the conversion, resolutions of the general meeting could be adopted over the objection of Fresenius AG or that resolutions supported by Fresenius AG could be defeated. However, under German law, resolutions may be adopted by the vote of a majority of the shares present at the meeting. Therefore, even if all of our preference shares are converted into ordinary shares, as long as less than approximately 72% of our ordinary shares are present at a meeting, Fresenius AG will continue to possess a controlling vote on most matters presented to the shareholders, other than election of the supervisory board and the matters subject to a ban on voting as set forth below, at least until we issue additional ordinary shares in a capital increase in which Fresenius AG does not participate.

After the transformation, Fresenius AG will be subject to various bans on voting at general meetings due to its ownership of the general partner. Fresenius AG will be banned from voting on resolutions concerning the election and removal from office of the supervisory board, ratification of the actions of the general partner and members of the supervisory board, the appointment of special auditors, the assertion of compensation claims

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against members of the executive bodies, the waiver of compensation claims, and the selection of auditors of the annual financial statements.

Certain matters requiring a resolution at the general meeting will also require the consent of the general partner after the transformation, such as amendments to the articles of association, consent to inter-company agreements, dissolution of the partnership limited by shares, mergers, a change in the legal form of the partnership limited by shares and other fundamental changes. The general partner will therefore have a veto right on these matters. Annual financial statements will be subject to approval by both the KGaA shareholders and the general partner.

The Articles of Association of Fresenius Medical Care KGaA

The articles of association of Fresenius Medical Care KGaA are based on our current articles of association, particularly with respect to capital structure, the supervisory board and the general meeting. Other parts of the articles of association, such as provisions dealing with management of the KGaA, have been adjusted to the new legal form. Certain material provisions of the articles of association are explained below, especially variations from our current articles of association. The following summary is qualified in its entirety by reference to the complete proposed form of articles of association of Fresenius Medical Care KGaA, an English translation of which is on file with the SEC.

Organization of the Company

The provisions relating to the management board in our current articles of association will be replaced in the articles of association of Fresenius Medical Care KGaA by new provisions relating to the general partner of Fresenius Medical Care KGaA. The general partner will be Management AG with its registered office in Hof an der Saale. Management AG will not make a capital contribution to the partnership and will not participate in the profit or loss of the partnership limited by shares.

Under the articles of association, possession of the power to control management of the KGaA through ownership of the general partner is conditioned upon ownership of a specific minimum portion of our share capital. Under German law, Fresenius AG could significantly reduce its holdings in our share capital while at the same time retaining its control over us through ownership of the general partner. Under our current legal structure as stock corporation, a shareholder must hold more than 50% of our ordinary shares, to exercise a controlling influence. If half our share capital were issued as preference shares (the maximum permissible by law), such controlling interest would represent 25% of our total share capital. This absolute threshold of 25% of the total share capital is the basis for the provision in the articles of association of Fresenius Medical Care KGaA requiring that a parent company within the group hold an interest of more than 25% of the share capital of Fresenius Medical Care KGaA. As a result, the general partner will be required to withdraw from the KGaA if its shareholder no longer holds, directly or indirectly, more than 25% of the share capital of Fresenius Medical Care KGaA. The effect of this provision is that the parent company within the group may not reduce its capital participation in Fresenius Medical Care KGaA below such amount without causing the withdrawal of the general partner. However, the articles of association also permit a transfer of all shares in the general partner to us, which would have the same effect as withdrawal of the general partner.

In addition, the articles of association provide that the general partner must withdraw if the shares of the general partner are acquired by a person who does not make an offer under the German Takeover Act to acquire the shares of our other shareholders within three months of the acquisition of the general partner. The consideration to be offered to shareholders must include any portion of the consideration paid for the general partner s shares in excess of the general partner s equity capital, even if the parties to the sale allocate the premium solely to the general partner s shares. Our articles of association provide that the general partner can be acquired only by a purchaser who at the same time acquires more than 25% of the KGaA s share capital. Thus, this provision would trigger a takeover offer at a lower threshold than the German Takeover Act, which requires that a person who acquires at least 30% of a company s shares make an offer to all shareholders. The provision will enable shareholders to participate in any potential control premium payable for the shares of the

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general partner, although the obligations to make the purchase offer and extend the control premium to shareholders could also have the effect of discouraging a change of control.

In the event that the general partner withdraws from the partnership as described above or for other reasons, the articles of association provide for continuation of the partnership as a so-called unified KGaA (*Einheits-KGaA*), i.e., a KGaA in which the general partner is a wholly-owned subsidiary of the KGaA. Upon the coming into existence of a unified KGaA, the Fresenius Medical Care KGaA shareholders would ultimately be restored to the status as shareholders in a stock corporation, since the shareholding rights in the general partner would be exercised by the KGaA supervisory board pursuant to the articles of association. If the KGaA is continued as a unified KGaA , an extraordinary or the next ordinary general meeting would vote on a change in the legal form of the partnership limited by shares into a stock corporation. The change of legal form back to the stock corporation is facilitated in this case because the articles of association provide for a simple majority vote and because the general partner is obligated to consent to the transformation of legal form.

The general partner of Fresenius Medical Care KGaA will conduct its business and will represent Fresenius Medical Care KGaA in external relations. However, the Company will be represented by its supervisory board in transactions with its general partner. The general meeting will not be entitled to vote on business measures which are outside the ordinary course of business. Our current articles of association do not include a right to vote on such matters and we intend to include a provision in the articles of association of Fresenius Medical Care KGaA which excludes such right. This does not affect the general meeting s right of approval with regard to measures of unusual significance, such as a sale of a substantial part of a company s assets, as developed in German Federal Supreme Court decisions.

The articles of association of Fresenius Medical Care KGaA do not contain a list of business management measures which require the consent of its supervisory board. Due to the legal differences between a stock corporation and a KGaA, the supervisory board of Fresenius Medical Care KGaA will not be entitled to create or enact such a list.

The provisions of the articles of association of Fresenius Medical Care KGaA on the general meeting correspond for the most part to the provisions of our current articles of association. Under the amendments to the German Stock Corporation Act through the Act on Corporate Integrity and Modernization of the Law on Shareholder Claims, the articles provide that from the outset of the general meeting the chairperson may place a reasonable time limit on the shareholders right to speak and ask questions, insofar as is permitted by law. This provision will not take effect until the corresponding amendment to the German Stock Corporation Act becomes effective.

The articles of association provide that to the extent legally required, the general partner must declare or refuse its consent to resolutions adopted by the meeting directly at the general meeting.

Annual Financial Statement and Allocation of Profits

The articles of association of Fresenius Medical Care KGaA on rendering of accounts require that the annual financial statement and allocation of profits of Fresenius Medical Care KGaA be submitted for approval to the general meeting of the KGaA.

Corresponding to the current situation with Fresenius Medical Care AG, the articles of association provide that Management AG is authorized to transfer up to a maximum of half of the annual surplus of Fresenius Medical Care KGaA to other retained earnings when setting up the annual financial statements.

Miscellaneous

The articles of association of Fresenius Medical Care KGaA also contain a safeguard clause in case a provision in the articles of association should subsequently prove to be invalid in whole or in part or subsequently loses its validity. In this case, the remaining provisions of the articles of association will remain unaffected and a provision is to apply which best fits the meaning and purpose of the articles of association.

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Articles of Association of Management AG

The articles of association of Management AG are based essentially on our existing articles of association. In particular, the current provisions of our articles of association on relations between our management board and our supervisory board have been incorporated into the new articles of association of Management AG. The amount of Management AG s share capital is 1,500,000, issued as 1,500,000 registered shares without par value. By law, notice of any transfer of Management AG s shares must be provided to the management board of Management AG in order for the transferee to be recognized as a new shareholder by Management AG.

Settlement of the Proceedings to Set Aside the Resolutions of the Extraordinary General Meeting of August 30, 2005

Several small ordinary shareholders challenged the resolutions adopted at the Extraordinary General Meeting of the Company on August 30, 2005 approving the conversion of the preference shares into ordinary shares, the adjustment of the employee participation programs, the creation of authorized capital and the transformation of the legal form of the Company to a partnership limited by shares, with the objective of having the resolutions declared null and void. The Company then pursued a release procedure *(Freigabeverfahren)*, which would have permitted the registration of the transformation of legal form in spite of the pending challenge proceedings. On December 19, 2005 the Company and the claimants agreed to a settlement *(Prozessvergleich)* with the participation of Fresenius AG and the general partner, Management AG and all proceedings were terminated. In this settlement, the Company, Fresenius AG and Management AG undertook to perform certain actions, which are summarized below. The Company published the full settlement in accordance with § 248a German Stock Corporation Act *(Aktiengesetz)*.

At the first ordinary General Meeting after the transformation of legal form, the Company s corporate governance will be modified by an amendment to our Articles of Association. Fresenius AG has undertaken to vote at this meeting for the resolution amending the Articles of Association to the following effect:

A joint committee *(gemeinsamer Ausschuss)* of the supervisory boards of Management AG and Fresenius Medical Care KGaA will be established (the Joint Committee). Certain extraordinary transactions will require approval of the Joint Committee. The Joint Committee will consist of (i) two members of the supervisory board of Management AG, and (ii) two members of the supervisory board of Fresenius Medical Care KGaA. Management AG will appoint one of its delegates to be chairman of the Joint Committee. The chairman will have the casting vote in the event of a tie.

The Joint Committee shall advise and decide on certain extraordinary management measures of Fresenius Medical Care KGaA. For example, transactions between the Company and Fresenius AG which are of considerable significance and the value of which in each case exceeds 0.25% of the consolidated revenue of the Company will require its approval. In addition, the acquisition and sale of significant participations and parts of the business, spin-off of significant parts of the business, the initial public offering of significant subsidiary enterprises and similar matters, which by statute require the approval of the General Meeting of the KGaA, will be subject to the additional approval of the Joint Committee. Matters are significant within the meaning of the previous sentences if 40% of consolidated revenues, the consolidated balance sheet total (assets plus liabilities) and consolidated profits, determined by reference to the arithmetic average of the said amounts shown in the audited consolidated accounts of the Company in the previous three fiscal years, are affected by the matter.

The members of the Joint Committee shall receive a fee of US$3,500.00 for each meeting attended.

The supervisory board of the Company shall have an Audit and Corporate Governance Committee which shall have three members, at least two of whom shall be independent members. Members are

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independent who have no significant business, professional or personal connection with the Company or with any of its affiliates, apart from membership on the supervisory board of the Company, Management AG or Fresenius AG. The Audit and Corporate Governance Committee will be responsible for reviewing the report of the general partner, Management AG, on relations with related parties and for reporting to the overall supervisory board thereon.

Management AG undertook in the settlement, in accordance with § 285 S. 1 No 9 a) S. 5 to 7 German Commercial Code *(Handelsgesetzbuch)* as amended by the Act on Disclosure of Board Members Remuneration *(Gesetz über die Offenlegung von Vorstandsvergütungen)* to provide data on the individual remuneration of its management board members.

In addition to the corporate governance elements, the parties to the settlement also agreed on payments to the ordinary shareholders of the Company. Management AG undertook to (i) make an *ex gratia* payment to the ordinary shareholders of the Company (other than Fresenius AG), of 0.12 for every share issued as an ordinary share up to August 30, 2005 and (ii) to pay to ordinary shareholders who, at the Extraordinary General Meeting of August 30, 2005, voted against the conversion proposal, an additional 0.69 per ordinary share. Ordinary shareholders who are shareholders at the close of business on the day of registration of the conversion and transformation with the commercial register will be entitled to a payment under (i) above. Ordinary shareholders who voted against the conversion resolution in the extraordinary general meeting on August 30, 2005, as evidenced by the voting cards held by the Company, will be entitled to a payment under (ii) above, but only in respect of shares voted against the conversion resolution. The right to receive payment under (ii) will lapse as to any shareholder who does not make a written claim for payment with the Company by February 28, 2006.

The Company shall also bear court fees and shareholder legal expenses in connection with the settlement. The total costs for the Company on this basis, exclusive of costs for legal advice to and legal defense of the Company, will be approximately 1.9 million.

Accounting Treatment

Conversion of Our Preference Shares into Ordinary Shares

Preference shareholders participating in the conversion are required to pay a premium to convert their preference shares into ordinary shares on a one-to-one basis. The conversion premium has been calculated as a percentage of the difference between the weighted average stock exchange price of the ordinary shares and the weighted average German stock exchange price of the preference shares on the Frankfurt Stock Exchange as calculated for the three month period prior to our first announcement of the conversion and the transformation. The conversion premium will be accounted for as an increase in our shareholders equity without affecting our statement of operations. We plan to use the net proceeds generated by the conversion to reduce outstanding indebtedness and for general corporate purposes. The amount of our subscribed capital will not be affected by the conversion. The total number of shares of both classes issued, i.e. the aggregate number of ordinary shares and preference shares, will remain unchanged. However, the conversion of our preference shares is expected to have an impact on the earnings (or loss) per share available to the holders of our ordinary shares upon conversion of our preference shares into ordinary shares.

See also the description of nonrecurring charges included in the *pro forma* financial statements of Fresenius Medical Care AG contained in Appendix A-1 to this prospectus.

Conversion of the Interests Held and Related Adjustments under the Employee Participation Programs

Our proposed offer to convert the interests held under the terms of various employee participation programs is expected to result in a new measurement date for the intrinsic value of awards issued in exchange for the awards converted and may result in variable accounting in interim and annual periods subsequent to the conversion of the award in accordance with the regulations set forth in Accounting Principles Board Opinion No. 25. The Financial Accounting Standards Board issued its final standard on accounting for share-based payments, Statements of Financial Accounting Standards No. 123R (revised 2004), *Share-Based Payment* (SFAS 123R), that requires companies to expense the cost of employee stock options and similar awards. SFAS 123R requires determining the cost that will be measured at fair value on the date of the share-based payment awards based upon an estimate of the number of awards expected to vest. We are obliged to adopt SFAS 123R no later than the beginning of 2006.

See also the description of nonrecurring charges included in the *pro forma* financial statements of Fresenius Medical Care AG contained in Appendix A-1 to this prospectus.

Transformation of Legal Form

The transformation of our legal form from a stock corporation into a partnership limited by shares will not represent a transaction that would result in measurement of the fair value of the shares of the KGaA. The carrying amounts of the assets and liabilities on our books will be carried over to the books of Fresenius Medical Care KGaA without adjustment as a result of the transformation of the legal form. We will pay the costs of the transformation transaction and the conversion offers, including the costs of soliciting shareholder approval of the transformation and conversion proposals at the general meeting and the separate meeting of preference shareholders held August 30, 2005. We estimate such costs to be approximately $14.3 million, of which $5.4 million will be offset against the proceeds of this offering and the balance of $8.9 million will be expensed under U.S. GAAP. The entire $14.3 million will be expensed under German GAAP. This estimate includes formation costs, auditor costs specifically relating to the transformation, the cost of required publications (in Germany and the United States), costs of the extraordinary general meeting, notary fees, court costs, stock exchange listing fees, costs of preparing, reviewing and printing the prospectus for the U.S. offer and the German stock exchange listing prospectus and the costs of external advisors (including the fees of information agents, counsel and accountants in Germany and the United States).

United States Federal Securities Laws Consequences

The transformation of our ordinary shares and preference shares held by United States persons into ordinary shares and preference shares of Fresenius Medical Care KGaA has been registered under the United States Securities Act of 1933, as amended, and the ordinary shares of Fresenius Medical Care KGaA to be issued pursuant to the U.S. offer have also been registered under that Act. The ordinary shares of Fresenius Medical Care KGaA to be issued pursuant to the German offer will be issued pursuant to the exemption for offshore transactions provided by Regulation S under the Securities Act. Shares of Fresenius Medical Care KGaA held by persons who may be deemed affiliates of the Company may be sold by such persons only in accordance with the provisions of Rule 145 under the Securities Act, pursuant to an effective registration under the Securities Act, or in transactions that are exempt from registration under the Securities Act including the Regulation S exemption under the Securities Act. Rule 145 provides, in general, that our ordinary and preference shares may be sold by an affiliate only if (a) the number of shares sold within any three-month period does not exceed the greater of (i) 1% of the total number of outstanding shares of the applicable class, (ii) the average weekly trading volume of such shares on the New York Stock Exchange during the four calendar weeks immediately preceding the date on which notice of the sales is filed with the SEC or (iii) the average weekly volume of trading in such securities reported through the consolidated transaction reporting system during such four-week period, (b) certain current public information is available regarding our Company (that information will be available as long as we continue to file annual reports and furnish other periodic reports with the SEC), and (c) the shares are sold in transactions directly with a market maker or in brokers transactions within the meaning of Rule 144 under the Securities Act.

INTERESTS OF CERTAIN PERSONS IN THE CONVERSION AND TRANSFORMATION

Interest of Fresenius AG

Fresenius AG currently holds approximately 35.53 million of our ordinary shares, constituting approximately 50.8% of our outstanding ordinary shares. As the holder of a majority of our voting shares, Fresenius AG is in a position to determine the results of general meeting resolutions which require only a simple majority, without regard to the vote of or attendance by other shareholders. This applies, for example,

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to resolutions on the election of members to the supervisory board and the appointment of our auditors. We are therefore controlled by Fresenius AG.

Because of its majority voting rights, Fresenius AG is entitled and obliged to consolidate our financial statements completely in its group financial statements. The ability to consolidate is of major significance for Fresenius AG because it provides comparable group financial statements on a consistent basis and capital markets transparency. Due to its control of Fresenius Medical Care KGaA through ownership of our general partner, Fresenius AG will be able to consolidate our financial statements in its group financial statements after the conversion and the transformation.

In addition to retaining its control of us, the various transactions and relationships to which the Company and Fresenius AG are parties will continue in effect after the transformation. For information with respect to such matters, see Major Shareholders and Related Party Transactions Related Party Transaction in our 2004 Form 20-F.

In connection with the RCG acquisition, the conversion and the transformation of legal form, we have availed ourselves extensively of services of Fresenius AG including, in particular, strategic and financial advice, legal, accounting, investor relations, public relations and human resources services. The services were provided primarily within the context of the structuring and implementation of these transactions and in connection with the extraordinary general meeting held on August 30, 2005, as well as communication with our shareholders. In accordance with the existing services agreements within the Fresenius Group, we entered into an agreement with Fresenius AG, on the basis of which we shall reimburse Fresenius AG for these services provided during 2005. This agreement also covers services that we will obtain from Fresenius AG in connection with the aforementioned transactions in the course of 2006.

Under the articles of association of Fresenius Medical Care KGaA, Fresenius AG will receive a guaranteed return on its capital investment in the general partner. See The Conversion and Transformation; Effects The Legal Structure of Fresenius Medical Care KGaA The Articles of Association of Fresenius Medical Care KGaA.

Interest of the Management Board and the Supervisory Board

At the date of this prospectus, the members of our management board are also the members of the management board of the general partner. We expect that their service contracts and compensation arrangements will contain the same terms and conditions after the transformation. The KGaA will reimburse the general partner for its expenses in connection with the management and administration of the partnership, including compensation paid to the general partner s management board and supervisory board. In addition, we expect that the general partner s supervisory board will appoint Gary Brukardt, currently the President and Chief Executive Officer of RCG, as an additional member of our management board after the closing of the RCG merger. Mr. Brukardt had been a director, President and Chief Executive Officer of RCG since 2003 and served as its Executive Vice President and Chief Operating Officer from 1996 until 2003.

All or most of the members of our supervisory board will become the members of the general partner s supervisory board and (other than Dr. Ulf M. Schneider) will also become the members of the supervisory board of the KGaA. At our general meeting in May 2005, our articles of association were amended to increase the compensation of the members of our supervisory board. The members of our supervisory board will receive additional remuneration for their service on the supervisory board of the general partner. However, our articles of association and those of Management AG provide that if a person is a member of the supervisory board of Fresenius Medical Care KGaA and of the supervisory board of Management AG and receives compensation for such service from Fresenius Medical Care KGaA and from Management AG, both his fixed fee compensation as a member of the supervisory board of the KGaA and his fixed fee compensation as a member of the supervisory board of Management AG will be reduced by half. As a result, those persons who are members of both supervisory boards will receive the fixed fee remuneration provided in the articles of association only once. The same rule shall apply if the chairman or deputy chairman of our supervisory board also serves as the chairman or deputy chairman, respectively, of Management AG. In addition, a person who serves simultaneously as deputy chairman of our supervisory board and as chairman of the supervisory board of Management AG, or as deputy chairman of the supervisory board of Management AG and chairman of our supervisory board, will be compensated only for service as chairman of the applicable supervisory board.

Recent Transactions in our Preference Shares

The following sets forth certain information with regard to transactions in our preference shares by members of our supervisory board and our management board during the sixty days preceding the date of this prospectus.

Name and Position	Transaction Date	Number of Shares	Price per Share	Nature of Transaction
Roberto Fusté, Member of the Management Board	November 4, 2005	16,600	32.410	Exercise of option
	November 4, 2005	16,600	65.514	Sale on Frankfurt Stock Exchange
	November 4, 2005	4,228	44.660	Exercise of option
	November 4, 2005	4,228	65.514	Sale on Frankfurt Stock Exchange
Dr. Emanuele Gatti, Member of the Management Board	November 4, 2005	8,600	32.410	Exercise of option
	November 4, 2005	8,600	66.069	Sale on Frankfurt Stock Exchange
	November 4, 2005	16,600	44.660	Exercise of option
	November 4, 2005	16,600	66.069	Sale on Frankfurt Stock Exchange
	November 4, 2005	16,600	58.980	Exercise of option
	November 4, 2005	16,600	66.582	Sale on Frankfurt Stock Exchange

MATERIAL TAX CONSEQUENCES OF THE CONVERSION

The discussion below is a summary of material United States federal and German tax consequences generally applicable to U.S. holders (as defined below) of the receipt of ADSs representing ordinary shares of Fresenius Medical Care KGaA in the conversion, as set forth in the opinions described below. A U.S. holder is:

- any citizen or resident of the U.S.;
- a corporation, partnership, or other entity created or organized in or under the laws of the U.S. or any political subdivision thereof; or
- an estate or trust the income of which is subject to U.S. federal income taxation regardless of source of income.

This discussion is based on the Internal Revenue Code of 1986, as amended (the Code), the U.S. Treasury regulations promulgated thereunder, Internal Revenue Service rulings, interpretations and judicial decisions, and German tax law, as currently in effect. All of these statutes, regulations and interpretations are subject to change at any time. Any change may be applied retroactively to the transactions described herein.

The discussion below is not a complete analysis of all of the potential U.S. federal and German tax consequences of receiving ADSs of Fresenius Medical Care KGaA in the conversion. In addition, the U.S. federal and German tax consequences to particular U.S. holders, such as insurance companies, tax-exempt entities, investors holding ADSs through partnerships or other fiscally transparent entities, investors liable for the alternative minimum tax, investors that hold ADSs as part of a straddle or a hedge, investors whose functional currency is not the U.S. dollar, financial institutions and dealers in securities, and to non-U.S. holders may be different from that discussed herein. **Investors should consult their own tax advisors with respect to the particular United States federal and German tax consequences applicable to receiving ADSs of Fresenius Medical Care KGaA in the conversion.**

German Tax Consequences of the Conversion

We have received a tax opinion from Nörr Stiefenhofer Lutz Partnerschaft, which has been filed as an exhibit to the registration statement that includes this prospectus, on the basis of the facts, assumptions, representations and covenants all of which must be true and accurate in all respects as of the effective time of the conversion. The tax opinion may be summarized as follows:

Consequences to the Company

The conversion and the preceding transformation may result in the termination of the existing VAT tax group between us and Fresenius AG. After the conversion and the transformation and possibly without having a VAT tax group in place between Fresenius Medical Care KGaA and Fresenius AG, there should be no material adverse VAT consequences.

Under German income tax law, the conversion of preference shares into ordinary shares and the discounted premium payments should be tax neutral for the Company. The premium payments will be shown in our contribution account for tax purposes.

Consequences to the Shareholders

Under German income tax law, the conversion of our outstanding preference shares into ordinary shares and the discounted premium payments should not have a tax effect for our shareholders. The conversion premium payable by shareholders will constitute subsequent costs of acquisition for the ordinary shares.

A tax opinion of counsel represents counsel s best legal judgment and is not binding on the German tax authorities or any court. Counsel s opinion notes that there are no conclusive judgements of the highest courts of Germany and/or published legal opinions of the German tax authorities on partial aspects relevant to the

German tax issues as a whole. Therefore, counsel s analysis in its opinion is based on the application of general principles rather than on explicit legal provisions and regulations, and should not be construed as a guarantee that the German tax authorities will share the views expressed by counsel. No ruling has been or will be sought from the German tax authorities as to the tax consequences of the conversion. No assurance can be given that a position contrary to that expressed in the tax opinion will not be asserted by the German tax authorities and, ultimately sustained by a court.

U.S. Tax Consequences of the Conversion

We have received a legal opinion from O Melveny & Myers LLP, which has been filed as an exhibit to the registration statement that includes this prospectus, to the effect that, on the basis of the facts, assumptions, representations, and covenants set forth or referred to therein, all of which must be true and accurate in all respects, the conversion of preference shares into ordinary shares will constitute a reorganization within the meaning of Section 368(a) of the Code for U.S. federal income tax purposes, in which case (i) the Company will not recognize any gain or loss upon issuance of ordinary shares in exchange for preference shares; (ii) U.S. holders of preference shares that participate in the conversion will not recognize gain or loss upon their receipt of ordinary shares; and (iii) U.S. holders of preference shares who do not participate in the conversion as well as U.S. holders of ordinary shares will not recognize gain or loss upon such conversion. Accordingly, we will report the conversion of preference shares to ordinary shares as a tax-free reorganization. The remainder of the disclosure assumes that the conversion will constitute a tax-free reorganization for U.S. federal income tax purposes.

Preference shareholders who participate in the conversion will be required to pay 9.75 per converted share. Generally, the aggregate tax basis of the ordinary shares received in the conversion will be equal to the aggregate tax basis of the preference shares surrendered increased by the total cash paid. Although the law is not entirely clear on how to treat basis and holding period for the ordinary shares received in the conversion, each ordinary share received by a preference shareholder should have a split basis and split holding period for purposes of determining long-term or short-term capital gain or loss. Accordingly, the portion of each ordinary share that is attributable to the cash paid for the conversion (such portion, the Cash Portion) will have a holding period that begins on the day following the date of the conversion and will have a basis equal to the total cash paid for converting into that ordinary share. The remaining portion of each ordinary share received by a converting preference shareholder that is attributable to the preference shares surrendered (such portion, the Preference Portion) will have a holding period determined by including (tacking) the holding period of such holder s preference shares and will have a basis in such Preference Portion equal to the tax basis of the preference share surrendered for such ordinary share.

An opinion of counsel represents counsel s best legal judgment and is not binding on the Internal Revenue Service or any court. No ruling has been, or will be, sought from the Internal Revenue Service as to the tax consequences of the transformation, and no authority exists directly on point. Accordingly, there can be no certainty that the Internal Revenue Service will not challenge the conclusions set forth in the opinion stated or referred to herein or that a court would not sustain such a challenge.

U.S. AND GERMAN TAX CONSEQUENCES OF HOLDING ADSs

The discussion below is not a complete analysis of all of the potential U.S. federal and German tax consequences of holding ADSs of Fresenius Medical Care KGaA. In addition, the U.S. federal and German tax consequences to particular U.S. holders, such as insurance companies, tax-exempt entities, investors holding ADSs through partnerships or other fiscally transparent entities, investors liable for the alternative minimum tax, investors that hold ADSs as part of a straddle or a hedge, investors whose functional currency is not the U.S. dollar, financial institutions and dealers in securities, and to non-U.S. holders may be different from that discussed herein. **Investors should consult their own tax advisors with respect to the particular United States federal and German tax consequences applicable to holding ADSs of Fresenius Medical Care KGaA.**

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Tax Treatment of Dividends

Currently, German corporations are required to withhold tax on dividends paid to resident and non-resident shareholders. The required withholding rate applicable is 20% plus a solidarity surcharge of 5.5% thereon, equal to 1.1% of the gross dividend (i.e., 5.5% of the 20% tax). Accordingly, a total German withholding tax of 21.1% of the gross dividend is required. A partial refund of this withholding tax can be obtained by U.S. holders under the U.S.-German Tax Treaty. For U.S. federal income tax purposes, U.S. holders are taxable on dividends paid by German corporations subject to a foreign tax credit for certain German income taxes paid. The amount of the refund of German withholding tax and the determination of the foreign tax credit allowable against U.S. federal income tax depend on whether the U.S. holder is a corporation owning at least 10% of the voting stock of the German corporation.

In the case of any U.S. holder, other than a U.S. corporation owning our ADSs representing at least 10% of our outstanding voting stock, the German withholding tax is partially refunded under the U.S.-German Tax Treaty to reduce the withholding tax to 15% of the gross amount of the dividend. Thus, for each $100 of gross dividend that we pay to a U.S. holder, other than a U.S. corporation owning our ADSs representing at least 10% of our outstanding voting stock, the dividend after partial refund of $6.10 of the $21.10 withholding tax under the U.S.-German Tax Treaty will be subject to a German withholding tax of $15. For U.S. foreign tax credit purposes, the U.S. holder would report dividend income of $100 (to the extent paid out of current and accumulated earnings and profits) and foreign taxes paid of $15, for purposes of calculating the foreign tax credit or the deduction for taxes paid.

Subject to certain exceptions, dividends received by a non-corporate U.S. holder will be subject to a maximum U.S. federal income tax rate of 15%. The lower rate applies to dividends only if the ADSs in respect of which such dividend is paid have been held by you for at least 61 days during the 121 day period beginning 60 days before the ex-dividend date. Periods during which you hedge a position in our ADSs or related property may not count for purposes of the holding period test. The dividends would also not be eligible for the lower rate if you elect to take dividends into account as investment income for purposes of limitations on deductions for investment income. U.S. holders should consult their own tax advisors regarding the availability of the reduced dividend rate in light of their own particular circumstances.

In the case of a corporate U.S. holder owning our ADSs representing at least 10% of our outstanding voting stock, the 21.1% German withholding tax is reduced under the U.S.-German Tax Treaty to 5% of the gross amount of the dividend. Such a corporate U.S. holder may, therefore, apply for a refund of German withholding tax in the amount of 16.1% of the gross amount of the dividends. A corporate U.S. holder will generally not be eligible for the dividends-received deduction generally allowed to U.S. corporations in respect of dividends received from other U.S. corporations.

Subject to certain complex limitations, a U.S. holder is generally entitled to a foreign tax credit equal to the portion of the withholding tax that cannot be refunded under the U.S.-German Tax Treaty.

Dividends paid in Euros to a U.S. holder of ADSs will be included in income in a dollar amount calculated by reference to the exchange rate in effect on the date the dividends, including the deemed refund of German corporate tax, are included in income by such a U.S. holder. If dividends paid in Euros are converted into dollars on the date included in income, U.S. holders generally should not be required to recognize foreign currency gain or loss in respect of the dividend income.

Under the U.S.-German Tax Treaty the refund of German tax, including the withholding tax, Treaty payment and solidarity surcharge, will not be granted when the ADSs are part of the business property of a U.S. holder s permanent establishment located in Germany or are part of the assets of an individual U.S. holder s fixed base located in Germany and used for the performance of independent personal services. But then withholding tax and solidarity surcharge may be credited against German income tax liability.

Refund Procedures

To claim a refund under the U.S.-German Tax Treaty, the U.S. holder must submit a claim for refund to the German tax authorities, with the original bank voucher, or certified copy thereof issued by the paying entity documenting the tax withheld within four years from the end of the calendar year in which the dividend is received. Claims for refund are made on a special German claim for refund form, which must be filed with the German tax authorities: Bundesamt für Finanzen, 53221 Bonn-Beuel, Germany. The claim refund forms may be obtained from the German tax authorities at the same address where the applications are filed, or from the Embassy of the Federal Republic of Germany, 4645 Reservoir Road, N.W., Washington, D.C. 20007-1998, or from the Office of International Operations, Internal Revenue Service, 1325 K Street, N.W., Washington, D.C. 20225, Attention: Taxpayer Service Division, Room 900 or can be downloaded from the homepage of the Bundesamt für Finanzen (www.bff-online.de).

U.S. holders must also submit to the German tax authorities certification of their last filed U.S. federal income tax return. Certification is obtained from the office of the Director of the Internal Revenue Service Center by filing a request for certification with the Internal Revenue Service Center, Foreign Certificate Request, P.O. Box 16347, Philadelphia, PA 19114-0447. Requests for certification are to be made in writing and must include the U.S. holder s name, address, phone number, social security number or employer identification number, tax return form number and tax period for which certification is requested. The Internal Revenue Service will send the certification back to the U.S. holder for filing with the German tax authorities.

U.S. holders of ADSs who receive a refund attributable to reduced withholding taxes under the U.S.-German Tax Treaty may be required to recognize foreign currency gain or loss, which will be treated as ordinary income or loss, to the extent that the dollar value of the refund received by the U.S. holders differs from the dollar equivalent of the refund on the date the dividend on which such withholding taxes were imposed was received by the depositary or the U.S. holder, as the case may be.

Taxation of Capital Gains

Under the U.S.-German Tax Treaty, a U.S. holder who is not a resident of Germany for German tax purposes will not be liable for German tax on capital gains realized or accrued on the sale or other disposition of ADSs unless the ADSs are part of the business property of a permanent establishment located in Germany or are part of the assets of a fixed base of an individual located in Germany and used for the performance of independent personal services.

Upon a sale or other disposition of the ADSs, a U.S. holder will recognize gain or loss for U.S. federal income tax purposes in an amount equal to the difference between the amount realized and the U.S. holder s tax basis in the ADSs. Such gain or loss will generally be capital gain or loss if the ADSs are held by the U.S. holder as a capital asset, and will be long-term capital gain or loss if the U.S. holder s holding period for the ADSs exceeds one year. Individual U.S. holders are generally taxed at a maximum 15% rate on net long-term capital gains.

Gift and Inheritance Taxes

The U.S.-Germany estate, inheritance and gift tax treaty provides that an individual whose domicile is determined to be in the U.S. for purposes of such treaty will not be subject to German inheritance and gift tax, the equivalent of the U.S. federal estate and gift tax, on the individual s death or making of a gift unless the ADSs are part of the business property of a permanent establishment located in Germany or are part of the assets of a fixed base of an individual located in Germany and used for the performance of independent personal services. An individual s domicile in the U.S., however, does not prevent imposition of German inheritance and gift tax with respect to an heir, donee, or other beneficiary who is domiciled in Germany at the time the individual died or the gift was made.

Such treaty also provides a credit against U.S. federal estate and gift tax liability for the amount of inheritance and gift tax paid in Germany, subject to certain limitations, in a case where ADSs are subject to German inheritance or gift tax and U.S. federal estate or gift tax.

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Other German Taxes

There are no German transfer, stamp or other similar taxes that would apply to U.S. holders who purchase or sell ADSs.

United States Information Reporting and Backup Withholding

Dividends and payments of the proceeds on a sale of ADSs, paid within the United States or through U.S.-related financial intermediaries are subject to information reporting and may be subject to backup withholding unless you (1) are a corporation or other exempt recipient or (2) provide a taxpayer identification number and certify (on Internal Revenue Service Form W-9) that no loss of exemption from backup withholding has occurred.

Non-U.S. shareholders are not U.S. persons generally subject to information reporting or backup withholding. However, a non-U.S. holder may be required to provide a certification (generally on Internal Revenue Service Form W-8BEN) of its non-U.S. status in connection with payments received in the United States or through a U.S.-related financial intermediary.

DESCRIPTION OF THE SHARES OF THE COMPANY

The following description of the capital shares of Fresenius Medical Care KGaA describes the material terms of our bearer ordinary shares and our bearer non-voting preference shares, but does not purport to be complete and is qualified in its entirety by reference to the form of articles of association of Fresenius Medical Care KGaA. For information with respect to the deposit agreements pursuant to which our shares will be held on behalf of U.S. shareholders who choose to hold such shares in the form of American Depositary Receipts, see Description of American Depositary Receipts.

General

At the date of this prospectus, our share capital consisted of 250,271,178.24, divided into 70,000,000 ordinary shares without par value *(Stückaktien)* and 27,762,179 non-voting preference shares without par value *(Stückaktien)*. Our share capital has been fully paid in.

If the holders of all of our outstanding preference shares accept the proposed conversion offer in accordance with the terms of the offers, the share capital of Fresenius Medical Care KGaA will consist of 250,271,178.24, consisting solely of ordinary shares without par value *(Stückaktien)*. The actual allocation of our share capital between ordinary shares and preference shares will depend on the results of the conversion offers. The relative rights and privileges of our ordinary shares and our preference shares will not change as a result of the conversion and transformation.

All shares of Fresenius Medical Care AG are and all shares of Fresenius Medical Care KGaA shares will be in bearer form. Our shares are and will be deposited as share certificates in global form *(Sammelurkunden)* with Clearstream Banking AG, Frankfurt am Main. Shareholders are not and will not be entitled to have their shareholdings issued in certificated form. All shares of Fresenius Medical Care KGaA will be freely transferable, subject to any applicable restrictions imposed by the United States Securities Act of 1933, as amended, or other applicable laws.

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Capital Increases in the Past Three Years

The following table shows the capital increases that occurred since January 1, 2002. The capital increases due to conditional capital were realized by the issuance of related shares in line with the stock option plans approved by the shareholders meeting in 1996, 1998 and 2001.

Number of Shares	Nominal Amount of the Capital Increase	Our Share Capital After the Capital Increase	Authorized Capital Used in the Capital Increase	Date of Registration with the Commercial Register
158,272	405,176.30	246,211,860.48	Conditional Capital	28 February 2002
12,067	30,891.52	246,242,752.00	Conditional Capital	3 February 2003
25,404	65,034.24	246,307,786.24	Conditional Capital	20 January 2004
82,107	210,193.92	246,517,980.16	Conditional Capital	3 March 2005
1,466,093	3,753,198.08	250,271,178.24	Conditional Capital	Issuance in 2005 (not yet registered with commercial register)

Authorized Capital

By resolution of our general meeting of shareholders on May 23, 2001 and May 24, 2005, our management board was authorized, with the approval of the supervisory board, to increase under certain conditions our share capital through the issue of preference shares. Such authorizations are effective until May 22, 2006 and May 23, 2010, respectively. Such authorizations were revoked at our extraordinary general meeting on August 30, 2005 as they were no longer appropriate due to the proposed conversion of our preference shares into ordinary shares.

Furthermore, by resolution of our extraordinary general meeting of shareholders on August 30, 2005, the general partner (the management board prior to the registration of the transformation), was authorized, with the approval of our supervisory board, to increase, on one or more occasions, our share capital until August 29, 2010 by a maximum amount of 35,000,000 through issue of new ordinary shares against cash contributions, our Authorized Capital I. The general partner is also entitled, subject to the approval of our supervisory board, to decide on the exclusion of statutory pre-emption rights of the shareholders. However, such an exclusion of pre-emption rights will only be permissible for fractional amounts. The newly issued shares may be taken up by certain credit institutions determined by the general partner if such credit institutions are obliged to offer the shares to the shareholders (indirect pre-emption rights). The general partner is also entitled, subject to the approval of our supervisory board, to determine further details of the increases of the capital out of our Authorized Capital I.

In addition, by resolution of our extraordinary general meeting of shareholders on August 30, 2005, the general partner (the management board prior to the registration of the transformation), was authorized, with the approval of our supervisory board, to increase, on one or more occasions, the share capital of our Company until August 29, 2010 by a maximum amount of 25,000,000 through the issue of new ordinary shares against cash contributions or contributions in kind, our Authorized Capital II. The general partner is also entitled, subject to the approval of our supervisory board, to decide on an exclusion of statutory pre-emption rights of the shareholders. However, such exclusion of pre-emption rights will be permissible only if, (i) in case of a capital increase against cash contributions, the nominal value of the issues shares does not exceed 10% of the nominal share value of Fresenius Medical Care KGaA s share capital and the issue price for the new shares is at the time of its determination by the general partner not significantly lower than the stock exchange price of the existing listed shares of the same type and with the same rights or, (ii) in case of a capital increase against contributions in kind, the purpose of such increase is to acquire an enterprise, parts of an enterprise or an interest in an enterprise. The general partner is also entitled, subject to the approval of our supervisory board, to determine further details of the increases of the capital out of our Authorized Capital II. Our authorized capital will become effective upon registration with the commercial register of the local court in Hof an der Saale. Because the resolutions for our authorized capital were adopted as part of the resolutions authorizing

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the transformation, we will not be able to issue shares from our authorized capital until the transformation becomes effective.

Conditional Capital

Through our employee participation programs, consisting of employee stock option programs and an international employee participation scheme, we have issued convertible bonds and stock option/ subscription rights *(Bezugsrechte)* to employees and the members of the management board of Fresenius Medical Care AG and employees and members of management of affiliated companies that entitle these persons to receive preference shares. Our current conditional capital available for such purposes is 14,938,933.76. With the implementation of the conversion, these programs shall be adjusted to the effect that the conversion rights and subscription rights refer to ordinary shares. We intend to put the participants in those programs in the same economic position in which they would have been without the implementation of the proposed conversion of preference shares into ordinary shares.

By resolution of our extraordinary general meeting of shareholders of August 30, 2005, our share capital was contingently increased through the issue of new non-voting preference shares and, if the conversion is implemented, new ordinary shares. The conditional capital increases will be made only to the extent that (i) convertible bonds for no par value shares are issued pursuant to the stock option program approved by the general shareholders meeting of September 24, 1996 and insofar as the holders of such convertible bonds exercise their conversion rights, (ii) stock options are granted pursuant to the stock option program approved by the general shareholders meetings of June 10, 1998 and of May 30, 2000 and insofar as the owners of such stock options exercise their subscription rights, and/or (iii) convertible bonds for no par value shares are issued pursuant to the international participation scheme for employees approved by the general shareholders meeting of May 23, 2001 and insofar as the holders of such convertible bonds exercise their conversion rights. The new non-voting preference shares and the new ordinary shares will participate in the profits as from the beginning of the fiscal year in which they are created as a result of exercise of the conversion rights (in the case of shares issued upon conversion of convertible bonds) or as from the beginning of the fiscal year in which they are issued (in the case of shares issued upon exercise of stock options).

Depending on the rate of acceptance of the conversion offer among the participants in our employee participation programs, the conditional capital created to cover the convertible bonds and the stock options will change. The supervisory board was therefore authorized to adjust the wording of the amendments to our articles of association adopted at the extraordinary meeting, i.e. the number of shares and the division of the share capital between preference shares and ordinary shares, prior to the registration of the resolution on the transformation of legal form with the commercial register, to the extent made necessary by the implementation of the adjustments of these programs and any issue of shares out of existing conditional capital during the period between the extraordinary general meeting and completion of the conversion. The adjusted conditional capital will be effective upon registration of the resolutions with the commercial register. We will not be able to issue shares from our conditional capital until the transformation becomes effective.

General provisions on Increasing the Capital of Stock Corporations and Partnerships Limited by Shares

Under the German Stock Corporation Act, the capital of a stock corporation or of a partnership limited by shares may be increased by a resolution of the general meeting, passed with a majority of three quarters of the capital represented at the vote, unless the Articles of Association of the stock corporation or the partnership limited by shares provide for a different majority.

In addition, the general meeting of a stock corporation or a partnership limited by shares may create authorized capital. The resolution creating authorized capital requires the affirmative vote of a majority of three quarters of the capital represented at the vote and may authorize the management board to issue shares up to a stated amount for a period of up to five years. The nominal value of the authorized capital may not exceed half of the capital at the time of the authorization.

In addition, the general meeting of a stock corporation or of a partnership limited by shares may create conditional capital for the purpose of issuing (i) shares to holders of convertible bonds or other securities which grant a right to shares, (ii) shares as consideration in the case of a merger with another company, or (iii) shares offered to management or employees. In each case, the authorizing resolution requires the affirmative vote of a majority of three quarters of the capital represented at the vote. The nominal value of the conditional capital may not exceed half or, in the case of conditional capital created for the purpose of issuing shares to management and employees 10%, of the company s capital at the time of the resolution.

In a partnership limited by shares all resolutions increasing the capital of the partnership limited by shares also require the consent of the general partner for their effectiveness.

Voting Rights

Each ordinary share entitles the holder thereof to one vote at general meetings of shareholders of Fresenius Medical Care KGaA. Resolutions are passed at an ordinary general or an extraordinary general meeting of our shareholders by a majority of the votes cast, unless a higher vote is required by law or our articles of association (such as the provisions in the Fresenius Medical Care KGaA articles of association relating to the election of our supervisory board). By statute, Fresenius AG as shareholder of the general partner will not be entitled to vote its ordinary shares in the election or removal of members of the supervisory board, the ratification of the acts of the general partners and members of the supervisory board, the appointment of special auditors, the assertion of compensation claims against members of the executive bodies arising out of the management of the Company, the waiver of compensation claims and the appointment of auditors. In the case of resolutions regarding such matters Fresenius AG s voting rights may also not be exercised by any other person.

Our preference shares do not have any voting rights, except as described in this paragraph. If we do not pay the minimum annual dividend payable on the preference shares for any year in the following year, and we do not pay both the dividend arrearage and the dividend payable on the preference shares for such following year in full in the next following year, then the preference shares shall have the same voting rights as the ordinary shares (one vote for each share held or for each three ADSs held) until all preference share dividend arrearages are fully paid up. In addition, holders of preference shares are entitled to vote on most matters affecting their preferential rights, such as changes in the rate of the preferential dividend. Any such vote requires the affirmative vote of 75% of the votes cast in a meeting of holders of preference shares.

Dividend Rights

The general partner will prepare and submit the annual financial statements for each fiscal year to our supervisory board and will propose any dividends for approval at the annual general meeting of shareholders. Usually, shareholders vote on a recommendation made by management (i.e., the general partner) and the supervisory board as to the amount of dividends to be paid. Any dividends are paid once a year, generally, immediately following our annual general meeting.

Under German law, dividends may only be paid from our balance sheet profits as determined by our unconsolidated annual financial statements *(Bilanzgewinn)* as approved by our annual general meeting of shareholders and the general partner. Unlike our consolidated annual financial statements, which are prepared on the basis of accounting principles generally accepted in the United States of America (U.S. GAAP), the unconsolidated annual financial statements referred to above are prepared on the basis of the accounting principles of the German Commercial Code *(HGB)*. Since our ordinary shares and our preference shares that are entitled to dividend payments are held in a clearing system, the dividends will be paid in accordance with the rules of the individual clearing system. We will publish notice of the dividends paid and the appointment of the paying agent or agents for this purpose in the electronic version of the German Federal Gazette *(elektronischer Bundesanzeiger)*. If dividends are declared, preference shareholders will receive 0.06 per share more than the dividend payable on our ordinary shares, but not less than 0.12 per share. Under German law, we must pay the annual dividend for our preference shares prior to paying any dividends on the ordinary shares. If the profit shown on the balance sheet in one or more fiscal years is not adequate to permit distribution of a dividend of 0.12 per preference share, the shortfall without interest must be made good out of the profit on the balance sheet in the following fiscal year or years after distribution of the minimum dividend on the preference shares for that year or years and prior to the distribution of a dividend on the ordinary shares. The right to this payment is an integral part of the profit share of the fiscal year from which the shortfall in the preference share dividend is made good. The preferential dividend rights of our preference shares will not change as a result of the transformation of legal form.

In the case of holders of ADRs, the depositary will receive all dividends and distributions on all deposited securities and will, as promptly as practicable, distribute the dividends and distributions to the holders of ADRs entitled to the dividend. See Description of American Depositary Receipts Share Dividends and Other Distributions.

Liquidation Rights

Our company may be dissolved by a resolution of our general shareholders meeting passed with a majority of three quarters of our share capital represented at such general meeting and the approval of the general partner. In accordance with the German Stock Corporation Act *(Aktiengesetz)*, in such a case, any liquidation proceeds remaining after paying all of our liabilities will be distributed among our shareholders in proportion to the total number of shares held by each shareholder. Our preference shares are not entitled to a preference in liquidation. Liquidation rights will not change as a result of the transformation of legal form.

Pre-emption Rights

Under the German Stock Corporation Act *(Aktiengesetz)*, each shareholder in a stock corporation or partnership limited by shares has a preferential right to subscribe for any issue by that company of shares, debt instruments convertible into shares, e.g. convertible bonds or option bonds, and participating debt instruments, e.g. profit participation rights or participating certificates, in proportion to the number of shares held by that shareholder in the existing share capital of the company. Such pre-emption rights are freely assignable. These rights may also be traded on German stock exchanges within a specified period of time prior to the expiration of the subscription period. Our general shareholders meeting may exclude pre-emption rights by passing a resolution with a majority of at least three quarters of our share capital represented at the general meeting at which the resolution to exclude the pre-emption rights is passed. In addition, an exclusion of pre-emption rights requires a report by the general partner justifying the exclusion by explaining why the interest of Fresenius Medical Care KGaA in excluding the pre-emption rights outweighs our shareholders interests in receiving such rights. Such justification is not required for any issue of new shares if:

- we increase our share capital against contributions in cash;
- the amount of the capital increase does not exceed 10% of our existing share capital; and
- the issue price is not significantly lower than the price for the shares quoted on a stock exchange.

Exclusion of Minority Shareholders

Under the provisions of Sections 327a *et seq.* of the German Stock Corporation Act concerning squeeze-outs, a shareholder who owns 95% of the issued share capital (a principal shareholder) may request that the annual shareholders meeting of a stock corporation or a partnership limited by shares resolve to transfer the shares of the other minority shareholders to the principal shareholder in return for adequate cash compensation. In a partnership limited by shares, the consent of the general partner(s) is not necessary for the effectiveness of the resolution. The amount of cash compensation to be paid to the minority shareholders must take account of the issuer s financial condition at the time the resolution is passed. The full value of the issuer, which is normally calculated using the capitalization of earnings method *(Ertragswertmethode)*, is decisive for determining the compensation amount.

In addition to the provisions for squeeze-outs of minority shareholders, Sections 319 *et seq.* of the German Stock Corporation Act provides for the integration of stock corporations. In contrast to the squeeze-out of minority shareholders, integration is only possible when the future principal company is a stock corporation with a stated domicile in Germany. A partnership limited by shares can not be integrated into another company.

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General Meeting

Our annual general meeting must be held within the first eight months of each fiscal year at the location of Fresenius Medical Care KGaA s registered office, or in a German city where a stock exchange is situated or at the location of a registered office of a domestic affiliated company. To attend the general meeting and exercise voting rights after the registration of the transformation, shareholders must register for the general meeting and prove ownership of shares. The relevant reporting date is the beginning of the 21st day prior to the general meeting.

Amendments to the Articles of Association

An amendment to our articles of association requires both a voting majority of 75% of the shares entitled to vote represented at the general meeting and the approval of the general partner.

DESCRIPTION OF AMERICAN DEPOSITARY RECEIPTS

The following description of our American Depositary Receipts discusses American Depositary Receipts evidencing our ordinary ADSs and our preference ADSs. As described below, however, under Stock Exchange Listing and Trading, we cannot assure holders of our preference ADSs that, after the conversion and the transformation, the preference ADSs of Fresenius Medical Care KGaA will be eligible for listing on the New York Stock Exchange or that we will be able to maintain an American Depositary Receipt facility for the preference shares of Fresenius Medical Care KGaA.

General

JPMorgan Chase Bank, N.A., a national banking association organized under the laws of the United States, is the depositary for our ordinary shares and preference shares. Each American Depositary Share (ADS) represents an ownership interest in one-third of one ordinary share or one-third of one preference share. We deposit the underlying shares with a custodian, as agent of the depositary, under the deposit agreements among ourselves, the depositary and all of the ADS holders of the applicable class. Each ADS also represents any securities, cash or other property deposited with the depositary but not distributed by it directly to ADS holders. The ADSs are evidenced by securities called American depositary receipts or ADRs. An ADR may be issued in either book-entry or certificated form by the depositary. If an ADR is issued in book-entry form, owners will receive periodic statements from the depositary showing their ownership interest in ADSs.

The depositary s office is located at 4 New York Plaza, New York, NY 10004, U.S.A.

An investor may hold ADSs either directly or indirectly through a broker or other financial institution. Investors who hold ADSs directly, by having an ADS registered in their names on the books of the depositary, are ADR holders. This description assumes an investor holds ADSs directly. Investors who hold ADSs through their brokers or financial institution nominees must rely on the procedures of their brokers or financial institutions to assert the rights of an ADR holder described in this section. Investors should consult with their brokers or financial institutions to find out what those procedures are.

Because the depositary s nominee will actually be the registered owner of the shares, investors must rely on it to exercise the rights of a shareholder on their behalf. The obligations of the depositary and its agents are set out in the deposit agreement. The deposit agreement and the ADSs are governed by New York law.

The deposit agreements establishing the ADR facilities for our ordinary shares and preference shares provide that, upon the conversion, the ordinary shares and preference shares of Fresenius Medical Care KGaA into which our ordinary shares and preference shares held by the depositary will be converted will continue to be treated as deposited securities under the respective deposit agreements. As a result, upon registration of the conversion, ADSs representing the right to receive our ordinary shares and preference shares will thereafter represent ADSs representing the right to ordinary and preference shares of Fresenius Medical Care KGaA, and ADRs evidencing our ADSs will thereafter evidence Fresenius Medical Care KGaA ADSs. With

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our consent, however, the depositary may require ADR holders to submit their ADRs and distribute new ADRs that evidence ADSs of Fresenius Medical Care KGaA. In the event the depositary elects to do so, holders of our ADRs will be notified by the depositary and provided with instructions to carry out such a conversion. We intend to carry out the conversion in a manner that does not result in a disruption of trading in our ordinary ADSs. Trading in the preference share ADSs is likely to be adversely affected by the conversion if the preference share ADSs are not listed on the New York Stock Exchange, and the lack of such a listing for the preference share ADSs could result in termination of the preference share ADS facility. See Stock Exchange Listing and Trading.

The following is a summary of the material terms of the deposit agreements. Because it is a summary, it does not contain all the information that may be important to investors. Except as specifically noted, the description covers both ordinary ADSs and, if we maintain an American Depositary Receipt facility for the preference shares of Fresenius Medical Care KGaA after the conversion and the transformation, preference ADSs. For more complete information, investors should read the entire applicable deposit agreements and the form of ADR of the relevant class which contains the terms of the ADS. Investors may obtain a copy of the deposit agreements at the SEC s Public Reference Room, located at 450 Fifth Street, N.W., Washington, D.C. 20549.

Share Dividends and Other Distributions

We may make different types of distributions with respect to our ordinary shares and our preference shares. The depositary has agreed to pay to investors the cash dividends or other distributions it or the custodian receives on the shares or other deposited securities, after deducting its expenses. Investors will receive these distributions in proportion to the number of underlying shares of the applicable class their ADSs represent.

Except as stated below, to the extent the depositary is legally permitted it will deliver distributions to ADR holders in proportion to their interests in the following manner:

Cash. The depositary shall convert cash distributions from foreign currency to U.S. dollars if this is permissible and can be done on a reasonable basis. The depositary will endeavor to distribute cash in a practicable manner, and may deduct any taxes or other governmental charges required to be withheld, any expenses of converting foreign currency and transferring funds to the United States, and certain other expenses and adjustments. In addition, before making a distribution the depositary will deduct any taxes withheld. If exchange rates fluctuate during a time when the depositary cannot convert a foreign currency, investors may lose some or all of the value of the distribution.

Shares. If we make a distribution in shares, the depositary will issue additional ADRs to evidence the number of ADSs representing the distributed shares. Only whole ADSs will be issued. Any shares which would result in fractional ADSs will be sold and the net proceeds will be distributed to the ADR holders otherwise entitled to receive fractional ADSs.

Rights to receive additional shares. In the case of a distribution of pre-emption rights to subscribe for ordinary shares or preference shares, or other subscription rights, if we provide satisfactory evidence that the depositary may lawfully distribute the rights, the depositary may arrange for ADR holders to instruct the depositary as to the exercise of the rights. However, if we do not furnish the required evidence or if the depositary determines it is not practical to distribute the rights, the depositary may:

- sell the rights if practicable and distribute the net proceeds as cash, or

- allow the rights to lapse, in which case ADR holders will receive nothing.

We have no obligation to file a registration statement under the U.S. Securities Act of 1933, as amended (the Securities Act) in order to make any rights available to ADR holders.

Other Distributions. If we make a distribution of securities or property other than those described above, the depositary may either:

- distribute the securities or property in any manner it deems fair and equitable;

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after consultation with us if practicable, sell the securities or property and distribute any net proceeds in the same way it distributes cash; or

hold the distributed property in which case the ADSs will also represent the distributed property.

Any U.S. dollars will be distributed by checks drawn on a bank in the United States for whole dollars and cents (fractional cents will be withheld without liability for interest and handled in accordance with the depositary s then current practices).

The depositary may choose any practical method of distribution for any specific ADR holder, including the distribution of foreign currency, securities or property, or it may retain the items, without paying interest on or investing them, on behalf of the ADR holder as deposited securities.

The depositary is not responsible if it decides that it is unlawful or impractical to make a distribution available to any ADR holders.

There can be no assurance that the depositary will be able to convert any currency at a specified exchange rate or sell any property, rights, shares or other securities at a specified price, or that any of these transactions can be completed within a specified time period.

Deposit, Withdrawal and Cancellation

The depositary will issue ADSs if an investor or his broker deposits ordinary shares or preference shares or evidence of rights to receive ordinary shares or preference shares with the custodian. Shares deposited with the custodian must be accompanied by certain documents, including instruments showing that such shares have been properly transferred or endorsed to the person on whose behalf the deposit is being made.

The custodian will hold all deposited shares for the account of the depositary. ADR holders thus have no direct ownership interest in the shares and only have the rights that are contained in the deposit agreements. The custodian will also hold any additional securities, property and cash received on or in substitution for the deposited shares. The deposited shares and any additional items are referred to as deposited securities.

Upon each deposit of shares, receipt of related delivery documentation and compliance with the other provisions of the deposit agreement, including the payment of the fees and charges of the depositary and any taxes or other fees or charges owing, the depositary will issue an ADR or ADRs of the applicable class in the name of the person entitled to them. The ADR or ADRs will evidence the number of ADSs to which the person making the deposit is entitled.

All ADSs issued will, unless specifically requested to the contrary, be part of the depositary s book-entry direct registration system, and a registered holder will receive periodic statements from the depositary which will show the number of ADSs registered in the holder s name. An ADR holder can request that the ADSs not be held through the depositary s direct registration system and that a certificated ADR be issued. Certificated ADRs will be delivered at the depositary s principal New York office or any other location that it may designate as its transfer office. If ADRs are in book-entry form, a statement setting forth the holder s ownership interest will be mailed to holders by the depositary.

When an investor surrenders ADSs at the depositary s office, the depositary will, upon payment of certain applicable fees, charges and taxes, and upon receipt of proper instructions, deliver the whole number of ordinary shares or preference shares represented by the ADSs turned in to the account the investor directs within Clearstream Banking AG, the central German clearing firm.

The depositary may restrict the withdrawal of deposited securities only in connection with:

temporary delays caused by closing our transfer books or those of the depositary, or the deposit of shares in connection with voting at a shareholders meeting, or the payment of dividends,

the payment of fees, taxes and similar charges, or

compliance with any U.S. or foreign laws or governmental regulations relating to the ADRs.

This right of withdrawal may not be limited by any other provision of the applicable deposit agreement.

Voting Rights

Only the depositary s nominee is able to exercise voting rights with respect to deposited shares. Upon receipt of a request from the depositary for voting instructions, a holder of ADSs may instruct the depositary how to exercise the voting rights for the shares which underlie the holder s ADSs. After receiving voting materials from us, the depositary will notify the ADR holders of any general shareholders meeting or solicitation of consents or proxies. The notice from the depositary will (a) contain such information as is contained in such notice and any solicitation materials, (b) state that each holder on the record date set by the depositary for notice and voting will be entitled to instruct the depositary as to the exercise of the voting rights, if any, pertaining to the whole number of deposited shares underlying such holder s ADRs and (c) specify how and the date by which such instructions may be given. For instructions to be valid, the depositary must receive them on or before the date specified in the depositary s request for instructions. The depositary s notice will also include an express indication that, if no specific voting instruction is received prior to the date set by the depositary for receipt of such instructions, then the holders shall in each case be deemed to have instructed the depositary to give a proxy to a designated bank, which will act as a proxy bank in accordance with Sections 128 and 135 of the German Stock Corporation Act (Aktiengesetz), to vote in accordance with its recommendation with regard to voting of the deposited shares pursuant to Section 128(2) of the German Stock Corporation Act (the Recommendation) as to any matter concerning which our notice to the depositary indicates that a vote is to be taken by holders of shares. The notice will also contain the proxy bank s Recommendation. However, no such deemed instruction shall be deemed given and no discretionary proxy shall be given with respect to any matter as to which we inform the depositary or (in the case of (y) or (z) below) the depositary reasonably believes that (x) we do not wish such proxy given, (y) substantial opposition exists or (z) the matter materially affects the rights of holders of shares. In addition, if the proxy bank fails or declines to supply the Recommendation to the depositary at least thirty (30) calendar days prior to any meeting of holders of deposited shares with respect to which we have notified the depositary, the depositary s notice shall not contain the Recommendation or the indication concerning the proxy to be given to the proxy bank and, if no specific voting instructions are received by the depositary from a holder with respect to the deposited shares, the depositary will not cast any vote at such meeting with respect to such deposited shares.

The depositary will try, as far as is practical, subject to the provisions of and governing the underlying shares or other deposited securities, to vote or to have its agents vote the shares or other deposited securities as instructed. The depositary will only vote or attempt to vote as holders instruct or are deemed to instruct, as described in the preceding paragraph. The depositary will not itself exercise any voting discretion. Neither the depositary nor its agents are responsible for any failure to carry out any voting instructions, for the manner in which any vote is cast or for the effect of any vote.

Our preference shares are non-voting, except in a limited number of circumstances. In those circumstances in which preference shares are entitled to vote, the procedures and limitations described above will apply in connection with the depositary s request for voting instructions from holders of ADSs resenting preference shares.

There is no guarantee that holders will receive voting materials in time to instruct the depositary to vote and it is possible that holders, or persons who hold their ADSs through brokers, dealers or other third parties, will not have the opportunity to exercise a right to vote.

Fees and Expenses

ADR holders will be charged a fee for each issuance of ADSs, including issuances resulting from distributions of shares, rights and other property, and for each surrender of ADSs in exchange for deposited securities. The fee in each case is $5.00 for each 100 ADSs (or any portion thereof) issued or surrendered.

The following additional charges shall be incurred by the ADR holders, by any party depositing or withdrawing shares or by any party surrendering ADRs or to whom ADRs are issued (including, without limitation, issuance pursuant to a stock dividend or stock split declared by the Company or an exchange of stock regarding the ADRs or the deposited securities or a distribution of ADRs), whichever is applicable:

to the extent not prohibited by the rules of any stock exchange or interdealer quotation system upon which the ADSs are traded, a fee of $1.50 per ADR or ADRs for transfers of certificated or direct registration ADRs;

a fee of $0.02 or less per ADS (or portion thereof) for any cash distribution made pursuant to the deposit agreement;

a fee of $0.02 per ADS (or portion thereof) per year for services performed, by the depositary in administering our ADR program (which fee shall be assessed against holders of ADRs as of the record date set by the depositary not more than once each calendar year and shall be payable in the manner described in the next succeeding provision);

any other charge payable by any of the depositary, any of the depositary s agents, including, without limitation, the custodian, or the agents of the depositary s agents in connection with the servicing of our shares or other deposited securities (which charge shall be assessed against registered holders of our ADRs as of the record date or dates set by the depositary and shall be payable at the sole discretion of the depositary by billing such registered holders or by deducting such charge from one or more cash dividends or other cash distributions);

a fee for the distribution of securities (or the sale of securities in connection with a distribution), such fee being in an amount equal to the fee for the execution and delivery of ADSs which would have been charged as a result of the deposit of such securities (treating all such securities as if they were shares) but which securities or the net cash proceeds from the sale thereof are instead distributed by the depositary to those holders entitled thereto;

stock transfer or other taxes and other governmental charges;

cable, telex and facsimile transmission and delivery charges incurred at your request;

transfer or registration fees for the registration of transfer of deposited securities on any applicable register in connection with the deposit or withdrawal of deposited securities;

expenses of the depositary in connection with the conversion of foreign currency into U.S. dollars; and

such fees and expenses as are incurred by the depositary (including without limitation expenses incurred in connection with compliance with foreign exchange control regulations or any law or regulation relating to foreign investment) in delivery of deposited securities or otherwise in connection with the depositary s or its custodian s compliance with applicable law, rule or regulation.

We will pay all other charges and expenses of the depositary and any agent of the depositary (except the custodian) pursuant to agreements from time to time between us and the depositary. The fees described above may be amended from time to time.

Payment of Taxes

ADR holders must pay any tax or other governmental charge payable by the custodian or the depositary on any ADS or ADR, deposited security or distribution. If an ADR holder owes any tax or other governmental charge, the depositary may (i) deduct the amount thereof from any cash distributions, or (ii) sell deposited securities and deduct the amount owing from the net proceeds of such sale. In either case the ADR holder remains liable for any shortfall. Additionally, if any tax or governmental charge is unpaid, the depositary may also refuse to effect any registration, registration of transfer, split-up or combination of deposited securities or withdrawal of deposited securities (except under limited circumstances mandated by securities regulations). If any tax or governmental charge is required to be withheld on any non-cash distribution, the depositary may sell the distributed property or securities to pay such taxes and distribute any remaining net proceeds to the ADR holders entitled thereto.

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By holding an ADR or an interest therein, holders will be agreeing to indemnify us, the depositary, its custodian and any of our or their respective directors, employees, agents and Affiliates against, and hold each of them harmless from, any claims by any governmental authority with respect to taxes, additions to tax, penalties or interest arising out of any refund of taxes, reduced rate of withholding at source or other tax benefit obtained.

DESCRIPTION OF THE PROPOSED POOLING ARRANGEMENTS

Fresenius Medical Care AG, Fresenius AG and the independent directors of Fresenius Medical Care AG are parties to two pooling agreements for the benefit of the holders of our ordinary shares and the holders of our preference shares (other than Fresenius AG and its affiliates). Upon consummation of the conversion and the transformation, we expect to enter into pooling arrangements that we believe will provide similar benefits for the holders of the ordinary shares and preference shares of Fresenius Medical Care KGaA. The following is a summary of the material provisions of the pooling arrangements which we expect to enter into with Fresenius AG and our independent directors.

General

The pooling arrangements will be entered into for the benefit of all persons who, from time to time, beneficially own our ordinary shares, including owners of ADSs evidencing our ordinary shares, other than Fresenius AG and its affiliates or their agents and representatives, and persons from time to time beneficially owning our preference shares (including, if we maintain an ADR facility for our preference shares after the transformation, ADSs evidencing our preference shares), other than Fresenius AG and its affiliates or their agents and representatives. Beneficial ownership is determined in accordance with the beneficial ownership rules of the SEC.

Independent Directors

Under the pooling arrangements, no less than one-third of the supervisory board of Management AG, the general partner of Fresenius Medical Care KGaA, must be independent directors, and there must be at least two independent directors. Independent directors are persons without a substantial business or professional relationship with us, Fresenius AG, or any affiliate of either, other than as a member of the supervisory board of Fresenius Medical Care KGaA or as a member of the supervisory board of Management AG. If an independent director resigns, is removed, or is otherwise unable or unwilling to serve in that capacity, a new person will be appointed to serve as an independent director in accordance with the provisions of our articles of association, the articles of association of the general partner, and the pooling arrangements, if as a result of the resignation or removal the number of independent directors falls below the required minimum.

Extraordinary Transactions

Under the pooling arrangements, we and our affiliates on the one hand, and Management AG and Fresenius AG and their affiliates on the other hand, must comply with all provisions of German law regarding: any merger, consolidation, sale of all or substantially all assets, recapitalization, other business combination, liquidation or other similar action not in the ordinary course of our business, any issuance of shares of our voting capital stock representing more than 10% of our total voting capital stock outstanding on a fully diluted basis, and any amendment to our articles of association which adversely affects any holder of ordinary shares or preference shares, as applicable.

Interested Transactions

We and Management AG and Fresenius AG have agreed that while the pooling arrangements are in effect, a majority of the independent directors must approve any transaction or contract, or any series of related transactions or contracts, between Fresenius AG or any of its affiliates, on the one hand, and us or our controlled affiliates, on the other hand, which involves aggregate payments in any year in excess of 5 million for each individual transaction or contract, or a related series of transactions or contracts. However, approval is not required if the transaction or contract, or series of related transactions or contracts, has been described in a business plan or budget that a majority of independent directors has previously approved. In any year in which the aggregate amount of transactions that require approval, or that would have required approval in that year but for the fact that such payment or other consideration did not exceed 5 million, has exceeded 25 million, a majority of the independent directors must approve all further interested transactions involving more than 2.5 million. However, approval is not required if the transaction or contract, or series of related transactions or contracts, has been described in a business plan or budget that a majority of independent directors has previously approved.

Listing of American Depositary Shares; SEC Filings

During the term of the pooling agreement, Fresenius AG has agreed to use its best efforts to exercise its rights as the direct or indirect holder of the general partner interest in Fresenius Medical Care KGaA to cause us to, and we have agreed to:

maintain the effectiveness of (i) the deposit agreement for the ordinary shares, or a similar agreement, and to assure that the ADSs evidencing the ordinary shares are listed on either the New York Stock Exchange or the Nasdaq Stock Market and (ii) if the preference shares remain eligible for listing on the New York Stock Exchange after the transformation, the deposit agreement for the preference shares, or a similar agreement, and to assure that the ADSs evidencing the preference shares are listed on either the New York Stock Exchange or the Nasdaq Stock Market;

file all reports, required by the New York Stock Exchange or the Nasdaq Stock Market, as applicable, the Securities Act, the Securities Exchange Act of 1934, as amended, and all other applicable laws;

prepare all financial statements required for any filing in accordance with generally accepted accounting principles of the U.S. (U.S. GAAP);

on an annual basis, prepare audited consolidated financial statements including, without limitation, a balance sheet, a statement of income and retained earnings, and a statement of changes in financial position, and all appropriate notes, all in accordance U.S. GAAP, and, on a quarterly basis, prepare and furnish consolidated financial statements prepared in accordance with U.S. GAAP;

furnish materials with the SEC with respect to annual and special shareholder meetings under cover of Form 6-K and make the materials available to the depositary for distribution to holders of ordinary share ADSs, and, if we maintain a preference share ADR facility, to holders of preference share ADSs at any time that holders of preference shares are entitled to voting rights; and

make available to the depositary for distribution to holders of ADSs representing our ordinary shares and, if we maintain a preference share ADR facility, ADSs representing our preference shares on an annual basis, a copy of any report prepared by the supervisory board or the supervisory board of the general partner and provided to our shareholders generally pursuant to Section 314(2) of the German Stock Corporation Act, or any successor provision. These reports concern the results of the supervisory board s examination of the managing board s report on our relation with affiliated enterprises.

Term

The pooling arrangements will terminate if:

Fresenius AG or its affiliates acquire all our voting capital stock;

Fresenius AG s beneficial ownership of our outstanding share capital is reduced to less than 25%;

Fresenius AG or an affiliate of Fresenius AG ceases to own the general partner interest in Fresenius Medical Care KGaA; or we no longer meet the minimum threshold for obligatory registration of the ordinary shares or ADSs representing our ordinary shares and the preference shares or ADSs representing our preference shares, as applicable, under Section 12(g)(1) of the Securities Exchange Act of 1934, as amended, and Rule 12g-1 thereunder.

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Amendment

Fresenius AG and a majority of the independent directors may amend the pooling arrangements, *provided*, that beneficial owners of 75% of the ordinary shares held by shareholders other than Fresenius AG and its affiliates at a general meeting of shareholders and 75% of the preference shares at a general meeting of preference shareholders, as applicable, approve such amendment.

Enforcement; Governing Law

The pooling arrangements are governed by New York law and may be enforced in the state and federal courts of New York. The Company and Fresenius AG have confirmed their intention to abide by the terms of the pooling arrangements as described above.

Directors and Officers Insurance

Subject to any mandatory restrictions imposed by German law, Fresenius Medical Care AG has obtained and Fresenius Medical Care KGaA will continue to maintain directors and officers insurance in respect of all liabilities arising from or relating to the service of the members of the supervisory board and our officers. We believe that our acquisition of that insurance is in accordance with customary and usual policies followed by public corporations in the U.S.

STOCK EXCHANGE LISTING AND TRADING

Both classes of our shares are currently listed on the Frankfurt Stock Exchange on the official market (*Amtlicher Markt*), with trading on the Prime Standard, the sub-segment of the official market with additional post-admission obligations. In addition, the shares are included in the electronic trading system Xetra. American Depositary Shares (ADSs), which represent our ordinary or preference shares, are listed on the New York Stock Exchange. Three ADSs correspond to one share.

Effect of the Conversion of the Preference Shares into Ordinary Shares

By law, the conversion will occur upon registration with the commercial register of the Company of the relevant amendments to the articles of association approved at the shareholder meetings on August 30, 2005. The ordinary shares to be acquired by preference shareholders participating in the conversion will become available only as a result of such registration.

The ordinary shares that will be held by shareholders participating in the conversion offer are not at this time admitted to the Frankfurt Stock Exchange. They will, together with our other ordinary and preference shares, be admitted to the Frankfurt Stock Exchange directly after the transformation into a KGaA. We intend to arrange for the registration of the transformation immediately following registration of the conversion.

Stock Exchange Listing of the Shares of Fresenius Medical Care KGaA

The transformation of the Company into the legal form of a KGaA will become effective upon being registered with the commercial register of the Company. Shareholders in Fresenius Medical Care AG, at the time of the registration of the transformation of legal form in the commercial register will thereupon become shareholders in Fresenius Medical Care KGaA. They will participate to the same extent and with the same number of shares in Fresenius Medical Care KGaA as they did in Fresenius Medical Care AG prior to the transformation becoming effective.

Because all of our shares are maintained in collective securities accounts and by depositary banks for each shareholder, the transformation of our ordinary shares or preference shares into ordinary shares or preference shares in Fresenius Medical Care KGaA will likewise take place exclusively through the collective accounts. The transformation will be dealt with by Clearstream Banking AG, Frankfurt am Main, by entries in the securities accounts of the shareholders by the depositary banks in each case. Shareholders will be informed of the changed entries. The existing shares in Fresenius Medical Care AG will be delisted from the Frankfurt Stock Exchange on registration of the transformation of legal form in the commercial register. We will admit both the ordinary shares and the preference shares in Fresenius Medical Care KGaA again to stock exchange trading on the Frankfurt Stock Exchange on the sub-segment of the official market, the Prime Standard listing section, directly after the transformation of legal form has become effective. We will then endeavor to ensure that the new admission takes place immediately after the transformation of legal form becomes effective and therefore that the usual stock exchange tradability both of the ordinary and the preference shares in the Company is secured at all times.

Under the deposit agreements establishing the American Depositary Receipt facilities for our ordinary shares and preference shares, upon effectiveness of the transformation, the ordinary shares and preference shares of Fresenius Medical Care KGaA into which the ordinary shares and preference shares of Fresenius Medical Care AG held by the depositary will be transformed will continue to be treated as deposited securities under the respective deposit agreements. As a result, American Depositary Shares (ADSs) representing the right to receive ordinary shares and preference shares of Fresenius Medical Care AG will, upon registration of the transformation, thereafter represent the right to ordinary and preference shares of Fresenius Medical Care KGaA, and ADRs evidencing Fresenius Medical Care AG ADSs will thereafter evidence Fresenius Medical Care KGaA ADSs. The Depositary, however, may, with our consent, require ADR holders to submit their ADRs and distribute new ADRs that evidence ADS of Fresenius Medical Care KGaA, which represent ordinary and preference shares in Fresenius Medical Care KGaA. In the event the depositary elects to do so, holders of Fresenius Medical Care AG ADRs will be notified by the depositary and provided with instructions to carry out such an exchange.

American Depositary Shares representing Fresenius Medical Care KGaA shares have been approved for listing on the New York Stock Exchange subject to official notice of issuance and, on the case of preference shares ADSs, satisfaction of that exchange s distribution criteria. However, we cannot assure you that the preference ADSs of Fresenius Medical Care KGaA will be eligible for listing on that exchange if the number of outstanding preference shares decreases substantially due to conversion of preference shares into ordinary shares. In addition, if substantially all of the preference shares are converted, we may terminate the deposit agreement for the preference shares, or the depositary may resign due to the substantially reduced compensation it is likely to receive for its services in such circumstances. While we will endeavor to provide for continuation of a U.S. trading market for the preference shares of Fresenius Medical Care KGaA outstanding after the conversion, if they are not eligible for New York Stock Exchange listing, if the depositary resigns as depositary for the preference shares and we are unable to designate a replacement depositary, or if we otherwise terminate the preference share deposit agreement, it is likely that a U.S. trading market for the preferences ADSs will cease to be available.

German Corporate Governance Code

Under the German Stock Corporation Act, the management board and the supervisory board of a company listed on a German stock exchange must make an annual declaration regarding their compliance with the recommendations of the Government Commission German Corporate Governance Code published by the Ministry of Justice in the official part of the electronic Federal Gazette. This Code provides important regulations for the management and supervision of companies and includes statutory provisions and additional recommendations and suggestions regarding corporate governance. Only the statutory provisions are binding, but listed companies must declare whether their governance practices deviate from the recommendations. We issued our most recent declaration as of December 2005, in which we declared that we comply with the recommendations, subject to certain exceptions. Our declaration is available on our website. Because the Code is designed to apply to listed stock corporations, we will comply with it in modified form after the transformation becomes effective. The general partner and the supervisory board will make a new declaration of compliance which will describe the exceptions and take account of the special characteristics of the KGaA. The new declaration of compliance will not include an exception regarding disclosure of the individual remuneration of board members. The general partner has agreed to provide this information in connection with the settlement of the shareholder litigation. See The

Conversion and Transformation; Effects Settlement of the Proceedings to Set Aside the Resolutions of the Extraordinary General Meeting of August 30, 2005.

SERVICE OF PROCESS AND ENFORCEABILITY OF CIVIL LIABILITIES

We are a German company. Some of our directors and executive officers and some of the experts named in this prospectus are residents of Germany. A substantial portion of our assets and the assets of those individuals is located outside the U.S. As a result, it may be difficult or impossible for investors to effect service of process upon those persons within the U.S. with respect to matters arising under the U.S. federal securities laws or to enforce against them in U.S. courts judgments of U.S. courts predicated on the civil liability provisions of the U.S. federal securities laws. We have been advised by our German counsel, Nörr Stiefenhofer Lutz, that there may be doubt as to the enforceability in Germany, in original actions, of liabilities predicated on the U.S. federal securities laws and that in Germany both recognition and enforcement of court judgments with respect to the civil liability provisions of the U.S. federal securities laws are solely governed by the provisions of the German Civil Procedure Code (*Zivilprozessordnung*). In some cases, especially when according to the German statutory provisions, the international jurisdiction of the U.S. court will not be recognized or if the judgment conflicts with basic principles of German law (e.g., the restrictions to compensatory damages and pre-trial discovery), the U.S. judgment might not be recognized by a German court. The service of process in U.S. proceedings on persons in Germany is regulated by a multilateral treaty guaranteeing service of writs and other legal documents in civil cases if the current address of the defendant is known.

EXPERTS

Our consolidated financial statements and schedule as of December 31, 2004 and 2003, and for each of the years in the three-year period ended December 31, 2004, included in the Fresenius Medical Care AG amended annual report on Form 20-F/ A for the year ended December 31, 2004, have been incorporated by reference herein in reliance upon the report of KPMG Deutsche Treuhand-Gesellschaft Aktiengesellschaft Wirtschaftprüfungsgesellschaft, independent registered public accounting firm, incorporated by reference herein, and upon the authority of said firm as experts in accounting and auditing.

The consolidated financial statements of Renal Care Group, Inc. at December 31, 2004 and 2003, and for each of the three years in the period ended December 31, 2004, appearing in this prospectus and registration statement have been audited by Ernst & Young LLP, independent registered public accounting firm, as set forth in their report thereon appearing elsewhere herein, and are included in reliance upon such report given on the authority of such firm as experts in accounting and auditing.

LEGAL MATTERS

Nörr Stiefenhofer Lutz, as our special German counsel, will pass upon the validity of the ordinary shares in connection with the conversion. Dr. Dieter Schenk, a member of the firm Nörr Stiefenhofer Lutz, is a member and deputy chairman of our supervisory board. Dr. Schenk is also a member of the supervisory board of Fresenius AG and one of the executors of the estate of Mrs. Else Kröner. The Else-Kröner Fresenius Stiftung, a charitable foundation established under the will of Mrs. Kröner, owns the majority of the voting shares of Fresenius AG, our controlling shareholder. Its voting rights are exercised by the executors of Mrs. Kröner s estate, currently Dr. Dieter Schenk and Dr. Karl Schneider (another member of the Fresenius AG supervisory board). Dr. h.c. Hans Kröner has resigned as executor of the estate; the court will appoint an additional executor to replace Dr. h.c. Hans Kröner. Our supervisory board member Dr. Bernd Fahrholz was a member of the firm Nörr Stiefenhofer Lutz until September 30, 2005.

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APPENDIX A-1

Unaudited pro forma condensed combined financial information of Fresenius Medical Care AG & Renal Care Group, Inc.

The unaudited *pro forma* condensed combined financial statements are based on the audited financial statements of each of Fresenius Medical Care AG (Fresenius Medical Care or FMC-AG) and Renal Care Group, Inc. (Renal Care Group or RCG), which are, in the case of Fresenius Medical Care, included in Fresenius Medical Care s amended Annual Report on Form 20-F for the year ended December 31, 2004 and, in the case of Renal Care Group, included in the Form 10-K for the year ended December 31, 2004 and unaudited financial statements of each of Fresenius Medical Care and Renal Care Group, which are, in the case of Fresenius Medical Care, included in Fresenius Medical Care s Quarterly Report in the Form 6-K for the quarter ended September 30, 2005 and, in the case of Renal Care Group, included in the Form 10-Q for the quarter ended September 30, 2005.

References to the Renal Care Group Acquisition mean the consummation of the Renal Care Group acquisition, borrowings under the new senior credit agreement, which we anticipate entering into, of the amount required to finance the acquisition and the payment of all fees and expenses related to such acquisition and borrowings. Borrowings also include a new credit facility with the European Investment Bank (EIB) to fund certain FMC-AG capital investment projects. EIB borrowings would be in lieu of borrowings under the new senior credit facilities. The unaudited *pro forma* condensed combined financial statements give effect to the Renal Care Group Acquisition (assuming that all of the required financing is obtained through the new senior credit agreement) as if each had occurred on January 1, 2004 in the case of the unaudited *pro forma* condensed combined income statement for the year ended 2004 and for the first nine months ended September 30, 2005, or on September 30, 2005 in the case of the unaudited pro forma condensed combined balance sheet data as of September 30, 2005.

The *pro forma* adjustments are based upon available information, preliminary estimates and certain assumptions that we believe are reasonable and are described in the accompanying notes to the unaudited pro forma condensed combined financial statements. The unaudited *pro forma* condensed combined financial statements do not take into account (i) any synergies or cost savings that may or are expected to occur as a result of the Renal Care Group Acquisition or (ii) any cash or non-cash charges that we may incur in connection with the Renal Care Group Acquisition, the level and timing of which cannot yet be determined. The unaudited *pro forma* condensed combined financial statements have been prepared in accordance with SEC rules and regulations.

The unaudited *pro forma* condensed combined financial statements assume that the Renal Care Group Acquisition would be accounted for using the purchase method of accounting in accordance with the Financial Accounting Standards Board, or FASB, Statement No. 141, Business Combinations, or SFAS No. 141, and the resultant goodwill and other intangible assets will be accounted for under FASB Statement No. 142, Goodwill and Other Intangible Assets, or SFAS No. 142. The total purchase price has been preliminarily allocated based on information available to us as of the date hereof, to the tangible and intangible assets acquired and liabilities assumed based on management s preliminary estimates of their current fair values. These estimates and assumptions of fair values of assets acquired and liabilities assumed and related operating results are subject to change that could result in material differences between the actual amounts and those reported in the unaudited *pro forma* condensed combined financial statements.

The unaudited *pro forma* condensed combined financial statements do not consider the transformation and conversion of preference shares into common shares. The effects of the conversion are presented in the tables in the paragraph Capitalization and Indebtedness.

The unaudited *pro forma* condensed combined financial statements are provided for illustrative purposes only and are subject to a number of uncertainties and assumptions and do not purport to represent what the combined companies actual performance or financial position would have been had the transactions occurred on the dates indicated and do not purport to indicate financial position or results of operations as of any future date or for any future period.

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Pro Forma Condensed Combined Balance Sheet
At September 30, 2005

	Historical FMC-AG	Historical RCG	Pro forma adjustments (1)	Pro forma combined balance sheet
		(unaudited) ($ in millions)		
Assets				
Current assets				
Cash and cash equivalents	80	26	$	106
Trade accounts receivable, less allowance for doubtful accounts	1,456	287		1,743
Accounts receivable from related parties	77			77
Inventories	448	34		482
Prepaid expenses and other current assets	273	34		307
Deferred taxes	192	36		228
Total current assets	**2,526**	**417**	**0**	**2,943**
Property, plant and equipment, net	1,160	355		1,515
Intangible assets	591	38	175 (c)	804
Goodwill	3,460	824	2,650 (c)	6,934
Deferred taxes	36			36
Other assets	196	8	(16)(a)	249
			61 (b)	
Total assets	**7,969**	**1,642**	**$ 2,870**	**12,481**
Liabilities and shareholders equity				
Current liabilities				
Accounts payable	187	34		$ 221
Accounts payable to related parties	149			149
Accrued expenses and other current liabilities	808	177		985
Short-term borrowings	177		306 (e)	483
Short-term borrowings from related parties	5			5
Current portion of long-term debt and capital lease obligations	118	37	(100)(d)	18
			(37)(d)	
Income tax payable	175	3	(6)(a)	86
			(86)(c)	
Deferred taxes	39			39
Total current liabilities	**1,658**	**251**	**77**	**1,986**
Long-term debt and capital lease obligations, less current portion	757	567	(404)(d)	4,758
			(567)(d)	

			296 (e)	
			2,000 (e)	
			2,000 (e)	
			109 (e)	
Other liabilities	93	15		108
Pension liabilities	97			97
Deferred taxes	315	51	70 (c)	436
Company-obligated mandatorily redeemable preferred securities of subsidiary Fresenius Medical Care Capital Trusts holding solely Company-guaranteed debentures of subsidiaries	1,205			1,205
Minority interest	14	57		71
Total liabilities	**4,139**	**941**	**3,581**	**8,661**
Shareholders equity				
Preference shares	73			73
Ordinary shares	229	1	(1)(c)	229
Treasury stock		(382)	382 (c)	0
Additional paid-in capital	2,793	432	(432)(c)	2,793
Retained earnings	860	649	(10)(a)	850
			(649)(c)	
Accumulated other comprehensive (loss) income	(125)	1	(1)(c)	(125)
Total shareholders equity	**3,830**	**701**	**(711)**	**3,820**
Total liabilities and shareholders equity	**7,969**	**1,642**	**$ 2,870**	**12,481**

(1) The unaudited *pro forma* condensed combined financial statements give effect to the Renal Care Group Acquisition and the new Senior Credit Facilities.

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Notes to unaudited pro forma condensed combined balance sheet

(a) Write-off of the existing deferred financing costs associated with the extinguishment of our existing senior credit agreement as set forth in the table below:

Deferred financing costs	**September 30, 2005**
	($ in millions)
Deferred financing costs	16
Less current income taxes	(6)
	10

(b) Capitalized estimated deferred financing costs associated with the new senior credit agreement of $61 million.

(c) The purchase of the outstanding shares on a fully diluted basis of Renal Care Group for $3,502 million in cash plus an additional $40 million of direct acquisition cost as set forth in the table below:

Acquisition cost	**September 30, 2005**
	($ in millions)
Goodwill	2,650
Patient relationships	175
Deferred taxes on patient relationships	(70)
Lower income taxes payable due to exercise of options prior to completion of acquisition	86
Net assets RCG as of September 30, 2005	701
Acquisition cost	3,542

For purposes of this *pro forma*, we estimated that the amounts for the assets and liabilities reflected on Renal Care Group s combined balance sheet approximate the fair values of such assets and liabilities and accordingly, such amounts have not been adjusted in the accompanying *pro forma* financial information. We believe our estimates and underlying assumptions of the initial purchase price allocations and fair values of Renal Care Group s assets and liabilities provide our current best estimate and are based upon the information available to us at this time. However, these valuations are preliminary and subject to change based upon completion of a final valuation analysis. Additionally, the final purchase price is subject to adjustments. Accordingly, the final amounts will differ from the amounts shown above.

Historical experience from prior acquisitions led to the recognition of patient relationships as intangible assets at an amount of approximately 5% of those acquisition costs.

Prior to the consummation of the acquisition of Renal Care Group stock options of Renal Care Group will be exercised. A resulting tax benefit of $86 million is reflected in the purchase price allocation as a reduction of income taxes payable.

(d) The refinancing of our existing senior credit agreement and of the debt of RCG as set forth in the table below:

Refinancing of existing senior credit agreement and of the debt of RCG	**September 30, 2005**
	($ in millions)
	100

Refinancing of existing credit agreement of FMC AG Current portion of long-term debt	
Long-term debt, less current portion	404
Refinancing total financial debt RCG Current portion of long-term debt	37
Long-term debt, less current portion	567
Total	1,108

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(e) The borrowing under the new senior credit agreement, the additional EIB loan and the existing accounts receivable facility in order to finance the acquisition of Renal Care Group as well as the repayment of the old senior credit agreement and the debt of Renal Care Group as set forth in the table below:

Funding	**September 30, 2005**
	($ in millions)
New revolver	296
Bank loan A	2,000
Bank loan B	2,000
Additional EIB loan	109
Additional A/ R facility	306
Total	4,711

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Pro Forma Condensed Combined Statement of Income
For the year ended December 31, 2004

	Historical FMC-AG	Historical RCG	Pro Forma Adjustments(1)	Pro Forma Combined
		(unaudited) ($ in millions, except per share data)		
Net revenue				
Dialysis Care	4,501	1,345		5,846
Dialysis Products	1,727		(50)(a)	1,677
	6,228	1,345	(50)	7,523
Costs of revenue				
Dialysis Care	3,232	934		4,166
Dialysis Products	910		(44)(a)	866
	4,142	934	(44)	5,032
Gross profit	2,086	411	(6)	2,491
Operating expenses				
Selling, general and administrative	1,182	157	35(b)	1,374
Research and development	52			52
Operating income	852	254	(41)	1,065
Other (income) expense				
Interest income	(14)			(14)
Interest expense	197	21	(50)(c)	445
			(4)(d)	
			281 (e)	
	183	21	227	431
Income before income taxes and minority interest	669	233	(268)	634
Income tax expense	266	76	(106)(f)	236
Minority interest	1	35		36
Net income	402	122	(162)	362
Basic income per Ordinary share	4.16			3.74
Fully diluted income per Ordinary share	4.14			3.72
Basic income per Preference share	4.23			3.87
Fully diluted income per Preference share	4.21			3.80
	70,000,000			70,000,000

Weighted average number of Ordinary shares outstanding		
Weighted average number of Preference shares outstanding	26,243,059	26,243,059
Total weighted average shares outstanding	96,243,059	96,243,059
Total weighted average shares outstanding assuming dilution	96,664,967	96,664,967
Total weighted average Preference shares outstanding assuming dilution	26,664,967	26,664,967

(1) The unaudited *pro forma* condensed combined financial statements give effect to the Renal Care Group Acquisition and the new Senior Credit Facilities.

Notes to unaudited pro forma condensed combined income statement for the year ended December 31, 2004

(a) Reflects the elimination of sales of dialysis machines and disposables from Fresenius Medical Care to Renal Care Group, the elimination of cost of revenue at Renal Care Group regarding the purchase of disposables from Fresenius Medical Care and the elimination of cost of revenue at Fresenius Medical Care regarding sales of dialysis machines to Renal Care Group and adjustments to depreciation of dialysis machines at Renal Care Group.

(b) Reflects amortization expense associated with the intangible asset. The patient relationships are being amortized over five years as set forth in the table below:

Patient relationships	Acquisition Costs	Amortization Period	Amortization per Annum
	($ in millions, except amortization period)		
Patient relationships	175	5	35

(c) Reflects the elimination of interest expense of \$50 million that was recognized on the existing 2003 senior credit agreement to be refinanced and extended and on the debt of Renal Care Group.

(d) Reflects the elimination of amortization of deferred financing costs of \$4 million that was recognized on the previous existing 2003 senior credit agreement.

(e) Reflects interest expense of \$275 million and the amortization of deferred financing costs of \$6 million associated with borrowings from the new senior credit agreement of \$4,330 million as of December 31, 2004, from the EIB loan of \$178 million and increased borrowings under the existing accounts receivable securitization facility of \$84 million. The revolving credit facility is assumed to bear interest at LIBOR plus a margin of 137.5 bps for an annual weighted average interest rate of 5.15%. For the \$2,000 million of term loan A and for \$465 million of term loan B, we entered into interest rate swaps converting LIBOR into an average fixed rate of 4.3223%. Including a margin of 137.5 bps for term loan A and 175 bps for term loan B, the annual weighted average interest rate is 5.70% for term loan A and 6.07% for such portion of term loan B. \$940 million of term loan B is assumed to bear interest at LIBOR plus a margin of 175 bps for an annual weighted interest rate of 5.53%. For the remaining \$595 million of term loan B we will enter into interest rate swaps changing LIBOR into a fixed rate. Assuming an interest rate swap at 4.871% plus the margin of 175 bps the annual weighted average interest rate is 6.62%. The EIB loan is assumed to bear interest at LIBOR plus a margin of 57 bps for an annual weighted average interest rate of 4.35%. The accounts receivable securitization facility is assumed to bear an annual weighted interest rate of 4.00%. If interest rates were to hypothetically change by $^{1}/8$%, it is estimated that our interest expense would vary by approximately \$2 million.

(f) Reflects the adjustment to the income tax expense amount of \$106 million based on the overall impact of the *pro forma* adjustments at 39.7%.

Nonrecurring Charges

The unaudited *pro forma* condensed combined financial statements do not reflect material nonrecurring charges or credits which result directly from the transaction and which will impact the income statement during the next 12 months. Nonrecurring charges, which are not reflected in the condensed combined income statement for the year ended December 31, 2004, include \$17 million for the write-off of the existing deferred financing costs associated with the extinguishment of our existing senior credit agreement and restructuring costs of \$50 million.

The payments to minority shareholders of \$8 million, which will be funded by Fresenius AG but which will, under U.S. GAAP, be shown as our expense, and the related court fees and shareholder legal expenses of \$2.5 million (excluding our costs for legal advice and legal defense), which we agreed to pay in connection with the settlement of the litigation with minority shareholders with respect to the share conversion and transformation of legal form, are also non-recurring and are not reflected in the income statement for the twelve months ended December 31, 2004.

For further discussion of nonrecurring charges, see notes to unaudited *pro forma* combined consolidated income statement for the nine months ended September 30, 2005.

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Pro Forma Condensed Combined Statement of Income
For the nine months ended September 30, 2005

	Historical FMC-AG	Historical RCG	Pro forma Adjustments(1)	Pro forma Combined Income Statement
	(unaudited) ($ in millions, except per share data)			
Net revenue:				
Dialysis Care	3,610	1,160		4,770
Dialysis Products	1,389		(44)(a)	1,345
	4,999	**1,160**	**(44)**	**6,115**
Costs of revenue:				
Dialysis Care	2,574	808		3,382
Dialysis Products	706		(40)(a)	666
	3,280	**808**	**(40)**	**4,048**
Gross profit	1,719	352	(4)	2,067
Operating expenses:				
Selling, general and administrative	984	138	26 (b)	1,148
Research and development	40			40
Operating income	**695**	**214**	**(30)**	**879**
Other (income) expense:				
Interest income	(11)			(11)
Interest expense	138	23	(46)(c)	324
			(3)(d)	
			212 (e)	
	127	**23**	**163**	**313**
Income before income taxes and minority interest	568	191	(193)	566
Income tax expense	227	65	(77)(f)	215
Minority interest	2	29		31
Net income	**339**	**97**	**(116)**	**320**
Basic income per Ordinary share	3.50			3.31
Fully diluted income per Ordinary share	3.48			3.28
Basic income per Preference share	3.56			3.37

Fully diluted income per Preference share	3.53	3.34
Weighted average number of Ordinary shares outstanding	70,000,000	70,000,000
Weighted average number of Preference shares outstanding	26,421,404	26,421,404
Total weighted average shares outstanding	96,421,404	96,421,404
Total weighted average shares outstanding assuming dilution	97,178,196	97,178,196
Total weighted average Preference shares outstanding assuming dilution	27,178,196	27,178,196

(1) The unaudited *pro forma* condensed combined financial statements give effect to the Renal Care Group Acquisition and the new Senior Credit Facilities.

Notes to unaudited pro forma condensed combined income statement for the nine months ended September 30, 2005

(a) Reflects the elimination of sales of dialysis machines and disposables from Fresenius Medical Care to Renal Care Group, the elimination of cost of revenue at Renal Care Group regarding the purchase of disposables from Fresenius Medical Care and the elimination of cost of revenue at Fresenius Medical Care regarding sales of dialysis machines to Renal Care Group and adjustments to depreciation of dialysis machines at Renal Care Group.

(b) Reflects amortization expense associated with the intangible asset. The patient relationships are being amortized over five years as set forth in the table below:

Patient Relationships	Acquisition Costs	Amortization Period	Amortization per Annum
	($ in millions, except amortization period)		
Patient relationships	175	5	35

The amortization for the nine months ended September 30, 2005 reflected in the *pro forma* statement amounts to $26 million.

(c) Reflects the elimination of interest expense of $46 million that was recognized on the existing 2003 senior credit agreement to be refinanced and extended and on the debt of Renal Care Group.

(d) Reflects the elimination of amortization of deferred financing costs of $3 million that was recognized on the previous existing 2003 senior credit agreement.

(e) Reflects interest expense of $207 million and the amortization of deferred financing costs of $5 million associated with borrowings from the new senior credit agreement of $4,296 million as of September 30, 2005, from the increased EIB loan of $109 million and increased borrowings under the existing accounts receivable securitization facility of $306 million. The revolving credit facility is assumed to bear interest at LIBOR plus a margin of 137.5bps for an annual weighted average interest rate of 5.15%. For the $2,000 million of term loan A and for $465 million of term loan B, we entered into interest rate swaps converting LIBOR into an average fixed rate of 4.3223%. Including a margin of 137.5 bps for term loan A and 175 bps for term loan B, the annual weighted average interest rate is 5.70% for term loan A and 6.07% for such portion of term loan B. $940 million of term loan B is assumed to bear interest at LIBOR plus a margin of 175 bps for an annual weighted interest rate of 5.53%. For the remaining $595 million of term loan B we will enter into interest rate swaps changing LIBOR into a fixed rate. Assuming an interest rate swap at 4.871% plus the margin of 175 bps the annual weighted average interest rate is 6.62%. The EIB loan is assumed to bear interest at LIBOR plus a margin of 57 bps for an annual weighted average interest rate of 4.35%. The accounts receivable securitization facility is assumed to bear an annual weighted interest rate of 4.00%. If interest rates were to hypothetically change by $^1/_8$%, it is estimated that our interest expense would vary by approximately $2 million.

(f) Reflects the adjustment to the income tax expense amount of $77 million based on the overall impact of the *pro forma* adjustments at 40.0%.

Nonrecurring Charges

The unaudited *pro forma* condensed combined financial statements do not reflect material nonrecurring charges or credits which result directly from the transaction and which will impact the income statement during the next 12 months. Nonrecurring charges, which are not reflected in the condensed combined income statement for the nine months ended September 30, 2005, include $19 million for the write-off of the existing deferred financing costs associated with the extinguishment of our existing senior credit agreement and restructuring costs of $50 million.

The payments to minority shareholders of $8 million, which will be funded by Fresenius AG but which will, under U.S. GAAP, be shown as our expense, and the related court fees and shareholder legal expenses of $2.5 million (excluding our costs for legal advice and legal defense), which we agreed to pay in connection

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with the settlement of the litigation with minority shareholders with respect to the share conversion and transformation of legal form, are also non-recurring and are not reflected in the income statement for the nine months ended September 30, 2005.

The conversion of interests held and related adjustments under the employee participation programs are necessary due to the conversion of preference shares into ordinary shares. The employee stock options, which currently entitle the holders to purchase preference shares, will be modified to an entitlement to purchase ordinary shares. If the conversion of employee stock options on preference shares into stock options on ordinary shares occurs in 2005, this would result in additional compensation expense. Under our current accounting policy, which is based on the guidance in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, (APB 25), the modification is expected to result in a new measurement date for the awards converted. Based on the market value of the Company s ordinary shares at September 30, 2005 and 100% acceptance of the exchange offer, additional compensation expense of $40.3 million for 2005 would result from the modification.

However, the Company does not expect to record this additional compensation expense in future financial statements under APB 25 due to the planned implementation of SFAS 123(R), *Share-Based Payment*, should the stock options be converted in 2005. The Company expects compensation expense after the adoption of SFAS 123(R) to be in line with the Company s SFAS 123(R) *pro forma* disclosures in the annual report on Form 20-F for the year ended December 31, 2004.

As a result of the conversion of the Company s preference shares into ordinary shares, the earnings per share calculation needs to reflect the difference between the market value of the ordinary shares less the conversion premium of 9.75 and the carrying value of the preference shares at the exchange date as an increase of income available to preference shareholders and as a reduction of income available to ordinary shareholders. This difference represents the preference shareholders benefit over their historic investment, retained earnings and the conversion premium paid. The benefit to the preference shareholders and the reduction of income available to ordinary shareholders will depend on the market price for ordinary shares at the date of the conversion and the number of preference shares converted into ordinary shares. Based on the market value of the Company s ordinary shares at September 30, 2005 and 100% acceptance of the conversion offer, the benefit for the preference shareholders would be $19.96 and the reduction for the ordinary shareholders would be $7.76.

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APPENDIX A-2

RENAL CARE GROUP, INC.
Condensed Consolidated Balance Sheets
(in thousands, except per share data)

	December 31, 2004	September 30, 2005
		(unaudited)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 17,931	$ 25,490
Accounts receivable, net	275,373	286,773
Inventories	23,359	33,953
Prepaid expenses and other current assets	26,817	34,020
Deferred income taxes	29,604	36,387
Total current assets	373,084	416,623
Property, plant and equipment, net	316,532	354,910
Intangible assets, net	34,320	37,942
Goodwill	694,264	824,022
Other assets	10,780	8,331
Total assets	$ 1,428,980	$ 1,641,828
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 139,929	$ 151,368
Due to third-party payors	80,007	62,535
Current portion of long-term debt	23,969	36,597
Total current liabilities	243,905	250,500
Long-term debt, net of current portion	479,645	566,696
Deferred income taxes	51,419	51,046
Other long-term liabilities	16,271	15,495
Minority interest	45,619	57,406
Total liabilities	836,859	941,143
Commitments and contingencies		
Stockholders equity:		
Preferred stock, $0.01 par value, 10,000 shares authorized, none issued		
Common stock, $0.01 par value, 150,000 shares authorized, 82,317 and 83,100 shares issued at December 31, 2004 and September 30, 2005, respectively	823	831
Treasury stock, 14,514 and 14,766 shares of common stock at December 31, 2004 and September 30, 2005, respectively	(372,249)	(381,635)
Additional paid-in capital	411,888	431,278

Retained earnings		551,863		648,943
Accumulated other comprehensive (loss) income, net of tax		(204)		1,268
Total stockholders equity		592,121		700,685
Total liabilities and stockholders equity	$	1,428,980	$	1,641,828

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
Condensed Consolidated Income Statements
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Net revenue	$ 356,111	$ 402,230	$ 974,993	$ 1,160,068
Operating costs and expenses:				
Patient care costs	239,400	267,889	648,621	769,322
General and administrative expenses	26,336	34,275	76,353	100,967
Provision for doubtful accounts	8,464	5,396	23,623	22,546
Depreciation and amortization	15,344	18,173	42,407	52,735
Total operating costs and expenses	289,544	325,733	791,004	945,570
Income from operations	66,567	76,497	183,989	214,498
Interest expense, net	6,869	8,715	13,599	23,957
Income before minority interest and income taxes	59,698	67,782	170,390	190,541
Minority interest	10,158	9,915	25,062	28,409
Income before income taxes	49,540	57,867	145,328	162,132
Provision for income taxes	19,072	22,636	55,590	65,052
Net income	$ 30,468	$ 35,231	$ 89,738	$ 97,080
Net income per share:				
Basic	$ 0.45	$ 0.52	$ 1.33	$ 1.43
Diluted	$ 0.44	$ 0.50	$ 1.28	$ 1.37
Weighted average shares outstanding:				
Basic	67,095	68,167	67,612	68,022
Diluted	69,339	71,023	69,930	70,721

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Nine Months Ended September 30, 2004	Nine Months Ended September 30, 2005
OPERATING ACTIVITIES		
Net income	$ 89,738	$ 97,080
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	42,407	52,735
Loss on sale of property and equipment	624	661
Distributions to minority shareholders	(11,409)	(15,807)
Income applicable to minority interest	25,062	28,409
Deferred income taxes	10,734	2,207
Changes in operating assets and liabilities, net of effects from acquisitions	(21,062)	(28,506)
Net cash provided by operating activities	136,094	136,779
INVESTING ACTIVITIES		
Purchases of property and equipment	(66,463)	(67,507)
Cash paid for acquisitions, net of cash acquired	(274,644)	(167,766)
Change in other assets	(7,185)	3,062
Net cash used in investing activities	(348,292)	(232,211)
FINANCING ACTIVITIES		
Net proceeds from issuance of long-term debt	325,000	100,000
Payments on long-term debt	(8,125)	(16,251)
Net borrowings under line of credit and capital leases	7,027	15,930
Net proceeds from issuance of common stock	17,799	12,698
Repurchase of treasury shares	(137,845)	(9,386)
Net cash provided by financing activities	203,856	102,991
(Decrease) increase in cash and cash equivalents	(8,342)	7,559
Cash and cash equivalents at beginning of period	50,295	17,931
Cash and cash equivalents at end of period	$ 41,953	$ 25,490

See accompanying notes to condensed consolidated financial statements.

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RENAL CARE GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SEPTEMBER 30, 2005
(dollars in thousands, except per share data)
(unaudited)

1. Basis of Presentation

Overview

Renal Care Group, Inc. provides dialysis services to patients with chronic kidney failure, also known as end-stage renal disease. As of September 30, 2005, we provided dialysis and ancillary services to over 32,000 patients through more than 450 owned outpatient dialysis centers in 34 states, in addition to providing acute dialysis services at more than 200 hospitals.

Renal Care Group s net revenue has been derived primarily from the following sources:

- outpatient hemodialysis services;
- ancillary services associated with dialysis, primarily the administration of Epogen® (erythropoietin alfa, to which we refer as EPO);
- home dialysis services;
- inpatient hemodialysis services provided to acute care hospitals and skilled nursing facilities;
- laboratory services; and
- management contracts with hospital-based and medical university dialysis programs.

Most patients with end-stage renal disease receive three dialysis treatments each week in an outpatient setting. Reimbursement for these services is provided primarily by the Medicare ESRD program based on rates established by the Centers for Medicare and Medicaid Services (CMS). For the nine months ended September 30, 2005 and 2004, approximately 57% and 53%, respectively, of our net revenue was derived from reimbursement under the Medicare and Medicaid programs. Medicare reimbursement is subject to rate and other legislative changes by Congress and to periodic changes in regulations, including changes that may reduce payments under the ESRD program. Neither Congress nor CMS approved an increase in the composite rate for 2004. Congress approved an increase of 1.6% in the Medicare ESRD composite rate for 2005, as well as changes in the way we are paid for separately billable drugs.

The Medicare composite rate applies to a designated group of outpatient dialysis services, including the dialysis treatment, supplies used for the treatment, certain laboratory tests and medications, and most of the home dialysis services we provide. Renal Care Group receives separate reimbursement outside the composite rate for some other services, drugs, including specific drugs such as EPO, and some physician-ordered tests, including laboratory tests, provided to dialysis patients.

Congress mandated a change in the way we are paid beginning in 2005 for most of the drugs, including EPO, that we bill for outside of the flat composite rate. This change resulted in lower reimbursement for these drugs and a higher composite rate. In 2005 we are reimbursed for the top ten separately billable ESRD drugs at average acquisition cost, and we are reimbursed for other separately billable ESRD drugs at average sales price plus 6.0%. In addition, the composite rate was increased by 8.7% for 2005. These regulations also include a case-mix adjustment that became effective in April 2005, a geographic adjustment to the composite rate and a budget-neutrality adjustment. Management believes these changes coupled with the 1.6% increase in the Medicare composite rate in 2005 have been slightly positive to Renal Care Group s revenue per treatment and earnings in 2005.

On August 1, 2005, CMS issued its proposed rules that would revise payment for separately billable drugs and biologicals. Under the proposal, the payment rate will be set at average sales price plus 6.0% for all

**RENAL CARE GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
SEPTEMBER 30, 2005**
(dollars in thousands, except per share data)
(unaudited)

separately billable ESRD drugs. CMS has also proposed to change the drug add-on adjustment that took effect January 1, 2005, and to update the geographic designations and wage index for the composite rate. CMS has indicated that the government s intent is to achieve revenue neutrality; however, management believes that the proposed rules could result in a reduction in reimbursement.

If a patient is younger than 65 years old and has private health insurance, then that patient s treatment is typically reimbursed at rates significantly higher than Medicare during the first 30 months of care. After that period, Medicare becomes the primary payor. Reimbursement for dialysis services provided pursuant to a hospital contract is negotiated with the individual hospital and is usually higher than the Medicare composite rate. Because dialysis is a life-sustaining therapy to treat a chronic disease, utilization is predictable and is not subject to seasonal fluctuations.

We derive a significant portion of our revenue and earnings from the administration of EPO. EPO is manufactured by a single company, Amgen, Inc. EPO is used to treat anemia, a medical complication frequently experienced by dialysis patients. Changes in our contract with Amgen for 2005 along with changes in Amgen s packaging practices for EPO has resulted in a slight increase in our cost of EPO in 2005. Net revenue from the administration of EPO was 24% and 27% of our net revenue for the nine months ended September 30, 2005 and 2004, respectively.

Change in Accounting Estimate

During the three months ended September 30, 2005 we obtained final determination of certain Medicare cost report settlements. Accordingly, during this period we recognized a change in estimate of $2,611 (net of related tax expense of $1,676), or $0.04 per share, resulting in a reduction to the provision for doubtful accounts.

Interim Financial Statements

Management believes the information contained in this quarterly report on Form 10-Q reflects all adjustments necessary to make the results of operations for the interim periods a fair representation of such operations. All such adjustments are of a normal recurring nature. Operating results for interim periods are not necessarily indicative of results that may be expected for the year as a whole. We suggest that you read these financial statements in conjunction with our consolidated financial statements and the related notes thereto included in our annual report on Form 10-K for the year ended December 31, 2004, as filed with the SEC on March 2, 2005.

Reclassifications

Certain prior year balances have been reclassified to conform to the current year presentation. These reclassifications had no effect on the results of operations as previously reported.

2. Acquisition by Fresenius Medical Care AG

On May 3, 2005 we entered into a definitive merger agreement with Fresenius Medical Care AG in which Fresenius Medical Care agreed to acquire all of Renal Care Group s outstanding stock. Fresenius Medical Care will pay $48.00 for each of our outstanding shares of common stock. Fresenius Medical Care will acquire Renal Care Group subject to its outstanding indebtedness, which was approximately $603.3 million as of September 30, 2005. In connection with the Fresenius Medical Care transaction, we incurred

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RENAL CARE GROUP, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)
SEPTEMBER 30, 2005
(dollars in thousands, except per share data)
(unaudited)

general and administrative expenses of approximately $10,350 pre-tax in the nine-month period ended September 30, 2005.

Our Board of Directors and the management and supervisory boards of Fresenius Medical Care have approved the transaction, and on August 24, 2005 our stockholders voted to approve the transaction. Completion of the transaction is subject to customary conditions to closing, including the termination or expiration of the waiting period under the Hart-Scott Rodino Antitrust Improvements Act of 1976, as amended. In June 2005, we received a request for additional information under the Hart-Scott Rodino Act from the Federal Trade Commission. We are providing information to the Federal Trade Commission to respond to this request. The Fresenius Medical Care transaction may not be completed before 30 days after certification by us and Fresenius Medical Care of substantial compliance with the Federal Trade Commission s request for additional information or until earlier satisfaction by the Federal Trade Commission that the transactions will not raise anticompetitive concerns. Management believes the transaction will close in the fourth quarter of 2005 or early in 2006.

On May 11, 2005, Renal Care Group was served with a complaint in the Chancery Court for the State of Tennessee Twentieth Judicial District at Nashville styled *Plumbers Local #65 Pension Fund, on behalf of itself and all others similarly situated, Plaintiff, vs. Renal Care Group, Inc., William P. Johnston, Gary Brukardt, Peter J. Grua, Joseph C. Hutts, Harry R. Jacobson, William V. Lapham, Thomas A. Lowery, Stephen D. McMurray and C. Thomas Smith, Defendants*. On May 26, 2005, Renal Care Group was served with a complaint in the Chancery Court for the State of Tennessee Twentieth Judicial District at Nashville styled *Hawaii Structural Ironworkers Pension Trust Fund, on behalf of itself and all others similarly situated, Plaintiff, vs. Renal Care Group, Inc., William P. Johnston, Gary Brukardt, Peter J. Grua, Joseph C. Hutts, Harry R. Jacobson, William V. Lapham, Thomas A. Lowery, Stephen D. McMurray and C. Thomas Smith, Defendants*. On May 31, 2005, Renal Care Group was served with a complaint in the Chancery Court for the State of Tennessee Twentieth Judicial District at Nashville styled *Indiana State District Council of Laborers and Hod Carriers Pension Fund, on behalf of itself and others similar situated, Plaintiff, vs. Renal Care Group, Inc., William P. Johnston, Gary Brukardt, Peter J. Grua, Joseph C. Hutts, Harry R. Jacobson, William V. Lapham, Thomas A. Lowery, Stephen D. McMurray and C. Thomas Smith, Defendants*. The original complaints in these three lawsuits were substantially identical. Each complaint was brought by the plaintiff shareholder as a purported class action on behalf of all shareholders similarly situated. The complaints allege that Renal Care Group and its directors engaged in self-dealing and breached their fiduciary duties to Renal Care Group s shareholders in connection with the merger agreement between Renal Care Group and Fresenius Medical Care because, among other things, Renal Care Group used a flawed process, the existence of the previously disclosed subpoena from the Department of Justice, the lack of independence of one of Renal Care Group s financial advisors and the existence of Renal Care Group s supplemental executive retirement plan. Renal Care Group removed these cases to federal court in June 2005.

The plaintiffs in the first two cases dismissed them without prejudice in July 2005, and the third plaintiff filed an amended complaint. The amended complaint asserts the same grounds articulated in the original complaint adding more specific allegations regarding the termination fee, the non-solicitation clause and the matching rights provision in the Merger Agreement, and it adds allegations that our proxy statement makes material misrepresentations and omissions regarding the process by which the merger agreement was negotiated. Specifically, the amended complaint asserts that the proxy statement makes material misstatements or omissions regarding: (1) the reason Renal Care Group s management and board engaged in a closed process of negotiating a potential merger with Fresenius and did not solicit potential competing bids from alternative purchasers; (2) the reason Renal Care Group s board did not appoint a special committee to

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evaluate the fairness of the merger; (3) the alternatives available to Renal Care Group including potential alternative transactions and other strategic business opportunities, which purportedly were considered by Renal Care Group s board during the strategic planning process the board engaged in during the second half of 2004; (4) all information regarding conflicts of interest suffered by defendants and their financial and legal advisors as alleged herein; (5) all information regarding past investment banking services Bank of America has performed for Renal Care Group and Fresenius and the compensation Bank of America received for those services; (6) the forecasts and projections prepared by Renal Care Group s management for fiscal years 2005 through 2008 that were referenced in the fairness opinions by Morgan Stanley; (7) the estimates of transaction synergies provided by Renal Care Group s management that were referenced in the fairness opinions by Morgan Stanley; and (8) information concerning the amount of money Bank of America and Morgan Stanley will receive in connection with the proposed merger. Renal Care Group believes that the allegations in the pending complaint are without merit. Completion of the merger is subject to customary conditions, including the absence of any order or injunction prohibiting the closing. The pending complaint seeks to enjoin and prevent the parties from completing the Fresenius Medical Care transaction. The pending complaint was remanded to Tennessee state court in September 2005.

3. Business Acquisitions

2005 Acquisitions

During the first nine months of 2005, we completed a number of acquisitions and purchased the minority partners ownership interests in some of our existing joint ventures. The combined net assets acquired and resulting net cash purchase price paid in these transactions were $167,766. Each of the transactions (other than the purchases of minority partners interests in existing joint ventures) involved the acquisition of the net assets of entities that provide care to ESRD patients through owned dialysis facilities. The acquired businesses either strengthened our existing market share within a specific geographic area or provided us with an entrance into one or more new markets. We began recording the results of operations for each of the acquired businesses at the effective dates of the respective transactions.

The following table summarizes the preliminarily estimated fair values of the assets acquired and liabilities assumed at the date of acquisition for the transactions completed during the first nine months of 2005:

Accounts receivable, net	$	1,122
Inventory and other current assets		982
Property, plant and equipment, net		20,067
Intangible assets		7,140
Goodwill		138,873
Total assets acquired		168,184
Total liabilities assumed		418
Net assets acquired	$	167,766

Some of the estimated fair values of assets and liabilities are preliminary and may be adjusted. Items that may be adjusted include items such as deferred tax assets and liabilities, and the valuation of certain assets. Intangible assets primarily represent the value assigned to contracts such as non-competition agreements

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entered into in the transactions. Related amounts will be amortized over the lives of the contracts, which generally range from five to twelve years.

Pro Forma Data

The following summary, prepared on a pro forma basis, combines our results of operations with those of the businesses we acquired in 2005. These pro forma results reflect the combined results of Renal Care Group and the acquired businesses as if the acquisitions had been consummated as of the beginning of the period presented, giving effect to adjustments such as amortization of intangibles, interest expense and related income taxes.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Pro forma net revenue	$ 372,291	$ 403,572	$ 1,023,534	$ 1,182,198
Pro forma net income	$ 32,704	$ 35,692	$ 96,472	$ 100,626
Pro forma net income per share:				
Basic	$ 0.49	$ 0.52	$ 1.43	$ 1.48
Diluted	$ 0.47	$ 0.50	$ 1.38	$ 1.42

The unaudited pro forma results of operations are not necessarily indicative of what actually would have occurred if the acquisitions had been completed prior to the beginning of the periods presented.

Joint Ventures

During the quarter ended September 30, 2005, we purchased minority ownership interests in seven existing joint ventures for approximately $20,900. These purchases reduced the number of joint ventures in which we were the majority and controlling owner to 68 at September 30, 2005.

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4. Long-Term Debt

Long-term debt consisted of the following as of December 31, 2004 and September 30, 2005:

	December 31, 2004	September 30, 2005
Term loan facility, bearing interest at a variable rate (5.3% at September 30, 2005)	$ 312,813	$ 296,563
Incremental term loan, bearing interest at a variable rate (5.1% at September 30, 2005)		100,000
9% senior subordinated notes	159,685	159,685
Obligations under capital leases	4,151	4,984
Other, including amounts outstanding under the revolving credit facility	3,357	20,541
Total indebtedness, excluding fair value premium	480,006	581,773
Add: 9% senior subordinated notes fair value premium	23,608	21,520
Total long-term debt	503,614	603,293
Less: current portion	23,969	36,597
	$ 479,645	$ 566,696

Credit Agreements

We are a party to a credit agreement (the 2004 Agreement) with a group of banks totaling up to $700,000. The 2004 agreement has a $150,000 revolving credit facility, a $325,000 term loan facility and a $225,000 incremental term loan facility. In May 2005, we completed an incremental term loan of $100,000 under the 2004 Agreement. We used the proceeds of this incremental term loan to finance some of our 2005 acquisitions. The revolving credit facility, the $325,000 term loan facility, and the $100,000 incremental term loan facility have a final maturity of February 10, 2009. Each of our wholly-owned subsidiaries has guaranteed all of our obligations under the 2004 Agreement. Further, our obligations under the 2004 Agreement, and our subsidiaries obligations under their guarantees, are secured by a pledge of the equity interests we hold in each of our subsidiaries. The 2004 Agreement includes financial covenants that are customary based on the amount and duration of the agreement.

The revolving credit facility under the 2004 Agreement may be used for acquisitions, repurchases of Company common stock, capital expenditures, working capital and general corporate purposes. All borrowings under the 2004 Agreement accrue interest at variable rates determined by the Company s leverage ratio. Effective June 30, 2004, we entered into interest rate swap agreements to hedge interest rate risk on $150,000 of our term loan (See Interest Rate Swap below). The portion of our borrowings that is subject to variable rates carries a degree of interest rate risk. Specifically, the Company will face higher interest costs on this debt if interest rates rise.

9% Senior Subordinated Notes

With our acquisition of National Nephrology Associates, Inc. in April 2004, we assumed all of NNA s outstanding debt including its 9% senior subordinated notes due 2011. We recorded the senior subordinated notes at the face value of $160,000 plus an additional $25,600 representing the difference between the fair

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value of the senior subordinated notes and the face amount on the date of acquisition. Accordingly, the senior subordinated notes were recorded at the estimated fair value of $185,600. As of September 30, 2005, the carrying value of the senior subordinated notes was $181,205.

The senior subordinated notes bear interest at the rate of 9% per annum on the face amount. The fair value premium is being recognized over the life of the senior subordinated notes using the effective interest method and is recorded as a reduction to interest expense. Accordingly, the effective interest rate on the senior subordinated notes as of September 30, 2005 was 6.4%. Each of our wholly-owned subsidiaries has guaranteed all of our obligations under these senior subordinated notes. The rights of the noteholders and our obligations under these senior subordinated notes are set forth in an indenture that NNA entered into in October 2003, which we assumed in connection with the NNA acquisition. The indenture includes customary financial covenants.

Interest Rate Swap

Effective June 30, 2004, we entered into interest rate swap agreements to hedge the interest rate risk on $150,000 of our term loan. Under these interest rate swap agreements we will exchange fixed and variable rate interest payments based on a $150,000 notional principal amount through March 30, 2007. The notional amount of $150,000 and interest payments of 3.5% are fixed in the agreements. We expect changes in cash flows under these agreements to offset the changes in interest rate payments attributable to fluctuations in LIBOR. The hedge is structured to qualify for the shortcut method as prescribed by Statement of Financial Accounting Standard (SFAS) No. 133, *Accounting for Derivative Instruments and Hedging Activities*; therefore, we record changes in the fair value of the agreement directly in other comprehensive income. As of September 30, 2005, the notional amount of the swap agreements was $150,000 and their fair value was $2,065, resulting in an unrealized gain of $1,472 during the nine month period ended September 30, 2005 (net of a related tax expense of $925).

Obligations Under Capital Leases

Obligations under capital leases consist primarily of capital leases for buildings and equipment maturing at various times through August 2019.

Other

The other long-term debt consists primarily of notes and amounts outstanding under the revolving credit facility, maturing at various times through February 2009.

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Maturities of Long-Term Debt

The aggregate maturities of long-term debt, excluding the fair value premium, at September 30, 2005 are as follows:

2005	$	7,443
2006		42,273
2007		79,854
2008		208,068
2009		82,143
Thereafter		161,992
	$	581,773

Guarantor Information

Our wholly-owned subsidiaries have guaranteed the 9% subordinated notes as well as our obligations under the 2004 Agreement. We conduct substantially all of our business through subsidiaries. Presented below is condensed consolidating financial information as of September 30, 2005 and December 31, 2004 and for the three months and nine months ended September 30, 2005 and 2004, respectively. The information segregates Renal Care Group, Inc. (the parent company), the combined wholly-owned subsidiary guarantors and the combined non-guarantor subsidiaries and reflects consolidating adjustments. All of the subsidiary guarantees are both full and unconditional, and joint and several.

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Condensed Consolidating Balance Sheets

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
As of December 31, 2004					
Cash and cash equivalents	$	$	$ 31,945	$ (14,014)	$ 17,931
Accounts receivable, net		198,778	76,595		275,373
Other current assets	45,749	23,320	10,711		79,780
Total current assets	45,749	222,098	119,251	(14,014)	373,084
Property, plant and equipment, net	29,542	189,434	96,408	1,148	316,532
Goodwill	1,483	574,815	117,666	300	694,264
Other assets	10,828	99,033	7,436	(72,197)	45,100
Total assets	$ 87,602	$ 1,085,380	$ 340,761	$ (84,763)	$ 1,428,980
Current liabilities (including intercompany assets and liabilities)	$ (699,042)	$ 813,091	$ 157,344	$ (27,488)	$ 243,905
Long-term debt	476,184	(259)	3,720		479,645
Long-term liabilities	64,976	2,253	461		67,690
Minority interest		39,610	5,989	20	45,619
Stockholders equity	245,484	230,685	173,247	(57,295)	592,121
Total liabilities and stockholders equity	$ 87,602	$ 1,085,380	$ 340,761	$ (84,763)	$ 1,428,980

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
As of September 30, 2005					
Cash and cash equivalents	$	$	$ 34,615	$ (9,125)	$ 25,490
Accounts receivable, net		212,032	74,741		286,773
Other current assets	55,756	32,919	15,685		104,360
Total current assets	55,756	244,951	125,041	(9,125)	416,623
Property, plant and equipment, net	36,771	222,178	94,833	1,128	354,910
Goodwill	1,483	699,929	122,310	300	824,022
Other assets	9,165	105,419	6,748	(75,059)	46,273

Total assets	$ 103,175	$ 1,272,477	$ 348,932	$ (82,756)	$ 1,641,828
Current liabilities (including intercompany assets and liabilities)	$ (731,456)	$ 890,292	$ 125,546	$ (33,882)	$ 250,500
Long-term debt	561,830	193	4,673		566,696
Long-term liabilities	58,700	6,211	1,630		66,541
Minority interest		48,029	9,428	(51)	57,406
Stockholders equity	214,101	327,752	207,655	(48,823)	700,685
Total liabilities and stockholders equity	$ 103,175	$ 1,272,477	$ 348,932	$ (82,756)	$ 1,641,828

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Condensed Consolidating Income Statements

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the three months ended September 30, 2004					
Net revenue	$ 1,718	$ 245,757	$ 110,181	$ (1,545)	$ 356,111
Total operating costs and expenses	12,402	198,053	80,634	(1,545)	289,544
Income (loss) from operations	(10,684)	47,704	29,547		66,567
Interest expense (income), net	6,850	(92)	111		6,869
Minority interest		9,300	858		10,158
Provision (benefit) for income taxes	(6,750)	14,821	11,001		19,072
Net income (loss)	$ (10,784)	$ 23,675	$ 17,577	$	$ 30,468

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the three months ended September 30, 2005					
Net revenue	$ 916	$ 291,743	$ 111,218	$ (1,647)	$ 402,230
Total operating costs and expenses	18,216	224,727	84,437	(1,647)	325,733
Income (loss) from operations	(17,300)	67,016	26,781		76,497
Interest expense (income), net	8,669	(117)	163		8,715
Minority interest		9,164	751		9,915
Provision (benefit) for income taxes	(9,234)	22,051	9,819		22,636
Net income (loss)	$ (16,735)	$ 35,918	$ 16,048	$	$ 35,231

Condensed Consolidating Income Statements

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total

For the nine months ended September 30, 2004					
Net revenue	$ 2,652	$ 674,627	$ 301,690	$ (3,976)	$ 974,993
Total operating costs and expenses	38,553	527,544	228,883	(3,976)	791,004
Income (loss) from operations	(35,901)	147,083	72,807		183,989
Interest expense (income), net	13,580	(92)	111		13,599
Minority interest		23,320	1,742		25,062
Provision (benefit) for income taxes	(18,942)	47,371	27,161		55,590
Net income (loss)	$ (30,539)	$ 76,484	$ 43,793	$	$ 89,738

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	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2005					
Net revenue	$ 2,327	$ 818,092	$ 344,788	$ (5,139)	$ 1,160,068
Total operating costs and expenses	55,101	635,114	260,494	(5,139)	945,570
Income (loss) from operations	(52,774)	182,978	84,294		214,498
Interest expense (income), net	23,992	(455)	420		23,957
Minority interest		25,985	2,424		28,409
Provision (benefit) for income taxes	(26,565)	60,381	31,236		65,052
Net income (loss)	$ (50,201)	$ 97,067	$ 50,214	$	$ 97,080

Condensed Consolidating Statements of Cash Flows

	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2004					
Cash flows from operating activities:					
Net income (loss)	$ (30,539)	$ 76,484	$ 43,793	$	$ 89,738
Changes in operating and intercompany assets and liabilities and non-cash items included in net income	(87,188)	74,728	26,476	32,340	46,356
Net cash provided by (used in) operating activities	(117,727)	151,212	70,269	32,340	136,094
Net cash (used in) provided by investing activities	(167,259)	(153,167)	(30,233)	2,367	(348,292)
Net cash provided by (used in) financing	264,829	(691)	(12,415)	(47,867)	203,856

activities									
(Decrease) increase in cash and cash equivalents		(20,157)		(2,646)		27,621		(13,160)		(8,342)
Cash and cash equivalents, at beginning of period		20,157		2,646		27,492				50,295
Cash and cash equivalents, at end of period	$		$		$	55,113	$	(13,160)	$	41,953

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	Parent Company	Guarantor Subsidiaries	Non-Guarantor Subsidiaries	Consolidating Adjustments	Consolidated Total
For the nine months ended September 30, 2005					
Cash flows from operating activities:					
Net income (loss)	$ (50,201)	$ 97,067	$ 50,214	$	$ 97,080
Changes in operating and intercompany assets and liabilities and non-cash items included in net income	(30,842)	93,255	(19,111)	(3,603)	39,699
Net cash provided by (used in) operating activities	(81,043)	190,322	31,103	(3,603)	136,779
Net cash (used in) provided by investing activities	(27,877)	(190,774)	(13,580)	20	(232,211)
Net cash provided by (used in) financing activities	108,920	452	(14,853)	8,472	102,991
Increase in cash and cash equivalents			2,670	4,889	7,559
Cash and cash equivalents, at beginning of period			31,945	(14,014)	17,931
Cash and cash equivalents, at end of period	$	$	$ 34,615	$ (9,125)	$ 25,490

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5. Net Income per Share

The following table sets forth the computation of basic and diluted net income per share (shares in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	**2005**	**2004**	**2005**
Numerator:				
Numerator for basic and diluted net income per share net income	$ 30,468	$ 35,231	$ 89,738	$ 97,080
Denominator:				
Denominator for basic net income per share weighted-average shares	67,095	68,167	67,612	68,022
Effect of dilutive securities:				
Stock options	2,244	2,856	2,318	2,699
Denominator for diluted net income per share adjusted weighted-average shares and assumed conversions	69,339	71,023	69,930	70,721
Net income per share:				
Basic	$ 0.45	$ 0.52	$ 1.33	$ 1.43
Diluted	$ 0.44	$ 0.50	$ 1.28	$ 1.37

6. Stockholders Equity

Stock-based Compensation

We account for stock-based compensation to employees and directors using the intrinsic value method in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees,* and related Interpretations. Accordingly, we recognize no compensation expense when we grant fixed options to employees and directors, because the exercise price of the stock options equals or exceeds the market price of the underlying stock on the dates of grant. Option grants to medical directors and non-vested stock grants are expensed over their vesting periods.

All outstanding stock options and all of the outstanding nonvested stock awards became fully vested on August 24, 2005, as a result of the stockholders vote to approve Fresenius Medical Care s acquisition of Renal Care Group, which represented a change of control under the applicable provisions of the Company s stock-based compensation plans. The information set forth below reflects the estimated pro forma after-tax charge the Company would have incurred during the third quarter of 2005 as a result of the accelerated vesting of stock options.

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The following table presents the pro forma effect on net income and net income per share as if we had applied the fair value based method and recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation,* (SFAS No. 123) to stock-based compensation to employees and directors:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2005	2004	2005
Net income, as reported	$ 30,468	$ 35,231	$ 89,738	$ 97,080
Add: stock-based compensation expense, net of related tax effects, included in the determination of net income as reported	131	319	188	431
Less: stock-based compensation expense, net of related tax effects, determined by the fair value-based method	(2,889)	(18,474)	(7,431)	(23,236)
Pro forma net income	$ 27,710	$ 17,076	$ 82,495	$ 74,275
Net income per share:				
Basic, as reported	$ 0.45	$ 0.52	$ 1.33	$ 1.43
Basic, pro forma	$ 0.41	$ 0.25	$ 1.22	$ 1.09
Diluted, as reported	$ 0.44	$ 0.50	$ 1.28	$ 1.37
Diluted, pro forma	$ 0.40	$ 0.24	$ 1.18	$ 1.05

The effects of applying SFAS No. 123 for providing pro forma disclosures are not likely to be representative of the effects on reported net income for future periods.

Stock Split

On April 27, 2004, we announced a three-for-two stock split in the form of a stock dividend distributed to shareholders of record as of May 7, 2004. On May 24, 2004 we issued one share for every two shares held by shareholders as of the record date. The par value of our common stock remained unchanged at $0.01.

Authorized Shares

On June 9, 2004, our shareholders approved an amendment to the certificate of incorporation increasing the number of authorized shares of common stock from 90,000 to 150,000.

7. Contingencies

On October 25, 2004, we received a subpoena from the office of the United States Attorney for the Eastern District of New York. The subpoena requires the production of documents related to numerous aspects of our business and operations, including those of RenaLab, Inc., our laboratory. The subpoena includes specific requests for documents related to testing for parathyroid hormone (PTH) levels and vitamin D therapies. To our knowledge, no proceedings have been initiated against Renal Care Group at this time, although we cannot predict whether or when proceedings might be initiated. We intend to cooperate with the government s investigation. Compliance with the subpoena will require us to incur substantial legal

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expenses and will require management attention. We cannot predict whether legal proceedings will be initiated against us in connection with this investigation or, if initiated, the outcome of any proceedings.

On August 9, 2005, we received a subpoena from the office of the United States Attorney for the Eastern District of Missouri. The subpoena requires the production of documents related to numerous aspects of our business and operations. The subpoena includes specific requests for documents related to our supply company, pharmaceutical and other services we provide to patients, our relationships with pharmaceutical companies, our relationships with physicians, medical director compensation, joint ventures with physicians and our purchases of dialysis equipment from Fresenius Medical Care. The subpoena was issued in connection with a joint civil and criminal investigation. To our knowledge, no proceedings have been initiated against Renal Care Group at this time, although we cannot predict whether or when proceedings might be initiated. We intend to cooperate with the government s investigation. Compliance with the subpoena will require us to incur substantial legal expenses and will require management attention. We cannot predict whether any legal proceedings will be initiated against us in connection with this investigation or, if initiated, the outcome of any proceedings.

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. We believe that we are in compliance with all applicable laws and regulations governing the Medicare and Medicaid programs. We are not aware of any other pending or threatened investigations involving allegations of potential noncompliance with applicable laws or regulations. While no regulatory inquiries other than those described above have been made, compliance with such laws and regulations can be subject to future government review and interpretation as well as significant regulatory action including fines, penalties, and exclusion from the Medicare and Medicaid programs.

We are involved in other litigation and regulatory investigations arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, these matters will be resolved without material adverse effect on our consolidated financial position or results of operations.

8. Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123(R)), which is a revision of SFAS No. 123. SFAS No. 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS No. 123(R) is similar to the approach described in SFAS No. 123. However, SFAS No. 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Pro forma disclosure is no longer an alternative. On April 14, 2005, the United States Securities and Exchange Commission announced it would permit most registrants subject to its oversight, including Renal Care Group, additional time to implement the requirements in SFAS No. 123(R). As announced, the SEC will permit companies to implement SFAS No. 123(R) at the beginning of their next fiscal year (instead of their next reporting period) that begins after June 15, 2005. We are evaluating the requirements of SFAS No. 123(R). We expect that the adoption of SFAS No. 123(R), effective January 1, 2006, will have an impact on our consolidated results of operations and earnings per share. We have not yet determined the method of adoption or the potential financial impact of adopting SFAS No. 123(R).

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To The Board of Directors and Shareholders of
Renal Care Group, Inc.

We have audited the accompanying consolidated balance sheets of Renal Care Group, Inc. as of December 31, 2003 and 2004, and the related consolidated income statements, statements of stockholders equity, and statements of cash flows for each of the three years in the period ended December 31, 2004. Our audits also included the financial statement schedule listed in the Index at Item 15(a) of the Company&ating that our proposal based on the alternative CDSS approach was deemed acceptable in principle on the terms proposed. The parties reengaged in negotiations in early January 2006 on a contract modification to incorporate these proposals. A contract modification has not yet been executed and would be required in order for us to implement the proposals and achieve Customer acceptance of the System. We anticipate that such modification would include a revised testing and acceptance procedure which would provide for acceptance of individual subsystems on satisfactory completion of the testing of the subsystem. Until such acceptance occurs, the Customer has advised us that it cannot negotiate appropriate price adjustments for omissions and deviations of a subsystem.

Subcontracts. We have subcontracted a significant portion of the requirements under the Greek contract, including the lease of certain equipment and TETRA network services for at least 10 years. In order for us to implement the technical proposals submitted to the Customer and contemplated by the modification being negotiated with the Customer, we would need to negotiate and execute modifications to the subcontracts with our subcontractors, including price. Certain of the omissions and deviations of the System are attributable to subcontracted work. Payments to the subcontractors are generally required only if we receive payment from the Customer related to the subcontractors work. If it is determined we breached our obligations to any of our subcontractors, we may incur additional losses. We and our principal subcontractor disagree as to whether the principal subcontractor fully performed its obligations under the subcontract.

Under the terms of the Greek contract, we are not obligated to provide TETRA network services to the Customer until the Customer has accepted the System. We and our subcontractors have provided System support and maintenance and TETRA network services to the Customer since the Olympics in August 2004, without receiving any compensation. In September 2005, our principal subcontractor notified us that it would no longer commit to continue providing TETRA network services, although it has continued to provide such services to date. On May 19, 2006, a second-tier subcontractor working for our principal subcontractor responsible for providing the TETRA radio network services provided legal notice to our principal subcontractor that it will stop supporting and maintaining the TETRA subsystem at an unspecified date in the future. In a letter dated May 24, 2006, our principal subcontractor requested payment within 10 days from us of all amounts due under the subcontract. In a letter dated May 26, 2006, we advised our principal subcontractor that under the terms of the subcontract, receipt of full payment from the Customer is a condition to our obligation to pay the subcontractor and that the Customer s refusal to pay us relates in part to deviations and omissions in our principal subcontractor s work. In a letter dated June 13, 2006, the second-tier subcontractor responsible for providing TETRA radio network operation and maintenance services notified our principal subcontractor that it would cease providing such services on June 30, 2006.

Legality of the Contract. In March 2005, the Customer notified us that an issue had been raised concerning the legality of the Greek contract by a Greek government auditor. In August 2005, we learned that the Court of Auditors of the Hellenic Republic (the Greek Audit Court), a government agency with authority to review and audit procurements, issued a decision finding that certain mistakes in the procurement process committed by the Greek government rendered the contract illegal. The Customer requested revocation of the Greek Audit Court decision. On November 17, 2005, the Greek Audit Court issued a decision finding that the errors committed by the Customer in the procurement process constituted pardonable mistakes with respect to prior payments under the contract. Although the rationale of the Greek Audit Court decision suggests that the Customer may be able to make future payments under the contract, the impact of the decision on the legality of the contract and the Customer s ability to make future payments is not clear. Recent communications from the Customer suggest that the Greek Audit Court may have to approve any modification to the contract, and any payments made under the modified contract.

Financial Status and Contingencies of the Contract. We have recorded $121 million of contract losses under the Greek contract as of April 30, 2006. While we recorded no losses on this contract during the three months ended April 30, 2006, $7 million was recorded during the three months ended April 30, 2005. These losses reflect our estimated total cost to complete the System and obtain Customer acceptance and estimated results of negotiations on reductions in price for omissions and deviations from contract requirements. Because of the significant uncertainties related to ultimate acceptance and payment from the Customer, our current accounting treatment assumes the contract value is limited to the cash received to date. Although we expect to pursue remaining amounts owed under the terms of the contract, this reduction in total estimated revenues to be realized under the contract increased the total loss by $32 million during the year ended January 31, 2006, which is included in the loss amounts discussed above. Through April 30, 2006, we have recognized revenues of $119 million, which represent a portion of the $147 million cash received to date based upon the percentage-of-completion method of revenue recognition.

As of April 30, 2006, the estimated future costs to complete the System and obtain Customer acceptance is $52 million. This estimated cost is included in the $121 million contract losses recorded as of April 30, 2006. Management has used this estimate and its judgment in evaluating the various uncertainties and assumptions necessary to recognize the total estimated loss on this contract. Such assumptions include obtaining mutual agreement with the Customer regarding system requirements, execution of a modification to the contract, completion of the System and Customer acceptance. The total costs are significantly affected by the timing of events such as executing a contract modification and ultimate Customer acceptance. Management has estimated that final acceptance of the System under a modified contract will occur in January 2008. Our recorded losses exclude potential subcontractor payments associated with the omissions and deviations related to specific subsystems supplied by subcontractors in the amount of $13 million that management believes will not be paid under the subcontract terms.

We have $14 million of accounts receivable relating to Value Added Taxes (VAT) that we have paid and believe we are entitled to recover either as a refund from the taxing authorities or as a payment under the Greek contract upon final billing. The contract requires the Customer to pay amounts owed for VAT for the System delivered. Failure by the Customer to pay these amounts could result in an additional obligation payable by us to the Greek taxing authorities and would increase our total losses on the contract.

In accordance with the terms of the contract, we are required to provide certain payment, performance and offset bonds in favor of the Customer. These bonding requirements have been met through the issuance of standby letters of credit. Under the terms of these bonding arrangements, the Customer currently has the right to call some or all of the $242 million of standby letters of credit outstanding. The letters of credit supporting the payment bonds ($157 million) and performance bonds ($33 million) may be called by the Customer submitting a written statement to the guaranteeing bank that we have not fulfilled our obligations under the contract. The letters of credit supporting the offset bonds ($52 million) may be called by the Customer submitting a written statement to the guaranteeing bank that we have not fulfilled our obligations under a separate offset contract requiring us, among other things, to use Greek subcontractors on the contract. We believe that any amounts obtained by the Customer through such a calling of these letters of credit may be retained by the Customer only

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as security against any actual damages it proves in arbitration, and that any excess must be returned to us. We do not currently believe it is probable that the Customer will call these standby letters of credit. If the standby letters of credit are called, we may have the right to call some or all of the $102 million in bonds provided by our subcontractors in connection with their work under the contract.

Arbitration Proceedings. Although we have been pursuing a contract modification with the Customer since shortly after the Memorandum was signed in July 2004, due to the difficulties in reaching mutually satisfactory terms, we instituted arbitration proceedings on April 21, 2006 before the International Chamber of Commerce (ICC) against the Customer to pursue our rights and remedies provided for in the contract and the Memorandum and under Greek law. The arbitration complaint filed by us: (1) seeks an order under the contract that the Customer s extended use of the System under the circumstances constitutes constructive acceptance and precludes the Customer from rejecting the System, (2) seeks damages for breach of contract, bad faith, use of the System and other damages, (3) seeks a determination as to the legal status of the contract as a result of the illegality issue discussed above, and (4) if the contract is determined to be illegal, seeks compensation for the commercial value of the System delivered and its use by the Customer and other damages. We are seeking total damages in excess of $76 million, with the precise amount to be proven in arbitration. We agreed to extend to July 31, 2006, the time period in which the Customer may submit its response to the arbitration complaint in order to provide the parties additional time to attempt to negotiate and complete a modification. Under the terms of the contract, disputes are subject to ultimate resolution by binding arbitration before a panel of three Greek arbitrators in Greece. Due to the complex nature of the legal and factual issues involved and the uncertainty of litigation in general, the outcome of the arbitration is uncertain. There is no assurance that we will prevail in the arbitration.

In the event we do not prevail in the arbitration or are unable to resolve the various disputes under the contract as anticipated, we could incur additional losses. If the Customer asserts claims against us in the arbitration and it is determined that we have breached the contract and, as a result, owe the Customer damages, such damages could include, but are not limited to, (1) re-procurement costs, (2) repayment of amounts paid of $147 million under the contract, (3) penalties for delayed delivery in an amount up to $15 million, and (4) forfeiture of good performance bonds in the amount of $33 million. Due to the early stage of the arbitration, the amount of any claims that the Customer may assert against us in the arbitration is not known.

Successful imposition of damages or claims by the Customer or subcontractors against us, the calling of our bonds, additional contract costs required to fulfill our obligations, or additional revenue reductions arising from the negotiation of the contract modification could have a material adverse affect on our consolidated financial position, results of operations and cash flows.

DS&S Joint Venture

In March 2006, we sold our interest in DS&S, a joint venture in which we owned a 50% interest. As part of the sale, we agreed to indemnify the purchaser for certain legal costs and expenses, including those relating to an on-going government investigation involving DS&S and any litigation resulting from that investigation up to the sum of the sales price of $9 million plus the amount received by us in repayment of a $1 million loan receivable owed by DS&S. As of April 30, 2006, we have deferred any gain on the sale of DS&S pending resolution of the on-going investigation and any resulting litigation.

INTESA Joint Venture

INTESA, a Venezuelan joint venture we formed in fiscal 1997 with Venezuela s national oil company, PDVSA, to provide information technology services in Latin America, is involved in various legal proceedings.

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We had previously consolidated our 60% interest in the joint venture, but the operations of INTESA were classified as discontinued operations as of January 31, 2003 and INTESA is currently insolvent. PDVSA has refused to take action to dissolve the joint venture or have it declared bankrupt.

Outsourcing Services Agreement and Guarantee. INTESA had derived substantially all its revenues from an outsourcing services agreement with PDVSA that it entered into at the time the joint venture was formed. The services agreement expired on June 30, 2002 and the parties were not able to reach agreement on a renewal. We guaranteed INTESA s obligations under the services agreement to PDVSA. Under the terms of the services agreement, INTESA s liability for damages to PDVSA in any calendar year is capped at $50 million. As a result, our maximum potential liability to PDVSA under the guarantee in any calendar year, based on our guarantee of PDVSA s ownership interest in INTESA, is $20 million. To date, PDVSA has not asserted any claims.

Expropriation of Our Interest in INTESA. In fiscal 2003 and 2004, PDVSA and the Venezuelan government took certain actions, including denying INTESA access to certain of its facilities and assets, which prevented INTESA from continuing operations. In fiscal 2005, the Overseas Private Investment Company (OPIC), a U.S. governmental entity that provides insurance coverage against expropriation of U.S. business interests by foreign governments, determined that the Venezuelan government had expropriated our interest in INTESA without compensation and paid us approximately $6 million in settlement of our claim.

Employment Claims of Former INTESA Employees. INTESA is a defendant in a number of lawsuits brought by former employees seeking unpaid severance and pension benefits. PDVSA and SAIC Bermuda, our wholly-owned subsidiary and the entity that held our interest in INTESA, were added as defendants in a number of these suits. Based on the procedural standing of the cases and our understanding of applicable laws and facts, we believe that our exposure to any possible loss related to these employment claims is either remote or, if reasonably possible, immaterial.

Other Legal Proceedings Involving INTESA. The Attorney General of Venezuela initiated a criminal investigation of INTESA in fiscal 2003 alleging unspecified sabotage by INTESA employees. We believe this investigation is inactive. In connection with our expropriation claim, OPIC determined that INTESA did not sabotage PDVSA s infrastructure as alleged by PDVSA and the Venezuelan government. In addition, the SENIAT, the Venezuelan tax authority, filed a claim against INTESA in fiscal 2004 for approximately $30 million for alleged non-payment of VAT taxes in fiscal 1998.

Potential Financial Impact. Many issues relating to INTESA, including the termination of the services agreement and the employment litigation brought by former INTESA employees, remain unresolved. Due to the complex nature of the legal and factual issues involved in these matters and the uncertain economic and political environment in Venezuela, the outcome is not presently determinable; however, adverse resolutions could materially harm our business, consolidated financial position, results of operations and cash flows.

Other Joint Ventures

We are an investor in Danet Partnership GbR (Danet GbR), a German partnership accounted for under the equity method. Danet GbR is the controlling shareholder in Danet GmbH, a German operating company. Danet GbR has an internal equity trading market similar to our limited market. We are required to provide liquidity rights to the other Danet GbR investors in certain circumstances. Absent a change in control whereby we gain control over Danet GbR, these rights allow Danet GbR investors who are withdrawing from the partnership to put their Danet GbR shares to us in exchange for the current fair value of those shares. If we gain control over Danet GbR, all Danet GbR investors have the right to put their shares to us in exchange for the current fair value of those shares. If Danet GbR investors put their shares to us, we may pay the put price in shares of our common

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stock or cash. We do not currently record a liability for these put rights because their exercise is contingent upon the occurrence of future events which we cannot determine will occur with any certainty. During the three months ended April 30, 2006, we paid less than $1 million to withdrawing Danet GbR investors who exercised their right to put their Danet GbR shares to us. The maximum potential obligation, assuming all the current Danet GbR investors were to put their Danet GbR shares to us, was $7 million as of April 30, 2006. If we were to incur the maximum obligation and buy all the partnership shares currently held by other Danet GbR investors, we would then own 100% of Danet GbR and would hold a controlling interest in Danet GmbH.

We have a guarantee that relates only to claims brought by the sole customer of another of our joint ventures, Bechtel SAIC Company, LLC, for specific contractual nonperformance of the joint venture. We also have a cross-indemnity agreement with the joint venture partner, pursuant to which we will only be ultimately responsible for the portion of any losses incurred under the guarantee equal to our ownership interest of 30%. Due to the nature of the guarantee, as of April 30, 2006 we are not able to project the maximum potential amount of future payments we could be required to make under the guarantee but, based on current conditions, we believe the likelihood of having to make any payment is remote. Accordingly, no liability relating to this guarantee is currently recorded.

On September 15, 2004, we entered into an agreement with EG&G Technical Services, Inc. (EG&G), and Parsons Infrastructure & Technology Group, Inc. (Parsons), to form Research and Development Solutions, LLC (RDS), a Delaware limited liability company that will pursue contracts offered by the Department of Energy s National Energy Technical Laboratory. We, EG&G and Parsons, each have a one-third equal joint venture interest. In conjunction with a contract award to RDS, each joint venture partner was required to sign a performance guarantee agreement with the U.S. Government. Under this agreement, we unconditionally guarantee all of RDS s obligations to the U.S. Government under the contract award, which has an estimated total value of $217 million. We also have a cross-indemnity agreement with each of the other two joint venture partners to protect us from liabilities for any U.S. Government claims resulting from the actions of the other two joint venture partners and to limit our liability to our share of the contract work. As of April 30, 2006, the fair value of the guarantee is not material to us.

Other

We are subject to investigations and reviews relating to compliance with various laws and regulations with respect to our role as a contractor to agencies and departments of the U.S. Government and in connection with performing services in countries outside of the United States. Such matters can lead to criminal, civil or administrative proceedings and we could be faced with penalties, fines, repayments or compensatory damages. Adverse findings could also have a material adverse effect on us because of our reliance on government contracts. Although we can give no assurance, based upon management s evaluation of current matters that are subject to U.S. Government investigations of which we are aware and based on management s current understanding of the facts, we do not believe that the outcome of any such matter would have a material adverse effect on our consolidated financial position, results of operations, cash flows or our ability to conduct business.

We are also involved in various claims and lawsuits arising in the normal conduct of our business, none of which, in the opinion of our management, based upon current information, will likely have a material adverse effect on our consolidated financial position, results of operations, cash flows or ability to conduct business.

In the normal conduct of our business, we seek to monetize our patent portfolio through licensing agreements. We also have and will continue to defend our patent positions when we believe our patents have been infringed and are involved in such litigation from time to time. As described in Note 11 of the notes to condensed consolidated financial statements for the three months ended April 30, 2006, on March 15, 2005, we

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sold our Telcordia subsidiary. Pursuant to the terms of the definitive stock purchase agreement, we will receive 50% of any net proceeds Telcordia receives in the future in connection with the enforcement of certain patent rights.

As part of the terms of the sale of Telcordia, in addition to the indemnification related to the Telkom South Africa litigation, we also have indemnified the buyer for all income tax obligations on and through the date of close. While we believe we have adequate accruals for these tax contingencies, the ultimate resolution of these matters could differ from the amounts accrued. All of these future contingent payments or contingent purchase price proceeds will continue to be reflected as discontinued operations in the period in which they arise.

Critical Accounting Policies

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The preparation of these financial statements in accordance with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting period. Management evaluates these estimates and assumptions on an on-going basis, including those relating to allowances for doubtful accounts, inventories, fair value and impairment of investments, fair value and impairment of intangible assets and goodwill, income taxes, warranty obligations, estimated profitability of long-term contracts, pension benefits, contingencies and litigation. Our estimates and assumptions have been prepared on the basis of the most current reasonably available information. The results of these estimates form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results could differ from these estimates under different assumptions and conditions.

We have several critical accounting policies that are both important to the portrayal of our financial condition and results of operations and require management s most difficult, subjective and complex judgments. Typically, the circumstances that make these judgments complex and difficult have to do with making estimates about the effect of matters that are inherently uncertain. We no longer consider our accounting policies for pension plans and derivative instruments to be critical accounting policies. With the sale of Telcordia, our remaining pension plans are not of a material size, and therefore our accounting policies for pension plans are not considered critical accounting policies as the impact of management judgment related to pension plans is not considered significant. Similarly, our use of derivative instruments has not been material since fiscal 2003, and therefore we no longer consider our derivative instrument accounting policies to be critical accounting policies. Our critical accounting policies are as follows:

Revenue Recognition. Our revenues are primarily recognized using the percentage-of-completion method as discussed in Statement of Position 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts. Under the percentage-of-completion method, revenues are recognized based on progress towards completion, with performance measured by the cost-to-cost method, efforts-expended method or units-of-delivery method, all of which require estimating total costs at completion. Estimating costs at completion on our long-term contracts, particularly due to the technical nature of the services being performed, is complex and involves significant judgment. Factors that must be considered in making estimates include labor productivity and availability, the nature and technical complexity of the work to be performed, potential performance delays, the availability and timing of funding from the customer, the progress toward completion and the recoverability of claims. Adjustments to original estimates are often required as work progresses, experience is gained and additional information becomes known, even though the scope of the work required under the contract may not change. Any adjustment as a result of a change in estimates is made when facts develop, events become known or an adjustment is otherwise warranted, such as in the case of a contract modification. When estimates indicate that we will experience a loss on the contract, we recognize the estimated loss at the time it is determined. Additional information may subsequently indicate that the loss is more or less than initially recognized, which would require further adjustment in our financial statements. We have procedures and processes in place to monitor the actual progress of a project against estimates and our estimates are updated quarterly or more frequently if circumstances warrant.

Although our primary revenue recognition policy is the percentage-of-completion method, we do have contracts under which we use alternative methods to record revenue (see Note 1 of the notes to consolidated financial statements for fiscal 2006). Selecting the appropriate revenue recognition method involves judgment based on the contract and can be complex depending upon the structure and terms and conditions of the contract.

Costs incurred on projects accounted for under the percentage-of-completion method can be recognized as pre-contract costs and deferred as an asset when we have been requested by the customer to begin work under a new contract, or extend or modify work under an existing contract (change order). We record pre-contract costs when formal contracts or contract modifications have not yet been executed, and it is probable that we will recover the costs through the issuance of a contract or contract modification. When the formal contract or contract modification has been executed, the costs are recorded to the contract and revenue is recognized based on the percentage-of-completion method of accounting.

Contract claims are unanticipated additional costs incurred in excess of the executed contract price that we seek to recover from the customer. Such costs are expensed as incurred. Additional revenue related to contract claims is recognized when the amounts are awarded by the customer.

Income Taxes. Income taxes are provided utilizing the liability method, which requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the carrying amounts and the tax basis of assets and liabilities. Under the liability method, changes in tax rates and laws are reflected in income in the period such changes are enacted. In addition, the provisions for federal, state, foreign and local income taxes are calculated on reported financial statement income before income taxes based on current tax law and include the cumulative effect of any changes in tax rates from those used previously in determining deferred tax assets and liabilities. Such provisions differ from the amounts currently payable because certain items of income and expense are recognized in different time periods for financial reporting purposes than for income tax purposes. We also have recorded liabilities for tax contingencies for open years based upon our best estimate of the taxes ultimately expected to be paid. A significant portion of our income taxes payable balance is comprised of tax accruals that have been recorded for tax contingencies.

Recording our provision for income taxes requires management to make significant judgments and estimates for matters whose ultimate resolution may not become known until final resolution of an examination by the IRS or State agencies. Additionally, recording liabilities for tax contingencies involves significant judgment in evaluating our tax positions and developing our best estimate of the taxes ultimately expected to be paid.

Stock-Based Compensation. We recognize as compensation expense the fair value of all stock-based awards, including stock options, granted to employees and others in exchange for services, typically over the period during which such awards are earned. We are also required to recognize as compensation expense the 15% discount on employee stock purchases made under our ESPP. The estimation of stock option fair value requires management to make complex estimates and judgments about, among other things, employee exercise behavior, forfeiture rates, and the volatility of our common stock. These judgments directly affect the amount of compensation expense that will ultimately be recognized.

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Investments in Marketable and Private Equity Securities. Our marketable debt and equity securities are carried on the balance sheet at fair value, with changes in fair value recorded through equity. When the fair value of a security falls below its cost basis and the decline is deemed to be other-than-temporary, we record the difference between cost and fair value as an unrealized loss. Investments accounted for on the cost method or equity method must be marked down to estimated fair value if an other-than-temporary decline occurs. In determining whether a decline is other-than-temporary, management considers a wide range of factors that may vary depending upon whether the investment is a marketable debt or equity security or a private investment. These factors include the duration and extent to which the fair value of the security or investment has been below its cost, recent financing rounds at a value that is below our carrying value, the operating performance of the entity, its liquidity and our investment intent. The private equity investments involve more judgment than the marketable equity securities because there is no readily available fair market value of a private equity security. Therefore, management, in addition to considering a wide range of other factors, must also use valuation methods to estimate the fair value of a private equity investment. Management judgments about these factors may impact the timing of when an other-than-temporary loss is recognized, and management s use of valuation methods to estimate fair value may also impact the amount of the impairment loss.

Business Combinations and Goodwill Impairment. We have engaged and expect to continue to engage in significant business acquisition activity. The accounting for business combinations requires management to make judgments and estimates of the fair value of assets acquired, including the identification and valuation of intangible assets, as well as the liabilities and contingencies assumed. Such judgments and estimates directly impact the amount of goodwill recognized in connection with each acquisition. As of January 31, 2006, goodwill represents 52% of our consolidated long-term assets and 12% of consolidated total assets.

Goodwill is tested annually in our fourth fiscal quarter and whenever an event occurs or circumstances change such that it is reasonably possible that an impairment condition may exist. The goodwill impairment test is a two-step process that requires management to make judgments in determining what assumptions to use in the calculation. The first step of the process consists of estimating the fair value of each of the reporting units based on a discounted cash flow model using revenue and profit forecasts and comparing those estimated fair values with the carrying values, which includes the allocated goodwill. If the fair value is less than the carrying value, a second step is performed to compute the amount of the impairment by determining an implied fair value of goodwill. The implied fair value of goodwill is the residual fair value derived by deducting the fair value of a reporting unit s identifiable assets and liabilities from its estimated fair value calculated in step one. The impairment charge represents the excess of the carrying amount of the reporting unit s goodwill over the implied fair value of goodwill. The revenue and profit forecasts used in step one are based on management s best estimate of future revenues and operating costs. Changes in these forecasts could cause a particular reporting unit to either pass or fail the first step in the impairment test, which could significantly change the amount of the impairment recorded from step two. In addition, the estimated future cash flows are adjusted to present value by applying a discount rate. Changes in the discount rate impact the impairment by affecting the calculation of the fair value of the reporting unit in step one.

Effects of Inflation

Our cost-reimbursement type contracts are generally completed within one year. As a result, we have generally been able to anticipate increases in costs when pricing our contracts. Bids for longer-term FFP and T&M contracts typically include sufficient provisions for labor and other cost escalations to cover cost increases over the period of performance. Consequently, revenues and costs have generally both increased commensurate with the general economy. As a result, net income as a percentage of total consolidated revenues has not been significantly impacted by inflation.

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Quantitative and Qualitative Disclosures About Market Risk

We are exposed to certain market risks in the normal course of business. Our current market risk exposures are primarily related to interest rates and foreign currency fluctuations. The following information about our market sensitive financial instruments contains forward-looking statements.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our cash equivalents, investments in marketable securities, interest rate swaps and long-term debt obligations.

We have established an investment policy to protect the safety, liquidity and after-tax yield of invested funds. This policy establishes guidelines regarding acceptability of instruments and maximum maturity dates and requires diversification in the investment portfolios by establishing maximum amounts that may be invested in designated instruments. We do not authorize the use of derivative financial instruments in our managed short- term investment portfolios. Our policy authorizes the limited use of derivative instruments only to hedge specific interest rate risks.

The table below provides information about our financial instruments at January 31, 2006 that are sensitive to changes in interest rates. For debt obligations and short-term investments, the table presents principal cash flows in U.S. dollars and related weighted average interest rates by expected maturity dates. For interest rate swap agreements, the table presents the notional amounts and weighted average interest rates. The notional amounts are used to calculate the contractual cash flows to be exchanged under the contracts. As described in Note 8 of the notes to consolidated financial statements for fiscal 2006, the swap agreements we entered into in May 2003 are expected to substantially offset interest rate exposures related to the swap agreements previously entered into in January 2002. As a result, on a combined basis, these swaps are no longer exposed to changing interest rates and we have excluded these swap agreements from the table below.

	2007	**2008**	**2009**	**2010**	**2011**	**There- after**	**Total**	**Estimated Fair Value as of January 31, 2006**
				(dollars in millions)				
Assets:								
Cash equivalents (1)	$ 1,032						$ 1,032	$ 1,032
Average interest rate	4.41%							
Investment in marketable securities:								
Variable rate	$ 1,659						$ 1,659	$ 1,659
Weighted average interest rate	4.53%							
Liabilities:								
Short-term and long-term debt:								
Variable interest rate (2)	$ 44		$ 1	$ 1	$ 1	$ 3	$ 50	$ 50
Weighted average interest rate	4.01%		4.46%	4.46%	4.46%	4.46%		
Fixed rate	$ 3	$ 1	$ 100			$ 1,100	$ 1,204	$ 1,252
Weighted average interest rate	5.87%	5.90%	6.75%			6.24%		
Interest Rate Derivatives								
Interest rate swap agreements								
Fixed to variable			$ 100				$ 100	$ 3
Average receive rate	6.75%	6.75%	6.75%					
Average pay rate	7.88%	7.88%	7.88%					

(1) Includes $21 million denominated in British pounds

(2) The fiscal 2006 amount includes $19 million denominated in Euros and $7 million denominated in Canadian dollars

Short term interest rates related to these financial instruments have increased since January 31, 2005, while long term interest rates remained relatively consistent. At January 31, 2006, our investments in marketable securities and cash equivalents were higher than January 31, 2005 by approximately $292 million and $64 million, respectively. We also had a larger portion of our marketable securities invested in financial instruments bearing variable interest rates at January 31, 2006 than January 31, 2005. Short term interest rates related to these financial instruments have increased since January 31, 2006. At April 30, 2006, a significant portion of our total

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assets consisted of cash equivalents which are subject to fluctuations in short term interest rates. This increase in overall investments in cash equivalents bearing variable interest rates has increased our sensitivity to changes in interest rates.

Foreign Currency Risk. Although the majority of our transactions are denominated in U.S. dollars, some transactions are denominated in various foreign currencies. Our objective in managing our exposure to foreign currency exchange rate fluctuations is to mitigate adverse fluctuations in earnings and cash flows associated with foreign currency exchange rate fluctuations. Our policy allows us to actively manage cash flows, anticipated transactions and firm commitments through the use of natural hedges and forward foreign exchange contracts. We do not use foreign currency derivative instruments for trading purposes.

We assess the risk of loss in fair values from the impact of hypothetical changes in foreign currency exchange rates on market sensitive instruments by performing a sensitivity analysis. The fair values for forward foreign exchange contracts were estimated using spot rates in effect on April 30, 2006. The differences that result from comparing hypothetical foreign exchange rates and actual spot rates as of April 30, 2006 are the hypothetical gains and losses associated with foreign currency risk. As of April 30, 2006, holding all other variables constant, a 10% weakening of the U.S. dollar against each hedged currency would affect the fair values of the forward foreign exchange contracts by immaterial amounts.

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BUSINESS

Overview

We are a leading provider of scientific, engineering, systems integration and technical services and solutions to all branches of the U.S. military, agencies of the U.S. Department of Defense (DoD), the intelligence community, the U.S. Department of Homeland Security (DHS) and other U.S. Government civil agencies, as well as to customers in selected commercial markets. Our customers seek our domain expertise to solve complex technical challenges requiring innovative solutions for mission-critical functions in such areas as national security, intelligence and homeland defense. Increasing demand for our services and solutions is driven by priorities including the ongoing global war on terror and the transformation of the U.S. military.

From fiscal 2002 to fiscal 2006, our consolidated revenues increased at a compound annual growth rate of 15.6% to a company record of $7.8 billion, inclusive of acquisitions and exclusive of Telcordia Technologies, Inc., our commercial telecommunications subsidiary, which we divested in March 2005. As of April 30, 2006, we had a portfolio of approximately 9,000 active contracts. Our total consolidated negotiated backlog as of April 30, 2006 was approximately $15.8 billion, which included funded backlog of approximately $3.9 billion, compared to $15.1 billion and $3.9 billion, respectively, as of January 31, 2006.

Currently, we serve more than 500 U.S. federal, state and local government agencies through our contracts, which include active task orders under indefinite delivery/indefinite quantity (IDIQ) contract vehicles, under which the U.S. Government issues task orders for specific services or products to be procured on previously negotiated terms. We believe we have a diversified portfolio of contracts, with revenues recognized in fiscal 2006 under our largest contract representing less than 3% of our total consolidated revenues. In addition to our national security customers, we provide services to various other U.S. federal civil agencies, including the U.S. National Aeronautics and Space Administration (NASA), the U.S. Department of Energy (DOE), the National Institutes of Health (NIH) and the National Cancer Institute (NCI). In May 2006, Washington Technology, a leading industry publication, ranked us number three in its list of Top Federal Prime Contractors in the United States based on IT, telecommunications and systems integration revenues. We expect to continue to derive the vast majority of our revenues and cash flows from our installed base of U.S. Government customers.

We view our 43,300 employees as our most valuable asset. We have historically attracted and retained our employees by providing challenging and important work, an entrepreneurial culture and broad employee stock ownership opportunities. Approximately 23,000 of our employees have national security clearances provided by the U.S. Government. Many U.S. Government programs require contractors to have high-level security clearances. Depending on the required level of clearance, security clearances can be difficult and time-consuming to obtain, and our large pool of cleared employees allows us to allocate the appropriate human resources to sensitive projects, facilitating our ability to win and execute contracts with the DoD, DHS and U.S. intelligence community. Our President and Chief Executive Officer, our seven Executive Vice Presidents and our five Group Presidents have industry experience averaging over 29 years and tenure with our company averaging over 10 years experience.

Our Government segment provides a broad range of technical services and solutions in the following areas, which are described under Services and Solutions:

Defense Transformation. We develop leading-edge concepts, technologies and systems to solve complex challenges facing the U.S. military and its allies, helping them transform the way they fight.

Intelligence. We develop solutions to help the U.S. defense, intelligence and homeland security communities build an integrated intelligence picture, allowing them to be more agile and dynamic in challenging environments and produce actionable intelligence.

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Homeland Security and Defense. We develop technical solutions and provide systems integration and mission-critical support services to help federal, state, local and foreign governments and private-sector customers protect the United States and allied homelands.

Logistics and Product Support. We provide logistics and product support solutions to enhance the readiness and operational capability of U.S. military personnel and weapon and support systems.

Systems Engineering and Integration. We provide systems engineering and integration solutions to help our customers design, manage and protect complex IT networks and infrastructure.

Research and Development. As one of the largest science and technology contractors to the U.S. Government, we conduct leading-edge research and development of new technologies with applications in areas such as national security, intelligence and life sciences.

The percentage of our total consolidated revenues generated by our Government segment for fiscal 2006, 2005 and 2004 was 94%, 94% and 93%, respectively.

Our Commercial segment provides technology-driven consulting, systems integration and outsourcing services and solutions in selected commercial markets, currently IT support for oil and gas exploration and production, applications and IT infrastructure management for utilities and data lifecycle management for pharmaceuticals, in the United States and abroad. We apply domain-specific expertise, and adapt consulting and technology services and solutions developed for our Government segment customers, to fulfill the needs of our Commercial segment customers. These needs include enterprise IT optimization, data lifecycle management, asset management and business process analysis and transformation. The percentage of our total consolidated revenues generated by our Commercial segment was 7% for each of fiscal 2006, 2005 and 2004.

Industry Background

In fiscal 2006, 2005 and 2004, we derived 89%, 86% and 85% of our revenues, respectively, from various departments and agencies of the U.S. Government. According to the Congressional Budget Office estimates, U.S. Government total discretionary outlays in government fiscal 2006 will be approximately $1,035 billion, and we estimate that more than $200 billion of this amount will be spent in areas in which we compete.

U.S. Government National Security Spending

Spending on national security accounts for the largest portion of the discretionary U.S. Government budget. According to Congressional Budget Office estimates, aggregate defense and homeland security discretionary outlays will be $555 billion for government fiscal 2006. These government fiscal 2006 outlays represent an increase of $56 billion over government fiscal 2005, an 11% increase.

Military

Global War on Terror. National security spending is driven primarily by the DoD. After substantial contraction in the DoD budget during the early 1990s with the end of the Cold War, spending on national security began to rebound significantly in 1999. This trend was accelerated by the U.S. Government s response to the September 11, 2001 terrorist attacks. According to Congressional Budget Office estimates, DoD discretionary outlays will grow at a rate of 6.0% from government fiscal 2005 to 2006. These discretionary outlays do not include the June 2006 legislation for $65.88 billion in supplemental defense appropriations for the global war on terror. As a result of the ongoing global war on terror and the U.S. military s continued deployment to Iraq and Afghanistan, we expect the U.S. Government to continue investing heavily in national security.

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Defense Transformation. Another key driver of recent U.S. Government national security spending has been defense transformation with a focus on command, control, communications, computers, intelligence, surveillance and reconnaissance (C4ISR). Although it predated the September 11, 2001 terrorist attacks, the effort to transform the military has accelerated as a result of the global war on terror. We believe that U.S. Government spending on defense transformation will be driven by several interrelated goals, including (1) improved threat assessment, dissemination of actionable intelligence and advance warning of threats, (2) a more mobile, versatile and effective military and (3) the development of network-centric warfighting capabilities. We believe the DoD s annual investment in defense transformation will average more than $75 billion in each of the next four government fiscal years. Of this amount, we expect approximately $60 billion will be spent each year to acquire transformational systems and capabilities and approximately $15 billion each year to improve and outsource business, logistics and product support functions. Of the spending on the acquisition of systems and capabilities, we estimate that approximately $30 billion will be spent each year on defense transformation-related research and development, testing and evaluation (RDT&E), a large portion of which will be spent on contractors like us. Of the $15 billion that we estimate will be spent each year to improve and outsource business, logistics and product support functions, we estimate that approximately $5 billion will be spent on contractors like us.

Intelligence

Budget data for government fiscal 1998, the most recent period for which intelligence-related budget data has been declassified, indicated an annual intelligence budget in excess of $26 billion. We believe that the U.S. Government s response to the global war on terror has resulted in increased spending by U.S. intelligence agencies and expect it to continue to grow in the foreseeable future. The Intelligence Reform and Terrorism Prevention Act of 2004 mandated better integration and timeliness of global and domestic threat assessment and dissemination of actionable information and created the office of Director of National Intelligence with budgetary authority over 16 intelligence agencies. We expect that the increased focus on coordination and interoperability among these intelligence agencies will require significant support by outside contractors like us.

Homeland Defense

In addition to spending on the global war on terror overseas, the U.S. Government has intensified its efforts to protect the United States against terrorism at home. The Congressional Budget Office estimates that homeland security outlays will increase from $33.3 billion in government fiscal 2005 to $61 billion in government fiscal 2006, representing a growth rate of 84.7%. Homeland security outlays include homeland defense, disaster relief and emergency preparedness activities. We believe that a significant portion of future homeland defense spending will focus on protecting U.S. citizens from chemical, biological, radiological and nuclear (CBRN) attacks, protecting and fortifying critical infrastructure, enhancing information security, upgrading enterprise systems to better facilitate communications and facilitating coordination and communication within and among government agencies.

U.S. Government IT Spending

The U.S. Government is the largest single consumer of IT solutions, systems and services in the world. According to the Government Electronics & Information Technology Association, an industry association, the portion of total U.S. Government IT spending that is contracted to private sector providers like us will be $65 billion in government fiscal 2006 and will grow at a compound annual growth rate of 2.9% to $75 billion in government fiscal 2011. We believe that the U.S. Government s demand for IT systems and services is driven by the national security concerns stemming from the global war on terror, the ongoing transformation of the military and the increased reliance on IT outsourcing by the U.S. Government.

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Commercial Services

We compete in targeted areas of the commercial business services market, which is driven largely by corporate investment in technology to enhance productivity, reduce costs and increase profitability. Competitive factors, including emerging technologies and globalization, are highlighting critical areas of corporate IT spending such as enterprise information technology optimization, data lifecycle management, asset management and business analysis and transformation. The ability of businesses to capture, access, analyze and transmit data rapidly throughout an organization and between remote geographic locations is becoming more critical. In addition, increased merger and acquisition activity is also generating higher corporate IT spending. With IT projects becoming more complex in scale and scope, businesses are increasingly turning to IT services providers for access to specialized expertise and systems engineering and integration capabilities that are either not readily available from internal resources or not in their core competency. As a result, we have focused our efforts in selected commercial markets in which we can leverage our specialized experience and skill sets, currently oil and gas, utilities and pharmaceuticals.

Oil and Gas. The oil and gas industry is experiencing a period of historically high levels of cash flow and profitability. At the same time, diminishing reserves at proven sites and disappointing trends in greenfield exploration are placing an increased premium on data integration and exploitation at all phases of the upstream exploration and development process. Also, the oil and gas industry is relying more heavily on data management and integration to match its upstream production capabilities with downstream distribution to its end-user customers more effectively and efficiently. According to IDC, total IT spending in the North American resource industries, which includes oil and gas, was approximately $16.2 billion in 2004.

Utilities. With the consolidation and deregulation of utilities in the United States and United Kingdom, utility companies are facing increased profitability and financial performance expectations from their stakeholders. Utilities resulting focus on more efficient power generation, distribution and asset management is driving investment in IT infrastructure and business processes. According to IDC, total IT spending in North America for the utilities market was approximately $16.9 billion in 2004.

Pharmaceuticals. Advances in medical knowledge and research tools have dramatically increased the sources and amount of information available to scientists in the fields of drug discovery and development. Simultaneously, the high costs of clinical trials, increased pressure on drug pricing and prescription reimbursement and product liability risks have increased the importance of systems to manage drug development data. We believe that these trends are driving spending on data integration and lifecycle management in every phase of the drug discovery and development process. Industry consolidation in the pharmaceuticals and life sciences sectors is also driving the necessity for data management and IT optimization. According to Health Industry Insights, an IDC company, worldwide total IT spending for the life sciences sector, which includes pharmaceutical companies and biotechnology companies, was approximately $30 billion in 2004.

Competitive Strengths

To maximize our ability to consistently deliver innovative solutions to help meet our customers most challenging needs, and to grow our business and increase stockholder value, we rely on the following key strengths:

Skilled Personnel and Experienced Management. Our people are our most valuable asset. Our professional staff is highly educated, with approximately 9,900, or 45%, holding advanced degrees, including more than 1,500 holding doctoral degrees. As of April 30, 2006, we had 43,300 employees, approximately 23,000 of whom had national security clearances. Many U.S. Government programs require contractors to have high-level security

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clearances. Depending on the required level of clearance, security clearances can be difficult and time consuming to obtain, and our large pool of cleared employees allows us to allocate the appropriate human resources to sensitive projects, facilitating our ability to win and execute contracts with the DoD, DHS and U.S. intelligence community. In addition, our President and Chief Executive Officer, our seven Executive Vice Presidents and our five Group Presidents have industry experience averaging over 29 years and tenure with our company averaging over 10 years.

Employee Ownership and Core Values. We believe that a cornerstone of our success has been our culture of employee ownership supported by our long-standing core values. Approximately 35,500 of our 43,300 employees own our stock. We believe that we have a high level of employee ownership relative to our competitors, and this better aligns our employees interests with those of our company, our other non-employee stockholders and our customers. Following the IPO, we intend to continue to provide our employees with opportunities to own our stock through bonuses in stock or stock options, stock contributions to our employee benefit plans and participation in our employee stock purchase plan. We believe that our employee ownership culture, in addition to our core values, differentiate us from our competition. These core values include:

- commitment to ethical conduct
- fostering entrepreneurship and innovation
- pursuit of technical excellence
- focus on high level of customer satisfaction

Knowledge of Customers Needs. Over the past 35 years, we have developed a deep and sophisticated knowledge of our customers, enabling us to design effective solutions that address their mission-critical needs and integrate these solutions with existing systems. We have also made strategic hires of managerial-level employees with significant government experience who have supplemented our knowledge of our customers business processes and who have extended our expertise into new areas.

Technical Expertise. We have deep technical expertise stemming from our work on our customers most challenging and complex problems. This technical expertise allows us to stay at the forefront of technology and innovation in key technical areas, such as:

- computer network technologies and infrastructure
- data mining and management
- high performance computing and storage
- modeling and simulation
- sensors, surveillance, and signal processing

supply chain management

unmanned vehicles and robotics

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Trusted Services and Solutions Provider. We have provided platform-independent systems engineering and IT services and solutions to the U.S. Government and other customers since 1969. Over this time, we believe we have earned a reputation as a trusted provider of services and solutions for complex problems, including those with significant national security implications. We believe our position as a prime contractor on several key U.S. Government programs reflects the U.S. Government s confidence in our abilities to address its mission-critical needs. As a result of our strong record of performance, we have become one of the top three IT and systems integrators for the U.S. Government, as evidenced by industry publications:

#2 Top Federal Prime IT Contractors INPUT (May 2005)
#2 Top Systems Integrators Federal Computer Week (September 2005)
#3 Top Federal Prime Contractors Washington Technology (May 2006)
#3 Top Technology Contractors Government Executive (August 2005)
#3 GSA Contractor Federal Computer Week (September 2005)
#3 Top U.S. Government IT Vendors IDC (October 2005)

Proven Marketing and Business Development Organization. Our highly effective marketing and business development organization has helped us achieve high contract win rates and grow our business with existing and new customers. Our non-IDIQ contract win rates, based on award values, were 69%, 65% and 64% in fiscal 2006, 2005 and 2004, respectively.

Ability to Complete and Integrate Acquisitions. To complement our internal growth, we have completed and integrated approximately 70 acquisitions of small- and medium-sized companies over the 10 fiscal years ended January 31, 2006, with an aggregate purchase price of approximately $1.7 billion. These acquisitions have provided us with highly skilled personnel including many with security clearances and specialized technical expertise, as well as valuable customer relationships, thereby enhancing our internally-developed capabilities. We believe that our ability to identify, acquire and integrate complementary businesses is a core strength that will continue to play a significant role in our growth and success.

Strong Relationships with Small Businesses. The U.S. Government is focused on supporting small and disadvantaged businesses through formal procurement regulations and set-asides. We have strong relationships with a large number of small and disadvantaged businesses that possess a wide range of skills and significant customer contacts. These relationships provide us access to specialized capabilities, allow us to participate with these businesses in programs with set-aside requirements and improve our competitive positioning in programs for which small and disadvantaged business participation is important.

Growth Strategy

We are focused on continuing to grow our business as a leading scientific, engineering, systems integration and technical services and solutions company. In our Government segment, we seek to become the leading provider of systems engineering, systems integration and technical services and solutions. In our Commercial segment, we seek to become a leading supplier of scientific, engineering and business solutions to our customers in additional targeted vertical markets. Elements of our growth strategy include:

Leverage Our Existing Customer Relationships. We plan to continue expanding the scope of the services we provide to our existing customers. We are adept at penetrating, cross-selling to and building-out existing customer accounts through our successful performance and comprehensive knowledge of our customers needs, which has led to many long-term contract relationships. We believe our high level of customer satisfaction and deep knowledge of our customers business processes enhances our ability to cross-sell additional services.

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Increase Our U.S. Government Customer Base. We believe that the U.S. Government s increased emphasis on national security, intelligence and homeland security has significantly increased our market opportunity. We have extensive experience supporting the U.S. Government in the areas of contingency and emergency response and recovery planning, information assurance, critical infrastructure protection and command, control, communications and intelligence. We intend to leverage this broad experience to expand our customer base to include organizations in the U.S. Government for which we have not historically worked. We believe our ability to win new customers is enhanced by our position as a prime contractor on four of the five largest IT services GWACs, which are task-order or delivery-order contracts for IT services established by one agency for government-wide use. These contracts enable us to sell our services and solutions to virtually any U.S. Government agency. In addition we have used and intend to continue to use strategic hires as a cost-effective way to build out customer accounts, to establish new competencies and to penetrate new markets.

Pursue Strategic Acquisitions. In order to complement our internal growth, we plan to continue to pursue strategic acquisitions in areas that we expect to experience high growth. Our acquisition strategy is focused on companies that will enable us to cost-effectively add new customers, specific agency knowledge and/or technical expertise. We have acquired more than 70 companies over the 10 fiscal years ended January 31, 2006 and we intend to continue to selectively acquire high quality companies that accelerate our access to existing or new markets that we believe have strong growth dynamics. Following the completion of the IPO, we will have greater flexibility to make acquisitions through the issuance of publicly traded shares of our common stock.

Grow High Value-Added Business in Selected Commercial Markets. We intend to grow in our current selected commercial markets and identify other markets in which we can leverage our specialized experience and skill sets.

Services and Solutions

We offer a broad range of services and solutions to address our customers most complex and critical needs. Below is a summary of our principal services and some representative projects that illustrate the breadth of our capabilities. References below to total contract value mean the aggregate potential value of a given contract, assuming that all options are exercised under that contract. See Risk Factors Risks Relating to Our Business.

Defense Transformation

We develop leading-edge concepts, technologies and systems to solve complex challenges facing the U.S. military and its allies, helping them transform the way they fight. To help ensure that U.S. military personnel are better equipped, protected and trained, we assist the DoD in developing and implementing advanced technologies into the current armed forces. As a leader in the emerging area of network-centric operations, we are helping the U.S. military to develop next-generation C4ISR capabilities, including advanced communications networks, shared situational awareness, improved collaborative planning and enhanced mobility and logistics. We received the 2004 Frost & Sullivan Competitive Strategy Leadership Award, which recognized us as one of the most trusted and influential high-level C4ISR systems integrators. Some examples of our defense transformation projects are described below.

U.S. Army s Future Combat Systems Program (FCS). The U.S. Army is undertaking a major program to design, prototype and build combat technologies and systems to serve as the centerpiece of the U.S. Army s transformation into a more mobile, versatile and effective force. We and The Boeing Company were selected in June 2003 by the U.S. Army as the lead systems integrator team for FCS. When completed, FCS will consist of 19 individual battlefield systems interconnected and commanded through an advanced network. The FCS network will be capable of monitoring and directing military equipment and personnel in all kinds of terrain and

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weather conditions and providing an integrated picture of the battlefield wherever located. This program highlights our ability to conceive and design a large system of systems employing leading-edge technology to address the military s future needs in new and innovative ways. The FCS Program is scheduled to run through December 31, 2014 and has a total contract value to us of approximately $3 billion. FCS currently is our largest non-IDIQ contract.

Global Information Grid-Bandwidth Expansion (GIG-BE). Providing military personnel with the right information at the right place and time requires a worldwide network with substantial bandwidth. We have provided significant contributions to the architecture of a new DoD global information network. Currently, we are the prime contractor supporting the Defense Information Systems Agency (DISA) in the development of the network s backbone, known as the GIG-BE program. GIG-BE is bringing an optical mesh network with 10-gigabyte-per-second connectivity to approximately 100 U.S. military bases, posts and stations worldwide. GIG-BE achieved initial operating capability in only 20 months, meeting the compressed schedule set forth by DISA and demonstrating our ability to rapidly develop and deploy highly complex network technology solutions. Under multiple task orders, the GIG-BE program has a total contract value to us of $450 million.

Net-Centric Enterprise Services. We are supporting the DoD s efforts to migrate from the current Global Command and Control System (GCCS) to the next generation of Joint Command and Control (JC2) based on a new services-based approach called Net-Centric Enterprise Service (NCES). We are helping define how a services-oriented architecture and web services technology should be integrated on an enterprise scale in support of warfighter operations. We are providing architecture, design, systems engineering, integration of commercial and government software, performance testing, security and information assurance engineering and deployment support to this migration effort. We believe our experience and capabilities developed in connection with the GIG-BE program, the GCCS-Joint program and the NCES initiatives have positioned us well for future major C4ISR programs.

Intelligence

We develop solutions to help the U.S. defense, intelligence and homeland security communities build an integrated intelligence picture, allowing them to be more agile and dynamic in challenging environments and produce actionable intelligence.

We provide operations, engineering and technical support for the development and improvement of technologies relating to intelligence collection, processing, dissemination, collaboration and implementation. Our intelligence services include activities related to (1) the support of intelligence and operations centers, (2) surveillance and reconnaissance through satellite technologies and unmanned aerial vehicle operations centers and (3) enhanced radar and sensors on weapon systems. We also support human intelligence and counterintelligence activities. Much of the information regarding our intelligence programs is classified. Some unclassified examples of our intelligence projects are provided below.

Geospatial Intelligence. Imagery, mapping and geospatial reference data are essential elements of all military activity. Our services include activities related to the acquisition, management, interpretation, integration, analysis and display of imagery and related mapping and intelligence data, referred to as geospatial intelligence. For example, we help U.S. Northern Command (NORTHCOM), the U.S. military command responsible for, among other things, U.S. homeland defense, and other government agencies provide timely, relevant, and actionable intelligence to homeland defenders. As part of this work, we developed, and now maintain, the geospatial component of NORTHCOM s intelligence operations. We are one of the largest contract producers of geospatial information for the National Geospatial-Intelligence Agency, having provided new imagery exploitation capabilities to 15 sites worldwide last year.

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Surveillance and Reconnaissance. Unmanned vehicles have become an increasingly important intelligence-gathering tool. Our technologies are used in some of the most sophisticated unmanned aerial vehicles (UAV) ever developed. We previously integrated and recently upgraded the operations center and ground stations for the Predator UAV, which was widely used in Iraq, and our technical staff supports operational crews during all Predator missions. We have also played a key role in the design and integration of the high-altitude, long-range Global Hawk UAV, and, at the other end of the spectrum, we helped test and evaluate a hand-launched UAV called Dragon Eye, which provided U.S. Marines in Iraq with infrared surveillance videos of their operating area. Our wide-ranging system, software and engineering services are at the forefront of developing and fielding emerging UAV surveillance and reconnaissance technologies.

Homeland Security and Defense

We develop technical solutions and provide systems integration and mission-critical support services to help federal, state, local and foreign governments and private-sector customers protect the United States and allied homelands. Our innovation and breadth of solutions in homeland security was recently recognized when Frost & Sullivan named us as the 2005 Homeland Security Company of the Year.

We provide services and solutions including vulnerability analysis, infrastructure protection and emergency response and recovery. We contribute to critical counterintelligence plans and programs to assess vulnerabilities and help safeguard important events and infrastructure, including the 2004 national political conventions, the U.S. Capitol, House and Senate office buildings and the Library of Congress. We are also developing countermeasures to address a range of threats from dirty bombs to improvised nuclear devices to full-scale nuclear weapons. We are also working on multiple fronts to attack the toughest problems in bioagent detection. Following a disaster, managing critical infrastructure information is crucial for ensuring continuity of operations. We have designed more than a dozen emergency operations centers, primarily for state and local agencies, to manage the interoperability between new equipment and legacy responder systems. Some examples of our projects in homeland security are described below.

Protecting Against Chemical, Biological, Radiological, and Nuclear (CBRN) Threats. We have an extensive understanding of the design and employment of weapons of mass destruction which is critical to detection of, protection from and response to these threats. Our expertise spans the range of CBRN threats, as evidenced by the DoD s recent selection of us as the prime contractor under the Guardian Installation Protection Program to provide CBRN protection for up to 200 DoD installations. Commanders at these installations are facing the full range of CBRN threats and a confusing array of CBRN detection, protection and response choices. As the prime contractor for the Guardian project, we will help choose and field the appropriate integrated detection, protection and response capabilities. The Guardian program has a total contract value to us of $390 million.

Protecting Ports, Borders and Transportation. Only a small portion of the millions of cargo containers moving by ship, road and rail are screened for weapons of mass destruction or other hazards. To help address this threat, we developed the Integrated Container Inspection System (ICIS), which scans sealed containers for hazardous materials at cargo terminals and border crossings without disrupting normal traffic flow. ICIS employs several of our technologies, including (1) EXPLORANIUM detectors for low-level radiation scanning, (2) optical character recognition technology for automated container identification and (3) VACIS® inspection systems for identification of a wide range of substances, including weapons, hazardous materials and drugs. Nearly 300 VACIS systems are deployed globally, and the ICIS has been deployed in two pilot programs in Hong Kong. Our products and services are now deployed in 20 major ports in multiple countries, demonstrating international adoption of this solution.

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Enterprise Systems Integration for Homeland Defense. Following the consolidation of 22 U.S. Government agencies into the Department of Homeland Security (DHS), we were selected under the STARS System Management and Integration program as the prime contractor to provide enterprise-wide integration services for the Immigration and Customs Enforcement element of the DHS. Some of the services included implementation of a data network backbone connecting the formerly separate agencies and the development of the first enterprise architecture in DHS. By laying this foundation, we helped the DHS map its IT systems to specific business functions, identify overlapping systems and more effectively identify needed IT programs. In fiscal 2006, we were selected as prime contractor under the follow-on Information Technology Engineering Support Services (ITESS) program to continue to provide integration services. The follow-on ITESS program has a total contract value to us of $446 million.

Logistics and Product Support

Maintaining and delivering a ready supply of fuel, parts, munitions, food and other supplies is a constant challenge for the U.S. military. Our logistics and product support solutions enhance the readiness and operational capability of U.S. military personnel and weapon and support systems.

To keep up with the pace of military operations, logisticians need intelligence sensors, communications networks and analytics, as well as the same best-in-class supply chain solutions that are used in the commercial sector, such as demand forecasting, total asset visibility and just-in-time inventory. To address these needs for the U.S. Navy, we are providing a supply chain management solution to Naval Aviation Depots and the Defense Logistics Agency in support of maintenance, repair and overhaul of 72 weapon systems. Under the contract, we employ a supplier/manufacturer network with supply chain management capability to supply more than 84,000 items. Our supply chain management system incorporates intelligent agent technology, which automatically tracks inventory levels in tens of thousands of bins as parts are consumed and forecasts when items should be reordered, cutting average supply delivery times. This program has a total contract value to us of $627 million.

Systems Engineering and Integration

Large government organizations face increasingly tough challenges to integrate and share massive amounts of data from geographically remote and disparate databases and legacy systems. We provide systems engineering and integration solutions to help our customers design, manage and protect complex IT networks and infrastructure. We support customers across the domains and mission areas of the U.S. Government, providing a range of services from full-scale systems deployment to systems engineering support services.

With the increasing complexity of weapons systems and military tactics, the U.S. military has an increasing need for more sophisticated training tools and solutions. Through our software and systems-engineering organizations, we have pioneered innovative modeling and simulation technologies, including distributed simulation for training and distributed test and evaluation. Today, our expertise ranges from traditional areas, such as training and analysis simulation, to emerging areas, such as simulation-based acquisition. Currently, we lead the development of the DoD s architecture and middleware for seamlessly integrating live-virtual-constructive simulation for experimentation, training, test and evaluation and acquisition. As a leader in modeling and simulation, we support the U.S. s three premier military simulation training programs: the Army Warfighter Simulation (WARSIM), the Joint Simulation System (JSIMS), and the Air Force National Air and Space Model (NASM). Additionally, our expertise in semi-automated forces technology in the United States resulted in our selection to lead the software implementation of British doctrine and tactics for the U.K.

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Combined Arms Tactical Trainer. These four programs have an aggregate total contract value to us of $126 million. Our success with these programs demonstrates our ability to leverage our experience and capabilities to obtain new projects.

Research and Development

As one of the largest science and technology contractors to the U.S. Government, we conduct leading-edge research and development of new technologies with applications in areas such as national security, intelligence and life sciences. We believe that being at the forefront of science and technology provides us with a competitive advantage and positions us as a solution provider for our customers next-generation challenges. Some examples of our research and development projects are described below.

Advanced Robotics. We develop and test advanced robotic systems, including prototype unmanned robotic vehicles. An advanced autonomous robotic vehicle that we developed in collaboration with Carnegie Mellon University recently competed in a Defense Advanced Research and Projects Agency (DARPA) sponsored test, designed to prove the concept of integration of advanced robotic vehicles into unmanned military systems. The mapping and route planning software we developed for this project has provided valuable insights that could be used for geospatial intelligence requirements for future military robotic systems. For DARPA, we developed a networked system of 100 small robots that are able to intelligently collaborate on missions. In the future, these robots may be used to search and map terrorist-occupied or earthquake-damaged buildings, as well as track intruders.

Wireless Sensors. For DARPA, we are also exploring innovative ways to deploy tiny wireless sensors, known as Smart Dust, that can self-configure into a network and gather and fuse information into actionable intelligence information. For example, we are researching how these sensors could help the U.S. military improve situational awareness, reconnaissance, surveillance and target acquisition capabilities in urban areas.

Biopharmaceutical and Medical Research. We operate the National Cancer Institute (NCI) at Frederick, Maryland, one of the world s premier cancer and AIDS research facilities. We support a wide range of research areas for NCI, the National Institute of Allergy and Infectious Diseases, and the U.S. Army, including the development of nanotechnology applications for the prevention and treatment of cancer, as well as vaccines for HIV, anthrax and malaria. The NCI s new cancer Biomedical Informatics Grid will enable cross-disciplinary sharing of research between more than 600 cancer researchers from over 50 different cancer centers. We are developing important grid-based middleware, applications and security for this groundbreaking initiative.

Commercial Services

We help our Commercial segment customers become more competitive, offering technology-driven consulting, systems integration and outsourcing services and solutions primarily to customers in selected commercial markets, currently IT support for oil and gas exploration and production, applications and IT infrastructure management for utilities and data lifecycle management for pharmaceuticals, in the United States and abroad. We apply domain-specific expertise, as well as consulting and technology services and solutions adapted from our experience with our Government segment customers, to fulfill the needs of our Commercial segment customers. These needs include enterprise IT optimization, data lifecycle management, asset management and business process analysis and transformation. Some examples of our commercial projects are described below.

The Digital Oilfield. The oil and gas industry faces significant challenges to maximize exploration and production while minimizing capital risk and requirements. The industry employs highly specialized systems and

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solutions to meet these challenges. To help one of the largest global oil and gas companies design and operationalize its next generation oilfield and refinery called the Field of the Future and Refinery of the Future, respectively, we are working to implement and manage mission-critical geophysical data collection and decision support systems. Our solutions provide the architecture for more complete asset awareness, enabling improved decision making. We have similar projects with two other major oil and gas companies.

Asset Management for Utility Companies. Asset management has become increasingly important to utility companies as they look to streamline costs and create other efficiencies related to their extensive assets, many of which have useful lives spanning decades. A leading U.K. utility company sought to create more efficient methods to provide maintenance and emergency repairs of its physical assets used in electricity delivery, such as power substations, pole-mounted transformers, overhead lines and underground cables. We helped design and implement an asset management system for this utility company. This system provides field personnel with up-to-date, easy-to-access mapping information which is used to readily locate electricity substations, transformers and power cables, as well as to facilitate the use of fault diagnosis tools to enable technicians to efficiently and effectively address power loss problems across the utility s power grid.

Contracts

As of April 30, 2006, we had a portfolio of approximately 9,000 active contracts, including active task orders under IDIQ contract vehicles. We have a diversified portfolio of contracts, with revenues recognized in fiscal 2006 under our largest contract representing approximately 4% of our total consolidated revenues. Listed below are the 10 contracts which generated the most revenues and which in the aggregate represented 14% of our total consolidated revenues in fiscal 2006.

Contract title	Customer
Future Combat Systems (FCS)	U.S. Army
Unified NASA Information Technology Services (UNITeS)	NASA
Global Information Grid-Bandwidth Expansion (GIG-BE)	U.S. Defense Information Systems Agency (DISA)
Air Force Industrial Prime Vendor	U.S. Air Force
Data Services Installation & Maintenance	DISA
Information Technology Services Agreement	Entergy
Safety, Reliability & Quality Assurance (SR&QA)	NASA
Omnibus 2000 Systems & Computer Resources Support	U.S. Army
EXECUTELOCUS (formerly Trailblazer Technical Development Program)	Confidential
Information Technology Systems, Engineering and Management Support Services (ISEM)	Department of Transportation

Contract Procurement. The U.S. Government technology services procurement environment has evolved in recent years due to statutory and regulatory procurement reform initiatives. U.S. Government agencies traditionally have procured technology services and solutions through agency-specific contracts awarded to a single contractor. However, in recent years the number of procurement contracting methods available to U.S. Government customers for services procurements has increased substantially. Today, there are three predominant contracting methods through which U.S. Government agencies procure technology services: traditional single award contracts, GSA Schedule contracts, and single and multiple award IDIQ contracts. Each of these is described below:

Traditionally, U.S. Government agencies have procured services and solutions through single award contracts which specify the scope of services that will be delivered and identify the contractor that will provide the specified services. When an agency has a requirement, interested contractors are solicited, qualified and then provided with a request for a proposal. The process of qualification, request for proposals and evaluation of bids requires the agency to maintain a large, professional procurement staff and can take a year or more to complete.

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GSA Schedule contracts are listings of services, products and prices of contractors maintained by the GSA for use throughout the U.S. Government. In order for a company to provide services under a GSA Schedule contract, the company must be pre-qualified and awarded a contract by GSA. When an agency uses a GSA Schedule contract to meet its requirements, the agency, or the GSA on behalf of the agency, conducts the procurement. The user agency, or the GSA on its behalf, evaluates the user agency s services requirements and initiates a competition limited to GSA Schedule qualified contractors. GSA Schedule contracts are designed to provide the user agency with reduced procurement time and lower procurement costs.

Single and multiple award IDIQ contracts are contract forms used to obtain commitments from contractors to provide certain products or services on pre-established terms and conditions. Under IDIQ contracts, the U.S. Government issues task orders for specific services or products it needs and the contractor supplies products or services in accordance with the previously agreed terms. The competitive process to obtain task orders is limited to the pre-selected contractor(s). If the IDIQ contract has a single prime contractor, the award of task orders is limited to that party. If the contract has multiple prime contractors, the award of the task order is competitively determined. Multiple-contractor IDIQ contracts that are open for any government agency to use for the procurement of services are commonly referred to as government-wide acquisition contracts, or GWACs. Due to the lower cost, reduced procurement time, and increased flexibility of GWACs, there has been greater use of GWACs among many agencies for large-scale procurements of technology services. IDIQ contracts often have multi-year terms and unfunded ceiling amounts, therefore enabling but not committing the U.S. Government to purchase substantial amounts of products and services from one or more contractors.

Below is a list of our 10 largest non-IDIQ contracts based on total contract value to us, including funded backlog and negotiated unfunded backlog as of April 30, 2006. For information regarding our backlog, see Backlog.

Top 10 non-IDIQ contracts by total contract value

Contract title	Customer	Total SAIC contract value	Contract expiration date
		(in millions)	
Future Combat Systems (FCS)	U.S. Army	$ 2,177	Dec 31, 2014
Navy Aviation Industrial Prime Vendor Generation II	U.S. Navy	627	Sep 30, 2014
Information Technology Services Agreement	Entergy	545	Dec 31, 2006
Information Technology Engineering & Support Services (ITESS)	DHS	446	Dec 31, 2010
Guardian Installation Protection Program	U.S. Army	390	Apr 27, 2010
EXECUTELOCUS (formerly Trailblazer Technical Development Program)	Confidential	362	Sep 30, 2006
City Time, Office of Payroll Administration	New York City	353	Aug 12, 2009
Information Technology & Telecommunications Services Outsourcing	San Diego County	320	Dec 13, 2006
Safety and Mission Assurance Support Services (S&MA)	NASA	276	Apr 30, 2011
Systems Engineering & Integration Contract (SEIC)	U.S. Air Force	257	Apr 21, 2017
		$ 5,753	

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Below is a list of our 10 largest GSA Schedule or IDIQ contract vehicles based on total contract vehicle ceiling value that could be awarded to all contractors, including us, as of April 30, 2006.

Top 10 GSA Schedule or IDIQ contract vehicles by total contract vehicle ceiling value (1)

Contract title	Customer	Total contract vehicle ceiling value to all contractors	Contract vehicle expiration date
		(in millions)	
SeaPort Enhanced (2)	U.S. Navy	$ 45,409	Apr 1, 2019
Millennia	GSA Federal Technology Service	25,000	Apr 27, 2009
Millennia Lite	GSA Federal Technology Service	20,000	Apr 21, 2010
Defense Medical Information Systems (D/SIDDOMS III)	Defense Contracting Command	8,000	Dec 14, 2013
Flexible Acquisition Sustainment Tool (FAST)	U.S. Air Force	7,441	Feb 23, 2008
Simulation, Training & Instrumentation Command (STRICOM) Omnibus	U.S. Army	4,000	Sep 20, 2008
DISN Global Solutions	DISA	3,000	Sep 30, 2010
Weapons of Mass Destruction Defeat Technology	Defense Threat Reduction Agency	1,260	Apr 30, 2008
Applications & Support for Widely-Diverse End User Requirements (ANSWER)	GSA Federal Technology Service	1,100	Dec 31, 2008
Next Generation Engineering	DISA	1,000	Apr 21, 2009
		$ 116,310	

(1) Total contract ceiling value represents the maximum amount of contract awards that could be awarded to all contractors, including us, eligible to compete for task orders under the contract vehicle.

(2) Contract with AMSEC, LLC, our 55% owned joint venture.

Backlog

Government segment funded backlog primarily represents the portion of backlog for which funding is appropriated and is payable to us upon completion of a specified portion of work, less revenues previously recognized on these contracts. Commercial segment funded backlog represents the full value on firm contracts, which may cover multiple future years, under which we are obligated to perform less revenues previously recognized on these contracts. Our funded backlog in the Government segment does not represent the full potential value of our contracts because the U.S. Government and our other customers often appropriate or authorize funds for a particular program or contract on a yearly or quarterly basis, even though the contract may call for performance over a number of years. When a definitive contract or contract amendment is executed and funding has been appropriated or otherwise authorized, funded backlog is increased by the difference between the funded dollar value of the contract or contract amendment and the revenues recognized to date on the contract. Negotiated unfunded backlog represents (1) firm orders for which funding has not been appropriated or otherwise authorized and (2) unexercised priced contract options. Negotiated unfunded backlog does not include any estimate of future potential task orders that might be awarded under IDIQ, GWAC or GSA Schedule contract vehicles.

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The approximate value of our total consolidated negotiated backlog as of January 31, 2006, 2005 and 2004 and April 30, 2006 was as follows:

	January 31			April 30
	2006	2005	2004	2006
	(in millions)			
Government Segment:				
Funded backlog	$ 3,398	$ 3,333	$ 3,127	$ 3,268
Negotiated unfunded backlog	11,169	9,656	7,359	11,814
Total negotiated backlog	$ 14,567	$ 12,989	$ 10,486	$ 15,082
Commercial Segment:				
Funded backlog	$ 490	$ 313	$ 228	$ 664
Negotiated unfunded backlog	5	114	187	18
Total negotiated backlog	$ 495	$ 427	$ 415	$ 682
Total Consolidated:				
Funded backlog	$ 3,888	$ 3,646	$ 3,355	$ 3,932
Negotiated unfunded backlog	11,174	9,770	7,546	11,832
Total consolidated negotiated backlog	$ 15,062	$ 13,416	$ 10,901	$ 15,764

We expect to recognize a substantial portion of our funded backlog as revenues within the next 12 months. However, the U.S. Government may cancel any contract or purchase order at any time. In addition, certain contracts and purchase orders in the Commercial segment may include provisions that allow the customer to cancel at any time. Most of our contracts have cancellation terms that would permit us to recover all or a portion of our incurred costs and potential fees in such cases. See Risk Factors Risks Relating to Our Business We may not realize as revenues the full amounts reflected in our backlog, which could adversely affect our operating results.

Key Customers

Our largest customer is the U.S. Government, in the aggregate accounting for 89%, 86% and 85% of our total consolidated revenues in fiscal 2006, 2005 and 2004, respectively. Within the U.S. Government, our largest customers for each of the last three fiscal years were the U.S. Army, U.S. Navy and U.S. Air Force. Each of these customers has a number of subsidiary agencies which have separate budgets and procurement functions. Our contracts may be with the highest level or with the subsidiary agencies of these customers.

The percentage of total consolidated revenues attributable to each of these three major customers for the last three fiscal years was as follows:

	Year Ended January 31		
	2006	2005	2004
U.S. Army	16%	13%	13%
U.S. Navy	14	13	12
U.S. Air Force	10	11	11

Competition

Competition for U.S. Government contracts is intense. We compete against a large number of major, established multinational corporations which may have greater financial capabilities than we do. We also compete against smaller, more specialized companies that concentrate their resources on particular areas. As a

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result of the diverse requirements of the U.S. Government and our commercial customers, we frequently form teams with other companies to compete for large contracts, while bidding against team members in other situations. Because of the current industry trend toward consolidation, we expect major changes in the competitive landscape. See Risk Factors Risks Relating to Our Business We face aggressive competition. We believe that our principal competitors include the following companies:

Among contractors focused principally on U.S. Government IT and other technical services, we compete primarily with companies such as Anteon International Corporation, which was acquired by General Dynamics, CACI International Inc, ManTech International Corporation, SRA International, Inc. and The Titan Corporation, which was acquired by L-3 Communications.

Among the large defense contractors which provide U.S. Government IT services in addition to other hardware systems and products, we compete primarily with engineering and technical services divisions of The Boeing Company, General Dynamics Corporation, Lockheed Martin Corporation, Northrop Grumman Corporation and Raytheon Company.

Among the diversified commercial and U.S. Government IT providers, we compete primarily with companies such as Accenture Ltd, BearingPoint, Inc., Booz Allen Hamilton Inc., Computer Sciences Corporation, Electronic Data Systems Corporation, International Business Machines Corporation and Unisys Corporation.

We compete on factors including, among others, our technical expertise, our ability to deliver cost-effective solutions in a timely manner, our reputation and standing with government and commercial customers, pricing and the size and scale of our company.

Patents and Proprietary Information

Our technical services and products are not generally dependent upon patent protection. We claim a proprietary interest in certain of our products, software programs, methodology and know-how. This proprietary information is protected by copyrights, trade secrets, licenses, contracts and other means.

We actively pursue opportunities to license our technologies to third parties and enforce our patent rights. We also evaluate potential spin-offs of our technologies.

In connection with the performance of services for customers in the Government segment, the U.S. Government has certain rights to data, software codes and related material that we develop under U.S. Government-funded contracts and subcontracts. Generally, the U.S. Government may disclose such information to third parties, including, in some instances, competitors. In the case of subcontracts, the prime contractor may also have certain rights to the programs and products that we develop under the subcontract.

Research and Development

We conduct research and development activities under customer-funded contracts and with independent research and development (IR&D) funds. IR&D efforts consist of projects involving basic research, applied research, development and systems and other concept formulation studies. In fiscal 2006, 2005 and 2004, we spent approximately $27 million, $25 million and $19 million, respectively, on IR&D, which was included in selling, general and administrative expenses.

Seasonality

The U.S. Government s fiscal year ends on September 30 of each year. It is not uncommon for U.S. Government agencies to award extra tasks or complete other contract actions in the weeks before the end of its

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fiscal year in order to avoid the loss of unexpended fiscal year funds. As a result of this cyclicality in the U.S. Government budget process, we have from time to time experienced higher revenues in our third fiscal quarter, ending October 31, and lower revenues in our fourth fiscal quarter, ending January 31.

Regulation

We are heavily regulated in most fields in which we operate. We deal with numerous U.S. Government agencies and entities, including all of the branches of the U.S. military, the DoD, NASA, intelligence agencies, the Nuclear Regulatory Commission and the DHS. When working with these and other U.S. Government agencies and entities, we must comply with and are affected by laws and regulations relating to the formation, administration and performance of contracts. These laws and regulations, among other things:

- require certification and disclosure of all cost or pricing data in connection with various contract negotiations

- impose acquisition regulations that define allowable and unallowable costs and otherwise govern our right to reimbursement under various cost-based U.S. Government contracts

- restrict the use and dissemination of information classified for national security purposes and the exportation of certain products and technical data.

In order to help ensure compliance with these laws and regulations, all of our employees are required to attend ethics training at least bi-annually and other compliance training relevant to their position.

Internationally, we are subject to special U.S. Government laws and regulations (such as the Foreign Corrupt Practices Act), local government regulations and procurement policies and practices (including regulations relating to import-export control, investments, exchange controls and repatriation of earnings) and varying currency, political and economic risks. Some international customers require contractors to comply with industrial cooperation regulations, sometimes referred to as offset programs. Offset programs may require in-country purchases, manufacturing and financial support projects as a condition to obtaining orders or other arrangements. Offset programs generally extend over several years and may provide for penalties in the event we fail to perform in accordance with offset requirements.

See Risk Factors Risks Relating to Our Business Our U.S. Government contracts may be terminated and we may be liable for penalties under a variety of procurement rules and regulations and changes in government regulations or practices could adversely affect our profitability, cash balances or growth prospects.

Environmental Matters

Our operations, including the environmental consulting and investigative services we provide to third parties, and our ownership or operation of real property are subject to various foreign, federal, state and local environmental protection and health and safety laws and regulations. Failure to comply with those laws could result in civil or criminal sanctions, including fines, penalties or suspension or debarment from contracting with the U.S. Government, or could cause us to have to incur costs to change or upgrade or close some of our operations or properties. Some environmental laws hold current or previous owners or operators of businesses and real property liable for contamination, even if they did not know of and were not responsible for the contamination. Environmental laws may also impose liability on any person who disposes, transports, or arranges for the disposal or transportation of hazardous substances to any site. In addition, we may face liability for personal injury, property damage and natural resource damages relating to contamination for which we are otherwise liable or relating to exposure to or the mishandling of chemicals or other hazardous substances in connection with our current and former operations or services.

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Although we do not currently anticipate that the costs of complying with, or the liabilities associated with, environmental laws will materially adversely affect us, we cannot ensure that we will not incur material costs or liabilities in the future. See Risk Factors Risks Relating to Our Business Our services and operations sometimes involve using, handling or disposing of hazardous materials, which could expose us to potentially significant liabilities.

Employees and Consultants

As of April 30, 2006, we employed approximately 43,300 full and part-time employees. We also use consultants to provide specialized technical and other services on specific projects. To date, we have not experienced any strikes or work stoppages and we consider our relations with our employees to be good.

The highly technical and complex services and products provided by us are dependent upon the availability of professional, administrative and technical personnel having high levels of training and skills and, in many cases, security clearances. Because of our growth and the increased competition for qualified personnel, it has become more difficult to meet all of our needs for these employees in a timely manner and this may affect our growth in the current fiscal year. We intend to continue to devote significant resources to recruit and retain qualified employees.

Properties

As of January 31, 2006, we conducted our operations in approximately 400 offices located in 44 states, the District of Columbia and various foreign countries. We occupy a total of approximately 10 million square feet of space. Of this total, we own approximately 3.1 million square feet, and the balance is leased. Our major locations are in the San Diego, California and Washington, D.C. metropolitan areas, where we occupy approximately 1.3 million square feet and 2.7 million square feet of space, respectively.

We own and occupy the following properties:

Location	Number of buildings	Square footage	Acreage
McLean, Virginia	4	900,000	18.3
San Diego, California	7	677,000	22.2
Vienna, Virginia	2	280,000	14.7
Virginia Beach, Virginia	2	159,200	22.5
Huntsville, Alabama	1	100,000	18.0
Columbia, Maryland	1	95,500	7.3
Orlando, Florida	1	85,000	18.0
Oak Ridge, Tennessee	1	83,000	12.5
Dayton, Ohio	2	79,400	4.5
Reston, Virginia	1	62,000	2.6
Richland, Washington	1	23,700	3.1

The nature of our business is such that there is no practicable way to relate occupied space to industry segments. We consider our facilities suitable and adequate for our present needs. See Note 16 of the notes to consolidated financial statements for fiscal 2006 for information regarding commitments under leases.

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Legal Proceedings

Firm Fixed-Price Contract with the Greek Government

Although we have been pursuing a contract modification under this agreement with the Hellenic Republic of Greece (Customer) since shortly after a memorandum agreement with the Customer (Memorandum) was signed in July 2004, due to the difficulties in reaching mutually satisfactory terms, we instituted arbitration proceedings on April 21, 2006, before the International Chamber of Commerce (ICC) against the Customer to pursue our rights and remedies provided for in the contract and the Memorandum and under Greek law. The arbitration complaint filed by us: (1) seeks an order under the contract that the Customer s extended use of the C4I system provided under the contract (System) under the circumstances constitutes constructive acceptance and precludes the Customer from rejecting the System, (2) seeks damages for breach of contract, bad faith, use of the System and other damages, (3) seeks a determination as to the legal status of the contract as a result of the illegality issue discussed above, and (4) if the contract is determined to be illegal, seeks compensation for the commercial value of the System delivered and its use by the Customer and other damages. We are seeking total damages in excess of $76 million, with the precise amount to be proven in arbitration. We agreed to extend to July 31, 2006 the time period in which the Customer may submit its response to the arbitration complaint in order to provide the parties additional time to attempt to negotiate and complete a modification. Under the terms of the contract, disputes are subject to ultimate resolution by binding arbitration before a panel of three Greek arbitrators in Greece. Due to the complex nature of the legal and factual issues involved and the uncertainty of litigation in general, the outcome of the arbitration is uncertain. There is no assurance that we will prevail in the arbitration.

In the event we do not prevail in the arbitration or are unable to resolve the various disputes under the contract as anticipated, we could incur additional losses. If the Customer asserts claims against us in the arbitration and it is determined that we have breached the contract and, as a result, owe the Customer damages, such damages could include, but are not limited to, (1) re-procurement costs, (2) repayment of amounts paid of $147 million under the contract, (3) penalties for delayed delivery in an amount up to $15 million, and (4) forfeiture of good performance bonds in the amount of $33 million. Due to the early stage of the arbitration, the amount of any claims that the Customer may assert against us is not known.

Successful imposition of damages or claims by the Customer or subcontractors against us, the calling of our bonds, additional contract costs required to fulfill our obligations, or additional revenue reductions arising from the negotiation of the contract modification could have a material adverse affect on our consolidated financial position, results of operations and cash flows. For a description of the contract, the disputes and the impact of the contract on our results of operations and financial condition, see Management s Discussion and Analysis of Financial Condition and Results of Operations Commitments and Contingencies Firm Fixed-Price Contract with the Greek Government.

Telkom South Africa

Our former Telcordia Technologies, Inc. subsidiary instituted arbitration proceedings before the ICC against Telkom South Africa in March 2001 as a result of a contract dispute. Telcordia is seeking to recover damages of approximately $130 million, plus interest at a rate of 15.5%. Telkom South Africa counterclaimed, seeking substantial damages from Telcordia, including repayment of approximately $97 million previously paid to Telcordia under the contract and the excess costs of reprocuring a replacement system, estimated by Telkom South Africa to be $234 million. On September 27, 2002, Telcordia prevailed in the initial phase of the arbitration. The arbitrator found that Telkom repudiated the contract and dismissed Telkom s counterclaims against Telcordia. The damages to be recovered by Telcordia were to be determined in a second phase of the arbitration. Telkom challenged the arbitration decision in the South African High Court (Transvaal Provincial Division), and, on November 27, 2003, the High Court judge ordered that the arbitration decision be set aside, that the arbitrator and the ICC be dismissed and that the case be re-arbitrated before a panel of three retired South

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African judges. Although the High Court judge denied Telcordia s motion for leave to appeal his ruling, on November 29, 2004, the South African Supreme Court of Appeal granted Telcordia s motion for leave to appeal the judge s ruling and will hear the appeal. Telcordia filed its appellate brief in September 2005. Telkom has also filed its full brief with the court. The hearing is scheduled for October 31, 2006. In parallel proceedings in the United States District Court (Northern District of New Jersey), Telcordia is seeking to have its ICC arbitration award confirmed. On January 24, 2005, the District Court declined to confirm Telcordia s award and in a February 17, 2005 opinion concluded that the District Court does not have personal jurisdiction over Telkom South Africa. Telcordia has appealed this ruling to the U.S. Court of Appeals for the Third Circuit. Oral arguments were held on January 13, 2006 and the parties are awaiting a decision.

On March 15, 2005, we sold Telcordia to an affiliate of Warburg Pincus LLC and Providence Equity Partners Inc. Pursuant to the definitive stock purchase agreement, we are entitled to receive all of the net proceeds from any judgment or settlement with Telkom South Africa, and, if this dispute is settled or decided adversely against Telcordia, we are obligated to indemnify the buyer of Telcordia against any loss that may result from such an outcome.

Due to the complex nature of the legal and factual issues involved and the uncertainty of litigation in general, the outcome of the arbitration and the related court actions are not presently determinable; however, an adverse resolution could materially harm our business, consolidated financial position, results of operations and cash flows.

INTESA Joint Venture

Informática, Negocios y Tecnología, S.A., (INTESA) a Venezuelan joint venture we formed in fiscal 1997 with Venezuela s national oil company, PDVSA, to provide information technology services in Latin America, is involved in various legal proceedings. We had previously consolidated our 60% interest in the joint venture, but the operations of INTESA were classified as discontinued operations as of January 31, 2003 and INTESA is currently insolvent. PDVSA has refused to take action to dissolve the joint venture or have it declared bankrupt.

Outsourcing Services Agreement and Guarantee. INTESA had derived substantially all its revenues from an outsourcing services agreement with PDVSA that it entered into at the time the joint venture was formed. The services agreement expired on June 30, 2002 and the parties were not able to reach agreement on a renewal. We guaranteed INTESA s obligations under the services agreement to PDVSA. Under the terms of the services agreement, INTESA s liability for damages to PDVSA in any calendar year is capped at $50 million. As a result, our maximum potential liability to PDVSA under the guarantee in any calendar year, based on our guarantee of their ownership interest in INTESA, is $20 million. To date, PDVSA has not asserted any claims.

Expropriation of Our Interest in INTESA. In fiscal 2003 and 2004, PDVSA and the Venezuelan government took certain actions, including denying INTESA access to certain of its facilities and assets, that prevented INTESA from continuing operations. In fiscal 2005, the Overseas Private Investment Company (OPIC), a U.S. governmental entity that provides insurance coverage against expropriation of U.S. business interests by foreign governments, determined that the Venezuelan government had expropriated our interest in INTESA without compensation and paid us approximately $6 million in settlement of our claim.

Employment Claims of Former INTESA Employees. INTESA is a defendant in a number of lawsuits brought by former employees seeking unpaid severance and pension benefits. PDVSA and SAIC Bermuda, our wholly- owned subsidiary and the entity that held our interest in INTESA, were added as defendants in a number of these suits. Based on the procedural standing of these cases and our understanding of applicable laws and facts, we believe that our exposure to any possible loss related to these employment claims is either remote or, if reasonably possible, immaterial.

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Other Legal Proceedings Involving INTESA. The Attorney General of Venezuela initiated a criminal investigation of INTESA in fiscal 2003 alleging unspecified sabotage by INTESA employees. We believe this investigation is inactive. In connection with our expropriation claim, OPIC determined that INTESA did not sabotage PDVSA s infrastructure as alleged by PDVSA and the Venezuelan government. In addition, the SENIAT, the Venezuelan tax authority, filed a claim against INTESA in fiscal 2004 for approximately $30 million for alleged non-payment of VAT taxes in fiscal 1998.

Potential Financial Impact. Many issues relating to INTESA, including the termination of the services agreement and the employment litigation brought by former INTESA employees, remain unresolved. Due to the complex nature of the legal and factual issues involved in these matters and the uncertain economic and political environment in Venezuela, the outcome is not presently determinable; however, adverse resolutions could materially harm our business, consolidated financial position, results of operations and cash flows.

Other

We are also involved in various investigations, claims and lawsuits arising in the normal conduct of our business, none of which, in the opinion of our management, based upon current information, is expected to have a material adverse effect on our consolidated financial position, results of operations, cash flows or our ability to conduct business.

In the normal conduct of our business, we seek to monetize our patent portfolio through licensing. We also have and will continue to defend our patent position when we believe our patents have been infringed and are involved in such litigation from time to time. On March 15, 2005, we sold our Telcordia subsidiary. Pursuant to the terms of the definitive stock purchase agreement, we will receive 50% of the net proceeds Telcordia receives in the future in connection with the prosecution of certain patent rights.

New SAIC

We formed SAIC, Inc., or New SAIC, as a Delaware corporation on August 12, 2005. To date, it has not conducted any activities other than those incident to its formation, and the preparation of the merger agreement, this proxy statement/prospectus, periodic reports, and the registration statement on Form S-1 with respect to the IPO of its new common stock. Upon completion of the merger, Old SAIC will be a wholly-owned subsidiary of New SAIC.

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MANAGEMENT

Directors and Executive Officers

The following is a list of the names and ages as of the date of this proxy statement/prospectus of all of Old SAIC s directors and key officers, indicating all positions and offices held by each such person and each such person s principal occupation or employment during at least the past five years. Except as otherwise noted, each of the persons listed below has served in his or her present capacity for Old SAIC for at least the past five years. All such persons have been elected to serve until their successors are elected or until their earlier resignation or retirement. Also included in the list is Louis A. Simpson, who has been nominated to stand for election as a director at the 2006 Annual Meeting of Stockholders of Old SAIC. Claudine B. Malone will not be standing for election as a director at that meeting. In addition, John H. Warner Jr., will be retiring as a director of Old SAIC immediately following the meeting as a result of reaching the mandatory retirement age.

We expect that each of the individuals listed below, including Mr. Simpson but excluding Ms. Malone and Mr. Warner, will serve in the same capacities with New SAIC immediately following the merger and IPO.

Name of director or officer	Age	Position(s) with the company and prior business experience
Deborah H. Alderson	49	Group President since October 2005. Ms. Alderson previously served as Deputy Group President from August 2005 to October 2005. Prior to joining us, Ms. Alderson held various positions with Anteon International Corporation, a systems integration services provider, including President of the Systems Engineering Group from January 2002 to August 2005, and Senior Vice President and General Manager of the Systems Engineering Group from November 1998 to January 2002. Ms. Alderson held various positions with Techmatics, Inc., a systems engineering provider, from 1985 to 1998.
Kenneth C. Dahlberg	61	Chairman of the Board since July 2004 and Chief Executive Officer, President and Director since November 2003. Prior to joining us, Mr. Dahlberg served as Corporate Executive Vice President of General Dynamics Corp. from March 2001 to October 2003. Mr. Dahlberg served as President of Raytheon International from February 2000 to March 2001, and from 1997 to 2000 he served as President and Chief Operating Officer of Raytheon Systems Company. Mr. Dahlberg held various positions with Hughes Aircraft from 1967 to 1997. Mr. Dahlberg has served as a director of Teledyne Technologies since February 2006.
Thomas E. Darcy	56	Executive Vice President Strategic Projects since November 2005. Mr. Darcy previously served as Corporate Executive Vice President since December 2003 and Chief Financial Officer since October 2000. From October 2000 to December 2003, Mr. Darcy was an Executive Vice President. Prior to joining us, Mr. Darcy was with the accounting firm currently known as PricewaterhouseCoopers LLP from July 1973 to September 2000, where he served as partner from 1985 to 2000.
Wolfgang H. Demisch	61	Director since 1990. Mr. Demisch has been a principal of Demisch Associates LLC, a consulting firm, since 2003. He was a Managing Director of Dresdner Kleinwort Wasserstein, formerly Wasserstein Perella Securities, Inc., from 1998 to 2002. From 1993 to 1998, he was Managing Director of BT Alex. Brown, and from 1988 to 1993, he was Managing Director of UBS Securities, Inc.

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Name of director or officer	Age	Position(s) with the company and prior business experience
Jere A. Drummond	66	Director since 2003. Mr. Drummond was employed by BellSouth Corporation from 1962 until his retirement in December 2001. He served as Vice Chairman of BellSouth Corporation from January 2000 until his retirement. He was President and Chief Executive Officer of BellSouth Communications Group, a provider of traditional telephone operations and products, from January 1998 until December 1999. He was President and Chief Executive Officer of BellSouth Telecommunications, Inc. from January 1995 until December 1997. Mr. Drummond is also a member of the board of directors of Borg-Warner Automotive, AirTran Holdings, Inc. and Centillium Communications, Inc.
Steven P. Fisher	46	Treasurer since January 2001 and Senior Vice President since July 2001. Mr. Fisher has held various positions with us since 1988, including serving as Assistant Treasurer and Corporate Vice President for Finance from 1997 to 2001 and Vice President from 1995 to 1997.
Donald H. Foley	61	Chief Engineering and Technology Officer since January 2005, Executive Vice President since July 2000, and a Director since July 2002. Dr. Foley has held various positions with us since 1992, including serving as Group President from February 2004 to January 2005 and a Sector Vice President from 1992 to July 2000.
John J. Hamre	55	Director since 2005. Dr. Hamre has served as the President and Chief Executive Officer of the Center for Strategic & International Studies, a public policy research institution, since 2000. Dr. Hamre served as U.S. Deputy Secretary of Defense from 1997 to 2000 and Under Secretary of Defense (Comptroller) from 1993 to 1997. Dr. Hamre is also a member of the board of directors of ChoicePoint, Inc., ITT Industries, Inc., and MITRE Corporation.
John R. Hartley	40	Senior Vice President and Corporate Controller since August 2005. Mr. Hartley has held various positions with our finance organization since 2001. For 12 years prior to that, he was with the accounting firm currently known as Deloitte & Touche LLP.
Anita K. Jones	64	Director since 1998. Dr. Jones is the Quarles Professor of Engineering at the University of Virginia where she has taught since 1989. From 1993 to 1997, Dr. Jones was on leave of absence from the University to serve as Director of Defense Research and Engineering in the U.S. Department of Defense. Dr. Jones also served as a Director of the Company from 1987 to 1993.
Harry M. J. Kraemer, Jr.	51	Director since 1997. Mr. Kraemer has been an executive partner of Madison Dearborn Partners, LLC, a private equity investment firm, since April 2005, and has served as a professor at the Kellogg School of Management at Northwestern University since January 2005. Mr. Kraemer previously served as the Chairman of Baxter International, Inc., or Baxter, a health-care products, systems and services company, from January 2000 until April 2004, as Chief Executive Officer of Baxter from January 1999 until April 2004 and as President of Baxter from April 1997 until April 2004. Mr. Kraemer also served as the Senior Vice President and Chief Financial Officer of Baxter from November 1993 to April 1997.

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Name of director or officer	Age	Position(s) with the company and prior business experience
Claudine B. Malone	70	Director since 1993. Ms. Malone has served as the President of Financial & Management Consulting, Inc., a consulting company, since 1982. Ms. Malone is also a member of the board of directors of Hasbro, Inc., Lafarge North America, and Novell, Inc.
Larry J. Peck	59	Group President since February 2004. Mr. Peck has held various positions with us since 1978, including serving as a Sector Vice President from 1994 to February 2004.
Lawrence B. Prior, III	50	Group President since February 2005. Prior to joining us, Mr. Prior served as Chief Financial Officer and then President and Chief Executive Officer of LightPointe Communications, Inc. from 2000 until 2004.
Arnold L. Punaro	59	Executive Vice President, Government Affairs, Communications and Support Operations since February 2005. Mr. Punaro has held various positions with us since 1997 including Sector Vice President and Senior Vice President, Director of Corporate Development. Mr. Punaro also served as the Staff Director of the Senate Armed Services Committee and retired as a Major General in the United States Marine Corps Reserve.
William A. Roper, Jr.	60	Executive Vice President since December 2005. Mr. Roper served as Corporate Executive Vice President from 2000 to December 2005, Senior Vice President from 1990 to 1999, Chief Financial Officer from 1990 to October 2000 and Executive Vice President from 1999 to 2000. Mr. Roper has served as a director of VeriSign, Inc. since November 2003.
Edward J. Sanderson, Jr.	57	Director since 2002. Mr. Sanderson retired from Oracle Corporation in 2001 after having served as an Executive Vice President since 1995. At Oracle, Mr. Sanderson was responsible for Oracle Product Industries, Oracle Consulting, and the Latin American Division. Prior to that he was President of Unisys World-wide Services and partner at both McKinsey & Company and Accenture (formerly Andersen Consulting).
Douglas E. Scott	49	Secretary since July 2003, Senior Vice President since January 1997 and General Counsel since 1992. Mr. Scott has held various positions with us since 1987, including serving as a Corporate Vice President from 1992 to January 1997.
Louis A. Simpson	69	Nominee for Director. Mr. Simpson has served as President and Chief Executive Officer, Capital Operations, of GEICO Corporation, an auto insurer, since May 1993. Mr. Simpson previously served as Vice Chairman of the Board of GEICO from 1985 to 1993. Mr. Simpson is also a member of the board of directors of VeriSign, Inc., Western Asset Funds, Inc. and Western Asset Income Fund and serves as a trustee of Western Asset Premier Bond Fund. Mr. Simpson previously served as a director from 1999 to 2002.
George T. Singley III	61	Group President since February 2004. Mr. Singley has held various positions with us since 1998, including serving as a Sector Vice President from 2001 to February 2004 and Group Senior Vice President from 2000 to 2001.

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Name of director or officer	Age	Position(s) with the company and prior business experience
Theoren P. Smith, III	51	Group President since February 2005. Dr. Smith served as Sector Vice President from July 2002 until February 2004 and Executive Vice President, Federal Business from February 2004 until February 2005. From 2000 to March 2002, Dr. Smith served as Global Chief Technology Officer at Cable & Wireless, PLC and as President of Cable & Wireless USA, Inc., which filed for bankruptcy protection in December 2003. Dr. Smith also served as Senior Vice President and Chief Technology Officer at Road Runner, LLC from 1999 to 2000.
Mark W. Sopp	40	Executive Vice President and Chief Financial Officer since November 2005. Mr. Sopp served as Senior Vice President, Chief Financial Officer and Treasurer of The Titan Corporation from April 2001 to July 2005, when Titan was acquired by L-3 Communications. From 1998 to 2001, Mr. Sopp served as a Vice President and Chief Financial Officer of Titan Systems Corporation, a subsidiary of The Titan Corporation. Titan provided information and communications products and services primarily to the U.S. Government.
Joseph P. Walkush	54	Executive Vice President since July 2000 and a Director since April 1996. Mr. Walkush has held various positions with us from 1976 to 1979 and since 1981, including serving as a Sector Vice President from 1994 to 2000.
John H. Warner, Jr.	65	Executive Vice President since December 2005, Chief Administrative Officer since December 2003, Corporate Executive Vice President from 1996 to 2005 and a Director since 1988. Dr. Warner has held various positions with us since 1973, including serving as Executive Vice President from 1989 to 1996.
A. Thomas Young	68	Director since 1995. Mr. Young retired from Lockheed Martin Corp. in 1995 after having served as an Executive Vice President from March 1995 to July 1995. Prior to its merger with Lockheed Corporation, Mr. Young served as the President and Chief Operating Officer of Martin Marietta Corp. from 1990 to 1995. Mr. Young is also on the board of directors of the Goodrich Corporation.

Board of Directors Composition and Committees

Our restated certificate of incorporation provides for a classified board of directors consisting of three classes, which shall be as equal in number as possible. The total number of authorized directors is to be between 10 and 18, with the exact size of the board to fixed by resolution of the board. Immediately following the merger and IPO, we expect to have 12 directors.

The board of directors of New SAIC will have the following standing committees: an audit committee, a compensation committee, an ethics and corporate responsibility committee and a nominating and corporate governance committee. Except as noted below, we expect that the membership for the New SAIC board committees immediately following the completion of the IPO will be the same as the current membership for Old SAIC s corresponding board committees.

Audit Committee. The purpose of the audit committee is to assist the board of directors in providing oversight of: (1) the integrity of our financial statements, including the financial reporting process, system of internal control and audit process, (2) our compliance with legal and regulatory requirements, (3) the registered public accountant s qualifications and independence, (4) the performance of our internal audit function and registered public accountants and (5) financial reporting risk assessment and mitigation. The current members of

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the Old SAIC audit committee are C.B. Malone (Chair), W.H. Demisch, J.A. Drummond, A.K. Jones and H.M.J. Kraemer, Jr. Our board of directors has determined that each member is an independent director under our corporate governance guidelines. Our board of directors has also determined that W.H. Demisch, J.A. Drummond, H.M.J. Kraemer, Jr. and C.B. Malone qualify as audit committee financial experts as defined by the rules under the Securities Exchange Act of 1934. The background and experience of each of our audit committee financial experts are set forth above.

Compensation Committee. The compensation committee s responsibilities include: (1) determining the compensation of the chief executive officer and reviewing and approving the compensation of the other executive officers named pursuant to Section 16 of the Securities Exchange Act of 1934, (2) exercising all rights, authority and functions under all of our stock, retirement and other compensation plans, (3) approving and making recommendations to the Board regarding non-employee director compensation, (4) preparing an annual report on executive compensation for inclusion in our proxy statement or annual report on Form 10-K, in accordance with the rules and regulations of the Securities and Exchange Commission and (5) providing guidance and monitoring the formation and implementation of human resource management. The current members of the Old SAIC compensation committee are E.J. Sanderson, Jr. (Chair), W.H. Demisch, A.K. Jones and H.M.J. Kraemer, Jr. Our board of directors has determined that each member is an independent director under our corporate governance guidelines.

Ethics and Corporate Responsibility Committee. The ethics and corporate responsibility committee s duties include: (1) reviewing and making recommendations regarding the ethical responsibilities of our employees and consultants under our administrative policies and procedures, (2) reviewing and assessing our policies and procedures addressing the resolution of conflicts of interest involving us, our employees, officers and directors and addressing any potential conflict of interest involving us and a director or an executive officer, (3) reviewing and establishing procedures for the receipt, retention and treatment of complaints regarding violation of our policies, procedures and standards related to ethical conduct and legal compliance and (4) reviewing and evaluating the effectiveness of our ethics, compliance and training programs and related administrative policies. The current members of the Old SAIC ethics and corporate responsibility committee are A.K. Jones (Chair), J.A. Drummond, J.J. Hamre, C.B. Malone and J.H. Warner, Jr.

Nominating and Corporate Governance Committee. The nominating and corporate governance committee s responsibilities include: (1) evaluating, identifying and recommending nominees to the board of directors, including nominees proposed by stockholders; (2) reviewing and making recommendations regarding the composition and procedures of the board of directors; (3) making recommendations regarding the size, composition and charters of the committees of the board of directors; (4) reviewing and developing long-range plans for chief executive officer and management succession; (5) developing and recommending to the board of directors a set of corporate governance principles; (6) recommending to the board an independent director to serve as the lead director; and (7) developing and overseeing an annual self-evaluation process of the board of directors and its committees. A.T. Young is currently the lead director. The current members of the Old SAIC nominating and corporate governance committee are J.A. Drummond (Chair), K.C. Dahlberg, C.B. Malone, J.H. Warner, Jr. and A.T. Young. Our board of directors has determined that the following members of the Old SAIC nominating and corporate governance committee are independent under our corporate governance guidelines: J.A. Drummond, C.B. Malone and A.T. Young. Immediately prior to the completion of the IPO, the membership of the nominating and corporate governance committee will be modified so that it will be comprised solely of independent directors.

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Compensation Committee Interlocks and Insider Participation

None of the members of our compensation committee has, at any time, been one of our officers or employees. None of our executive officers currently serves, or in the past fiscal year has served, as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving on our board of directors or compensation committee.

Director Compensation

We intend to establish director compensation policies for New SAIC subsequent to the completion of the IPO that will be substantially similar to the existing policies of Old SAIC. However, where we have described director compensation previously consisting of shares of Old SAIC class A common stock, we instead expect to issue twice as many shares of New SAIC class A preferred stock, after giving effect to the conversion of each share of Old SAIC class A common stock into two shares of New SAIC class A preferred stock in the merger.

All non-employee directors are paid an annual retainer of $25,000 and the chairperson of a committee is paid an additional annual retainer of $10,000, except for the chairperson of the audit committee who is paid an additional annual retainer of $15,000. The lead director is also paid an additional annual retainer of $10,000. Non-employee directors also receive $1,500 for each meeting of the board of directors and $2,000 for each meeting of a committee on which they serve and are reimbursed for expenses incurred while attending meetings or otherwise performing services as a director. The directors are eligible to defer their fees into our Keystaff Deferral and Key Executive Stock Deferral Plans. In addition, a stock bonus of 1,000 shares of Old SAIC class A common stock is offered to independent director nominees as an inducement to join the board of directors.

Directors are eligible to receive stock options under the 1999 Stock Incentive Plan. For services rendered as a director during fiscal 2006, W.H. Demisch, J.A. Drummond, J.J. Hamre, A.K. Jones, H.M.J. Kraemer, Jr., C.B. Malone, E.J. Sanderson, Jr. and A.T. Young each received options to purchase 11,000 shares of Old SAIC class A common stock at $43.92 per share, which was the stock price on the date of grant. All such options vest as to 20%, 20%, 20% and 40% on the first, second, third and fourth year anniversaries of the date of grant, respectively.

See Certain Relationships and Related Party Transactions for information with respect to transactions between us and certain persons related to or entities in which certain directors may be deemed to have an interest.

Indemnification of Directors and Officers

In conjunction with the IPO, we have entered into separate indemnification agreements with our directors and executive officers, in addition to the indemnification provided for in our restated certificate of incorporation. These agreements, among other things, provide that we will indemnify, subject to applicable law and the terms thereof, our directors and executive officers for certain expenses (including attorneys fees), judgments, fines and settlement amounts incurred by a director or executive officer in any action or proceeding arising out of such person s service as a director or executive officer of us or any of our subsidiaries or any other company or enterprise to which the person provides services at our request. We believe that these provisions and agreements are necessary to attract and retain qualified persons as directors and executive officers.

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EXECUTIVE COMPENSATION

We have not paid our executive officers any compensation for their service to New SAIC since its formation in August 2005. The following table sets forth information regarding the annual and long-term compensation for services to Old SAIC for the fiscal years ended January 31, 2006, 2005 and 2004, of those persons who were, at January 31, 2006 (1) the Chief Executive Officer and (2) the other four most highly compensated executive officers of Old SAIC, all of whom are collectively referred to as our Named Executive Officers. The following summary compensation table sets forth the annual and long-term compensation earned by the Named Executive Officers for the relevant fiscal year, whether or not paid in such fiscal year:

		Annual compensation			Long-term compensation		
Name and principal position(s)	**Year**	**Salary (1)**	**Bonus (2)**	**Other annual compensation (3)**	**Restricted Stock Awards (4)**	**Number of securities underlying options**	**All other compensation (5)**
K.C. Dahlberg	2006	$ 1,000,000	$ 1,100,000	$ 10,250	$ 400,023	200,000	$ 15,482
Chairman, Chief Executive Officer and President	2005	1,000,000	1,500,000	77,897(6)	299,989	260,000	
	2004	250,000(7)	1,010,000(8)	229,459(9)	2,687,686	225,000	
D.H. Foley	2006	473,846	500,000	650	100,006	40,000	15,336
Chief Engineering and Technology Officer	2005	457,692	484,994	300	110,012	65,000	9,052
	2004	446,923	415,018		109,998	70,000	13,445
J.H. Warner, Jr.	2006	475,962	450,000	5,575	100,006	25,000	14,598
Executive Vice President	2005	475,962	550,018	5,375	99,996	55,000	9,052
	2004	475,962	510,015	4,725	99,992	50,000	13,445
W.A. Roper, Jr.	2006	475,962	400,000	350	100,006	40,000	14,691
Executive Vice President	2005	475,962	799,996	6,275	130,003	55,000	9,052
	2004	475,962	500,009	5,825	149,988	60,000	13,442
G.T. Singley	2006	375,000	500,000	2,343	100,006	40,000	14,424
Group President	2005	315,000	400,003	2,594	65,002	45,000	9,052
	2004	273,269	234,998	2,418	49,996	30,000	13,462

(1) Includes amounts paid in lieu of unused comprehensive leave.

(2) Amounts include the award of the following number of shares of Old SAIC class A common stock with a market value as of the date of grant (calculated by multiplying the Formula Price, as defined below under Market for Old SAIC Common Stock and Related Stockholder Matters, of Old SAIC class A common stock on the date of grant by the number of shares awarded) for fiscal 2006, 2005 and 2004, respectively, as follows: (a) K.C. Dahlberg: 5,000 net shares (on an after taxes basis) with a market value of $219,600 based on an original bonus amount of $357,354, 10,000 shares with a market value of $405,500 and 0 shares; (b) D.H. Foley: 1,701 net shares (on an after taxes basis) with a market value of $74,750 based on an original bonus amount of $100,000, 3,699 shares with a market value of $149,994 and 3,834 shares with a market value of $140,018; (c) J.H. Warner, Jr.: 1,113 net shares (on an after taxes basis) with a market value of $48,896.50 based on an original bonus amount of $50,000, 1,850 shares with a market value of $75,018 and 2,191 shares with a market value of $80,015; (d) W.A. Roper, Jr.: 1,170 net shares (on an after taxes basis) with a market value of $51,400 based on an original bonus amount of $80,000, 2,466 shares with a market value of $99,996 and 1,917 shares with a market value of $70,009; and (e) G.T. Singley: 1,543 net shares (on an after taxes basis) with a market value of $67,800 based on an original bonus amount of $100,000, 3,206 shares with a market value of $130,003 and 3,012 shares with a market value of $109,998.

(3) Represents amounts paid or reimbursed by us on behalf of the Named Executive Officers for athletic, airline and country club memberships, financial planning and tax preparation services and relocation expenses.

(4) Amounts reported represent the market value on the date of grant (calculated by multiplying the Formula Price of the class A common stock on the date of grant by the number of shares awarded), without giving effect to the diminution in value attributable to the restrictions on such stock. Restricted stock vests as to 20%, 20%, 20% and 40% on the first, second, third and fourth year anniversaries

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of the date of grant, respectively. See Summary of Stock-Based Compensation Plans Continued Vesting on Vesting Stock and Options for Retirees for rights to continued vesting after retirement for certain holders. The amount reported represents the following number of restricted shares of class A common stock awarded for fiscal 2006, 2005 and 2004, respectively: (a) K.C. Dahlberg: 9,108 shares, 7,398 shares and 84,545 shares; (b) D.H. Foley: 2,277 shares, 2,713 shares and 3,012 shares; (c) J.H. Warner, Jr.: 2,277 shares, 2,466 shares and 2,738 shares; (d) W.A. Roper, Jr.: 2,277 shares, 3,206 shares and 4,107 shares; and (e) G.T. Singley: 2,277 shares, 1,603 shares and 1,369 shares. As of January 31, 2006, the aggregate restricted stock holdings (other than restricted stock which has been deferred into the Key Executive Stock Deferral Plan) for the Named Executive Officers were as follows: (a) K.C. Dahlberg: 0 shares; (b) D.H. Foley: 3,313 shares with a market value as of such date of $145,507; (c) J.H. Warner, Jr.: 1,366 shares, with a market value as of such date of $59,995; (d) W.A. Roper, Jr.: 0 shares; and (e) G.T. Singley: 2,449 shares with a market value of $107,560. Dividends are payable on such restricted stock if and when declared. Although the Company has never declared or paid a dividend on its capital stock, we intend to pay a special dividend immediately prior to the completion of the IPO.

(5) Represents amounts contributed or accrued by us for the Named Executive Officers under our 401(k) Profit Sharing Plan, Employee Stock Retirement Plan and SAIC Retirement Plan.

(6) Includes $67,897 for country club dues.

(7) Mr. Dahlberg joined us as Chief Executive Officer in November 2003. Accordingly, compensation for 2004 is for a partial year.

(8) Includes $660,000 paid as a cash sign-on bonus.

(9) Represents the reimbursement of expenses incurred in connection with the relocation of K.C. Dahlberg and his family to our principal place of business.

Option Grants in Last Fiscal Year

The following table sets forth information regarding grants of options to purchase shares of class A common stock pursuant to our 1999 Stock Incentive Plan made during fiscal 2006 to the Named Executive Officers:

					Potential realizable value at assumed annual rates of stock price appreciation for option term(3)	
Name	**Number of securities underlying options granted(1)**	**% of total options granted to employees in fiscal 2006**	**Exercise price (Per share)(2)**	**Expiration date**	**5%**	**10%**
K.C. Dahlberg	200,000(4)	3.0%	$40.55	3/31/10	$ 2,240,643	$ 4,951,236
D.H. Foley	65,000(4)	1.0	40.55	3/31/10	728,209	1,609,152
J.H. Warner, Jr.	55,000(4)	*	40.55	3/31/10	616,177	1,361,590
W.A. Roper, Jr.	55,000(4)	*	40.55	3/31/10	616,177	1,361,590
G.T. Singley	45,000(4)	*	40.55	3/31/10	504,145	1,114,028

* Less than 1% of the total options granted to employees in fiscal 2006.

(1) All such options vest as to 20%, 20%, 20% and 40% on the first, second, third and fourth year anniversaries of the date of grant, respectively. See Summary of Stock-Based Compensation Plans Continued Vesting on Vesting Stock and Options for Retirees for rights to continued vesting after retirement for certain holders.

(2) The exercise price is equal to the Formula Price of the Old SAIC class A common stock on the date of grant.

(3) The potential realizable value is based on an assumption that the Formula Price of the Old SAIC class A common stock will appreciate at the annual rate shown (compounded annually) from the date of grant until the end of the five-year option term. These values are calculated based on the regulations promulgated by the Securities and Exchange Commission and should not be viewed in any way as an estimate or forecast of the future performance of our common stock.

(4) Although the listed grants of options were made during fiscal 2006, such grants relate to service for the fiscal year ended January 31, 2005.

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Option Exercises and Fiscal Year-End Values

The following table sets forth information regarding the exercise of options during fiscal 2006 and unexercised options to purchase Old SAIC class A common stock granted during fiscal 2006 and prior years under our 1999 Stock Incentive Plan to the Named Executive Officers and held by them at January 31, 2006:

			Number of securities underlying unexercised options at January 31, 2006		Value of unexercised in-the-money options at January 31, 2006(1)	
Name	**Shares acquired on exercise**	**Value realized**	**Exercisable**	**Unexercisable**	**Exercisable**	**Unexercisable**
K.C. Dahlberg			102,000	383,000	$ 1,175,580	$ 2,647,070
D.H. Foley	50,000	$ 650,100	85,000	190,000	995,570	1,560,030
J.H. Warner, Jr.	55,000	719,950	64,000	146,000	744,680	1,158,270
W.A. Roper, Jr.	120,000	1,755,600	216,000	184,000	2,711,580	1,624,870
G.T. Singley	17,000	222,530	22,200	84,800	248,214	541,726

(1) Based on the Formula Price of the Old SAIC class A common stock as of such date less the exercise price of such options.

Employment and Severance Agreements

Old SAIC and Mr. Dahlberg are parties to two letter agreements, each dated October 3, 2003 (Dahlberg Letter Agreements) pursuant to which Mr. Dahlberg serves as Old SAIC s Chief Executive Officer. Pursuant to the Dahlberg Letter Agreements, Mr. Dahlberg received or will receive: (1) a base salary of $1,000,000 per year, (2) a cash sign-on bonus of $660,000, (3) an award of 84,545 shares of vesting Old SAIC class A common stock, (4) an award of a vesting option to purchase up to 225,000 shares of Old SAIC class A common stock, (5) reimbursement of expenses incurred in connection with the relocation of Mr. Dahlberg and his family to our principal place of business, (6) a gross up to Mr. Dahlberg s salary to cover the federal, state and local income and employment tax liability on the relocation benefits, (7) a country club membership, (8) first class seating for business travel, (9) up to $10,000 for financial planning and/or tax preparation within the first two years of employment and (10) disability insurance. The Dahlberg Letter Agreements provide that in the event Mr. Dahlberg s employment is involuntarily terminated before November 2006, for reasons other than cause, we would continue Mr. Dahlberg s base salary, target short-term bonus and benefits until November 2006. In order to receive these severance benefits, Mr. Dahlberg would be required to sign a release and a non-compete/non-solicitation agreement. At the end of the severance period, Mr. Dahlberg would be provided with at least two years of non-paid consulting status during which his unvested options and stock would continue to vest. For purposes of the Dahlberg Letter Agreements, cause is defined as (1) a willful failure to substantially perform his duties, (2) gross misconduct or (3) conviction of a felony.

Old SAIC has entered into severance agreements with all of its executive officers other than Mr. Warner, who is retiring as an executive officer on July 14, 2006. The severance agreements provide that if the officer is involuntarily terminated without cause or resigns for good reason within a 24 month period following a change in control, the officer will be paid all accrued salary and a pro rata bonus for the year of termination and a single lump sum equal to three times the officer s then current salary and bonus amount. The officer will also receive such life insurance, disability, medical, dental, hospitalization, financial counseling and tax consulting benefits as are provided to other similarly situated executives who continue in the employ of Old SAIC for the 36 months following termination and up to 12 months of outplacement counseling. Vesting will be accelerated as provided in Old SAIC s various equity incentive and deferral plans. The officer is not entitled to receive a gross up payment to account for any excise tax that might be payable under the Internal Revenue Code, although he or she may elect to receive the full value of the severance payments and pay the excise tax or have the severance payments reduced to the extent necessary to avoid an excise tax.

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Other than these agreements, we have not entered into any employment or severance agreements with our executive officers.

Equity Compensation Plans

Information with respect to our equity compensation plans as of January 31, 2006 is set forth below:

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights(a)	Weighted-average exercise price of outstanding options, warrants and rights(b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))(c)
Equity compensation plans approved by security holders (1)	27,554,786(2)	$34.27	33,276,685(3)(4)
Equity compensation plans not approved by security holders (5)			(5)
Total	27,554,786	$34.27	33,276,685

(1) The following equity compensation plans approved by security holders are included in this plan category: the 1999 Stock Incentive Plan, the Restated Bonus Compensation Plan and the 2004 Employee Stock Purchase Plan. No information is provided with respect to the New SAIC equity compensation plans described below. See Summary of Stock-Based Compensation Plans.

(2) Represents shares of Old SAIC class A common stock reserved for issuance upon the exercise of outstanding options awarded under the 1999 Stock Incentive Plan. Does not include shares to be issued pursuant to purchase rights under the 2004 Employee Stock Purchase Plan.

(3) Represents 8,169,812 shares of Old SAIC class A common stock under the 2004 Employee Stock Purchase Plan and 25,106,873 shares under the 1999 Stock Incentive Plan. The maximum number of shares that may be awarded under the 1999 Stock Incentive Plan is limited to the sum of (a) 24 million shares, (b) the number of shares available for awards under the 1998 Stock Option Plan as of September 30, 1999 and (c) the number of shares which become available under the 1998 Stock Option Plan after September 30, 1999 as a result of forfeitures, expirations, cancellations or sales of shares acquired through the exercise of options to us to satisfy tax withholding obligations. In addition, the 1999 Stock Incentive Plan provides for an automatic share reserve increase on the first day of each calendar year after 1999 by an amount equal to 5% of outstanding shares of Old SAIC class A common stock on such day. However, shares reserved for future awards under the 1999 Stock Incentive Plan is limited to 15% of total outstanding shares of Old SAIC class A common stock.

(4) The Restated Bonus Compensation Plan provides for bonus awards that may be paid in cash, restricted stock or vested stock. The Restated Bonus Compensation Plan does not provide for a maximum number of shares available for future issuance however, the bonus pool for each fiscal year cannot exceed 7.5% of our revenues for the fiscal year.

(5) The Stock Compensation Plan and the Management Stock Compensation Plan are not approved by security holders and are included in this plan category. These plans do not provide for a maximum number of shares available for future issuance.

Summary of Stock-Based Compensation Plans

Set forth below is a summary of the stock-based compensation plans maintained by Old SAIC, which will be assumed by New SAIC following the merger, and the new stock-based compensation plans to be adopted by New SAIC in connection with the merger. All shares of Old SAIC class A common stock outstanding under these compensation plans will be converted into shares of New SAIC class A preferred stock and all stock options and other rights to receive shares of Old SAIC class A common stock under these compensation plans will be assumed by New SAIC pursuant to the merger and will thereafter represent the right to acquire shares of New SAIC class A preferred stock. The special dividend will be paid with respect to Old SAIC class A common stock held by the Old SAIC stock-based compensation plans following the merger and conversion of such shares into New SAIC class A preferred stock.

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1999 Stock Incentive Plan

General. In 1999, our board of directors and stockholders approved the 1999 Stock Incentive Plan. The 1999 Stock Incentive Plan was adopted as a successor to our 1998 Stock Option Plan. The 1999 Stock Incentive Plan provides our and our affiliates employees, directors and consultants the opportunity to receive stock options, stock appreciation rights, vested stock awards, restricted stock awards, restricted stock units, performance awards and other similar types of stock awards. Options granted under the 1999 Stock Incentive Plan may be either incentive stock options, as defined under Section 422 of the Code or nonqualified stock options. The 1999 Stock Incentive Plan terminates on April 9, 2019, but no incentive stock options may be granted under the plan after April 9, 2009.

If the 2006 Equity Incentive Plan becomes effective, we will cease granting awards under the 1999 Stock Incentive Plan. If the 2006 Equity Incentive Plan does not become effective, the 1999 Stock Incentive Plan will continue in operation pursuant to its terms.

Share Reserve. We are authorized to grant stock options and stock awards for the purchase of 6,000,000 shares of Old SAIC class A common stock, plus the shares described below, under the 1999 Stock Incentive Plan. Shares of Old SAIC class A common stock available for issuance under the 1998 Stock Option Plan as of September 30, 1999 and shares of Old SAIC class A common stock subject to outstanding options under the 1998 Stock Option Plan as of September 30, 1999 that may be returned to us because the options are forfeited, expire or are canceled without delivery of shares of stock, the shares are retained to satisfy tax withholding on option exercises or the options result in the forfeiture of shares of stock back to us will continue to be available for issuance under the 1999 Stock Incentive Plan.

Automatic Annual Increase of Share Reserve. The 1999 Stock Incentive Plan provides that the share reserve will be cumulatively increased for each year after 1999 by a number of shares that is equal to 5% of the outstanding shares of Old SAIC class A common stock as of the first business day of each calendar year, provided that in no event will the number of shares authorized for issuance exceed 15% of the outstanding shares of Old SAIC class A common stock. If the 2006 Equity Incentive Plan becomes effective, this annual share increase will cease.

Administration. The 1999 Stock Incentive Plan is administered by our board of directors or a committee or employee as the board of directors may appoint to administer the plan. The board, board committee or employee is referred in the 1999 Stock Incentive Plan as the administrator.

Eligibility. Awards under the 1999 Stock Incentive Plan may be granted to our employees, directors and consultants. Incentive stock options may be granted only to our employees. The administrator determines the individuals who are granted awards under the 1999 Stock Incentive Plan.

Nontransferability of Awards. Unless otherwise provided in an award agreement, awards granted under the 1999 Stock Incentive Plan are not transferable except to a designated beneficiary upon death and may be exercised during the awardee s lifetime only by the awardee or by his or her legal representative.

Right of Repurchase. Pursuant to Old SAIC s certificate of incorporation, all shares of Old SAIC class A common stock acquired pursuant to awards under the 1999 Stock Incentive Plan are subject to our right of repurchase upon the participant s termination of employment or affiliation with us at the then prevailing Formula Price of shares of Old SAIC class A common stock. These restrictions will lapse following the completion of the merger.

Stock Options. An option represents the right to purchase shares of Old SAIC class A common stock upon the payment of a pre-established exercise price. The 1999 Stock Incentive Plan authorizes the administrator to determine the exercise price of options at the time the options are granted. Unless otherwise specified in an award agreement, the exercise price will be the fair market value of Old SAIC class A common stock on the date of the grant. The exercise price of an incentive stock option may not be less than 100% of the fair market value of our class A common stock on the date of grant. The exercise price of a nonqualified stock option may not be less than 85% of the fair market value of our class A common stock on the date of grant. The 1999 Stock Incentive Plan authorizes the administrator to determine the vesting schedule applicable to options, as well as the means of payment for shares issued on exercise of an option. The term of an option may be no more than ten years from the date of grant, except that an incentive stock option granted to a 10% stockholder may not have a term of more than five years. No option may be exercised after the expiration of its term.

Stock Awards. Stock awards may be restricted stock awards, vested stock awards, restricted stock units, stock appreciation rights, performance awards or other similar stock awards. Restricted stock awards and vested stock awards are grants of a specific number of shares of our class A common stock that either vest or have restrictions that lapse over time in accordance with a vesting schedule. Restricted stock units represent a promise to deliver shares of our class A common stock, or an amount of cash or property equal to the value of the underlying shares, at a future date. Stock appreciation rights are rights to receive cash and/or shares of our class A common stock based on the amount by which the fair market value of a specific number of shares of our class A common stock on the exercise date exceeds the exercise price established by the administrator. Performance awards are rights to receive amounts, in cash or shares of class A common stock, based upon our or a participant s performance during the period between the date of grant and a pre-established future date. The terms and conditions of a stock award will be found in an award agreement. Vesting and restrictions on the ability to exercise stock awards may be conditioned upon the achievement of one or more goals, as determined by the administrator in its discretion. Recipients of restricted shares may have voting rights and may receive dividends on the granted shares prior to the time the restrictions lapse.

Change in Control. The 1999 Stock Incentive Plan provides that, except as provided in an award agreement, outstanding awards will become fully vested upon the occurrence of a change of control. The merger will not constitute a change of control.

Amendment and Termination. Our board of directors may at any time amend, suspend or terminate the 1999 Stock Incentive Plan. However, no amendment may, without stockholder approval, increase the maximum number of shares for which awards may be granted or change the class of employees eligible to participate in the 1999 Stock Incentive Plan.

2004 Employee Stock Purchase Plan

General. In 2004, our board of directors and stockholders approved the 2004 Employee Stock Purchase Plan. The 2004 Employee Stock Purchase Plan was adopted as a successor to our 2001 Employee Stock Purchase Plan. The 2004 Employee Stock Purchase Plan provides our employees with an opportunity to purchase Old SAIC class A common stock through voluntary payroll deductions. The 2004 Employee Stock Purchase Plan terminates on July 31, 2007, unless earlier terminated by our board of directors.

If the 2006 Employee Stock Purchase Plan becomes effective, we will cease issuing shares under the 2004 Employee Stock Purchase Plan. If the 2006 Employee Stock Purchase Plan does not become effective, the 2004 Employee Stock Purchase Plan will continue in operation pursuant to its terms.

Share Reserve. We have reserved a total of 6,000,000 shares of Old SAIC class A common stock for purchase under the 2004 Employee Stock Purchase Plan.

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Administration. The 2004 Employee Stock Purchase Plan is administered by a committee of the board.

Eligibility. Generally, all of our employees are eligible to participate in the 2004 Employee Stock Purchase Plan, except for employees of subsidiaries that have not been designated as eligible for participation. However, no person may participate in the 2004 Employee Stock Purchase Plan who owns stock having more than 5% of the total combined voting power or value of all classes of our capital stock.

Purchase of Shares. Shares of class A common stock purchased under the 2004 Employee Stock Purchase Plan may be acquired in our limited market or purchased from us out of authorized but unissued shares. Shares are purchased for the account of each participant on four predetermined purchase dates during the year.

Payroll Deductions. The 2004 Employee Stock Purchase Plan permits participants to purchase shares of Old SAIC class A common stock through payroll deductions of between 1% and 10% of the participant s compensation up to a maximum of $25,000 per year. Compensation is defined by a committee of the board and includes at a minimum regular wages, salary or commissions paid to the employee.

Company Contribution. We contribute a certain percent of the purchase price of each share of Old SAIC class A common stock purchased under the 2004 Employee Stock Purchase Plan. The percent we contribute is determined by a committee of the board within a range between 0% and 15% of the purchase price.

Purchase Price. Unless otherwise determined by our board of directors, the purchase price of each share of Old SAIC class A common stock purchased under the 2004 Employee Stock Purchase Plan is the prevailing Formula Price.

Withdrawals. Participants may withdraw from the 2004 Employee Stock Purchase Plan, terminate their election to purchase shares and obtain repayment of the balance of any funds held in their accounts, without interest, at any time prior to the purchase of shares.

Restrictions on Shares Purchased. All shares purchased pursuant to the 2004 Employee Stock Purchase Plan are subject to our right of repurchase upon the participant s termination of employment or affiliation with us at the then prevailing Formula Price of shares of Old SAIC class A common stock. These restrictions will lapse following the completion of the merger.

Qualification Under the Code. The 2004 Employee Stock Purchase Plan is designed to qualify as an employee stock purchase plan under Section 423(b) of the Code.

Nontransferability. Amounts credited to a participant employee s stock purchase account may not be transferred by a participant other than by will or the laws of descent and distribution.

Amendment and Termination. Our board of directors has the authority to amend or terminate the 2004 Employee Stock Purchase Plan, except that no amendment may, without stockholder approval, increase the maximum number of shares available for purchase under the 2004 Employee Stock Purchase Plan or deny to participating employees the right to withdraw from the 2004 Employee Stock Purchase Plan and obtain all amounts then held in their stock purchase accounts.

Amended and Restated 1984 Bonus Compensation Plan

General. Our 1984 Bonus Compensation Plan was approved by our directors and stockholders in 1984 and amended and restated by our directors and stockholders in 1999. The Amended and Restated 1984 Bonus

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Compensation Plan provides for the grant of annual and long-term bonuses and other stock- and cash-based performance awards. If the 2006 Equity Incentive Plan becomes effective, we will cease granting awards under the Restated Bonus Compensation Plan. If the 2006 Equity Incentive Plan does not become effective, the Restated Bonus Compensation Plan will continue in effect until terminated by our board of directors.

Authorized Awards. The Restated Bonus Compensation Plan authorizes the grant to eligible participants of bonus awards in each of our fiscal years with an aggregate fair market value of up to the bonus pool for that year. The bonus pool for each fiscal year is established by the committee of our board of directors administering the Restated Bonus Compensation Plan, but may not exceed 7.5% of our consolidated revenue for the year. The maximum fair market value of awards that may be granted to any individual during a fiscal year under the Restated Bonus Compensation Plan is $25,000,000. Bonus awards may be denominated in cash or shares of Old SAIC class A common stock, or any combination of cash and stock.

Administration. The Restated Bonus Compensation Plan is administered by a committee of our board of directors as determined in accordance with the provisions of the Restated Bonus Compensation Plan.

Eligibility. Employees, directors and consultants of us and our affiliates are eligible to participate in the Restated Bonus Compensation Plan. The committee, in its discretion, determines the eligible individuals who will be granted bonus awards.

Form of Bonus Award. Bonus awards under the Restated Bonus Compensation Plan may be granted in the form of cash, restricted stock or vested stock. Restricted stock awards are grants of Old SAIC shares of class A common stock subject generally to forfeiture and transfer restrictions which lapse in accordance with a vesting schedule or upon the satisfaction of specified conditions. Vested stock awards are grants of shares of Old SAIC class A common stock that have rights that vest in accordance with a vesting schedule or upon the satisfaction of specified conditions. The vesting schedule or conditions are established by the committee at the time of grant.

Bonus Programs. Awards under the Restated Bonus Compensation Plan are granted under one of several programs, as described below:

> *CEO Bonus Program.* The CEO bonus program provides for the grant of bonus awards to employees who are involved in corporate development or administration or are senior employees. Awards are made upon recommendation of our chief executive officer and may be granted up to the aggregate amount of the CEO bonus fund for the year.
>
> *Group Bonus Program.* The group bonus fund provides for the grant of bonus awards to individuals who contribute to the success of each of our major operating groups. Awards are granted upon recommendation of each group manager and may be granted up to the amount of the group bonus fund for the year.
>
> *Performance Awards.* Performance awards are rights to receive amounts, in cash or shares of Old SAIC class A common stock, based upon our or a participant s performance during the period between the date of grant and a pre-established future date.

Nontransferability. Except as otherwise provided in the award agreement, bonus awards granted pursuant to the Restated Bonus Compensation Plan are not transferable except to a designated beneficiary upon death. All shares of Old SAIC class A common stock acquired pursuant to bonus awards under the Restated Bonus Compensation Plan are subject to our right of repurchase upon the participant s termination of employment or affiliation with us at the then prevailing Formula Price.

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Change in Control. The Restated Bonus Compensation Plan provides that, except as provided in the award agreement, outstanding bonus awards become fully vested on the occurrence of a change in control. The merger will not constitute such a change in control.

Amendment and Termination. Our board of directors or its committee administering the Restated Bonus Compensation Plan may at any time amend, suspend or terminate the Restated Bonus Compensation Plan.

Management Stock Compensation Plan

General. Our Management Stock Compensation Plan was approved by our board of directors in 1996. The Management Stock Compensation Plan is an unfunded compensation arrangement established to make deferred awards of Old SAIC class A common stock to selected management and highly compensated employees. The Management Stock Compensation Plan will continue in effect until all amounts have been distributed in accordance with the terms of the plan or our board of directors terminates the plan.

Administration. The Management Stock Compensation Plan is administered by a committee appointed by our board of directors.

Eligibility. Awards under the Management Stock Compensation Plan may be granted to members of our management or highly compensated employees as determined by a committee appointed by our board of directors.

Participation and Awards. Awards are made by an individual or group of individuals appointed by our board called the awarding authority. The awarding authority has discretion to designate those employees who are to receive share units to be credited to an account created for that employee.

Awards Held in Trust. Within a reasonable period of time following the date of an award, we contribute to a trust fund, formed for purposes of the Management Stock Compensation Plan, shares of Old SAIC class A common stock or an amount of money sufficient for the trustee to purchase shares of Old SAIC class A common stock corresponding to the share units awarded.

Vesting and Forfeiture. Each award is subject to a vesting schedule not to exceed seven years. Awards granted prior to January 1, 2006 will generally vest at the rate of one-third at the end of each of the fifth, sixth and seventh year following the date of award. New awards issued on or after January 1, 2006 will generally vest 100% at the end of the fourth year following the date of award. Vesting ceases upon termination of the awardee s employment for any reason other than death of the awardee. In the event of the death of an awardee, all of his or her accounts become immediately vested. The unvested portion of an awardee s account upon termination of employment is immediately forfeited by the awardee, and the unvested shares are returned to us or reallocated in accordance with the committee s directions and the terms of the trust.

Distribution. For awards made prior to 2006, generally, an awardee may elect to have the vested portion of his or her account distributed within a reasonable period of time following the date it becomes vested or the awardee s employment terminates. If the awardee fails to make an election, his or her account is distributed in full within a reasonable period of time following the seventh anniversary of the date of the award. For awards made after January 1, 2006, participants will generally receive a distribution of their award following termination or retirement. Each distribution is made in the form of Old SAIC class A common stock.

Nontransferability. No awardee may assign any of the benefits or payments or proceeds which the awardee may expect to receive under the Management Stock Compensation Plan except pursuant to the laws of descent and distribution or to a designated beneficiary in the event of the awardee s death.

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Change in Control. Every account will become fully vested and will be immediately distributed to the awardees upon the occurrence of a change in control. The merger will not constitute such a change in control.

Amendment and Termination. Our board of directors may at any time amend or terminate the Management Stock Compensation Plan for any reason. In the event of an amendment or termination, benefits will either be paid out when due under the terms of the Management Stock Compensation Plan or as soon as possible as determined by the committee in its sole discretion.

Stock Compensation Plan

General. Our Stock Compensation Plan was approved by our board of directors in 1996 and was amended in 2001. The Stock Compensation Plan is an unfunded compensation arrangement established to make deferred awards of Old SAIC class A common stock to selected employees. The Stock Compensation Plan will continue in effect until all amounts have been distributed in accordance with the terms of the plan or our board of directors terminates the plan.

Administration. The Stock Compensation Plan is administered by a committee appointed by our board of directors.

Eligibility. Awards under the Stock Compensation Plan may be granted to our employees.

Participation and Awards. Awards are made by an individual or group of individuals appointed by our board called the awarding authority. The awarding authority has discretion to designate those employees who are to receive share units to be credited to an account created in favor of that employee.

Awards Held in Trust. Within a reasonable period of time following the date of an award, we contribute to a trust fund, formed for purposes of the Stock Compensation Plan, shares of Old SAIC class A common stock or an amount of money sufficient for the trustee to purchase shares of Old SAIC class A common stock corresponding to the share units awarded.

Vesting and Forfeiture. Each award is subject to a vesting schedule not to exceed seven years. Awards granted prior to January 1, 2006 will generally vest at the rate of one-third at the end of each of the fifth, sixth and seventh year following the date of award. New awards issued on or after January 1, 2006 will generally vest 100% at the end of the fourth year following the date of award. Vesting ceases upon termination of the awardee s employment for any reason other than death of the awardee. In the event of the death of an awardee, all of his or her accounts become immediately vested. The unvested portion of an awardee s account upon termination of employment is immediately forfeited by the awardee, and the unvested shares are returned to us or reallocated in accordance with the committee s directions and the terms of the trust.

Distribution. For awards made prior to 2006, generally, an awardee may elect to have the vested portion of his or her account distributed within a reasonable period of time following the date it becomes vested or the awardee s employment terminates. If the awardee fails to make this election, his or her account is distributed in full within a reasonable period of time following the seventh anniversary of the date of the award. For awards made after January 1, 2006, participants will receive a distribution of their award once they become vested. Each distribution is made in the form of Old SAIC class A common stock.

Nontransferability. No awardee may transfer any of the benefits or payments or proceeds which the awardee may expect to receive under the plan except pursuant to the laws of descent and distribution or to a designated beneficiary in the event of awardee s death.

Change in Control. Every account will become fully vested and will be immediately distributed to the awardees upon the occurrence of a change in control. The merger will not constitute such a change in control.

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Amendment and Termination. Our board of directors may at any time amend or terminate the Stock Compensation Plan for any reason. In the event of an amendment or termination, benefits will either be paid out when due under the terms of the Stock Compensation Plan or as soon as possible as determined by the committee in its sole discretion.

2006 Equity Incentive Plan

In August 2005, our board of directors adopted the 2006 Equity Incentive Plan, which as subsequently amended is attached to this proxy statement/prospectus as Annex C. The 2006 Equity Incentive Plan provides for the grant of stock options (including incentive stock options, as defined in section 422 of the Internal Revenue Code, and nonstatutory stock options), restricted stock, restricted stock units, deferred stock, stock appreciation rights, performance shares and other similar types of awards (including other awards under which recipients are not required to pay any purchase or exercise price, such as phantom stock rights), as well as cash awards. New SAIC stock subject to the 2006 Equity Incentive Plan will either be our new class A preferred stock or new common stock as determined by the committee of our board of directors administering the 2006 Equity Incentive Plan. The 2006 Equity Incentive Plan will not become effective until approved by our stockholders, which approval we are seeking in this proxy statement/prospectus. For a discussion of the 2006 Equity Incentive Plan see Proposal II Approval of 2006 Equity Incentive Plan.

2006 Employee Stock Purchase Plan

In August 2005, our board of directors adopted the 2006 Employee Stock Purchase Plan, which as subsequently amended is attached to this proxy statement/prospectus as Annex D. The 2006 Employee Stock Purchase Plan provides our employees (and the employees of any of our majority-owned subsidiaries designated by our board of directors) with an opportunity to purchase new class A preferred stock (or new common stock as determined by the compensation committee of our board of directors) through accumulated payroll deductions at a discounted purchase price. The 2006 Employee Stock Purchase Plan will become effective on the date on which the first offering period commences as determined by the compensation committee, subject to the closing of the merger and stockholder approval, which approval we are seeking in this proxy statement/prospectus. For a discussion of the 2006 Equity Incentive Plan see Proposal III Approval of 2006 Employee Stock Purchase Plan.

Continued Vesting on Vesting Stock and Options for Retirees

Certain qualifying retirees may continue holding and vesting in their vesting stock (including units of vesting stock held in the Key Executive Stock Deferral Plan) and stock options after retirement, if they have held such securities for at least 12 months prior to retirement. Qualifying retirement is defined as terminating service with us (1) after age 59 $^{1}/2$ with at least ten years of service with us, (2) after age 59 $^{1}/2$ when age at termination plus years of service with us equals at least 70 or (3) after reaching the applicable mandatory retirement age regardless of their length of service with us for officers and directors subject to the reporting requirements of Section 16 of the Securities Exchange of 1934, so-called Section 16 Officers and Directors. We have the right to terminate this continued vesting in certain circumstances. We also have the right to repurchase shares held by retirees after their options are exercised and/or their shares are fully vested. If a retiree is a participant in our Alumni Program (a program for eligible retirees where we have no repurchase right on their shares during the first five years after termination, but would have the right to repurchase the shares during the second five years on an established schedule with the ability to accelerate the repurchase during the second five years), we have the right to repurchase shares held by the retiree upon the termination of the retiree s participation in the Alumni Program. The policy change was implemented for all unvested stock and options awarded after July 1, 2004.

However, for Section 16 Officers and Directors retiring after reaching mandatory retirement age, this policy change applies to all unvested stock and options held by them, regardless of when the vesting stock and options were awarded.

Deferred Compensation Plans

We maintain two deferred compensation plans, the Keystaff Deferral Plan and the Key Executive Stock Deferral Plan, for the benefit of key executives and directors that allow eligible participants to elect to defer all or a portion of their annual bonus compensation. We make no contributions under the Keystaff Deferral Plan but do credit participant accounts for deferred compensation amounts and interest earned. Interest is accrued based on the Moody s Seasoned Corporate Bond Rate (5.59% in 2006). Deferred balances will generally be paid upon termination. Under the Key Executive Stock Deferral Plan, eligible participants may elect to defer all or a portion of their annual bonus compensation. We make no contributions to the accounts of participants, which generally correspond to shares of Old SAIC class A common stock held in a trust for the benefit of participants. Deferred balances will generally be paid upon retirement or termination.

Employee Stock Retirement Plan

Prior to adoption of the SAIC Retirement Plan in January 2006, we maintained an Employee Stock Retirement Plan (ESRP), in which eligible employees participated. Cash or stock contributions to the ESRP were based upon amounts determined annually by our board of directors and were allocated to participants accounts based on their annual eligible compensation. We recognized the fair value of Old SAIC class A common stock or the amount of cash contributed in the year of contribution as compensation expense. The vesting requirements for the ESRP were the same as the vesting requirements for our contributions to the 401(k) Plan. Any participant who left us, whether by retirement or otherwise, was able to elect to receive either cash or shares of our common stock as a distribution from their account. Shares of Old SAIC class A common stock distributed from the ESRP bore a limited put right that, if exercised, required us to repurchase all or a portion of the shares at their then current fair value during two specified 60-day periods following distribution. If the shares were not put to us during the specified periods, the shares no longer bore a put right, and we were not required to repurchase the shares.

401(k) Plan

Prior to adoption of the SAIC Retirement Plan in January 2006, we maintained a principal 401(k) Profit Sharing Plan (401(k) Plan), which was the result of the merger of our Profit Sharing Retirement Plan with our Cash or Deferred Arrangement effective November 28, 2003. The 401(k) Plan was qualified under Section 401(a) of the Code and its associated trust was exempt from federal income taxation under Section 501(a) of the Code. The 401(k) Plan allowed eligible participants to defer a portion of their income through payroll deductions. Such deferrals were fully vested, were not taxable to the participant until distributed from the 401(k) Plan upon termination, retirement, permanent disability or death and could be matched by us. In addition, we could also provide a profit sharing contribution. Participants interests in our matching and profit sharing contributions vested ratably over five years. Participants also became fully vested upon reaching age 59 $^{1}/2$, permanent disability or death.

SAIC Retirement Plan

Effective January 1 2006, Old SAIC adopted the SAIC Retirement Plan, which is the result of the merger of our ESRP with our 401(k) Plan. The plan is a combined 401(k) plan and an employee stock ownership plan

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(ESOP). The plan is qualified under Section 401(a) of the Code and its associated trust is exempt from federal income taxation under Section 501(a) of the Code. The ESOP feature of the plan is intended to qualify under Sections 401(a) and 4975(e)(7) of the Code and is designed as such to invest primarily in company stock. The plan allows eligible participants to defer a portion of their income through payroll deductions. Such deferrals are fully vested, are not taxable to the participant until distributed from the plan upon termination, retirement, permanent disability or death and may be matched by us. In addition, we may also provide a profit sharing and/or ESOP contribution. Cash or stock contributions to the plan are based upon amounts determined annually by our board of directors and are allocated to participants accounts based on their annual eligible compensation. We recognize the fair value of Old SAIC class A common stock or the amount of cash contributed in the year of contribution as compensation expense. Participants interests in our matching, profit sharing and ESOP contributions vest ratably over five years. Participants also become fully vested upon reaching age 59 $^{1}/_{2}$, permanent disability or death. We currently provide a matching 50% contribution for each dollar an employee contributes to the plan, up to a certain percentage of the employee s eligible compensation. Any participant who leaves us, whether by retirement or otherwise, may be able to elect to take a distribution in shares of our common stock from the balances of their account invested in our stock. Shares of Old SAIC class A common stock distributed from the plan bear a limited put right that, if exercised, would require us to repurchase all or a portion of the shares at their then current fair value during two specified 60-day periods following distribution. If the shares are not put to us during the specified periods, the shares no longer bear a put right, and we will not be required to repurchase the shares. Although we have no current intention to do so, if necessary, we believe we have the ability to eliminate the limited put right feature on shares held by the plan.

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CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

In conjunction with the retirement of J.R. Beyster from the board of directors, in fiscal 2005, we made a $4 million cash donation in the name of J.R. Beyster, our former Chairman of the Board, Chief Executive Officer and President, to the UC San Diego Foundation for the benefit of the Beyster Institute, a part of the Rady School of Management at the University of California, San Diego. The Beyster Institute at the Rady School of Management engages in teaching, research, public education and outreach related to advancing and encouraging others in the field of employee ownership and entrepreneurship. The Beyster Institute was previously a part of the Foundation for Enterprise Development (the Foundation), a non-profit organization established by J.R. Beyster, which is engaged in a broad range of research and education activities. In addition, in each of fiscal 2006 and fiscal 2005, we donated $150,000 in cash to the Foundation and we have a commitment to donate $150,000 per year for three more years. In fiscal 2004, we made total annual contributions of $700,000 to the Foundation, in the form of cash, rent-free occupancy in our facilities and donated services. J.R. Beyster is the President and a member of the Board of Trustees of the Foundation and M.A. Walkush, sister of J.P. Walkush, an Executive Vice President and a Director, and a consulting employee of us, is a consultant and a Senior Fellow for the Foundation. Each of T.E. Darcy, an Executive Vice President, and J.P. Walkush have previously served as members of the Board of Trustees of the Foundation.

On July 9, 2004, we and J.R. Beyster entered into a letter agreement in conjunction with J.R. Beyster s retirement from the board of directors. Pursuant to this letter, in fiscal 2005, we (1) paid J.R. Beyster $104,000 as compensation for providing business and strategic support to assist with the transition to our new Chairman, Chief Executive Officer and President, (2) provided J.R. Beyster and his spouse with medical, dental, vision and life insurance benefits equivalent to those generally provided to our employees, (3) transferred ownership of the company car utilized by J.R. Beyster and (4) provided travel agency services to J.R. Beyster and his spouse.

J.R. Beyster, as Trustee of the Beyster Family Trust, entered into a Rule 10b5-1 trading plan with Bull, Inc., our wholly-owned broker-dealer subsidiary. The Rule 10b5-1 trading plan, dated June 15, 2004, directed Bull, Inc. to sell on behalf of the Beyster Family Trust 190,639 shares of Old SAIC class A common stock in Old SAIC s limited market in the July 2004 trade and 190,639 shares of Old SAIC class A common stock in Old SAIC s limited market in the October 2004 trade, provided the sale price was at or above $25.00 per share. Pursuant to this trading plan, the Beyster Family Trust sold 190,639 shares of Old SAIC class A common stock in Old SAIC s limited market in the July 2004 trade and 190,639 shares of Old SAIC class A common stock in Old SAIC s limited market in the October 2004 trade.

J.F. Beyster, son of J.R. Beyster, is an employee of our company. For services rendered during each of fiscal 2006, 2005 and 2004, J.F. Beyster received a salary of $69,192, $70,162 and $70,692, respectively. J.F. Beyster is a Mechanical Engineer.

M.A. Beyster, daughter of J.R. Beyster, was previously an employee of our company. For services rendered during fiscal 2006, M.A. Beyster received a salary of $115,442. For services rendered during fiscal 2005, M.A. Beyster received a salary of $146,332, cash bonuses of $9,000 and $3,000 and options to acquire 300 shares of Old SAIC class A common stock at $38.14 per share, which was the fair market value on the date of the grant. For services rendered during fiscal 2004, M.A. Beyster received $133,535 in cash compensation, 82 shares of Old SAIC class A common stock, which had a market value on the date of the grant of $2,995, 55 shares of Old SAIC vesting class A common stock, which had a market value on the date of the grant of $2,009 and options to acquire 300 shares of Old SAIC class A common stock at $36.52 per share, which was the Formula Price on the date of the grant. Such shares of Old SAIC vesting class A common stock and options both vest as to 20%, 20%, 20% and 40% on the first, second, third and fourth year anniversaries of the date of grant, respectively. M.A.

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Beyster had served as a Business Development Manager in our Life Science Office developing business in pharmaceutical and biotechnology firms, and has previously served as a Business Development Manager for each of our Pfizer Bio Sciences Division and our Engineering and Environmental Management Services Group.

B.D. Rockwood, son of Stephen D. Rockwood, our former Executive Vice President and Chief Technology Officer and Director, is an employee of our company. For services rendered during fiscal 2006, B.D. Rockwood received a salary of $185,000, a cash bonus of $3,200, 10 net shares of Old SAIC class A common stock (on an after-tax basis) with a market value of $453 based on an original bonus amount of $800, 592 shares of Old SAIC vesting class A common stock which had a market value on the date of grant of $26,001 and options to acquire 1,000 shares of Old SAIC class A common stock at $43.92 per share, which was the Formula Price on the date of the grant. For services rendered during fiscal 2005, B.D. Rockwood received a salary of $185,000, a cash bonus of $14,000, 148 shares of Old SAIC class A common stock which had a market value on the date of grant of $6,001, 123 shares of Old SAIC vesting class A common stock which had a market value on the date of grant of $4,988 and options to acquire 1,250 shares of Old SAIC class A common stock at $40.55 per share, which was the Formula Price on the date of each grant. For services rendered during fiscal 2004, B.D. Rockwood received $181,279 in cash compensation, 55 shares of Old SAIC class A common stock, which had a market value on the date of grant of $2,009, 41 shares of Old SAIC vesting class A common stock, which had a market value on the date of grant of $1,497 and options to acquire 500 shares of Old SAIC class A common stock at $36.52 per share, which was the Formula Price on the date of the grant. Such vesting shares of class A common stock and options both vest as to 20%, 20%, 20% and 40% on the first, second, third and fourth year anniversaries of the date of grant, respectively. B.D. Rockwood is a Director of Business Operations in the Security and Transportation Technology business unit, and has previously served as a Business Developer in such business unit.

W.A. Downing, a former director whose term expired in June 2005, also provided consulting services to us in the areas of homeland security, weapons of mass destruction, intelligence and national security policy matters and received compensation at a fixed hourly rate in addition to his annual retainer and meeting fees as a director. In fiscal 2006, 2005 and 2004, W.A. Downing received compensation of $317,500, $332,500 and $387,813, respectively, for these consulting services.

D.M. Albero, son of C.M. Albero, former Group President and current Chairman of the Board of AMSEC LLC, is an employee of AMSEC LLC. For services rendered during fiscal 2006, D.M. Albero received a salary of $107,804. For services rendered during fiscal 2005, D.M. Albero received a salary of $103,061, a cash bonus of $8,000 and 65 vesting shares of Old SAIC class A common stock, which had a market value on the date of grant of $2,479. Such vesting shares of Old SAIC class A common stock vest as to 20%, 20%, 20% and 40% on the first, second, third and fourth year anniversaries of the date of grant, respectively. For services rendered during fiscal 2004, D.M. Albero received $109,463 in cash compensation. D.M. Albero is a Senior Consulting Analyst.

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PRINCIPAL STOCKHOLDERS

The following table presents information concerning the beneficial ownership of the shares of Old SAIC class A common stock as of May 17, 2006 by each of our current directors, our nominee for director, our Chief Executive Officer, each of the other Named Executive Officers and all of our executive officers and current directors as a group. To our knowledge, no person, other than Vanguard Fiduciary Trust Company (Vanguard), in its capacity as trustee of certain of our retirement plans) beneficially owned more than 5% of the outstanding shares of Old SAIC class A common stock as of this date.

Name and address of beneficial owner	Number of shares beneficially owned (1)	Percentage of outstanding common stock (2)
K.C. Dahlberg	290,926	*
W.H. Demisch	158,835	*
J.A. Drummond	10,876	*
D.H. Foley	208,272	*
J.J. Hamre	2,120	*
A.K. Jones	65,203	*
H.M.J. Kraemer, Jr.	101,845	*
C.B. Malone	122,018	*
W.A. Roper, Jr.	485,546	*
E.J. Sanderson, Jr.	15,897	*
L.A. Simpson		
G.T. Singley	92,352	*
J.P. Walkush	331,615	*
J.H. Warner, Jr.	404,153	*
A.T. Young	84,420	*
Vanguard Fiduciary Trust Company, as trustee 400 Vanguard Boulevard Malvern, PA 19355 (3)	69,573,599	41.1%
All executive officers and directors as a group (22 persons)	2,994,039	1.8%

* Less than 1%.

Unless otherwise noted, the address for each beneficial holder is c/o SAIC, Inc., 10260 Campus Point Drive, San Diego, California 92121.

(1) The beneficial ownership set forth in the table includes: (a) the approximate number of shares allocated to the account of the individual by the Trustee of the SAIC Retirement Plan as follows: K.C. Dahlberg (875 shares), D.H. Foley (110 shares), G.T. Singley (1,427 shares), J.P. Walkush (23,638 shares), J.H. Warner, Jr. (302 shares) and all executive officers and directors as a group (84,445 shares); (b) shares held in a rabbi trust in the form of share units for the account of the individual in the Key Executive Stock Deferral Plan, the Stock Compensation Plan and/or the Management Stock Compensation Plan as follows: K.C. Dahlberg (101,051 shares), W.H. Demisch (23,349 shares), J.A. Drummond (2,216 shares), D.H. Foley (17,243 shares), J.J. Hamre (1,120 shares), A.K. Jones (3,502 shares), H.M.J. Kraemer, Jr. (18,884 shares), W.A. Roper, Jr. (184,680 shares), G.T. Singley (6,892 shares), J.P. Walkush (49,184 shares), J.H. Warner, Jr. (46,114 shares), A.T. Young (29,522 shares) and all executive officers and directors as a group (570,067 shares); (c) shares subject to options exercisable within 60 days following May 17, 2006 as follows: K.C. Dahlberg (154,000 shares), W.H. Demisch (24,600 shares), J.A. Drummond (7,200 shares), D.H. Foley (155,000 shares), A.K. Jones (24,600 shares), H.M.J. Kraemer, Jr. (24,600 shares), C.B. Malone (11,400 shares), W.A. Roper, Jr. (170,000 shares), E.J. Sanderson, Jr. (12,600 shares), G.T. Singley (47,000 shares), J.P. Walkush (81,000 shares), J.H. Warner, Jr. (118,000 shares), A.T. Young (24,600 shares) and all executive officers and directors as a group (1,086,405 shares); (d) shares held directly by or jointly with spouses, minor children or other relatives sharing a household with the individual as follows: W.H. Demisch (98,309 shares) and all executive officers and directors as a group (104,209 shares); and (e) shares held by certain trusts established by the individual as follows: C.B. Malone (110,618 shares), J.H. Warner, Jr. (116,506 shares) and all executive officers and directors as a group (362,878 shares).

(2) Based on 169,163,606 shares of Old SAIC class A common stock outstanding as of May 17, 2006 and assuming the conversion of the 206,147 shares of Old SAIC class B common stock outstanding as of May 17, 2006 into shares of Old SAIC class A common stock at a conversion ratio of 20 for 1.

(3) Shares held by Vanguard are voted as directed by the plan participants.

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DESCRIPTION OF CAPITAL STOCK, CERTIFICATE OF INCORPORATION AND BYLAWS

Authorized Capitalization

New SAIC s capital structure consists of 2 billion authorized shares of common stock; 1.5 billion authorized shares of class A preferred stock, of which 100 million will be designated series A-1 preferred stock, 100 million will be series A-2 preferred stock, 150 million will be series A-3 preferred stock and 1.15 billion will be series A-4 preferred stock; and 10 million authorized shares of undesignated preferred stock.

Old SAIC s capital structure consists of 1 billion authorized shares of class A common stock, 5 million authorized shares of class B common stock and 3,000,000 authorized shares of preferred stock. As of the record date, shares of class A common stock, shares of class B common stock and no shares of preferred stock were outstanding.

When the merger becomes effective, all the outstanding new class A preferred stock of New SAIC will be validly issued, fully paid and nonassessable. When our IPO is completed, all the outstanding new common stock of New SAIC will be validly issued, fully paid and nonassessable.

Description of New SAIC s Restated Certificate of Incorporation

Other key provisions of New SAIC s restated certificate of incorporation, which is included as Annex B to this proxy statement/prospectus, are as follows:

Right of First Refusal. New SAIC s restated certificate of incorporation does not include the right of first refusal that is contained in our current certificate of incorporation.

Right of Repurchase. New SAIC s restated certificate of incorporation does not include the right of repurchase on termination of affiliation as an employee, director or consultant that is contained in our current certificate of incorporation.

No Stockholder Action by Written Consent. New SAIC s restated certificate of incorporation prohibits stockholder action by written consent. This does not differ from our current certificate of incorporation.

No Stockholder Ability to Call a Special Meeting. New SAIC s restated certificate of incorporation provides that special meetings of our stockholders may be called only by our board of directors, a majority of our board of directors or a committee designated by our board of directors. This does not differ from our current certificate of incorporation.

Limitation of Director Liability. New SAIC s restated certificate of incorporation provides that our directors are not liable to the corporation or any of our stockholders for monetary damages for breach of fiduciary duty as a director, except for liability:

for breach of duty of loyalty to the corporation or its stockholders

for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law

under Section 174 of the General Corporation Law of the State of Delaware

for transactions from which the director derived an improper personal benefit

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These director liability provisions do not differ from our current certificate of incorporation.

Indemnification of Directors and Officers. New SAIC s restated certificate of incorporation provides that we must indemnify our directors and officers to the fullest extent authorized by the General Corporation Law of the State of Delaware, subject to limited exceptions. This does not differ from our current certificate of incorporation.

Classified Board of Directors. New SAIC s restated certificate of incorporation provides for a classified board of directors. This does not differ from our current certificate of incorporation.

Cumulative Voting. New SAIC s restated certificate of incorporation provides that our stockholders are entitled to cumulative voting in the election of our directors. This does not differ from our current certificate of incorporation.

Comparison of Our Currently Outstanding Old SAIC Common Stock to New SAIC Class A Preferred Stock and Common Stock

The following table compares our currently outstanding Old SAIC class A and class B common stock to New SAIC class A preferred stock and common stock.

	Old SAIC Common Stock	**New SAIC Class A Preferred Stock**	**New SAIC Common Stock**
Public market	None	None	We have been approved for listing of the new common stock on the New York Stock Exchange.
Voting	One vote per class A share and 20 votes per class B share on all matters voted upon by our stockholders. There is cumulative voting for the election of directors.	10 votes per share on all matters to be voted upon by our stockholders. There is cumulative voting for the election of directors.	One vote per share on all matters to be voted upon by our stockholders. There is cumulative voting for the election of directors.
Conversion	Class A common stock is not convertible; class B common stock is convertible into class A common stock on a 20 for 1 basis.	Class A preferred stock is convertible into common stock on a 1 for 1 basis after initial restriction periods that expire at different times for each of series A-1, A-2, A-3 and A-4 preferred stock. Restriction periods expire: series A-1 preferred stock: 90 days after our IPO	Not convertible

series A-2 preferred stock: 180 days after our IPO

series A-3 preferred stock: 270 days after our IPO

series A-4 preferred stock: 360 days after our IPO

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	Old SAIC Common Stock	New SAIC Class A Preferred Stock	New SAIC Common Stock
Transfer restrictions	Subject to a right of first refusal by Old SAIC. A limited internal market is maintained, which permits stockholders to offer for sale class A common stock on predetermined trade dates and at prices determined by our board of directors.	Class A preferred stock may not be transferred to anyone other than a permitted transferee until the following restriction periods have expired: series A-1 preferred stock: 90 days after our IPO series A-2 preferred stock: 180 days after our IPO series A-3 preferred stock: 270 days after our IPO series A-4 preferred stock: 360 days after our IPO. Class A preferred stock that is transferred after expiration of the applicable restriction period to someone who is not a permitted transferee automatically will convert into new common stock. A permitted transferee of an employee includes the employee s immediate family members or a trust established by that employee for the sole benefit of one or more of his or her immediate family members.	None
Mergers or consolidations	In the event we merge, consolidate or enter into a business combination, other than a transaction in which we are the survivor and does not result in any reclassification or change in the outstanding shares, the consideration to be received with respect to each class B share must equal 20 times the consideration to be received with respect to each class A share. In any such transaction in which shares of capital stock are distributed, they may differ as to the rights of the holders thereof to the extent and only to the extent that such rights differ as set forth in Old SAIC s certificate of incorporation.	In the event of any merger or consolidation to which New SAIC is a party (whether or not New SAIC is the surviving entity), the holders of class A preferred stock and new common stock will be entitled to receive, on a per share basis, the same amount and form of stock and other securities and property (including cash).	

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	Old SAIC Common Stock	New SAIC Class A Preferred Stock	New SAIC Common Stock
Dividends and other distributions	Subject to the rights of the holders of preferred stock, holders of class A and class B common stock are entitled to receive dividends in cash, stock or otherwise as our board of directors may declare from time to time out of our legally available assets or funds, provided that any dividend declared and paid with respect to each class B share shall be equal to 20 times the per share dividend declared and paid with respect to each class A share.	Subject to the rights of any other series of preferred stock that may come into existence from time to time, the holders of class A preferred stock and the holders of new common stock will be entitled to share equally, on a per share basis, in such dividends and other distributions of cash, property or shares of New SAIC as may be declared thereon by the board of directors out of funds legally available therefor, provided, however, that in the event such dividend is paid in the form of shares of capital stock or rights to acquire capital stock, the holders of class A preferred stock shall receive class A preferred stock or rights to acquire class A preferred stock, as the case may be, and the holders of new common stock shall receive new common stock or rights to acquire new common stock, as the case may be.	
Subdivisions or combinations	Neither class may be subdivided, consolidated, reclassified or otherwise changed unless the relative powers, preferences, rights, qualifications, limitations and restrictions applicable to the other class are maintained.	If New SAIC shall in any manner split, subdivide or combine the outstanding shares of new class A preferred stock, the outstanding shares of the new common stock shall be proportionately split, subdivided or combined in the same manner and on the same basis; and if New SAIC shall in any manner split, subdivide or combine the outstanding shares of new common stock, the outstanding shares of new class A preferred stock shall be proportionately split, subdivided or combined in the same manner and on the same basis.	
Liquidation	Subject to the rights of any series of preferred stock that may come into existence from time to time, in the event of the voluntary or involuntary liquidation, dissolution or winding up of Old SAIC, the holders of class A common stock and the holders of class B common stock will be entitled to share, equally and ratably, all assets and funds of whatever kind available for distribution to the holders of common stock; provided, however, that the amount of such assets and funds distributed with respect to each class B share will be equal to 20 times the per share amount distributed with respect to each class A share.	Subject to the rights of any other series of preferred stock that may come into existence from time to time, in the event of the voluntary or involuntary liquidation, dissolution or winding up of New SAIC, the holders of new class A preferred stock and the holders of new common stock will be entitled to share equally, on a per share basis, all assets of whatever kind available for distribution to the holders of capital stock.	

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Additional Preferred Stock

We have authorized 10 million shares of undesignated preferred stock. Our board of directors has the authority to issue shares of this preferred stock, from time to time, on terms that it may determine, in one or more series, and to fix the designations, voting powers, preferences and relative participating, optional or other special rights of each series, and the qualifications, limitations or restrictions of each series, to the fullest extent permitted by Delaware law. The issuance of shares of our undesignated preferred stock could have the effect of decreasing the market price of our common stock, impeding or delaying a possible takeover and adversely affecting the voting and other rights of the holders of common stock. We have no present intention to issue shares of our undesignated preferred stock.

Anti-Takeover Effects of Various Provisions of Delaware Law and New SAIC s Restated Certificate of Incorporation and Restated Bylaws

Our current certificate of incorporation and bylaws, and New SAIC s restated certificate of incorporation and restated bylaws, contain provisions that may have some anti-takeover effects. Provisions of Delaware law may have similar effects under both our current certificate of incorporation and New SAIC s restated certificate of incorporation.

Delaware Anti-Takeover Statute

We are now, and New SAIC will be, subject to Section 203 of the General Corporation Law of the State of Delaware. Subject to specific exceptions, Section 203 prohibits a publicly held Delaware corporation from engaging in a business combination with an interested stockholder for a period of three years after the time of the transaction in which the person became an interested stockholder, unless:

- the business combination, or the transaction in which the stockholder became an interested stockholder is approved by the board of directors prior to the time the interested stockholder attained that status, or

- upon consummation of the transaction that resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced (excluding those shares owned by persons who are directors and also officers, and employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer), or

- at or subsequent to the time a person became an interested stockholder, the business combination is approved by the board of directors and authorized at an annual or special meeting of stockholders by the affirmative vote of at least two-thirds of the outstanding voting stock that is not owned by the interested stockholder

Business combinations include mergers, asset sales and other transactions resulting in a financial benefit to the interested stockholder. Subject to various exceptions, an interested stockholder is a person who, together with his or her affiliates and associates, owns, or within three years did own, 15% or more of the corporation s outstanding voting stock based on the percentage of the votes of such voting stock. These restrictions could prohibit or delay the accomplishment of mergers or other takeover or change-in-control attempts with respect to us and, therefore, may discourage attempts to acquire us.

In addition, various provisions of our certificate of incorporation and bylaws and New SAIC s restated certificate of incorporation and restated bylaws, which are summarized in the following paragraphs, may be

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deemed to have an anti-takeover effect and may delay, defer or prevent a tender offer or takeover attempt that a stockholder might consider in its best interest, including those attempts that might result in a premium over the market price for the shares held by stockholders.

Mergers with Related Persons

Our certificate of incorporation and New SAIC s restated certificate of incorporation generally require that mergers and certain other business combinations between us and a related person must be approved by the holders of securities having 80% of our outstanding voting power, as well as by the holders of a majority of the voting power of such securities that are not owned by the related person. A related person means any holder of 5% or more of our outstanding voting power. Under Delaware law, unless the certificate of incorporation provides otherwise, only a majority of our outstanding voting power is required to approve certain of these transactions, such as mergers and consolidations, while certain other of these transactions would not require stockholder approval.

These requirements of our certificate of incorporation and New SAIC s restated certificate of incorporation do not and will not, apply, however, to a business combination with a related person, if the transaction:

- is approved by our board of directors before the related person acquired beneficial ownership of 5% or more of our outstanding voting power, or
- is approved by a majority of the members of our board of directors who are not affiliated with the related person and who were directors before the related person became a related person, or
- involves only us and one or more of our subsidiaries and certain other conditions are satisfied

No Stockholder Action by Written Consent; Calling of Special Meetings of Stockholders

Our certificate of incorporation and New SAIC s restated certificate of incorporation prohibit stockholder action by written consent. They also provide that special meetings of our stockholders may be called only by the board of directors, a majority of the board of directors or a committee designated by the board of directors.

Advance Notice Requirements For Stockholder Proposals

Our bylaws and New SAIC s restated bylaws provide that stockholders seeking to bring business before an annual meeting of stockholders, including the nomination of persons for election to the board of directors, must provide timely notice of their proposal in writing to the corporate secretary. Under New SAIC s restated bylaws, to be timely, a stockholder s notice generally must be delivered or mailed and received at our principal offices not later than the close of business on the 90th day, nor earlier than the close of business on the 120th day, prior to the first anniversary of the preceding year s annual meeting (provided, however, that in the event that the date of the annual meeting is more than 30 days before or more than 70 days after such anniversary date, notice by the stockholder must be so delivered not earlier than the close of business on the 120th day prior to such annual meeting and not later than the close of business on the later of the 90th day prior to such annual meeting or the 10th day following the day on which public announcement of the date of such meeting is first made by New SAIC). These provisions may impede stockholders ability to bring matters before an annual meeting of stockholders or make nominations for directors at an annual meeting of stockholders.

Authorized but Unissued Shares

New SAIC s authorized but unissued shares of new common stock, new class A preferred stock and undesignated preferred stock will be available for future issuance without your approval. We may issue these

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additional shares for a variety of corporate purposes, including raising additional capital, making acquisitions or joint ventures and incentivizing employees. The existence of authorized but unissued shares of new common stock, new class A preferred stock and undesignated preferred stock could render more difficult or discourage an attempt to obtain control of us by means of a proxy contest, tender offer, merger or otherwise.

Supermajority Provisions

The General Corporation Law of the State of Delaware provides generally that the affirmative vote of a majority in voting power of the shares entitled to vote on any matter is required to amend a corporation s certificate of incorporation, unless the certificate of incorporation requires a greater percentage.

Our current certificate of incorporation provides that the following provisions may be amended only by a vote of at least two-thirds of the in voting power of the outstanding shares of our stock entitled to vote:

- the authority of the board of directors to make, repeal, alter, amend and rescind the bylaws
- the provisions relating to the number, classification, election and removal of the directors
- the provisions relating to the inability of stockholders to act by written consent or call special meetings
- the provisions requiring approval of two-thirds of the voting power of our stock entitled to vote on the foregoing

In addition, our current certificate of incorporation and the restated certificate of incorporation of New SAIC provide that, under certain circumstances, any amendment of the article related to business combinations requires (1) the vote of at least 80% in voting power of all of the outstanding shares of our stock entitled to vote and (2) the vote of at least a majority in voting power of the outstanding shares of our stock entitled to vote other than shares of voting stock that are beneficially owned by a related person that directly proposed such amendment.

The restated certificate of incorporation of New SAIC requires a two-thirds vote of the stockholders to amend any of the provisions relating to the number of directors and the establishment of classes of directors for purposes of director elections, stockholders acting by written consent, the calling of special meetings or any amendment of the restated bylaws of New SAIC by the stockholders.

Limitations on Liability and Indemnification of Directors and Officers

The General Corporation Law of the State of Delaware authorizes corporations to limit or eliminate the personal liability of directors to corporations and their stockholders for monetary damages for breaches of directors fiduciary duties. Our certificate of incorporation and New SAIC s restated certificate of incorporation include a provision that eliminates the personal liability of directors to the corporation or its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability:

for breach of duty of loyalty to the corporation or its stockholders

for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law

under Section 174 of the General Corporation Law of the State of Delaware

for transactions from which the director derived an improper personal benefit

Our certificate of incorporation and New SAIC s restated certificate of incorporation provide that we must indemnify our directors and officers to the fullest extent authorized by the General Corporation Law of the State

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of Delaware, subject to limited exceptions, and under specified circumstances advance and pay their expenses in defending any proceedings to the fullest extent not prohibited by applicable law. We are authorized by the General Corporation Law of the State of Delaware to carry directors and officers insurance providing indemnification for our directors, officers and certain employees and to enter into separate indemnification agreements with our directors and executive officers. We currently maintain certain directors and officers coverage, and we have entered into indemnification agreements with our directors, executive officers and board-appointed officers. We believe that these indemnification provisions and indemnification agreements and this insurance are necessary to attract and retain qualified directors and executive officers.

The limitation of liability and indemnification provisions in our certificate of incorporation may discourage stockholders from bringing a lawsuit against directors for breach of their fiduciary duty. These provisions may also have the effect of reducing the likelihood of derivative litigation against directors and officers, even though such an action, if successful, might otherwise benefit us and our stockholders. In addition, your investment may be adversely affected to the extent we pay the costs of defense, settlement and damage awards against directors and officers pursuant to these indemnification provisions.

Transfer Agent and Registrar

Mellon Investor Services LLC will be the transfer agent and registrar for new class A preferred stock and new common stock.

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MARKET FOR OLD SAIC STOCK AND

RELATED STOCKHOLDER MATTERS

The following description of Old SAIC s limited market, the method of determining prices and the historical prices of our class A common stock is provided to better enable you to compare our current stock system with the revised capital structure and terms of the new class A preferred stock and new common stock following the merger and IPO.

The Limited Market

Since its inception, Old SAIC has followed a policy of remaining essentially employee owned. As a result, there has never been a general public market for any of our securities. In order to provide some liquidity for our stockholders, however, Old SAIC has historically maintained a limited secondary market, which we call the limited market, through our wholly-owned broker-dealer subsidiary, Bull, Inc.

The limited market has permitted existing stockholders to offer for sale shares of class A common stock on predetermined days which we call a trade date. Historically, there have been four trade dates each year. However, a scheduled trade date could be postponed or cancelled. When we announced our intention to conduct the IPO in September 2005, we postponed a limited market trade originally scheduled for September 2005 to October 2005, and also stated at that time that we believed the October 2005 trade would be the last one conducted before completion of the IPO. However, after the December 2005 postponement of the special meeting of stockholders and the announced delay in our IPO schedule, we conducted a limited market trade in January 2006.

We now plan to complete the IPO in the Fall of 2006, and a limited market trade has been scheduled for June 30, 2006. If the IPO is completed on our current schedule, the June 2006 limited market trade will be the last limited market trade. If, however, the IPO is postponed, we intend to conduct a limited market trade at the same time as the retirement plans trades until the IPO process recommences. In addition to the trades currently scheduled for June 30, 2006 (retirement plans and limited market trades), a retirement plans trade has been scheduled for October 27, 2006 and at least three additional retirement plans trade dates will be announced, at which time limited market trades also may be held if the IPO is postponed.

In these trades, participants may offer to buy or sell shares in accordance with the terms of the plans. In addition, we intend to conduct four scheduled trades directly between us and our retirement plans following completion of the IPO in which participants may offer to buy or sell shares in accordance with the terms of the plans. In all these retirement plans trades, we will have the right, but not the obligation, to buy the net balance of shares offered by participants in our retirement plans. In addition, following the IPO, our retirement plans will have the opportunity to convert shares of new class A preferred stock into new common stock and sell those shares into the public market to the extent permissible under the transfer restrictions on the new class A preferred stock.

All sales and purchases are made at the prevailing price of the class A common stock determined by the board of directors or its stock policy committee pursuant to the valuation process described below. All participants who wish to participate in a particular trade must submit a trade request in the form of a limit order. A limit order is a request to buy stock at or below the limit price specified by the person placing the order or a request to sell stock at any price equal to or above the limit price specified. A limit order will not be processed if the limit price is not satisfied by the price established by the board of directors unless the order is modified. A participant may not submit both a buy limit order and a sell limit order on the same account for the same trade.

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The purchase of class A common stock in the limited market is currently restricted to:

- current employees of Old SAIC and eligible subsidiaries who desire to purchase class A common stock in an amount that does not exceed a pre-approved limit established by the board of directors or a designated committee of the board, currently $20,000

- current employees, consultants and non-employee directors of Old SAIC and eligible subsidiaries who have been specifically approved by the board of directors or its designated committee or subcommittee to purchase a specified number of shares which may exceed the pre-approved limit

- trustees or agents of the retirement and benefit plans of Old SAIC and its eligible subsidiaries

These employees, consultants, directors, trustees and agents are referred to as authorized buyers. No one, other than these authorized buyers, is eligible to purchase class A common stock in the limited market.

The following shares of class A common stock, with certain exceptions, may not be sold in the limited market:

- shares acquired through an option exercise or a vested stock bonus less than six months prior to sale

- shares acquired through a vesting stock bonus that vested less than six months prior to sale

If the aggregate number of shares offered for sale in the limited market on any trade date is greater than the aggregate number of shares sought to be purchased by authorized buyers, offers by stockholders to sell 2,000 or less shares of class A common stock (or up to the first 2,000 shares if more than 2,000 shares of class A common stock are offered by any such stockholder) will be accepted first. Offers to sell shares in excess of 2,000 shares of class A common stock will be accepted on a pro-rata basis determined by dividing the total number of shares remaining under purchase orders by the total number of shares remaining under sell orders. If, however, there are insufficient purchase orders to support the primary allocation of 2,000 shares of class A common stock for each proposed seller, then the purchase orders will be allocated equally among all of the proposed sellers up to the total number of shares offered for sale.

We are currently authorized, but not obligated, to purchase shares of class A common stock in the limited market on any trade date, but only if and to the extent that the number of shares offered for sale by stockholders exceeds the number of shares sought to be purchased by authorized buyers, and we, in our discretion, determine to make such purchases. However, the number of shares we may purchase in the limited market on any given trade date is subject to legal and contractual restrictions. Under Delaware law, we may repurchase our shares only out of available surplus. In addition, financial covenants under our credit agreement or agreements we enter into in the future may restrict our ability to repurchase shares. In deciding whether to make such purchases, we will consider a variety of factors, including our cash position and cash flows, investment and capital activities, financial performance, financial covenants, the number of shares outstanding and the amount of the undersubscription in the market. We have purchased a significant amount of class A common stock in the limited market during recent periods. We purchased a total of 8,359,372 shares on the trade dates in fiscal 2006 and a total of 9,331,128 shares on the trade dates in fiscal 2005. These purchases accounted for 64.4% and 75.4%, respectively, of the total shares purchased by all buyers in the limited market during fiscal 2006 and 2005. Our purchases balanced the number of shares offered for sale by stockholders with the number of shares sought to be purchased by authorized buyers. We may not continue to purchase such excess shares in the future. Accordingly, if the aggregate number of shares offered for sale in the limited market exceeds the aggregate number of shares sought to be purchased by authorized buyers, and we elect not to participate in a trade or otherwise limit our participation in a trade, our stockholders may be unable to sell all the shares they desire to sell in the limited market. Because no other market exists for our stock, our stockholders may be unable to sell all the shares they

desire to sell. In addition, if a limited market trade were undersubscribed and prorated or the liquidity of our stock in the limited market were otherwise impaired, the stock price, as set by the board of directors, could be adversely impacted because the independent appraiser could apply or increase any liquidity discount used in valuing our stock.

During fiscal 2006 and 2005, the trustees of certain of our retirement and benefit plans purchased an aggregate of 1,875,484 and 2,294,161 shares, respectively, in the limited market. These purchases accounted for approximately 14.4% and 18.5% of the total shares purchased by all buyers in the limited market during fiscal 2006 and 2005, respectively. Such purchases may change in the future, depending on the levels of participation in and contributions to such plans and the extent to which such contributions are invested in class A common stock. In addition, the trustees of our retirement plans are not permitted to purchase shares of our class A common stock in the limited market unless the stock price established by the board of directors is determined in good faith by the plan fiduciaries, in reliance on an appraisal by an independent appraiser, to be the fair market value of the shares. The inability of the retirement plans to purchase shares in the limited market could adversely impact the liquidity of our stock.

To the extent that purchases by the trustees of our retirement and benefit plans decrease, and purchases by us decrease or do not increase, the ability of stockholders to resell their shares in the limited market would likely be adversely affected. Although all shares of class A common stock offered for sale were sold in the limited market on each trade date occurring during fiscal 2006 and 2005, a stockholder desiring to sell all or a portion of his or her shares of our class A common stock on any future trade date in the limited market may not be able to do so.

To the extent that the aggregate number of shares sought to be purchased by authorized buyers exceeds the aggregate number of shares offered for sale by stockholders, we may, but are not obligated to, sell authorized but unissued shares of class A common stock in the limited market. In making this determination, we will consider a variety of factors, including our cash position and cash flows, investment and capital activities, financial performance, financial covenants, the number of shares outstanding and the amount of the over subscription in the limited market. The final determination is not made before the trade date. In fiscal 2006 and 2005, we did not sell any shares of class A common stock in the limited market as the number of shares sought to be purchased by authorized buyers did not exceed the number of shares offered for sale by stockholders. To the extent that we choose not to sell authorized but unissued shares of class A common stock in the limited market, the ability of individuals to purchase shares in the limited market may be adversely affected. We cannot assure our stockholders that they will be able to buy shares of our class A common stock on any future trade date in the limited market.

Price Determination of Old SAIC Class A Common Stock and Class B Common Stock

Valuation Process

Our board of directors has historically determined the price of the class A common stock using the valuation process described below. In establishing the stock price, the board of directors considers a broad range of valuation data and financial information, including analysis provided by Houlihan Lokey Howard & Zukin Financial Advisors, Inc., or HLHZ, our independent appraisal firm. The board also considers valuation data and financial information relating to publicly traded companies considered by our appraiser to be comparable to Old SAIC or relevant to the valuation of our stock. The valuation process includes the valuation formula set forth below, which has an earnings component and an equity component and includes a variable called the market factor. After considering the analysis of the independent appraisal firm and other valuation data and information,

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the board of directors sets the market factor at the value that causes the formula to yield a stock price that the board believes represents a fair market value for the class A common stock within a broad range of financial criteria. The stock price and market factor, as determined by the board of directors, remain in effect until subsequently changed by the board of directors or its designated committee.

The class A common stock is traded in the limited market maintained by Bull, Inc. at the stock price determined by the board of directors. In accordance with our current certificate of incorporation, the price of the class B common stock is equal to 20 times the stock price applicable to the class A common stock.

Role of Appraiser

In conjunction with the board of directors valuation process, HLHZ performs an appraisal of our class A common stock using market multiple analysis of comparable public companies as part of its methodology to value Old SAIC as a whole and major business areas of Old SAIC.

In its appraisal of our stock, HLHZ may apply, and from time to time has applied, a liquidity discount based on its assessment of the liquidity provided by the limited market. HLHZ provides substantial valuation data and analysis, which the board relies upon, among other factors, in establishing the stock price. The data and analysis include the reasonable range of fair market value established by the appraisers. In establishing the range of fair market value, the appraiser considers, among other things, the volatility of the stock prices and implied volatility of stock options of the comparable companies and any significant publicly traded securities that we may own. After the board has established the stock price, HLHZ reviews the price and provides an opinion letter to the board of directors and the Old SAIC retirement plans committee as to whether the stock price appears to reflect the fair market value of our stock. The trustees of our retirement plans are not permitted to purchase shares of our class A common stock unless the stock price established by the board of directors is determined in good faith by the plan fiduciaries, in reliance on an appraisal by an independent appraiser, among other factors, to be the fair market value of the shares. If the trustees of our retirement plans are not permitted to purchase shares of our class A common stock, the liquidity of our stock and our stock price would be adversely impacted.

Stock Price Formula

The following formula is used in the valuation method:

The price per share is equal to the sum of:

(1) a fraction, the numerator of which is our stockholders equity at the end of the fiscal quarter immediately preceding the date on which a price determination is to occur, adjusted to reflect the value of our publicly traded equity securities classified as investments in marketable securities, as well as the profit or loss impact, if any, on stockholders equity arising from investment activities, non-recurring gains or losses on sales of business units, subsidiary common stock or similar transactions closed, as of the valuation date (E), and the denominator of which is the number of outstanding common shares and common share equivalents at the end of such fiscal quarter (W1) and

(2) a fraction, the numerator of which is 5.66 multiplied by the market factor (M or market factor), multiplied by our operating income for the four fiscal quarters immediately preceding the price determination, net of taxes, excluding investment activities, losses on impaired intangible assets, non-recurring gains or losses on sales of business units, subsidiary common stock and similar items, and including our equity in the income or loss of unconsolidated affiliates and the minority interest in income or

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loss of consolidated subsidiaries (P), and the denominator of which is the weighted average number of outstanding common shares and common share equivalents for those four fiscal quarters, as used by us in computing diluted earnings per share (W).

The formula, shown as an equation, is as follows:

$$\text{Stock Price} = \frac{E}{W1} + \frac{5.66MP}{W}$$

The number of outstanding common shares and common share equivalents described above in the formula assumes that each share of class B common stock is converted into 20 shares of class A common stock.

The board of directors first used a valuation formula in establishing the price of the class A common stock in 1972. The valuation formula has periodically been modified ever since. The market factor concept was first added to the formula in 1973. The 5.66 factor was added to the formula in 1976 as a constant to cause the price generated by the formula to reflect a fair market value of the class A common stock. In 1984, the board of directors, with the assistance of an outside appraisal firm, began its current practice of establishing the value of the market factor to reflect the broad range of business, financial and market forces that also affect the fair market value of the class A common stock. In 2001, the board of directors approved the modifications of the definitions of the E or the stockholders equity component and P or the earnings component of the formula. Before approving these changes to the formula, the board of directors consulted with HLHZ and then determined that these definitional changes were appropriate and that our valuation process would continue to generate a fair market value of the class A common stock within a broad range of financial criteria.

Other Valuation Considerations

In determining the price of the class A common stock, the board of directors considers many relevant factors, including:

- valuation input from HLHZ
- the performance of the general securities markets and relevant industry groups
- our historical financial performance versus comparable public companies
- the prospects for our future performance
- the value of our investments

general economic conditions

general capital market considerations

other factors the board of directors deems appropriate

Although orders to buy or sell shares of class A common stock in the limited market must be entered prior to the board s determination of the stock price, this information is not made available to the board of directors and is not a consideration in determining the price. However, if we elect not to purchase shares in the limited market to fully balance an undersubscribed trade, this could impact both the current and subsequent valuations of our stock.

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Review of Stock Price

Our board of directors has historically reviewed the stock price at least four times each year, generally during its regularly scheduled board meetings, approximately one week before the four predetermined trade dates. Due to the uncertainty of the completion date of the IPO, the limited market trades and retirement plan transactions have not occurred on a regular basis and the stock price has only been reviewed by the board of directors as necessary to support such trades. When a trade does occur, the board of directors reviews the stock price during the period between a board meeting and the trade date to determine whether the stock price continues to represent a fair market value, and if necessary, modifies the price. The board of directors has authorized its stock policy committee to conduct this review, and, in some instances, the stock policy committee has conducted this review.

Modification of Valuation Process

The board of directors has broad discretion to modify the valuation process. However, the board of directors does not anticipate changing the valuation process unless:

- a change in the formula or any other aspect of the valuation process used to value the class A common stock is required under applicable law

- in the good faith exercise of its fiduciary duties and after consultation with our independent accountants as to whether the change would result in a charge to earnings upon the sale of class A common stock, the board of directors, including a majority of the directors who are not our employees, determines that the valuation process no longer results in a fair market value for the class A common stock

- in the good faith exercise of its fiduciary duties, the board of directors, including a majority of directors who are not our employees, after consulting with an independent appraisal firm, determines that a change in the formula or any other aspect of the valuation process is appropriate and that the stock price established by the board of directors through the modified valuation process reflects a fair market value of the class A common stock

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Historical Stock Prices

The following table sets forth information concerning the stock price for the class A common stock, the applicable price for the class B common stock and each of the variables contained in the formula, including the market factor, in effect for the periods beginning on the dates indicated. The class A common stock has been rounded to the nearest penny. There can be no assurance that the class A common stock or the class B common stock will in the future provide returns comparable to historical returns or that the price will not decline.

The values of the variables of the stock price formula presented in the following table reflect the financial data that existed at the time of each stock price determination and have not been adjusted to reflect the restatement of our consolidated financial statements in fiscal 2003, 2004 and the first quarter of fiscal 2005 or Telcordia discontinued operations.

Date	Market Factor	E or Adjusted Stockholders Equity(1)	W1 or Shares Outstanding(2)	P or Adjusted Earnings(3)	W or Weighted Avg. Shares Outstanding(4)	Price Per Share of Class A Common Stock	Price Per Share of Class B Common Stock	Percentage Price Change(5)
April 11, 2003	1.90	$ 2,006,774,000	190,974,359	$ 349,930,000	203,232,903	$ 29.02	$ 580.40	1.5%
July 11, 2003	1.90	$ 2,102,168,000	192,229,993	$ 358,704,000	197,175,777	$ 30.50	$ 610.00	5.1%
October 10, 2003	1.90	$ 2,133,849,000	190,791,535	$ 368,075,000	192,079,951	$ 31.79	$ 635.80	4.2%
January 9, 2004	2.20	$ 2,196,927,000	190,348,029	$ 380,148,000	189,499,866	$ 36.52	$ 730.40	14.9%
April 16, 2004	2.30	$ 2,190,267,000	191,418,123	$ 375,064,000	188,561,115	$ 37.34	$ 746.80	2.2%
July 16, 2004	2.20	$ 2,261,422,000	191,943,098	$ 386,692,000	188,653,945	$ 37.31	$ 746.20	(0.1)%
October 8, 2004	2.30	$ 2,283,435,000	189,671,084	$ 378,169,000	188,637,287	$ 38.14	$ 762.80	2.2%
January 14, 2005	2.50	$ 2,304,706,000	188,204,746	$ 376,716,000	188,302,652	$ 40.55	$ 811.00	6.3%
April 8, 2005	2.80	$ 2,891,459,000	186,780,832	$ 317,202,000	187,634,157	$ 42.27	$ 845.40	4.2%
June 10, 2005	2.90	$ 2,800,164,000	183,331,888	$ 300,756,000	186,096,747	$ 41.80	$ 836.00	(1.1)%
October 7, 2005	2.80	$ 2,834,277,000	181,337,258	$ 322,016,000	183,804,842	$ 43.39	$ 867.80	3.8%
December 23, 2005	2.90	$ 2,838,172,000	179,685,724	$ 311,605,000	181,872,078	$ 43.92	$ 878.40	1.2%
January 6, 2006	2.90	$ 2,838,178,000	179,685,724	$ 311,605,000	181,872,078	$ 43.92	$ 878.40	0%
May 5, 2006	2.90	$ 2,813,647,000	175,219,381	$ 350,386,000	179,717,826	$ 48.06	$ 961.20	9.4%
June 23, 2006	2.50	$ 2,960,905,000	176,592,361	$ 382,095,000	177,210,991	$ 47.28	$ 945.60	(1.6)%

(1) E is our stockholders equity at the end of the fiscal quarter immediately preceding the date on which a price determination is to occur, adjusted to reflect the value of publicly traded equity securities classified as investments in marketable securities, as well as the profit or loss impact, if any, on stockholders equity arising from investment activities, non-recurring gains or losses on sales of business units, subsidiary common stock, or similar transactions closed, as of the valuation date.

(2) W1 is the number of outstanding common shares and common share equivalents at the end of the fiscal quarter immediately preceding the date on which a price determination is to occur.

(3) P is our operating income for the four fiscal quarters immediately preceding the price determination, net of taxes, excluding investment activities, losses on impaired intangible assets, non-recurring gains or losses on sales of business units, subsidiary common stock and similar items, and including our equity in the income or loss of unconsolidated affiliates and the minority interest in income or loss of consolidated subsidiaries. The aggregate amount of these items on a pre-tax basis is disclosed as segment operating income in our consolidated quarterly and annual financial statements filed with the SEC. The operations of our INTESA joint venture have been classified as discontinued operations as of January 31, 2003 and are no longer reflected in operating income. Beginning with the April 11, 2003 stock price determination, the P variable of the formula no longer includes the operations of INTESA. The operations of

our former subsidiary, Telcordia Technologies, Inc. were classified as discontinued operations as of January 31, 2005 and are no longer reflected in operating income. Beginning with the April 8, 2005 stock price determination, the P variable of the formula no longer includes the operations of Telcordia Technologies, Inc. The amounts shown for P prior to April 8, 2005 have not been adjusted to reflect the discontinued operations classification.

(4) W is the weighted average number of outstanding common shares and common share equivalents for the four fiscal quarters immediately preceding the price determination, as used by us in computing diluted earnings per share.

(5) Value shown represents the percentage change in the price per share of class A common stock from the prior valuation.

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Holders of Old SAIC Class A Common Stock and Class B Common Stock

As of May 17, 2006, there were 39,330 holders of record of class A common stock and 189 holders of record of class B common stock of Old SAIC. Substantially all of the class A common stock and the class B common stock is owned of record or beneficially by our current and former employees, directors and consultants and their respective family members and by our various employee benefit plans.

Dividend Policy

Old SAIC has never declared or paid any cash dividends on its capital stock other than the special dividend. The special dividend is expected to range from approximately $8 to $10 per share of Old SAIC class A common stock and from approximately $160 to $200 per share of Old SAIC class B common stock, which is the equivalent of a range from approximately $4 to $5 per share of new class A preferred stock. New SAIC does not expect to pay any dividends on our capital stock in the foreseeable future and we currently intend to retain any future earnings to finance our operations and growth. The exact amount of the proposed special dividend and any future determination to pay cash dividends will be at the discretion of our board of directors and will depend on available cash, estimated cash needs, earnings, financial condition, operating results, capital requirements, applicable contractual restrictions and other factors our board of directors deems relevant.

STOCKHOLDER PROPOSALS

The 2006 Annual Meeting of Stockholders of Old SAIC will be held on Friday, July 14, 2006, at 11:00 a.m. at the SAIC Conference Center, 1710 SAIC Drive, McLean, Virginia. It is no longer possible for a stockholder to give timely notice of an intention to bring any business before the 2006 Annual Meeting of Stockholders.

Any stockholder proposals intended to be presented at the 2007 Annual Meeting of Stockholders of Old SAIC must be received by Old SAIC not later than February 7, 2007 in order to be considered for inclusion in Old SAIC s proxy statement and form of proxy relating to that meeting. In addition, Section 2.07 of Old SAIC s Bylaws provides that in order for a stockholder to propose any matter for consideration at an annual meeting (other than by inclusion in our proxy statement), such stockholder must have given timely prior written notice to the Secretary of Old SAIC of his or her intention to bring such business before the meeting. To be timely, notice must be received by Old SAIC not less than 50 days nor more than 75 days prior to the meeting. Such notice must contain certain information required by Section 2.07 of Old SAIC s Bylaws, including a brief description of the business the stockholder proposes to bring before the meeting, the reasons for conducting such business at the annual meeting, the name and record address of the stockholder proposing such business, the class and number of shares of common stock beneficially owned by such stockholder and any material interest of such stockholder in the business so proposed.

The bylaw provision setting forth the advance notice requirements for stockholder proposals for New SAIC is described under Description of Capital Stock, Certificate of Incorporation and Bylaws Anti-Takeover Effects of Various Provisions of Delaware Law and New SAIC s Restated Certificate of Incorporation and Restated Bylaws Advance Notice Requirements for Stockholder Proposals.

WHERE YOU CAN FIND MORE INFORMATION

Old SAIC files annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission but its common stock, which is subject to various restrictions, is not publicly traded. After the transactions, New SAIC will file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. Old SAIC s Securities and Exchange Commission filings are available to the public over the Internet at the Securities and Exchange Commission s web site at www.sec.gov. You may read and copy any reports, statements or other information that we file with the Securities and Exchange Commission at its Public Reference Room, 100 F Street, N.E., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the operation of the Public Reference Room.

We have filed a registration statement on Form S-4 to register with the Securities and Exchange Commission the shares of new class A preferred stock to be delivered in connection with the merger. This proxy statement/prospectus is part of that registration statement and, as allowed by Securities and Exchange Commission rules, does not include all of the information you can find in the registration statement or the exhibits to the registration statement. We also have filed a registration statement on Form S-1 relating to our proposed public offering of shares of new common stock. You may obtain copies of the Form S-4 and the Form S-1 (and any amendments to those documents) in the manner described above.

You should rely only on the information contained in this proxy statement/prospectus. We have not authorized anyone to provide you with information different from the information contained in this proxy statement/prospectus. The information contained in this proxy statement/prospectus is accurate only as of the date of this proxy statement/prospectus, regardless of when it is delivered.

Neither the Securities and Exchange Commission nor any other national or state securities commission has approved or disapproved of these securities or determined if this proxy statement/prospectus is accurate or adequate. Any representation to the contrary is a criminal offense. This proxy statement/prospectus does not constitute an offer to sell or a solicitation of any offer to buy any securities in any jurisdiction where such an offer or solicitation would be illegal.

LEGAL MATTERS

The validity of the shares of our new class A preferred stock to be issued pursuant to the merger, and certain tax consequences of the merger, will be passed upon for us by Heller Ehrman LLP, San Diego, California.

EXPERTS

The consolidated financial statements of Science Applications International Corporation as of January 31, 2006 and 2005, and for each of the three years in the period ended January 31, 2006, included in this proxy statement/prospectus have been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report appearing herein, and have been so included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

The consolidated balance sheet of SAIC, Inc. as of January 31, 2006, included in this proxy statement/prospectus has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report appearing herein, and has been so included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

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I NDEX TO CONSOLIDATED FINANCIAL STATEMENTS

SAIC, Inc.

Science Applications International Corporation

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholder

SAIC, Inc.

We have audited the accompanying consolidated balance sheet of SAIC, Inc. and subsidiary (the Company) (a wholly-owned subsidiary of Science Applications International Corporation) as of January 31, 2006. This financial statement is the responsibility of the Company s management. Our responsibility is to express an opinion on this financial statement based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the balance sheet is free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the balance sheet, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall balance sheet presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, such consolidated balance sheet presents fairly, in all material respects, the financial position of SAIC, Inc. and subsidiary as of January 31, 2006, in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

San Diego, California

April 24, 2006

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SAIC, INC.

(a wholly-owned subsidiary of Science Applications International Corporation)

CONSOLIDATED BALANCE SHEET

		January 31, 2006
ASSETS		
Cash	$	1,000
STOCKHOLDER S EQUITY (Note 2)		
Common stock	$	1
Preferred stock		
Additional paid-in capital		999
Total stockholder s equity	$	1,000

See accompanying notes to consolidated balance sheet.

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SAIC, INC.

NOTES TO CONSOLIDATED BALANCE SHEET

1. **Organization and Purpose** SAIC, Inc. (Company) was incorporated on August 12, 2005 and capitalized on August 18, 2005 as a wholly-owned subsidiary of Science Applications International Corporation. Subject to the approval of the stockholders of Science Applications International Corporation, SAIC Merger Sub, Inc., a wholly-owned subsidiary of the Company, will merge with Science Applications International Corporation, and all of the outstanding common stock of Science Applications International Corporation will be exchanged for Class A preferred stock of the Company.

2. **Stockholder s Equity** On August 18, 2005, the Company was authorized to issue 10,000 shares of $0.01 par value common stock and had issued and outstanding 10,000 shares held by Science Applications International Corporation. On November 18, 2005, the Company restated its certificate of incorporation to (i) increase its authorized common stock to 2,000,000,000 shares, (ii) lower the par value on its common stock from $0.01 to $0.0001, (iii) authorize 1,500,000,000 shares of Class A preferred stock of which 50,000,000 shares are designated Series A-1 preferred stock and none of which are issued and outstanding, 150,000,000 shares are designated Series A-2 preferred stock and none of which are issued and outstanding, 150,000,000 shares are designated Series A-3 preferred stock and none of which are issued and outstanding and 1,150,000,000 shares are designated Series A-4 preferred stock and none of which are issued and outstanding and (iv) authorize 10,000,000 shares of blank-check preferred stock, none of which are issued and outstanding. The Company s board of directors is expressly authorized to provide for the issuance of all or any of the shares of preferred stock in one or more series and to fix the relative rights, preferences and privileges of each such series.

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SAIC, INC.

(a wholly-owned subsidiary of Science Applications International Corporation)

CONSOLIDATED BALANCE SHEETS

(Unaudited)

	April 30, 2006	January 31, 2006
ASSETS		
Cash	$ 1,000	$ 1,000
STOCKHOLDER S EQUITY (Note 2)		
Common stock	$ 1	$ 1
Preferred stock		
Additional paid-in capital	999	999
Total stockholder s equity	$ 1,000	$ 1,000

See accompanying notes to consolidated balance sheets.

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SAIC, INC.

NOTES TO CONSOLIDATED BALANCE SHEETS

(Unaudited)

1. Organization and Purpose SAIC, Inc. (the Company) was incorporated on August 12, 2005 and capitalized on August 18, 2005 as a wholly-owned subsidiary of Science Applications International Corporation. Subject to the approval of the stockholders of Science Applications International Corporation, SAIC Merger Sub, Inc., a wholly-owned subsidiary of the Company, will merge with Science Applications International Corporation, and all of the outstanding common stock of Science Applications International Corporation will be exchanged for Class A preferred stock of the Company.

2. Stockholder s Equity On August 18, 2005, the Company was authorized to issue 10,000 shares of $0.01 par value common stock and had issued and outstanding 10,000 shares held by Science Applications International Corporation. On November 18, 2005, the Company restated its certificate of incorporation to (i) increase its authorized common stock to 2,000,000,000 shares, (ii) lower the par value on its common stock from $0.01 to $0.0001, (iii) authorize 1,500,000,000 shares of Class A preferred stock of which 50,000,000 shares are designated as Series A-1 preferred stock and none of which are issued and outstanding, 150,000,000 shares are designated Series A-2 preferred stock and none of which are issued and outstanding, 150,000,000 shares are designated Series A-3 preferred stock and none of which are issued and outstanding and 1,150,000,000 are designated as Series A-4 preferred stock and none of which are issued and outstanding and (iv) authorize 10,000,000 shares of blank-check preferred stock, none of which are issued and outstanding. The Company s board of directors is expressly authorized to provide for the issuance of all or any of the shares of preferred stock in one or more series and to fix the relative rights, preferences and privileges of each such series.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Stockholders

Science Applications International Corporation

We have audited the accompanying consolidated balance sheets of Science Applications International Corporation and subsidiaries (the Company) as of January 31, 2006 and 2005, and the related consolidated statements of income, stockholders equity and comprehensive income, and cash flows for each of the three years in the period ended January 31, 2006. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Science Applications International Corporation and subsidiaries as of January 31, 2006 and 2005, and the results of their operations and their cash flows for each of the three years in the period ended January 31, 2006 in conformity with accounting principles generally accepted in the United States of America.

/s/ DELOITTE & TOUCHE LLP

San Diego, California

April 24, 2006

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF INCOME

	Year Ended January 31		
	2006	2005	2004
	(In millions, except per share amounts)		
Revenues	$ 7,792	$ 7,187	$ 5,833
Costs and expenses:			
Cost of revenues	6,801	6,283	5,053
Selling, general and administrative expenses	494	418	378
Goodwill impairment			7
Gain on sale of business units, net		(2)	
Operating income	497	488	395
Non-operating income (expense):			
Net (loss) gain on marketable securities and other investments, including impairment losses	(15)	(16)	5
Interest income	97	45	49
Interest expense	(89)	(88)	(80)
Other income (expense), net	7	(12)	5
Minority interest in income of consolidated subsidiaries	(13)	(14)	(10)
Income from continuing operations before income taxes	484	403	364
Provision for income taxes	139	131	140
Income from continuing operations	345	272	224
Discontinued operations (Note 18):			
Income from discontinued operations of Telcordia before income taxes (including gain on sale of $871 million in 2006)	875	149	146
Gain from discontinued operations of INTESA joint venture before income taxes		6	
Provision for income taxes	293	18	19
Income from discontinued operations	582	137	127
Net income	$ 927	$ 409	$ 351
Earnings per share:			
Basic:			
Income from continuing operations	$ 1.98	$ 1.49	$ 1.22
Income from discontinued operations	3.35	.74	.68
	$ 5.33	$ 2.23	$ 1.90
Diluted:			
Income from continuing operations	$ 1.92	$ 1.45	$ 1.19
Income from discontinued operations	3.23	.73	.67

	$ 5.15	$ 2.18	$ 1.86
Common equivalent shares:			
Basic	174	183	185
Diluted	180	188	189

See accompanying notes to consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

CONSOLIDATED BALANCE SHEETS

	January 31	
	2006	**2005**
	(In millions)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,035	$ 983
Investments in marketable securities	1,659	1,367
Receivables, net	1,517	1,520
Prepaid expenses and other current assets	192	216
Assets of discontinued operations		900
Total current assets	4,403	4,986
Property, plant and equipment, net	356	339
Intangible assets, net	63	50
Goodwill	655	468
Deferred income taxes	66	69
Other assets	112	98
	$ 5,655	$ 6,010
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 953	$ 864
Accrued payroll and employee benefits	468	433
Income taxes payable	14	200
Notes payable and current portion of long-term debt	47	70
Deferred income taxes	9	52
Liabilities of discontinued operations		680
Total current liabilities	1,491	2,299
Long-term debt, net of current portion	1,192	1,215
Other long-term liabilities	111	99
Commitments and contingencies (Notes 16 and 19)		
Minority interest in consolidated subsidiaries	54	46
Stockholders equity:		
Common stock (Note 1)	2	2
Additional paid-in capital	2,506	2,278
Retained earnings	415	212
Other stockholders equity	(84)	(105)
Accumulated other comprehensive loss	(32)	(36)
Total stockholders equity	2,807	2,351
	$ 5,655	$ 6,010

See accompanying notes to consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY

AND COMPREHENSIVE INCOME

	Common stock Shares	Common stock Amount	Additional paid-in capital	Retained earnings	Other stock-holders equity	Accumulated other comprehensive loss	Comprehensive income
				(In millions)			
Balance at February 1, 2003	187	$ 2	$ 1,691	$ 414	$ (73)	$ (14)	
Net income				351			$ 351
Other comprehensive loss						(16)	(16)
Issuances of common stock	15		368				
Repurchases of common stock	(16)		(154)	(404)			
Income tax benefit from employee stock transactions			56				
Stock compensation			1				
Unearned stock compensation, net of amortization					(19)		
Balance at January 31, 2004	186	2	1,962	361	(92)	(30)	$ 335
Net income				409			$ 409
Other comprehensive loss						(6)	(6)
Issuances of common stock	15		465				
Repurchases of common stock	(19)		(217)	(558)			
Income tax benefit from employee stock transactions			67				
Stock compensation			1				
Unearned stock compensation, net of amortization					(13)		
Balance at January 31, 2005	182	2	2,278	212	(105)	(36)	$ 403
Net income				927			$ 927
Other comprehensive income						4	4
Issuances of common stock	13		443				
Repurchases of common stock	(24)		(283)	(724)			
Income tax benefit from employee stock transactions			67				
Stock compensation			1				
Unearned stock compensation, net of amortization					21		
Balance at January 31, 2006	171	$ 2	$ 2,506	$ 415	$ (84)	$ (32)	$ 931

See accompanying notes to consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended January 31		
	2006	**2005**	**2004**
		(In millions)	
Cash flows from operating activities:			
Net income	$ 927	$ 409	$ 351
Income from discontinued operations	(582)	(137)	(127)
Adjustments to reconcile net income to net cash provided by continuing operating activities:			
Depreciation and amortization	70	56	37
Stock-based compensation	39	25	17
Impairment losses on marketable securities and other investments	6	20	19
Loss (gain) on sale of marketable securities and other investments	9	(4)	(24)
Loss (gain) on disposal of property, plant and equipment	2	(16)	2
Minority interest in income of consolidated subsidiaries	13	14	10
Other non-cash items	(4)	11	(4)
Goodwill impairment			7
Increase (decrease) in cash, excluding effects of acquisitions and divestitures, from changes in:			
Receivables	51	(221)	(165)
Prepaid expenses and other current assets	39	(1)	(54)
Deferred income taxes	(42)	59	13
Other assets	(19)	3	(1)
Accounts payable and accrued liabilities	54	158	169
Accrued payroll and employee benefits	94	128	127
Income taxes payable	(76)	77	34
Other long-term liabilities	14	7	(37)
Total cash flows provided by operating activities	595	588	374
Cash flows from investing activities:			
Expenditures for property, plant and equipment	(54)	(42)	(115)
Acquisitions of business units, net of cash acquired of $4 million, $4 million, and $11 million in 2006, 2005 and 2004 respectively	(212)	(212)	(193)
Payments for businesses acquired in previous years	(14)	(20)	
Purchases of marketable securities available-for-sale	(7,852)	(6,387)	(10,771)
Proceeds from sales and maturities of marketable securities and other investments	7,561	6,290	10,628
Proceeds from disposal of property, plant and equipment	1	33	
Investments in affiliates	(2)	(9)	(9)
Other	(11)	2	(8)
Total cash flows used in investing activities	(583)	(345)	(468)
Cash flows from financing activities:			
Proceeds from notes payable and issuance of long-term debt		27	351
Payments on settlement of treasury lock contracts			(5)
Payments of notes payable, long-term debt and capital lease obligations	(46)	(24)	(3)
Dividends paid to minority interest stockholders	(4)	(4)	(3)
Sales of common stock	155	130	85
Repurchases of common stock	(818)	(607)	(451)
Total cash flows used in financing activities	(713)	(478)	(26)
Decrease in cash and cash equivalents from continuing operations	(701)	(235)	(120)

Cash flows of discontinued operations (Revised see Note 1):			
Cash (used in) provided by operating activities of discontinued operations	(319)	179	141
Cash provided by (used in) investing activities of discontinued operations	1,072	(60)	(16)
Increase in cash and cash equivalents of discontinued operations	753	119	125
Cash and cash equivalents at beginning of year	983	1,099	1,094
Cash and cash equivalents at end of year	$ 1,035	$ 983	$ 1,099
Supplemental schedule of non-cash investing and financing activities:			
Common stock exchanged upon exercise of stock options	$ 189	$ 168	$ 107
Common stock issued for settlement of accrued employee benefits	$ 71	$ 98	$ 82
Capital lease obligations for property, plant and equipment	$	$	$ 9
Fair value of assets acquired in acquisitions	$ 288	$ 284	$ 345
Cash paid in acquisitions, net of cash acquired	(212)	(212)	(193)
Future acquisition payment accrued	(2)		
Issuance of common stock in acquisitions and other consideration of $2 million in 2004	(17)	(4)	(49)
Liabilities assumed in acquisitions	$ 57	$ 68	$ 103

See accompanying notes to consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 Summary of Significant Accounting Policies:

Consolidation

The consolidated financial statements include the accounts of Science Applications International Corporation and all majority-owned and wholly-owned subsidiaries (collectively referred to as the Company). All intercompany transactions and accounts have been eliminated in consolidation. Outside investors interests in the majority-owned subsidiaries are reflected as minority interest. Unless otherwise noted, references to years are for fiscal years ended January 31, not calendar years. For example, the fiscal year ended January 31, 2006 is referred to as 2006 in these notes to consolidated financial statements.

Certain wholly-owned subsidiaries have fiscal years ended December 31, and as a result, the financial position and results of operations of these subsidiaries for such periods are included in the Company s consolidated financial statements for the years ended January 31. There were no intervening events for these subsidiaries from December 31 through January 31 for each of the years presented that would materially affect the consolidated financial position or results of operations.

Investments in affiliates and corporate joint ventures where the Company has an ownership interest representing between 20% and 50%, or over which the Company exercises significant influence, are accounted for under the equity method whereby the Company recognizes its proportionate share of net income or loss and does not consolidate the affiliates individual assets and liabilities. Equity investments in affiliates over which the Company does not exercise significant influence and whose securities do not have a readily determinable fair market value as defined in Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, are carried at cost or adjusted cost net of other-than-temporary impairments.

On September 1, 2005, the Company s newly formed wholly-owned subsidiary, SAIC, Inc., filed a registration statement on Form S-1 with the Securities and Exchange Commission (SEC) for an initial public offering of common stock (public offering). In addition, SAIC, Inc. filed a registration statement on Form S-4 with the SEC and the Company delivered to its stockholders a proxy statement/prospectus to obtain stockholder approval of a merger agreement pursuant to which the Company would become a wholly-owned subsidiary of SAIC, Inc. A special meeting of the stockholders that was previously scheduled for December 16, 2005 to vote on the merger was postponed due to developments regarding the firm fixed-price contract with the Greek government as discussed in Note 19. The Company intends to reschedule the special meeting of the stockholders and, subject to stockholder approval of the merger agreement, satisfactory market conditions and other factors, complete the merger and the public offering in the Fall of 2006.

Operating Cycle

The Company s operating cycle for long-term contracts is typically greater than one year and is measured by the average time intervening between the inception and the completion of those contracts. Contract related assets and liabilities are classified as current assets and current liabilities.

Discontinued Operations

On March 15, 2005, the Company completed the sale of its subsidiary, Telcordia Technologies, Inc. (Telcordia). The operating results of Telcordia have been classified as discontinued operations (Note 18) for all periods presented.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Reclassifications

The Company has reclassified the amounts described below in the accompanying consolidated balance sheets as of January 31, 2005 and in the consolidated statements of income, stockholders equity and comprehensive income, and cash flows for 2005 and 2004 to conform to the 2006 presentation.

In the consolidated statements of income for 2005 and 2004, the Company reclassified $54 million and $47 million, respectively, from cost of revenues to selling, general and administrative expenses in order to classify these costs to be consistent with 2006 and its allocation of costs under cost accounting standards for U.S. Government contracts.

In the consolidated balance sheet for 2005, the Company reclassified $43 million of pre-contract costs to prepaid expenses which were previously reported in unbilled receivables.

In the consolidated statements of stockholders equity and comprehensive income for 2005 and 2004, the Company reclassified $55 million and $46 million, respectively, from repurchases of common stock to issuances of common stock to reflect shares issued under the Employee Stock Purchase Plan which were previously reported as a reduction to repurchases of common stock because it was part of the net limited market trade activity.

These reclassifications were also reflected in the consolidated statements of cash flows for 2005 and 2004 and did not change previously reported net income or earnings per share.

Cash Flows

In 2006, 2005 and 2004, the Company has separately disclosed the operating and investing portions of the cash flows attributable to its discontinued operations (Note 18), which in prior periods were reported on a combined basis as a single amount.

In 2005 and 2004, the Company increased purchases of marketable securities available-for-sale and proceeds from sales and maturities of marketable securities and other investments by $6 billion and $11 billion, respectively, to reflect purchases, sales and maturities of marketable securities that occur within the Company s investment portfolios that are managed by third party investment managers (managed portfolios). The Company previously did not report the cash outflows and inflows that occurred within the managed portfolios as purchases and sales and maturities, respectively, but rather reported the cash outflows and inflows between the Company and the managed portfolios. This reclassification had no effect on previously reported total cash flows from investing activities.

In 2006, 2005 and 2004, the Company reclassified $71 million, $98 million and $82 million, respectively, from stock-based compensation to changes in accrued payroll and employee benefits to reflect issuances of vested stock in those years as settlement of certain bonus and retirement plan amounts expensed during the prior fiscal year. In addition, the Company disclosed these issuances of vested stock in the supplemental schedule of non-cash financing activities. This reclassification had no effect on previously reported total cash flows provided by operating activities.

Use of Estimates

The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America (GAAP), requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting periods. Management evaluates these estimates and assumptions on an on-going basis including those relating to allowances for doubtful accounts, inventories, fair value and impairment of investments, fair value and impairment of intangible assets and goodwill, income taxes, estimated profitability of long-term contracts, pension benefits, contingencies and litigation. Estimates have been prepared on the basis of the most current information and actual results could differ from those estimates.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Fair Value of Financial Instruments

The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties and is determined based on quoted market prices, if available, or management s best estimate. It is management s belief that the carrying amounts shown for the Company s financial instruments, which include cash equivalents, short-term investments in marketable securities, long-term investments in marketable securities and long-term investments in private equity securities, are reasonable estimates of their related fair values. Cash equivalents and short-term investments in marketable securities are recorded at fair value. The fair value of short-term and long-term investments in marketable securities is based upon quoted market prices. The fair value of long-term investments in private equity securities is estimated using various valuation techniques and factors, such as discounted cash flow models, market prices of comparable companies and recent capital transactions of portfolio companies. The fair value of long-term debt (Note 13) is estimated based on quoted market prices for similar instruments and current rates offered to the Company for similar debt with the same remaining maturities.

Revenue Recognition

The Company s revenues are primarily from contracts with the U.S. Government, commercial customers, and various international, state and local governments or from subcontracts with other contractors engaged in work with such customers. The Company performs under a variety of contracts, some of which provide for reimbursement of cost plus fees, or target cost and fee with risk sharing, and others which are fixed-price or time-and-materials type contracts. Revenues and fees on these contracts are primarily recognized using the percentage-of-completion method of accounting, most often based on contract costs incurred to date compared with total estimated costs at completion (cost-to-cost method). The Company also uses efforts-expended methods of percentage-of-completion (using measures such as labor dollars) for measuring progress towards completion in situations in which this approach is more representative of the progress on the contract than the cost-to-cost method. The efforts-expended method is utilized when there are significant amounts of materials or hardware on a contract for which procurement of materials does not represent significant progress on the contract. Additionally, the Company utilizes the units-of-delivery method under percentage-of-completion on contracts where separate units of output are produced. Under the units-of-delivery method, revenue is recognized when the units are delivered to the customer, providing that all other requirements for revenue recognition have been met. On contracts that provide for incentive or award fees, the Company includes an estimate of the ultimate incentive or award fee to be received on the contract in the estimated contract revenues for purposes of applying the percentage-of-completion method of accounting.

Revenues from services and maintenance contracts are recognized over the term of the respective contracts as the services are performed and revenue is earned. Revenues from unit-priced contracts are recognized as transactions are processed based on objective measures of output. Revenues from the sale of manufactured products are recorded upon passage of title and risk of loss to the customer, which is generally upon delivery, providing that all other requirements for revenue recognition have been met. The Company evaluates its contracts for multiple deliverables and, when appropriate, segments the contract into separate units of accounting for proper revenue recognition.

The Company provides for anticipated losses on contracts by recording an expense during the period in which the losses are first identified. Amounts billed to customers but not yet recognized as revenue under certain types of contracts are deferred. Unbilled receivables are stated at estimated realizable value. Contract costs incurred for U.S. Government contracts, including indirect costs, are subject to audit and adjustment by negotiations between the Company and government representatives. The Company has agreed upon and settled indirect contract costs through 2003. Revenues on U.S. Government contracts have been recorded in amounts that are expected to be realized upon final settlement.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Pre-contract Costs

Costs incurred on projects accounted for under the percentage-of-completion accounting method can be recognized as pre-contract costs and deferred as an asset (prepaid expenses and other current assets) when the Company has been requested by the customer to begin work under a new contract, or extend or modify work under an existing contract (change order). The Company records pre-contract costs when formal contracts or contract modifications have not yet been executed, and it is probable that the Company will recover the costs through the issuance of a contract or contract modification. When the formal contract or contract modification has been executed, the costs are recorded to the contract and revenue is recognized based on the percentage-of-completion method of accounting.

Contract claims are unanticipated additional costs incurred in excess of the executed contract price that the Company seeks to recover from the customer. Such costs are expensed as incurred. Additional revenue related to contract claims is recognized when the amounts are awarded by the customer.

Cash and Cash Equivalents

Cash equivalents are highly liquid investments purchased with original maturities of three months or less, excluding amounts held in the Company s managed portfolios. Items qualifying as cash equivalents but held in the Company s managed portfolios are included in marketable securities on the Company s consolidated balance sheets. Cash and cash equivalents at January 31, 2006 and 2005 include $1.0 billion and $968 million, respectively, invested in commercial paper and institutional money market funds.

Investments in Marketable and Private Equity Securities

Marketable debt and equity securities are classified as either available-for-sale or held-to-maturity at the time of purchase. Available-for-sale securities are carried at fair value and held-to-maturity debt securities are carried at amortized cost. Unrealized gains and losses on available-for-sale securities are recorded net of related tax effects in accumulated other comprehensive income in stockholders equity. Realized gains and losses on the sale of available-for-sale securities are determined using the adjusted cost of the specific securities sold.

At each balance sheet date, management assesses whether an impairment loss on its marketable and private equity securities has occurred due to declines in fair value and other market conditions that may be other-than-temporary. If management determines that a decline in the fair value has occurred and such decline is deemed to be other-than-temporary in nature, an impairment loss is recognized to reduce the security to its estimated fair value (Note 4).

Inventories

Inventories are valued at the lower of cost or market. Cost is determined using the average cost and first-in, first-out methods.

Property, Plant and Equipment

Depreciation of buildings is recognized using the straight-line method over estimated useful lives of ten to forty years while the related improvements are amortized using the straight-line method over the shorter of the lease term or ten years. Depreciation of equipment is recognized using the straight-line method or the declining-balance method over the estimated useful lives of three to ten years.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Additions to property and equipment together with major renewals and betterments are capitalized. Maintenance, repairs and minor renewals and betterments are expensed as incurred. When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts and any resulting gain or loss is recognized.

The Company assesses potential impairments to its long-lived assets when there is evidence that events or changes in circumstances have made recovery of the asset s carrying value unlikely and the carrying amount of the asset exceeds the estimated future undiscounted cash flows. When the carrying amount of the asset exceeds the estimated future undiscounted cash flows, an impairment loss is recognized to reduce the asset s carrying amount to its estimated fair value based on the present value of the estimated future cash flows.

Goodwill and Intangible Assets

Goodwill, which represents the excess of the cost of an acquired entity over the net amounts assigned to assets acquired and liabilities assumed, is assessed for impairment at least annually or whenever events or circumstances indicate a condition of impairment may exist. The goodwill impairment test is a two-step process. The first step consists of estimating the fair values of each of the reporting units based on a discounted cash flow model using revenue and profit forecasts and comparing those estimated fair values with the carrying values, which include the allocated goodwill. If the fair value is less than the carrying value, a second step is performed to compute the amount of the impairment by determining an implied fair value of goodwill. The implied fair value of goodwill is the residual fair value derived by deducting the fair value of a reporting unit s identifiable assets and liabilities from its estimated fair value calculated in step one. The impairment expense represents the excess of the carrying amount of the reporting units goodwill over the implied fair value of their goodwill. The Company performs its annual goodwill impairment test each January 31.

Intangible assets with finite lives are amortized using a method that best reflects how their economic benefits are utilized or, if a pattern of economic benefits cannot be reliably determined, on a straight-line basis over their useful lives of one to twelve years. Intangible assets with indefinite lives are not amortized but are assessed for impairment on an annual basis. Intangible assets, amortized or not, are also evaluated for impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable.

Income Taxes

Income taxes are provided utilizing the liability method. The liability method requires the recognition of deferred tax assets and liabilities, on an annual basis, for the expected future tax consequences of temporary differences between the carrying amounts and tax bases of assets and liabilities (Note 12). Under the liability method, changes in tax rates and laws are reflected in income in the period such changes are enacted.

The provisions for federal, state, foreign and local income taxes are calculated on income before income taxes based on current tax law and include the cumulative effect of any changes in tax rates from those used previously in determining deferred tax assets and liabilities. Such provisions differ from the amounts currently payable because certain items of income and expense are recognized in different time periods for financial reporting purposes than for income tax purposes.

Stock-Based Compensation

The Company has a number of stock-based employee compensation plans, including stock options, stock purchase and restricted stock plans, which are described in Notes 10 and 15. The Company accounts for stock-based employee compensation using the intrinsic value method for each period presented under the recognition

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

and measurement principles of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under the intrinsic value method, no compensation expense is reflected in net income for options granted to employees, as all options granted under those plans had an exercise price equal to the fair market value of the underlying common stock on the date of grant, and no compensation expense is recognized for the employee stock purchase plan because it is a non-compensatory plan. The Company accounts for stock options granted to non-employees using the fair value method under SFAS No. 123, Accounting for Stock-Based Compensation.

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to the employee stock options and employee stock purchase plan:

	Year Ended January 31		
	2006	**2005**	**2004**
	(In millions, except per share amounts)		
Net income, as reported	$ 927	$ 409	$ 351
Pro forma stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effect	(16)	(31)	(36)
Pro forma net income	$ 911	$ 378	$ 315
Earnings per share:			
Basic as reported	$ 5.33	$ 2.23	$ 1.90
Basic pro forma	$ 5.24	$ 2.07	$ 1.70
Diluted as reported	$ 5.15	$ 2.18	$ 1.86
Diluted pro forma	$ 5.06	$ 2.01	$ 1.67

The pro forma compensation costs were determined using weighted-average per share fair values of options granted in 2006, 2005 and 2004 of $8.70, $5.20 and $4.12, respectively. The fair value for options granted prior to September 1, 2005 was estimated at the date of grant using the Black-Scholes option pricing model with the following assumptions for 2006, 2005 and 2004: no dividend yield, no volatility, risk-free interest rates ranging from 2.5% to 4.4% and expected lives of five years. The fair value of options granted after September 1, 2005 was calculated using the same assumptions for 2006 except a peer-weighted volatility rate of 33% and estimated useful life of 3.9 years was applied. In 2006, the pro forma stock-based employee compensation expense was reduced by $10 million, net of related tax effect, representing the effects of unvested stock options that were forfeited by employees of Telcordia as a result of the sale of Telcordia.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options which have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Prior to September 1, 2005, the Company met the definition of a non-public company for the purposes of applying the provisions of SFAS No. 123 and, therefore, assumed no volatility in its fair value calculations. Effective with the filing of a registration statement by SAIC, Inc. with the SEC on September 1, 2005, the Company met the definition of a public company under SFAS No. 123 and, accordingly, has included a volatility estimate based on the estimated stock volatility of the Company s peers in valuing awards granted after September 1, 2005.

SFAS No. 123(R), Share-Based Payment, which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25 was adopted by the Company effective February 1, 2006. Pursuant to SFAS No. 123(R),

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

restatement of earlier periods is not permitted and there will be no carryover expense on the unvested portion of awards granted prior to September 1, 2005. There will be carryover expense to be recognized in the Company s consolidated financial statements primarily over the next four years of $11 million associated with awards granted between September 1, 2005 and January 31, 2006. Because the Company applied the minimum value method (which assumes no volatility in estimating fair value) to awards granted prior to September 1, 2005, the amount of expense to be recognized in the consolidated financial statements following adoption of SFAS No. 123(R) will be significantly greater than the historical amounts presented in the pro forma table above. In addition, the Company s employee stock purchase plan (ESPP) will be compensatory under SFAS No. 123(R), requiring the 15% discount on employee stock purchases made under the plan to be recognized as compensation expense (Note 10) beginning in 2007. The amount of compensation expense in 2007 is dependent upon the number of awards to be granted and ESPP participation levels. Since February 1, 2006, the Company awarded stock options with an estimated fair value of $49 million, (based on the same assumptions used above) net of estimated forfeitures, that will be recognized in the Company s consolidated financial statements ratably over the next four years. Substantially all of these stock options were granted in conjunction with the annual fiscal year bonus compensation awards. Of the total options granted in 2006, 2005 and 2004, 75%, 75% and 67%, respectively, of the options were granted in conjunction with the annual fiscal year bonus compensation awards. If the Company had adopted SFAS No. 123(R) in 2006, it would have also recognized expense of $9 million for the discount on ESPP shares.

Common Stock and Earnings Per Share

The Company is authorized to issue 1 billion shares of Class A common stock, par value $.01 and 5 million shares of Class B common stock, par value $.05. As of January 31, 2006 and 2005, 167,379,000 shares and 177,369,000 shares of Class A common stock, respectively, and 206,000 shares and 217,000 shares of Class B common stock, respectively, were issued and outstanding. Pursuant to the Company s Certificate of Incorporation, no additional shares of Class B common stock may be issued. Each share of Class B common stock is convertible into 20 shares of Class A common stock. Class A common stock and Class B common stock are collectively referred to as common stock in the consolidated financial statements and notes to consolidated financial statements and are shown assuming that the Class B common stock was converted into Class A common stock. The Class A common stock and Class B common stock have identical rights with respect to voting, dividends, liquidation and other rights except that the Class B common stock has 20 votes per share and shall receive 20 times the per share dividend declared and paid on the Class A common stock, and 20 times the assets and funds distributed upon liquidation as the Class A common stock. Pursuant to the Company s Certificate of Incorporation, the Class A common stock is subject to certain restrictions, including the Company s right to repurchase shares held by a stockholder upon termination of the stockholder s affiliation with the Company, the Company s right of first refusal with respect to sales of Class A common stock by a stockholder other than in the Company s limited market and certain other restrictions on transfer of Class A common stock. The shares of Class B common stock are generally subject to similar contractual restrictions. Repurchases of the Company s common stock reduce the amount of retained earnings in the stockholders equity section of the Company s consolidated balance sheets. Shares of common stock are retired upon repurchase.

Although there has never been a general public market for the Company s common stock, the Company has maintained a limited market through its wholly-owned broker-dealer subsidiary, Bull, Inc. Determinations of the price of the common stock are made by the board of directors pursuant to a valuation process that includes valuation input from an independent appraiser and a stock price formula. The board of directors believes that the valuation process results in a value which represents a fair market value for the Class A common stock within a broad range of financial criteria. The board of directors reserves the right to alter the formula and valuation process.

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If the stockholders approve the merger and the Company completes the public offering, each share of the Company s Class A common stock would be converted into the right to receive two shares of SAIC, Inc. Class A preferred stock, and subject to the exercise of appraisal rights, each share of the Company s Class B common stock would be converted into the right to receive 40 shares of SAIC, Inc. Class A preferred stock. If the merger is completed, the new common stock of SAIC, Inc. would have the same economic rights as the new Class A preferred stock but would be entitled to one vote per share while the new Class A preferred stock would be entitled to 10 votes per share. After the merger, SAIC, Inc. expects to offer its shares of common stock to the public. As a publicly traded company, SAIC, Inc. would have no right of first refusal on transfers of the new Class A preferred stock or the new common stock and no right to repurchase those shares upon termination of affiliation of an employee, director or consultant.

In conjunction with the proposed public offering, the board of directors expects to declare a special dividend that will be paid to the holders of the Company s common stock as of a record date that will be set by the board of directors. Payment would be conditioned upon completion of the public offering and it is anticipated that the dividend would be paid within 25 days after the completion of the public offering.

Basic earnings per share (EPS) is computed by dividing income available to common stockholders by the weighted average number of shares of common stock outstanding. Shares of common stock granted to officers and employees of the Company are included in the computation of weighted average shares outstanding only after the shares become fully vested. Diluted EPS is computed similar to basic EPS, except the weighted average number of shares of common stock outstanding is increased to include the effect of dilutive common stock equivalents, which is comprised of stock options and other stock awards granted under stock-based compensation plans that were outstanding during the periods.

A reconciliation of the weighted average number of shares outstanding used to compute basic and diluted EPS is as follows:

	Year Ended January 31		
	2006	2005	2004
	(In millions)		
Basic weighted average shares	174	183	185
Add: Dilutive common stock equivalents			
Stock options	4	5	3
Restricted stock awards	2		1
Diluted weighted average shares	180	188	189

There were no adjustments to income from continuing operations and income from discontinued operations in calculating basic and diluted EPS for the years ended January 31, 2006, 2005 and 2004.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash equivalents, accounts receivable, short-term investments in marketable securities, and foreign currency forward exchange contracts.

The Company invests its available cash principally in U.S. Government and agency securities, corporate obligations, asset-backed and mortgage-backed securities, municipal debt and commercial paper and has established guidelines relative to diversification and maturities in an effort to maintain safety and liquidity. These guidelines are periodically reviewed and modified to take advantage of trends in yields and interest rates.

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Although credit risk is limited, the Company s receivables are concentrated with its principal customers which are the various agencies of the U.S. Government and commercial customers engaged in work for the U.S. Government.

Foreign Currency

Financial statements of consolidated international subsidiaries, for which the functional currency is the local currency, are translated into U.S. dollars using the exchange rate at each balance sheet date for assets and liabilities and a weighted average exchange rate for revenues, expenses, gains and losses. Translation adjustments are recorded as accumulated other comprehensive income (loss) in stockholders equity. Transaction gains and losses are recognized as incurred.

Note 2 Business Segment Information:

The Company provides scientific, engineering, systems integration and technical services and solutions to all branches of the U.S. military, agencies of the U.S. Department of Defense, the intelligence community, the U.S. Department of Homeland Security and other U.S. Government civil agencies, as well as to selected commercial markets. The Company also designs and develops high-technology products. These products include customized and standard hardware and software, such as automatic equipment identification technology, sensors and nondestructive imaging and security instruments. Product revenues represented 2% of consolidated revenues in 2006, 2005 and 2004.

The Company defines its reportable segments using the management approach, which is based on the way the chief operating decision maker (CODM) manages the operations within the Company for the allocation of resources, decision making and performance assessment.

Using the management approach, the Company has three reportable segments: Government, Commercial, and Corporate and Other. The Company s operating business units are aggregated into the Government or Commercial segments, depending on the nature of the customers, the contractual requirements and the regulatory environment governing the business unit s services. The Corporate and Other segment includes the operations of the Company s broker-dealer subsidiary, Bull, Inc., and its internal real estate management subsidiary, Campus Point Realty Corporation, and various corporate activities, including elimination of intersegment revenues. In addition, in certain circumstances, for management purposes as determined by the CODM, certain revenue and expense items related to operating business units are excluded from the evaluation of a business unit s operating performance and are reflected in the Corporate and Other segment.

Business units in the Government segment provide technical services and products through contractual arrangements as either a prime contractor or subcontractor to other contractors, primarily for departments and agencies of the U.S. Government. Operations in the Government segment are subject to specific regulatory accounting and contracting guidelines such as Cost Accounting Standards (CAS) and Federal Acquisition Regulations. Business units in the Commercial segment provide technical services and products primarily to customers in commercial markets and their operations are generally not subject to specific regulatory accounting or contracting guidelines.

The internal measure of operating income before income taxes (segment operating income) excludes losses on impaired intangible assets, non-recurring gains or losses on sales of business units, subsidiary common stock and similar items, and includes equity in the income or loss of unconsolidated affiliates and the minority interest in income or loss of consolidated subsidiaries. The accounting policies of the reportable segments are the

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

same as those described in Note 1. Certain corporate expenses are reflected in segment operating income based on agreed-upon allocations to the segments or as required by CAS. Corporate expense variances to these allocations are retained in the Corporate and Other segment. Elimination of intersegment revenues is also reflected in the Corporate and Other segment. Sales between segments were $3 million, $45 million and $25 million in 2006, 2005 and 2004, respectively, and were recorded at cost. Asset information by segment is not a key measure of performance used by the CODM. The Company also monitors capital expenditures by the business units. Interest income, interest expense and provision for income taxes, as reported in the consolidated financial statements, are not part of segment operating income and are primarily recorded at the corporate level.

The Company formed SAIC Venture Capital Corporation to manage its investments in publicly traded and private technology companies. The Company may also spin off technologies that are considered non-strategic but may bring future value from an investment perspective. These activities are of an investment nature and are not reported to the CODM as part of the core operating segments of the Company and, therefore, are shown as Investment activities in the reconciliation of total reportable segment operating income to operating income in the accompanying consolidated statements of income.

Effective February 1, 2005, the Company no longer allocated an internal interest expense or income (Cost of Capital). Segment information for 2005 and 2004 has been revised to reflect the elimination of Cost of Capital.

The following table summarizes segment information:

	Year Ended January 31		
	2006	2005	2004
	(In millions)		
Revenues:			
Government	$ 7,289	$ 6,738	$ 5,426
Commercial	533	521	419
Corporate and Other	(30)	(72)	(12)
Total reportable segment revenues	$ 7,792	$ 7,187	$ 5,833
Segment operating income (loss):			
Government	$ 499	$ 516	$ 442
Commercial	37	40	28
Corporate and Other	(45)	(86)	(69)
Total reportable segment operating income	$ 491	$ 470	$ 401

Capital expenditures:			
Government	$ 35	$ 36	$ 18
Commercial	5	3	2
Corporate and Other	14	3	95
Total reportable segment and consolidated capital expenditures	$ 54	$ 42	$ 115

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The following table is a summary of depreciation and amortization included in the calculation of reportable segment operating income:

	Year Ended January 31		
	2006	**2005**	**2004**
		(In millions)	
Depreciation and amortization:			
Government	$ 55	$ 40	$ 25
Commercial	5	6	4
Corporate and Other	10	10	8
Total reportable segment and consolidated depreciation and amortization	$ 70	$ 56	$ 37

The following table reconciles total reportable segment operating income to the Company s consolidated operating income:

	Year Ended January 31		
	2006	**2005**	**2004**
		(In millions)	
Total reportable segment operating income:	$ 491	$ 470	$ 401
Investment activities	(2)	(3)	(4)
Equity in (income) loss of unconsolidated affiliates	(5)	5	(5)
Goodwill impairment			(7)
Gain on sale of business units, net		2	
Minority interest in income of consolidated subsidiaries	13	14	10
Total consolidated operating income	$ 497	$ 488	$ 395

The following tables summarize revenues and long-lived assets, which includes property, plant and equipment, intangible assets, goodwill, deferred taxes and other assets, by geographic location of the entity that is performing the services:

Year Ended January 31

	2006	2005	2004
		(In millions)	
Revenues:			
United States	$ 7,564	$ 6,980	$ 5,683
United Kingdom	169	161	137
Canada and all other international	59	46	13
Total consolidated revenues	$ 7,792	$ 7,187	$ 5,833

	January 31	
	2006	2005
	(In millions)	
Long-lived assets:		
United States	$ 1,197	$ 970
United Kingdom	27	26
Canada and all other international	28	28
Total consolidated long-lived assets	$ 1,252	$ 1,024

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In 2006, 2005 and 2004, 89%, 86% and 85%, respectively, of the Company s consolidated revenues were attributable to prime contracts with the U.S. Government or to subcontracts with other contractors engaged in work for the U.S. Government and are reflected in the Government segment revenues. As a percentage of consolidated revenues, customers comprising 10% or more of consolidated revenues were as follows:

	Year Ended January 31		
	2006	2005	2004
U.S. Army	16%	13%	13%
U.S. Navy	14%	13%	12%
U.S. Air Force	10%	11%	11%

Note 3 Composition of Certain Financial Statement Captions:

	January 31	
	2006	2005
	(In millions)	
Prepaid expenses and other current assets:		
Prepaid expenses	$ 46	$ 51
Inventories	60	57
Pre-contract costs (Note 1)	34	43
Income taxes receivable	3	22
Other	49	43
	$ 192	$ 216
Property, plant and equipment, at cost:		
Computers and other equipment	$ 213	$ 191
Buildings and improvements	220	220
Leasehold improvements	81	61
Office furniture and fixtures	43	39
Land	48	45
	605	556
Less accumulated depreciation and amortization	249	217
	$ 356	$ 339

Other assets:		
Equity method investments (Note 6)	$ 23	$ 20
Cost method investments	38	47
Other	51	31
	$ 112	$ 98
Accounts payable and accrued liabilities:		
Accounts payable	$ 388	$ 298
Other accrued liabilities	395	417
Collections in excess of revenues on uncompleted contracts	170	149
	$ 953	$ 864
Accrued payroll and employee benefits:		
Salaries, bonuses and amounts withheld from employees compensation	$ 273	$ 249
Accrued vacation	181	163
Accrued contributions to employee benefit plans	14	21
	$ 468	$ 433
Other long-term liabilities:		
Accrued pension liabilities	$ 24	$ 19
Deferred compensation	44	44
Other	43	36
	$ 111	$ 99

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Note 4 Short-term and Long-term Investments in Marketable Securities:

The aggregate cost basis and market value of short-term and long-term available-for-sale investments by major security type were as follows:

	January 31			
	2006		2005	
	Cost basis	Market value	Cost basis	Market value
	(In millions)			
Short-term investments:				
U.S. Government and agency securities	$ 139	$ 139	$ 289	$ 287
Corporate obligations	890	890	449	448
Municipal debt	488	488	358	358
Asset-backed and mortgage-backed securities			258	257
Other	142	142	17	17
Total short-term investments	1,659	1,659	1,371	1,367
Long-term corporate obligations and equity securities	5	5	4	4
	$ 1,664	$ 1,664	$ 1,375	$ 1,371

At January 31, 2006, aggregate gross unrealized gains and losses were not material.

At January 31, 2006, $1,659 million of investments in debt securities have effective maturities less than one year. Subsequent to January 31, 2006, the Company liquidated all of its short-term investments in marketable securities.

The net (loss) gain on marketable securities and other investments, including impairment losses consisted of the following:

Year Ended January 31

	2006	2005	2004
		(In millions)	
Impairment losses	$ (6)	$ (20)	$ (19)
Gross realized gains on sale of marketable securities	1	2	22
Gross realized losses on sale of marketable securities	(9)	(4)	(2)
Net (loss) gain on sale of other investments	(1)	6	4
	$ (15)	$ (16)	$ 5

The impairment losses in 2006, 2005 and 2004 were due to declines in fair value of the Company s private equity securities that were deemed to be other-than-temporary. The carrying value of the Company s private equity securities as of January 31, 2006 was $38 million.

The gross realized losses on the sale of marketable securities in 2006 were primarily due to the liquidation of fixed rate securities prior to their stated maturity date to achieve greater liquidity for the Company. The market value of the securities had been negatively impacted by rising interest rates.

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In 2004, the primary component of the gross realized gains on marketable securities was a gain before income taxes of $17 million from the sale of the Company s investment in publicly-traded equity securities of Tellium, Inc. The remainder of the aggregate gain was related to sales of certain other investments.

Note 5 Receivables, Net:

Receivables consisted of the following:

	January 31	
	2006	2005
	(In millions)	
Billed less allowance for doubtful accounts of $6 million and $2 million at January 31, 2006 and 2005, respectively	$ 1,083	$ 1,145
Unbilled	411	355
Contract retentions	23	20
	$ 1,517	$ 1,520

Unbilled receivables consists of costs and fees billable on contract completion or other specified events, the majority of which is expected to be billed and collected within one year. Contract retentions are billed when the Company has negotiated final indirect rates with the U.S. Government and, once billed, are subject to audit and approval by outside third parties. Consequently, the timing of collection of retention balances is outside the Company s control. Based on the Company s historical experience, the majority of the retention balance is expected to be collected beyond one year.

Note 6 Acquisitions and Investments in Affiliates:

The Company completed acquisitions of certain business assets and companies in 2006, 2005 and 2004, which individually and in the aggregate were not considered material business combinations in the year acquired. In some cases, the Company acquired all of the issued and outstanding common stock of certain companies while in other cases, the Company acquired certain specific assets and liabilities. All of these acquisitions have been accounted for under the purchase method of accounting and the operations of the companies acquired have been included in the accompanying consolidated financial statements from their respective dates of acquisition. The aggregate purchase price was allocated to the assets acquired and liabilities assumed based upon their estimated fair values. The excess of the purchase price over the fair value of tangible and identifiable intangible assets acquired has been recorded as goodwill.

In 2006, the Company completed four acquisitions for an aggregate purchase price of $234 million, which consisted of $216 million in cash, 390,000 shares of the Company s common stock that had a fair value of $17 million on the date of issuance and future acquisition payments of $1 million payable once certain conditions have been met. The preliminary purchase price allocations resulted in identifiable intangible assets of $35 million (amortizable over a weighted average life of five years) and goodwill of $186 million, $32 million of which is tax deductible. The Company has not yet obtained all the information required to complete the purchase price allocations related to three of these acquisitions. The final purchase price allocations will be completed once the information identified by the Company has been received, which should not be longer than one year from the dates of acquisition.

In 2005, the Company completed four acquisitions for an aggregate purchase price of $236 million, which consisted of $227 million in cash, 107,000 shares of the Company s common stock that had a fair value of $4 million on the date of issuance and future acquisition payments of $5 million, all of which has been paid. The

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final purchase price allocation resulted in identifiable intangible assets of $44 million (amortizable over a weighted average life of nine years) and goodwill of $157 million, $33 million of which is tax deductible.

In 2004, the Company completed ten acquisitions for an aggregate purchase price of $289 million, which consisted of $204 million in cash, 1.4 million shares of the Company s common stock that had a fair value of $47 million on the dates of issuance, other consideration of $2 million and future acquisition payments of $36 million. The final purchase price allocation resulted in identifiable intangible assets of $41 million (amortizable over a weighted average life of three years) and goodwill of $215 million, $57 million of which is tax deductible. Potential contingent payments related to these acquisitions were $11 million, all of which have been paid or settled as of January 31, 2006.

At January 31, 2006, the Company had 11 equity investments, accounted for under the equity method with the Company s direct ownership ranging from 14% to 50%. The Company recognized revenues of $15 million in 2006 and $12 million in 2005 and 2004 from these related parties. The carrying value of the Company s equity method investments was $23 million and $20 million at January 31, 2006 and 2005, respectively, which includes the excess of the Company s equity investments over its equity in the underlying net assets of $4 million in 2006 and 2005. During 2005, the Company recorded an impairment loss of $9 million on its investment in a 50% owned joint venture, Data Systems and Solutions, LLC (DS&S). The impairment loss was primarily due to a significant business downturn at DS&S caused by a loss of business and an ongoing government investigation and is reflected in Other (expense) income in the consolidated statements of income. The Company sold its interest in DS&S in March 2006 as described in Note 19.

Note 7 Goodwill and Intangible Assets:

The changes in the carrying amount of goodwill by segment were as follows:

	Government	Commercial	Total
		(In millions)	
Goodwill at February 1, 2004	$ 277	$ 24	$ 301
Acquisitions	155		155
Foreign currency translation		1	1
Adjustments	11		11
Goodwill at January 31, 2005	443	25	468
Acquisitions	186		186
Foreign currency translation		(1)	(1)
Adjustments	2		2
Goodwill at January 31, 2006	$ 631	$ 24	$ 655

Goodwill adjustments in 2006 and 2005 were a result of finalization of purchase price allocations related to prior year acquisitions.

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Intangible assets consisted of the following:

	January 31					
	2006			2005		
	Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
	(In millions)					
Amortizable assets:						
Customer contracts	$ 48	$ 24	$ 24	$ 31	$ 11	$ 20
Non-compete agreements	25	20	5	32	13	19
Software and technology	33	5	28	5		5
Other	6	2	4	7	1	6
Total amortizable intangible assets	112	51	61	75	25	50
Non-amortizable intangible assets:						
Tradenames	2		2			
Total intangible assets	$ 114	$ 51	$ 63	$ 75	$ 25	$ 50

Customer contracts and non-compete agreements with a gross carrying value of $3 million became fully amortized at January 31, 2005 and, therefore, are no longer reflected in the gross carrying value after that date. In addition, intangible assets arising from acquisitions made prior to February 1, 2005 increased by $7 million due to the finalization of purchase price allocations. Of this $7 million increase, $5 million represents amortizable intangible assets and $2 million represents indefinite-life intangible assets. Amortization expense related to amortizable intangible assets was $29 million, $20 million and $6 million for 2006, 2005 and 2004, respectively.

Based on the intangible assets as of January 31, 2006, the estimated annual amortization expense related to amortizable intangible assets is as follows:

Year Ending January 31	(In millions)
2007	$ 24
2008	13
2009	10
2010	6

2011	3
Thereafter	5
	$ 61

Actual amortization expense in future periods could differ from these estimates as a result of acquisitions, divestitures, impairments and other factors. In 2006 and 2005, impairment losses on intangible assets were not material. In 2004, the Company did not recognize any impairment losses on intangible assets.

Note 8 Derivative Instruments:

The Company is exposed to certain market risks which are inherent in certain transactions entered into during the normal course of business. They include sales contracts denominated in foreign currencies, investments in equity securities and exposure to changing interest rates. The Company has a risk management policy in place which is used to assess and manage cash flow and fair value exposures. The policy permits the use of derivative instruments with certain restrictions and appropriate authorization. The Company presently uses derivative instruments to manage exposures to foreign currency and interest rate risks and uses natural hedges to

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minimize exposure for net investments in foreign subsidiaries. The Company does not hold derivative instruments for trading or speculative purposes.

Interest Rate Risk

The Company entered into interest rate swap agreements in February 2004 (2004 swap agreements) to convert the fixed interest payments on its $100 million 6.75% notes (Note 13) to a variable rate, based on a rolling six-month LIBOR plus a margin. The interest rate swap agreements were entered into to better balance the fixed and variable rate long-term debt obligations. These swap agreements are designated as fair value hedges of changes in the notes fair value and were fully effective in offsetting the change in fair value of the underlying notes. The fair value of the 2004 swap agreements at January 31, 2006 was a liability of $3 million, of which $1 million and $2 million are reflected in other accrued liabilities and other long-term liabilities, respectively.

In 2004, the Company modified its prior plan for financing the $91 million purchase of land and buildings under two operating leases and issued $300 million of fixed rate debt (Note 13). In anticipation of this debt issuance, the Company entered into interest rate lock agreements to lock in the effective borrowing rate on portions of the anticipated debt financing. Due to declines in interest rates from the dates of entering into the treasury lock contracts to the date of the debt issuance, the Company was required to pay $5 million to settle the treasury lock contracts upon the debt issuance. This loss of $5 million before income taxes is being amortized to interest expense over the term of the related debt. The treasury lock contracts were designated as cash flow hedges that were fully effective, therefore, the net of tax loss of $3 million was recorded as a component of accumulated other comprehensive loss in stockholders equity.

The Company entered into four forward starting interest rate swap agreements in January 2002 (2002 swap agreements) pursuant to its previous plan to use five-year variable interest rate mortgage to finance the purchase of the land and buildings noted above. The mortgage financing would have required payments to a third party lender based on a variable interest rate. Under the terms of the 2002 swap agreements, the Company would either pay to or receive from the swap agreements counterparty an amount which would effectively have made the net cash outflow a fixed amount. The 2002 swap agreements were designated as cash flow hedges and were fully effective through May 29, 2003 with cumulative net of tax losses of $9 million recorded as a component of accumulated other comprehensive loss in stockholders equity. As of May 29, 2003, the 2002 swap agreements were no longer designated in a cash flow hedging relationship and, therefore, all future changes in fair value will be recorded directly into income through August 2008, the expiration date of the swap agreements. The cumulative loss before income taxes of $14 million on the 2002 swap agreements through May 29, 2003 is being amortized as additional interest expense over the contemplated five-year mortgage term that would have ended in August 2008.

In conjunction with the modified financing plan which resulted in the issuance of fixed rate debt in June 2003, on May 29, 2003, the Company entered into additional interest rate swap agreements (2003 swap agreements) to offset the effects of the 2002 swap agreements. The net change in the fair values of the 2002 and 2003 swap agreements since May 29, 2003 was not material and was recorded as additional interest expense. At January 31, 2006, the combined fair value of the 2003 and 2002 swap agreements was $7 million, of which $3 million and $4 million are reflected in other accrued liabilities and other long-term liabilities, respectively.

Foreign Currency Risk

Although the majority of the Company s transactions are in U.S. dollars, some transactions are denominated in foreign currencies. The Company s objective in managing its exposure to foreign currency rate fluctuations is

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

to mitigate adverse fluctuations in earnings and cash flows associated with foreign currency exchange rate fluctuations. The Company currently manages cash flow exposure of receivables, payables and anticipated transactions through the use of natural hedges and foreign currency forward exchange contracts. Foreign currency forward exchange contracts are contracts requiring the Company to exchange a stated quantity of foreign currency for a fixed amount of a second currency, typically U.S. dollars. At January 31, 2006, currencies hedged were the U.S. dollar and British pound. The Company has designated certain of its foreign currency forward exchange contracts as cash flow hedges of transactions primarily related to sales contracts and receivables forecasted to occur by July 2006. The effective portion of the change in the fair value of these derivatives is recorded in comprehensive income and recognized in the income statement when the related hedged item affects earnings. Contracts designated as cash flow hedges were fully effective in 2006, 2005 and 2004 and net of tax gains and losses recorded as a component of accumulated other comprehensive income in stockholders equity were not material.

Note 9 Revolving Credit Facilities:

The Company has two revolving credit facilities (credit facilities) totaling $750 million with a group of financial institutions that provide for (i) a five-year revolving credit facility of up to $500 million, which allows borrowings until July 2007 and (ii) a five-year revolving credit facility of up to $250 million, which allows borrowings until July 2009. Borrowings under the credit facilities are unsecured and bear interest at a rate determined, at the Company s option, based on either LIBOR plus a margin or a defined base rate. The Company pays a facility fee on the total commitment amount and a fee if utilization exceeds 50% of the total commitment amount. During 2006, 2005 and 2004, the Company did not borrow under either of its credit facilities.

The Company has a firm fixed-price contract with the Greek government with bonding requirements, approximately $109 million of which have been met through the issuance of standby letters of credit under the $500 million five-year revolving credit facility. The standby letters of credit reduce the amount available for borrowings under the $500 million five-year revolving credit facility. The Company pays fees for the standby letters of credit issued under the $500 million five-year revolving credit facility, but the outstanding standby letters of credit are not considered borrowings and the Company does not incur related interest costs. The terms of the standby letters of credit require them to remain outstanding until the customer has formally accepted the system pursuant to the contract. The Company is in dispute with the customer on this contract as discussed in Note 19. The Company does not expect to issue any additional standby letters of credit for this contract under the $500 million five-year revolving credit facility.

As of January 31, 2006, the entire amount under the $250 million five-year revolving credit facility was available and $391 million of the $500 million five-year revolving credit facility was available. These credit facilities contain customary affirmative and negative covenants. The financial covenants contained in the credit facilities require the Company to maintain a trailing four quarter interest coverage ratio of not less than 3.5 to 1.0 and a ratio of consolidated funded debt to a trailing four quarter earnings before interest, taxes, depreciation and amortization of not more than 3.0 to 1.0. These covenants also restrict certain of the Company s activities, including, among other things, the Company s ability to create liens, dispose of assets, merge or consolidate with other entities, and create guaranty obligations. If the Company completes the public offering and related events described in Note 1, the Company would need to obtain consents under these revolving credit facilities prior to the merger and payment of a special dividend. The credit facilities also contain customary events of default, including, among others, defaults based on certain bankruptcy and insolvency events; nonpayment; cross-defaults to other debt; breach of specified covenants; change of control, and material inaccuracy of representations and warranties. As of January 31, 2006, the Company was in compliance with all the financial covenants under the credit facilities.

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Note 10 Employee Benefit Plans:

Effective January 1, 2006, the Company merged the Employee Stock Retirement Plan (ESRP) into the 401(k) Profit Sharing Plan (401(k)) to create a combined plan renamed the SAIC Retirement Plan (SRP). The SRP is both a 401(k) plan and an employee stock ownership plan (ESOP). Any shares of Company common stock that were held in the 401(k) and ESRP are now held within the ESOP portion of the SRP. The SRP allows eligible participants to defer a portion of their income through payroll deductions. Employee deferrals are fully vested and are not taxable to the participant until distributed from the SRP following termination, retirement, permanent disability or death and may be matched by the Company. Employees are eligible to immediately participate in the SRP and receive the Company matching contribution upon their employment with the Company. The Company s matching contribution is a 50% match for each dollar an employee contributes to the 401(k), up to 6% of the employee s eligible compensation. In addition, the Company may also provide profit sharing contributions in cash and Company common stock. These contributions are based upon amounts determined annually by the board of directors and are allocated to participants accounts based on their annual eligible compensation. The Company recognizes the fair value of the Company s common stock in the year of contribution as compensation expense. Employees must meet a one-year eligibility period to qualify for any profit sharing contributions made by the Company. Participants interests in the Company s matching and profit sharing contributions vest 20% per year in the first through fifth year of service. Participants also become fully vested upon reaching age 59 $^1/_2$, permanent disability or death. The Company s contributions, including the matching contributions, expensed under the ESRP, 401(k) and SRP were $121 million, $95 million and $103 million for 2006, 2005 and 2004, respectively.

Any participant who leaves the Company, whether by retirement or otherwise, is no longer required to divest their Company common stock holdings that have been retained more than five years in the SRP and, based on the eligibility requirements, may be able to elect to receive either cash or shares of Company common stock as a distribution from their SRP stock account. Shares of Company common stock distributed from the SRP bear a limited put right that, if exercised, would require the Company to repurchase all or a portion of the shares at their then current fair value during two specified 60-day periods following distribution. If the shares are not put to the Company during the specified periods, the shares no longer bear a put right, and the Company will not be required to repurchase the shares. If the initial public offering is completed (Note 1), the limited put right feature on existing shares will expire and new shares distributed from the SRP will no longer be eligible for a put right. At January 31, 2006, the SRP held 67 million shares of common stock with a fair value of $2.9 billion and there were 5 million shares distributed from the SRP with a limited put right that remained outstanding with a fair value of $202 million. On March 2, 2006, the second period available to exercise the put right expired and 3 million shares with a fair value of $123 million remained outstanding.

The Company has a principal bonus compensation plan, which provides for bonuses to reward outstanding performance. Bonuses are awarded in the form of cash, fully vested or vesting shares of the Company s common stock. The board of directors or its committee administering the bonus compensation plan may at any time amend, suspend, or terminate the plan. Awards of vesting shares of the Company s common stock vest at the rate of 20%, 20%, 20% and 40% after one, two, three and four years, respectively. Except as otherwise provided in the award agreement, outstanding bonus awards become fully vested upon the occurrence of a change in control of the Company. The fair market value of these vesting shares awarded is recorded as unearned compensation, which is included in stockholders equity and amortized over the vesting period. The amounts expensed under this plan were $118 million, $121 million and $106 million in 2006, 2005 and 2004, respectively.

The Company has a Stock Compensation Plan (SCP) and Management Stock Compensation Plan (MSCP), together referred to as the Stock Compensation Plans. The board of directors may at any time amend or terminate the Stock Compensation Plans. The Stock Compensation Plans provide for awards in share units to eligible employees. Benefits from these plans are payable in shares of the Company s common stock that are

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

held in trust to fund benefit payments to participants. Participants interests in these share units vest on a seven year schedule at the rate of one-third at the end of each of the fifth, sixth and seventh years following the date of the award. In 2006, the board of directors amended the vesting period for new awards under the Stock Compensation Plans. New awards issued on or after January 1, 2006 vest 100% after four years and participants are no longer allowed to elect their distribution option. SCP participants receive a lump sum distribution of their awards in shares of Company common stock once they become vested while the MSCP participants receive a distribution of their awards in shares of Company common stock following termination or retirement. Upon a change in control of the Company, participant accounts will become fully vested and will be immediately distributed. The fair value of shares awarded under these plans is recorded as unearned compensation which is included in stockholders equity and amortized over the vesting period. The amounts expensed under these plans were $6 million, $7 million and $6 million in 2006, 2005 and 2004, respectively.

The Company has an Employee Stock Purchase Plan (ESPP) which allows eligible employees to purchase shares of the Company s common stock at a discount of 15% of the fair market value. The ESPP terminates on July 31, 2007, unless terminated earlier by the board of directors. The Company has not recognized any expense under this plan because it is a non-compensatory plan. Effective February 1, 2006, in accordance with SFAS No. 123(R), the ESPP became compensatory, requiring that 15% discount be recognized as compensation expense. The pro forma effect on net income and earnings per share of the discount is presented in Note 1. At January 31, 2006, 8 million shares of the Company s common stock were reserved for issuance under the ESPP.

The Company maintains two deferred compensation plans for the benefit of key executives and directors and allows eligible participants to elect to defer all or a portion of their annual bonus compensation. The Company makes no contributions under the Keystaff Deferral Plan (KDP) but does credit participant accounts for deferred compensation amounts and interest earned. Interest is accrued based on the Moody s Seasoned Corporate Bond Rate (5.59% in 2006). Deferred balances will generally be paid upon termination. Under the Key Executive Stock Deferral Plan (KESDP), eligible participants may elect to defer all or a portion of their annual bonus compensation in share units. The Company makes no contributions to the accounts of KESDP participants. Benefits from the KESDP are payable in shares of the Company s common stock that are held in a trust for the benefit of KESDP participants. Deferred balances will generally be paid upon retirement or termination.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 11 Pension Plan:

The following tables set forth the funded status and amounts recognized in the consolidated balance sheets for the Company s foreign defined benefit pension plan for certain employees in the United Kingdom. The plan has a January 31 measurement date.

	Year Ended January 31	
	2006	2005
	(In millions)	
Change in benefit obligation:		
Benefit obligation at beginning of year	$ 95	$ 76
Service cost	3	3
Interest cost	5	4
Plan participants contributions	1	1
Actuarial loss	16	8
Benefits paid	(1)	(1)
Foreign currency translation	(6)	4
Benefit obligation at end of year	$ 113	$ 95
Change in plan assets:		
Fair value of plan assets at beginning of year	$ 63	$ 53
Actual gain on plan assets	13	5
Company contributions	3	3
Plan participants contributions	1	1
Benefits paid	(1)	(1)
Foreign currency translation	(4)	2
Fair value of plan assets at end of year	$ 75	$ 63
Funded status at end of year	$ (38)	$ (32)
Unrecognized net actuarial loss	42	38
Net prepaid benefit cost	$ 4	$ 6
Amounts recognized in the consolidated balance sheets consist of:		
Accrued benefit cost	$ (24)	$ (19)
Accumulated other comprehensive income (pre-tax)	28	25

Net prepaid benefit cost	$ 4	$ 6

The accumulated benefit obligation for the defined benefit pension plan was $100 million and $82 million at January 31, 2006 and 2005, respectively. The fair value of the pension assets was less than the accumulated benefit obligation at January 31, 2006 and 2005. As a result, a minimum pension liability adjustment, net of tax, of $3 million, $3 million, and $4 million was included in other comprehensive income in 2006, 2005 and 2004, respectively.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Amounts for the defined benefit pension plan with an accumulated benefit obligation in excess of plan assets were as follows:

	January 31	
	2006	2005
	(In millions)	
Projected benefit obligation	$ 113	$ 95
Accumulated benefit obligation	$ 100	$ 82
Fair value of plan assets	$ 75	$ 63

The components of net periodic benefit cost to the Company of this plan were as follows:

	Year Ended January 31		
	2006	2005	2004
	(In millions)		
Components of net periodic benefit cost:			
Service cost	$ 3	$ 3	$ 2
Interest cost	5	4	3
Expected return on plan assets	(5)	(4)	(3)
Amortization of actuarial loss	2	1	2
Net periodic benefit cost	$ 5	$ 4	$ 4

Actuarial Assumptions

The weighted-average assumptions used in determining the benefit obligations and the net periodic benefit cost of pension were as follows:

January 31	
2006	2005

Assumptions used to determine benefit obligations at the plan s measurement date:		
Discount rate	4.7%	5.3%
Rate of compensation increase	3.6%	3.6%

	Year Ended January 31	
	2006	2005
Assumptions used to determine net periodic benefit cost:		
Discount rate	5.3%	5.5%
Expected return on plan assets	7.6%	8.0%
Rate of compensation increase	3.6%	3.5%

The long-term rate of return assumption represents the expected average earnings on funds invested or to be invested by the plan. This return is determined in consultation with investment advisors and is based on a variety of factors including long-term historical market returns for the various asset classes in the plans and review of peer data. A weighting of these asset class returns, based on the anticipated long-term allocation of the asset classes in the plans, is performed to determine an overall average expected long-term rate of return.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Plan Assets

As of the measurement date, pension plan assets were allocated as follows:

	January 31	
	2006	**2005**
International equity securities	71%	75%
Debt securities	21	19
Real estate and cash	8	6
	100%	100%

The Company s overall investment strategy for all pension plan assets is to utilize a total return investment approach whereby a mix of equity securities, fixed income, real estate and cash investments are used to maximize the long-term return of plan assets for a prudent level of risk. Risk tolerance is established through consideration of plan demographics, plan liabilities, plan funded status and overall corporate financial condition. The investment portfolio contains a diversified blend of international equity securities, fixed income securities, and real estate investments. Target asset allocation as prescribed by the investment strategy is substantially similar to actual allocation at measurement date.

Cash Flows

During 2007, the Company expects to contribute approximately $6 million to the defined benefit pension plan. Estimated annual benefit payments, which reflect expected future service, as appropriate, are expected to be $1 million for each of the years in 2007 to 2011. Total estimated benefit payments for 2012 through 2016 are expected to be $11 million.

Other

The Company also makes contributions to a defined benefit pension plan for employees working on one U.S. Government contract. As part of the contractual agreement, the customer reimburses the Company for contributions made to the plan as allowable under cost accounting standards. If the Company were to cease to be the contractor as a result of a recompetition process, this defined benefit pension plan and related plan assets and liabilities would transfer to the new contractor. Any excess ERISA required contributions that were made by the Company and not currently reimbursed under the contract would be settled at contract termination by the new contractor. The Company currently has a receivable for $2 million representing excess contributions made under ERISA but not currently reimbursed under the contract because it exceeds the allowable amount under CAS.

In addition, certain employees at AMSEC LLC, a consolidated joint venture, continue to participate in a defined benefit pension and a retiree medical and life insurance plan sponsored by the other joint venture participant. AMSEC LLC recorded expense of $1 million in 2006, 2005 and 2004 for payments made to the other joint venture partner for the cost of the benefits these plans provide.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 12 Income Taxes:

Income from continuing operations before income taxes included the following:

	Year Ended January 31		
	2006	**2005**	**2004**
		(In millions)	
United States	$ 469	$ 386	$ 354
Foreign	15	17	10
	$ 484	$ 403	$ 364

The provision for income taxes included the following:

	Year Ended January 31		
	2006	**2005**	**2004**
		(In millions)	
Current:			
Federal	$ 169	$ 83	$ 95
State	(9)	(18)	19
Foreign	10	8	4
Deferred:			
Federal	(21)	54	19
State	(9)	4	3
Foreign	(1)		
	$ 139	$ 131	$ 140

Deferred income taxes are provided for differences in the basis of assets and liabilities for financial reporting purposes and tax reporting purposes. Deferred tax assets (liabilities) are comprised of the following:

	January 31	
	2006	2005
	(In millions)	
Accrued vacation pay	$ 52	$ 44
Investments	25	19
Deferred compensation	29	29
Vesting stock bonuses	18	18
State taxes	4	6
Accrued liabilities		5
Unrealized net losses on marketable securities		2
Total deferred tax assets	128	123
Employee benefit contributions	(7)	(9)
Deferred revenue	(38)	(84)
Depreciation and amortization	(1)	(1)
Other	(22)	(10)
Total deferred tax liabilities	(68)	(104)
Net deferred tax assets, before valuation allowance	60	19
Valuation allowance	(3)	(2)
Net deferred tax assets	$ 57	$ 17

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

A reconciliation of the provision for income taxes to the amount computed by applying the statutory federal income tax rate (35%) to income from continuing operations before income taxes follows:

	Year Ended January 31		
	2006	2005	2004
		(In millions)	
Amount computed at statutory rate	$ 170	$ 141	$ 127
State income taxes, net of federal tax benefit	19	9	14
Change in accruals for tax contingencies	(50)	(19)	(1)
Non-deductible items	4	1	1
Non-taxable interest income	(4)	(1)	(1)
	$ 139	$ 131	$ 140
Effective income tax rate	28.7%	32.5%	38.4%

The lower effective tax rate for 2006 was primarily due to the reversal of $50 million in tax accruals for tax contingencies as a result of settlements of federal and state audits and audit issues in amounts different than the recorded accruals for tax contingencies, as well as the expiration of statutes on open tax years.

Income taxes paid in 2006, 2005 and 2004 were $590 million, $34 million and $79 million, respectively, and in 2006, included income tax payments of approximately $280 million related to the sale of Telcordia (Note 18).

At January 31, 2006, the Company had approximately $50 million of federal net operating loss carry forwards. The Company anticipates that it will fully utilize these carry forwards before they begin to expire in the year 2025.

The Company is subject to routine compliance reviews by the Internal Revenue Service (IRS), which is currently auditing 2002 to 2004, and other taxing jurisdictions on various tax matters, including challenges to various positions the Company has taken. The Company has recorded liabilities for tax contingencies for open years based upon its best estimate of the taxes ultimately to be paid. As of January 31, 2006, the income taxes payable balance included $113 million for tax contingencies. The income taxes payable at January 31, 2006 also includes deposits made with various tax authorities for anticipated tax payments due on prior tax periods. While the Company believes it has adequate accruals for tax contingencies, there is no assurance that the tax authorities will not assert that the Company owes taxes in excess of its accruals, or that there will not be accruals in excess of the final settlement amounts agreed to by the tax authorities.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Note 13 Notes Payable and Long-Term Debt:

Notes payable and long-term debt consisted of the following:

	January 31	
	2006	2005
	(In millions)	
5.5% notes due 2033	$ 296	$ 296
6.25% notes due 2012	548	548
7.125% notes due 2032	248	248
6.75% notes due 2008	94	95
3-year note due 2006	17	30
Other notes payable	36	68
	1,239	1,285
Less current portion	47	70
	$ 1,192	$ 1,215

In 2004, the Company completed an offering of $300 million of senior unsecured notes (5.5% notes). The 5.5% notes are due on July 1, 2033 with interest payable on a semi-annual basis beginning January 1, 2004. The note discounts, issuance costs and the loss on the treasury lock contracts (Note 8) are amortized to interest expense, using the effective interest method, which results in an effective interest rate of 5.8%. The fair value of the 5.5% notes was less than the carrying value by $19 million at January 31, 2006.

In 2003, the Company issued $550 million of 6.25% senior unsecured notes (6.25% notes) and $250 million of 7.125% senior unsecured notes (7.125% notes). The 6.25% notes and the 7.125% notes are due on July 1, 2012 and July 1, 2032, respectively, with interest payable semi-annually beginning January 1, 2003. The note discounts, issuance costs and the loss on the treasury lock contracts (Note 8) are amortized to interest expense, which results in an effective interest rate of 6.5% for the 6.25% notes and 7.43% for the 7.125% notes. The fair value of the 6.25% notes and 7.125% notes exceeded the carrying value by $20 million and $38 million, respectively, at January 31, 2006.

In 1998, the Company issued $100 million of 6.75% senior unsecured notes with a nominal discount (6.75% notes) which are due February 1, 2008 with interest payable semi-annually beginning August 1, 1998. The 6.75% notes have an effective interest rate of 8.3%, due principally to the amortization of a loss on a forward treasury lock agreement, the discount on issuance of the notes and underwriting fees associated with the offering. The fair value of the 6.75% notes exceeded the carrying value by $9 million at January 31, 2006. In 2005, the Company entered into interest rate swaps related to this debt as described in Note 8.

The Company is subject to certain restrictions on the notes described above, such as limitations on liens and sale and leaseback transactions. As of January 31, 2006, the Company was in compliance with these restrictions.

In conjunction with the acquisition of a business, in 2004, the Company s 55% owned joint venture, AMSEC LLC, entered into a 3-year term note for $45 million (3-year note) maturing December 1, 2006. The 3-year note is secured by certain assets of the joint venture. Principal is paid quarterly and interest is paid monthly. The interest rate is adjusted monthly based on 30-day LIBOR plus 85 basis points and was 5.24% at January 31, 2006.

The Company has various other notes payable with interest rates from 2.9% to 6.0% that are due on various dates through 2016.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Maturities of notes payable and long-term debt are as follows:

Year Ending January 31	(In millions)
2007	$ 47
2008	1
2009	101
2010	1
2011	1
2012 and after	1,103
Total principal payments	1,254
Less unamortized discount	15
	$ 1,239

Note 14 Comprehensive Income and Accumulated Other Comprehensive Loss:

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) represents certain components of revenues, expenses, gains and losses that are included in comprehensive income but are excluded from net income. These amounts are recorded directly as an adjustment to stockholders equity, net of tax, and were as follows:

	Year Ended January 31		
	2006	2005	2004
		(In millions)	
Other comprehensive income (loss):			
Foreign currency translation adjustments	$ (2)	$ 2	$ 2
Deferred taxes	1		(1)
Net foreign currency translation adjustments	(1)	2	1
Unrealized (loss) gain on marketable securities	(3)	(10)	7
Reclassification of net realized loss (gain)	8	2	(19)
Deferred taxes	(1)	2	5

Net unrealized gain (loss) on marketable securities	4	(6)	(7)
Unrealized loss on derivative instruments			(12)
Reclassification of net realized loss on derivative instruments	3	4	2
Deferred taxes	(1)	(1)	4
Net unrealized gain (loss) on derivatives	2	3	(6)
Minimum pension liability adjustments, net of tax	(1)	(5)	(4)
	$ 4	$ (6)	$ (16)

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The components of accumulated other comprehensive loss were as follows:

	January 31	
	2006	2005
	(In millions)	
Foreign currency translation adjustments	$ (1)	$
Unrealized net loss on derivative instruments	(11)	(13)
Unrealized net loss on marketable securities		(4)
Minimum pension liability adjustments	(20)	(19)
	$ (32)	$ (36)

As of January 31, 2006, $2 million of the unrealized net loss on derivative instruments is expected to be recognized as expense within the next 12 months.

Note 15 Common Stock and Options:

The Company has options outstanding under the 1999 Stock Incentive Plan. The 1999 Stock Incentive Plan provides the Company and its affiliates employees, directors and consultants the opportunity to receive stock options, stock appreciation rights, vested stock awards, restricted stock awards, restricted stock units, performance awards, and other similar types of stock awards. The plan also provides that, except as provided in an award agreement, outstanding awards will become fully vested upon the occurrence of a change in control of the Company. Options are granted with exercise prices equal to the fair market value at the date of grant and for terms not greater than ten years. Options outstanding at January 31, 2006 were granted with terms of five years. Options granted under these plans generally become exercisable 20%, 20%, 20%, and 40% after one, two, three and four years, respectively.

A summary of changes in outstanding options under the plans during the three years ended January 31, 2006, were as follows:

	Shares of common stock under options	Weighted average exercise price	Shares of common stock exercisable under options

	(In millions)			(In millions)
February 1, 2003	44	$	25.54	15
Options granted	10	$	29.14	
Options canceled	(3)	$	28.60	
Options exercised	(9)	$	15.26	
January 31, 2004	42	$	28.50	15
Options granted	7	$	36.68	
Options canceled	(2)	$	30.38	
Options exercised	(10)	$	23.20	
January 31, 2005	37	$	31.44	14
Options granted	6	$	41.10	
Options canceled	(6)	$	32.00	
Options exercised	(9)	$	29.48	
January 31, 2006	28	$	34.27	9

As of January 31, 2006, 53 million shares of common stock were reserved for issuance upon exercise of options which are outstanding or which may be granted.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

A summary of options outstanding as of January 31, 2006 was as follows:

Range of exercise prices	Options outstanding	Weighted average exercise price	Weighted average remaining contractual life	Options exercisable	Weighted average exercise price	Weighted average remaining contractual life
	(In millions)		(In years)	(In millions)		(In years)
$28.31 to $29.02	7	$ 28.65	2.1	2	$ 28.64	2.1
$30.20 to $31.79	4	$ 31.00	1.0	3	$ 30.92	.6
$32.27 to $32.95	5	$ 32.90	1.1	3	$ 32.86	1.1
$33.06 to $36.52	5	$ 36.33	3.1	1	$ 36.02	2.9
$37.31 to $40.55	6	$ 40.10	4.1			
$41.80 to $43.39	1	$ 43.10	4.7			
	28			9		

The Company has restricted stock awards in the form of vesting shares outstanding under the 1999 Stock Incentive Plan, the bonus compensation plan and the Stock Compensation Plans (Note 10). The Company granted 1 million shares of vesting stock in 2006 and 2 million shares in 2005 and 2004. The weighted average grant date fair values were $41.04, $36.91 and $29.57 for 2006, 2005 and 2004, respectively.

Note 16 Leases:

The Company occupies most of its facilities under operating leases. Most of the leases require the Company to pay maintenance and operating expenses such as taxes, insurance and utilities and also contain renewal options extending the leases from one to twenty years. Certain of the leases contain purchase options and provisions for periodic rate escalations to reflect cost-of-living increases. Certain equipment, primarily computer-related, is leased under short-term or cancelable operating leases. Rental expense for facilities and equipment was $126 million, $109 million and $107 million in 2006, 2005 and 2004, respectively, which is net of sublease income of $7 million, $6 million and $5 million in 2006, 2005 and 2004, respectively.

In 2004, the Company was awarded a contract with the Greek Government (Note 19) that requires the Company to lease certain equipment under an operating lease from a subcontractor for ten years. The lease term commences as soon as the development and integration of the system under contract is completed and accepted by the customer. The terms of the customer contract and lease agreement provide that if the customer defaults on its payments to the Company to cover the future lease payments, then the Company is not required to make the lease payments to the subcontractor. Consequently, the maximum contingent lease liability of $91 million at January 31, 2006 is not reflected in the future minimum lease commitments table below and such amount has not been recorded in the consolidated financial statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Minimum lease commitments, primarily for facilities under non-cancelable operating leases in effect at January 31, 2006 are as follows:

Year Ending January 31	Operating lease commitment	Sublease income
	(In millions)	
2007	$ 103	$ 8
2008	66	6
2009	47	4
2010	31	2
2011	16	
2012 and after	37	
	$ 300	$ 20

As of January 31, 2006, the Company had capital lease obligations of $4 million that are payable over the next four years.

Note 17 Supplementary Income Statement and Cash Flow Information:

Depreciation and amortization expense for property, plant and equipment and assets acquired under capital leases was $41 million, $36 million and $30 million in 2006, 2005 and 2004, respectively.

Independent research and development costs of $27 million, $25 million and $19 million in 2006, 2005 and 2004, respectively, were included in selling, general and administrative expenses.

Interest paid amounted to $81 million, $87 million and $73 million in 2006, 2005 and 2004, respectively.

Note 18 Discontinued Operations:

Telcordia

On March 15, 2005, the Company completed the sale of Telcordia to TTI Holding Corporation (Buyer), an affiliate of Warburg Pincus LLC and Providence Equity Partners Inc. The initial sale price of $1.35 billion was subject to a working capital adjustment, reduction for the net proceeds from a sale leaseback transaction of certain Telcordia-owned real estate between Telcordia and an unrelated third party in conjunction with the closing of the sale of Telcordia, and other adjustments as agreed upon between the Buyer and the Company. During 2006, the Company finalized the closing balance sheet and working capital adjustments with the Buyer, resolved certain sales tax matters and recorded a gain on sale before income taxes of $871 million.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

During 2006, the adjusted cash proceeds from the sale, including proceeds from the sale leaseback transaction that was entered into in connection with the sale of Telcordia and after tax gain on sale were as follows:

		(In millions)
Initial sale price	$	1,350
Less: Working capital adjustments		(244)
Direct and incremental selling costs		(34)
Proceeds received from sale of Telcordia and real estate		1,072
Less: Accrued liabilities for other purchase price adjustments per the definitive stock purchase agreements and related amendments		(2)
Adjusted sales price for Telcordia business and real estate		1,070
Less:		
Net book basis of assets and liabilities, including cash of $7 million		(199)
Gain on sale before income taxes		871
Provision for income taxes		325
Gain on sale, net of income taxes	$	546

The Company is entitled to receive additional amounts as contingent sales price, including all of the net proceeds from any judgment or settlement of the litigation Telcordia initiated against Telkom South Africa and 50% of the net proceeds Telcordia receives in connection with the prosecution of certain patent rights of Telcordia as described in Note 19. In addition to customary indemnifications to the Buyer, the Company has indemnified the Buyer for all income tax obligations on and through the date of close and has indemnified the Buyer against any loss Telcordia may incur as a result of an adverse judgment in the Telkom South Africa litigation. While the Company believes it has adequate accruals for these contingencies, the ultimate resolution of these matters could differ from the amounts accrued. The impact of these future contingent payments or contingent purchase price proceeds as well as changes in estimates for these items, if any, will continue to be reflected as discontinued operations in the period in which they arise.

As a result of the sale of Telcordia, the Company s common stock is no longer an investment choice in the Telcordia 401(k) Plan. As of January 31, 2006, the Telcordia 401(k) Plan held 3.5 million shares of the Company s common stock, which had a fair value of $156 million. The Company no longer has a right of repurchase under the terms of its Restated Certificate of Incorporation with respect to the shares of the Company s common stock held by the Telcordia 401(k) Plan or any other contractual right to repurchase these shares. However, the Company agreed with Telcordia to provide an opportunity for the Telcordia 401(k) Plan to sell shares of the Company s Class A common stock in any trade in which its retirement plans have such an opportunity prior to completion of the public offering. Further, the Company agreed that if the public offering is completed, the Telcordia 401(k) Plan will have the same opportunity to sell shares of Class A preferred stock of SAIC, Inc. as other stockholders generally, but will not have the opportunity to sell such shares in any additional opportunities provided to the Company s retirement plans that are not otherwise provided to other stockholders generally.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The operating results of Telcordia have been classified as discontinued operations for all periods presented. Telcordia s results of operations had previously been reported as the Non-Regulated Telecommunications segment in 2004. A summary of Telcordia s operating results is as follows:

	Year Ended January 31		
	2006	**2005**	**2004**
		(In millions)	
Revenue	$ 89	$ 874	$ 887
Cost and expenses:			
Cost of revenues	57	489	484
Selling, general and administrative expenses, including depreciation and amortization of $30 million and $44 million in 2005 and 2004, respectively	28	235	258
Other (expense) income, net		(1)	1
Income before income taxes	4	149	146
(Benefit) provision for income taxes	(32)	16	19
Income from discontinued operations	$ 36	$ 133	$ 127

In 2006, Telcordia s operating results reflect the period prior to the sale of February 1, 2005 through March 14, 2005. In addition, during 2006, after the sale of Telcordia, an income tax benefit of $32 million related to Telcordia s discontinued operations was recorded to reflect the resolution of certain tax contingencies of Telcordia that related to its operations prior to the sale.

INTESA Joint Venture

In 2003, the Company s foreign joint venture, INTESA, ceased operations and was classified as discontinued operations. As described in Note 19, in 2005, the Company received a $6 million settlement related to an insurance claim. This claim is considered a recovery of prior losses that were recorded as part of the discontinued operations and, therefore, has been recorded as a gain from discontinued operations of $4 million, net of income tax expense of $2 million. INTESA and the Company are involved in various legal proceedings relating to INTESA as described in Note 19.

Note 19 Commitments and Contingencies:

Letters of Credit and Surety Bonds

The Company has outstanding letters of credit aggregating $266 million at January 31, 2006, principally related to guarantees on contracts with domestic commercial and foreign government customers. Of the total outstanding letters of credit, $234 million was related to the firm fixed-price contract with the Greek government described below, $109 million of which was issued under the Company s five year revolving credit facility (Note 9). The Company also has outstanding surety bonds aggregating $78 million, principally related to performance and payment type bonds.

Telkom South Africa

The Company s former Telcordia subsidiary instituted arbitration proceedings before the International Chamber of Commerce (ICC) against Telkom South Africa in March 2001 as a result of a contract dispute. Telcordia is seeking to recover damages of approximately $130 million, plus interest at a rate of 15.5%. Telkom South Africa counterclaimed, seeking substantial damages from Telcordia, including repayment of approximately $97 million previously paid to Telcordia under the contract and the excess costs of reprocuring a

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

replacement system, estimated by Telkom South Africa to be $234 million. On September 27, 2002, Telcordia prevailed in the initial phase of the arbitration. The arbitrator found that Telkom South Africa repudiated the contract and dismissed Telkom South Africa s counterclaims against Telcordia. The damages to be recovered by Telcordia were to be determined in a second phase of the arbitration. Telkom South Africa successfully challenged the arbitrator s partial award in the Company s favor in the South African trial court and the Company has appealed this decision to the South African Supreme Court. In a separate proceeding, the Company unsuccessfully attempted to have its partial arbitration award confirmed by the U.S. District Court (New Jersey). The Company has appealed the ruling of U.S. District Court (New Jersey) to the U.S. Court of Appeals for the Third Circuit. Oral arguments were held on January 13, 2006 and the parties are awaiting the decision.

On March 15, 2005, the Company sold Telcordia to an affiliate of Warburg Pincus LLC and Providence Equity Partners Inc. (Note 18). Pursuant to the definitive stock purchase agreement relating to the sale, the Company is entitled to receive all of the net proceeds from any judgment or settlement with Telkom South Africa, and, if this dispute is settled or decided adversely against Telcordia, the Company is obligated to indemnify the buyer of Telcordia against any loss that may result from such an outcome.

Due to the complex nature of the legal and factual issues involved in the dispute and the uncertainty of litigation in general, the outcome of the arbitration and the related court actions are not presently determinable, however, an adverse resolution could materially harm the Company s business, consolidated financial position, results of operations and cash flows. The Company does not have any assets or liabilities recorded related to this contract and the related legal proceedings as of January 31, 2006 and 2005. The Company does not believe a material loss is probable based on the procedural standing of the case and its understanding of applicable laws and facts.

Firm Fixed-Price Contract with the Greek Government

Original Contract. In May 2003, the Company entered into a euro-denominated firm-fixed-price contract with the Hellenic Republic of Greece (the Customer), as represented by the Ministry of Defense, to provide a C4I (Command, Control, Communications, Coordination and Integration) System (the System), to support the 2004 Athens Summer Olympic Games (the Olympics), and to serve as the security system for the Customer s public order departments following completion of the Olympics. The System is comprised of 29 subsystems, organized into three major functional areas: the Command Decision Support System (CDSS), the Communication and Information System and the Command Center Systems. A significant amount of effort on this contract has been and will be performed by subcontractors to the Company. Under the contract, the System was to be completed, tested, and accepted by September 1, 2004, at a price of approximately $199 million. To date, the Company has received advance payments totaling approximately $147 million. The contract also requires the Company to provide five years of System support and maintenance for approximately $11 million and ten years of TETRA radio network services for approximately $102 million. Under the terms of the contract, the Company s obligation to provide the System support and maintenance and TETRA radio network services only begins upon System acceptance, which has not yet occurred. The contract contains an unpriced option for an additional five years of TETRA network services.

The Memorandum. On July 7, 2004, shortly before the start of the Olympics, the Company entered into an agreement (the Memorandum) with the Hellenic Republic, as represented by the Committee for Planning and Monitoring the Olympic Security Command Centers, pursuant to which the parties recognized and agreed that: (1) delivery and acceptance of the System had not been completed by the scheduled date; (2) the System would be delivered for use at the Olympics in its then-current state, which included certain omissions and deviations attributable to both parties; (3) a new process for testing and acceptance of the System would be instituted, with final acceptance to occur no later than October 1, 2004; (4) the Customer would proceed with the necessary

SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

actions for the completion of a contract modification as soon as possible; and (5) the Company would receive a milestone payment of approximately $23 million immediately upon the execution of the contract modification.

Delivery of System, Testing and Negotiations. The Customer took delivery of the System for use and operation during the Olympics, and continues to use significant portions of the System. The System has not been accepted by the Customer under the terms of the Greek contract, and the contract modification anticipated under the Memorandum has not been obtained. In November 2004, the Company delivered a revised version of the CDSS portion of the System to the Customer. Beginning in December 2004 and continuing through April 2005, the Customer performed subsystems acceptance testing on each of the subsystems comprising the System based on test procedures that had not been mutually agreed upon by the parties. The Customer identified numerous omissions and deviations in its test reports. The Company believes that certain of these omissions and deviations are valid, while others are not. From December 2004 through April 2005, the Company engaged in negotiations with the Customer concerning a modification to the contract to resolve the disputes. On April 28, 2005, the Customer formally notified the Company that the System delivered had significant deviations and omissions from the contractual requirements and may not be accepted.

Under the terms of the contract and the Memorandum between the parties, the Company submitted various proposals to the Customer to remedy these omissions and deviations. The most significant of these proposals includes a redevelopment of CDSS using an alternative technical approach, and a redesigned port security system. The first proposal for an alternative CDSS technical approach was submitted in June 2005. On November 25, 2005, the Customer notified the Company that its technical advisors declined to recommend either the acceptance or rejection of the Company s remediation plan for an alternative CDSS. On December 5, 2005, the Company sent a letter advising the Customer that unless an agreement is reached with respect to the alternative CDSS approach, the Company intends to initiate the dispute process contained in the Greek contract, which includes binding arbitration as its final step. On December 13, 2005, the Customer delivered a letter to the Company indicating that the Company s proposal based on the alternative CDSS approach is deemed acceptable in principle on the terms proposed. The parties reengaged in negotiations in early January 2006 on a contract modification to incorporate these proposals. A contract modification has not yet been executed and would be required in order for the Company to implement the proposals and achieve Customer acceptance of the System. The Company anticipates that such modification would include the parties agreement on appropriate price adjustments for omissions and deviations not satisfied by the proposed remediation of the System and a revised testing and acceptance process as contemplated under the Memorandum.

Subcontracts. The Company has subcontracted a significant portion of the requirements under the Greek contract, including the lease of certain equipment and TETRA network services for at least 10 years. In order for the Company to implement the technical proposals submitted to the Customer and contemplated by the modification being negotiated with the Customer, the Company would need to negotiate and execute modifications to the subcontracts with our subcontractors, including price. Certain of the omissions and deviations of the System are attributable to subcontracted work. Payments to the subcontractors are generally required only if the Company receives payment from the Customer related to the subcontractors work. If it is determined the Company breached its obligations to any of its subcontractors, the Company may incur additional losses.

Under the terms of the Greek contract, the Company is not obligated to provide TETRA network services to the Customer until the Customer has accepted the System. The Company and its subcontractors have provided System support and maintenance and TETRA network services to the Customer since the Olympics in August 2004, without receiving any compensation. In September 2005, the principal subcontractor notified the Company that it would no longer commit to continue providing TETRA network services, although it has continued to provide such services to date.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

Legality of the Contract. In March 2005, the Customer notified the Company that an issue had been raised concerning the legality of the contract by a Greek government auditor. In August 2005, the Company learned that the Court of Auditors of the Hellenic Republic (the Greek Audit Court), a government agency with authority to review and audit procurements, issued a decision finding that certain mistakes in the procurement process committed by the Greek government rendered the contract illegal. The Customer requested revocation of the Greek Audit Court decision. On November 17, 2005, the Greek Audit Court issued a decision finding that the errors committed by the Customer in the procurement process constituted pardonable mistakes with respect to prior payments under the contract. Although the rationale of the Greek Audit Court decision suggests that the Customer may be able to make future payments under the contract, the impact of the decision on the legality of the contract and the Customer s ability to make future payments is not clear.

Financial Status and Contingencies of the Contract. The Company has recorded $121 million of contract losses as of January 31, 2006. Of this amount, $83 million was recorded in fiscal 2006, $34 million in fiscal 2005 and $4 million in fiscal 2004. These losses reflect the Company s estimated total cost to complete the System and obtain Customer acceptance and estimated reductions in price as a result of omissions and deviations from the contract requirements. Because of the significant uncertainties related to ultimate acceptance and payment from the Customer, the Company s current accounting treatment limits the total revenue to be realized under the contract to the cash received to date. Although the Company expects to pursue remaining amounts owed under the terms of the contract, this reduction in total estimated revenues to be realized under the contract increased the total loss by $32 million during 2006, which is included in the loss amounts discussed above. Through January 31, 2006, the Company has recognized revenues of $119 million, which represent a portion of the $147 million cash collected to date based upon the percentage-of-completion method of revenue recognition.

As of January 31, 2006, the estimated future costs to complete the System and obtain Customer acceptance is $52 million. This estimated cost is included in the $121 million contract loss recorded as of January 31, 2006. Management has used this estimate and its judgment in evaluating the various uncertainties and assumptions necessary to recognize the total estimated losses on this contract. Such assumptions include obtaining mutual agreement with the Customer regarding system requirements, execution of a modification to the contract, completion of the System and Customer acceptance. The total costs are significantly affected by the timing of events such as executing a contract modification and ultimate Customer acceptance. Management has estimated that final acceptance of the System under a modified contract will occur in January 2008. The Company s recorded losses exclude potential subcontractor payments associated with the omissions and deviations related to specific subsystems supplied by subcontractors in the amount of $12 million that management believes will not be paid under the subcontract terms.

The Company has $13 million of accounts receivable relating to Value Added Taxes (VAT) that it has paid and believes it is entitled to recover either as a refund from the taxing authorities or as a payment under the Greek contract upon final billing. The contract requires the Customer to pay amounts owed for VAT for the System delivered. Failure by the customer to pay these amounts could result in an additional obligation payable by the Company to the Greek taxing authorities and would increase the Company s total losses on the contract.

In accordance with the terms of the contract, the Company is required to provide certain payment, performance and offset bonds in favor of the customer. The bonding requirements have been met through the issuance of standby letters of credit. Under the terms of these bonding arrangements, the Customer has currently the right to call some or all of the $234 million of standby letters of credit outstanding. The Company does not currently believe it is probable that the Customer will call these standby letters of credit. If the standby letters of credit are called, the Company may have the right to call some or all of the $99 million in performance bonds provided by its subcontractors guaranteeing the performance of their work under the contract.

Arbitration Proceedings. Although the Company has been pursuing a contract modification with the Customer since shortly after the Memorandum was signed in July 2004, due to the difficulties in reaching

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

mutually satisfactory terms, the Company instituted arbitration proceedings on April 21, 2006 before the International Chamber of Commerce (ICC) against the Customer to pursue the Company s rights and remedies provided for in the contract and the Memorandum and under Greek law. The arbitration complaint filed by the Company: (1) seeks an order under the contract that the Customer s extended use of the System under the circumstances constitutes constructive acceptance and precludes the Customer from rejecting the System, (2) seeks damages for breach of contract, bad faith, use of the System and other damages, (3) seeks a determination as to the legal status of the contract as a result of the illegality issue discussed above, and (4) if the contract is determined to be illegal, seeks compensation for the commercial value of the System delivered and its use by the Customer and other damages. Under the terms of the Contract, disputes are subject to ultimate resolution by binding arbitration before a panel of three Greek arbitrators in Greece. Due to the complex nature of the legal and factual issues involved and the uncertainty of litigation in general, the outcome of the arbitration is uncertain. There is no assurance that the Company will prevail in the arbitration.

In the event the Company does not prevail in the arbitration or is unable to resolve the various disputes under the contract as anticipated, it could incur additional losses. If the Customer asserts claims against the Company in the arbitration and it is determined that the Company has breached the contract and, as a result, owes the Customer damages, such damages could include, but are not limited to, (1) re-procurement costs, (2) repayment of amounts paid under the contract, (3) penalties for delayed delivery in an amount up to $15 million, and (4) forfeiture of a good performance bond in the amount of $32 million.

Successful imposition of damages or claims by the Customer or subcontractors against the Company, the calling of the Company s bonds, additional contract costs required to fulfill its obligations, or additional revenue reductions arising from the negotiation of the contract modification could have a material adverse affect on the Company s consolidated financial position, results of operations and cash flows.

DS&S Joint Venture

In March 2006, the Company sold its interest in DS&S, a joint venture in which the Company owned a 50% interest at January 31, 2006. DS&S maintains a $25 million credit facility, under which $7 million in principal amount and $12 million in standby letters of credit were outstanding at January 31, 2006. The Company and the other joint venture member each guaranteed 50% of DS&S s commitments under this credit facility (up to a maximum amount of $12.5 million each, plus certain additional charges), but the Company has not been required to perform on this guarantee. As of January 31, 2006, the Company had a loan receivable of $1 million due from DS&S, which was repaid in conjunction with the sale. The Company and the other joint venture member also each guaranteed the payment of 50% of certain legal and accounting fees incurred by DS&S in conjunction with an ongoing government investigation. As of January 31, 2006, the fair value of the guarantee for legal and accounting fees was not material to the Company and the Company has not been required to perform on this guarantee. The Company sold its interest in DS&S and received repayment of the loan receivable. The Company was released from its guarantee obligations relating to DS&S s credit facility and legal and accounting fees as part of the sale. In addition, as part of the sale, the Company agreed to indemnify the joint venture member who purchased the Company s interest in DS&S for certain legal costs and expenses relating to the on-going government investigation involving DS&S and any litigation resulting from that investigation up to the sum of the purchase price plus the amount received by the Company in repayment of the $1 million loan receivable.

INTESA Joint Venture

INTESA, a Venezuelan joint venture the Company formed in 1997 with Venezuela s national oil company, PDVSA, to provide information technology services in Latin America, is involved in various legal proceedings.

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The Company had previously consolidated its 60% interest in the joint venture, but the operations of INTESA were classified as discontinued operations as of January 31, 2003 and INTESA is currently insolvent. PDVSA has refused to take action to dissolve the joint venture or have it declared bankrupt.

Outsourcing Services Agreement and Guarantee. INTESA had derived substantially all its revenues from an outsourcing services agreement with PDVSA that it entered into at the time the joint venture was formed. The services agreement expired on June 30, 2002 and the parties were not able to reach agreement on a renewal. The Company guaranteed INTESA s obligations under the services agreement to PDVSA. Under the terms of the services agreement, INTESA s liability for damages to PDVSA in any calendar year is capped at $50 million. As a result, the Company s maximum potential liability to PDVSA under the guarantee in any calendar year, based on the Company s guarantee of their ownership interest in INTESA, is $20 million. To date, PDVSA has not asserted any claims.

Expropriation of the Company s Interest in INTESA. In 2003 and 2004, PDVSA and the Venezuelan government took certain actions, including denying INTESA access to certain of its facilities and assets, that prevented INTESA from continuing operations. In 2005, the Overseas Private Investment Company (OPIC), a U.S. governmental entity that provides insurance coverage against expropriation of U.S. business interests by foreign governments, determined that the Venezuelan government had expropriated the Company s interest in INTESA without compensation and paid the Company approximately $6 million in settlement of its claim.

Employment Claims of Former INTESA Employees. INTESA is a defendant in a number of lawsuits brought by former employees seeking unpaid severance and pension benefits. PDVSA and SAIC Bermuda, the Company s wholly-owned subsidiary and the entity that held the Company s interest in INTESA, were added as defendants in a number of these suits. Based on the procedural standing of the cases and the Company s understanding of applicable laws and facts, the Company believes that its exposure to any possible losses related to these employment claims is either remote, or if reasonably possible, not material.

Other Legal Proceedings Involving INTESA. The Attorney General of Venezuela initiated a criminal investigation of INTESA in 2003 alleging unspecified sabotage by INTESA employees. The Company believes this investigation is inactive. In connection with the Company s expropriation claim, OPIC determined that INTESA did not sabotage PDVSA s infrastructure as alleged by PDVSA and the Venezuelan government. In addition, the SENIAT, the Venezuelan tax authority, filed a claim against INTESA in 2004 for approximately $30 million for alleged non-payment of VAT taxes in 1998.

Potential Financial Impact. Many issues relating to INTESA, including the termination of the services agreement and the employment litigation brought by former INTESA employees, remain unresolved. Due to the complex nature of the legal and factual issues involved in these matters and the uncertain economic and political environment in Venezuela, the outcome is not presently determinable and no amounts have been accrued; however, adverse resolutions could materially harm the Company s business and could have a material adverse affect on its consolidated financial position, results of operations and cash flows.

Other Joint Ventures

The Company is an investor in Danet Partnership GbR (Danet GbR), a German partnership, accounted for under the equity method. Danet GbR is the controlling shareholder in Danet GmbH, a German operating company (Danet GmbH). Danet GbR has an internal equity trading market similar to the Company s limited market. The Company is required to provide liquidity rights to the other Danet GbR investors in certain circumstances. Absent a change in control whereby the Company gains control over Danet GbR, these rights allow Danet GbR investors who are withdrawing from the partnership to put their Danet GbR shares to the Company in exchange for the current fair value of those shares. If the Company gains control over Danet GbR,

SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

all Danet GbR investors have the right to put their Danet GbR shares to the Company in exchange for the current fair value of those shares. If Danet GbR investors put their shares to the Company, the Company may pay the put price in shares of its common stock or cash. The Company does not currently record a liability for these put rights because their exercise is contingent upon the occurrence of future events which the Company cannot determine will occur with any certainty. In 2006, the Company paid $2 million to withdrawing Danet GbR investors who exercised their right to put their Danet GbR shares to the Company. The maximum potential obligation assuming all the current Danet GbR investors were to put their Danet GbR shares to the Company would be $7 million as of January 31, 2006. If the Company were to incur the maximum obligation and buy all the partnership shares currently held by other Danet GbR investors, the Company would then own 100% of Danet GbR and would hold a controlling interest in Danet GmbH.

The Company has a guarantee that relates only to claims brought by the sole customer of another of its joint ventures, Bechtel SAIC Company, LLC, for specific contractual nonperformance of the joint venture. The Company also has a cross-indemnity agreement with the joint venture partner, pursuant to which it will only be ultimately responsible for the portion of any losses incurred under the guarantee equal to its ownership interest of 30%. Due to the nature of the guarantee, the Company is not able to project the maximum potential amount of future payments it could be required to make under the guarantee as of January 31, 2006 but, based on current conditions, the Company believes the likelihood of having to make any payment is remote. Accordingly, no liability relating to this guarantee is currently recorded.

On September 15, 2004, the Company entered into an agreement with EG&G Technical Services, Inc. (EG&G) and Parsons Infrastructure & Technology Group, Inc. (Parsons) to form Research and Development Solutions, LLC (RDS), a Delaware limited liability company that will pursue contracts offered by the Department of Energy s National Energy Technical Laboratory. The Company, EG&G and Parsons, each have a one-third equal joint venture interest. In conjunction with a contract award to RDS, each joint venture partner was required to sign a performance guarantee agreement with the U.S. Government. Under this agreement, the Company unconditionally guarantees all of RDS s obligations to the U.S. Government under the contract award, which has an estimated total value of $217 million. The Company also has a cross-indemnity agreement with each of the other two joint venture partners to protect it from liabilities for any U.S. Government claims resulting from the actions of the other two joint venture partners and to limit the Company s liability to its share of the contract work. As of January 31, 2006, the fair value of the guarantee is not material to the Company.

Gracian v. SAIC Class Action Lawsuit

This class action lawsuit was voluntarily dismissed by the plaintiffs without prejudice on September 21, 2005.

Other

The Company is subject to investigations and reviews relating to compliance with various laws and regulations with respect to its role as a contractor to agencies and departments of the U.S. Government and in connection with performing services in countries outside of the United States. Such matters can lead to criminal, civil or administrative proceedings and the Company could be faced with fines, repayments or compensatory damages. Adverse findings could also have a material adverse effect on the Company because of its reliance on government contracts. Although the Company can give no assurance, based upon management s evaluation of current matters that are subject to U.S Government investigations of which the Company is aware and based on management s current understanding of the facts, the Company does not believe that the outcome of any such matter would have a material adverse effect on its consolidated financial position, results of operations, cash flows or its ability to conduct business.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

The Company is also involved in various claims and lawsuits arising in the normal conduct of its business, none of which, in the opinion of the Company s management, based upon current information, is expected to have a material adverse effect on its consolidated financial position, results of operations, cash flows or its ability to conduct business.

In the normal conduct of its business, the Company seeks to monetize its patent portfolio through licensing agreements. The Company also has and will continue to defend its patent positions when it believes its patents have been infringed and is involved in such litigation from time to time. As described in Note 18, on March 15, 2005, the Company sold its Telcordia subsidiary. Pursuant to the terms of the definitive stock purchase agreement, the Company will receive 50% of the net proceeds Telcordia receives in the future in connection with the prosecution of certain patent rights.

The Company is subject to routine compliance reviews by the IRS and other taxing jurisdictions on various tax matters, which may include challenges to various tax positions the Company has taken. The Company has recorded liabilities for tax contingencies for open years based upon its best estimate of the taxes ultimately expected to be paid. As of January 31, 2006, $113 million of tax accruals have been recorded for tax contingencies. The Company is currently undergoing several routine IRS and other tax jurisdiction examinations. While the Company believes it has adequate accruals for tax contingencies, there is no assurance that the tax authorities will not assert that the Company owes taxes in excess of its accruals, or that there will not be accruals in excess of the final amounts agreed to by the tax authorities.

Note 20 Selected Quarterly Financial Data (Unaudited):

Selected unaudited financial data for each quarter of the last two years is as follows:

	First Quarter(1)	Second Quarter(1)	Third Quarter(1)	Fourth Quarter
	(In millions, except per share amounts)			
2006				
Revenues	$ 1,846	$ 1,952	$ 2,028	$ 1,966
Operating income	$ 112	$ 144	$ 108	$ 133
Income from continuing operations	$ 55	$ 85	$ 72	$ 133
Income from discontinued operations	$ 530	$ 12	$ 19	$ 21
Net income	$ 585	$ 97	$ 91	$ 154
Basic earnings per share(2)	$ 3.27	$ .55	$ .53	$ .90
Diluted earnings per share(2)	$ 3.18	$ .54	$ .51	$ .87
2005				
Revenues	$ 1,706	$ 1,768	$ 1,837	$ 1,876

Operating income	$	120	$	114	$	130	$	124
Income from continuing operations	$	67	$	52	$	68	$	85
Income from discontinued operations	$	22	$	29	$	27	$	59
Net income	$	89	$	81	$	95	$	144
Basic earnings per share(2)	$	.48	$	.44	$	.52	$	.80
Diluted earnings per share(2)	$	.47	$	.43	$	.51	$	.78

(1) Amounts for the first, second and third quarters of 2005 have been reclassified to conform to the presentation of Telcordia as discontinued operations at January 31, 2005.

(2) Earnings per share are computed independently for each of the quarters presented and therefore may not sum to the total for the year.

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CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, in millions, except per share amounts)

	Three Months Ended April 30	
	2006	**2005**
Revenues	$ 1,958	$ 1,846
Costs and expenses:		
Cost of revenues	1,686	1,614
Selling, general and administrative expenses	129	120
Operating income	143	112
Non-operating income (expense):		
Interest income	29	19
Interest expense	(23)	(22)
Minority interest in income of consolidated subsidiaries	(3)	(3)
Other income (expense), net	2	(1)
Income from continuing operations before income taxes	148	105
Provision for income taxes	54	50
Income from continuing operations	94	55
Discontinued operations (Note 11):		
Income from discontinued operations of Telcordia before income taxes (including gain on sale of $861 for the three months ended April 30, 2005)		865
(Benefit) provision for income taxes	(12)	335
Income from discontinued operations	12	530
Net income	$ 106	$ 585
Earnings per share:		
Basic:		
Income from continuing operations	$ .56	$ .31
Income from discontinued operations	.07	2.96
	$ .63	$ 3.27
Diluted:		
Income from continuing operations	$ .54	$ .30
Income from discontinued operations	.07	2.88
	$ .61	$ 3.18

Common equivalent shares:		
Basic	168	179
Diluted	174	184

See accompanying notes to condensed consolidated financial statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS

(Unaudited, in millions)

	April 30, 2006	January 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 2,717	$ 1,035
Investments in marketable securities		1,659
Receivables, net	1,519	1,517
Prepaid expenses and other current assets	170	192
Deferred income taxes	9	
Total current assets	4,415	4,403
Property, plant and equipment (less accumulated depreciation of $258 and $249 at April 30, 2006 and January 31, 2006, respectively)	364	356
Intangible assets, net	60	63
Goodwill	667	655
Deferred income taxes	64	66
Other assets	116	112
	$ 5,686	$ 5,655
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued liabilities	$ 928	$ 953
Accrued payroll and employee benefits	364	468
Income taxes payable	45	14
Notes payable and current portion of long-term debt	27	47
Deferred income taxes		9
Total current liabilities	1,364	1,491
Long-term debt, net of current portion	1,192	1,192
Other long-term liabilities	112	111
Commitments and contingencies (Note 10)		
Minority interest in consolidated subsidiaries	56	54
Stockholders equity:		
Common stock	2	2
Additional paid-in capital	2,599	2,506
Retained earnings	464	415
Other stockholders equity	(71)	(84)
Accumulated other comprehensive loss	(32)	(32)
Total stockholders equity	2,962	2,807
	$ 5,686	$ 5,655

See accompanying notes to condensed consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, in millions)

	Three Months Ended April 30	
	2006	**2005**
Cash flows from continuing operating activities:		
Net income	$ 106	$ 585
Income from discontinued operations	(12)	(530)
Adjustments to reconcile net income to net cash provided by (used in) continuing operating activities:		
Depreciation and amortization	15	16
Stock-based compensation	15	8
Minority interest in income of consolidated subsidiaries	3	3
Impairment losses on marketable securities		2
Other	(2)	1
Increase (decrease) in cash and cash equivalents, excluding effects of acquisitions and divestitures, resulting from changes in:		
Receivables	2	(13)
Prepaid expenses and other current assets	21	19
Deferred income taxes	(15)	4
Other assets	(3)	(2)
Accounts payable and accrued liabilities	(39)	(17)
Accrued payroll and employee benefits	(74)	(87)
Income taxes payable	62	(1)
Other long-term liabilities	2	6
Total cash flows provided by (used in) continuing operating activities	81	(6)
Cash flows from investing activities:		
Expenditures for property, plant and equipment	(18)	(11)
Acquisition of business, net of cash acquired of $1 in 2006	(14)	
Payments for businesses acquired in previous years		(12)
Purchases of marketable securities available-for-sale	(4,258)	(880)
Proceeds from sales and maturities of investments in marketable securities and other	5,927	872
Other		(2)
Total cash flows provided by (used in) investing activities	1,637	(33)
Cash flows from financing activities:		
Proceeds from notes payable and issuance of long-term debt		10
Payments on notes payable and long-term debt	(20)	(34)
Dividends paid to minority interest stockholders	(1)	(1)
Sales of common stock	16	31
Repurchases of common stock	(32)	(244)
Total cash flows used in financing activities	(37)	(238)

Increase (decrease) in cash and cash equivalents from continuing operations	1,681	(277)
Cash flows of discontinued operations:		
Cash provided by operating activities of discontinued operations		12
Cash provided by investing activities of discontinued operations	1	1,093
Increase in cash and cash equivalents from discontinued operations	1	1,105
Cash and cash equivalents at beginning of period	1,035	983
Cash and cash equivalents at end of period	$ 2,717	$ 1,811
Supplemental schedule of non-cash investing and financing activities:		
Common stock exchanged upon exercise of stock options	$ 52	$ 82
Common stock issued for settlement of accrued employee benefits	$ 32	$ 39
Fair value of assets acquired in acquisition	$ 18	$
Cash paid in acquisition, net of cash acquired of $1 in 2006	(14)	
Future acquisition payments accrued	(1)	
Liabilities assumed in acquisition	$ 3	$

See accompanying notes to condensed consolidated financial statements.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1 Summary of Significant Accounting Policies:

The condensed consolidated financial statements include the accounts of Science Applications International Corporation and all majority-owned and wholly-owned subsidiaries (collectively referred to as the Company or SAIC). All intercompany transactions and accounts have been eliminated in consolidation. The Company recognized revenues of $4 million and $3 million on sales to certain unconsolidated affiliates during the three months ended April 30, 2006 and 2005, respectively.

The accompanying financial information has been prepared in accordance with the instructions to Form 10-Q and therefore does not necessarily include all information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. The preparation of financial statements, in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingencies at the date of the financial statements as well as the reported amounts of revenues and expenses during the reporting periods. Estimates have been prepared by management on the basis of the most current and best available information and actual results could differ from those estimates.

In the opinion of management, financial information as of April 30, 2006 and for the three months ended April 30, 2006 and 2005 reflects all adjustments, which include only normal recurring adjustments, necessary for a fair presentation thereof. Operating results for the three months ended April 30, 2006 are not necessarily indicative of the results that may be expected for the fiscal year ending January 31, 2007. For further information and details on the Company s significant accounting policies, refer to the consolidated financial statements and notes to consolidated financial statements included in the Company s 2006 Annual Report on Form 10-K.

Reclassifications

Certain amounts in the condensed consolidated statements of income and cash flows for the three months ended April 30, 2005 have been reclassified to conform to the presentation for the three months ended April 30, 2006.

In the condensed consolidated statement of income for the three months ended April 30, 2005, the Company reclassified $13 million from cost of revenues to selling, general and administrative expenses to be consistent with the classification of these costs for the three months ended April 30, 2006 and its allocation of costs under cost accounting standards for U.S. Government contracts. This reclassification did not change previously reported net income or earnings per share.

In the condensed consolidated statement of cash flows for the three months ended April 30, 2005, the Company reclassified $39 million from stock-based compensation to changes in accrued payroll and employee benefits to reflect issuances of vested stock during the three months ended April 30, 2005 as settlement of certain bonus and retirement plan amounts expensed during the prior fiscal year. In addition, the Company disclosed these issuances of vested stock in the supplemental schedule of non-cash financing activities. This reclassification had no effect on previously reported total cash flows used in continuing operating activities.

In the condensed consolidated statement of cash flows for the three months ended April 30, 2005, the Company reclassified $12 million from repurchases of common stock to issuances of common stock to reflect shares issued under the Employee Stock Purchase Plan. The Company previously reported these amounts as a reduction to repurchases of common stock because they were part of the net limited market trade activity. This reclassification had no effect on previously reported total cash flows used in financing activities.

In the condensed consolidated statement of cash flows for the three months ended April 30, 2005, the Company increased purchases of marketable securities available-for-sale and proceeds from sales and maturities of marketable securities and other investments by $871 million to reflect purchases, sales and maturities of

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

marketable securities that occur within the Company s investment portfolios that are managed by third-party investment managers (managed portfolios). The Company previously did not report the cash outflows and inflows that occurred within the managed portfolios as purchases and sales and maturities, respectively, but rather reported the cash outflows and inflows between the Company and the managed portfolios. This reclassification had no effect on previously reported total cash flows used in investing activities.

Discontinued Operations

On March 15, 2005, the Company completed the sale of its subsidiary, Telcordia Technologies, Inc. (Telcordia). The operating results of Telcordia have been classified as discontinued operations (Note 11) for all periods presented.

Common Stock

The Company is authorized to issue 1 billion shares of Class A common stock, par value $.01 and 5 million shares of Class B common stock, par value $.05. As of April 30, 2006 and January 31, 2006, 169,280,000 and 167,379,000 shares of Class A common stock, respectively, and 206,000 shares of Class B common stock were issued and outstanding. Each share of Class B common stock is convertible into 20 shares of Class A common stock. Class A common stock and Class B common stock are collectively referred to as common stock in the condensed consolidated financial statements and notes to condensed consolidated financial statements and are shown assuming that the Class B common stock was converted into Class A common stock.

On September 1, 2005, the Company s newly formed wholly-owned subsidiary, SAIC, Inc., filed a registration statement on Form S-1 with the Securities and Exchange Commission (SEC) for an initial public offering of common stock (public offering). In addition, SAIC, Inc. filed a registration statement on Form S-4 with the SEC and the Company expects to deliver to its stockholders a proxy statement/prospectus to obtain stockholder approval of a merger agreement pursuant to which the Company would become a wholly-owned subsidiary of SAIC, Inc. Subject to stockholder approval of the merger agreement, satisfactory market conditions and other factors, the Company expects to complete the merger and the public offering in the Fall of 2006.

In conjunction with the proposed public offering, the Company expects to pay a special dividend to the holders of the Company s common stock as of a record date to be set by the board of directors. Payment will be conditioned upon completion of the public offering and it is anticipated that the dividend will be paid within 25 days after the completion of the public offering.

Note 2 Business Segment Information:

The following summarizes interim business segment information:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Revenues:		
Government	$ 1,809	$ 1,717
Commercial	146	131
Corporate and Other	3	(2)
Total reportable segment revenues	$ 1,958	$ 1,846
Segment operating income (loss):		
Government	$ 141	$ 114
Commercial	15	7
Corporate and Other	(14)	(11)
Total reportable segment operating income	$ 142	$ 110

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

As discussed in more detail in Note 2 of the notes to consolidated financial statements in the Company s 2006 Annual Report on Form 10-K, certain corporate expenses are reflected in segment operating income based on agreed-upon allocations to the segments or as required by Government Cost Accounting Standards. Corporate expense variances to these allocations are retained in the Corporate and Other segment. In certain circumstances, for management purposes as determined by the chief operating decision maker, certain revenue and expense items related to operating business units are excluded from the evaluation of a business unit s operating performance and are reflected in the Corporate and Other segment. The elimination of intersegment revenues is also reflected in the Corporate and Other segment. There were no sales between segments for the three months ended April 30, 2006 compared to $2 million for the three months ended April 30, 2005. Sales between segments are recorded at cost.

The following is a summary of depreciation and amortization included in the calculation of reportable segment operating income:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Depreciation and amortization:		
Government	$ 11	$ 12
Commercial	1	1
Corporate and Other	3	3
Total consolidated and reportable segment depreciation and amortization	$ 15	$ 16

The following reconciles total reportable segment operating income to the Company s total consolidated operating income:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Total reportable segment operating income	$ 142	$ 110
Investment activities		(1)
Equity in income of unconsolidated affiliates	(2)	
Minority interest in income of consolidated subsidiaries	3	3

Total consolidated operating income	$ 143	$ 112

Note 3 Stock-Based Compensation:

Change in Accounting Principle. The Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, on February 1, 2006. This statement requires that the Company recognize as compensation expense the fair value of all stock-based awards, including stock options, granted to employees and others in exchange for services, typically over the period during which such awards are earned. SFAS No. 123(R) requires that the Company recognize as compensation expense the 15% discount on employee stock purchases made under its Employee Stock Purchase Plan (ESPP). SFAS No. 123(R) also requires that cash flows resulting from excess tax benefits be classified as cash flows from financing activities instead of cash flows from operating activities.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Prior to February 1, 2006, the Company accounted for employee stock-based compensation using the intrinsic value method of Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations. Under the intrinsic value method, no compensation expense was reflected in net income for stock options granted to employees, as all stock options had an exercise price equal to the fair value of the underlying common stock on the date of grant. Additionally, no compensation expense was recognized for the ESPP because it was a non-compensatory plan. Compensation expense was recognized for grants of vesting and vested stock awards based on the fair value of the underlying common stock on the date of grant, with vesting stock expense recognized on the straight line basis over the period under which the awards are earned. The Company accounted for stock options granted to non-employees using the fair value method under SFAS No. 123, Accounting for Stock-Based Compensation.

The Company adopted SFAS No. 123(R) using the modified prospective transition method for stock-based awards granted after September 1, 2005, the date the Company s wholly-owned subsidiary, SAIC, Inc., made its initial filing with the SEC for the public offering described in Note 1, and the prospective transition method for stock-based awards granted prior to September 1, 2005. Under the modified prospective transition method, compensation expense associated with options granted between September 1, 2005 and January 31, 2006, valued at approximately $11 million, is recognized over their remaining vesting period, net of estimated forfeitures. In accordance with the modified prospective transition method, results from prior periods have not been restated. Under the prospective transition method, the Company continues to account for options granted prior to September 1, 2005 under the provisions of APB Opinion No. 25. Accordingly, no compensation expense will be recognized for options granted prior to September 1, 2005 unless a modification is made to those options. This difference in accounting treatment is due to the fact that the Company met the definition of a non-public company under SFAS No. 123 and applied the minimum value method (assumed no volatility in its pro forma stock-based employee compensation expense disclosures) under SFAS No. 123 prior to September 1, 2005. The cumulative effect of adopting SFAS No. 123(R) using the modified prospective transition method was de minimus.

Stock-Based Compensation Expense. The Company recognizes stock-based compensation expense on options and vesting stock awards using the straight-line method over the period the awards are earned. Total stock-based compensation expense for the three months ended April 30, 2006 was $15 million, including $5 million associated with stock options, $7 million associated with vesting stock awards and $3 million associated with the 15% discount on the fair value of stock purchased by employees through the ESPP. For the three months ended April 30, 2005, stock-based compensation expense was $8 million associated with vesting stock awards. These amounts do not include amounts accrued under the Company s Bonus Compensation Plan during the three months ended April 30, 2006 and 2005 as the amounts to be settled through the issuance of vested stock are not known when the accruals are made. The Company issued $32 million and $39 million in vested stock during the three months ended April 30, 2006 and 2005, respectively, as settlement of certain bonus and retirement plan amounts expensed during the respective prior fiscal years.

Tax benefits recognized related to stock-based compensation for the three months ended April 30, 2006 and 2005 were $5 million and $3 million, respectively. Tax benefits realized related to the exercise of options for the three months ended April 30, 2006 and 2005 were $17 million and $27 million, respectively, and were recorded as additional paid-in capital. These amounts continue to be shown as cash flows from operating activities in the accompanying statements of cash flows as the tax benefits relate to awards granted prior to September 1, 2005.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Stock Options. The 1999 Stock Incentive Plan provides the Company and its affiliates employees, directors and consultants the opportunity to receive stock options, stock appreciation rights, vested stock awards, restricted stock awards, restricted stock units, performance awards, and other similar types of stock awards. Unless otherwise stated in an award agreement, the plan also provides that outstanding awards will become fully vested upon the occurrence of a change in control of the Company as defined by the plan. Options are granted with exercise prices equal to the fair value of the Company s Class A common stock on the date of grant and for terms not greater than ten years. Options outstanding at April 30, 2006 were granted with terms of five years. Options granted under this plan generally become exercisable 20%, 20%, 20%, and 40% after one, two, three and four years, respectively. As of April 30, 2006, 54 million shares of common stock were authorized and reserved for issuance upon exercise of options which are outstanding or which may be granted. Shares are issued from this reserve upon exercise.

The fair value of the Company s stock option awards is estimated on the date of grant using the Black-Scholes option-pricing model. As the Company s common stock is not publicly-traded, expected volatility is based on a weighted average historical volatility, for a period consistent with the estimated option lives, of a group of publicly-traded peer companies. The risk-free rate is based on the yield curve of a zero-coupon U.S. Treasury bond with a maturity equal to the expected term of the option on the grant date. The Company uses historical data to estimate forfeitures. The expected term of awards granted is derived from historical experience under the Company s stock-based compensation plans and represents the period of time the awards are expected to be outstanding. The fair value of options granted during the three months ended April 30, 2006 was determined using the following weighted average assumptions: no dividend yield, a weighted average volatility rate of 33%, a risk-free rate of 4.7% and expected lives of 3.9 years. The weighted average grant-date fair value of stock options granted during the three months ended April 30, 2006 was $14.35.

Stock option activity under the 1999 Stock Incentive Plan for the three months ended April 30, 2006 was as follows:

	Shares of common stock under options	Weighted average exercise price	Weighted average remaining contractual term	Aggregate intrinsic value
	(In millions)			(In millions)
Outstanding at February 1, 2006	27.6	$ 34.27	2.5	$ 266
Options granted	4.4	43.92		
Options forfeited or expired	(.7)	33.28		
Options exercised	(2.2)	30.98		28
Outstanding at April 30, 2006	29.1	36.01	2.8	230
Exercisable at April 30, 2006	12.0	32.82	1.7	133

Vested and expected to vest in the future as of April 30, 2006	26.7	35.59	2.7	222
Available for grant at April 30, 2006	25.3			

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

During the three months ended April 30, 2006, the Company received cash from exercises of stock options of $16 million and common stock exchanged at fair value upon exercise of stock options of $52 million.

As of April 30, 2006, there was $56 million of total unrecognized compensation cost related to stock options granted under the 1999 Stock Incentive Plan which is expected to be recognized over a weighted-average period of 3.6 years. As explained, the Company continues to account for stock option awards granted prior to September 1, 2005 under the provisions of APB Opinion No. 25.

Stock Awards. The Company has a Bonus Compensation Plan (BCP) which provides for bonuses to reward outstanding performance in the form of cash, vested or vesting shares of the Company s common stock. The board of directors or its committee administering the bonus compensation plan may at any time amend, suspend, or terminate the plan. Awards of vesting shares of the Company s common stock vest at the rate of 20%, 20%, 20% and 40% after one, two, three and four years, respectively. Outstanding bonus awards become fully vested upon the occurrence of a change in control of the Company as defined by the plan unless otherwise provided in an award agreement.

The fair value of the Company s stock awards granted through the BCP is determined based on the fair value of the Company s Class A common stock on the grant date. Compensation expense is measured at the grant date and generally recognized over the vesting period of four years. The number of shares available for grant under the BCP is determined each year by the administering committee. The BCP does not provide for a maximum number of shares available for future issuance however, the bonus pool (including cash and stock awards) for each fiscal year cannot exceed 7.5% of the Company s revenues for the fiscal year.

Vesting stock award activity under the BCP for the three months ended April 30, 2006 was as follows:

	Shares of common stock under stock awards	Weighted average grant-date fair value
	(in millions)	
Unvested at February 1, 2006	2.4	$ 36.22
Awards granted	.9	43.92
Awards vested	(.6)	34.23
Unvested at April 30, 2006	2.7	39.24

As of April 30, 2006, there was $82 million of total unrecognized compensation cost related to vesting stock awards granted under the BCP which is expected to be recognized over a weighted-average period of 2.9 years. The fair value of vesting stock awards that vested under the BCP during the three months ended April 30, 2006 was $27 million.

Stock Compensation Plans. The Company has a Stock Compensation Plan (SCP) and Management Stock Compensation Plan (MSCP), together referred to as the Stock Compensation Plans. The board of directors may at any time amend or terminate the Stock Compensation Plans. The Stock Compensation Plans provide for awards

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

in share units to eligible employees. Benefits from these plans are payable in shares of the Company s common stock that are held in a trust for the benefit of the plans participants. The fair value of stock awards granted under the Stock Compensation Plans, which are vesting stock awards, is based on the fair value of the award on the date of grant.

For awards granted prior to January 1, 2006, participants interests in these share units vested on a seven year schedule at the rate of one-third at the end of each of the fifth, sixth and seventh years following the date of the award. In 2006, the board of directors amended the vesting period for new awards granted under the Stock Compensation Plans. New awards granted on or after January 1, 2006 vest 100% after four years. Upon a change in control of the Company as defined by the plan, participant accounts will become fully vested and will be immediately distributed. The Stock Compensation Plans do not provide for a maximum number of shares available for future issuance.

Vesting stock award activity under the Stock Compensation Plans for the three months ended April 30, 2006 was as follows:

	Shares of common stock under stock awards	Weighted average grant-date fair value
	(In millions)	
Unvested at February 1, 2006	1.4	$ 30.99
Awards granted	.2	43.92
Unvested at April 30, 2006	1.6	32.55

As of April 30, 2006, there was $32 million of total unrecognized compensation cost related to vesting stock awards granted under the Stock Compensation Plans which is expected to be recognized over a weighted-average period of 4.0 years.

ESPP. The ESPP allows eligible employees to purchase shares of the Company s common stock at a discount of 15% of fair value on the date of purchase. The current ESPP terminates on July 31, 2007, unless terminated earlier by the board of directors.

Note 4 Acquisition:

During the three months ended April 30, 2006, the Company completed one acquisition in its Government segment for an aggregate purchase price of $16 million, which consisted of $15 million paid in cash and accrued acquisition payments of $1 million payable once certain conditions have been met. The preliminary purchase price allocation resulted in identifiable intangible assets of $2 million and goodwill of $12 million, all of which is tax deductible. The Company has not yet obtained all the information required to complete the purchase price allocation related to this acquisition. The final purchase price allocation will be completed once the information identified by the Company has been received, which should not be longer than one year from the date of acquisition.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Note 5 Intangible Assets:

Intangible assets consisted of the following:

	April 30, 2006			January 31, 2006		
	Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
	(In millions)					
Amortizable intangible assets:						
Customer contracts	$ 44	$ 22	$ 22	$ 48	$ 24	$ 24
Non-compete agreements	23	18	5	25	20	5
Software and technology	33	7	26	33	5	28
Other	7	2	5	6	2	4
Total amortizable intangible assets	107	49	58	112	51	61
Non-amortizable intangible assets:						
Tradenames	2		2	2		2
Total intangible assets	$ 109	$ 49	$ 60	$ 114	$ 51	$ 63

Amortizable intangible assets with a gross carrying value of $7 million became fully amortized at January 31, 2006 and, therefore, are no longer reflected in the gross carrying value after that date. Amortization expense related to amortizable intangible assets was $5 million and $6 million for the three months ended April 30, 2006 and 2005, respectively.

Based on the intangible assets as of April 30, 2006, the estimated annual amortization expense related to amortizable intangible assets, including the preliminary allocation of purchase price and related intangible amortization of acquisitions made through April 30, 2006, is as follows (in millions):

Year Ending January 31,	
2007	$ 24

2008	13
2009	10
2010	6
2011	4
Thereafter	6
	$ 63

Actual amortization expense in future periods could differ from these estimates as a result of acquisitions, divestitures, impairments and other factors.

There were no impairment losses for intangible assets during the three months ended April 30, 2006 and 2005.

Note 6 Revolving Credit Facilities:

As of April 30, 2006, the Company had two revolving credit facilities (old credit facilities) totaling $750 million with a group of financial institutions that provided for (i) a five-year revolving credit facility of up to $500 million, which allowed borrowings until July 2007 and (ii) a five-year revolving credit facility of up to $250 million, which allowed borrowings until July 2009. Borrowings under the old credit facilities were

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

unsecured and bore interest at a rate determined, at the Company s option, based on either LIBOR plus a margin or a defined base rate. The Company paid a facility fee on the total commitment amount and a fee if utilization exceeded 50% of the total commitment amount. There were no borrowings outstanding under the old credit facilities as of April 30, 2006.

As of April 30, 2006, the entire amount under the $250 million five-year revolving credit facility was available and $387 million of the $500 million five-year revolving credit facility was available, reduced by $113 million of standby letters of credit issued in connection with the Company s contract with the Greek government. The terms of these standby letters of credit require them to remain outstanding until the customer formally accepts the system pursuant to the contract. The Company is in dispute with the customer on this contract as discussed in Note 10. The old credit facilities contained various covenants and restrictions, including financial covenants. The Company was in compliance with these financial covenants as of April 30, 2006.

On June 6, 2006, the Company terminated the old credit facilities and entered into a new five-year credit facility (new credit facility) to provide for borrowings of up to $750 million through 2011. Borrowings under the new credit facility are unsecured and bear interest at a rate determined, at the Company s option, based on either LIBOR plus a margin or a defined base rate. The Company pays a facility fee on the total commitment amount and an additional fee if borrowings exceed 50% of the total commitment amount, which fees may vary depending upon the Company s credit ratings. The new credit facility contains certain customary representations and warranties, as well as certain affirmative and negative covenants. The financial covenants contained in the new credit facility require that, for a period of four fiscal quarters beginning with the fiscal year ended January 31, 2006, the Company maintains a ratio of consolidated funded debt to earnings before interest, taxes, depreciation and amortization (EBITDA) of not more than 3.0 to 1.0 and a ratio of EBITDA to interest expense of greater than 3.5 to 1.0. Other covenants restrict certain of the Company s activities, including among other things, its ability to create liens, dispose of certain assets and merge or consolidate with other entities. The new credit facility also contains certain customary events of default, including, among others, defaults based on certain bankruptcy and insolvency events, nonpayment, cross-defaults to other debt, breach of specified covenants, ERISA events, material monetary judgments, change of control events and the material inaccuracy of its representations and warranties.

The Company transitioned its standby letters of credit issued in connection with the Greek contract to the new credit facility on June 6, 2006.

Note 7 Accumulated Other Comprehensive Loss and Comprehensive Income:

The components of accumulated other comprehensive loss were as follows:

	April 30, 2006	January 31, 2006
	(In millions)	

Unrealized net loss on derivative instruments	$ (11)	$ (11)
Minimum pension liability adjustments	(20)	(20)
Foreign currency translation adjustments	(1)	(1)
	$ (32)	$ (32)

Of the unrealized loss on derivative instruments as of April 30, 2006, $2 million is expected to be recognized as expense within the next 12 months.

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

Comprehensive income consisted of the following:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Net income	$ 106	$ 585
Other comprehensive income (loss), net of tax:		
Unrealized loss on marketable securities		(1)
Other		3
Total comprehensive income	$ 106	$ 587

Note 8 Earnings Per Share (EPS):

A reconciliation of the weighted average number of shares outstanding used to compute basic and diluted EPS is as follows:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Basic weighted average shares	168	179
Add: Dilutive common share equivalents		
Stock options	4	5
Unvested stock awards	2	
Diluted weighted average shares	174	184

Options to purchase 5,475,000 shares of common stock at prices between $43.39 and $43.92 per share were excluded from the calculation of dilutive common share equivalents during the three months ended April 30, 2006 because their effect would have been antidilutive. Such options expire in April 2011. There were no antidilutive potential shares for the three months ended April 30, 2005.

There were no adjustments to income from continuing operations and income from discontinued operations in calculating basic and diluted EPS for the three months ended April 30, 2006 and 2005.

Note 9 Other Income (Expense), Net:

The components of other income (expense), net were as follows:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Impairment losses on marketable securities and other investments	$	$ (2)
Equity interest in earnings of unconsolidated affiliates	2	
Other		1
Total other income (expense), net	$ 2	$ (1)

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SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(Unaudited)

For the three months ended April 30, 2005, the Company recognized impairment losses of $2 million on certain private equity securities due to declines in fair market value that were deemed to be other-than-temporary. The carrying value of the Company s private equity securities as of April 30, 2006 was $38 million.

Note 10 Commitments and Contingencies:

Telkom South Africa

As disclosed in the Company s 2006 Annual Report on Form 10-K, the Company s former Telcordia subsidiary instituted arbitration proceedings before the International Chamber of Commerce (ICC) against Telkom South Africa in March 2001 as a result of a contract dispute. Telcordia is seeking to recover damages of approximately $130 million, plus interest at a rate of 15.5%. Telkom South Africa counterclaimed, seeking substantial damages from Telcordia, including repayment of approximately $97 million previously paid to Telcordia under the contract and the excess costs of reprocuring a replacement system, estimated by Telkom South Africa to be $234 million. On September 27, 2002, Telcordia prevailed in the initial phase of the arbitration. The arbitrator found that Telkom South Africa repudiated the contract and dismissed Telkom South Africa s counterclaims against Telcordia. The damages to be recovered by Telcordia were to be determined in a second phase of the arbitration. Telkom South Africa successfully challenged the arbitrator s partial award in the Company s favor in the South African trial court and the Company has appealed this decision to the South African Supreme Court. In a separate proceeding, the Company unsuccessfully attempted to have its partial arbitration award confirmed by the U.S. District Court (New Jersey). The Company has appealed the ruling of United States District Court (New Jersey) to the U.S. Court of Appeals for the Third Circuit. Oral arguments were held on January 13, 2006 and the parties are awaiting a decision.

On March 15, 2005, the Company sold Telcordia to an affiliate of Warburg Pincus LLC and Providence Equity Partners Inc. (Note 11). Pursuant to the definitive stock purchase agreement relating to the sale, the Company is entitled to receive all of the net proceeds from any judgment or settlement with Telkom South Africa, and, if this dispute is settled or decided adversely against Telcordia, the Company is obligated to indemnify the buyer of Telcordia against any loss that may result from such an outcome.

Due to the complex nature of the legal and factual issues involved in the dispute and the uncertainty of litigation in general, the outcome of the arbitration and the related court actions are not presently determinable; however, an adverse resolution could materially harm the Company s business, consolidated financial position, results of operations and cash flows. The Company does not have any assets or liabilities recorded related to this contract and the related legal proceedings as of April 30, 2006 and January 31, 2006. The Company does not believe a material loss is probable based on the procedural standing of the case and its understanding of applicable laws and facts.

Firm Fixed-Price Contract with the Greek Government

Original Contract. In May 2003, the Company entered into a euro-denominated firm-fixed-price contract with the Hellenic Republic of Greece (the Customer), as represented by the Ministry of Defense, to provide a C4I (Command, Control, Communications, Coordination and Integration) System (the System), to support the 2004 Athens Summer Olympic Games (the Olympics), and to serve as the security system for the Customer s public order departments following completion of the Olympics. The System is comprised of 29 subsystems, organized into three major functional areas: the Command Decision Support System (CDSS), the Communication and Information System and the Command Center Systems. A significant amount of effort on this contract has been and will be performed by subcontractors to the Company. Under the contract, the System was to be completed,

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(Unaudited)

tested, and accepted by September 1, 2004, at a price of approximately $199 million. To date, the Company has received advance payments totaling approximately $147 million. The contract also requires the Company to provide five years of System support and maintenance for approximately $12 million and ten years of TETRA radio network services for approximately $104 million. Under the terms of the contract, the Company s obligation to provide the System support and maintenance and TETRA radio network services only begins upon System acceptance, which has not yet occurred. The contract contains an unpriced option for an additional five years of TETRA network services.

The Memorandum. On July 7, 2004, shortly before the start of the Olympics, the Company entered into an agreement (the Memorandum) with the Hellenic Republic, as represented by the Committee for Planning and Monitoring the Olympic Security Command Centers, pursuant to which the parties recognized and agreed that: (1) delivery and acceptance of the System had not been completed by the scheduled date; (2) the System would be delivered for use at the Olympics in its then-current state, which included certain omissions and deviations attributable to both parties; (3) a new process for testing and acceptance of the System would be instituted, with final acceptance to occur no later than October 1, 2004; (4) the Customer would proceed with the necessary actions for the completion of a contract modification as soon as possible; and (5) the Company would receive a milestone payment of approximately $23 million immediately upon the execution of the contract modification.

Delivery of System, Testing and Negotiations. The Customer took delivery of the System for use and operation during the Olympics, and continues to use significant portions of the System. The System has not been accepted by the Customer under the terms of the Greek contract, and the contract modification anticipated under the Memorandum has not been obtained. In November 2004, the Company delivered a revised version of the CDSS portion of the System to the Customer. Beginning in December 2004 and continuing through April 2005, the Customer performed subsystems acceptance testing on each of the subsystems comprising the System based on test procedures that had not been mutually agreed upon by the parties. The Customer identified numerous omissions and deviations in its test reports. The Company believes that certain of these omissions and deviations are valid, while others are not. From December 2004 through April 2005, the Company engaged in negotiations with the Customer concerning a modification to the contract to resolve the disputes. On April 28, 2005, the Customer formally notified the Company that the System delivered had significant deviations and omissions from the contractual requirements and may not be accepted.

Under the terms of the contract and the Memorandum between the parties, the Company submitted various proposals to the Customer to remedy these omissions and deviations. The most significant of these proposals includes a redevelopment of CDSS using an alternative technical approach, and a redesigned port security system. The first proposal for an alternative CDSS technical approach was submitted in June 2005. On November 25, 2005, the Customer notified the Company that its technical advisors declined to recommend either the acceptance or rejection of the Company s remediation plan for an alternative CDSS. On December 5, 2005, the Company sent a letter advising the Customer that unless an agreement is reached with respect to the alternative CDSS approach, the Company intends to initiate the dispute process contained in the Greek contract, which includes binding arbitration as its final step. On December 13, 2005, the Customer delivered a letter to the Company indicating that the Company s proposal based on the alternative CDSS approach is deemed acceptable in principle on the terms proposed. The parties reengaged in negotiations in early January 2006 on a contract modification to incorporate these proposals. A contract modification has not yet been executed and would be required in order for the Company to implement the proposals and achieve Customer acceptance of the System. The Company anticipates that such modification would include a revised testing and acceptance procedure which would provide for acceptance of individual subsystems on satisfactory completion of the testing of the subsystem. Until such acceptance occurs, the Customer has advised the Company that it cannot negotiate appropriate price adjustments for omissions and deviations of a subsystem.

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Subcontracts. The Company has subcontracted a significant portion of the requirements under the Greek contract, including the lease of certain equipment and TETRA network services for at least 10 years. In order for the Company to implement the technical proposals submitted to the Customer and contemplated by the modification being negotiated with the Customer, the Company would need to negotiate and execute modifications to the subcontracts with our subcontractors, including price. Certain of the omissions and deviations of the System are attributable to subcontracted work. Payments to the subcontractors are generally required only if the Company receives payment from the Customer related to the subcontractors work. If it is determined the Company breached its obligations to any of its subcontractors, the Company may incur additional losses.

Under the terms of the Greek contract, the Company is not obligated to provide TETRA network services to the Customer until the Customer has accepted the System. The Company and its subcontractors have provided System support and maintenance and TETRA network services to the Customer since the Olympics in August 2004, without receiving any compensation. In September 2005, the principal subcontractor notified the Company that it would no longer commit to continue providing TETRA network services, although it has continued to provide such services to date. On May 19, 2006, a second-tier subcontractor working for the Company s principal subcontractor responsible for providing the TETRA radio network services provided legal notice to the principal subcontractor that it will stop supporting and maintaining the TETRA subsystem at an unspecified date in the future. In a letter dated May 24, 2006, the principal subcontractor requested payment within 10 days from the Company for all payments under the subcontract. In a letter dated May 26, 2006, the Company advised its principal subcontractor that under the terms of the subcontract, receipt of full payment from the Customer is a condition to the Company s obligation to pay the subcontractor and that the Customer s refusal to pay the Company relates in part to deviations and omissions in the principal subcontractor s work.

Legality of the Contract. In March 2005, the Customer notified the Company that an issue had been raised concerning the legality of the contract by a Greek government auditor. In August 2005, the Company learned that the Court of Auditors of the Hellenic Republic (the Greek Audit Court), a government agency with authority to review and audit procurements, issued a decision finding that certain mistakes in the procurement process committed by the Greek government rendered the contract illegal. The Customer requested revocation of the Greek Audit Court decision. On November 17, 2005, the Greek Audit Court issued a decision finding that the errors committed by the Customer in the procurement process constituted pardonable mistakes with respect to prior payments under the contract. Although the rationale of the Greek Audit Court decision suggests that the Customer may be able to make future payments under the contract, the impact of the decision on the legality of the contract and the Customer s ability to make future payments is not clear. Recent communications from the Customer suggest that the Greek Audit Court may have to approve any modification to the contract, and payments made under the modified contract.

Financial Status and Contingencies of the Contract. The Company has recorded $121 million of contract losses as of April 30, 2006. While no losses were recorded on the contract during the three months ended April 30, 2006, $7 million was recorded during the three months ended April 30, 2005. These losses reflect the Company s estimated total cost to complete the System and obtain Customer acceptance and estimated reductions in price as a result of omissions and deviations from the contract requirements. Because of the significant uncertainties related to ultimate acceptance and payment from the Customer, the Company s current accounting treatment limits the total revenue to be realized under percentage of completion on the contract to the cash received to date. Although the Company expects to pursue remaining amounts owed under the terms of the contract, this reduction in total estimated revenues to be realized under the contract increased the total loss by $32 million during the year ended January 31, 2006, which is included in the loss amounts discussed above. Through April 30, 2006, the Company has recognized revenues of $119 million, which represents a portion of the $147 million cash collected to date based upon the percentage-of-completion method of revenue recognition.

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As of April 30, 2006, the estimated future costs to complete the System and obtain Customer acceptance is $52 million. This estimated cost is included in the $121 million contract loss recorded as of April 30, 2006. Management has used this estimate and its judgment in evaluating the various uncertainties and assumptions necessary to recognize the total estimated losses on this contract. Such assumptions include obtaining mutual agreement with the Customer regarding system requirements, execution of a modification to the contract, completion of the System and Customer acceptance. The total costs are significantly affected by the timing of events such as executing a contract modification and ultimate Customer acceptance. Management has estimated that final acceptance of the System under a modified contract will occur in January 2008. The Company s recorded losses exclude potential subcontractor payments associated with the omissions and deviations related to specific subsystems supplied by subcontractors in the amount of $13 million that management believes will not be paid under the subcontract terms.

The Company has $14 million of accounts receivable relating to Value Added Taxes (VAT) that it has paid and believes it is entitled to recover either as a refund from the taxing authorities or as a payment under the Greek contract upon final billing. The contract requires the Customer to pay amounts owed for VAT for the System delivered. Failure by the customer to pay these amounts could result in an additional obligation payable by the Company to the Greek taxing authorities and would increase the Company s total losses on the contract.

In accordance with the terms of the contract, the Company is required to provide certain payment, performance and offset bonds in favor of the Customer. These bonding requirements have been met through the issuance of standby letters of credit. Under the terms of these bonding arrangements, the Customer currently has the right to call some or all of the $242 million of standby letters of credit outstanding. The letters of credit supporting the payment bonds ($157 million) and performance bonds ($33 million) may be called by the Customer submitting a written statement to the guaranteeing bank that the Company has not fulfilled its obligations under the contract. The letters of credit supporting the offset bonds ($52 million) may be called by the Customer submitting a written statement to the guaranteeing bank that the Company has not fulfilled its obligations under a separate offset contract requiring the Company, among other things, to use Greek subcontractors on the contract. The Company believes that any amounts obtained by the Customer through such a calling of these letters of credit may be retained by the Customer only as security against any actual damages it proves in arbitration, and that any excess must be returned to the Company. The Company does not currently believe it is probable that the Customer will call these standby letters of credit. If the standby letters of credit are called, the Company may have the right to call some or all of the $102 million in bonds provided by its subcontractors in connection with their work under the contract.

Arbitration Proceedings. Although the Company has been pursuing a contract modification with the Customer since shortly after the Memorandum was signed in July 2004, due to the difficulties in reaching mutually satisfactory terms, the Company instituted arbitration proceedings on April 21, 2006 before the International Chamber of Commerce (ICC) against the Customer to pursue the Company s rights and remedies provided for in the contract and the Memorandum and under Greek law. The arbitration complaint filed by the Company: (1) seeks an order under the contract that the Customer s extended use of the System under the circumstances constitutes constructive acceptance and precludes the Customer from rejecting the System, (2) seeks damages for breach of contract, bad faith, use of the System and other damages, (3) seeks a determination as to the legal status of the contract as a result of the illegality issue discussed above, and (4) if the contract is determined to be illegal, seeks compensation for the commercial value of the System delivered and its use by the Customer and other damages. The Company is seeking damages in excess of $76 million, with the precise amount to be proven in arbitration. The Company agreed to extend to July 31, 2006 the time period in which the Customer may submit its response to the arbitration complaint in order to provide the parties additional time to attempt to negotiate and complete a modification. Under the terms of the contract, disputes are subject to

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ultimate resolution by binding arbitration before a panel of three Greek arbitrators in Greece. Due to the complex nature of the legal and factual issues involved and the uncertainty of litigation in general, the outcome of the arbitration is uncertain. There is no assurance that the Company will prevail in the arbitration.

In the event the Company does not prevail in the arbitration or is unable to resolve the various disputes under the contract as anticipated, it could incur additional losses. If the Customer asserts claims against the Company in the arbitration and it is determined that the Company has breached the contract and, as a result, owes the Customer damages, such damages could include, but are not limited to, (1) re-procurement costs, (2) repayment of amounts paid under the contract, (3) penalties for delayed delivery in an amount up to $15 million, and (4) forfeiture of good performance bonds in the amount of $33 million.

Successful imposition of damages or claims by the Customer or subcontractors against the Company, the calling of the Company s bonds, additional contract costs required to fulfill its obligations, or additional revenue reductions arising from the negotiation of the contract modification could have a material adverse affect on the Company s consolidated financial position, results of operations and cash flows.

DS&S Joint Venture

In March 2006, the Company sold its interest in DS&S, a joint venture in which the Company owned a 50% interest. As part of the sale, the Company agreed to indemnify the purchaser for certain legal costs and expenses, including those relating to an on-going government investigation involving DS&S and any litigation resulting from that investigation up to the sum of the sales price of $9 million plus the amount received by the Company in repayment of a $1 million loan receivable owed by DS&S. As of April 30, 2006, the Company has deferred any gain on this sale pending resolution of the on-going investigation and any resulting litigation.

INTESA Joint Venture

INTESA, a Venezuelan joint venture the Company formed in 1997 with Venezuela s national oil company, PDVSA, to provide information technology services in Latin America, is involved in various legal proceedings. The Company had previously consolidated its 60% interest in the joint venture, but the operations of INTESA were classified as discontinued operations as of January 31, 2003 and INTESA is currently insolvent. PDVSA has refused to take action to dissolve the joint venture or have it declared bankrupt.

Outsourcing Services Agreement and Guarantee. INTESA had derived substantially all its revenues from an outsourcing services agreement with PDVSA that it entered into at the time the joint venture was formed. The services agreement expired on June 30, 2002 and the parties were not able to reach agreement on a renewal. The Company guaranteed INTESA s obligations under the services agreement to PDVSA. Under the terms of the services agreement, INTESA s liability for damages to PDVSA in any calendar year is capped at $50 million. As a result, the Company s maximum potential liability to PDVSA under the guarantee in any calendar year, based on the Company s guarantee of their ownership interest in INTESA, is $20 million. To date, PDVSA has not asserted any claims.

Expropriation of the Company s Interest in INTESA. In 2003 and 2004, PDVSA and the Venezuelan government took certain actions, including denying INTESA access to certain of its facilities and assets, which prevented INTESA from continuing operations. In 2004, the Overseas Private Investment Company (OPIC), a U.S. governmental entity that provides insurance coverage against expropriation of U.S. business interests by foreign governments, determined that the Venezuelan government had expropriated the Company s interest in INTESA without compensation and paid the Company approximately $6 million in settlement of its claim.

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Employment Claims of Former INTESA Employees. INTESA is a defendant in a number of lawsuits brought by former employees seeking unpaid severance and pension benefits. PDVSA and SAIC Bermuda, the Company s wholly-owned subsidiary and the entity that held the Company s interest in INTESA, were added as defendants in a number of these suits. Based on the procedural standing of the cases and the Company s understanding of applicable laws and facts, the Company believes that its exposure to any possible losses related to these employment claims is either remote, or if reasonably possible, not material.

Other Legal Proceedings Involving INTESA. The Attorney General of Venezuela initiated a criminal investigation of INTESA in 2003 alleging unspecified sabotage by INTESA employees. The Company believes this investigation is inactive. In connection with the Company s expropriation claim, OPIC determined that INTESA did not sabotage PDVSA s infrastructure as alleged by PDVSA and the Venezuelan government. In addition, the SENIAT, the Venezuelan tax authority, filed a claim against INTESA in 2004 for approximately $30 million for alleged non-payment of VAT taxes in 1998.

Potential Financial Impact. Many issues relating to INTESA, including the termination of the services agreement and the employment litigation brought by former INTESA employees, remain unresolved. Due to the complex nature of the legal and factual issues involved in these matters and the uncertain economic and political environment in Venezuela, the outcome is not presently determinable and no amounts have been accrued; however, adverse resolutions could materially harm the Company s business and could have a material adverse affect on its consolidated financial position, results of operations and cash flows.

Other Joint Ventures

The Company is an investor in Danet Partnership GbR (Danet GbR), a German partnership, accounted for under the equity method. Danet GbR is the controlling shareholder in Danet GmbH, a German operating company. Danet GbR has an internal equity trading market similar to the Company s limited market. The Company is required to provide liquidity rights to the other Danet GbR investors in certain circumstances. Absent a change in control whereby the Company gains control over Danet GbR, these rights allow Danet GbR investors who are withdrawing from the partnership to put their Danet GbR shares to the Company in exchange for the current fair value of those shares. If the Company gains control over Danet GbR, all Danet GbR investors have the right to put their Danet GbR shares to the Company in exchange for the current fair value of those shares. If Danet GbR investors put their shares to the Company, the Company may pay the put price in shares of its common stock or cash. The Company does not currently record a liability for these put rights because their exercise is contingent upon the occurrence of future events which the Company cannot determine will occur with any certainty. During the three months ended April 30, 2006, the Company paid less than $1 million to withdrawing Danet GbR investors who exercised their right to put their Danet GbR shares to the Company. The maximum potential obligation assuming all the current Danet GbR investors were to put their Danet GbR shares to the Company was $7 million as of April 30, 2006. If the Company were to incur the maximum obligation and buy all the partnership shares currently held by other Danet GbR investors, the Company would then own 100% of Danet GbR and would hold a controlling interest in Danet GmbH.

The Company has a guarantee that relates only to claims brought by the sole customer of another of its joint ventures, Bechtel SAIC Company, LLC, for specific contractual nonperformance of the joint venture. The Company also has a cross-indemnity agreement with the joint venture partner, pursuant to which it will only be ultimately responsible for the portion of any losses incurred under the guarantee equal to its ownership interest of 30%. Due to the nature of the guarantee, the Company is not able to project the maximum potential amount of future payments it could be required to make under the guarantee as of April 30, 2006 but, based on current conditions, the Company believes the likelihood of having to make any payment is remote. No liability relating to this guarantee is currently recorded.

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On September 15, 2004, the Company entered into an agreement with EG&G Technical Services, Inc. (EG&G) and Parsons Infrastructure & Technology Group, Inc. (Parsons) to form Research and Development Solutions, LLC (RDS), a Delaware limited liability company that will pursue contracts offered by the Department of Energy s National Energy Technical Laboratory. The Company, EG&G and Parsons, each have a one-third equal joint venture interest. In conjunction with a contract award to RDS, each joint venture partner was required to sign a performance guarantee agreement with the U.S. Government. Under this agreement, the Company unconditionally guarantees all of RDS s obligations to the U.S. Government under the contract award, which has an estimated total value of $217 million. The Company also has a cross-indemnity agreement with each of the other two joint venture partners to protect it from liabilities for any U.S. Government claims resulting from the actions of the other two joint venture partners and to limit the Company s liability to its share of the contract work. As of April 30, 2006, the fair value of the guarantee is not material to the Company.

Other

The Company is subject to investigations and reviews relating to compliance with various laws and regulations with respect to its role as a contractor to agencies and departments of the U.S. Government and in connection with performing services in countries outside of the United States. Such matters can lead to criminal, civil or administrative proceedings and the Company could be faced with fines, repayments or compensatory damages. Adverse findings could also have a material adverse effect on the Company because of its reliance on government contracts. Although the Company can give no assurance, based upon management s evaluation of current matters that are subject to U.S Government investigations of which the Company is aware and based on management s current understanding of the facts, the Company does not believe that the outcome of any such matter would have a material adverse effect on its consolidated financial position, results of operations, cash flows or its ability to conduct business.

The Company is also involved in various claims and lawsuits arising in the normal conduct of its business, none of which, in the opinion of the Company s management, based upon current information, is expected to have a material adverse effect on its consolidated financial position, results of operations, cash flows or its ability to conduct business

In the normal conduct of its business, the Company seeks to monetize its patent portfolio through licensing agreements. The Company also has and will continue to defend its patent positions when it believes its patents have been infringed and is involved in such litigation from time to time. As described in Note 11, the Company sold its Telcordia subsidiary. Pursuant to the terms of the definitive stock purchase agreement, the Company will receive 50% of the net proceeds Telcordia receives in the future in connection with the prosecution of certain patent rights.

The Company is subject to routine compliance reviews by the Internal Revenue Service (IRS) and other taxing jurisdictions on various tax matters, which may include challenges to various tax positions the Company has taken. The Company has recorded liabilities for tax contingencies for open years based upon its best estimate of the taxes ultimately expected to be paid. As of April 30, 2006, the income taxes payable balance included $58 million of tax expense accruals that have been recorded for tax contingencies. The Company is currently undergoing several routine IRS and other tax jurisdiction examinations. While the Company believes it has adequate accruals for tax contingencies, there is no assurance that the tax authorities will not assert that the Company owes taxes in excess of its accruals, or that there will not be accruals in excess of the final amounts agreed to by the tax authorities.

SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

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(Unaudited)

Note 11 Discontinued Operations:

On March 15, 2005, the Company completed the sale of its Telcordia subsidiary for approximately $1.35 billion. The sales price continues to be subject to adjustment for the settlement of certain litigation and tax contingencies as described below. The Company recorded a gain on sale before income taxes of $861 million during the three months ended April 30, 2005. During the three months ended April 30, 2006, an income tax benefit of $12 million was recorded to reflect the resolution of certain tax contingencies related to Telcordia operations prior to the sale.

The Company is entitled to receive additional amounts as contingent sales price, including all of the net proceeds from any judgment or settlement of the litigation Telcordia initiated against Telkom South Africa and 50% of the net proceeds Telcordia receives in connection with the prosecution of certain patent rights of Telcordia as described in Note 10. In addition to customary indemnifications to the buyer, the Company has indemnified the buyer for all income tax obligations on and through the date of close and for any loss Telcordia may incur as a result of an adverse judgment in the Telkom South Africa litigation. While the Company believes it has adequate accruals for these contingencies, the ultimate resolution of these matters could differ from the amounts accrued. The impact of these future contingent payments or contingent purchase price proceeds as well as changes in estimates for these items, if any, will continue to be reflected as discontinued operations in the period in which they arise.

The operating results of Telcordia have been classified as discontinued operations for all periods presented. Telcordia s operating results were as follows:

	Three Months Ended April 30	
	2006	2005
	(In millions)	
Revenues	$ —	$ 89
Costs and expenses		
Cost of revenues		57
Selling, general and administrative expenses		28
Income before income taxes	$ —	$ 4

As a result of the sale of Telcordia, the Company s common stock is no longer an investment choice in the Telcordia 401(k) Plan. As of April 30, 2006, the Telcordia 401(k) Plan held 3.5 million shares of the Company s common stock, which had a fair value of $156 million. The Company no longer has a right of repurchase under the terms of its Restated Certificate of Incorporation with respect to the shares of the Company s common stock held by the Telcordia 401(k) Plan or any other contractual right to repurchase these shares. However, the Company agreed to provide an opportunity for the Telcordia 401(k) Plan to sell shares of the Company s Class A common stock in any trade in which its retirement plans have such an opportunity prior to completion of the public offering. Further, the Company agreed that if the public offering is completed, the Telcordia 401(k) Plan will have the same opportunity to sell shares of Class A preferred stock of SAIC, Inc. as other stockholders generally, but will not have the opportunity to sell such shares in any additional opportunities provided to the Company s retirement plans that are not otherwise provided to other stockholders generally.

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Annex A

AGREEMENT AND PLAN OF MERGER

(as amended and restated)

This AGREEMENT AND PLAN OF MERGER, as amended and restated as of June 26, 2006 (this *Agreement*), is by and among Science Applications International Corporation, a Delaware corporation (*Old SAIC*), SAIC, Inc., a Delaware corporation and a wholly-owned subsidiary of Old SAIC (*New SAIC*), and SAIC Merger Sub, Inc., a Delaware corporation and a wholly-owned subsidiary of New SAIC (*SAIC MergerSub*).

RECITALS

A. The respective boards of directors of Old SAIC, New SAIC and SAIC MergerSub have determined that it is advisable and in the best interests of each corporation that SAIC MergerSub merge with and into Old SAIC (the *Merger*) upon the terms and subject to the conditions of this Agreement. As a result of the Merger, Old SAIC will become a wholly owned subsidiary of New SAIC and the separate existence of SAIC MergerSub will cease.

B. The respective boards of directors of Old SAIC, New SAIC and SAIC MergerSub, by resolutions duly adopted, have authorized, approved and adopted this Agreement. The Board of Directors of Old SAIC resolved that this Agreement will be submitted to the stockholders of Old SAIC at a special meeting of stockholders. The respective stockholders of New SAIC and SAIC MergerSub will also adopt this Agreement.

C. The parties intend by this Agreement to effect a reorganization under Sections 351 and/or 368 of the Internal Revenue Code of 1986, as amended (the *Code*).

NOW, THEREFORE, Old SAIC, New SAIC and SAIC MergerSub hereby agree as follows.

ARTICLE I

THE MERGER

1.1 *The Merger.* Upon the terms and subject to the conditions of this Agreement, and in accordance with the relevant provisions of the General Corporation Law of the State of Delaware (the *DGCL*), SAIC MergerSub will merge with and into Old SAIC upon the Effective Time, as defined in this Agreement. Old SAIC will be the surviving corporation in the Merger (the *Surviving Corporation*). Upon the Effective Time, the separate existence of SAIC MergerSub will cease, and the Surviving Corporation will succeed to all of the rights and property of SAIC MergerSub, and will be subject to all of the debts and liabilities of SAIC MergerSub, as provided for in Section 259 of the DGCL. On and after the Effective Time, the Surviving Corporation will carry on its business with the assets of SAIC MergerSub, as well as with the assets of the Surviving Corporation.

1.2 *Effective Time*. As soon as practicable following the satisfaction or waiver of the conditions set forth in Article III, the Merger will be consummated by filing a certificate of merger (the *Certificate of Merger*) with the Secretary of State of the State of Delaware in accordance with the DGCL. The Merger will become effective when the Certificate of Merger is filed or such later time as is set forth in the Certificate of Merger. The time when the Merger becomes effective is called the *Effective Time*.

1.3 *Certificate of Incorporation and Bylaws*. The Certificate of Incorporation and the Bylaws of Old SAIC in effect at the Effective Time will be the Certificate of Incorporation and Bylaws of the Surviving Corporation and will remain in effect until changed or amended as provided therein or by applicable law. The name of the Surviving Corporation will be Science Applications International Corporation.

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1.4 *Tax Treatment of Merger*. The parties agree to treat the Merger for U.S. federal income tax purposes as a tax-free reorganization under Sections 351 and/or 368 of the Code.

ARTICLE II

EFFECT ON CAPITAL STOCK AND EMPLOYEE BENEFIT PLANS

2.1 *Effect on Capital Stock*. At the Effective Time, by virtue of the Merger and without any action on the part of Old SAIC, New SAIC or SAIC MergerSub, or the stockholders, as applicable, of such entities:

(a) (i) Each share of Old SAIC class A common stock, par value $0.01 per share, issued and outstanding immediately before the Effective Time will convert into the right to receive in the aggregate two shares of New SAIC Class A preferred stock, par value $0.0001 per share (the *New SAIC Class A Preferred Shares*); and (ii) each share of Old SAIC class B common stock, par value $0.05 per share, issued and outstanding immediately before the Effective Time will, subject to the exercise of appraisal rights as set forth in Section 2.4 below, convert into the right to receive in the aggregate forty New SAIC Class A Preferred Shares. The New SAIC Class A Preferred Shares receivable by each holder as a result of such conversions will be divided among (A) shares of New SAIC series A-1 preferred stock; (B) shares of New SAIC series A-2 preferred stock; (C) shares of New SAIC series A-3 preferred stock; and (D) shares of New SAIC series A-4 preferred stock, as follows:

(1) First, subject to clause (2) and clause (3), the New SAIC Class A Preferred Shares receivable by each holder will be divided among four series of New SAIC Class A preferred stock on the following basis:

(a) 20% will be series A-1 shares;

(b) 20% will be series A-2 shares;

(c) 30% will be series A-3 shares; and

(d) 30% will be series A-4 shares.

(2) Second, any fractional shares that would otherwise be allocated to New SAIC series A-1 preferred stock, series A-2 preferred stock, series A-3 preferred stock and series A-4 preferred stock as a result of the division in clause (1) above will be aggregated and reallocated as described in clause (3) below.

(3) Third, if the total number of shares aggregated as a result of clause (2) above is one, that share will be allocated to New SAIC series A-1 preferred stock. If the total number of shares aggregated as a result of clause (2) above is two, then one of those shares will be allocated to New SAIC series A-1 preferred stock and one of those shares will be allocated to New SAIC series A-2 preferred stock. If the total number of shares aggregated as a result of clause (2) above is three, then one of those shares will be allocated to New SAIC series A-1 preferred stock, one of those shares will be allocated to New SAIC series A-2 preferred stock and one of those shares will be allocated to New SAIC series A-3 preferred stock.

As of the Effective Time, all shares of Old SAIC class A common stock and Old SAIC class B common stock will no longer be outstanding and will automatically be canceled and will cease to exist, and each holder of a certificate representing any such shares of Old SAIC class A common stock or Old SAIC class B common stock will cease to have any rights with respect thereto, except the right to receive the New SAIC Class A Preferred Shares to be issued in consideration therefor, subject to the exercise of appraisal rights as set forth in Section 2.4 below, and the right to receive any dividend declared and payable with respect to Old SAIC class A common stock and class B common stock held on the record date for such dividend.

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(b) Each share of SAIC MergerSub common stock outstanding immediately before the Effective Time will convert into one share of class A common stock, par value $0.01 per share, of the Surviving Corporation.

2.2 *Options or Other Rights*. Each option or other right to purchase or otherwise acquire shares of Old SAIC class A common stock granted and outstanding pursuant to Old SAIC s stock incentive or other plans immediately before the Effective Time will convert into an option or right to acquire shares of New SAIC Class A Preferred Shares. The number of New SAIC Class A Preferred Shares to be received by each holder pursuant to such option or other right shall be divided among the four series of New SAIC Class A Preferred Shares in the manner set forth in Section 2.1(a). From and after the Effective Time, New SAIC shall have all administrative authority with respect to such stock incentive or other plans to the extent that Old SAIC had such authority immediately prior to the Effective Time.

2.3 *Stock Certificates.* Following the Effective Time, each holder of a certificate or certificates formerly representing outstanding shares of Old SAIC class A common stock or class B common stock shall surrender the same to New SAIC or its transfer agent for cancellation. Upon surrender of such certificate or certificates, the holder thereof shall be entitled to receive in exchange therefor a number of shares of a series of New SAIC Class A Preferred Shares as determined pursuant to Section 2.1(a). Until so surrendered, subject to Section 2.5, each certificate which prior to the Effective Time represented shares of Old SAIC common stock shall be deemed for all purposes to represent ownership of the number of New SAIC Class A Preferred Shares determined under Section 2.1(a) as though such surrender had taken place. To the fullest extent authorized by law, all instructions, owners and notices recorded on Old SAIC s stock ledger in respect of shares of Old SAIC s common stock, whether certificated or uncertificated, will be recorded on the stock ledger of New SAIC in respect of such New SAIC Class A Preferred Shares. New SAIC Class A Preferred Shares issued pursuant to the Merger will be reflected on the stock ledger of New SAIC as uncertificated shares, except to the extent New SAIC determines that it will deliver a certificate or certificates therefor.

2.4 *Appraisal Rights*. Notwithstanding any provision of this Agreement to the contrary and to the extent available under the DGCL, any shares of Old SAIC class B common stock outstanding immediately prior to the Effective Time that are held by a stockholder who has neither voted in favor of the Merger nor consented thereto in writing and who has demanded properly in writing appraisal for such shares in accordance with Section 262 of the DGCL (collectively, the *Class B Dissenting Shares*) will not be converted into, or represent the right to receive, the New SAIC Class A Preferred Shares. Such stockholders will be entitled to receive payment of the appraised value of Class B Dissenting Shares held by them in accordance with the provisions of such Section 262, except that all Class B Dissenting Shares held by stockholders who have failed to perfect or who effectively have withdrawn or lost their rights to appraisal of such Class B Dissenting Shares under such Section 262 will thereupon be deemed to have been converted into, and to have become exchangeable for, as of the Effective Time, the right to receive the New SAIC Class A Preferred Shares. Notwithstanding anything to the contrary contained in this Section 2.4, if the Merger is terminated or abandoned, then the right of any stockholder to be paid the fair value of such stockholder s Class B Dissenting Shares pursuant to Section 262 of the DGCL will cease.

2.5 *Dividends and Distributions.* No dividends or other distributions with respect to New SAIC Class A Preferred Shares with a record date after the Effective Time shall be paid to the holder of any unsurrendered Old SAIC stock certificate with respect to the New SAIC Class A Preferred Shares to be received in respect thereof pursuant to the Merger until the surrender of such certificate in accordance with this Article II. Subject to the effect of applicable laws, following surrender of any such certificate, there shall be paid to the person receiving New SAIC Class A Preferred Shares pursuant to the Merger, without interest, (i) at the time of such surrender, the proportionate amount of any dividends or other distributions with a record date after the Effective Time theretofore paid with respect to the whole New SAIC Class A Preferred Shares received by the person pursuant

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to the Merger, and (ii) at the appropriate payment date, the proportionate amount of any dividends or other distributions with a record date after the Effective Time but prior to such surrender and a payment date subsequent to such surrender payable with respect to such New SAIC Class A Preferred Shares.

2.6 *Covenant to Contribute Capital*. Upon the Effective Time, each issued and outstanding share of common stock of New SAIC that is owned by Old SAIC immediately prior to the Effective Time will be returned to New SAIC as a contribution to capital.

ARTICLE III

CONDITIONS TO CONSUMMATION OF THE MERGER

3.1 *Conditions to Each Party s Obligation to Effect the Merger*. The respective obligations of each party to effect the Merger are subject to the satisfaction or waiver, where permissible, prior to the Effective Time, of the following conditions:

(a) this Agreement shall have been duly adopted by the requisite vote of the stockholders of Old SAIC and SAIC Merger Sub;

(b) New SAIC shall have amended its Certificate of Incorporation to read substantially in the form attached hereto as Exhibit A;

(c) New SAIC shall have amended its Bylaws to read substantially in the form attached hereto as Exhibit B;

(d) The members of the Board of Directors, members of the committees of the Board of Directors and the executive officers of Old SAIC in office immediately prior to Effective Time, including any persons elected or appointed after the date of this Agreement, shall be elected or appointed to serve as the members of the Board of Directors, members of committees of the Board of Directors and the executive officers, respectively, of New SAIC, from and after the Effective Time in accordance with the bylaws of New SAIC, except for such persons who resign or leave Old SAIC, if any, prior to the Effective Time;

(e) the registration statement on Form S-4 and any post-effective amendment thereto filed with the Securities and Exchange Commission (*SEC*) by New SAIC in connection with the Merger shall have become effective under the Securities Act of 1933, as amended (the *Securities Act*), and shall not be the subject of any stop order or proceeding seeking a stop order;

(f) the registration statement on Form S-1 filed with the SEC by New SAIC in connection with the registration of New SAIC common stock shall become effective under the Securities Act, and shall not be the subject of any stop order or proceeding seeking a stop order, and the Board of Directors or a designated committee of the Board of Directors of Old SAIC shall have determined, in its sole discretion, that the sale of such stock will be successfully completed promptly after the completion of the Merger;

(g) no statute, rule, regulation, executive order, decree, injunction or other order shall have been enacted, entered, promulgated or enforced by any court or governmental authority that is in effect and has the effect of prohibiting the consummation of the Merger; and

(h) Old SAIC shall have received all governmental approvals and third-party consents required to be obtained by Old SAIC or its subsidiaries in connection with the Merger, except where the failure to obtain such approvals or consents would not reasonably be expected to have a material adverse effect on the business, financial condition or results of operations of Old SAIC and its subsidiaries taken as a whole.

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ARTICLE IV

TERMINATION

4.1 *Termination of Agreement*. This Agreement may be terminated and the Merger may be abandoned at any time prior to the Effective Time, before or after the approval of this Agreement by the stockholders of Old SAIC or SAIC MergerSub, by either (i) the mutual written consent of the Board of Directors of Old SAIC, the Board of Directors of New SAIC and the Board of Directors of SAIC MergerSub, or (ii) the Board of Directors of Old SAIC in its sole discretion.

4.2 *Effect of Termination and Abandonment*. In the event of termination of this Agreement and abandonment of the Merger pursuant to this Article IV, this Agreement shall forthwith become null and void and have no effect, and no party hereto shall have any liability or further obligation to any other party to this Agreement.

ARTICLE V

MISCELLANEOUS

5.1 *Further Assurances*. Each of Old SAIC, New SAIC and SAIC MergerSub shall use its best efforts to take all such action as may be necessary or appropriate to effectuate the Merger under the DGCL. If, at any time after the Effective Time, any further action is necessary or desirable to carry out the purposes of this Agreement, the Surviving Corporation, Old SAIC, New SAIC, SAIC MergerSub and their respective officers or other authorized persons are authorized to take any such necessary or desirable actions.

5.2 *Amendment*. This Agreement may be amended by the parties hereto at any time before or after adoption of the Agreement by the stockholders of Old SAIC or SAIC MergerSub, but after such stockholder approval, no amendment shall be made which by law requires the further approval of such stockholders without obtaining such further approval. This Agreement may not be amended except by an instrument in writing signed on behalf of each of the parties hereto.

5.3 *Entire Agreement; Assignment*. This Agreement and the exhibits and any documents delivered by the parties in connection herewith constitute the entire agreement and supersede all prior agreements and understandings, both written and oral, among the parties with respect to the subject matter hereof. Neither this Agreement nor any right, interest or obligation under this Agreement may be assigned, in whole or in part, by operation of law or otherwise, without the prior written consent of the other parties.

5.4 *Governing Law*. This Agreement will be governed by and construed in accordance with the substantive laws of the State of Delaware regardless of the laws that might otherwise govern under principles of conflicts of laws applicable thereto.

5.5 *Parties in Interest*. Nothing in this Agreement, express or implied, is intended to confer upon any other person any rights or remedies of any nature whatsoever under or by reason of this Agreement.

5.6 *Counterparts*. This Agreement may be executed in one or more counterparts, each of which will be deemed to be an original, but all of which will constitute one and the same agreement, and will become effective when one or more counterparts have been signed by each of the parties and delivered to the other parties.

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IN WITNESS WHEREOF, each of the parties has caused this Agreement to be executed on its behalf by its respective officers thereunto duly authorized.

SCIENCE APPLICATIONS INTERNATIONAL CORPORATION

a Delaware corporation

By:	/s/ DOUGLAS E. SCOTT
Name:	Douglas E. Scott
Title:	Senior Vice President, General Counsel and Secretary

SAIC, INC.,

a Delaware corporation

By:	/s/ DOUGLAS E. SCOTT
Name:	Douglas E. Scott
Title:	Senior Vice President, General Counsel and Secretary

SAIC MERGER SUB, INC.,

a Delaware corporation

By:	/s/ DOUGLAS E. SCOTT
Name:	Douglas E. Scott
Title:	Secretary

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Annex B

RESTATED CERTIFICATE OF INCORPORATION OF SAIC, INC.

SAIC, Inc., a Delaware corporation, hereby certifies as follows:

1. The name of the Corporation is SAIC, Inc.

2. The original Certificate of Incorporation of the Corporation was filed with the Secretary of State of the State of Delaware on August 12, 2005.

3. This Restated Certificate of Incorporation restates and amends the provisions of the Corporation s Certificate of Incorporation as heretofore amended and supplemented.

4. This Restated Certificate of Incorporation was duly adopted by the Corporation s Board of Directors and stockholders in accordance with Sections 228, 242 and 245 of the General Corporation Law of the State of Delaware (the *DGCL*).

5. The text of the Corporation s Certificate of Incorporation is hereby amended and restated to read in its entirety as follows:

FIRST: NAME. The name of the Corporation is SAIC, Inc.

SECOND: ADDRESS. The address of the registered office of the Corporation in the State of Delaware is 1209 Orange Street, in the City of Wilmington, County of New Castle, and the name of its registered agent at that address is The Corporation Trust Company.

THIRD: PURPOSE. The purpose of the Corporation is to engage in any lawful act or activity for which corporations may be organized under the DGCL.

FOURTH: CAPITALIZATION

(A) Authorized Capitalization.

The Corporation is authorized to issue three classes of capital stock to be designated, respectively, *Common Stock*, *Class A Preferred Stock* and *Preferred Stock*. The total number of shares of capital stock of all classes which the Corporation shall have the authority to issue is 3,510,000,000 shares, each with a par value of $0.0001 per share, of which:

(1) 2,000,000,000 shares shall be Common Stock;

(2) 1,500,000,000 shares shall be Class A Preferred Stock, of which (a) 100,000,000 shares shall be designated Series A-1 Preferred Stock (the *Series A-1 Preferred Stock*), (b) 100,000,000 shares shall be designated Series A-2 Preferred Stock (the *Series A-2 Preferred Stock*), (c) 150,000,000 shares shall be designated Series A-3 Preferred Stock (the *Series A-3 Preferred Stock*), and (d) 1,150,000,000 shares shall be designated Series A-4 Preferred Stock (the *Series A-4 Preferred Stock*); and

(3) 10,000,000 shares shall be Preferred Stock.

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The number of authorized shares of any class or classes of stock may be increased or decreased (but not below the number of shares thereof then outstanding) by the affirmative vote of the holders of at least a majority of the voting power of the issued and outstanding shares of Common Stock and Class A Preferred Stock of the Corporation, voting as a single class, irrespective of the provisions of Section 242(b)(2) of the DGCL or any corresponding provision hereinafter enacted.

(B) Common Stock and Class A Preferred Stock.

(1) ***General.*** The powers, preferences and rights of the Common Stock and the Class A Preferred Stock, and the qualifications, limitations or restrictions thereof, shall be in all respects identical, except as otherwise required by law or expressly provided in this Restated Certificate of Incorporation. The Common Stock and the Class A Preferred Stock shall be subject to the express terms of the Preferred Stock and any series thereof that may come into existence from time to time. The powers, preferences and rights of the Series A-1 Preferred Stock, the Series A-2 Preferred Stock, the Series A-3 Preferred Stock and the Series A-4 Preferred Stock, and the qualifications, limitations or restrictions thereof, shall be in all respects identical, except as otherwise required by law or expressly provided in this Restated Certificate of Incorporation.

(2) ***Voting.*** In all matters submitted to a vote of the stockholders of the Corporation, each holder of Common Stock shall be entitled to one vote, in person or by proxy, for each share of Common Stock standing in such holder s name on the stock transfer records of the Corporation; and each holder of Class A Preferred Stock shall be entitled to ten votes, in person or by proxy, for each share of Class A Preferred Stock standing in such holder s name on the stock transfer records of the Corporation. Unless otherwise required under applicable law (except as provided in Section (A)) or this Restated Certificate of Incorporation and subject to any rights that may be conferred upon the holders of any series of Preferred Stock that may come into existence from time to time, the holders of Common Stock and Class A Preferred Stock shall vote together as a single class on all matters submitted to a vote of stockholders of the Corporation.

(3) ***Dividends and Other Distributions.*** Subject to the rights of any series of Preferred Stock that may come into existence from time to time, and subject to Section (B)(7)(g), the holders of Common Stock and the holders of Class A Preferred Stock shall be entitled to share equally, on a per share basis, in such dividends and other distributions of cash, property or shares of the Corporation as may be declared thereon by the Board of Directors out of funds legally available therefor; *provided, however,* that in the event such dividend is paid in the form of shares of the Corporation s capital stock or rights to acquire shares of the Corporation s capital stock, the holders of Common Stock shall receive Common Stock or rights to acquire Common Stock, as the case may be, and the holders of Class A Preferred Stock shall receive Class A Preferred Stock or rights to acquire Class A Preferred Stock, as the case may be.

(4) ***Subdivisions or Combinations.*** If the Corporation shall in any manner split, subdivide or combine the outstanding shares of Common Stock, the outstanding shares of Class A Preferred Stock shall be proportionately split, subdivided or combined in the same manner and on the same basis; and if the Corporation shall in any manner split, subdivide or combine the outstanding shares of Class A Preferred Stock, the outstanding shares of Common Stock shall be proportionately split, subdivided or combined in the same manner and on the same basis.

(5) ***Mergers or Consolidations.*** In the event of any merger or consolidation to which the Corporation is a party (whether or not the Corporation is the surviving entity), the holders of Common Stock and Class A Preferred Stock shall be entitled to receive, on a per share basis, the same amount and form of stock and other securities and property (including cash).

(6) ***Liquidation.*** Subject to the rights of any series of Preferred Stock that may come into existence from time to time, in the event of the voluntary or involuntary liquidation, dissolution or winding up of the Corporation, the holders of Common Stock and the holders of Class A Preferred Stock shall be entitled to share equally, on a per share basis, in all assets of the Corporation of whatever kind available for distribution to the holders of the Corporation s capital stock.

(7) ***Conversion and Transfer Restrictions of the Class A Preferred Stock***

(a) Each record holder of shares of Class A Preferred Stock may convert any or all of those shares into an equal number of shares of Common Stock; *provided, however,* that: (A) no share of Series A-1 Preferred Stock may be converted into a share of Common Stock prior to 90 days after the public offering date; (B) no share of Series A-2 Preferred Stock may be converted into a share of Common Stock prior to 180 days after the public offering date; (C) no share of Series A-3 Preferred Stock may be converted into a share of Common Stock prior to 270 days after the public offering date; and (D) no share of Series A-4 Preferred Stock may be converted into a share of Common Stock prior to 360 days after the public offering date. Shares of Common Stock may not be converted into shares of Class A Preferred Stock.

(b) A record holder of shares of Class A Preferred Stock may effect a voluntary conversion of any or all of those shares in accordance with Section (B)(7)(a) by surrendering the certificates, if any, for the number of shares to be converted, accompanied by any required tax transfer stamps, and delivering a written notice by the record holder to the Corporation stating that such record holder desires to convert such shares into the same number of shares of Common Stock and requesting that the Corporation issue such shares of Common Stock to persons named therein, setting forth the number of shares of Common Stock to be issued to each such person and the denominations in which the certificates therefor, if any, are to be issued. To the extent permitted by law, such a voluntary conversion shall be deemed to have been effected at the close of business on the date of surrender of certificates, if any, or the date of receipt by the Corporation of the notice of conversion, if the shares to be converted are uncertificated.

(c) Shares of Series A-1 Preferred Stock may not be transferred to anyone other than a permitted transferee prior to 90 days after the public offering date. Shares of Series A-2 Preferred Stock may not be transferred to anyone other than a permitted transferee prior to 180 days after the public offering date. Shares of Series A-3 Preferred Stock may not be transferred to anyone other than a permitted transferee prior to 270 days after the public offering date. Shares of Series A-4 Preferred Stock may not be transferred to anyone other than a permitted transferee prior to 360 days after the public offering date. Except as provided in this Section (B)(7)(c), any purported transfer of shares of Class A Preferred Stock prior to the applicable date referred to in this Section (B)(7)(c) shall be void. Shares of Class A Preferred Stock may be transferred to a permitted transferee prior to the applicable date referred to in this Section (B)(7)(c), and such permitted transferee will take such shares subject to the provisions of this Section (B)(7)(c). In addition to any vote required by law or this Restated Certificate of Incorporation, the affirmative vote of the holders of a majority of the outstanding shares of Common Stock, voting as a single class, shall be required in order to reduce, at any time within 360 days after the public offering date, the time periods in this Section (B)(7)(c) during which the Class A Preferred Stock cannot be transferred to anyone other than a permitted transferee.

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(d) After the applicable time period in Section (B)(7)(c) has expired, each share of Class A Preferred Stock shall automatically convert into one share of Common Stock upon the transfer of that share if, after the transfer, the share is not owned by a permitted transferee. In addition, notwithstanding any other provision of this Section (B)(7), each share of Class A Preferred Stock shall automatically convert into one share of Common Stock at the time of the transfer of that share in the following circumstances: (A) a transfer by a qualified retirement plan described in Section 401(a) of the Code sponsored by the Corporation or any of its subsidiaries (i) to the Corporation; (ii) to a distributee of any such plan pursuant to the terms of the plan; or (iii) pursuant to instructions of a participant in any such plan to sell or exchange Class A Preferred Stock pursuant to the terms of the plan; or (B) a transfer upon the exercise by a distributee of any such plan of any put right under the terms of the plan requiring the Corporation to purchase the share from the distributee. For purposes of the foregoing sentence, any transfer shall be deemed to be a transfer of Common Stock. In the case of any such automatic conversion, stock certificates, if any, formerly representing each such share of Class A Preferred Stock shall thereupon and, except for a transfer to the Corporation where the shares are being retired, thereafter be deemed to represent such number of shares of Common Stock into which such shares of Class A Preferred Stock could be converted pursuant to the terms hereof, such shares of Class A Preferred Stock so converted shall no longer be deemed to be outstanding, and all rights of a holder with respect to such shares shall immediately terminate, except any rights under Section (B)(7)(g).

(e) Shares of Class A Preferred Stock shall be transferred on the books of the Corporation, and a new certificate therefor, if any, issued, upon presentation at the office of the Secretary of the Corporation (or at such additional place or places as may from time to time be designated by the Secretary of the Corporation) of the certificate, if any, for the shares, in proper form for transfer and accompanied by all requisite stock transfer tax stamps, and such documentation as shall be reasonably satisfactory to the Corporation, including documentation showing compliance with this Article Fourth.

(f) Any person (other than a permitted transferee) who takes shares of Class A Preferred Stock in a transfer otherwise permitted by Section (B)(7) may treat the endorsement on the certificate, if any, representing such shares, or the instrument accompanying the transfer of such shares, as authorizing such person on behalf of the transferor to convert the shares in the manner provided in Section (B)(7)(a) for the purpose of registering the transfer to such person of the shares of Common Stock issuable upon conversion, and to give on behalf of the transferor the written notice of conversion required by Section (B)(7)(b), and may convert such shares of Class A Preferred Stock accordingly.

(g) Upon any conversion of shares of Class A Preferred Stock into shares of Common Stock pursuant to the provisions of this Section (B)(7), any dividend, for which the record date is prior to and the payment date is subsequent to the conversion, that has been declared on the shares of Class A Preferred Stock so converted shall be deemed to have been declared, and shall be payable, with respect to the shares of Common Stock into or for which the shares of Class A Preferred Stock are so converted, *provided* that any such dividend, for which the record date is prior to and the payment date is subsequent to the conversion, that is declared on the shares of Class A Preferred Stock payable in shares of Class A Preferred Stock shall be deemed to have been declared, and shall be payable, in shares of Common Stock.

(h) Any shares of Class A Preferred Stock that have been converted to shares of Common Stock will be retired with no further action by the Corporation, and will resume the status of authorized and unissued Class A Preferred Stock.

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(i) The Corporation at all times shall reserve and keep available, out of its authorized but unissued Common Stock, at least the number of shares of Common Stock that would become issuable upon the conversion of all shares of Class A Preferred Stock then outstanding.

(j) Every certificate for shares of Class A Preferred Stock shall bear a legend on its face reading as follows:

The shares of Class A Preferred Stock represented by this certificate may not be transferred (which term includes, without limitation, buying a put option, selling a call option or entering into any other hedging or insurance transaction relating to the shares) to any person in connection with a transfer that does not meet the qualifications set forth in Section (B)(7) of Article Fourth of the Restated Certificate of Incorporation of the Corporation, and no person who receives the shares represented by this certificate in connection with a transfer that does not meet the qualifications prescribed by Section (B)(7) of Article Fourth is entitled to own or to be registered as the record holder of the shares of Class A Preferred Stock represented by this certificate, but the record holder of this certificate may at any time (except as provided in Section (B)(7)(a) of Article Fourth) convert the shares of Class A Preferred Stock represented by this certificate into the same number of shares of Common Stock for purposes of effecting the sale or other disposition of the shares of Class A Preferred Stock to any person. Each holder of this certificate, by accepting the certificate, accepts and agrees to all of the foregoing.

In the case of uncertificated shares, an appropriate notice containing the applicable transfer restrictions shall be sent to the registered owner thereof.

(8) ***Definitions.*** For purposes of this Article Fourth, the following terms shall have the following meanings:

(a) *Code* means the Internal Revenue Code of 1986, as amended.

(b) *Employee benefit plan* means a pension plan within the meaning of Section 3(2) of the Employee Retirement Income Security Act of 1974, as amended, and a nonqualified deferred compensation plan within the meaning of Section 409A(d)(1) of the Code.

(c) *Immediate family member* means a person s spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law and anyone (other than domestic employees) who shares such person s home.

(d) *Individual retirement account* means an account as defined in Section 408(a) of the Code.

(e) *Permitted transferee* means:

(i) an immediate family member of the transferor;

(ii) a trust for the sole benefit of the transferor or an immediate family member of the transferor, and the transferor or any immediate family member of the transferor who receives shares of Class A Preferred Stock from any such trust;

(iii) an individual retirement account that receives shares of Class A Preferred Stock, provided that (A) the transferor is an employee benefit plan sponsored by the Corporation or any of its subsidiaries, (B) the transferor is a distributee of an employee benefit plan described in subclause

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(A), or (C) the transferor is an individual retirement account for the benefit of a distributee described in subclause (B);

(iv) the beneficial owner of an individual retirement account, provided that the transferor is such individual retirement account;

(v) the estate of a deceased holder of shares, provided that such transfer was pursuant to the deceased holder s will or the laws of distribution;

(vi) the beneficiary of an estate referred to in clause (v) above, provided that the transferor is such estate and such beneficiary is the immediate family member of the deceased or a trust for the sole benefit of such immediate family member;

(vii) an employee benefit plan sponsored by the Corporation or any of its subsidiaries;

(viii) a lending institution in connection with a pledge of shares and such shares are pledged as bona fide collateral for a loan to the transferor;

(ix) the Corporation or any of its subsidiaries;

(x) any distributee of an employee benefit plan sponsored by the Corporation or any of its subsidiaries pursuant to the terms of such plan, provided that the transferor is such employee benefit plan; and

(xi) an employee of the Corporation or any of its subsidiaries, provided that the transferor is the Corporation or any of its subsidiaries.

(f) *Public offering date* means the commencement of the Corporation s initial public offering of its Common Stock pursuant to a registration statement filed under the Securities Act of 1933, as amended.

(g) *Transfer* (and the related term *transferred*) means any sale, pledge, gift, assignment or other transfer (including by merger, testamentary disposition, interspousal disposition pursuant to a domestic relations proceeding or otherwise or otherwise by operation of law) of any ownership or voting interest in any share of Class A Preferred Stock, including:

(i) any offer, pledge, sale, contract to sell, sale of any option or contract to purchase, purchase of any option or contract to sell, grant of any option, right or warrant to purchase, loan or other direct or indirect transfer or disposal of: (A) any shares of Class A Preferred Stock; (B) any securities convertible into or exercisable or exchangeable for Class A Preferred Stock; or (C) any shares of Common Stock into which the shares of Class A Preferred Stock are convertible; or

(ii) entry into any swap or other arrangement (including by way of insurance) that transfers to another, in whole or in part, any of the economic consequences of ownership of any shares of Class A Preferred Stock or any shares of Common Stock into which the shares of Class A Preferred Stock are convertible;

regardless of whether any transaction described in clause (i) or (ii) above is to be settled by delivery of Class A Preferred Stock, Common Stock or other securities, in cash or otherwise; *provided, however,* that an original issuance of shares of capital stock by the Corporation or the transfer of shares of capital stock from the Corporation s treasury shall not be considered a transfer for purposes of this Article Fourth.

(h) *Subsidiary* means a corporation or other entity of which securities or other interests representing at least fifty percent of the voting power in the election of directors are held by the Corporation or its subsidiaries.

(C) Preferred Stock.

The Board of Directors is expressly authorized to provide for the issuance of all or any shares of the Preferred Stock, in one or more series, and to fix for each such series the number of shares thereof and such voting powers, full or limited, or no voting powers, and such distinctive designations, preferences and relative, participating, optional or other special rights and such qualifications, limitations or restrictions thereof, as shall be stated and expressed in the resolution or resolutions adopted by the Board of Directors providing for the issuance of such series and as may be permitted by the DGCL, including, without limitation, the authority to provide that any such series may be (a) subject to redemption at such time or times and at such price or prices; (b) entitled to receive dividends (which may be cumulative or non-cumulative) at such rates, on such conditions, and at such times, and payable in preference to, or in such relation to, the dividends payable on any other class or classes or any other series; (c) entitled to such rights upon the dissolution of, or upon any distribution of the assets of, the Corporation; or (d) convertible into, or exchangeable for, shares of any other class or classes of stock, or of any other series of the same or any other class or classes of stock, of the Corporation at such price or prices or at such rates of exchange and with such adjustments; all as may be stated in such resolution or resolutions.

FIFTH: BALLOT. Elections of directors need not be by written ballot unless the Bylaws of the Corporation shall otherwise provide.

SIXTH: BYLAWS. In furtherance and not in limitation of the powers conferred by statute, the Board of Directors is expressly authorized to make, repeal, alter, amend and rescind the Bylaws of the Corporation. No section of the Bylaws shall be adopted, repealed, altered, amended or rescinded by the stockholders of the Corporation except by the vote of the holders of not less than two-thirds of the total voting power of all outstanding shares of voting stock of the Corporation.

SEVENTH: THE BOARD OF DIRECTORS.

(A) Number of Directors and Classes of Directors. The number of directors which shall constitute the whole Board of Directors of the Corporation shall be not less than ten (10) and not more than eighteen (18), and the exact number shall be fixed by the Board of Directors. The Board shall be divided into three classes, Class I, Class II and Class III. Such classes shall be as nearly equal in number of directors as possible. Each such director shall serve for a term ending on the third annual meeting following the annual meeting at which such director was elected; provided, however, that the directors first elected to Class I shall serve for a term ending on the annual meeting next following the public offering date (used herein as defined for purposes of Article FOURTH), the directors first elected to Class II shall serve for a term ending on the second annual meeting next following the public offering date, and the directors first elected to Class III shall serve for a term ending on the third annual meeting next following the public offering date. The foregoing notwithstanding, each director shall serve until his or her successor shall have been duly elected and qualified, unless he or she shall resign, become disqualified, disabled or shall otherwise be removed.

At each annual election, the directors chosen to succeed those whose terms then expire shall be of the same class as the directors they succeed, unless, by reason of any intervening changes in the authorized number of

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directors, the Board shall designate one or more directorships whose term then expires as directorships of another class in order more nearly to achieve equality of number of directors among the classes.

Notwithstanding the rule that the three classes shall be as nearly equal in number of directors as possible, in the event of any change in the authorized number of directors each director then continuing to serve as such shall nevertheless continue as a director of the class of which he or she is a member until the expiration of his current term, or his or her prior death, resignation or removal. If any newly created directorship may, consistently with the rule that the three classes shall be as nearly equal in number of directors as possible, be allocated to one of two or more classes, the Board shall allocate it to that of the available classes whose term of office is due to expire at the earliest date following such allocation.

(B) Removal. Unless otherwise restricted by applicable law, any director or the entire Board may be removed, but only for cause, by the holders of two-thirds of the total voting power of all outstanding shares then entitled to vote at an election of directors.

(C) Cumulative Voting. At any election of directors of the Corporation, a holder of any class or series of stock then entitled to vote in such election shall be entitled to as many votes as shall equal the number of votes which (except for this Section (C) as to cumulative voting) such holder would be entitled to cast for the election of directors with respect to such holder s shares of stock multiplied by the number of directors to be elected in the election in which such holder s class or series of shares is entitled to vote, and such holder may cast all of such votes for a single director or may distribute them among the number to be voted for, or for any two or more of them as such holder may see fit.

(D) Vacancies. Any vacancy in the Board of Directors, whether because of death, resignation, disqualification, an increase in the number of directors, or any other cause, may only be filled by vote of the majority of the remaining directors, although less than a quorum. Each director so chosen to fill a vacancy shall hold office until his or her successor shall have been elected and shall qualify or until such director shall resign or shall have been removed.

EIGHTH: MEETINGS OF STOCKHOLDERS.

(A) No Action by Written Consent. No action shall be taken by the stockholders except at an annual or special meeting of stockholders, and no action may be effected by any consent in writing in lieu of a meeting of stockholders.

(B) Special Meetings. Special meetings of the stockholders of the Corporation for any purpose or purposes may be called at any time by the Board of Directors, or by a majority of the members of the Board of Directors, or by a committee of the Board of Directors which has been duly designated by the Board of Directors and whose powers and authority, as provided in a resolution of the Board of Directors or in the Bylaws of the Corporation, include the power to call such meetings, but such special meetings may not be called by any other person or persons; provided, however, that, if and to the extent that any special meeting of stockholders may be called by any other person or persons specified in any provisions of this Restated Certificate of Incorporation or any amendment thereto or any certificate filed under Section 151(g) of the DGCL (or its successor statute as in effect from time to time hereafter), then such special meeting may also be called by the person or persons, in the manner, at the times and for the purposes so specified.

NINTH: AMENDMENT. The Corporation reserves the right to amend, alter, change or repeal any provision contained in this Restated Certificate of Incorporation, in the manner now or hereafter prescribed by statute, and all rights conferred on stockholders herein are granted subject to this reservation. Notwithstanding the foregoing, the provisions set forth in Articles FIFTH, SIXTH, SEVENTH, EIGHTH and this Article NINTH may not be repealed or amended in any respect unless such repeal or amendment is approved by the affirmative vote of the holders of not less than two-thirds of the total voting power of all outstanding shares of voting stock of the Corporation.

TENTH: BUSINESS COMBINATIONS

(A) For the purposes of this Article TENTH:

(1) The term *person* shall mean any individual, firm, limited liability company, partnership, limited partnership, corporation or other entity.

(2) The term *Subsidiary* shall mean any corporation more than fifty percent (50%) of any class of equity security of which is owned, directly or indirectly, by the Corporation.

(3) The term *Substantial Part of the Assets* shall mean assets having a fair market value or book value, whichever is greater, equal to more than ten percent of the fair market value or book value, whichever is greater, of the total assets of a person as of the end of its most recent fiscal year ending prior to the time the determination is made.

(4) A person shall be a *Beneficial Owner* of any shares of voting stock of the Corporation (a) which such person or any of its *affiliates* or *associates* (as defined on the date of the adoption hereof in Rule 12b-2 under the Securities Exchange Act of 1934, as amended (the *Exchange Act*)) beneficially owns, directly or indirectly, (b) which such person or any of its *affiliates* or *associates* has, directly or indirectly, (i) the right to acquire (whether such right is exercisable immediately or only after the passage of time) pursuant to any agreement, arrangement or understanding or upon the exercise of conversion rights, exchange rights, warrants or options, or otherwise or (ii) the right to vote or direct the voting of pursuant to any agreement, arrangement or understanding, *provided, however,* that a person shall not be deemed the Beneficial Owner of, or to beneficially own, any security by reason of such agreement, arrangement or understanding if the agreement, arrangement or understanding to vote such security (1) arises solely from a revocable proxy or consent given to such person in response to a public proxy or consent solicitation made pursuant to, and in accordance with, the applicable rules and regulations promulgated under the Exchange Act and (2) is not also then reportable on Schedule 13D under the Exchange Act (or any comparable or successor report), or (c) which are beneficially owned, directly or indirectly, by any other person with which such person or any of its *affiliates* or *associates* has any such agreement, arrangement or understanding for the purpose of acquiring, holding, voting or disposing of any shares of such voting stock.

(5) The term *Related Person* shall mean any person (except any profit-sharing, employee stock ownership or other employee benefit plan of the Corporation or any Subsidiary or any trustee of or fiduciary with respect to any such plan when acting in such capacity) which is the Beneficial Owner (as herein defined) of five percent (5%) or more of the total voting power of all of the outstanding shares of voting stock of the Corporation.

(6) For the purposes of determining whether a person is a Related Person, the number of shares of voting stock of the Corporation deemed to be outstanding shall include all shares deemed owned by such person through application of Section (A)(4), but shall not include any other shares of voting stock which may be issuable pursuant to any agreement, arrangement or understanding, or upon exercise of conversion rights, warrants or options, or otherwise.

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(7) The term *Business Combination* shall mean (a) any merger or consolidation of the Corporation or a Subsidiary with or into a Related Person, (b) any sale, lease, exchange, transfer, mortgage, pledge or other disposition (whether in one transaction or in a series of transactions) of all or any Substantial Part of the Assets (as herein defined) of a Related Person to the Corporation or to a Subsidiary, (c) any sale, lease, exchange, transfer, mortgage, pledge or other disposition (whether in one transaction or in a series of transactions) of all or any Substantial Part of the Assets of the Corporation (including without limitation any securities of a Subsidiary) to a Related Person, (d) the issuance of any securities of the Corporation or a Subsidiary to a Related Person, (e) the acquisition by the Corporation or a Subsidiary of any securities of a Related Person, (f) any reclassification of the securities (including any reverse stock split) or recapitalization of the Corporation, or any merger or consolidation of the Corporation with any Subsidiary or any other transaction (whether or not with or into or otherwise involving a Related Person) which has the effect, directly or indirectly, of increasing the proportionate amount of the outstanding shares of any class of equity securities or securities convertible into equity securities of the Corporation or any Subsidiary which is directly or indirectly owned by a Related Person, (g) any loan or other extension of credit by the Corporation or a Subsidiary to a Related Person or any guarantee by the Corporation or a Subsidiary of any loan or other extension of credit by any person to a Related Person, (h) the adoption of any plan or proposal for the dissolution, liquidation or termination of the Corporation or any Subsidiary proposed by or on behalf of a Related Person and (i) any agreement, contract or other arrangement providing for any of the foregoing Business Combination transactions.

(8) The term *Continuing Director* shall mean any member of the Board of Directors of the Corporation who is unaffiliated with the Related Person and was a member of the Board prior to the time that the Related Person became a Related Person, and any successor of a Continuing Director who is unaffiliated with the Related Person and is recommended or elected to succeed a Continuing Director by a majority of Continuing Directors, provided that such recommendation or election shall only be effective if made at a meeting at which a Continuing Director Quorum is present.

(9) The term *Continuing Director Quorum* shall mean a majority of the Continuing Directors capable of exercising the powers conferred upon them under the provisions of this Restated Certificate of Incorporation or the Bylaws of the Corporation or by law.

(B) The approval or authorization of any Business Combination (as herein defined) of the Corporation with any Related Person (as herein defined) shall require the affirmative vote of the holders of (i) at least 80% of the total voting power of all of the outstanding shares of voting stock of the Corporation and (ii) a majority of the total voting power of all of the outstanding shares of voting stock of the Corporation other than shares of voting stock of which such Related Person is the Beneficial Owner (as herein defined). Such affirmative vote shall be required notwithstanding the fact that no vote may be required, or that the affirmative vote of a lesser percentage of stockholders may be specified, by law or otherwise.

(C) The provisions of this Article TENTH shall not be applicable to any particular Business Combination, and such Business Combination shall require only such affirmative vote, if any, as may be required by law or otherwise, if:

(1) The Board of Directors of the Corporation shall by resolution have approved or ratified a memorandum of understanding approving such Business Combination with such Related Person prior to the time such Related Person became the Beneficial Owner, directly or indirectly, of five percent (5%) or more of the voting shares of the Corporation; or

(2) The Business Combination shall have been approved by a majority of the Continuing Directors (as herein defined) at a meeting at which a Continuing Director Quorum (as herein defined) is present; or

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(3) The Business Combination involves solely the Corporation and a Subsidiary (as herein defined) in which a Related Person has no direct or indirect interest (other than an interest arising solely because of control of the Corporation); provided, that if the Corporation is not the surviving corporation, (a) each stockholder of the Corporation receives the same type of consideration in such transaction in proportion to such stockholder s stockholdings, (b) the provisions of Articles SIXTH, SEVENTH, EIGHTH, NINTH, TENTH and ELEVENTH of this Restated Certificate of Incorporation are continued in effect or adopted by such surviving corporation as part of its articles of incorporation or certificate of incorporation, as the case may be, and such articles or certificate have no provisions inconsistent with such provisions, and (c) the provisions of the Corporation s Bylaws are continued in effect or adopted by such surviving corporation.

(D) Nothing contained in this Article TENTH shall be construed to relieve any Related Person of any fiduciary obligation imposed upon it by law.

(E) A majority of the Continuing Directors shall have the power and duty to determine, on the basis of information then known to them, whether (a) any person is a Related Person, (b) any Business Combination relates to a Substantial Part of the Assets of any person and (c) any director is a Continuing Director acting at a meeting at which a Continuing Director Quorum is or was present. Any such determination by a majority of the Continuing Directors shall be conclusive and binding for all purposes of this Article TENTH.

(F) The stockholders of the Corporation shall be entitled to statutory appraisal rights to the maximum extent permissible under Section 262 of the General Corporation Law of the State of Delaware, notwithstanding any exception otherwise provided therein, with respect to any Business Combination with a Related Person requiring the affirmative vote of the holders of outstanding stock of the Corporation having at least 80% of the voting power of the Corporation unless such vote is not required pursuant to Section C.

(G) No Business Combination subject to the provisions of Section B of this Article TENTH shall, unless such Business Combination shall be the subject of one of the exceptions provided for in Sections C(1), (2) or (3), be consummated, and the Corporation shall not enter into any such Business Combination, unless the agreement relating to such Business Combination shall provide that each stockholder of the Corporation who has voted against the Business Combination shall receive, at the time of the consummation of such Business Combination and in exchange for such stockholder s shares of the capital stock of the Corporation, at the option of such stockholder, either (i) the consideration offered by the Related Persons as part of the Business Combination, or (ii) consideration per share of capital stock of the Corporation held by such stockholder (either in cash or in the same form and of the same kind as the consideration paid by the Related Person in acquiring shares of capital stock of the Corporation, at the option of such stockholder) in an amount not less than the greater of the following:

(1) The highest per share price (including brokerage commissions, transfer taxes and soliciting dealers fees) paid by such Related Person in acquiring any of the capital stock of the Corporation, or

(2) A price bearing the same percentage relationship to the market price of the capital stock of the Corporation immediately prior to the announcement of the Business Combination as the highest price per share (including brokerage commissions, transfer taxes and soliciting dealers fees) of the capital stock of the Corporation previously paid by such Related Person for shares of capital stock of the Corporation bears to the market price of the capital stock of the Corporation immediately prior to the time such Related Person initially acquired any shares of capital stock of the Corporation notwithstanding that such person was not a Related Person at the time of such initial acquisition.

(H) Notice of any proposed alteration, amendment, rescission or repeal of this Article TENTH shall be included in the notice of any annual or special meeting of stockholders at which such proposal is to be considered.

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(I) The provisions set forth in this Article TENTH may not be amended, altered, changed or repealed nor may any provision inconsistent with such provisions be added to the Restated Certificate of Incorporation of the Corporation except upon the affirmative vote of the holders of (i) at least eighty percent (80%) of the total voting power of all outstanding shares of voting stock of the Corporation and (ii) a majority of the total voting power of all of the outstanding shares of voting stock of the Corporation other than shares of voting stock which are Beneficially Owned by a Related Person which has directly or indirectly proposed such amendment, alteration, change or repeal; *provided, however*, that any or all of such provisions may be amended, altered, changed or repealed, and any such new provisions may be added, upon the affirmative vote of the holders of not less than a majority of the total voting power of all outstanding voting securities of the Corporation, if such amendment, change, alteration or repeal or additional provision shall first have been approved and recommended by a resolution adopted by a majority vote of the Continuing Directors at a meeting at which a Continuing Director Quorum was present.

ELEVENTH: INDEMNIFICATION AND LIMITATION OF LIABILITY

(A) Indemnification.

(1) ***Indemnification of Directors and Officers.*** The Corporation shall indemnify its directors and elected and appointed officers to the fullest extent authorized or permitted by the DGCL, as the same exists or may hereafter be amended, and such right to indemnification shall continue as to a person who has ceased to be a director or officer of the Corporation and shall inure to the benefit of his or her heirs, executors and administrators; provided, however, that, except for proceedings to enforce rights to indemnification, the Corporation shall not be obligated to indemnify any director or officer (or his or her heirs, executors or administrators) in connection with a proceeding (or part thereof) initiated by such person unless such proceeding (or part thereof) was authorized or consented to by the Board of Directors of the Corporation.

(2) ***Advancement of Expenses.*** The Corporation shall to the fullest extent not prohibited by applicable law pay the expenses (including attorneys fees) incurred by past or present directors and officers of the Corporation in defending any proceeding in advance of its final disposition; *provided, however*, that, to the extent required by law, such payment of expenses in advance of the final disposition of the proceeding shall be made only upon receipt of an undertaking by such persons to repay all amounts advanced if it should be ultimately determined that such person is not entitled to be indemnified under this Article ELEVENTH or otherwise.

(3) ***Indemnification of Employees and Agents.*** The Corporation may, to the extent authorized from time to time by the Board of Directors, provide rights to indemnification and to the advancement of expenses to employees and agents of the Corporation who are not directors or officers similar to those conferred in this Section (A) to directors and officers of the Corporation.

The rights to indemnification and to the advancement of expenses conferred in this Section (A) shall not be exclusive of any other right which any person may have or hereafter acquire under this Restated Certificate of Incorporation, the Bylaws, any statute, agreement, insurance policy, vote of stockholders or disinterested directors, or otherwise.

(B) Limitation on Liability. No director shall be personally liable to the Corporation or any of its stockholders for monetary damages for breach of fiduciary duty as a director, except for liability (1) for any breach of the director s duty of loyalty to the Corporation or its stockholders, (2) for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law, (3) pursuant to Section 174 of the DGCL or (4) for any transaction from which the director derived an improper personal benefit.

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(C) **Repeal or Modification of Rights.** Any repeal or modification of Section (A) shall not adversely affect any rights to indemnification and advancement of expenses of a director or officer of the Corporation existing pursuant to Section (A) with respect to any acts or omissions occurring prior to such repeal or modification. Any repeal or modification of Sections (A) or (B) shall not have any effect on the liability or alleged liability of any director of the Corporation for or with respect to any acts or omissions of such director occurring prior to such repeal or modification.

IN WITNESS WHEREOF, SAIC, Inc. has caused this Restated Certificate of Incorporation to be executed in its corporate name by its [title] as of this day of , 2006.

SAIC, Inc.

By: ____________________

Name: ____________________

Title: ____________________

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Annex C

2006 EQUITY INCENTIVE PLAN

1. **Purpose of this Plan**

The purpose of this 2006 Equity Incentive Plan is to enhance the long-term stockholder value of SAIC, Inc. and its affiliated companies by offering opportunities to eligible individuals to participate in the growth in value of the equity of SAIC, Inc.

2. **Definitions and Rules of Interpretation**

2.1 **Definitions.**

This Plan uses the following defined terms:

(a) ***Administrator*** means the Board or the Committee, or any officer or employee of the Company to whom the Board or the Committee delegates authority to administer this Plan.

(b) ***Affiliate*** means a parent or subsidiary (as each is defined in Section 424 of the Code) of the Company and any other entity that the Board or Committee designates as an Affiliate for purposes of this Plan.

(c) ***Applicable Law*** means any and all laws of whatever jurisdiction, within or without the United States, and the rules of any stock exchange or quotation system on which Shares are listed or quoted, applicable to the taking or refraining from taking of any action under this Plan, including the administration of this Plan and the issuance or transfer of Awards or Award Shares.

(d) ***Award*** means a Stock Award, SAR, Cash Award, or Option granted in accordance with the terms of this Plan.

(e) ***Award Agreement*** means the document evidencing the grant of an Award.

(f) ***Award Shares*** means Shares covered by an outstanding Award or purchased under an Award.

(g) ***Awardee*** means: (i) a person to whom an Award has been granted, including a holder of a Substitute Award or (ii) a person to whom an Award has been transferred in accordance with all applicable requirements of Sections 6.5, 7(h), and 17.

(h) ***Board*** means the Board of Directors of the Company.

(i) ***Cash Award*** means the right to receive cash as described in Section 8.3.

(j) ***Cause*** means employment related dishonesty, fraud, misconduct or disclosure or misuse of confidential information, or other employment related conduct that is likely to cause significant injury to the Company, an Affiliate, or any of their respective employees, officers or directors (including, without limitation, commission of a felony or similar offense), in each case as determined by the Administrator. Cause shall not require that a civil judgment or criminal conviction have been entered

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against or guilty plea shall have been made by the Awardee regarding any of the matters referred to in the previous sentence. Accordingly, the Administrator shall be entitled to determine Cause based on the Administrator s good faith belief. If the Awardee is criminally charged with a felony or similar offense that shall be a sufficient, but not a necessary, basis for such belief.

(k) ***Change in Control*** means any transaction or event that the Board specifies as a Change in Control under Section 10.4.

(l) ***Code*** means the Internal Revenue Code of 1986.

(m) ***Committee*** means a committee or subcommittee of the Board of Directors of the Company composed of one or more Company Directors appointed in accordance with the Company s charter documents and Section 4.

(n) ***Company*** means SAIC, Inc., a Delaware corporation.

(o) ***Company Director*** means a member of the Board.

(p) ***Consultant*** means an individual who, or an employee of any entity that, provides bona fide services to the Company or an Affiliate not in connection with the offer or sale of securities in a capital-raising transaction, but who is not an Employee.

(q) ***Director*** means a member of the Board of Directors of the Company or an Affiliate.

(r) ***Divestiture*** means any transaction or event that the Board specifies as a Divestiture under Section 10.5.

(s) ***Effective Date*** means the effective date of the merger of SAIC Merger Sub, Inc. with and into Science Applications International Corporation (the ***Merger***) subject to stockholder approval of the Plan. In the event the Merger does not become effective or stockholder approval of the Plan is not obtained, the Plan shall be null and void and no terms of the Plan shall take effect.

(t) ***Employee*** means a regular employee of the Company or an Affiliate, including an officer or Director, who is treated as an employee in the personnel records of the Company or an Affiliate, but not individuals who are classified by the Company or an Affiliate as: (i) leased from or otherwise employed by a third party, (ii) independent contractors, or (iii) intermittent or temporary workers. The Company s or an Affiliate s classification of an individual as an Employee (or as not an Employee) for purposes of this Plan shall not be altered retroactively even if that classification is changed retroactively for another purpose as a result of an audit, litigation or otherwise. An Awardee shall not cease to be an Employee due to transfers between locations of the Company, or between the Company and an Affiliate, or to any successor to the Company or an Affiliate that assumes the Awardee s Options under Section 10. Neither service as a Director nor receipt of a director s fee shall be sufficient to make a Director an Employee.

(u) ***Exchange Act*** means the Securities Exchange Act of 1934.

(v) ***Executive*** means, if the Company has any class of any equity security registered under Section 12 of the Exchange Act, an individual who is subject to Section 16 of the Exchange Act or who is a covered employee under Section 162(m) of the Code, in either case because of the individual s

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relationship with the Company or an Affiliate. If the Company does not have any class of any equity security registered under Section 12 of the Exchange Act, Executive means any (i) Director, (ii) officer elected or appointed by the Board, or (iii) beneficial owner of more than 10% of any class of the Company s equity securities.

(w) ***Expiration Date*** means, with respect to an Award, the date stated in the Award Agreement as the expiration date of the Award or, if no such date is stated in the Award Agreement, then the last day of the maximum exercise period for the Award, disregarding the effect of an Awardee s Termination or any other event that would shorten that period.

(x) ***Fair Market Value*** means the value of a share of the stock of Company as determined under Section 18.2.

(y) ***Fundamental Transaction*** means any transaction or event described in Section 10.3.

(z) ***Good Reason*** means (i) a material diminution in responsibility or compensation, or (ii) requiring Awardee to work in a location (other than normal business travel) which is more than 50 miles from Awardee s place of employment before the change.

(aa) ***Grant Date*** means the date the Administrator approves the grant of an Award. However, if the Administrator specifies that an Award s Grant Date is a future date or the date on which a condition is satisfied, the Grant Date for such Award is that future date or the date that the condition is satisfied.

(bb) ***Incentive Stock Option*** means an Option intended to qualify as an incentive stock option under Section 422 of the Code and designated as an Incentive Stock Option in the Award Agreement for that Option.

(cc) ***Involuntary Termination*** means termination by the Company without Cause or termination by the Awardee for Good Reason.

(dd) ***Nonstatutory Option*** means any Option other than an Incentive Stock Option.

(ee) ***Objectively Determinable Performance Condition*** shall mean a performance condition (i) that is established (A) at the time an Award is granted or (B) no later than the earlier of (1) 90 days after the beginning of the period of service to which it relates, or (2) before the elapse of 25% of the period of service to which it relates, (ii) that is uncertain of achievement at the time it is established, and (iii) the achievement of which is determinable by a third party with knowledge of the relevant facts. Examples of measures that may be used in Objectively Determinable Performance Conditions include net revenue dollars, revenue growth, earnings per share, return on assets, return on equity, net order dollars, net profit dollars, net profit growth, other financial objectives, objective customer satisfaction indicators, efficiency measures and individual performance, each with respect to the Company and/or an Affiliate or individual business unit.

(ff) ***Officer*** means an officer of the Company as defined in Rule 16a-1 adopted under the Exchange Act.

(gg) ***Option*** means a right to purchase Shares of the Company granted under this Plan.

(hh) ***Option Price*** means the price payable under an Option for Shares, not including any amount payable in respect of withholding or other taxes.

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(ii) ***Option Shares*** means Shares covered by an outstanding Option or purchased under an Option.

(jj) ***Plan*** means this 2006 Equity Incentive Plan.

(kk) ***Prior Plans*** mean the Science Application International Corporation 1999 Stock Incentive Plan, 1998 Stock Option Plan and 1984 Bonus Compensation Plan.

(ll) ***Purchase Price*** means the price payable under a Stock Award for Shares, not including any amount payable in respect of withholding or other taxes.

(mm) ***Qualified Domestic Relations Order*** means a qualified domestic relations order as defined in, and otherwise meeting the requirements of, Section 414(p) of the Code, except that reference to a plan in that definition shall be to this Plan.

(nn) ***Rule 16b-3*** means Rule 16b-3 adopted under Section 16(b) of the Exchange Act.

(oo) ***SAR or Stock Appreciation Right*** means a right to receive cash and/or Shares based on a change in the Fair Market Value of a specific number of Shares pursuant to an Award Agreement, as described in Section 8.1.

(pp) ***Securities Act*** means the Securities Act of 1933.

(qq) ***Share*** means a share of the Class A Preferred Stock or Common Stock of the Company, as determined by the Committee, or other securities substituted for the Class A Preferred Stock or Common Stock under Section 10.

(rr) ***Stock Award*** means an offer by the Company to sell shares subject to certain restrictions pursuant to the Award Agreement as described in Section 8.2 or, as determined by the Committee, a notional account representing the right to be paid an amount based on Shares. Types of Awards which may be granted as Stock Awards include such awards as are commonly known as restricted stock, deferred stock, restricted stock units, performance shares, phantom stock or similar types of awards as determined by the Administrator.

(ss) ***Substitute Award*** means a Substitute Option, Substitute SAR or Substitute Stock Award granted in accordance with the terms of this Plan.

(tt) ***Substitute Option*** means an Option granted in substitution for, or upon the conversion of, an option granted by another entity to purchase equity securities in the granting entity.

(uu) ***Substitute SAR*** means a SAR granted in substitution for, or upon the conversion of, a stock appreciation right granted by another entity with respect to equity securities in the granting entity.

(vv) ***Substitute Stock Award*** means a Stock Award granted in substitution for, or upon the conversion of, a stock award granted by another entity to purchase equity securities in the granting entity.

(ww) ***Ten Percent Stockholder*** is any person who, directly or by attribution under Section 424(d) of the Code, owns stock possessing more than ten percent of the total combined voting power of all classes of stock of the Company or of any Affiliate on the Grant Date.

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(xx) ***Termination*** means that the Awardee has ceased to be, with or without any cause or reason, an Employee, Director or Consultant. However, unless so determined by the Administrator, or otherwise provided in this Plan, Termination shall not include a change in status from an Employee, Consultant or Director to another such status. An event that causes an Affiliate to cease being an Affiliate shall be treated as the Termination of that Affiliate s Employees, Directors, and Consultants.

2.2 **Rules of Interpretation.** Any reference to a Section, without more, is to a Section of this Plan. Captions and titles are used for convenience in this Plan and shall not, by themselves, determine the meaning of this Plan. Except when otherwise indicated by the context, the singular includes the plural and vice versa. Any reference to a statute is also a reference to the applicable rules and regulations adopted under that statute. Any reference to a statute, rule or regulation, or to a section of a statute, rule or regulation, is a reference to that statute, rule, regulation, or section as amended from time to time, both before and after the Effective Date and including any successor provisions.

3. **Shares Subject to This Plan; Term of This Plan**

3.1 **Number of Award Shares.** The Shares issuable under this Plan shall be authorized but unissued or reacquired Shares, including Shares repurchased by the Company on the open market. The number of Shares initially available for issuance over the term of this Plan shall be 75,000,000. Except as required by Applicable Law, Shares subject to an outstanding Award shall not reduce the number of Shares available for issuance under this Plan until the earlier of the date such Shares are vested pursuant to the terms of the applicable Award or the actual date of delivery of the Shares to the Awardee. Those Shares (i) that are issued under the Plan that are forfeited or repurchased by the Company at the original purchase price or less or that are issuable upon exercise of awards granted under the Plan that expire or become unexercisable for any reason after the Effective Date without having been exercised in full, (ii) that are restored pursuant to the decision of the Board or Committee pursuant to Section 6.4(a) to deliver only such Shares as are necessary to award the net Share appreciation and (iii) that are not delivered to a holder in consideration for applicable tax withholding will continue to be available for issuance under this Plan. The repurchase of Shares by the Company shall not increase the maximum number of Shares that may be issued under this Plan to the extent the Company repurchases Shares that were originally exercised or purchased with other previously owned Shares. The maximum number of Shares shall be cumulatively increased on February 1, 2007 and on each February 1 thereafter for nine more years, by the least of: (i) a number of Shares determined by the Board or the Committee; (ii) 30,000,000 Shares, or (iii) 5% of the Company s outstanding shares of Common Stock as of the preceding January 31 (measured on an as-converted basis with respect to outstanding shares of Class A Preferred Stock).

3.2 **Source of Shares.** Award Shares may be: (a) Shares that have never been issued, (b) Shares that have been issued but are no longer outstanding, or (c) Shares that are outstanding and are acquired to discharge the Company s obligation to deliver Award Shares.

3.3 **Term of this Plan.**

(a) This Plan shall become effective on the Effective Date, and Awards may be granted under this Plan on and after, the Effective Date. Upon effectiveness of this Plan, no additional awards will be made under the Prior Plans.

(b) Subject to the provisions of Section 14, Awards may be granted under this Plan during the ten year period from the latest date the Company s stockholders approve this Plan.

4. **Administration**

4.1 **General.**

(a) The Board shall have ultimate responsibility for administering this Plan. To the extent permitted by Applicable Law, the Board may delegate certain of its responsibilities to a Committee. In addition, to the extent permitted by Applicable Law, the Board or the Committee may further delegate its responsibilities to any officer of the Company or any Affiliate. Where this Plan specifies that an action must be taken or a determination made by the Board, only the Board may take that action or make that determination. Where this Plan specifies that an action must be taken or a determination made by the Committee, only the Committee may take that action or make that determination. Where this Plan references the Administrator, the action may be taken or determination made by the Board, the Committee, or other Administrator. However, only the Board or a Committee consisting solely of independent directors as defined in the Company s Corporate Governance Guidelines may approve grants of Awards to Executives, and an Administrator other than the Board or the Committee may grant Awards only within the guidelines established by the Board or Committee. Moreover, all actions and determinations by any Administrator are subject to the provisions of this Plan.

(b) So long as the Company has registered and outstanding a class of equity securities under Section 12 of the Exchange Act and to the extent necessary or helpful to comply with Applicable Law with respect to officers subject to Section 16 of the Exchange Act and/or others, a Committee shall consist of two or more Company Directors who are Non-Employee Directors as defined in Rule 16b-3 and, after the expiration of any transition period permitted by Treasury Regulations Section 1.162-27(h)(3), who are outside directors as defined in Section 162(m) of the Code.

4.2 **Authority of the Board or the Committee.** Subject to the other provisions of this Plan, the Board or the Committee shall have the authority to:

(a) grant Awards, including Substitute Awards;

(b) determine the Fair Market Value of Shares;

(c) determine the Option Price and the Purchase Price of Awards;

(d) select the Awardees;

(e) determine the times Awards are granted;

(f) determine the number of Shares subject to each Award;

(g) determine the type of Shares subject to each Award;

(h) determine the methods of payment that may be used to purchase Award Shares;

(i) determine the methods of payment that may be used to satisfy withholding tax obligations;

(j) determine the other terms of each Award, including but not limited to the time or times at which Awards may be exercised, whether and under what conditions an Award is assignable, whether an Option is a Nonstatutory Option or an Incentive Stock Option and automatic cancellation of the Award if certain objective requirements determined by the Administration are not met;

(k) modify or amend any Award;

(l) authorize any person to sign any Award Agreement or other document related to this Plan on behalf of the Company;

(m) determine the form of any Award Agreement or other document related to this Plan, and whether that document, including signatures, may be in electronic form;

(n) interpret this Plan and any Award Agreement or document related to this Plan;

(o) correct any defect, remedy any omission, or reconcile any inconsistency in this Plan, any Award Agreement or any other document related to this Plan;

(p) adopt, amend, and revoke rules and regulations under this Plan, including rules and regulations relating to sub-plans and Plan addenda;

(q) adopt, amend, and revoke special rules and procedures which may be inconsistent with the terms of this Plan, set forth (if the Administrator so chooses) in sub-plans regarding (for example) the operation and administration of this Plan and the terms of Awards, if and to the extent necessary or useful to accommodate non-U.S. Applicable Laws and practices as they apply to Awards and Award Shares held by, or granted or issued to, persons working or resident outside of the United States or employed by Affiliates incorporated outside the United States;

(r) determine whether a transaction or event should be treated as a Change in Control, a Divestiture or neither;

(s) determine the effect of a Fundamental Transaction and, if the Board determines that a transaction or event should be treated as a Change in Control or a Divestiture, then the effect of that Change in Control or Divestiture;

(t) appoint such additional administrators as are necessary to perform various administrative acts and determine the duties of such administrators; and

(u) make all other determinations the Administrator deems necessary or advisable for the administration of this Plan.

4.3 **Scope of Discretion.** Subject to the provisions of this Section 4.3, on all matters for which this Plan confers the authority, right or power on the Board, the Committee, or other Administrator to make decisions, that body may make those decisions in its sole and absolute discretion. Those decisions will be final, binding and conclusive. In making its decisions, the Board, Committee or other Administrator need not treat all persons eligible to receive Awards, all Awardees, all Awards or all Award Shares the same way. Notwithstanding anything herein to the contrary, and except as provided in Section 13.3, the discretion of the Board, Committee or other Administrator is subject to the specific provisions and specific limitations of this Plan, as well as all rights conferred on specific Awardees by Award Agreements and other agreements.

5. **Persons Eligible to Receive Awards**

5.1 **Eligible Individuals.** Awards (including Substitute Awards) may be granted to, and only to, Employees, Directors and Consultants, including to prospective Employees, Directors and Consultants conditioned on the beginning of their service for the Company or an Affiliate. However, Incentive Stock Options may only be granted to Employees, as provided in Section 7(g).

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5.2 **Section 162(m) Limitation.**

(a) **Options and SARs.** Subject to the provisions of this Section 5.2, for so long as the Company is a publicly held corporation within the meaning of Section 162(m) of the Code: (i) no Employee may be granted within any fiscal year of the Company under this Plan Options to purchase, and SARs to receive compensation calculated with reference to, more than an aggregate of 1,000,000 Shares, subject to adjustment pursuant to Section 10, and (ii) Options and SARs may be granted to an Executive only by the Committee (and, notwithstanding anything to the contrary in Section 4.1(a), not by the Board). If an Option or SAR is cancelled without being exercised or if the Option Price of an Option is reduced, that cancelled or repriced Option or SAR shall continue to be counted against the limit on Awards that may be granted to any individual under this Section 5.2.

(b) **Cash Awards and Stock Awards.** Any Cash Award or Stock Award intended as qualified performance-based compensation within the meaning of Section 162(m) of the Code must be awarded, vest or become exercisable contingent on the achievement of one or more Objectively Determinable Performance Conditions. The Committee shall have the discretion to determine the time and manner of compliance with Section 162(m) of the Code.

6. **Terms and Conditions of Options**

The following rules apply to all Options:

6.1 **Price.** No Option may have an Option Price less than 85% of the fair market value of the underlying share on the Grant Date, provided that the Administrator may grant Options with an Option Price less than 85% of the fair market value of the underlying share on the Grant Date in connection with a merger or acquisition, including substitution and/or conversion of options of an acquired entity. Notwithstanding the foregoing, in the event an Option is granted with an exercise price less than that set forth in this Section 6.1, if the mistake was unintentional, a violation of this provision shall not cause such Option to be void or voidable.

6.2 **Term.** No Option shall be exercisable after its Expiration Date. No Option may have an Expiration Date that is more than ten years after its Grant Date. Additional provisions regarding the term of Incentive Stock Options are provided in Sections 7(a) and 7(e).

6.3 **Vesting.** Options shall be exercisable: (a) on the Grant Date, or (b) in accordance with a schedule related to the Grant Date, the date the Awardee s directorship, employment or consultancy begins, or a different date specified in the Award Agreement. Additional provisions regarding the vesting of Incentive Stock Options are provided in Section 7(c). No Option granted to an individual who is subject to the overtime pay provisions of the Fair Labor Standards Act may be exercised before the expiration of six months after the Grant Date.

6.4 **Form and Method of Payment.**

(a) The Board or Committee shall determine the acceptable form and method of payment for exercising an Option. So long as variable accounting pursuant to APB 25 does not apply and the Board or Committee otherwise determines there is no material adverse accounting consequence at the time of exercise, the Board or Committee may require the delivery in Shares for the value of the net appreciation of the Shares at the time of exercise over the exercise price. The difference between full number of Shares covered by the exercised portion of the Award and the number of Shares actually delivered shall be restored to the amount of Shares available for issuance under Section 3.1.

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(b) Acceptable forms of payment for all Option Shares are cash, check or wire transfer, denominated in U.S. dollars except as specified by the Administrator for non-U.S. Employees or non-U.S. sub-plans.

(c) In addition, the Administrator may permit payment to be made by any of the following methods:

(i) other shares of stock of the Company, or the designation of other shares of stock of the Company, which (A) are mature shares for purposes of avoiding variable accounting treatment under generally accepted accounting principles (generally mature shares are those that have been owned by the Awardee for more than six months on the date of surrender), and (B) have a Fair Market Value on the date of surrender equal to the Option Price of the Shares as to which the Option is being exercised;

(ii) provided that a public market exists for the Shares (or if applicable, the Common Stock issued upon conversion of the Shares), consideration received by the Company under a procedure under which a licensed broker-dealer advances funds on behalf of an Awardee or sells Option Shares (or if applicable, the Common Stock issued upon conversion of the Option Shares) on behalf of an Awardee (a ***Cashless Exercise Procedure***), provided that if the Company extends or arranges for the extension of credit to an Awardee under any Cashless Exercise Procedure, no Officer or Director may participate in that Cashless Exercise Procedure;

(iii) cancellation of any debt owed by the Company or any Affiliate to the Awardee by the Company including without limitation waiver of compensation due or accrued for services previously rendered to the Company; and

(iv) any combination of the methods of payment permitted by any paragraph of this Section 6.4.

(d) The Administrator may also permit any other form or method of payment for Option Shares permitted by Applicable Law.

6.5 **Nonassignability of Options.** Except as determined by the Administrator, no Option shall be assignable or otherwise transferable by the Awardee except by will or by the laws of descent and distribution. However, Options may be transferred and exercised in accordance with a Qualified Domestic Relations Order and may be exercised by a guardian or conservator appointed to act for the Awardee. Incentive Stock Options may only be assigned in compliance with Section 7(h).

6.6 **Substitute Options.** The Board may cause the Company to grant Substitute Options in connection with the acquisition by the Company or an Affiliate of equity securities of any entity (including by merger, tender offer, or other similar transaction) or of all or a portion of the assets of any entity. Any such substitution shall be effective on the effective date of the acquisition. Substitute Options may be Nonstatutory Options or Incentive Stock Options. Unless and to the extent specified otherwise by the Board, Substitute Options shall have the same terms and conditions as the options they replace, except that (subject to the provisions of Section 10) Substitute Options shall be Options to purchase Shares rather than equity securities of the granting entity, shall have an Option Price determined by the Board and shall be on terms that, as determined by the Board in its sole and absolute discretion, properly reflect the substitution.

6.7 **Repricing, etc.** The Committee may reprice, cancel and regrant or otherwise adjust the exercise price of Options previously granted under the Plan.

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7. **Incentive Stock Options**

The following rules apply only to Incentive Stock Options and only to the extent these rules are more restrictive than the rules that would otherwise apply under this Plan. With the consent of the Awardee, or where this Plan provides that an action may be taken notwithstanding any other provision of this Plan, the Administrator may deviate from the requirements of this Section, notwithstanding that any Incentive Stock Option modified by the Administrator will thereafter be treated as a Nonstatutory Option.

(a) The Expiration Date of an Incentive Stock Option shall not be later than ten years from its Grant Date, with the result that no Incentive Stock Option may be exercised after the expiration of ten years from its Grant Date.

(b) No Incentive Stock Option may be granted more than ten years from the date this Plan was approved by the Board.

(c) Options intended to be incentive stock options under Section 422 of the Code that are granted to any single Awardee under all incentive stock option plans of the Company and its Affiliates, including incentive stock options granted under this Plan, may not vest at a rate of more than $100,000 in Fair Market Value of stock (measured on the grant dates of the options) during any calendar year. For this purpose, an option vests with respect to a given share of stock the first time its holder may purchase that share, notwithstanding any right of the Company to repurchase that share. Unless the administrator of that option plan specifies otherwise in the related agreement governing the option, this vesting limitation shall be applied by, to the extent necessary to satisfy this $100,000 rule, treating certain stock options that were intended to be incentive stock options under Section 422 of the Code as Nonstatutory Options. The stock options or portions of stock options to be reclassified as Nonstatutory Options are those with the highest option prices, whether granted under this Plan or any other equity compensation plan of the Company or any Affiliate that permits that treatment. This Section 7(c) shall not cause an Incentive Stock Option to vest before its original vesting date or cause an Incentive Stock Option that has already vested to cease to be vested.

(d) In order for an Incentive Stock Option to be exercised for any form of payment other than those described in Section 6.4(b), that right must be stated at the time of grant in the Award Agreement relating to that Incentive Stock Option.

(e) Any Incentive Stock Option granted to a Ten Percent Stockholder, must have an Expiration Date that is not later than five years from its Grant Date, with the result that no such Option may be exercised after the expiration of five years from the Grant Date.

(f) The Option Price of an Incentive Stock Option shall never be less than the Fair Market Value of the Shares at the Grant Date. The Option Price for the Shares covered by an Incentive Stock Option granted to a Ten Percent Stockholder shall never be less than 110% of the Fair Market Value of the Shares at the Grant Date.

(g) Incentive Stock Options may be granted only to Employees. If an Awardee changes status from an Employee to a Consultant, that Awardee s Incentive Stock Options become Nonstatutory Options if not exercised within the time period described in Section 7(i) (determined by treating that change in status as a Termination solely for purposes of this Section 7(g)).

(h) No rights under an Incentive Stock Option may be transferred by the Awardee, other than by will or the laws of descent and distribution. During the life of the Awardee, an Incentive Stock Option may be exercised only by the Awardee. The Company s compliance with a Qualified Domestic Relations Order, or the exercise of an Incentive Stock Option by a guardian or conservator appointed to act for the Awardee, shall not violate this Section 7(h).

(i) An Incentive Stock Option shall be treated as a Nonstatutory Option if it remains exercisable after, and is not exercised within, the three-month period beginning with the Awardee s Termination for any reason other than the Awardee s death or disability (as defined in Section 22(e) of the Code). In the case of Termination due to death, an Incentive Stock Option shall continue to be treated as an Incentive Stock Option if it remains exercisable after, and is not exercised within, the three month period after the Awardee s Termination provided it is exercised before the Expiration Date. In the case of Termination due to disability, an Incentive Stock Option shall be treated as a Nonstatutory Option if it remains exercisable after, and is not exercised within, one year after the Awardee s Termination.

(j) An Incentive Stock Option may only be modified by the Board.

8. **Stock Appreciation Rights, Stock Awards and Cash Awards**

8.1 **Stock Appreciation Rights.** The following rules apply to SARs:

(a) ***General***. SARs may be granted either alone, in addition to, or in tandem with other Awards granted under this Plan. The Administrator may grant SARs to eligible participants subject to terms and conditions not inconsistent with this Plan and determined by the Administrator. The specific terms and conditions applicable to the Awardee shall be provided for in the Award Agreement. SARs shall be exercisable, in whole or in part, at such times as the Administrator shall specify in the Award Agreement. The grant or vesting of a SAR may be made contingent on the achievement of Objectively Determinable Performance Conditions.

(b) ***Exercise of SARs.*** Upon the exercise of an SAR, in whole or in part, an Awardee shall be entitled to a payment in an amount equal to the excess of the Fair Market Value of a fixed number of Shares covered by the exercised portion of the SAR on the date of exercise, over the Fair Market Value of the Shares covered by the exercised portion of the SAR on the Grant Date. The amount due to the Awardee upon the exercise of a SAR shall be paid in cash, Shares or a combination thereof, over the period or periods specified in the Award Agreement. An Award Agreement may place limits on the amount that may be paid over any specified period or periods upon the exercise of a SAR, on an aggregate basis or as to any Awardee. A SAR shall be considered exercised when the Company receives written notice of exercise in accordance with the terms of the Award Agreement from the person entitled to exercise the SAR. If a SAR has been granted in tandem with an Option, upon the exercise of the SAR, the number of shares that may be purchased pursuant to the Option shall be reduced by the number of shares with respect to which the SAR is exercised.

(c) ***Nonassignability of SARs.*** Except as determined by the Administrator, no SAR shall be assignable or otherwise transferable by the Awardee except by will or by the laws of descent and distribution. Notwithstanding anything herein to the contrary, SARs may be transferred and exercised in accordance with a Qualified Domestic Relations Order.

(d) ***Substitute SARs.*** The Board may cause the Company to grant Substitute SARs in connection with the acquisition by the Company or an Affiliate of equity securities of any entity (including by

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merger, tender offer, or other similar transaction) or of all or a portion of the assets of any entity. Any such substitution shall be effective on the effective date of the acquisition. Unless and to the extent specified otherwise by the Board, Substitute SARs shall have the same terms and conditions as the SARs they replace, except that (subject to the provisions of Section 10) Substitute SARs shall be exercisable with respect to the Fair Market Value of Shares rather than equity securities of the granting entity and shall be on terms that, as determined by the Board in its sole and absolute discretion, properly reflects the substitution.

(e) ***Repricing, etc.*** The Committee may reprice, cancel and regrant or otherwise adjust the exercise price of SARs previously granted under the Plan.

8.2 **Stock Awards.** The following rules apply to all Stock Awards:

(a) ***General***. The specific terms and conditions of a Stock Award applicable to the Awardee shall be provided for in the Award Agreement. The Award Agreement shall state the number of Shares that the Awardee shall be entitled to receive or purchase, the terms and conditions on which the Shares shall vest (Stock Awards may be made in fully vested awards when appropriate in the discretion of the Administrator), the price to be paid, whether Shares are to be delivered at the time of grant or at some deferred date specified in the Award Agreement, whether the Award is payable solely in Shares, cash or either and, if applicable, the time within which the Awardee must accept such offer. The offer shall be accepted by execution of the Award Agreement. The Administrator may require that all Shares subject to a right of repurchase or risk of forfeiture be held in escrow until such repurchase right or risk of forfeiture lapses. The grant or vesting of a Stock Award may be made contingent on the achievement of Objectively Determinable Performance Conditions.

(b) ***Right of Repurchase***. If so provided in the Award Agreement, Award Shares acquired pursuant to a Stock Award may be subject to repurchase by the Company or an Affiliate if not vested in accordance with the Award Agreement.

(c) ***Form of Payment***. The Administrator shall determine the acceptable form and method of payment for exercising a Stock Award. Acceptable forms of payment for all Award Shares are cash, check or wire transfer, denominated in U.S. dollars except as specified by the Administrator for non-U.S. sub-plans. In addition, the Administrator may permit payment to be made by any of the methods permitted with respect to the exercise of Options pursuant to Section 6.4.

(d) ***Nonassignability of Stock Awards*****.** Except as determined by the Administrator, no Stock Award shall be assignable or otherwise transferable by the Awardee except by will or by the laws of descent and distribution. Notwithstanding anything to the contrary herein, Stock Awards may be transferred and exercised in accordance with a Qualified Domestic Relations Order.

(e) ***Substitute Stock Award.*** The Board may cause the Company to grant Substitute Stock Awards in connection with the acquisition by the Company or an Affiliate of equity securities of any entity (including by merger, tender offer, or other similar transaction) or of all or a portion of the assets of any entity. Unless and to the extent specified otherwise by the Board, Substitute Stock Awards shall have the same terms and conditions as the stock awards they replace, except that (subject to the provisions of Section 10) Substitute Stock Awards shall be Stock Awards to purchase Shares rather than equity securities of the granting entity and shall have a Purchase Price and other terms that, as determined by the Board in its sole and absolute discretion, properly reflects the substitution. Any such Substitute Stock Award shall be effective on the effective date of the acquisition.

(f) ***Forfeiture and Repurchase Rights***.

(i) **General**. In the event of the Awardee s termination, any unvested Shares shall be forfeited, or if the Awardee paid a purchase price to acquire the Stock Award, the Company shall have the right, during the seven months after the Awardee s Termination, to repurchase any or all of the Award Shares that were unvested as of the date of that Termination. The repurchase price shall be determined by the Administrator in accordance with this Section 8.2(f) which shall be either (i) the Purchase Price for the Award Shares (minus the amount of any cash dividends paid or payable with respect to the Award Shares for which the record date precedes the repurchase) or (ii) the lower of (A) the Purchase Price for the Shares or (B) the Fair Market Value of those Award Shares as of the date of the Termination. The repurchase price shall be paid in cash. The Company may assign this right of repurchase.

(ii) **Procedure**. The Company or its assignee may choose to give the Awardee a written notice of exercise of its repurchase rights under this Section 8.2(f). However, the Company s failure to give such a notice shall not affect its rights to repurchase Award Shares. The Company must, however, tender the repurchase price during the period specified in this Section 8.2(f) for exercising its repurchase rights in order to exercise such rights.

8.3 **Cash Awards.** Cash Awards may be granted either alone, in addition to, or in tandem with other Awards granted under this Plan. After the Administrator determines that it will offer a Cash Award, it shall advise the Awardee, by means of an Award Agreement, of the terms, conditions and restrictions related to the Cash Award. The grant or vesting of a Cash Award may be made contingent on the achievement of Objectively Determinable Performance Conditions.

9. **Exercise of Awards**

9.1 **In General.** An Award shall be exercisable in accordance with this Plan and the Award Agreement under which it is granted.

9.2 **Time of Exercise.** Options and Stock Awards shall be considered exercised when the Company receives: (a) written (including electronically pursuant to Section 18.4 below) notice of exercise from the person entitled to exercise the Option or Stock Award, (b) full payment, or provision for payment, in a form and method approved by the Administrator, for the Shares for which the Option or Stock Award is being exercised, and (c) with respect to Nonstatutory Options, payment, or provision for payment, in a form approved by the Administrator, of all applicable withholding taxes due upon exercise. An Award may be exercised for a fraction of a Share. SARs shall be considered exercised when the Company receives written notice of the exercise from the person entitled to exercise the SAR.

9.3 **Issuance of Award Shares.** The Company shall issue Award Shares in the name of the person properly exercising the Award. If the Awardee is that person and so requests, the Award Shares shall be issued in the name of the Awardee and the Awardee s spouse. The Company shall endeavor to issue Award Shares promptly after an Award is exercised or after the Grant Date of a Stock Award, as applicable. Until Award Shares are actually issued, as evidenced by the appropriate entry on the stock register of the Company or its transfer agent, the Awardee will not have the rights of a stockholder with respect to those Award Shares, even though the Awardee has completed all the steps necessary to exercise the Award. No adjustment shall be made for any dividend, distribution, or other right for which the record date precedes the date the Award Shares are issued, except as provided in Section 10.

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9.4 **Termination.**

(a) ***In General***. Except as provided in an Award Agreement or in writing by the Administrator, including in an Award Agreement, and as otherwise provided in Sections 9.4(b), (c), (d) and (e) after an Awardee s Termination for other than Cause, the Awardee s Awards shall be exercisable to the extent (but only to the extent) they are vested on the date of that Termination and only during the ninety (90) days after the Termination, but in no event after the Expiration Date. Unless otherwise provided in the Award Agreement, in the event of termination for Cause the Award may not be exercised after the date of Termination. To the extent the Awardee does not exercise an Award within the time specified for exercise, the Award shall automatically terminate.

(b) ***Leaves of Absence***. If Awardee is an employee of the Company or an Affiliate and is on a leave of absence pursuant to the terms of the Company s Administrative Policy No. SH-1 Unpaid Leave or similar policy maintained by an Affiliate, as such policies may be revised from time to time, Awardee shall not, during the period of such absence be deemed, by virtue of such absence alone, to have terminated Awardee s employment. Awardee shall continue to vest in the Option during any approved medical or military leave of absence. Medical leave shall include family or medical leaves, workers compensation leave, or pregnancy disability leave. For all other leaves of absence, the Option will fully vest only during active employment and shall not vest during a leave of absence, unless required under local law. However, if Awardee returns to active employment with the Company or an Affiliate following such a leave, the Option will be construed to vest as if there had been no break in active employment. During any leave of absence, Awardee shall have the right to exercise the vested portion of the Option.

(c) ***Death or Disability***. Unless otherwise provided in the Award Agreement or determined by the Administrator, if an Awardee s Termination is due to death or disability (as determined by the Administrator with respect to all Awards other than Incentive Stock Options and as defined by Section 22(e) of the Code with respect to Incentive Stock Options), the unvested portion of all Awards of that Awardee shall be accelerated and become fully exercisable upon the Termination, and all Awards of the Awardee shall be exercisable until the Expiration Date. In the case of Termination due to death, an Award may be exercised as provided in Section 17. In the case of Termination due to disability, if a guardian or conservator has been appointed to act for the Awardee and been granted this authority as part of that appointment, that guardian or conservator may exercise the Award on behalf of the Awardee. Unless otherwise provided in the Award Agreement, death or disability occurring after an Awardee s Termination shall not cause the Termination to be treated as having occurred due to death or disability. To the extent an Award is not so exercised within the time specified for its exercise, the Award shall automatically terminate.

(d) ***Divestiture***. If an Awardee s Termination is due to a Divestiture, the Board may take any one or more of the actions described in Section 10.3 or 10.4 with respect to the Awardee s Awards.

(e) ***Administrator Discretion***. Notwithstanding the provisions of Section 9.4 (a)-(d), the Plan Administrator shall have complete discretion, exercisable either at the time an Award is granted or at any time while the Award remains outstanding, to:

(i) Extend the period of time for which the Award is to remain exercisable, following the Awardee s Termination, from the limited exercise period otherwise in effect for that Award to such greater period of time as the Administrator shall deem appropriate, but in no event beyond the Expiration Date; and/or

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(ii) Permit the Award to be exercised, during the applicable post-Termination exercise period, not only with respect to the number of vested Shares for which such Award may be exercisable at the time of the Awardee s Termination but also with respect to one or more additional installments in which the Awardee would have vested had the Awardee not been subject to Termination.

(f) ***Consulting or Employment Relationship***. Nothing in this Plan or in any Award Agreement, and no Award or the fact that Award Shares remain subject to repurchase rights or risk of forfeiture, shall: (A) interfere with or limit the right of the Company or any Affiliate to terminate the employment or consultancy of any Awardee at any time, whether with or without cause or reason, and with or without the payment of severance or any other compensation or payment, (B) confer upon any employee any right to continue in the employ of, or affiliation with, the Company or a Subsidiary nor constitute any promise or commitment by the Company or a Subsidiary regarding future positions, future work assignments, future compensation or any other term or condition of employment or affiliation or (C) interfere with the application of any provision in any of the Company s or any Affiliate s charter documents or Applicable Law relating to the election, appointment, term of office, or removal of a Director.

10. **Certain Transactions and Events**

10.1 **In General.** Except as provided in this Section 10, no change in the capital structure of the Company, merger, sale or other disposition of assets or of a subsidiary, change in control, issuance by the Company of shares of any class of securities or securities convertible into shares of any class of securities, exchange or conversion of securities, or other transaction or event shall require or be the occasion for any adjustments of the type described in this Section 10. Additional provisions with respect to the foregoing transactions are set forth in Section 14.3.

10.2 **Changes in Capital Structure.** In the event of any stock split, reverse stock split, recapitalization, combination or reclassification of stock, stock dividend, spin-off, extraordinary cash dividend or similar change to the capital structure of the Company (not including a Fundamental Transaction or Change in Control), the Board shall make whatever adjustments it concludes are appropriate to: (a) the number and type of Awards that may be granted under this Plan, (b) the number and type of Options that may be granted to any individual under this Plan, (c) the terms of any SAR, (d) the Purchase Price of any Stock Award, (e) the Option Price and number and class of securities issuable under each outstanding Option, and (f) the repurchase price of any securities substituted for Award Shares that are subject to repurchase rights. The specific adjustments shall be determined by the Board. Unless the Board specifies otherwise, any securities issuable as a result of any such adjustment shall be rounded down to the next lower whole security. The Board need not adopt the same rules for each Award or each Awardee.

10.3 **Fundamental Transactions.** In the event of (a) a merger or consolidation in which the Company is not the surviving corporation (other than a merger or consolidation with a wholly-owned subsidiary, a reincorporation of the Company in a different jurisdiction, or other transaction in which there is no substantial change in the stockholders of the Company or their relative stock holdings and the Awards granted under this Plan are assumed, converted or replaced by the successor corporation, which assumption shall be binding on all participants), (b) a merger in which the Company is the surviving corporation but after which the stockholders of the Company immediately prior to such merger (other than any stockholder that merges, or which owns or controls another corporation that merges, with the Company in such merger) cease to own their shares or other equity interest in the Company, (c) the sale of all or substantially all of the

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assets of the Company, or (d) the acquisition, sale, or transfer of more than 50% of the outstanding shares of the Company by tender offer or similar transaction (each, a ***Fundamental Transaction***), any or all outstanding Awards may be assumed, converted or replaced by the successor corporation (if any), which assumption, conversion or replacement shall be binding on all participants under this Plan. In the alternative, the successor corporation may substitute equivalent Awards or provide substantially similar consideration to participants as was provided to stockholders (after taking into account the existing provisions of the Awards). The successor corporation may also issue, in place of outstanding Shares held by the participants, substantially similar shares or other property subject to repurchase restrictions no less favorable to the participant. In the event such successor corporation (if any) does not assume or substitute Awards, as provided above, pursuant to a transaction described in this Subsection 10.3, the vesting with respect to such Awards shall fully and immediately accelerate or the repurchase rights of the Company shall fully and immediately terminate, as the case may be, so that the Awards may be exercised or the repurchase rights shall terminate before, or otherwise in connection with the closing or completion of the Fundamental Transaction or event, but then terminate. Notwithstanding anything in this Plan to the contrary, the Committee may, in its sole discretion, provide that the vesting of any or all Award Shares subject to vesting or right of repurchase shall accelerate or lapse, as the case may be, upon a transaction described in this Section 10.3. If the Committee exercises such discretion with respect to Options, such Options shall become exercisable in full prior to the consummation of such event at such time and on such conditions as the Committee determines, and if such Options are not exercised prior to the consummation of the Fundamental Transaction, they shall terminate at such time as determined by the Committee. Subject to any greater rights granted to participants under the foregoing provisions of this Section 10.3, in the event of the occurrence of any Fundamental Transaction, any outstanding Awards shall be treated as provided in the applicable agreement or plan of merger, consolidation or sale of assets.

10.4 **Changes in Control.** The Board may also, but need not, specify that other transactions or events constitute a ***Change in Control*** . The Board may do that either before or after the transaction or event occurs. Examples of transactions or events that the Board may treat as Changes in Control are: (a) any person or entity, including a group as contemplated by Section 13(d)(3) of the Exchange Act, acquires securities holding 25% or more of the total combined voting power or value of the Company, or (b) as a result of or in connection with a contested election of Company Directors, the persons who were Company Directors immediately before the election cease to constitute a majority of the Board. In connection with a Change in Control, notwithstanding any other provision of this Plan, the Board may, but need not, take any one or more of the actions described in Section 10.3. In addition, the Board may extend the date for the exercise of Awards (but not beyond their original Expiration Date). The Board need not adopt the same rules for each Award or each Awardee. Notwithstanding anything in this Plan to the contrary, in the event of an Involuntary Termination of services for any reason other than death, disability or Cause, within 18 months following the consummation of a Fundamental Transaction or Change in Control, any Awards, assumed or substituted in a Fundamental Transaction or Change in Control, which are subject to vesting conditions and/or the right of repurchase in favor of the Company or a successor entity, shall fully accelerate for vesting so that such Award Shares are immediately exercisable upon Termination or, if subject to the right of repurchase in favor of the Company, such repurchase rights shall lapse as of the date of Termination. Such Awards shall be exercisable for a period of six months following Termination.

10.5 **Divestiture.** If the Company or an Affiliate sells or otherwise transfers equity securities of an Affiliate to a person or entity other than the Company or an Affiliate, or leases, exchanges or transfers all or any portion of its assets to such a person or entity, then the Board may specify that such transaction or event constitutes a ***Divestiture*** . In connection with a Divestiture, notwithstanding any other provision of this Plan, the Board may, but need not, take one or more of the actions described in Section 10.3 or 10.4 with

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respect to Awards or Award Shares held by, for example, Employees, Directors or Consultants for whom that transaction or event results in a Termination. The Board need not adopt the same rules for each Award or Awardee.

10.6 **Dissolution.** If the Company adopts a plan of dissolution, the Board may cause Awards to be fully vested and exercisable (but not after their Expiration Date) before the dissolution is completed but contingent on its completion and may cause the Company s repurchase rights on Award Shares to lapse upon completion of the dissolution. The Board need not adopt the same rules for each Award or each Awardee. Notwithstanding anything herein to the contrary, in the event of a dissolution of the Company, to the extent not exercised before the earlier of the completion of the dissolution or their Expiration Date, Awards shall terminate immediately prior to the dissolution.

10.7 **Cut-Back to Preserve Benefits.** If the Administrator determines that the net after-tax amount to be realized by any Awardee, taking into account any accelerated vesting, termination of repurchase rights, or cash payments to that Awardee in connection with any transaction or event set forth in this Section 10 would be greater if one or more of those steps were not taken or payments were not made with respect to that Awardee s Awards or Award Shares, then, at the election of the Awardee, to such extent, one or more of those steps shall not be taken and payments shall not be made.

11. **Grants to Non-Employee Directors**

11.1 **Certain Transactions and Events.**

(a) In the event of a Fundamental Transaction while the Awardee remains a non-Employee Director, the Shares at the time subject to each outstanding Award held by such Awardee pursuant to this Plan, but not otherwise vested, shall automatically vest in full and become exercisable for all Shares as fully vested Shares and all repurchase rights shall automatically terminate in full immediately prior to the effective date of the Fundamental Transaction. Immediately following the consummation of the Fundamental Transaction, each Award shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or Affiliate thereof).

(b) In the event of a Change in Control while the Awardee remains a non-Employee Director, the Shares at the time subject to each outstanding Award held by such Awardee pursuant to this Plan, but not otherwise vested, shall automatically vest in full and become exercisable for all the Shares as fully vested Shares and all repurchase rights shall automatically terminate in full immediately prior to the effective date of the Change in Control. Each such Award shall remain exercisable for such fully vested Shares until the expiration or sooner termination of the Award term in connection with a Change in Control.

(c) Each Award which is assumed in connection with a Fundamental Transaction shall be appropriately adjusted, immediately after such Fundamental Transaction, to apply to the number and class of securities which would have been issuable to the Awardee in consummation of such Fundamental Transaction had the Award been exercised immediately prior to such Fundamental Transaction. Appropriate adjustments shall also be made to the Option Price or Purchase Price payable per share under each outstanding Award, provided the aggregate Option Price or Purchase Price payable for such securities shall remain the same. To the extent the actual holders of the Company s outstanding Shares receive cash consideration for their Shares in consummation of the Fundamental Transaction, the successor corporation may, in connection with the assumption of the outstanding Awards granted to non-Employee Directors under this Plan, substitute one or more shares of its own common stock with a fair market value equivalent to the cash consideration paid per Share in such Fundamental Transaction.

12. **Withholding and Tax Reporting**

12.1 **Tax Withholding Alternatives.**

(a) ***General***. Whenever Award Shares are issued or become free of restrictions, the Company may require the Awardee to remit to the Company an amount sufficient to satisfy any applicable tax withholding requirement, whether the related tax is imposed on the Awardee or the Company. The Company shall have no obligation to deliver Award Shares or release Award Shares from an escrow or permit a transfer of Award Shares until the Awardee has satisfied those tax withholding obligations. Whenever payment in satisfaction of Awards is made in cash, the payment will be reduced by an amount sufficient to satisfy all tax withholding requirements.

(b) ***Method of Payment***. The Awardee shall pay any required withholding using the forms of consideration described in Section 6.4(b), except that, in the discretion of the Administrator, the Company may also permit the Awardee to use any of the forms of payment described in Section 6.4(c). The Administrator, in its sole discretion, may also permit Award Shares to be withheld to pay required withholding. If the Administrator permits Award Shares to be withheld, the Fair Market Value of the Award Shares withheld, as determined as of the date of withholding, shall not exceed the amount determined by the applicable minimum statutory withholding rates to the extent the Administrator determines such limit is necessary or advisable in light of generally accepted accounting principles.

12.2 **Reporting of Dispositions.** Any holder of Option Shares acquired under an Incentive Stock Option shall promptly notify the Administrator, following such procedures as the Administrator may require, of the sale or other disposition of any of those Option Shares if the disposition occurs during: (a) the longer of two years after the Grant Date of the Incentive Stock Option and one year after the date the Incentive Stock Option was exercised, or (b) such other period as the Administrator has established.

13. **Compliance With Law**

The grant of Awards and the issuance and subsequent transfer of Award Shares shall be subject to compliance with all Applicable Law, including all applicable securities laws. Awards may not be exercised, and Award Shares may not be transferred, in violation of Applicable Law. Thus, for example, Awards may not be exercised unless: (a) a registration statement under the Securities Act is then in effect with respect to the related Award Shares, or (b) in the opinion of legal counsel to the Company, those Award Shares may be issued in accordance with an applicable exemption from the registration requirements of the Securities Act and any other applicable securities laws. The failure or inability of the Company to obtain from any regulatory body the authority considered by the Company s legal counsel to be necessary or useful for the lawful issuance of any Award Shares or their subsequent transfer shall relieve the Company of any liability for failing to issue those Award Shares or permitting their transfer. As a condition to the exercise of any Award or the transfer of any Award Shares, the Company may require the Awardee to satisfy any requirements or qualifications that may be necessary or appropriate to comply with or evidence compliance with any Applicable Law.

14. **Amendment or Termination of this Plan or Outstanding Awards**

14.1 **Amendment and Termination.** The Board may at any time amend, suspend, or terminate this Plan.

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14.2 **Stockholder Approval.** The Company shall obtain the approval of the Company s stockholders for any amendment to this Plan if stockholder approval is necessary or desirable to comply with any Applicable Law or with the requirements applicable to the grant of Awards intended to be Incentive Stock Options. The Board may also, but need not, require that the Company s stockholders approve any other amendments to this Plan.

14.3 **Effect.** No amendment, suspension, or termination of this Plan, and no modification of any Award even in the absence of an amendment, suspension, or termination of this Plan, shall impair any existing contractual rights of any Awardee unless the affected Awardee consents to the amendment, suspension, termination, or modification. Notwithstanding anything herein to the contrary, no such consent shall be required if the Board determines, in its sole and absolute discretion, that the amendment, suspension, termination, or modification (including an amendment of the designation of the class of securities to be issued under Awards): (a) is required or advisable in order for the Company, this Plan or the Award to satisfy Applicable Law, to meet the requirements of any accounting standard or to avoid any adverse accounting treatment, or (b) in connection with any transaction or event described in Section 10, is in the best interests of the Company or its stockholders. The Board may, but need not, take the tax or accounting consequences to affected Awardees into consideration in acting under the preceding sentence. Those decisions shall be final, binding and conclusive. Termination of this Plan shall not affect the Administrator s ability to exercise the powers granted to it under this Plan with respect to Awards granted before the termination of Award Shares issued under such Awards even if those Award Shares are issued after the termination.

15. **Reserved Rights**

15.1 **Nonexclusivity of this Plan.** This Plan shall not limit the power of the Company or any Affiliate to adopt other incentive arrangements including, for example, the grant or issuance of stock options, stock, or other equity-based rights under other plans.

15.2 **Unfunded Plan.** This Plan shall be unfunded. Although bookkeeping accounts may be established with respect to Awardees, any such accounts will be used merely as a convenience. The Company shall not be required to segregate any assets on account of this Plan, the grant of Awards, or the issuance of Award Shares. The Company and the Administrator shall not be deemed to be a trustee of stock or cash to be awarded under this Plan. Any obligations of the Company to any Awardee shall be based solely upon contracts entered into under this Plan, such as Award Agreements. No such obligations shall be deemed to be secured by any pledge or other encumbrance on any assets of the Company. Neither the Company nor the Administrator shall be required to give any security or bond for the performance of any such obligations.

16. **Escrow of Stock Certificates**

To enforce any restrictions on Award Shares, the Administrator may require the holder to deposit any certificates (or indicia of ownership) representing Award Shares, with stock powers or other transfer instruments approved by the Administrator endorsed in blank, with the Company or an agent of the Company to hold in escrow until the restrictions have lapsed or terminated. The Administrator may also cause a legend or legends referencing the restrictions to be placed on any such certificates.

17. **Beneficiaries**

An Awardee may, if permitted by the Administrator and on a form prescribed by the Administrator, file a written designation of one or more beneficiaries who are to receive the Awardee s rights under the Awardee s

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Awards after the Awardee s death. An Awardee may change such a designation at any time by written notice. If an Awardee designates a beneficiary, the beneficiary may exercise the Awardee s Awards after the Awardee s death. If an Awardee dies when the Awardee has no living beneficiary designated under this Plan, the Company shall allow the executor or administrator of the Awardee s estate to exercise the Award or, if there is none, the person entitled to exercise the Option under the Awardee s will or the laws of descent and distribution. In any case, no Award may be exercised after its Expiration Date.

18. **Miscellaneous**

18.1 **Governing Law.** This Plan, the Award Agreements and all other agreements entered into under this Plan, and all actions taken under this Plan or in connection with Awards or Award Shares, shall be governed by the laws of the State of Delaware without giving effect to principles of conflicts of law.

18.2 **Determination of Value.** Fair Market Value of a Share shall be determined as follows:

(a) ***Listed Stock***. If Shares are traded on any established stock exchange or quoted on a national market system, Fair Market Value shall be the closing sales price as quoted on that stock exchange or system for the day before the date the value is to be determined (the ***Value Date***) as reported in *The Wall Street Journal* or a similar publication. If no sales are reported as having occurred on the day before the Value Date, Fair Market Value shall be that closing sales price for the last preceding trading day on which sales of Shares are reported as having occurred. If no sales are reported as having occurred during the five trading days before the Value Date, Fair Market Value shall be the closing bid for the Shares on the day before the Value Date. If the Shares of the Company are listed on multiple exchanges or systems, Fair Market Value shall be based on sales or bid prices on the primary exchange or system on which Shares of the Company are traded or quoted.

(b) ***Stock Quoted by Securities Dealer***. If Shares are regularly quoted by a recognized securities dealer but selling prices are not reported on any established stock exchange or quoted on a national market system, Fair Market Value shall be the mean between the high bid and low asked prices on the day before the Value Date. If no prices are quoted for the day before the Value Date, Fair Market Value shall be the mean between the high bid and low asked prices on the last preceding trading day on which any bid and asked prices were quoted.

(c) ***No Established Market***. If Shares are not traded on any established stock exchange or quoted on a national market system and are not quoted by a recognized securities dealer, the Administrator (following guidelines established by the Board or Committee) will determine Fair Market Value of the Shares in good faith.

(d) ***Class A Preferred Stock***. If shares of the Company s Common Stock are traded on any established stock exchange or quoted on a national market system, the Fair Market Value of shares of the Company s Class A Preferred Stock shall be equal to the Fair Market Value of the Company s Common Stock, as of the relevant valuation date for all purposes under this Plan.

18.3 **Availability of Shares.** During the term of this Plan, the Company shall at all times keep available such number of Shares as are still issuable under this Plan.

18.4 **Electronic Communications.** Any Award Agreement, notice of exercise of an Award, or other document required or permitted by this Plan may be delivered in writing or, to the extent determined by the Administrator, electronically. Signatures may also be electronic if permitted by the Administrator.

18.5 **Notices.** Unless the Administrator specifies otherwise, any notice to the Company under any Award Agreement or with respect to any Awards or Award Shares shall be in writing (or, if so authorized by Section 18.4, communicated electronically), shall be addressed to the Secretary of the Company, and shall only be effective when received by the Secretary of the Company.

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Annex D

2006 EMPLOYEE STOCK PURCHASE PLAN

1. **Establishment of Plan**.

SAIC, Inc. (the ***Company***) proposes to grant options for purchase of the Company s Class A Preferred Stock or the Company s Common Stock as determined by the Committee to eligible employees of the Company and its Participating Subsidiaries pursuant to this 2006 Employee Stock Purchase Plan (this ***Plan***). The Company intends this Plan to qualify as an employee stock purchase plan under Section 423 of the Code (including any amendments to or replacements of such Section), although the Company makes no undertaking or representation to maintain such qualification. In addition, the Plan authorizes the grant of options under a Non-423 Plan Component pursuant to rules, procedures or sub-plans adopted by the Board (or its designate) designed to achieve desired tax or other objectives. To the extent that the Company grants options to employees of its Affiliates, such grants shall be made under the Non-423 Plan Component. Any term not expressly defined in this Plan but defined for purposes of Section 423 of the Code shall have the same definition herein.

2. **Definitions**.

This Plan uses the following defined terms:

(a) ***Affiliate*** means any entity other than a Subsidiary in which the Company has a controlling interest and which is not a subsidiary corporation as defined in Section 424(f) of the Code.

(b) ***Annual Increase*** means the automatic annual increase in the Share Limit described in Section 3.

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

(d) ***Class A Preferred Stock*** means the Class A Preferred Stock of the Company.

(e) ***Code*** means the Internal Revenue Code of 1986, as amended.

(f) ***Committee*** means the Compensation Committee of the Board.

(g) ***Common Stock*** means the Common Stock of the Company.

(h) ***Company*** means SAIC, Inc., a Delaware corporation.

(i) ***employee*** has the meaning set forth in Section 4.

(j) ***Employee Stock Purchase Committee*** means a committee consisting of one or more management employees of the Company appointed in accordance with Section 5.

(k) ***fair market value*** means the value of a Share as determined under Section 10.

(l) ***First Offering Period*** means the period commencing and ending on those dates determined by the Committee.

(m) ***Maximum Share Amount*** means a maximum number of Shares which may be purchased by any employee at any single Purchase Date described in Section 12.

(n) ***Non-423 Plan Component*** means a component of this Plan which does not qualify under Section 423 of the Code.

(o) ***Notice Period*** means the period within two (2) years from the Offering Date relating to the applicable shares or one (1) year from the Purchase Date on which the applicable shares were purchased.

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(p) ***Offering Date*** means the first business day of each Offering Period.

(q) ***Offering Period*** means a period of three (3) months except for the First Offering Period as set forth in Section 7 of this Plan. The duration and timing of Offering Periods may be changed pursuant to Section 7, Section 16 and Section 29 of this Plan, provided that no Offering Period shall exceed a period of twenty-four (24) months.

(r) ***Parent Corporation*** shall have the same meaning as parent corporation in Section 424(e) of the Code.

(s) ***Participating Subsidiaries*** means Science Applications International Corporation and such Parent Corporations, Subsidiaries or Affiliates that the Board designates from time to time as corporations that shall participate in this Plan.

(t) ***Plan*** means this 2006 Employee Stock Purchase Plan of the Company.

(u) ***Purchase Date*** means the last business day of each Purchase Period.

(v) ***Purchase Period*** means a period of three (3) months, except for the first Purchase Period, coincident with an Offering Period. The duration and timing of Purchase Periods may be changed pursuant to Section 7, Section 16 and Section 29 of this Plan, provided that no Purchase Period shall exceed a period of six (6) months.

(w) ***Reserves*** means the number and type of Shares covered by each option under this Plan which has not yet been exercised and the number and type of Shares which have been authorized for issuance under this Plan, including the Annual Increase, but have not yet been placed under option.

(x) ***Share*** means a share of the Class A Preferred Stock or Common Stock, as determined by the Committee.

(y) ***Share Limit*** means the limit on the total number of Shares available for issuance under this Plan described in Section 3.

(z) ***Subsidiary*** shall have the same meaning as subsidiary corporation in Section 424(f) of the Code.

(aa) ***Value Date*** means the date the fair market value of a Share is to be determined.

3. **Number of Shares**.

The total number of Shares initially available for issuance pursuant to this Plan shall be 9,000,000 (the ***Share Limit***), subject to adjustments effected in accordance with Section 16 of this Plan. Notwithstanding the foregoing and subject to Section 16, the Share Limit shall automatically increase on February 1, 2007 and February 1 of each year thereafter until and including February 1, 2016 (unless the Plan is terminated earlier in accordance with the provisions hereof) by the ***Annual Increase*** which shall consist of a number of shares equal to the least of (i) 9,000,000, (ii) two percent (2%) of the number of shares of Common Stock of the Company outstanding on the last day of the immediately preceding fiscal year (measured on an as-converted basis with respect to outstanding shares of Class A Preferred Stock), or (iii) a lesser number determined by the Committee prior to such February 1. To the extent the Board (or its designate) shall have implemented a Non-423 Plan Component, the Share Limit shall be reduced by the number of shares issued under the Non-423 Plan Component. Shares issued under this Plan may consist, in whole or in part, of authorized and unissued shares or treasury shares reacquired in private transactions or open market purchases, but all shares issued under this Plan and the Non-423 Plan Component shall be counted against the Share Limit.

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4. **Purpose**.

The purpose of this Plan is to provide eligible employees of the Company and Participating Subsidiaries with a convenient means of acquiring an equity interest in the Company through payroll deductions, to enhance such employees sense of participation in the affairs of the Company and Participating Subsidiaries, and to provide an incentive for continued employment. For the purposes of this Plan, employee shall mean any individual who is an employee of the Company or a Participating Subsidiary. Whether an individual qualifies as an employee shall be determined by the Committee, in its sole discretion. The Committee shall be guided by the provisions of Treasury Regulation Section 1.421-7 and Section 3401(c) of the Code and the Treasury Regulations thereunder as to employees in the United States, with the intent that the Plan cover all employees within the meaning of those provisions other than those who are not eligible to participate in the Plan, provided, however, that any determinations regarding whether an individual is an employee shall be prospective only, unless otherwise determined by the Committee. Unless the Committee makes a contrary determination, the employees of the Company shall, for all purposes of this Plan, be those individuals who are carried as employees of the Company or a Participating Subsidiary for regular payroll purposes or are on a leave of absence for not more than 90 days. Any inquiries regarding eligibility to participate in the Plan shall be directed to the Committee, whose decision shall be final.

5. **Administration**.

This Plan shall be administered by the Committee. The Committee may delegate certain administrative responsibilities to an Employee Stock Purchase Committee, including (a) prescribing, amending and rescinding rules and regulations relating to the Plan; (b) prescribing forms for carrying out the provisions and purposes of the Plan; (c) interpreting the Plan; and (d) making all other determinations deemed necessary or advisable for the administration of the Plan, including factual determinations. Subject to the provisions of this Plan, the Committee shall have all authority to (i) determine and change the percentage discount pursuant to Section 10, (ii) determine and change the Offering Periods and Offering Dates pursuant to Section 7, (iii) determine and change the purchase price for shares pursuant to Section 10, (iv) prescribe minimum holding periods for the Shares issued under this Plan, and (v) prescribe, amend and rescind rules and regulations relating to this Plan. All decisions of the Committee and the Employee Stock Purchase Committee shall be final and binding upon all participants. Members of the Committee and the Employee Stock Purchase Committee shall receive no compensation for their services in connection with the administration of this Plan, other than standard fees as established from time to time by the Board for services rendered by Board members serving on Board committees. All expenses incurred in connection with the administration of this Plan shall be paid by the Company.

6. **Eligibility**.

Any employee of the Company or the Participating Subsidiaries is eligible to participate in an Offering Period (as hereinafter defined) under this Plan except the following:

(a) employees who are not employed by the Company or a Participating Subsidiary prior to the beginning of such Offering Period or prior to such other time period as specified by the Committee;

(b) employees who, together with any other person whose stock would be attributed to such employee pursuant to Section 424(d) of the Code, own stock or hold options to purchase stock possessing five percent (5%) or more of the total combined voting power or value of all classes of stock of the Company or any of its Participating Subsidiaries or who, as a result of being granted an option under this Plan with respect to such Offering Period, would own stock or hold options to purchase stock possessing five percent (5%) or more of the total combined voting power or value of all classes of stock of the Company or any of its Participating Subsidiaries;

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(c) individuals who provide services to the Company or any of its Participating Subsidiaries as independent contractors who are reclassified as common law employees for any reason except for federal income and employment tax purposes; and

(d) employees who reside in countries for whom such employees participation in the Plan would result in a violation under any corporate or securities laws of such country of residence.

7. **Offering Dates**.

The Offering Periods of this Plan may be up to twenty-four (24) months in duration and may consist of up to eight (8) Purchase Periods of up to six (6) months in duration during which payroll deductions of the participants are accumulated under this Plan. However, unless and until determined otherwise by the Committee, except for the First Offering Period, each Offering Period shall have a duration of three months and shall commence on April 1, July 1, October 1 or January 1 and each Offering Period shall have only one Purchase Period which shall run simultaneously with the Offering Period. The First Offering Period shall commence and end on those dates determined by the Committee. The Committee shall have the power to change the Offering Dates, the Purchase Dates and the duration of Offering Periods or Purchase Periods without stockholder approval if such change is announced prior to the relevant Offering Period or prior to such other time period as specified by the Committee.

8. **Participation in this Plan**.

Eligible employees may become participants in an Offering Period under this Plan on the Offering Date, after satisfying the eligibility requirements, by delivering a subscription agreement to the Company prior to such Offering Date, or such other time period as specified by the Committee. An eligible employee who does not deliver a subscription agreement to the Company after becoming eligible to participate in an Offering Period shall not participate in that Offering Period or any subsequent Offering Period unless such employee enrolls in this Plan by delivering a subscription agreement with the Company prior to such Offering Period, or such other time period as specified by the Committee. Once an employee becomes a participant in an Offering Period by filing a subscription agreement, such employee shall automatically participate in the Offering Period commencing immediately following the last day of the prior Offering Period unless the employee withdraws or is deemed to withdraw from this Plan or terminates further participation in the Offering Period as set forth in Section 13 below. Such participant is not required to file any additional subscription agreement in order to continue participation in this Plan.

9. **Grant of Option on Enrollment**.

Enrollment by an eligible employee in this Plan with respect to an Offering Period shall constitute the grant (as of the Offering Date) by the Company to such employee of an option to purchase on the Purchase Date up to that number of Shares determined by a fraction, the numerator of which is the amount accumulated in such employee s payroll deduction account during such Purchase Period and the denominator of which is eighty-five percent (85%) (unless such percentage is changed pursuant to Section 10) of the fair market value of a Share on the Purchase Date (but in no event less than the par value of a Share), provided, however, that the number of Shares subject to any option granted pursuant to this Plan shall not exceed the lesser of (x) the maximum number of shares set by the Committee pursuant to Section 12(c) below with respect to the applicable Purchase Date, or (y) the maximum number of shares which may be purchased pursuant to Section 12(b) below with respect to the applicable Purchase Date. The fair market value of a Share shall be determined as provided in Section 10 below. Notwithstanding the foregoing, in the event of a change in generally accepted accounting principles which would adversely affect the accounting treatment applicable to any current Offering Period, the Committee may make such changes to the number of Shares purchased at the end of Purchase Period or the purchase price paid as are

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allowable under generally accepted accounting principles and as it deems necessary in the sole discretion of the Committee to avoid or minimize adverse accounting consequences.

10. **Purchase Price**.

The purchase price per Share at which a Share shall be sold in any Offering Period shall be eighty-five percent (85%) of the fair market value of the Shares on the Purchase Date; provided that the Committee may change the purchase price to be anywhere from eighty-five percent (85%) to one hundred percent (100%) of the fair market value of a Share on the Offering Date or the Purchase Date.

For purposes of this Plan, fair market value of a Share shall be determined as follows:

(a) ***Listed Stock***. If Shares are traded on any established stock exchange or quoted on a national market system, fair market value shall be the closing sales price as quoted on that stock exchange or system for the day before the Value Date as reported in The Wall Street Journal or a similar publication. If no sales are reported as having occurred on the day before the Value Date, fair market value shall be that closing sales price for the last preceding trading day on which sales of Shares are reported as having occurred. If no sales are reported as having occurred during the five trading days before the Value Date, fair market value shall be the closing bid for the Shares on the day before the Value Date. If the Shares of the Company are listed on multiple exchanges or systems, fair market value shall be based on sales or bid prices on the primary exchange or system on which Shares of the Company are traded or quoted.

(b) ***Stock Quoted by Securities Dealer***. If Shares are regularly quoted by a recognized securities dealer but selling prices are not reported on any established stock exchange or quoted on a national market system, fair market value shall be the mean between the high bid and low asked prices on the day before the Value Date. If no prices are quoted for the day before the Value Date, fair market value shall be the mean between the high bid and low asked prices on the last preceding trading day on which any bid and asked prices were quoted.

(c) ***No Established Market***. If Shares are not traded on any established stock exchange or quoted on a national market system and are not quoted by a recognized securities dealer, the Committee (following guidelines established by the Board) will determine the fair market value of the Shares in good faith.

(d) ***Class A Preferred Stock***. If shares of the Company s Common Stock are traded on any established stock exchange or quoted on a national market system, the fair market value of shares of the Company s Class A Preferred Stock shall be equal to the fair market value of the Company s Common Stock, as of the relevant valuation date, for all purposes under this Plan.

11. **Payment of Purchase Price; Changes in Payroll Deductions; Issuance of Shares**.

(a) The purchase price of the shares is accumulated by regular payroll deductions made during each Offering Period. The deductions are made as a percentage of the participant s compensation in one percent (1%) increments, not less than one percent (1%), nor greater than ten percent (10%), or such lower limit set by the Committee. Compensation shall mean, in the case of employees subject to tax in the United States, all W-2 cash compensation, including, but not limited to, base salary, wages, bonuses, incentive compensation, commissions, overtime, shift premiums, plus draws against commissions, provided, however that compensation shall not include any long term disability or workers compensation payments, car allowances, relocation payments or expense reimbursements and further provided, however, that for purposes of determining a participant s compensation, any election by such participant to reduce his or her regular cash remuneration under

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Sections 125 or 401(k) of the Code shall be treated as if the participant did not make such election. In the case of employees not subject to tax in the United States, the Committee shall establish a comparable definition of compensation. Payroll deductions shall commence on the first payday of the Offering Period and shall continue to the end of the Offering Period unless sooner altered or terminated as provided in this Plan. If payroll deductions are not permitted in a jurisdiction, participants in that jurisdiction may contribute via check or pursuant to another method approved by the Committee.

(b) A participant may increase or decrease the rate of payroll deductions during an Offering Period by filing with the Company a new authorization for payroll deductions, in which case the new rate shall become effective for the next payroll period commencing after the tenth business day after the Company s receipt and processing of the authorization and shall continue for the remainder of the Offering Period unless changed as described below. Such change in the rate of payroll deductions may be made at any time during an Offering Period, but not more than one (1) change may be made effective during any Purchase Period. A participant may increase or decrease the rate of payroll deductions for any subsequent Offering Period by filing with the Company a new authorization for payroll deductions prior to the beginning of such Offering Period, or such other time period as specified by the Committee.

(c) A participant may reduce his or her payroll deduction percentage to zero during an Offering Period by filing with the Company a request for cessation of payroll deductions. Such reduction shall be effective beginning with the next payroll period after the Company s receipt of the request and no further payroll deductions shall be made for the duration of the Offering Period. Payroll deductions credited to the participant s account prior to the effective date of the request shall be used to purchase Shares in accordance with Section (e) below. A participant may not resume making payroll deductions during the Offering Period in which he or she reduced his or her payroll deductions to zero.

(d) All payroll deductions made for a participant are credited to his or her account under this Plan and are deposited with the general funds of the Company. No interest accrues on the payroll deductions, unless required by local law. All payroll deductions received or held by the Company may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions, unless required by local law.

(e) On each Purchase Date, for so long as this Plan remains in effect, and provided that the participant has not submitted a signed and completed withdrawal form before that date, which notifies the Company that the participant wishes to withdraw from that Offering Period under this Plan and have all payroll deductions accumulated in the account maintained on behalf of the participant, as of that date returned to the participant, the Company shall apply the funds then in the participant s account to the purchase of whole and fractional Shares reserved under the option granted to such participant with respect to the Offering Period to the extent that such option is exercisable on the Purchase Date. The purchase price per share shall be as specified in Section 10 of this Plan. In the event that this Plan has been oversubscribed, all funds not used to purchase shares on the Purchase Date shall be returned to the participant, without interest. No Share shall be purchased on a Purchase Date on behalf of any employee whose participation in this Plan has terminated prior to such Purchase Date.

(f) As soon as practicable after the Purchase Date, the Company shall issue shares for the participant s benefit representing the shares purchased upon exercise of his or her option.

(g) During a participant s lifetime, his or her option to purchase shares hereunder is exercisable only by him or her. The participant shall have no interest or voting rights in shares covered by his or her option until such option has been exercised and shares have been issued to the participant.

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12. **Limitations on Shares to be Purchased**.

(a) No participant shall be entitled to purchase stock under this Plan at a rate which, when aggregated with his or her rights to purchase stock under all other employee stock purchase plans of the Company or any Subsidiary, exceeds $25,000 in fair market value, determined as of the Offering Date (or such other limit as may be imposed by the Code) for each calendar year in which the employee participates in this Plan. The Company shall have the authority to take all necessary action, including but not limited to, suspending the payroll deductions of any participant, in order to ensure compliance with this Section.

(b) No participant shall be entitled to purchase more than the Maximum Share Amount on any single Purchase Date. Prior to the commencement of any Offering Period or prior to such time period as specified by the Committee, the Committee may, in its sole discretion, set a Maximum Share Amount. The Maximum Share Amount shall be 2,500 shares. If a new Maximum Share Amount is set, then all participants must be notified of such Maximum Share Amount prior to the commencement of the next Offering Period. The Maximum Share Amount shall continue to apply with respect to all succeeding Purchase Dates and Offering Periods unless revised by the Committee as set forth above.

(c) If the number of shares to be purchased on a Purchase Date by all employees participating in this Plan exceeds the number of shares then available for issuance under this Plan, then the Company shall make a pro rata allocation of the remaining shares in as uniform a manner as shall be reasonably practicable and as the Committee shall determine to be equitable. In such event, the Company shall give written notice of such reduction of the number of shares to be purchased under a participant s option to each participant affected.

(d) Any payroll deductions accumulated in a participant s account which are not used to purchase stock due to the limitations in this Section 12 shall be returned to the participant as soon as practicable after the end of the applicable Purchase Period, without interest unless required by local law.

13. **Withdrawal**.

(a) Each participant may withdraw from an Offering Period under this Plan by signing and delivering to the Company a written notice to that effect on a form provided for such purpose. Such withdrawal may be elected at any time prior to the end of an Offering Period, or such other time period as specified by the Committee.

(b) Upon withdrawal from this Plan, the accumulated payroll deductions shall be returned to the withdrawn participant, without interest, and his or her interest in this Plan shall terminate. In the event a participant voluntarily elects to withdraw from this Plan, he or she may not resume his or her participation in this Plan during the same Offering Period, but he or she may participate in any Offering Period under this Plan which commences on a date subsequent to such withdrawal by filing a new authorization for payroll deductions in the same manner as set forth in Section 8 above for initial participation in this Plan.

(c) At such times, if any, when there are multiple Purchase Periods within an Offering Period and the purchase price can be based on the fair market value at the beginning of the Offering Period, if the fair market value on the first day of the current Offering Period in which a participant is enrolled is higher than the fair market value on the first day of any subsequent Offering Period, the Company shall automatically enroll such participant in the subsequent Offering Period. Any funds accumulated in a participant s account prior to the first day of such subsequent Offering Period shall be applied to the purchase of shares on the Purchase Date immediately prior to the first day of such subsequent Offering Period, if any.

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14. **Termination of Employment**.

Termination of a participant s employment for any reason, including retirement, death or the failure of a participant to remain an eligible employee of the Company or of a Participating Subsidiary, shall immediately terminate his or her participation in this Plan. In such event, the payroll deductions credited to the participant s account shall be returned to him or her or, in the case of his or her death, to his or her legal representative, without interest. For purposes of this Section 14, an employee shall not be deemed to have terminated employment or failed to remain in the continuous employ of the Company or of a Participating Subsidiary in the case of sick leave, military leave, or any other leave of absence approved by the Board, provided, however that such leave is for a period of not more than ninety (90) days or reemployment upon the expiration of such leave is guaranteed by contract or statute.

15. **Return of Payroll Deductions**.

In the event a participant s interest in this Plan is terminated by withdrawal, termination of employment or otherwise, or in the event this Plan is terminated by the Board, the Company shall deliver to the participant all payroll deductions credited to such participant s account. No interest shall accrue on the payroll deductions of a participant in this Plan, unless required by local law.

16. **Capital Changes**.

Subject to any required action by the stockholders of the Company, the Reserves, as well as the price per Share covered by each option under this Plan which has not yet been exercised, shall be proportionately adjusted for any increase or decrease in the number of issued and outstanding Shares resulting from a stock split or the payment of a stock dividend (but only on the Shares), any other increase or decrease in the number of issued and outstanding Shares effected without receipt of any consideration by the Company or other change in the corporate structure or capitalization affecting the Company s present Shares, provided, however, that conversion of any convertible securities of the Company shall not be deemed to have been effected without receipt of consideration. Such adjustment shall be made by the Committee, whose determination shall be final, binding and conclusive. Except as expressly provided herein, no issue by the Company of shares of stock of any class, or securities convertible into shares of stock of any class, shall affect, and no adjustment by reason thereof shall be made with respect to, the number or price of Shares subject to an option.

In the event of the proposed dissolution or liquidation of the Company, the Offering Period shall terminate immediately prior to the consummation of such proposed action, unless otherwise provided by the Committee. The Committee may, in the exercise of its sole discretion in such instances, declare that this Plan shall terminate as of a date fixed by the Committee and give each participant the right to purchase shares under this Plan prior to such termination. In the event of (i) a merger or consolidation in which the Company is not the surviving corporation (other than a merger or consolidation with a wholly-owned subsidiary, a reincorporation of the Company in a different jurisdiction, or other transaction in which there is no substantial change in the stockholders of the Company or their relative stock holdings and the options under this Plan are assumed, converted or replaced by the successor corporation, which assumption shall be binding on all participants), (ii) a merger in which the Company is the surviving corporation but after which the stockholders of the Company immediately prior to such merger (other than any stockholder that merges, or which owns or controls another corporation that merges, with the Company in such merger) cease to own their shares or other equity interest in the Company, (iii) the sale of all or substantially all of the assets of the Company, or (iv) the acquisition, sale, or transfer of more than 50% of the outstanding shares of the Company by tender offer or similar transaction, the Plan shall continue with regard to Offering Periods that commenced prior to the closing of the proposed

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transaction and shares shall be purchased based on the fair market value of the surviving corporation s stock on each Purchase Date, unless otherwise provided by the Committee.

The Committee may, if it so determines in the exercise of its sole discretion, also make provision for adjusting the Reserves, as well as the price per Share covered by each outstanding option, in the event that the Company effects one or more reorganizations, recapitalizations, rights offerings or other increases or reductions of its outstanding Shares, or in the event of the Company being consolidated with or merged into any other corporation.

17. **Nonassignability**.

Neither payroll deductions credited to a participant s account nor any rights with regard to the exercise of an option or to receive shares under this Plan may be assigned, transferred, pledged or otherwise disposed of in any way (other than by will, the laws of descent and distribution or as provided in Sections 25 or 26 below) by the participant. Any such attempt at assignment, transfer, pledge or other disposition shall be void and without effect.

18. **Reports**.

Individual accounts shall be maintained for each participant in this Plan. Each participant shall receive, as soon as practicable after the end of each Purchase Period, a report of his or her account setting forth the total payroll deductions accumulated, the number of shares purchased, the per share price thereof and the remaining cash balance, if any, carried forward to the next Purchase Period or Offering Period, as the case may be.

19. **Notice of Disposition**.

Each participant shall notify the Company in writing if the participant disposes of any of the shares purchased in any Offering Period pursuant to this Plan if such disposition occurs within the Notice Period. The Company may, at any time during the Notice Period, place a legend or legends on any certificate representing shares acquired pursuant to this Plan requesting the Company s transfer agent to notify the Company of any transfer of the shares. The obligation of the participant to provide such notice shall continue notwithstanding the placement of any such legend on the certificates.

20. **No Rights to Continued Employment**.

An employee s employment with the Company or a Subsidiary is not for any specified term and may be terminated by such employee or by the Company or a Subsidiary at any time, for any reason, with or without cause. Nothing in this Plan shall confer upon any employee any right to continue in the employ of, or affiliation with, the Company or a Subsidiary nor constitute any promise or commitment by the Company or a Subsidiary regarding future positions, future work assignments, future compensation or any other term or condition of employment or affiliation.

21. **Equal Rights and Privileges**.

All eligible employees shall have equal rights and privileges with respect to this Plan so that this Plan qualifies as an employee stock purchase plan within the meaning of Section 423 or any successor provision of the Code and the related regulations, except for differences that may be mandated by local law and that are consistent with Code Section 423(b)(5); provided, however, that participants participating in the Non-423 Plan Component by means of rules, procedures or sub-plans adopted pursuant to Section 22 need not have the same rights and privileges as participants participating in the Section 423 Plan.

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22. **Additional Provisions to Comply with Local Law**.

The Committee may from time to time establish one or more sub-plans under the Plan for purposes of satisfying applicable laws of state and local domestic United States and non-United States jurisdictions. The Committee shall establish such sub-plans by adopting supplements to this Plan containing such additional terms and conditions not otherwise inconsistent with the Plan as the Committee shall deem necessary or desirable. To the extent inconsistent with the requirements of Code Section 423, such sub-plans and/or supplements shall be considered part of the Non-423 Plan Component, and the options granted thereunder shall not be considered to comply with Section 423. All supplements adopted by the Committee shall be deemed to be part of the Plan and the Company shall not be required to provide copies of any supplement to participants in any jurisdiction that is not the subject of such supplement.

23. **Notices**.

All notices or other communications by a participant to the Company under or in connection with this Plan shall be deemed to have been duly given when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.

24. **Term; Stockholder Approval**.

After this Plan is adopted by the Board, this Plan shall become effective on the date on which the First Offering Period commences subject to the effectiveness of the merger of SAIC Merger Sub, Inc. with and into Science Applications International Corporation. This Plan shall be approved by the stockholders of the Company, in any manner permitted by applicable corporate law, within twelve (12) months before or after the date this Plan is adopted by the Board. No purchase of shares pursuant to this Plan shall occur prior to such stockholder approval. This Plan shall continue until the earlier to occur of (a) termination of this Plan by the Board (which termination may be effected by the Board at any time), (b) issuance of all of the Shares available for issuance under this Plan, or (c) ten (10) years from the approval of this Plan by stockholders.

25. **Death of a Non-U.S. Participant**.

In the event a non U.S. participant dies with accumulated payroll deductions having been accumulated to purchase shares at the next Purchase Date, such amounts shall be paid to the estate of the participant.

26. **Designation of Beneficiary**.

(a) A participant may file a written designation of a beneficiary who is to receive any shares and cash, if any, from the participant s account under this Plan in the event of such participant s death subsequent to the end of an Purchase Period but prior to delivery to him of such shares and cash. In addition, a participant may file a written designation of a beneficiary who is to receive any cash from the participant s account under this Plan in the event of such participant s death prior to a Purchase Date.

(b) Such designation of beneficiary may be changed by the participant at any time by written notice. In the event of the death of a participant and in the absence of a beneficiary validly designated under this Plan who is living at the time of such participant s death, the Company shall deliver such shares or cash to the executor or administrator of the estate of the participant, or if no such executor or administrator has been appointed (to the knowledge of the Company), the Company, in its discretion, may deliver such shares or cash to the spouse or to any one or more dependents or relatives of the participant, or if no spouse, dependent or relative is known to the Company, then to such other person as the Company may designate.

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27. **Conditions Upon Issuance of Shares; Limitation on Sale of Shares**.

Shares shall not be issued with respect to an option unless the exercise of such option and the issuance and delivery of such shares pursuant thereto shall comply with all applicable provisions of law, domestic or foreign, including, without limitation, the Securities Act of 1933, as amended, the Securities Exchange Act of 1934, as amended, the rules and regulations promulgated thereunder, and the requirements of any stock exchange or automated quotation system upon which the shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

28. **Applicable Law**.

The Plan shall be governed by the substantive laws (excluding the conflict of laws rules) of the State of Delaware.

29. **Amendment or Termination**.

The Board may at any time amend or terminate this Plan, except that any such termination cannot affect options previously granted under this Plan, nor may any amendment make any change in an option previously granted which would adversely affect the right of any participant, nor may any amendment be made without approval of the stockholders of the Company obtained in accordance with Section 24 above within twelve (12) months of the adoption of such amendment (or earlier if required by Section 24) if such amendment would:

(a) increase the number of shares that may be issued under this Plan; or

(b) change the designation of the employees (or class of employees) eligible for participation in this Plan.

Notwithstanding the foregoing, the Board may make such amendments to the Plan as the Board determines to be advisable, including changes with respect to current Offering Periods or Purchase Periods, if the continuation of the Plan or any Offering Period would result in financial accounting treatment for the Plan that is different from the financial accounting treatment in effect on the date this Plan is adopted by the Board.

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Annex E

SECTION 262 OF THE GENERAL CORPORATION LAW OF

THE STATE OF DELAWARE

Section 262 Appraisal Rights.

(a) Any stockholder of a corporation of this State who holds shares of stock on the date of the making of a demand pursuant to subsection (d) of this section with respect to such shares, who continuously holds such shares through the effective date of the merger or consolidation, who has otherwise complied with subsection (d) of this section and who has neither voted in favor of the merger or consolidation nor consented thereto in writing pursuant to §228 of this title shall be entitled to an appraisal by the Court of Chancery of the fair value of the stockholder s shares of stock under the circumstances described in subsections (b) and (c) of this section. As used in this section, the word stockholder means a holder of record of stock in a stock corporation and also a member of record of a nonstock corporation; the words stock and share mean and include what is ordinarily meant by those words and also membership or membership interest of a member of a nonstock corporation; and the words depository receipt mean a receipt or other instrument issued by a depository representing an interest in one or more shares, or fractions thereof, solely of stock of a corporation, which stock is deposited with the depository.

(b) Appraisal rights shall be available for the shares of any class or series of stock of a constituent corporation in a merger or consolidation to be effected pursuant to §251 (other than a merger effected pursuant to §251(g) of this title), §252, §254, §257, §258, §263 or §264 of this title:

(1) Provided, however, that no appraisal rights under this section shall be available for the shares of any class or series of stock, which stock, or depository receipts in respect thereof, at the record date fixed to determine the stockholders entitled to receive notice of and to vote at the meeting of stockholders to act upon the agreement of merger or consolidation, were either (i) listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc. or (ii) held of record by more than 2,000 holders; and further provided that no appraisal rights shall be available for any shares of stock of the constituent corporation surviving a merger if the merger did not require for its approval the vote of the stockholders of the surviving corporation as provided in subsection (f) of §251 of this title.

(2) Notwithstanding paragraph (1) of this subsection, appraisal rights under this section shall be available for the shares of any class or series of stock of a constituent corporation if the holders thereof are required by the terms of an agreement of merger or consolidation pursuant to §§251, 252, 254, 257, 258, 263 and 264 of this title to accept for such stock anything except:

a. Shares of stock of the corporation surviving or resulting from such merger or consolidation, or depository receipts in respect thereof;

b. Shares of stock of any other corporation, or depository receipts in respect thereof, which shares of stock (or depository receipts in respect thereof) or depository receipts at the effective date of the merger or consolidation will be either listed on a national securities exchange or designated as a national market system security on an interdealer quotation system by the National Association of Securities Dealers, Inc. or held of record by more than 2,000 holders;

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c. Cash in lieu of fractional shares or fractional depository receipts described in the foregoing subparagraphs a. and b. of this paragraph; or

d. Any combination of the shares of stock, depository receipts and cash in lieu of fractional shares or fractional depository receipts described in the foregoing subparagraphs a., b. and c. of this paragraph.

(3) In the event all of the stock of a subsidiary Delaware corporation party to a merger effected under §253 of this title is not owned by the parent corporation immediately prior to the merger, appraisal rights shall be available for the shares of the subsidiary Delaware corporation.

(c) Any corporation may provide in its certificate of incorporation that appraisal rights under this section shall be available for the shares of any class or series of its stock as a result of an amendment to its certificate of incorporation, any merger or consolidation in which the corporation is a constituent corporation or the sale of all or substantially all of the assets of the corporation. If the certificate of incorporation contains such a provision, the procedures of this section, including those set forth in subsections (d) and (e) of this section, shall apply as nearly as is practicable.

(d) Appraisal rights shall be perfected as follows:

(1) If a proposed merger or consolidation for which appraisal rights are provided under this section is to be submitted for approval at a meeting of stockholders, the corporation, not less than 20 days prior to the meeting, shall notify each of its stockholders who was such on the record date for such meeting with respect to shares for which appraisal rights are available pursuant to subsection (b) or (c) hereof that appraisal rights are available for any or all of the shares of the constituent corporations, and shall include in such notice a copy of this section. Each stockholder electing to demand the appraisal of such stockholder s shares shall deliver to the corporation, before the taking of the vote on the merger or consolidation, a written demand for appraisal of such stockholder s shares. Such demand will be sufficient if it reasonably informs the corporation of the identity of the stockholder and that the stockholder intends thereby to demand the appraisal of such stockholder s shares. A proxy or vote against the merger or consolidation shall not constitute such a demand. A stockholder electing to take such action must do so by a separate written demand as herein provided. Within 10 days after the effective date of such merger or consolidation, the surviving or resulting corporation shall notify each stockholder of each constituent corporation who has complied with this subsection and has not voted in favor of or consented to the merger or consolidation of the date that the merger or consolidation has become effective; or

(2) If the merger or consolidation was approved pursuant to §228 or §253 of this title, then, either a constituent corporation before the effective date of the merger or consolidation, or the surviving or resulting corporation within ten days thereafter, shall notify each of the holders of any class or series of stock of such constituent corporation who are entitled to appraisal rights of the approval of the merger or consolidation and that appraisal rights are available for any or all shares of such class or series of stock of such constituent corporation, and shall include in such notice a copy of this section. Such notice may, and, if given on or after the effective date of the merger or consolidation, shall, also notify such stockholders of the effective date of the merger or consolidation. Any stockholder entitled to appraisal rights may, within 20 days after the date of mailing of such notice, demand in writing from the surviving or resulting corporation the appraisal of such holder s shares. Such demand will be sufficient if it reasonably informs the corporation of the identity of the stockholder and that the stockholder intends thereby to demand the appraisal of such holder s shares. If such notice did not notify stockholders of the effective date of the merger or consolidation, either (i) each such constituent corporation shall send a second notice before the effective

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date of the merger or consolidation notifying each of the holders of any class or series of stock of such constituent corporation that are entitled to appraisal rights of the effective date of the merger or consolidation or (ii) the surviving or resulting corporation shall send such a second notice to all such holders on or within 10 days after such effective date; provided, however, that if such second notice is sent more than 20 days following the sending of the first notice, such second notice need only be sent to each stockholder who is entitled to appraisal rights and who has demanded appraisal of such holder s shares in accordance with this subsection. An affidavit of the secretary or assistant secretary or of the transfer agent of the corporation that is required to give either notice that such notice has been given shall, in the absence of fraud, be prima facie evidence of the facts stated therein. For purposes of determining the stockholders entitled to receive either notice, each constituent corporation may fix, in advance, a record date that shall be not more than 10 days prior to the date the notice is given, provided, that if the notice is given on or after the effective date of the merger or consolidation, the record date shall be such effective date. If no record date is fixed and the notice is given prior to the effective date, the record date shall be the close of business on the day next preceding the day on which the notice is given.

(e) Within 120 days after the effective date of the merger or consolidation, the surviving or resulting corporation or any stockholder who has complied with subsections (a) and (d) hereof and who is otherwise entitled to appraisal rights, may file a petition in the Court of Chancery demanding a determination of the value of the stock of all such stockholders. Notwithstanding the foregoing, at any time within 60 days after the effective date of the merger or consolidation, any stockholder shall have the right to withdraw such stockholder s demand for appraisal and to accept the terms offered upon the merger or consolidation. Within 120 days after the effective date of the merger or consolidation, any stockholder who has complied with the requirements of subsections (a) and (d) hereof, upon written request, shall be entitled to receive from the corporation surviving the merger or resulting from the consolidation a statement setting forth the aggregate number of shares not voted in favor of the merger or consolidation and with respect to which demands for appraisal have been received and the aggregate number of holders of such shares. Such written statement shall be mailed to the stockholder within 10 days after such stockholder s written request for such a statement is received by the surviving or resulting corporation or within 10 days after expiration of the period for delivery of demands for appraisal under subsection (d) hereof, whichever is later.

(f) Upon the filing of any such petition by a stockholder, service of a copy thereof shall be made upon the surviving or resulting corporation, which shall within 20 days after such service file in the office of the Register in Chancery in which the petition was filed a duly verified list containing the names and addresses of all stockholders who have demanded payment for their shares and with whom agreements as to the value of their shares have not been reached by the surviving or resulting corporation. If the petition shall be filed by the surviving or resulting corporation, the petition shall be accompanied by such a duly verified list. The Register in Chancery, if so ordered by the Court, shall give notice of the time and place fixed for the hearing of such petition by registered or certified mail to the surviving or resulting corporation and to the stockholders shown on the list at the addresses therein stated. Such notice shall also be given by 1 or more publications at least 1 week before the day of the hearing, in a newspaper of general circulation published in the City of Wilmington, Delaware or such publication as the Court deems advisable. The forms of the notices by mail and by publication shall be approved by the Court, and the costs thereof shall be borne by the surviving or resulting corporation.

(g) At the hearing on such petition, the Court shall determine the stockholders who have complied with this section and who have become entitled to appraisal rights. The Court may require the stockholders who have demanded an appraisal for their shares and who hold stock represented by certificates to submit their certificates of stock to the Register in Chancery for notation thereon of the pendency of the appraisal proceedings; and if any stockholder fails to comply with such direction, the Court may dismiss the proceedings as to such stockholder.

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(h) After determining the stockholders entitled to an appraisal, the Court shall appraise the shares, determining their fair value exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with a fair rate of interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors. In determining the fair rate of interest, the Court may consider all relevant factors, including the rate of interest which the surviving or resulting corporation would have had to pay to borrow money during the pendency of the proceeding. Upon application by the surviving or resulting corporation or by any stockholder entitled to participate in the appraisal proceeding, the Court may, in its discretion, permit discovery or other pretrial proceedings and may proceed to trial upon the appraisal prior to the final determination of the stockholder entitled to an appraisal. Any stockholder whose name appears on the list filed by the surviving or resulting corporation pursuant to subsection (f) of this section and who has submitted such stockholder s certificates of stock to the Register in Chancery, if such is required, may participate fully in all proceedings until it is finally determined that such stockholder is not entitled to appraisal rights under this section.

(i) The Court shall direct the payment of the fair value of the shares, together with interest, if any, by the surviving or resulting corporation to the stockholders entitled thereto. Interest may be simple or compound, as the Court may direct. Payment shall be so made to each such stockholder, in the case of holders of uncertificated stock forthwith, and the case of holders of shares represented by certificates upon the surrender to the corporation of the certificates representing such stock. The Court s decree may be enforced as other decrees in the Court of Chancery may be enforced, whether such surviving or resulting corporation be a corporation of this State or of any state.

(j) The costs of the proceeding may be determined by the Court and taxed upon the parties as the Court deems equitable in the circumstances. Upon application of a stockholder, the Court may order all or a portion of the expenses incurred by any stockholder in connection with the appraisal proceeding, including, without limitation, reasonable attorney s fees and the fees and expenses of experts, to be charged pro rata against the value of all the shares entitled to an appraisal.

(k) From and after the effective date of the merger or consolidation, no stockholder who has demanded appraisal rights as provided in subsection (d) of this section shall be entitled to vote such stock for any purpose or to receive payment of dividends or other distributions on the stock (except dividends or other distributions payable to stockholders of record at a date which is prior to the effective date of the merger or consolidation); provided, however, that if no petition for an appraisal shall be filed within the time provided in subsection (e) of this section, or if such stockholder shall deliver to the surviving or resulting corporation a written withdrawal of such stockholder s demand for an appraisal and an acceptance of the merger or consolidation, either within 60 days after the effective date of the merger or consolidation as provided in subsection (e) of this section or thereafter with the written approval of the corporation, then the right of such stockholder to an appraisal shall cease. Notwithstanding the foregoing, no appraisal proceeding in the Court of Chancery shall be dismissed as to any stockholder without the approval of the Court, and such approval may be conditioned upon such terms as the Court deems just.

(l) The shares of the surviving or resulting corporation to which the shares of such objecting stockholders would have been converted had they assented to the merger or consolidation shall have the status of authorized and unissued shares of the surviving or resulting corporation.

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PART II. INFORMATION NOT REQUIRED

IN PROXY STATEMENT/PROSPECTUS

Item 20. Indemnification of Officers and Directors

Section 145 of the General Corporation Law of the State of Delaware permits a Delaware corporation to indemnify its directors, officers, employees and agents, subject to certain limitations.

As permitted by the General Corporation Law of the State of Delaware, our restated certificate of incorporation includes a provision that eliminates the personal liability of our directors for monetary damages for breach of fiduciary duty as a director, except for liability (1) for any breach of the director s duty of loyalty to us or our stockholders, (2) for acts or omissions not in good faith or that involve intentional misconduct or a knowing violation of law, (3) under Section 174 of the General Corporation Law of the State of Delaware or (4) for any transaction from which the director derived an improper personal benefit.

As permitted by the General Corporation Law of the State of Delaware, our restated certificate of incorporation provides that (1) we shall indemnify our directors and officers to the fullest extent permitted by the General Corporation Law of the State of Delaware, subject to certain limited exceptions, (2) we may indemnify our other employees and agents as set forth in the General Corporation Law of the State of Delaware, (3) we are required to advance expenses, as incurred, to our directors and executive officers in connection with a legal proceeding to the fullest extent not prohibited by applicable law, subject to the receipt by us of an undertaking to repay such amounts to the extent required by law and (4) the rights conferred in the restated certificate of incorporation are not exclusive.

We have entered into indemnification agreements with each of our directors and executive officers to give such directors and officers additional contractual assurances regarding the scope of the indemnification set forth in our restated certificate of incorporation and to provide additional procedural protections. We also intend to enter into indemnification agreements with any new directors, executive officers and board-appointed officers in the future.

The exculpation and indemnification provisions in our restated certificate of incorporation and the indemnification provisions of indemnification agreements that have been entered into between us and each of our directors and executive officers may be sufficiently broad to permit indemnification of our directors and executive officers for liabilities arising under the Securities Act of 1933.

We also intend to maintain director and officer liability insurance, if available on reasonable terms, to insure our directors and officers against the cost of defense, the cost of settlement or payment of a judgment under certain circumstances.

Item 21. Exhibits and Financial Statement Schedules

Description of Exhibit

Exhibit Number	
2.1	Agreement and Plan of Merger, as amended and restated as of June 26, 2006, by and among Science Applications International Corporation, Registrant and SAIC Merger Sub, Inc. (attached as Annex A to the proxy statement/prospectus that is part of this registration statement).
3.1	Restated Certificate of Incorporation of Registrant filed on November 18, 2005.

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Exhibit Number	Description of Exhibit
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3.3	Restated Bylaws of Registrant. Incorporated by reference to Registrant s Amendment No. 2 to Form S-1 Registration Statement No. 333-128021, filed on November 9, 2005.
3.4	Form of Restated Bylaws of Registrant to be in effect as of the effective time of the merger.
4.1	Form of Indenture between Science Applications International Corporation and The Chase Manhattan Bank, as Trustee. Incorporated by reference to Exhibit 4.1 to Science Applications International Corporation s Amendment No. 1 to Form S-3 Registration Statement No. 333-37117, filed on November 19, 1997.
4.2	Indenture dated June 28, 2002 between Science Applications International Corporation and JPMorgan Chase Bank, as trustee. Incorporated by reference to Exhibit 4.2 to Science Applications International Corporation s Current Report on Form 8-K filed July 3, 2002 with the SEC.
4.3	Form of class A preferred stock certificate.
4.4	Form of common stock certificate.
5.1	Opinion of Heller Ehrman LLP regarding the legality of the securities being registered.
5.2	Opinion of Douglas E. Scott, Esq.
8.1	Opinion of Heller Ehrman LLP regarding certain tax matters.
10.1*	Science Applications International Corporation s Bonus Compensation Plan, as restated effective July 9, 1999. Incorporated by reference to Annex III to Science Applications International Corporation s Proxy Statement for the 1999 Annual Meeting of Stockholders as filed April 29, 1999 with the SEC. SEC File Number: 0-12771.
10.2*	Science Applications International Corporation s 1999 Stock Incentive Plan, as amended through August 15, 1999. Incorporated by reference to Exhibit 10(e) to Science Applications International Corporation s Annual Report on Form 10-K for the fiscal year ended January 31, 2000.
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10.6*	Science Applications International Corporation s Key Executive Stock Deferral Plan, as amended and restated effective January 1, 2005. Incorporated by reference to Exhibit 10.1 to Science Applications International Corporation s Current Report on Form 8-K as filed March 1, 2006 with the SEC.
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10.12*	Form of Non-Qualified Stock Option Agreement of Science Applications International Corporation s 1999 Stock Incentive Plan. Incorporated by reference to Exhibit 10.7 to Science Applications International Corporation s Current Report on Form 8-K as filed on April 3, 2006 with the SEC.
10.13	Five Year Credit Agreement, dated June 6, 2006, by and among Science Applications International Corporation, Citicorp USA, Inc., as administrative agent, Wachovia Bank, National Association, as syndication agent, and the other lenders party thereto. Incorporated by reference to Exhibit 10.1 to Science Applications International Corporation s Quarterly Report on Form 10-Q for the quarterly period ended April 30, 2006 as filed on June 9, 2006 with the SEC.
10.14*	Employment Agreement dated October 3, 2003, between Kenneth C. Dahlberg and Science Applications International Corporation. Incorporated by reference to Exhibit 10.1 to Science Applications International Corporation s Quarterly Report on Form 10-Q for the quarterly period ended October 31, 2003 as filed on December 12, 2003 with the SEC.
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10.22*	Mutual Release of Claims dated January 27, 2006, by and between Science Applications International Corporation and Duane Andrews. Incorporated by reference to Exhibit 99.3 to Science Applications International Corporation s Current Report on Form 8-K as filed on February 1, 2006 with the SEC.
10.23*	Form of 2006 Equity Incentive Plan (attached as Annex C to the proxy statement/prospectus that is part of this registration statement).
10.24*	Form of 2006 Employee Stock Purchase Plan (attached as Annex D to the proxy statement/prospectus that is part of this registration statement).
14	Science Applications International Corporation s Code of Ethics for Principal Executive Officer and Senior Financial Officers. Incorporated by reference to Exhibit 14 to Science Applications International Corporation s Annual Report on Form 10-K for the fiscal year ended January 31, 2004 as filed with the SEC on April 16, 2004.
21.1	Subsidiaries of the Registrant.
23.1	Consent of Independent Registered Public Accounting Firm, Deloitte & Touche LLP relating to Registrant.
23.2	Consent of Independent Registered Public Accounting Firm, Deloitte & Touche LLP relating to Science Applications International Corporation.
23.3	Consent of Heller Ehrman LLP (included in Exhibits 5.1 and 8.1).
24.1	Power of Attorney (included on signature page).
99.1	Consent of C. M. Albero
99.2	Consent of W. H. Demisch
99.3	Consent of J. A. Drummond
99.4	Consent of S. P. Fisher
99.5	Consent of D. H. Foley
99.6	Consent of J. J. Hamre
99.7	Consent of D. H. Alderson
99.8	Consent of A. K. Jones
99.9	Consent of H. M. J. Kraemer, Jr.
99.10	Consent of C. B. Malone
99.11	Consent of J. R. Hartley
99.12	Consent of L. J. Peck

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Exhibit Number	Description of Exhibit
99.13	Consent of L. B. Prior, III
99.14	Consent of A. L. Punaro
99.15	Consent of W. A. Roper, Jr.
99.16	Consent of E. J. Sanderson, Jr.
99.17	Consent of G. T. Singley III
99.18	Consent of T. P. Smith, III
99.19	Consent of M.W. Sopp
99.20	Consent of J. P. Walkush
99.21	Consent of J. H. Warner, Jr.
99.22	Consent of A. T. Young
99.23	Consent of Houlihan Lokey Howard & Zukin Financial Advisors, Inc.
99.24	Consent of L. A. Simpson

* Executive Compensation Plans and Arrangements.
Previously filed.

Item 22. Undertakings.

(A) The undersigned registrant hereby undertakes:

(1) To file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) To include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

(ii) To reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) if, in the aggregate, the changes in volume and price represent no more than 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement;

(iii) To include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

Provided however, that:

(A) Paragraphs (a)(1)(i) and (a)(1)(ii) of this section do not apply if the registration statement is on Form S-8, and the information required to be included in a post-effective amendment by those paragraphs is contained in reports filed with or furnished to the Commission by the

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registrant pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference in the registration statement; and

(B) Paragraphs (a)(1)(i), (a)(1)(ii) and (a)(1)(iii) of this section do not apply if the registration statement is on Form S-3 or Form F-3 and the information required to be included in a post-effective amendment by those paragraphs is contained in reports filed with or furnished to the Commission by the registrant pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934 that are incorporated by reference in the registration statement, or is contained in a form of prospectus filed pursuant to Rule 424(b) that is part of the registration statement.

(2) That, for the purpose of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

(3) To remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering.

* * *

(5) That, for the purpose of determining liability under the Securities Act of 1933 to any purchaser:

(i) If the registrant is relying on Rule 430B:

(A) Each prospectus filed by the registrant pursuant to Rule 424(b)(3)shall be deemed to be part of the registration statement as of the date the filed prospectus was deemed part of and included in the registration statement; and

(B) Each prospectus required to be filed pursuant to Rule 424(b)(2), (b)(5), or (b)(7) as part of a registration statement in reliance on Rule 430B relating to an offering made pursuant to Rule 415(a)(1)(i), (vii), or (x) for the purpose of providing the information required by section 10(a) of the Securities Act of 1933 shall be deemed to be part of and included in the registration statement as of the earlier of the date such form of prospectus is first used after effectiveness or the date of the first contract of sale of securities in the offering described in the prospectus. As provided in Rule 430B, for liability purposes of the issuer and any person that is at that date an underwriter, such date shall be deemed to be a new effective date of the registration statement relating to the securities in the registration statement to which that prospectus relates, and the offering of such securities at that time shall be deemed to be the initial bona fide offering thereof. *Provided, however*, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such effective date, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such effective date; or

(ii) If the registrant is subject to Rule 430C, each prospectus filed pursuant to Rule 424(b) as part of a registration statement relating to an offering, other than registration statements relying on Rule 430B

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or other than prospectuses filed in reliance on Rule 430A, shall be deemed to be part of and included in the registration statement as of the date it is first used after effectiveness. Provided, however, that no statement made in a registration statement or prospectus that is part of the registration statement or made in a document incorporated or deemed incorporated by reference into the registration statement or prospectus that is part of the registration statement will, as to a purchaser with a time of contract of sale prior to such first use, supersede or modify any statement that was made in the registration statement or prospectus that was part of the registration statement or made in any such document immediately prior to such date of first use.

(6) That, for the purpose of determining liability of the registrant under the Securities Act of 1933 to any purchaser in the initial distribution of the securities, the undersigned registrant undertakes that in a primary offering of securities of the undersigned registrant pursuant to this registration statement, regardless of the underwriting method used to sell the securities to the purchaser, if the securities are offered or sold to such purchaser by means of any of the following communications, the undersigned registrant will be a seller to the purchaser and will be considered to offer or sell such securities to such purchaser:

(i) Any preliminary prospectus or prospectus of the undersigned registrant relating to the offering required to be filed pursuant to Rule 424;

(ii) Any free writing prospectus relating to the offering prepared by or on behalf of the undersigned registrant or used or referred to by the undersigned registrant;

(iii) The portion of any other free writing prospectus relating to the offering containing material information about the undersigned registrant or its securities provided by or on behalf of the undersigned registrant; and

(iv) Any other communication that is an offer in the offering made by the undersigned registrant to the purchaser.

(B) The undersigned registrant hereby undertakes that, for purposes of determining any liability under the Securities Act of 1933, each filing of the registrant s annual report pursuant to Sections 13(a) or 15(d) of the Securities Exchange Act of 1934 (and, where applicable, each filing of an employee benefit plan s annual report pursuant to Section 15(d) of the Securities Exchange Act of 1934) that is incorporated by reference in the registration statement shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

(C) (1) The undersigned registrant hereby undertakes as follows: that prior to any public reoffering of the securities registered hereunder through use of a prospectus which is a part of this registration statement, by any person or party who is deemed to be an underwriter within the meaning of Rule 145(c), the issuer undertakes that such reoffering prospectus will contain the information called for by the applicable registration form with respect to reofferings by persons who may be deemed underwriters, in addition to the information called for by the other items of the applicable form.

(2) The registrant undertakes that every prospectus: (i) that is filed pursuant to paragraph (1) immediately preceding, or (ii) that purports to meet the requirements of Section 10(a)(3) of the Act and is used in connection with an offering of securities subject to Rule 415, will be filed as part of an amendment to the registration statement and will not be used until such amendment is effective, and that, for purposes of determining any liability under the Securities Act of 1933, each such post-effective amendment shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of such securities at that time shall be deemed to be the initial *bona fide* offering thereof.

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(D) Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of the registrant pursuant to the foregoing provisions, or otherwise, the registrant has been advised that in the opinion of the Securities Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by the registrant of expenses incurred or paid by a director, officer or controlling person of the registrant in the successful defense of any action, suit or proceeding) is asserted by such director, officer or controlling person in connection with the securities being registered, the registrant will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of such issue.

(E) The undersigned registrant hereby undertakes to respond to requests for information that is incorporated by reference in the prospectus pursuant to Item 4, 10(b), 11, or 13 of this form, within one business day of receipt of such request, and to send the incorporated documents by first class mail or other equally prompt means. This includes information contained in documents filed subsequent to the effective date of the registration statement through the date of responding to the request.

(F) The undersigned registrant hereby undertakes to supply by means of a post-effective amendment all information concerning a transaction, and the company being acquired involved therein, that was not the subject of and included in the registration statement when it became effective.

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SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the registrant has caused this Post-Effective Amendment No. 2 to Registration Statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Diego, State of California on the 26th of June, 2006.

SAIC, INC.

By: /s/ D. E. SCOTT

D. E. Scott

Senior Vice President,

General Counsel and Secretary

Pursuant to the requirements of the Securities Act of 1933, this Post-Effective Amendment No. 2 to Registration Statement has been signed below by the following persons in the capacities and on the dates indicated.

Signature	Title	Date
/s/ K. C. DAHLBERG **K. C. Dahlberg**	Chairman of the Board, Chief Executive Officer and Director (Principal Executive Officer)	June 26, 2006
/s/ M. W. SOPP **M. W. Sopp**	Chief Financial Officer (Principal Financial Officer)	June 26, 2006
/s/ J. R. HARTLEY **J. R. Hartley**	Controller (Principal Accounting Officer)	June 26, 2006
* **W. H. Demisch**	Director	June 26, 2006
* **J. A. Drummond**	Director	June 26, 2006
* **D. H. Foley**	Director	June 26, 2006

*	Director	June 26, 2006
J. J. Hamre		
*	Director	June 26, 2006
A. K. Jones		
*	Director	June 26, 2006
H. M. J. Kraemer, Jr.		
*	Director	June 26, 2006
C. B. Malone		

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Signature	Title	Date
* **E. J. Sanderson, Jr.**	Director	June 26, 2006
* **J. P. Walkush**	Director	June 26, 2006
* **J. H. Warner, Jr.**	Director	June 26, 2006
* **A. T. Young**	Director	June 26, 2006

*By: /s/ D. E. Scott

D.E. Scott
Attorney-in-fact

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EXHIBIT INDEX

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10.24*	Form of 2006 Employee Stock Purchase Plan (attached as Annex D to the proxy statement/prospectus that is part of this registration statement).
14	Science Applications International Corporation s Code of Ethics for Principal Executive Officer and Senior Financial Officers. Incorporated by reference to Exhibit 14 to Science Applications International Corporation s Annual Report on Form 10-K for the fiscal year ended January 31, 2004 as filed with the SEC on April 16, 2004.
21.1	Subsidiaries of the Registrant.
23.1	Consent of Independent Registered Public Accounting Firm, Deloitte & Touche LLP relating to Registrant.
23.2	Consent of Independent Registered Public Accounting Firm, Deloitte & Touche LLP relating to Science Applications International Corporation.
23.3	Consent of Heller Ehrman LLP (included in Exhibits 5.1 and 8.1).
24.1	Power of Attorney (included on signature page).
99.1	Consent of C. M. Albero
99.2	Consent of W. H. Demisch
99.3	Consent of J. A. Drummond
99.4	Consent of S. P. Fisher
99.5	Consent of D. H. Foley
99.6	Consent of J. J. Hamre
99.7	Consent of D. H. Alderson
99.8	Consent of A. K. Jones
99.9	Consent of H. M. J. Kraemer, Jr.
99.10	Consent of C. B. Malone
99.11	Consent of J. R. Hartley

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Exhibit Number	Description of Exhibit
99.12	Consent of L. J. Peck
99.13	Consent of L. B. Prior, III
99.14	Consent of A. L. Punaro
99.15	Consent of W. A. Roper, Jr.
99.16	Consent of E. J. Sanderson, Jr.
99.17	Consent of G. T. Singley III
99.18	Consent of T. P. Smith, III
99.19	Consent of M.W. Sopp
99.20	Consent of J. P. Walkush
99.21	Consent of J. H. Warner, Jr.
99.22	Consent of A. T. Young
99.23	Consent of Houlihan Lokey Howard & Zukin Financial Advisors, Inc.
99.24	Consent of L. A. Simpson

* Executive Compensation Plans and Arrangements.
Previously filed.

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ATTN: STOCK PROGRAMS

10260 CAMPUS POINT DRIVE

SAN DIEGO, CA 92121

BY INTERNET - www.proxyvote.com

Use the Internet to transmit your proxy and/or voting instructions and for electronic delivery of information up until 11:59 p.m. Eastern time on ___________, 2006. Have your proxy and voting instruction card in hand when you access the web site and follow the instructions to obtain your records and to create an electronic proxy and/or voting instruction form.

ELECTRONIC DELIVERY OF FUTURE SHAREHOLDER COMMUNICATIONS

If you would like to reduce the costs incurred by SAIC in mailing proxy materials, you can consent to receiving all future proxy statements, proxy cards and annual reports electronically via e-mail or the Internet. To sign up for electronic delivery, please follow the instructions above to vote using the Internet and, when prompted, indicate that you agree to receive or access shareholder communications electronically in future years.

BY PHONE - 1-800-690-6903

Use any touch-tone telephone to transmit your voting instructions up until 11:59 p.m. Eastern time on _____________, 2006. Have your proxy and voting instruction card in hand when you call and then follow the instructions.

BY MAIL

Mark, sign and date your proxy and voting instruction card and return it in the postage-paid envelope we have provided or return it to SAIC, c/o ADP, 51 Mercedes Way, Edgewood, NY 11717.

TO VOTE, MARK BLOCKS BELOW IN BLUE OR BLACK INK AS FOLLOWS: SAIC01 KEEP THIS PORTION FOR YOUR RECORDS

THIS PROXY AND VOTING INSTRUCTION CARD IS VALID ONLY WHEN SIGNED AND DATED.

The Board of Directors recommends a vote FOR proposals 1, 2 and 3.

VOTE ON PROPOSALS	For	Against	Abstain
1. Approval and adoption of the Agreement and Plan of Merger.	¨	¨	¨
2. Approval and adoption of the 2006 Equity Incentive Plan.	¨	¨	¨
3. Approval and adoption of the 2006 Employee Stock Purchase Plan.	¨	¨	¨

ADDITIONAL BUSINESS

In the discretion of the proxy holders or the Trustee, on any other business as may properly come before the special meeting and any adjournments, postponements or continuations thereof.

Please complete, date, sign and mail promptly in the enclosed envelope which requires no postage.

Please sign EXACTLY as name or names appear hereon. When signing as attorney, executor, trustee, administrator or guardian, please give your full title. If a trust requires the signature of more than one trustee, all required trustees must sign.

	Yes	No
HOUSEHOLDING ELECTION - Please indicate if you consent to receive certain future investor communications in a single package per household.	¨	¨

Signature [PLEASE SIGN WITHIN BOX] Date

Signature [Joint Owners] Date

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Proxy and Voting Instruction Card for Special Meeting of Stockholders on ________________, 2006

This Proxy and Voting Instruction Card is Solicited on Behalf of the Board of Directors

The undersigned hereby appoints K.C. DAHLBERG and D.E. SCOTT, and each of them, with full power of substitution, as proxies to represent the undersigned and to vote all of the shares of Class A common stock and/or Class B common stock the undersigned is entitled to vote at the Special Meeting of Stockholders of Science Applications International Corporation (the Company) to be held at the ____________________on ________________, 2006, at _____ P.M. (local time), and at any adjournment, postponement or continuation thereof (the Special Meeting of Stockholders), as indicated on the reverse side.

The undersigned also hereby instructs the Trustee, Vanguard Fiduciary Trust Company, and any successor, under the Science Applications International Corporation Retirement Plan of the Company, the Telcordia Technologies 401(k) Savings Plan of Telcordia Technologies, Inc. and the AMSEC Employees 401(k) Profit Sharing Plan of AMSEC LLC (collectively, the Plans) to vote all of the shares of Class A common stock and/or Class B common stock held for the undersigned s account in each of the Plans at the Special Meeting of Stockholders of the Company, as indicated on the reverse side.

The shares of Class A common stock and/or Class B common stock to which this proxy and voting instruction card relate will be voted as directed. **If this proxy and voting instruction card is properly signed and returned but no instructions are indicated with respect to a particular item, (A) the shares represented by this proxy and voting instruction card which the undersigned is to vote will be voted FOR proposals 1, 2 and 3, and, in the discretion of the proxy holders, on any other matters properly coming before the meeting and any adjournment, postponement or continuation thereof and (B) the shares represented by this proxy and voting instruction card held for the undersigned s account in each of the Plans will be voted on a plan-by-plan basis, in the same proportion as the shares held in each Plan for which voting instructions have been received are voted. All allocated shares of Class A common stock and/or Class B common stock held in the Plans as to which no voting instructions are received, together with all shares held in the Plans which have not yet been allocated to the accounts of participants, will be voted, on a plan-by-plan basis, in the same proportion as the shares held in each Plan for which voting instructions have been received are voted.** This proxy and voting instruction card, if properly executed and delivered in a timely manner, will revoke all prior proxies and voting instruction cards.

Please complete, sign, date and return the Proxy and Voting Instruction Card promptly using the enclosed envelope.

(Continued, and to be signed and dated on the reverse side.)