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CURATIVE HEALTH SERVICES INC

Form 10-Q

May 15, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities
-----Exchange Act of 1934

For the quarterly period ended March 31, 2001

OR

-----Transition report pursuant to Section 13 or 15 (d) of the Securities
-----Exchange Act of 1934

Commission File Number: 000-19370

Curative Health Services, Inc.

(Exact name of registrant as specified in its charter)

MINNESOTA
(State or other jurisdiction of
incorporation or organization)

41-1503914
(I.R.S. Employer
Identification Number)

150 Motor Parkway
Hauppauge, NY 11788-5108
(Address of principal executive offices)
Telephone Number (631) 232-7000

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

Yes -----

No

As of April 30, 2001 there were 7,065,403 shares of the Registrant's Common Stock, \$.01 par value, outstanding.

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Part I. Financial Information

Item 1. Condensed Consolidated Financial Statements

Curative Health Services, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)
(Unaudited)

	Three Months Ended March 31,	
	2001	2000
	----	----
Revenues	\$13,517	\$22,200
Cost and Expenses:		
Cost of product sales and services	8,097	13,984
Selling, general and administrative	5,129	6,535
	-----	-----
Total costs and operating expenses	13,226	20,519
	-----	-----
Income from operations	291	1,681
Interest income	557	624
	---	---

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Income before income taxes	848	2,305
Income taxes	356	916
	---	---
Net income	\$ 492	\$ 1,389
	===	=====
Net income per common share, basic	\$.07	\$.14
	===	===
Net income per common share, diluted	\$.07	\$.14
	===	===
Weighted average common shares, basic	7,121	10,011
	=====	=====
Weighted average common shares, diluted	7,355	10,108
	=====	=====

Curative Health Services, Inc. and Subsidiaries

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

	March 31, 2001	December 31, 2000

	(Unaudited)	
ASSETS		
Cash and cash equivalents	\$ 6,670	\$ 19,016
Marketable securities held-to-maturity	-	26,978
Accounts receivable, net	19,223	9,843
Deferred tax assets	3,131	2,806
Note receivable	1,483	-
Assets available for sale	-	3,683
Inventory	1,012	-
Prepaid and other current assets	824	1,664
	---	----
Total current assets	32,343	63,990
Property and equipment, net	6,915	7,065
Goodwill	34,182	2,988
Other assets	1,306	1,123
	----	----
Total assets	\$ 74,746	\$ 75,166
	=====	=====
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	\$ 10,994	\$ 7,308
Accrued expenses	8,543	12,288
	----	----
Total current liabilities	19,537	19,596
Stockholders' equity		
Common stock	70	71
Additional paid in capital	30,044	30,896
Retained earnings	25,095	24,603
	----	----
Total stockholders' equity	55,209	55,570

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	-----	-----
Total liabilities and stockholders' equity	\$ 74,746	\$ 75,166
	=====	=====

Curative Health Services, Inc. and Subsidiaries

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Three Months Ended March 31,	
	2001	2000
	----	----
OPERATING ACTIVITIES:		
Net income	\$ 492	\$ 1,389
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in operations of investee	111	97
Depreciation and amortization	579	1,212
Changes in operating assets and liabilities	(3,146)	1,236
	-----	-----
NET CASH (USED IN) PROVIDED BY OPERATING ACTIVITIES	(1,964)	3,934
INVESTING ACTIVITIES:		
Notes receivable	2,200	-
Acquisition of Millennium Health, Inc.	(38,535)	-
Purchase of property and equipment	(171)	(308)
Sales of marketable securities	26,978	2,030
	-----	-----
NET CASH (USED IN) PROVIDED BY INVESTING ACTIVITIES	(9,528)	1,722
FINANCING ACTIVITIES:		
Stock repurchases	(1,118)	(4,756)
Proceeds from exercise of stock options	264	36
	---	--
NET CASH USED IN FINANCING ACTIVITIES	(854)	(4,720)
	-----	-----
(DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(12,346)	936
Cash and cash equivalents at beginning of period	19,016	16,215
	-----	-----
CASH AND CASH EQUIVALENTS AT END OF PERIOD	\$ 6,670	\$ 17,151
	=====	=====

SUPPLEMENTAL INFORMATION PERTAINING TO NONCASH INVESTING AND FINANCING ACTIVITIES

In March 2000, the Company recorded an increase of \$1,417,000 to its investment in Accordant Health Services, Inc. and a corresponding increase to paid in capital related to an increase in the value of the Company's equity interest in Accordant.

Curative Health Services, Inc. and Subsidiaries

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NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

The condensed consolidated financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the financial position and operating results for the interim periods. The condensed consolidated financial statements should be read in conjunction with the consolidated financial statements for the year ended December 31, 2000 and notes thereto contained in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission. The results of operations for the three months ended March 31, 2001 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2001.

Note 2. Net Income per Common Share

Net income per common share, basic, is computed by dividing the net income by the weighted average number of common shares outstanding. Net income per common share, diluted, is computed by dividing net income by the weighted average number of shares outstanding plus dilutive common share equivalents. The following table sets forth the computation of basic and diluted earnings per share:

	2001	2000
	----	----
Weighted average shares, basic	7,121	10,011
Effect of diluted stock options	234	97
	---	--
Weighted average shares, diluted	7,355	10,108
	=====	=====

Note 3. Purchase of Millennium Health, Inc.

On March 31, 2001 the Company purchased all of the outstanding capital stock of eBiocare.com, Inc. which does business as Millennium Health, Inc. ("Millennium") for \$32.3 million in cash and the assumption and repayment of approximately \$5 million in debt. The transaction was accounted for as a stock purchase and the accounts of Millennium and related goodwill are included in the consolidated financial statements at March 31, 2001.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Results of Operations

Revenues. The Company's revenues for the first quarter of fiscal year 2001 decreased 39 percent to \$13,517,000 compared to \$22,200,000 for the first quarter of the prior fiscal year. The revenue decrease is attributable to the termination of 42 hospital based programs during the last 12 months, renegotiation of existing contracts which resulted in reduced revenue to the Company, the conversion of 15 under arrangement model programs to management models which have lower revenue and expenses, and a reduction of Procuren revenues as a result of a decline in Procuren patients. The reduction in revenue was partially offset by the opening of 9 new programs over the last 12 months. The Company ended the first quarter of 2001 with 119 hospital based Wound Care

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Centers operating compared to 153 at the end of the first quarter 2000. Revenues at existing centers declined 24 percent in the first quarter of 2001 as compared to the same period in 2000, primarily due to such contract renegotiations and declining Procuren revenues. At any time during the year, 10% to 20% of the Company's contracts are being renegotiated with the client hospital for a variety of contractual terms or issues. Historically, some contracts have expired without renewal and others have been terminated by the Company or the client hospital for various reasons prior to their scheduled expiration. Hospitals are currently facing financial challenges associated with lower occupancy rates and reduced revenue streams due to pricing pressures from third party payors. Program terminations by client hospitals have been effected for such reasons as reduced reimbursement, financial restructuring, layoffs, bankruptcies or even hospital closings. Further, the Medicare program implemented a new reimbursement system during 2000 for hospital outpatient services which has reduced reimbursement rates to hospitals. The termination, non-renewal or renegotiation of a material number of management contracts could result in a continued decline in the Company's revenue. As the result of the recent legal action against the Company, further unanticipated terminations or non-renewals may take place. Additionally, new business development has been slower than normal given the legal uncertainties facing the Company. Any inability of the Company to develop new Wound Care Centers could continue the revenue decline. The Company has and expects that it will continue to modify its management contracts with many of its hospital customers which could result in reduced revenue to the Company or even contract terminations. Further, the Company has been notified by Cytomedix, Inc. that it intends to exercise its option under the asset purchase agreement to close its Procuren processing facilities by July 2001. As a result, there will be no revenue or expenses related to Procuren subsequent to the expected closing date. Although the Company does not expect that this event will have a material effect on its operations or financial condition other than reducing revenues, there can be no assurance that this event will not result in the termination of hospital contracts. The Company has a number of initiatives to counter the decline in revenue, although there can be no assurance that the initiatives will be successful. Total new patients decreased 15 percent from 15,636 in the first quarter of 2000 to 13,260 for the same period in 2001. The total number of new patients receiving Procuren(R) therapy decreased from 1,018 in the first quarter of 2000 to 436 in the first quarter of 2001. The percentage of patients receiving Procuren(R) therapy decreased during the first quarter of 2001 to 3 percent from 7 percent for the same period in 2000.

Costs of Product Sales and Services. Costs of product sales and services for the first quarter decreased from \$13,984,000 in 2000 to \$8,097,000 in 2001, a decrease of 42 percent. The decrease is attributable to reduced staffing and operating expenses of approximately \$1,559,000 related to the operation of 119 programs at the end of the first quarter 2001 compared with 153 programs operating at the end of the first quarter 2000, and reduced expenditures of approximately \$835,000 related to Procuren production. Additionally there were 23 fewer under-arrangement programs in operation at the end of the first quarter of 2001 as compared to the same period for 2000 at which the services component of costs is higher than at the Company's other centers due to the additional clinical staffing and expenses that these models require. For the first quarter of 2001 this reduction in the number of under-arrangement programs accounted for approximately \$1,501,000 of the decrease in product costs and services. During 2000, the Company eliminated 58 sales positions which resulted in a reduction of approximately \$1,315,000 in product costs and services for the first quarter of 2001 as compared with the same period in 2000. As a percentage of revenues, costs of product sales and services for the first quarter of 2001 was 60 percent compared to 63 percent for the same period in 2000. The decrease is attributed to the lower number of under arrangement programs in operation during the first quarter of 2001 and the elimination of sales positions.

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Selling, General and Administrative. Selling, general and administrative expenses for the first quarter decreased from \$6,535,000 in 2000 to \$5,129,000 in 2001 a decrease of 22 percent. The decrease is primarily attributable to the positions eliminated at the Company during 2000 as well as the closing of the Company's Dallas field office. As a percentage of revenues, selling, general and administrative expenses were 38 percent in the first quarter of 2001 compared to 29 percent for 2000. The increase is due to the reduced revenue base in 2001.

Net Income. Net income was \$492,000 or \$0.07 per diluted share in the first quarter of 2001 compared to \$1,389,000 or \$0.14 per diluted share in the first quarter of 2000. The decrease in earnings of \$897,000 for the three months ended March 31, 2001 as compared to March 31, 2000 is attributable to reduced revenues offset by lower expenses. The net income per diluted share for the first quarter of 2001 was positively affected as compared to the first quarter of 2000 by a 2.8 million share decrease in the weighted average common shares, diluted. This decrease was primarily attributable to the Company's repurchase of shares.

Liquidity and Capital Resources.

Working capital was \$12.8 million at March 31, 2001 compared to \$44.4 million at December 31, 2000. Total cash and cash equivalents as of March 31, 2001 was \$6.7 million and was invested primarily in highly liquid money market funds, commercial paper and government securities. The Company's cash and cash equivalents and marketable securities held-to-maturity declined from \$46 million at December 31, 2000 to \$6.7 million at March 31, 2001. The decline is primarily attributable to the use of \$38.5 million for the purchase of Millennium Health, Inc. on March 30, 2001. The ratio of current assets to current liabilities was 3.3:1 at December 31, 2000 and 1.7:1 at March 31, 2001.

Cash flows used in operating activities for the first three months of 2001 totaled \$1,964,000 primarily attributable to the payment of severance and other accrued expenses. Cash flows used in investing activities totaled \$9,528,000 primarily attributable to the purchase of Millennium Health, Inc. offset by the sale of marketable securities. Cash flows used in financing activities totaled \$854,000, primarily attributable to the Company's repurchase of shares of common stock.

For the first three months of 2001, the Company experienced a net increase in accounts receivable of \$9,380,000 primarily attributable to the purchase of Millennium Health. Accounts receivable days outstanding were 71 days as of March 31, 2001 as compared to 61 days at December 31, 2000. Days outstanding for the wound care business was 59 days and for the specialty pharmacy business 87 days at March 31, 2001.

The Company's longer term cash requirements include working capital for the expansion of its wound care and specialty pharmacy businesses. Other cash requirements are anticipated for capital expenditures in the normal course of business, the acquisition of software, computers and equipment related to the Company's management information systems. Additionally the Company expects to incur significant legal costs related to the Department of Justice actions and shareholder class action lawsuits filed against the Company (See Legal Proceedings, Part II Item 1). The Company expects that based on its current business plan, its existing cash and cash equivalents will be sufficient to satisfy its current working capital needs. The Company anticipates obtaining a revolving line of credit to supplement its working capital needs as the result of the Millennium acquisition and the Department of Justice's letter of credit request (See Legal Proceedings, Part II, Item 1). The effects of inflation and foreign currency translation risks are considered immaterial.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

The Company does not have operations subject to risks of material foreign

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currency fluctuations, nor does it use derivative financial instruments in its operations or investment portfolios. The Company places its investments in instruments that meet high credit quality standards, as specified in the Company's investment policy guidelines. The Company does not expect any material loss with respect to its investment portfolio or exposure to market risks associated with interest rates.

Curative Health Services, Inc. and Subsidiaries

Part II. Other Information

Item 1. Legal Proceedings

With respect to the Company's pending litigation and legal actions previously disclosed, there have been no material developments other than disclosed in Item 3 - "Legal Proceedings" in the Company's Annual Report on form 10K filed for the year ended December 31, 2000.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 10.24 Curative Health Services, Inc. 2000 Stock Incentive Plan.

Exhibit 10.30 Stock Purchase Agreement, dated as of March 19, 2001, by and among Curative Health Services, Inc. and certain stockholders of eBiocare.com, Inc. (Incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on April 13, 2001)

Exhibit 10.31 Form of Stockholder Purchase Agreement, between Curative Health Services, Inc. and all other stockholders of eBiocare.com, Inc. (Incorporated by reference to Exhibit 2.2 to the Company's Current Report on Form 8-K filed on April 13, 2001)

Exhibit 10.32 Form of Option/Warrant Repurchase and Surrender Agreement, between eBiocare.com, Inc. and the holders of options and warrants to purchase common stock of eBiocare (Incorporated by reference to Exhibit 2.3 to the Company's Current Report on Form 8-K filed on April 13, 2001)

(b) Forms 8-K

There were no reports on Form 8-K during the quarter ended March 31, 2001.

SIGNATURES

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

Dated: May 15, 2001

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Curative Health Services, Inc.
(Registrant)

/s/ John C. Prior

John C. Prior
President

/s/ Thomas Axmacher

Thomas Axmacher
Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit 10.24

CURATIVE HEALTH SERVICES, INC. 2000 STOCK INCENTIVE PLAN

Section 1. Purpose of Plan; Effect on Prior Plan.

(a) Purpose. The purpose of the Plan (as defined below) is to promote the interests of Curative Health Services, Inc., a Minnesota corporation, and its shareholders by aiding the Company in attracting and retaining employees, officers, consultants, independent contractors and non-employee directors capable of assuring the future success of the Company, to offer such persons incentives to put forth maximum efforts for the success of the Company's business and to afford such persons an opportunity to acquire a proprietary interest in the Company.

(b) Effect on Prior Plan. From and after the Effective Date, no stock options or other awards shall be granted under the Company's 1991 Stock Option Plan, as amended (the "Prior Plan"). All stock options granted and outstanding thereunder prior to the Effective Date shall remain outstanding in accordance with the terms of the Prior Plan.

Section 2. Definitions.

As used in the Plan, the following terms shall have the meanings set forth below:

(a) "Affiliate" shall mean (i) any entity that, directly or indirectly through one or more intermediaries, is controlled by the Company and (ii) any entity in which the Company has a significant equity interest, in each case as determined by the Committee.

(b) "Award" shall mean any Option, Stock Appreciation Right, Restricted Stock, Restricted Stock Unit, Performance Award, Other Stock Grant or Other Stock-Based Award granted under the Plan.

(c) "Award Agreement" shall mean any written agreement, contract or other

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instrument or document evidencing any Award granted under the Plan.

(d) "Board" shall mean the Board of Directors of the Company.

(e) "Code" shall mean the Internal Revenue Code of 1986, as amended from time to time, and any regulations promulgated thereunder.

(f) "Committee" shall mean a committee of Directors designated by the Board to administer the Plan. The Committee shall be comprised of not less than such number of Directors as shall be required to permit Awards granted under the Plan to qualify under Rule 16b-3, and each member of the Committee shall be a "Non-Employee Director" within the meaning of Rule 16b-3 and an "outside director" within the meaning of Section 162(m) of the Code. The Company expects to have the Plan administered in accordance with the requirements for the award of "qualified performance-based compensation" within the meaning of Section 162(m) of the Code.

(g) "Company" shall mean Curative Health Services, Inc., a Minnesota corporation, and any successor corporation.

(h) "Director" shall mean a member of the Board.

(i) "Effective Date" shall mean the date given in Section 10 of the Plan.

(j) "Eligible Person" shall mean any employee, officer, consultant, independent contractor or Director providing services to the Company or any Affiliate whom the Committee determines to be an Eligible Person.

(k) "Fair Market Value" shall mean, with respect to any property (including, without limitation, any Shares or other securities), the fair market value of such property determined by such methods or procedures as shall be reasonably established in good faith from time to time by the Committee.

(l) "Incentive Stock Option" shall mean an option granted under Section 6(a) of the Plan that is intended to meet the requirements of Section 422 of the Code or any successor provision.

(m) "Non-Qualified Stock Option" shall mean an option granted under Section 6(a) of the Plan that is not intended to be an Incentive Stock Option.

(n) "Option" shall mean an Incentive Stock Option or a Non-Qualified Stock Option, and shall include Reload Options.

(o) "Other Stock Grant" shall mean any right granted under Section 6(e) of the Plan.

(p) "Other Stock-Based Award" shall mean any right granted under Section 6(f) of the Plan.

(q) "Participant" shall mean an Eligible Person designated to be granted an Award under the Plan.

(r) "Performance Award" shall mean any right granted under Section 6(d) of the Plan.

(s) "Person" shall mean any individual, corporation, partnership, association or trust.

(t) "Plan" shall mean the Curative Health Services, Inc. 2000 Stock Incentive Plan, as amended from time to time, the provisions of which are set

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forth herein.

(u) "Reload Option" shall mean any Option granted under Section 6(a)(iv) of the Plan.

(v) "Restricted Stock" shall mean any Shares granted under Section 6(c) of the Plan.

(w) "Restricted Stock Unit" shall mean any unit granted under Section 6(c) of the Plan evidencing the right to receive a Share (or a cash payment equal to the Fair Market Value of a Share) at some future date.

(x) "Rule 16b-3" shall mean Rule 16b-3 promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended, or any successor rule or regulation.

(y) "Shares" shall mean shares of Common Stock, \$.01 par value per share, of the Company or such other securities or property as may become subject to Awards pursuant to an adjustment made under Section 4(c) of the Plan.

(z) "Stock Appreciation Right" shall mean any right granted under Section 6(b) of the Plan.

Section 3. Administration.

(a) Power and Authority of the Committee. The Plan shall be administered by the Committee. Subject to the express provisions of the Plan and to applicable law, the Committee shall have full power and authority to: (i) designate Participants; (ii) determine the type or types of Awards to be granted to each Participant under the Plan; (iii) determine the number of Shares to be covered by (or with respect to which payments, rights or other matters are to be calculated in connection with) each Award; (iv) determine the terms and conditions of any Award or Award Agreement; (v) amend the terms and conditions of any Award or Award Agreement and accelerate the exercisability of Options or the lapse of restrictions relating to Restricted Stock, Restricted Stock Units or other Awards; (vi) determine whether, to what extent and under what circumstances Awards may be exercised in cash, Shares, other securities, other Awards or other property, or canceled, forfeited or suspended; (vii) determine whether, to what extent and under what circumstances cash, Shares, promissory notes, other securities, other Awards, other property and other amounts payable with respect to an Award under the Plan shall be deferred either automatically or at the election of the holder thereof or the Committee; (viii) interpret and administer the Plan and any instrument or agreement, including an Award Agreement, relating to the Plan; (ix) establish, amend, suspend or waive such rules and regulations and appoint such agents as it shall deem appropriate for the proper administration of the Plan; and (x) make any other determination and take any other action that the Committee deems necessary or desirable for the administration of the Plan, subject to the exclusive authority of the Board under Section 7(a) herein to amend or terminate this Plan. Unless otherwise expressly provided in the Plan or unless otherwise disapproved by the Board, all designations, determinations, interpretations and other decisions under or with respect to the Plan or any Award shall be within the sole discretion of the Committee, may be made at any time and shall be final, conclusive and binding upon any Participant, any holder or beneficiary of any Award and any employee of the Company or any Affiliate.

(b) Delegation. The Committee may delegate its powers and duties under the Plan to one or more officers of the Company or any Affiliate or a committee of such officers, subject to such terms, conditions and limitations as the Committee may establish in its sole discretion, provided, however, that the Committee shall not delegate its powers and duties under the Plan (i) with regard to officers or

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directors of the Company or any Affiliate who are subject to Section 16 of the Securities Exchange Act of 1934, as amended or (ii) in such a manner as would cause the Plan not to comply with the requirements of Section 162(m) of the Code.

(c) Power and Authority of the Board of Directors. Notwithstanding anything to the contrary contained herein, the Board may, at any time and from time to time, without any further action of the Committee, exercise the powers and duties of the Committee under the Plan.

Section 4. Shares Available for Awards.

(a) Shares Available. Subject to adjustment as provided in Section 4(c) of the Plan, the aggregate number of Shares that may be issued under all Awards under the Plan shall be 1,600,000. Shares to be issued under the Plan may be either authorized but unissued Shares or Shares acquired in the open market or otherwise. Any Shares that are used by a Participant as full or partial payment to the Company of the purchase price relating to an Award, or in connection with the satisfaction of tax obligations relating to an Award, shall again be available for granting Awards (other than Incentive Stock Options) under the Plan. In addition, if any Shares covered by an Award or to which an Award relates are not purchased or are forfeited, or if an Award otherwise terminates without delivery of any Shares, then the number of Shares counted against the aggregate number of Shares available under the Plan with respect to such Award, to the extent of any such forfeiture or termination, shall again be available for granting Awards under the Plan. Notwithstanding the foregoing, the number of Shares available for granting Incentive Stock Options under the Plan shall not exceed 1,600,000, subject to adjustment as provided in the Plan and subject to the provisions of Section 422 or 424 of the Code or any successor provision.

(b) Accounting for Awards. For purposes of this Section 4, if an Award entitles the holder thereof to receive or purchase Shares, the number of Shares covered by such Award or to which such Award relates shall be counted on the date of grant of such Award against the aggregate number of Shares available for granting Awards under the Plan.

(c) Adjustments. In the event that the Committee shall determine that any dividend or other distribution (whether in the form of cash, Shares, other securities or other property), recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase or exchange of Shares or other securities of the Company, issuance of warrants or other rights to purchase Shares or other securities of the Company or other similar corporate transaction or event affects the Shares such that an adjustment is determined by the Committee to be appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan, then the Committee shall, in such manner as it may deem equitable, adjust any or all of (i) the number and type of Shares (or other securities or other property) that thereafter may be made the subject of Awards, (ii) the number and type of Shares (or other securities or other property) subject to outstanding Awards and (iii) the purchase or exercise price with respect to any Award; provided, however, that the number of Shares covered by any Award or to which such Award relates shall always be a whole number.

(d) Award Limitations Under the Plan. No Eligible Person may be granted any Award or Awards under the Plan, the value of which Award or Awards is based solely on an increase in the value of the Shares after the date of grant of such Award or Awards, for more than 500,000 Shares (subject to adjustment as provided for in Section 4(c) of the Plan), in the aggregate in any calendar year. The foregoing annual limitation specifically includes the grant of any Award or Awards representing "qualified performance-based compensation" within the

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meaning of Section 162(m) of the Code.

Section 5. Eligibility.

Any Eligible Person shall be eligible to be designated a Participant. In determining which Eligible Persons shall receive an Award and the terms of any Award, the Committee may take into account the nature of the services rendered by the respective Eligible Persons, their present and potential contributions to the success of the Company or such other factors as the Committee, in its discretion, shall deem relevant. Notwithstanding the foregoing, an Incentive Stock Option may only be granted to full or part-time employees (which term as used herein includes, without limitation, officers and Directors who are also employees), and an Incentive Stock Option shall not be granted to an employee of an Affiliate unless such Affiliate is also a "subsidiary corporation" of the Company within the meaning of Section 424(f) of the Code or any successor provision.

Section 6. Awards.

(a) Options. The Committee is hereby authorized to grant Options to Participants with the following terms and conditions and with such additional terms and conditions not inconsistent with the provisions of the Plan as the Committee shall determine:

(i) Exercise Price. The purchase price per Share purchasable under an Option shall be determined by the Committee; provided, however, that such purchase price shall not be less than 100% of the Fair Market Value of a Share on the date of grant of such Option.

(ii) Option Term. The term of each Option shall be fixed by the Committee.

(iii) Time and Method of Exercise. The Committee shall determine the time or times at which an Option may be exercised in whole or in part and the method or methods by which, and the form or forms (including, without limitation, cash, Shares, promissory notes, other securities, other Awards or other property, or any combination thereof, having a Fair Market Value on the exercise date equal to the relevant exercise price) in which, payment of the exercise price with respect thereto may be made or deemed to have been made.

(iv) Reload Options. The Committee may grant Reload Options, separately or together with another Option, pursuant to which, subject to the terms and conditions established by the Committee, the Participant would be granted a new Option when the payment of the exercise price of a previously granted option is made by the delivery of Shares owned by the Participant pursuant to Section 6(a)(iii) of the Plan or the relevant provisions of another plan of the Company, and/or when Shares are tendered or withheld as payment of the amount to be withheld under applicable income tax laws in connection with the exercise of an Option, which new Option would be an Option to purchase the number of Shares not exceeding the sum of (A) the number of Shares so provided as consideration upon the exercise of the previously granted option to which such Reload Option relates and (B) the number of Shares, if any, tendered or withheld as payment of the amount to be withheld under applicable tax laws in connection with the exercise of the option to which such Reload Option relates pursuant to the relevant provisions of the plan or agreement relating to such option. Reload Options may be granted with respect to Options previously granted under the Plan or any other stock option plan of the Company or may be granted in connection with any Option granted under the Plan or any other stock option plan of the Company at the time of such grant. Such Reload Options shall have a per share exercise price equal to the Fair Market Value of one Share as of the date of grant of the new Option. Any Reload Option shall be subject to availability of

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sufficient Shares for grant under the Plan.

(v) With respect to Incentive Stock Options granted under the Plan, to the extent that the aggregate Fair Market Value (determined at the time the Incentive Stock Option is granted) of the Shares with respect to which all Incentive Stock Options are exercisable for the first time by an employee during any calendar year exceeds \$100,000, in accordance with Section 422A(d) of the Code, such Options shall be treated as Non-Qualified Stock Options.

(b) Stock Appreciation Rights. The Committee is hereby authorized to grant Stock Appreciation Rights to Participants subject to the terms of the Plan and any applicable Award Agreement. A Stock Appreciation Right granted under the Plan shall confer on the holder thereof a right to receive upon exercise thereof the excess of (i) the Fair Market Value of one Share on the date of exercise (or, if the Committee shall so determine, at any time during a specified period before or after the date of exercise) over (ii) the grant price of the Stock Appreciation Right as specified by the Committee, which price shall not be less than 100% of the Fair Market Value of one Share on the date of grant of the Stock Appreciation Right. Subject to the terms of the Plan and any applicable Award Agreement, the grant price, term, methods of exercise, dates of exercise, methods of settlement and any other terms and conditions of any Stock Appreciation Right shall be as determined by the Committee. The Committee may impose such conditions or restrictions on the exercise of any Stock Appreciation Right as it may deem appropriate.

(c) Restricted Stock and Restricted Stock Units. The Committee is hereby authorized to grant Restricted Stock and Restricted Stock Units to Participants with the following terms and conditions and with such additional terms and conditions not inconsistent with the provisions of the Plan as the Committee shall determine:

(i) Restrictions. Shares of Restricted Stock and Restricted Stock Units shall be subject to such restrictions as the Committee may impose (including, without limitation, a waiver by the Participant of the right to vote or to receive any dividend or other right or property with respect thereto), which restrictions may lapse separately or in combination at such time or times, in such installments or otherwise as the Committee may deem appropriate.

(ii) Stock Certificates. Any Restricted Stock granted under the Plan shall be registered in the name of the Participant and shall bear an appropriate legend referring to the terms, conditions and restrictions applicable to such Restricted Stock. In the case of Restricted Stock Units, no Shares shall be issued at the time such Awards are granted.

(iii) Forfeiture. Except as otherwise determined by the Committee, upon termination of employment (as determined under criteria established by the Committee) during the applicable restriction period, all Shares of Restricted Stock and all Restricted Stock Units at such time subject to restriction shall be forfeited and reacquired by the Company; provided, however, that the Committee may, when it finds that a waiver would be in the best interest of the Company, waive in whole or in part any or all remaining restrictions with respect to Shares of Restricted Stock or Restricted Stock Units. Upon the lapse or waiver of restrictions and the restricted period relating to Restricted Stock Units evidencing the right to receive Shares, such Shares shall be issued and delivered to the holders of the Restricted Stock Units.

(d) Performance Awards. The Committee is hereby authorized to grant Performance Awards to Participants subject to the terms of the Plan and any applicable Award Agreement. A Performance Award granted under the Plan (i) may be denominated or payable in cash, Shares (including, without limitation, Restricted Stock and

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Restricted Stock Units), other securities, other Awards or other property and (ii) shall confer on the holder thereof the right to receive payments, in whole or in part, upon the achievement of such performance goals during such performance periods as the Committee shall establish. Subject to the terms of the Plan and any applicable Award Agreement, the performance goals to be achieved during any performance period, the length of any performance period, the amount of any Performance Award granted, the amount of any payment or transfer to be made pursuant to any Performance Award and any other terms and conditions of any Performance Award shall be determined by the Committee.

(e) Other Stock Grants. The Committee is hereby authorized, subject to the terms of the Plan and any applicable Award Agreement, to grant to Participants Shares without restrictions thereon as are deemed by the Committee to be consistent with the purpose of the Plan.

(f) Other Stock-Based Awards. The Committee is hereby authorized to grant to Participants subject to the terms of the Plan and any applicable Award Agreement, such other Awards that are denominated or payable in, valued in whole or in part by reference to, or otherwise based on or related to, Shares (including, without limitation, securities convertible into Shares), as are deemed by the Committee to be consistent with the purpose of the Plan. Shares or other securities delivered pursuant to a purchase right granted under this Section 6(f) shall be purchased for such consideration, which may be paid by such method or methods and in such form or forms (including, without limitation, cash, Shares, promissory notes, other securities, other Awards or other property or any combination thereof), as the Committee shall determine, the value of which consideration, as established by the Committee, shall not be less than 100% of the Fair Market Value of such Shares or other securities as of the date such purchase right is granted.

(g) General.

(i) No Cash Consideration for Awards. Awards shall be granted for no cash consideration or for such minimal cash consideration as may be required by applicable law.

(ii) Awards May Be Granted Separately or Together. Awards may, in the discretion of the Committee, be granted either alone or in addition to, in tandem with or in substitution for any other Award or any award granted under any plan of the Company or any Affiliate other than the Plan. Awards granted in addition to or in tandem with other Awards or in addition to or in tandem with awards granted under any such other plan of the Company or any Affiliate may be granted either at the same time as or at a different time from the grant of such other Awards or awards.

(iii) Forms of Payment under Awards. Subject to the terms of the Plan and of any applicable Award Agreement, payments or transfers to be made by the Company or an Affiliate upon the grant, exercise or payment of an Award may be made in such form or forms as the Committee shall determine (including, without limitation, cash, Shares, promissory notes, other securities, other Awards or other property or any combination thereof), and may be made in a single payment or transfer, in installments or on a deferred basis, in each case in accordance with rules and procedures established by the Committee. Such rules and procedures may include, without limitation, provisions for the payment or crediting of reasonable interest on installment or deferred payments or the grant or crediting of dividend equivalents with respect to installment or deferred payments.

(iv) Limits on Transfer of Awards. No Award (other than Other Stock Grants) and no right under any such Award shall be transferable by a Participant otherwise than by will or by the laws of descent and distribution; provided, however, that, if so determined by the Committee, a Participant may, in the manner

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established by the Committee, transfer Options (other than Incentive Stock Options) or designate a beneficiary or beneficiaries to exercise the rights of the Participant and receive any property distributable with respect to any Award upon the death of the Participant. Each Award or right under any Award shall be exercisable during the Participant's lifetime only by the Participant or, if permissible under applicable law, by the Participant's guardian or legal representative. No Award or right under any such Award may be pledged, alienated, attached or otherwise encumbered, and any purported pledge, alienation, attachment or encumbrance thereof shall be void and unenforceable against the Company or any Affiliate.

(v) Term of Awards. The term of each Award shall be for such period as may be determined by the Committee.

(vi) Restrictions; Securities Exchange Listing. All Shares or other securities delivered under the Plan pursuant to any Award or the exercise thereof shall be subject to such restrictions as the Committee may deem advisable under the Plan, applicable federal or state securities laws and regulatory requirements, and the Committee may cause appropriate entries to be made or legends to be affixed to reflect such restrictions. If any securities of the Company are traded on a securities exchange, the Company shall not be required to deliver any Shares or other securities covered by an Award unless and until such Shares or other securities have been admitted for trading on such securities exchange.

Section 7. Amendment and Termination; Adjustments.

(a) Amendments to the Plan. The Board may amend, alter, suspend, discontinue or terminate the Plan at any time; provided, however, that, notwithstanding any other provision of the Plan or any Award Agreement, without the approval of the shareholders of the Company, no such amendment, alteration, suspension, discontinuation or termination shall be made that, absent such approval:

(i) would violate the rules or regulations of the Nasdaq National Market System or any securities exchange that are applicable to the Company; or

(ii) would cause the Company to be unable, under the Code, to grant Incentive Stock Options under the Plan.

(b) Amendments to Awards. The Committee may waive any conditions of or rights of the Company under any outstanding Award, prospectively or retroactively. Except as otherwise provided herein or in the Award Agreement, the Committee may not amend, alter, suspend, discontinue or terminate any outstanding Award, prospectively or retroactively, if such action would adversely affect the rights of the holder of such Award, without the consent of the Participant or holder or beneficiary thereof.

(c) Correction of Defects, Omissions and Inconsistencies. The Committee may correct any defect, supply any omission or reconcile any inconsistency in the Plan or any Award in the manner and to the extent it shall deem desirable to carry the Plan into effect.

Section 8. Income Tax Withholding; Tax Bonuses.

(a) Withholding. In order to comply with all applicable federal or state income tax laws or regulations, the Company may take such action as it deems appropriate to ensure that all applicable federal or state payroll, withholding, income or other taxes, which are the sole and absolute responsibility of a Participant, are withheld or collected from such Participant. In order to assist a Participant in paying all or a portion of the federal and state taxes to be withheld or collected upon exercise or receipt of (or the lapse of restrictions

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relating to) an Award, the Committee, in its discretion and subject to such additional terms and conditions as it may adopt, may permit the Participant to satisfy such tax obligation by (i) electing to have the Company withhold a portion of the Shares otherwise to be delivered upon exercise or receipt of (or the lapse of restrictions relating to) such Award with a Fair Market Value equal to the amount of such taxes or (ii) delivering to the Company Shares other than Shares issuable upon exercise or receipt of (or the lapse of restrictions relating to) such Award with a Fair Market Value equal to the amount of such taxes. The election, if any, must be made on or before the date that the amount of tax to be withheld is determined.

(b) Tax Bonuses. The Committee, in its discretion, shall have the authority, at the time of grant of any Award under this Plan or at any time thereafter, to approve cash bonuses to designated Participants to be paid upon their exercise or receipt of (or the lapse of restrictions relating to) Awards in order to provide funds to pay all or a portion of federal and state taxes due as a result of such exercise or receipt (or the lapse of such restrictions). The Committee shall have full authority in its discretion to determine the amount of any such tax bonus.

Section 9. General Provisions.

(a) No Rights to Awards. No Eligible Person, Participant or other Person shall have any claim to be granted any Award under the Plan, and there is no obligation for uniformity of treatment of Eligible Persons, Participants or holders or beneficiaries of Awards under the Plan. The terms and conditions of Awards need not be the same with respect to any Participant or with respect to different Participants.

(b) Award Agreements. No Participant will have rights under an Award granted to such Participant unless and until an Award Agreement shall have been duly executed on behalf of the Company and, if requested by the Company, signed by the Participant.

(c) No Limit on Other Compensation Arrangements. Nothing contained in the Plan shall prevent the Company or any Affiliate from adopting or continuing in effect other or additional compensation arrangements, and such arrangements may be either generally applicable or applicable only in specific cases.

(d) No Right to Employment. The grant of an Award shall not be construed as giving a Participant the right to be retained in the employ of the Company or any Affiliate, nor will it affect in any way the right of the Company or an Affiliate to terminate such employment at any time, with or without cause. In addition, the Company or an Affiliate may at any time dismiss a Participant from employment free from any liability or any claim under the Plan or any Award, unless otherwise expressly provided in the Plan or in any Award Agreement.

(e) Governing Law. The validity, construction and effect of the Plan or any Award, and any rules and regulations relating to the Plan or any Award, shall be determined in accordance with the laws of the State of Minnesota.

(f) Severability. If any provision of the Plan or any Award is or becomes or is deemed to be invalid, illegal or unenforceable in any jurisdiction or would disqualify the Plan or any Award under any law deemed applicable by the Committee, such provision shall be construed or deemed amended to conform to applicable laws, or if it cannot be so construed or deemed amended without, in the determination of the Committee, materially altering the purpose or intent of the Plan or the Award, such provision shall be stricken as to such jurisdiction or Award, and the remainder of the Plan or any such Award shall remain in full force and effect.

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(g) No Trust or Fund Created. Neither the Plan nor any Award shall create or be construed to create a trust or separate fund of any kind or a fiduciary relationship between the Company or any Affiliate and a Participant or any other Person. To the extent that any Person acquires a right to receive payments from the Company or any Affiliate pursuant to an Award, such right shall be no greater than the right of any unsecured general creditor of the Company or any Affiliate.

(h) No Fractional Shares. No fractional Shares shall be issued or delivered pursuant to the Plan or any Award, and the Committee shall determine whether cash shall be paid in lieu of any fractional Shares or whether such fractional Shares or any rights thereto shall be canceled, terminated or otherwise eliminated.

(i) Headings. Headings are given to the Sections and subsections of the Plan solely as a convenience to facilitate reference. Such headings shall not be deemed in any way material or relevant to the construction or interpretation of the Plan or any provision thereof.

Section 10. Effective Date of the Plan.

The Plan shall be effective as of the date on which the approval of the shareholders of the Company is obtained (the "Effective Date").

Section 11. Term of the Plan.

No Award shall be granted under the Plan after the tenth anniversary of the Effective Date or any earlier date of discontinuation or termination established pursuant to Section 7(a) of the Plan. However, unless otherwise expressly provided in the Plan or in an applicable Award Agreement, any Award theretofore granted may extend beyond such date.