

ABA RPPT/Tax Section Joint Meeting — San Francisco
Friday, September 16, 2005

Program of Employee Benefit Plans and Other Compensation Arrangements Group
Fact Situation for Workshop
Concerning IRC Section 409A (Nonqualified Deferred Compensation)

Protos Corporation is a non-public corporation making widgets which is based in San Francisco, California. Its fiscal year runs from October 1 to September 30. It maintains a nonqualified deferred compensation plan and a number of other employee benefit plans and programs (which are described below). The purpose of this workshop is to discuss the changes that will need to be made in the benefit plans and programs of Protos Corporation to comply with the new tax rules governing nonqualified deferred compensation under Section 409A of the Internal Revenue Code.

Protos Corporation maintains a nonqualified deferred compensation plan with the following features:

- (1) Participants annually are given the right to elect whether they wish to defer a portion of their salary for each fiscal year of the employer by making an election no later than the September 15th preceding the beginning of the fiscal year (e.g., the deferral election for the fiscal year October 1, 2005 through September 30, 2006 must be made by September 15, 2005).
- (2) Participants annually are given the right to elect to defer all or a portion of their bonus for each fiscal year of the employer by making an election no later than June 30 of the applicable fiscal year, at a time when the amount of the bonus, if any, is still not ascertainable (e.g., the deferral election for the fiscal year October 1, 2005 through September 30, 2006 must be made by June 30, 2006).
- (3) Participants in Protos Corporation's long-term incentive plan receive performance awards based on a three-year performance cycle. The amount of the award earned for each performance cycle is determined at the end of the performance cycle. A new three-year performance cycle begins each fiscal year. Participants are given the right to elect to defer their award for each cycle by making an election no later than June 30 of the final year of the performance cycle (e.g., the deferral election for the performance cycle from October 1, 2003 through September 30, 2006 must be made by June 30, 2006).
- (4) Deferred amounts are credited to a bookkeeping account in the name of the participant. The participant can elect the fund or funds to serve as the measure for crediting earnings and losses on his or her deferral account, which are the same funds available under Protos Corporation's 401(k) plan.
- (5) When a participant makes his or her initial deferral election, the participant also elects (i) when distributions will commence, which may be a fixed date, termina-

tion of employment, or the earlier of a fixed date or termination of employment (the "Distribution Commencement Date") and (ii) the form of distribution, which may be a lump sum or installments over 3, 5 or 10 years. Actual distribution will be made on such date within 6 months after the Distribution Commencement Date as the Administrative Committee for the deferred compensation plan shall determine.

- (6) A participant may at any time at least 6 months in advance of his or her elected Distribution Commencement Date elect a later Distribution Commencement Date and/or change his or her election as to the form of distribution (lump sum or installments).
- (7) In the event of the participant's disability or death, the participant's entire account balance will be distributed to the participant or, in the event of the participant's death, his or her beneficiary. Disability is defined as a disability entitling the participant to benefits under Protos Corporation's long-term disability plan.
- (8) In the event of hardship, a participant may request a distribution from his or her deferral account in an amount needed to meet the hardship. Hardship is defined as a sudden and unexpected illness or accident of a person or of a dependent, a loss of such person's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of such person.
- (9) A participant may elect to withdraw all or any portion of his or her deferral account at any time, provided that any such withdrawal will result in a forfeiture of 10% of the amount withdrawn.
- (10) In the event of a Change of Control of Protos Corporation, a participant will receive an immediate distribution of his or her deferral account (unless he or she has elected at least 6 months prior to the Change of Control not to receive such distribution). The term "Change of Control" is defined to mean (i) any person or persons acting together as a group acquire at least 30% of the total voting power of all classes of stock of Protos Corporation, or (ii) current directors of Protos Corporation (including as current directors any successor directors whose election or nomination for election was approved by at least two-thirds of current directors) cease to constitute a majority of the Board of Directors, or (iii) any merger, consolidation or complete liquidation of Protos Corporation is consummated unless the shareholders of Protos Corporation immediately before the merger or consolidation hold a majority of the common stock of the continuing or surviving corporation immediately after the merger or consolidation, or (iv) there is a sale of all or substantially all of the assets of Protos Corporation.
- (11) The Administrative Committee may in its discretion at any time accelerate the payment of deferred amounts.

- (12) Protos Corporation maintains a rabbi trust to assist it in meeting its obligations under the deferred compensation plan. The trust is maintained in California and the trustee is a California bank. However, a portion of the assets of the trust are held in a subtrust in Bermuda. The rabbi trust provides that, if the credit rating of Protos Corporation is reduced or if there is a Change of Control of Protos Corporation, Protos Corporation must immediately contribute to the trust an amount sufficient to cover all benefit obligations under the deferred compensation plan.

Protos Corporation also maintains the following other benefit plans and programs:

- A. A tax-qualified defined benefit pension plan. A participant can elect upon termination of employment to receive distribution in a lump sum or in the form of a straight life annuity or under various contingent annuitant options (except that benefits must be paid in the form of a joint and 50% survivor annuity with the spouse as contingent annuitant unless the spouse consents in a notarized writing to an alternative form of payment).
- B. A tax-qualified 401(k) plan. A participant elects the percentage of his or her compensation that he or she wishes to contribute on a pre-tax basis to the plan and can change that election at any time. A participant can elect upon termination of employment to receive distribution in a lump sum or in installments over 3, 5 or 10 years.
- C. A nonqualified supplemental retirement plan for key employees. Distributions are made in the same form as elected by the participant under the tax-qualified defined benefit pension plan.
- D. A stock incentive plan pursuant to which Protos Corporation grants stock options, stock appreciation rights, restricted stock, and performance-based restricted stock units. The stock appreciation rights are payable in cash or stock, as elected by the participant. The per share option price under the stock options and stock appreciation rights is set at the fair market value of Protos Corporation common stock on the grant date as determined by the Plan Administrative Committee in its sole discretion (typically, based on book value). The Plan Administrative Committee has the authority to accelerate vesting and to extend the term of options and stock appreciation rights and has from time to time done so with respect to options and stock appreciation rights that are still outstanding. With respect to the restricted stock, participants are allowed at least 6 months prior to vesting (i) to extend the period during which the restricted stock remains forfeitable and nontransferable for an additional period of at least 12 months or (ii) to convert the restricted stock into an unsecured promise of Protos Corporation to pay deferred compensation with a value as of the date of the conversion equal to the value of the shares of stock represented by the restricted stock (with such deferral account to be adjusted based on interest at the fixed rate of 10% and to be paid upon termination of employment). The performance-based restricted stock units vest upon the satisfac-

tion of certain performance measures and become payable in cash or stock 3 months after the end of the calendar year in which they vest.

- E. Employment agreements with senior officers. These agreements provide that, if employment is terminated by Protos Corporation without Cause, or is terminated by the officer for Good Reason, the officer will continue to receive each month for a period of 24 months following termination of employment an amount equal to one-twelfth of the sum of (i) his or her base salary and (ii) his or her average annual bonus for the prior three fiscal years. The officer would also receive medical and life insurance benefits for this 24-month period. Good Reason is defined as (i) a reduction in authority, duties or responsibility, (ii) relocation of the officer's office more than 50 miles, (iii) reduction in base salary, (iv) significant reduction in employee benefits (other than in connection with an across-the-board reduction affecting substantially all senior officers), or (v) a Change of Control if the officer terminates employment for any reason within 12 months following the Change of Control.

- F. Special Bonus. On September 1, 2005, Protos Corporation announced that it would pay a special bonus of \$10,000 to the CEO and the CFO. Pursuant to the terms of this bonus award, the bonus will be paid on April 1, 2006.