

BALLANTYNE OF OMAHA INC
Form 10-Q
November 10, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2008

OR

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

For the transition period from _____ to _____

Commission File Number: 1-13906

BALLANTYNE OF OMAHA, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or Other Jurisdiction of
Incorporation or Organization)

47-0587703
(IRS Employer
Identification Number)

4350 McKinley Street, Omaha, Nebraska
(Address of Principal Executive Offices)

68112
Zip Code

(402) 453-4444

Registrant's telephone number, including area code:

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 twelve 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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act (check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer
(Do not check if a smaller
reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date:

Class
Common Stock, \$.01, par value

Outstanding as of November 6, 2008
14,051,065 shares

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Part I. FINANCIAL INFORMATION

Item 1. Condensed Consolidated Financial Statement

Ballantyne of Omaha, Inc. and Subsidiaries

Condensed Consolidated Balance Sheets

September 30, 2008 and December 31, 2007

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	September 30, 2008 (Unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	\$ 6,440,726	\$ 4,220,355
Restricted cash	1,195,240	1,191,747
Short-term investments		13,000,000
Accounts receivable (less allowance for doubtful accounts of \$528,212 in 2008 and \$534,526 in 2007)	6,975,669	7,841,348
Inventories, net	11,646,888	9,883,555
Recoverable income taxes	1,466,502	1,365,530
Deferred income taxes	2,169,013	1,695,926
Consignment inventory	432,316	2,767,899
Other current assets	682,253	322,102
Total current assets	31,008,607	42,288,462
Investment in securities	10,919,895	
Investment in Digital Link II joint venture	3,327,966	3,727,485
Property, plant and equipment, net	3,574,905	3,633,124
Deferred income taxes	356,556	
Goodwill	2,317,171	2,420,993
Intangible assets, net	1,619,951	2,047,185
Other assets	18,757	23,099
Total assets	\$ 53,143,808	\$ 54,140,348
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	\$ 5,984,597	\$ 6,134,703
Warranty reserves	469,585	381,710
Accrued group health insurance claims	254,807	201,687
Accrued bonuses	189,545	54,178
Other accrued expenses	2,473,901	2,151,413
Customer deposits	1,083,327	974,910
Total current liabilities	10,455,762	9,898,601
Deferred income taxes		98,532
Other accrued expenses, net of current portion	1,192,517	1,101,517
Total liabilities	11,648,279	11,098,650
Stockholders equity:		
Preferred stock, par value \$.01 per share; Authorized 1,000,000 shares, none outstanding		
Common stock, par value \$.01 per share; Authorized 25,000,000 shares; issued 16,148,868 shares in 2008 and 15,956,243 in 2007	161,488	159,562
Additional paid-in capital	34,953,588	34,637,868
Accumulated other comprehensive income (loss):		
Foreign currency translation adjustment	(377,972)	(59,427)
Pension liability adjustment	75,833	75,833
Unrealized loss on investments in securities	(830,105)	
Retained earnings	22,828,151	23,543,316
	56,810,983	58,357,152
Less 2,097,805 common shares in treasury, at cost	(15,315,454)	(15,315,454)
Total stockholders equity	41,495,529	43,041,698
Total liabilities and stockholders equity	\$ 53,143,808	\$ 54,140,348

See accompanying notes to the condensed consolidated financial statements.

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Ballantyne of Omaha, Inc. and Subsidiaries

Condensed Consolidated Statements of Operations

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

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	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenues	\$ 12,309,109	\$ 12,615,705	\$ 40,149,385	\$ 38,206,449
Cost of revenues	10,162,989	10,526,839	33,643,529	30,913,586
Gross profit	2,146,120	2,088,866	6,505,856	7,292,863
Selling and administrative expenses:				
Selling	835,294	787,270	2,365,814	2,279,622
Administrative	1,989,584	1,312,779	5,649,852	4,339,829
Goodwill impairment				639,466
Total selling and administrative expenses	2,824,878	2,100,049	8,015,666	7,258,917
Gain on the transfer of assets				234,557
Gain on the sale of assets			258,170	
Gain (loss) on disposal of fixed assets	24,783		23,498	(11,004)
Income (loss) from operations	(653,975)	(11,183)	(1,228,142)	257,499
Interest income	127,855	211,305	403,391	636,548
Interest expense	(8,805)	(11,531)	(26,503)	(30,685)
Equity in loss of joint venture	(164,329)	(79,754)	(462,229)	(153,134)
Other income (expense), net	74,474	(39,075)	121,148	(111,827)
Income (loss) before income taxes	(624,780)	69,762	(1,192,335)	598,401
Income tax benefit (expense)	284,132	58,876	477,170	(94,190)
Net income (loss)	\$ (340,648)	\$ 128,638	\$ (715,165)	\$ 504,211
Basic earnings (loss) per share	\$ (0.02)	\$ 0.01	\$ (0.05)	\$ 0.04
Diluted earnings (loss) per share	\$ (0.02)	\$ 0.01	\$ (0.05)	\$ 0.04
Weighted average shares outstanding:				
Basic	13,933,152	13,836,537	13,894,300	13,805,506
Diluted	13,933,152	14,110,477	13,894,300	14,096,263

See accompanying notes to the condensed consolidated financial statements.

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Ballantyne of Omaha, Inc. and Subsidiaries

Condensed Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2008 and 2007

(Unaudited)

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	2008	2007
Cash flows from operating activities:		
Net income (loss)	\$ (715,165)	\$ 504,211
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Provision for doubtful accounts	19,887	31,583
Provision for obsolete inventory	549,847	520,773
Depreciation of consignment inventory	857,160	707,833
Depreciation of property, plant, and equipment	694,933	807,068
Amortization of intangibles	327,151	70,834
Equity in loss of joint venture	462,229	153,134
Goodwill impairment		639,466
Gain (loss) on disposal of fixed assets	(23,498)	11,004
Gain on sale of assets	(258,170)	
Deferred income taxes	(894,225)	(833,449)
Share-based compensation expense	171,396	69,562
Excess tax benefits from stock options exercised	(92,362)	(173,888)
Changes in assets and liabilities:		
Accounts receivable	968,348	302,434
Inventories	(2,389,310)	(6,016,116)
Consignment inventory	1,478,423	(2,902,527)
Other current assets	(270,734)	962,609
Accounts payable	(321,506)	991,970
Warranty reserves	95,048	(136,915)
Accrued group health insurance claims	53,120	(48,099)
Accrued bonus	135,367	146,184
Other accrued expenses	320,184	50,399
Customer deposits	119,440	476,788
Current income taxes	(5,502)	(13,730)
Other assets	(8,328)	7,300
Net cash provided by (used in) operating activities	1,273,733	(3,671,572)
Cash flows from investing activities:		
Increase in acquisition costs	(46,969)	(183,364)
Investment in joint venture	(62,711)	(276,755)
Proceeds from sale of assets	271,360	
Decrease (increase) in restricted cash	(3,493)	360,658
Capital expenditures	(632,772)	(421,407)
Proceeds from sales of investment securities	1,250,000	4,500,000
Net cash provided by investing activities	775,415	3,979,132
Cash flows from financing activities:		
Payments on long-term debt		(14,608)
Proceeds from exercise of stock options	90,113	65,415
Excess tax benefits from stock options exercised	92,362	173,888
Net cash provided by financing activities	182,475	224,695
Effect of exchange rate changes on cash and cash equivalents	(11,252)	
Net increase in cash and cash equivalents	2,220,371	532,255
Cash and cash equivalents at beginning of year	4,220,355	2,622,654
Cash and cash equivalents at end of year	\$ 6,440,726	\$ 3,154,909

See accompanying notes to the condensed consolidated financial statements.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

1. Nature of Operations

Ballantyne of Omaha, Inc., a Delaware corporation (Ballantyne or the Company), and its wholly-owned subsidiaries Strong Westrex, Inc., Strong Technical Services, Inc., and Strong Digital Systems, Inc., design, develop, manufacture, service and distribute theatre and lighting systems. The Company s products are distributed to movie exhibition companies, sports arenas, auditoriums, amusement parks and special venues.

2. Summary of Significant Accounting Policies

Basis of Presentation

The condensed consolidated financial statements included herein are presented in accordance with the requirements of Form 10-Q and consequently do not include all of the disclosures normally required by accounting principles generally accepted in the United States of America for annual reporting purposes or those made in the Company's annual Form 10-K filing. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company's Form 10-K for fiscal 2007.

In the opinion of management, the unaudited condensed consolidated financial statements of the Company reflect all adjustments of a normal recurring nature necessary to present a fair statement of the financial position and the results of operations and cash flows for the respective interim periods. The results for interim periods are not necessarily indicative of trends or results expected for a full year. All significant intercompany balances and transactions have been eliminated in consolidation.

The preparation of condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results and changes in facts and circumstances may alter such estimates and affect results of operations and financial position in future periods. Certain amounts in the accompanying condensed consolidated financial statements and notes thereto have been reclassified to conform to the 2008 presentation.

Revenue Recognition

Ballantyne manufactures and sells motion picture projectors which are highly complex and have many components that make up a complete system, which is referred to as an integrated system. Each customer selects options for certain components in determining the integrated system they chose to purchase. To recognize revenue, the Company follows the requirements of Staff Accounting Bulletin 104, *Revenue Recognition*, which consists of determining that:

- Persuasive evidence of an arrangement exists
- Delivery has occurred or services have been rendered
- The seller's price to the buyer is fixed or determinable
- Collectibility is reasonably assured

Once the customer has determined the features for their integrated system, the Company manufactures the system to their preference and then ships the system when it is complete. Revenue is generally recognized upon shipment of the product to the third party. In those limited situations where the shipping terms are FOB destination point, the Company recognizes revenue when the product is delivered.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

Consignment Inventory

Digital and film projection equipment is provided to potential customers for consignment and demonstration purposes under customer use agreements. Additionally, during 2007, the Company entered into operating lease agreements with third party customers for the use of certain projection equipment of which a majority of the projection equipment was sold during the first quarter of 2008. The Company recognized revenue in accordance with Staff Accounting Bulletin 104, *Revenue Recognition*, upon delivery of title to customer. No other income was generated under these operating lease agreements. The Company considered the guidance contained within ARB 43, EITF 01-08 and SFAS No. 13 to determine the proper accounting treatment for the agreements referenced above.

Consignment inventory is reviewed for impairment by comparing the inventory to estimated future usage and sales. Digital and film projection equipment on consignment amounted to approximately \$0.4 million and \$2.8 million at September 30, 2008 and December 31, 2007, respectively.

Recently Adopted Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159 *The Fair Value Option for Financial Assets and Financial Liabilities*. SFAS No. 159 permits entities to choose to measure many financial assets and financial liabilities at fair value. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings. SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. Although the Company adopted the provisions of SFAS No. 159 effective with the beginning of the Company's 2008 fiscal year, it did not elect the fair value option for any financial instruments or other items held by the Company. Therefore, the adoption of SFAS No. 159 did not have an impact on the Company's consolidated financial position or results of operations.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. In February 2008, FASB issued FASB Staff Position (FSP) No. 157-2, *Effective Date of FASB Statement No. 157* which delayed the effective date of FASB 157 for certain non-financial assets and non-financial liabilities to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. In October 2008, the FASB issued FASB Staff Position No. FAS 157-3, *Determining Fair Value of a Financial Asset in a Market that is not Active*. FSP No. FAS 157-3 clarifies the application of FASB Statement No. 157, *Fair Value Measurements*, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. FSB No. FAS 157-3 is effective for the Company beginning in the third quarter of 2008. The partial adoption of SFAS No. 157 did not have a material impact on the Company's consolidated financial position or results of operations. See further discussion in Note 9.

Recently Issued Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* (SFAS No. 141(R)). SFAS No. 141(R) establishes principles and requirements for how an acquirer in a business combination recognizes and measures in its financial statements the identifiable assets acquired, liabilities assumed, and any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141(R) also establishes disclosures requirements to enable the evaluation of the nature and financial effects of the business combination. The provisions of SFAS No. 141(R) will be effective for the Company's business combinations occurring on or after January 1, 2009. Management is currently assessing the effect of this pronouncement on the Company's consolidated financial statements.

In May 2008, the FASB issued SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles* (SFAS No. 162). SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States (GAAP). SFAS No. 162 will be effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board's related amendments to remove the GAAP hierarchy from auditing standards. The Company does not believe the adoption will have a material impact on its consolidated financial statements.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

In September 2008, the FASB issued FASB Staff Position FAS 133-1 and FIN 45-4, Disclosures about Credit Derivatives and Certain Guarantees which amends FASB Statement No. 133 and FASB Interpretation FIN 45. FSP No. FAS 133-1 and FIN 45-4 requires sellers of credit derivatives, including credit derivatives embedded in hybrid instruments, to disclose additional information about exposure to potential loss from credit-risk-related events. The new disclosures require both sellers of credit derivatives and guarantors to disclose the current status of payment/performance risk. The disclosures are effective for annual and interim reporting periods ending after November 15, 2008. The Company does not believe the adoption will have a material impact on its consolidated financial statements.

3. Investment in Digital Link II Joint Venture

On March 6, 2007, the Company entered into an agreement with RealD to form an operating entity, Digital Link II, LLC (the LLC). Under the agreement, the LLC was formed with the Company and RealD as the only two members with membership interests of 44.4% and 55.6%, respectively. The LLC was formed for purposes of commercializing certain 3D technology and to fund the deployment of digital projector systems and servers to exhibitors. As of September 30, 2008, total current and non-current assets of the joint venture amounted to approximately \$1.1 million and \$10.0 million, respectively. Total liabilities and equity at September 30, 2008 amounted to \$3.3 million and \$7.8 million, respectively. The joint venture, which operates on a fiscal year end of March 31, 2008, reported a net loss for the six months ended September 30, 2008 of approximately \$0.6 million which primarily resulted from depreciation expense related to projection equipment on consignment to third party customers.

The Company accounts for its investment by the equity method. Under this method, the Company records its proportionate share of Digital Link II's net income or loss based on the most recently available financial statements. The Company's portion of losses of the LLC amounted to approximately \$0.5 million for the nine months ended September 30, 2008.

4. Earnings (Loss) Per Common Share

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The Company computes and presents earnings (loss) per share in accordance with SFAS No. 128, *Earnings Per Share*. Basic earnings (loss) per share has been computed on the basis of the weighted average number of shares of common stock outstanding. Diluted earnings (loss) per share has been computed on the basis of the weighted average number of shares of common stock outstanding after giving effect to potential common shares from dilutive stock options. The following table provides a reconciliation between basic and diluted income (loss) per share:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Basic earnings (loss) per share:				
Income (loss) applicable to common stock	\$ (340,648)	\$ 128,638	\$ (715,165)	\$ 504,211
Weighted average common shares outstanding	13,933,152	13,836,537	13,894,300	13,805,506
Basic earnings (loss) per share	\$ (0.02)	\$ 0.01	\$ (0.05)	\$ 0.04
Diluted earnings (loss) per share:				
Income (loss) applicable to common stock	\$ (340,648)	\$ 128,638	\$ (715,165)	\$ 504,211
Weighted average common shares outstanding	13,933,152	13,836,537	13,894,300	13,805,506
Assuming conversion of options outstanding		273,940		290,757
Weighted average common shares outstanding, as adjusted	13,933,152	14,110,477	13,894,300	14,096,263
Diluted earnings (loss) per share	\$ (0.02)	\$ 0.01	\$ (0.05)	\$ 0.04

Table of Contents**Ballantyne of Omaha, Inc. and Subsidiaries****Notes to the Condensed Consolidated Financial Statements****Three and Nine Months Ended September 30, 2008 and 2007****(Unaudited)**

For the three and nine months ended September 30, 2008, options and restricted stock outstanding were not included in the computation of diluted earnings (loss) per share as the Company reported a loss from continuing operations available to common stockholders. For the three and nine months ended September 30, 2007, options to purchase 101,063 shares of common stock at a weighted average price of \$9.71 per share were outstanding, but were not included in the computation of diluted earnings per share as the options' exercise price was greater than the average market price of the common shares. Options outstanding as of September 30, 2008 expire December 2008 and May 2012.

5. Business Acquisitions

On October 12, 2007, the Company, through a wholly-owned subsidiary, Strong Digital Systems, Inc., acquired 100% of the outstanding shares of Marcel Desrochers, Inc. (MDI), a manufacturer and supplier of film and digital cinema screens, for cash consideration. As a result of the acquisition, MDI is forming a core business established to supply cinema screens to the digital and film cinema marketplace. The total purchase price of MDI at the date of acquisition was \$2.5 million including cash acquired. The purchase price excluded an additional \$0.9 million of restricted funds that were placed in escrow to secure certain indemnification and other obligation contingencies. Funds for the purchase were provided by internally generated cash flows. Direct transaction costs related to the acquisition amounted to \$0.4 million.

Goodwill recorded in connection with this acquisition represents the excess of the purchase price over the fair value of the net tangible and intangible assets acquired and are expected to be deductible for tax purposes.

6. Comprehensive Income (Loss)

The accumulated other comprehensive income (loss), net, shown in the Company's consolidated balance sheets includes the unrealized loss on investments in securities, pension liability adjustments and the accumulated foreign currency translation adjustment. The following table shows the difference between the Company's reported net earnings (loss) and its comprehensive income (loss):

\$ in thousands	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Comprehensive income (loss):				
Net income (loss)	\$ (340,648)	\$ 128,638	\$ (715,165)	\$ 504,211
Other comprehensive income (loss):				

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Unrealized gain (loss) on investment in securities	116,240			(830,105)		
Foreign currency translation adjustment	(189,855)			(318,545)		
Total comprehensive income (loss)	\$ (414,263)	\$ 128,638	\$ (1,863,815)	\$ 504,211		

7. Sale of Product Line

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During 2008, the Company sold its Coater and Marinade product line in exchange for \$275,000 in cash. In connection with the sale, the Company recorded a pre-tax net gain of approximately \$258,000 (estimated \$159,000 after-tax) which is net of related costs to sell. The product line was sold to a former Chief Financial Officer of the Company.

The Company recorded the sale of the Coater and Marinade product line in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets. Based on the guidance, the Coater and Marinade product line is not considered a separate accounting component of the Company as the cash flows of the product line could not be clearly distinguished from the rest of the Company. Therefore, the Company has not presented the operations of the Coater and Marinade product line as discontinued operations.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

8. Investments

The Company has certain investments in auction-rate securities which are classified as available-for-sale securities. Interest rates on these auction-rate securities are reset through an auction process that resets the applicable interest at pre-determined intervals every seven days. The investment securities are held within closed-end funds that continue to be AAA rated and fully collateralized at a minimum 200% net asset to fund ratio. The Company accounts for its investments in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities .

During 2008, the market for the Company's investments in auction-rate securities began experiencing a liquidity issue when the securities came up for auction due to an imbalance of buyers and sellers for the securities. The Company cannot predict how long the current imbalance in the auction market will continue. As a result, for a period of time, the Company may be unable to liquidate the auction rate securities held until a successful auction occurs or the securities are redeemed by the issuer of the investments. Based on the continued unsuccessful auctions of these investments, the investment securities have been reclassified to noncurrent assets within the Condensed Consolidated Balance Sheet as of September 30, 2008. As of September 30, 2008, the Company has liquidated, at par, \$1,250,000 of its auction rate securities of which \$50,000 were sold through the normal auction process and \$1,200,000 were redeemed by the fund itself.

Due to the inability to trade all of the Company's investments in auction-rate securities in the current market, the Company continues to earn interest on its investments at the maximum contractual default rate. The weighted average maximum contractual default rate being earned as of September 30, 2008 was 8.48%.

Based on the valuations performed (Note 9), the Company determined there was an impairment in the fair value of its investments of approximately \$0.8 million. When events or circumstances exist that require the Company to record an impairment on its investments, the Company determines whether the impairment should be classified as temporary or other-than-temporary. A temporary impairment charge results in an unrealized loss being recorded in the other comprehensive income (loss) component of stockholders' equity. Such an unrealized loss does not affect net income (loss) for the applicable accounting period. An other-than-temporary impairment charge is recorded as a realized loss in the consolidated statement of operations and reduces net income (loss) for the applicable accounting period. The differentiating factors between temporary and other-than temporary impairment are primarily the length of the time and the extent to which the market value has been less than cost, the financial condition and near-term prospects of the issuer and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in market value. Based on this assessment as of September 30, 2008, the Company determined the impairment in the fair value of its investments is temporary.

9. Fair Value of Financial Instruments

Effective January 1, 2008, the Company adopted the provisions of SFAS No. 157, Fair Value Measurements (SFAS No. 157) which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements with respect to financial assets and liabilities. Under SFAS 157, fair value is the price to sell an asset or transfer a liability between market participants as of the measurement date. Fair value measurements assume the asset or liability is exchanged in an orderly manner; the exchange is in the principal market for that asset or liability (or in the most advantageous market when no principal market exists); and the market participants are independent, knowledgeable, able and willing to transact an exchange. Pursuant to the provisions of FSP No. 157-2, the Company has decided to defer adoption of SFAS No. 157 for one year for nonfinancial assets and nonfinancial liabilities that are recognized or disclosed at fair value in the financial statements on a nonrecurring basis.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

SFAS 157 establishes a hierarchy for fair value measurements based upon observable independent market inputs and unobservable market assumptions. Inputs refer broadly to the assumptions that market participants would use in pricing the asset or liability, including assumptions about risk. Considerable judgment is required in interpreting market data used to develop the estimates of fair value. The following represents the three categories of inputs used in determining the fair value of financial assets and liabilities:

Level 1: Quoted market prices in active markets for identical assets or liabilities.

Level 2: Observable market based inputs or unobservable inputs that are corroborated by market data.

Level 3: Unobservable inputs that are used in the measurement of assets and liabilities. Unobservable inputs require management to make certain projections and assumptions about the information that would be used by market participants in pricing the asset or liability.

Because of the inability to trade the Company's auction-rate securities, a readily determinable fair value using market observables (Level 1 input) does not exist. Therefore, in accordance with SFAS No. 157, Fair Value Measurement, the Company obtained Gifford Fong Associates, a third party valuation expert, to assist with the determination of the estimated fair value of its auction-rate securities (Level 3 input). The valuation expert used a cash flow model to determine the fair value of these securities. The significant inputs and assumptions used in preparing this model are summarized as follows:

- Interest rate indices – LIBOR curve and commercial paper rates obtained.
- Rating transition matrix – the rating transition matrix gives transition probabilities for the underlying collateral migrating from one rating level to another in one year, particularly the transition probability to default status. The rating transition matrix is constructed from rating migration and default data published by various rating agencies.
- Default and recovery rates – the default rate is estimated using a credit spread (discount margin) over the risk free rate curve obtained.
- Illiquidity risk – in a distressed market, investors may not be able to find willing buyers, hence reduced liquidity.
- Estimate for the timing of full redemption of the securities – the full redemption is estimated to take place in two years on the historical observation that economic cycles usually turn around in two years.

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- Estimated weighted average coupon the yield, considered to be the weighted average cost of capital (WACC), is related to the financial strength and outlook of each fund.

Financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2008 are summarized in the following table by the type of inputs applicable to the fair value measurements under the provisions of SFAS No. 157:

Description	9/30/08	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available-for-sale securities	\$ 10,919,895	\$	\$	\$ 10,919,895
Total	\$ 10,919,895	\$	\$	\$ 10,919,895

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A reconciliation of assets and liabilities measured at fair value on a recurring basis with the use of significant unobservable inputs (Level 3) from January 1, 2008 to September 30, 2008 follows:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3)	
	Investments in Auction-Rate Securities	Total
Beginning balance	\$ 13,000,000	\$ 13,000,000
Total gains or losses (realized/unrealized)		
Included in other comprehensive income (loss)	(830,105)	(830,105)
Purchases, issuances and settlements	(1,250,000)	(1,250,000)
Transfers in and/or out of Level 3		
Ending balance	\$ 10,919,895	\$ 10,919,895

The amount of total gains or losses for the period included in earnings (loss) (or changes in net assets) attributable to the change in unrealized gains or losses relating to assets still held at the reporting date

10. Inventories

Inventories consist of the following:

	September 30, 2008	December 31, 2007
Raw materials and components	\$ 5,965,124	\$ 4,911,345
Work in process	1,245,504	772,055
Finished goods	4,436,260	4,200,155
	\$ 11,646,888	\$ 9,883,555

The inventory balances are net of reserves of approximately \$2,500,000 and \$1,901,000 as of September 30, 2008 and December 31, 2007, respectively.

11. Property, Plant and Equipment

Property, plant and equipment include the following:

	September 30, 2008	December 31, 2007
Land	\$ 313,500	\$ 313,500
Buildings and improvements	3,962,989	3,962,989
Machinery and equipment	7,270,444	7,199,257
Office furniture and fixtures	1,928,320	1,662,578
	13,475,253	13,138,324
Less accumulated depreciation	(9,900,348)	(9,505,200)
Net property, plant and equipment	\$ 3,574,905	\$ 3,633,124

Depreciation expense amounted to approximately \$243,000 and \$695,000 for the three and nine months ended September 30, 2008, respectively, as compared to approximately \$270,000 and \$807,000 for the three and nine months ended September 30, 2007.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

12. Income Taxes

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Income taxes are accounted for under the asset and liability method. The Company uses an estimate of its annual effective rate based on the facts and circumstances at the time while the actual effective rate is calculated at year-end. The Company has recorded a receivable for the amount of the income tax refund due to the Company primarily as a result of estimated payments made by the Company during 2007 in excess of the amounts actually owed. In addition, the Company has recorded a receivable for the carry back of certain net operating losses to previous year's taxable income resulting in additional tax refunds due.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized.

The Company has adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The adoption of this interpretation did not have a material impact on the Company's consolidated financial position.

The Company's uncertain tax positions are related to tax years that remain subject to examination by the relevant taxable authorities. The Company has examinations not yet initiated for Federal purposes for fiscal years 2005 through 2007. In most cases, the Company has examinations open for State or local jurisdictions based on the particular jurisdictions statute of limitations. The Company does not currently have any examinations in process.

An estimate for the underpayment of income taxes, including interest and penalties are classified as a component of tax expense in the Condensed Consolidated Statements of Operations. During 2008, the Company made interest and penalty payments to various states related to back taxes paid in 2007. Additionally, during the third quarter the overall estimate was reduced for underpayments, including penalty and interest, the Company is no longer obligated to pay due to the expirations of the statute of limitations, which had an impact to the quarterly effective tax rate of 11.9%. The effective tax rates for the three and nine months ended September 30, 2008 was approximately 45.5% and 40.0%, respectively. The estimate relating largely to state tax matters approximated \$0.1 million as of September 30, 2008 and \$0.2 million as of December 31, 2007.

Table of Contents**Ballantyne of Omaha, Inc. and Subsidiaries****Notes to the Condensed Consolidated Financial Statements****Three and Nine Months Ended September 30, 2008 and 2007****(Unaudited)****13. Warranty Reserves**

The Company generally grants a warranty to its customers for a one-year period following the sale of all new equipment and on selected repaired equipment for a one-year period following the repair. The warranty period is extended under certain circumstances and for certain products. The Company accrues for these costs at the time of sale or repair or when events dictate that additional accruals are necessary. The following table summarizes warranty activity for the periods indicated below:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Warranty accrual at beginning of period	\$ 347,571	\$ 516,201	\$ 381,710	\$ 617,052
Charged to expense	196,990	44,115	298,542	137,058
Amounts written off, net of recoveries	(74,976)	(80,179)	(210,667)	(273,973)
Warranty accrual at end of period	\$ 469,585	\$ 480,137	\$ 469,585	\$ 480,137

14. Debt

The Company is party to a revolving credit facility (the Original Credit Facility) with First National Bank of Omaha expiring August 30, 2009. The credit facility provides for borrowings up to the lesser of \$4.0 million or amounts determined by an asset-based lending formula, as defined. Borrowings available under the credit facility amounted to \$4.0 million at September 30, 2008. The Company pays interest on outstanding amounts equal to the Prime Rate plus 0.25% (5.25% at September 30, 2008) and pay a fee of 0.125% on the unused portion.

Effective September 26, 2008, the Company entered into a Ninth Amendment to its Original Credit Facility to extend the maturity date of its interim extension of credit (the Interim Credit Facility) to August 30, 2009 and to reduce the available borrowings to \$9.4 million. The Interim Credit Facility is evidenced by a Promissory Note with an interest rate set at a floating rate set to after-tax interest income received on certain investment securities. The credit facilities contain certain restrictions primarily related to restrictions on acquisitions and dividends. All of the Company's personal property and certain stock in our subsidiaries secure the credit facilities. No amounts are currently outstanding under either of the credit facilities.

15. Note Receivable

During July 2006, the Company entered into a note receivable arrangement with Digital Link LLC (Digital Link) pertaining to the sale and installation of digital projectors. The sale amounted to \$780,000 of which 25% was due upon installation and was collected. The remaining amounts are due over a 5-year period at an 8% interest rate. At September 30, 2008, \$358,820 is due from Digital Link. Only the payments received since inception in 2006 on the note receivable totaling \$421,180 have been recorded as revenue with the remaining amounts to be recognized as revenue in future periods when payment is received from Digital Link as described in the note receivable arrangement or when collections from the Digital Link can be reasonably assured. Additionally, until collections from Digital Link can be reasonably assured, no receivable will be recorded on this transaction. The costs incurred with the sale of projectors to Digital Link were expensed during 2006 with no future associated costs to be incurred.

Table of Contents**Ballantyne of Omaha, Inc. and Subsidiaries****Notes to the Condensed Consolidated Financial Statements****Three and Nine Months Ended September 30, 2008 and 2007****(Unaudited)****16. Supplemental Cash Flow Information**

Supplemental disclosures to the consolidated statements of cash flows are as follows:

	Nine Months Ended September 30,	
	2008	2007
Cash paid during the period for:		
Interest	\$ 5,471	\$ 21,154
Income taxes	\$ 652,175	\$ 941,370
Non-cash investing activities:		
Non-cash investment in joint venture	\$	\$ 2,543,771

17. Stock Compensation

The Company accounts for awards of share-based compensation in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, (SFAS No. 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors based on estimated fair values. Share-based compensation expense was \$96,374 and \$15,495 for the three months ended September 30, 2008 and 2007 and \$171,396 and \$69,562 for the nine months ended September 30, 2008 and 2007, respectively.

Stock Options

The Company currently maintains a 2005 Outside Directors Stock Option Plan (2005 Outside Directors Plan) which has been approved by the Company's stockholders. During the current period, the Board of Directors made the decision to discontinue granting further stock options under this Plan. The Company also maintains a 1995 Employee Stock Option Plan and a 1995 Directors Stock Plan which both expired in 2005, however, there are outstanding stock options remaining under these two expired plans.

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All past and future grants under the Company's stock option plans were granted at prices based on the fair market value of the Company's common stock on the date of grant. The outstanding options generally vest over periods ranging from zero to three years from the grant date and expire between 5 and 10 years after the grant date. No stock options were granted during the nine months ended September 30, 2008 and 2007, respectively.

The following table summarizes the Company's activities with respect to its stock options for the nine months ended September 30, 2008:

	Number of Options	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Options outstanding at December 31, 2007	443,750	\$ 2.33	3.41	\$ 1,594,983
Granted				
Exercised	(123,625)	\$ 0.73		
Forfeited				
Outstanding at September 30, 2008	320,125	\$ 2.95	2.59	\$ 215,650
Exercisable at September 30, 2008	320,125	\$ 2.95	2.59	\$ 215,650

Table of Contents**Ballantyne of Omaha, Inc. and Subsidiaries****Notes to the Condensed Consolidated Financial Statements****Three and Nine Months Ended September 30, 2008 and 2007****(Unaudited)**

The aggregate intrinsic value in the table above represents the total that would have been received by the option holders if all in-the-money options had been exercised on September 30, 2008.

The following table summarizes information about stock options outstanding and exercisable at September 30, 2008:

Range of option exercise price	Number of options	Options Outstanding at September 30, 2008		Number of options	Options Exercisable at September 30, 2008	
		Weighted average contractual life	Weighted average exercise price per option		Weighted average contractual life	Weighted average exercise price per option
\$0.62 to 0.63	160,000	3.58	\$ 0.62	160,000	3.58	\$ 0.62
\$4.25 to 4.75	118,125	2.07	4.55	118,125	2.07	4.55
\$7.30	42,000	0.26	7.30	42,000	0.26	7.30
\$0.62 to 7.30	320,125	2.59	\$ 2.95	320,125	2.59	\$ 2.95

Restricted Stock Plan

During 2005, the Company adopted and the stockholders approved, the 2005 Restricted Stock Plan. Under terms of the plan, the compensation committee of the Board of Directors selects which employees of the Company are to receive restricted stock awards and the terms of such awards. The total number of shares reserved for issuance under the plan is 250,000 shares. The plan expires in September 2010. During May 2008, the Company granted 54,000 shares to certain employees. A portion of the shares vest at January 2009 with the remaining shares being earned if the Company achieves certain earning thresholds, as defined within the restricted stock agreements. Once the shares are earned, vesting would occur on January 1, 2010. At September 30, 2008, 196,000 shares remain available for issuance under the Plan.

On May 21, 2008, the Company adopted and the stockholders approved the Ballantyne of Omaha, Inc. Non-Employee Director Restricted Stock Plan (Non-Employee Plan) to replace the 2005 Non-Employee Director Stock Option Plan. The total number of shares reserved for issuance under the plan is 120,000 shares. During May 2008, the Company granted 15,000 restricted shares under the Non-Employee Plan. The shares vest the day after the Company's 2009 Annual Meeting. At September 30, 2008, 105,000 shares remain available for issuance under the Plan.

In connection with restricted stock granted to certain employees and non-employee directors, the Company is accruing compensation expense based on the estimated number of shares expected to be issued utilizing the most current information available to the Company at the date of the

financial statements.

Employee Stock Purchase Plan

The Company's Employee Stock Purchase Plan, approved by the stockholders, provides for the purchase of shares of Ballantyne common stock by eligible employees at a per share purchase price equal to 85% of the fair market value of a share of Ballantyne common stock at either the beginning or end of the offering period, as defined, whichever is lower. Purchases are made through payroll deductions of up to 10% of each participating employee's salary. The maximum number of shares that can be purchased by participants in any offering period is 2,000 shares. Additionally, the Plan has set certain limits, as defined, in regard to the number of shares that may be purchased by all eligible employees during an offering period. At September 30, 2008, 123,746 shares of common stock remained available for issuance under the Plan. The Plan expires in October 2010.

Table of Contents**Ballantyne of Omaha, Inc. and Subsidiaries****Notes to the Condensed Consolidated Financial Statements****Three and Nine Months Ended September 30, 2008 and 2007****(Unaudited)****18. Postretirement Health Care**

Components of the net period benefit cost for the Company's post retirement health care plan includes:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net periodic benefit cost:				
Service cost	\$	\$ 2,979	\$	\$ 8,937
Interest cost	4,974	5,416	14,922	16,254
Amortization of prior-service cost		5,598		16,793
Total net periodic benefit cost	\$ 4,974	\$ 13,993	\$ 14,922	\$ 41,984

The Company expects to pay \$20,874 of benefits under its postretirement benefit plan in 2008. As of September 30, 2008, benefits of \$5,445 have been paid.

19. Guarantee

On July 28, 2008, the Company provided a guarantee to a note entered into by its joint venture, Digital Link II, LLC to finance digital projection equipment deployed in the normal course of business. The loan provides for borrowings of approximately \$1.3 million and bears interest equal to 7% per annum. The Company's guarantee of the note is limited to its 44.4% ownership percentage, which amounts to approximately \$0.6 million. RealD, who holds a membership interest of 55.6% in the joint venture, has provided a guarantee for the remainder of the note outstanding, which amounts to approximately \$0.7 million. The Company has recorded a liability for the fair value of the obligation undertaken by issuing the guarantee of approximately \$0.04 million. The guarantees will expire by the end of 2011. Under the terms of the guarantees, the Company and RealD would be required to fulfill the guarantees should the joint venture be in default of its loan or contract terms.

20. Concentrations

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The Company's top ten customers accounted for approximately 46% of 2008 consolidated net revenues and were primarily from the theatre segment. Trade accounts receivable from these customers represented approximately 38% of net consolidated receivables at September 30, 2008. Sales to Regal Cinemas, Inc. represented over 10% of consolidated sales. Additionally, receivables from Regal Cinemas, Inc. represented over 10% of net consolidated receivables at September 30, 2008. While the Company believes its relationships with such customers are stable, most arrangements are made by purchase order and are terminable at will by either party. A significant decrease or interruption in business from its significant customers could have a material adverse effect on the Company's business, financial condition and results of operations. It could also be adversely affected by such factors as changes in foreign currency rates and weak economic and political conditions in each of the countries in which it sells its products.

Financial instruments that potentially expose the Company to a concentration of credit risk primarily consist of accounts receivables. The Company sells product to a large number of customers in many different geographic regions. To minimize credit concentration risk, the Company performs ongoing credit evaluations of its customers' financial condition.

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Ballantyne of Omaha, Inc. and Subsidiaries

Notes to the Condensed Consolidated Financial Statements

Three and Nine Months Ended September 30, 2008 and 2007

(Unaudited)

21. Litigation

Ballantyne is currently a defendant in an asbestos case entitled *Larry C. Stehman and Leila Stehman v. Asbestos Corporation, Limited and Ballantyne of Omaha, Inc. individually and as successor in interest to Strong International, Strong Electric Corporation and Century Projector Corporation, et al*, filed December 8, 2006 in the Superior Court of the State of California, County of San Francisco. The Company believes that it has strong defenses and intends to defend the suit vigorously. It is not possible at this time to predict the outcome of this case, or the amount of damages, if any, that a jury may award. The plaintiffs have made no monetary demand upon Ballantyne. It is possible that an adverse resolution of this case could have a material adverse effect on the Company's financial position.

22. Business Segment Information

The presentation of segment information reflects the manner in which management organizes segments for making operating decisions and assessing performance.

As of September 30, 2008, the Company's operations were conducted principally through two business segments: Theatre and Lighting. Theatre operations include the design, manufacture, assembly, sale and service of motion picture projectors, motion picture screens, xenon lamphouses and power supplies, sound systems, film handling equipment and the sale and service of xenon lamps, lenses and digital projection equipment and accessories. The lighting segment operations include the design, manufacture, assembly and sale of follow spotlights, stationary searchlights and computer operated lighting systems for the motion picture production, television, live entertainment, theme parks and architectural industries. The Company allocates resources to business segments and evaluates the performance of these segments based upon reported segment gross profit. However, certain key operations of a particular segment are tracked on the basis of operating profit. All intersegment sales are eliminated in consolidation.

Table of Contents**Ballantyne of Omaha, Inc. and Subsidiaries****Notes to the Condensed Consolidated Financial Statements****Three and Nine Months Ended September 30, 2008 and 2007****(Unaudited)****Summary by Business Segments**

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Net revenue				
Theatre				
Products	\$ 10,263,557	\$ 10,521,596	\$ 34,086,965	\$ 31,885,555
Services	833,215	854,223	2,353,829	2,711,926
Total theatre	11,096,772	11,375,819	36,440,794	34,597,481
Lighting	1,199,479	1,064,562	3,510,431	3,082,435
Other	12,858	175,324	198,160	526,533
Total revenue	\$ 12,309,109	\$ 12,615,705	\$ 40,149,385	\$ 38,206,449
Gross profit				
Theatre				
Products	\$ 1,630,499	\$ 1,564,677	\$ 6,172,034	\$ 5,969,057
Services	214,596	79,303	(650,195)	301,230
Total theatre	1,845,095	1,643,980	5,521,839	6,270,287
Lighting	294,265	367,878	896,437	791,602
Other	6,760	77,008	87,580	

(c) The Committee, in its discretion, may determine that, upon the occurrence of a Change in Control of the Company, each Option and Stock Appreciation Right outstanding shall terminate within a specified number of days after notice to the Participant, and/or that each Participant shall receive, with respect to each Share subject to such Option or Stock Appreciation Right, an amount equal to the excess (if any) of the Fair Market Value of such Share immediately prior to the occurrence of such Change in Control over the exercise price per Share of such Option and/or Stock Appreciation Right; such amount to be payable in cash, in one or more kinds of stock or property (including the stock or property, if any, payable in the transaction) or in a combination thereof, as the Committee, in its discretion, shall determine.

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11.3. Change in Control. For purposes of the Plan, unless otherwise provided in an Award Agreement, Change in Control means the occurrence of any one of the following events:

(i) During any twenty-four (24) month period, individuals who, as of the beginning of such period, constitute the Board (the Incumbent Directors) cease for any reason to constitute at least a majority of the Board, provided that any person becoming a director subsequent to the beginning of such period whose election or nomination for election was approved by a vote of at least a majority of the Incumbent Directors then on the Board (either by a specific vote or by approval of the proxy statement of the Company in which such person is named as a nominee for director, without written objection to such nomination) shall be an Incumbent Director; provided, however, that no individual initially elected or nominated as a director of the Company as a result of an actual or threatened election contest with respect to directors or as a result of any other actual or threatened solicitation of proxies by or on behalf of any person other than the Board shall be deemed to be an Incumbent Director;

(ii) Any person (as such term is defined in the Exchange Act and as used in Sections 13(d)(3) and 14(d)(2) of the Exchange Act) is or becomes a beneficial owner (as defined in Rule 13d-3 under the Exchange Act), directly or indirectly, of securities of the Company representing 50% or more of the combined voting power of the Company's then outstanding securities eligible to vote for the election of the Board (the Company Voting Securities); provided, however, that the event described in this paragraph (ii) shall not be deemed to be a Change in Control by virtue of any of the following acquisitions: (A) by the Company or any Affiliate, (B) by any employee benefit plan (or related trust) sponsored or maintained by the Company or any Affiliate, (C) by any underwriter temporarily holding securities pursuant to an offering of such securities, (D) pursuant to a Non-Qualifying Transaction, as defined in paragraph (iii), or (E) by any person of Voting Securities from the Company, if a majority of the Incumbent Board approves in advance the acquisition of beneficial ownership of 50% or more of Company

Voting Securities by such person;

(iii) The consummation of a merger, consolidation, statutory share exchange or similar form of corporate transaction involving the Company or any of its Affiliates that requires the approval of the Company's stockholders, whether for such transaction or the issuance of securities in the transaction (a Business Combination), unless immediately following such Business Combination: (A) more than 60% of the total voting power of (x) the corporation resulting from such Business Combination (the Surviving Corporation), or (y) if applicable, the ultimate parent corporation that directly or indirectly has beneficial ownership of 100% of the voting securities eligible to elect directors of the Surviving Corporation (the Parent Corporation), is represented by Company Voting Securities that were outstanding immediately prior to such Business Combination (or, if applicable, is represented by shares into which such Company Voting Securities were converted pursuant to such Business Combination), and such voting power among the holders thereof is in substantially the same proportion as the voting power of such Company Voting Securities among the holders thereof immediately prior to the Business Combination, (B) no person (other than any employee benefit plan (or related trust) sponsored or maintained by the Surviving Corporation or the Parent Corporation), is or becomes the beneficial owner, directly or indirectly, of 50% or more of the total voting power of the outstanding voting securities eligible to elect directors of the Parent Corporation (or, if there is no Parent Corporation, the Surviving Corporation) and (C) at least a majority of the members of the board of directors of the Parent Corporation (or, if there is no Parent Corporation, the Surviving Corporation) following the consummation of the Business Combination were Incumbent Directors at the time of the Board's approval of the execution of the initial agreement providing for such Business Combination (any Business Combination which satisfies all of the criteria specified in (A), (B) and (C) above shall be deemed to be a Non-Qualifying Transaction);

(iv) The stockholders of the Company approve a plan of complete liquidation or dissolution of the Company or the consummation of a sale of all or substantially all of the Company's assets; or

(v) The occurrence of any other event that the Board determines by a duly approved resolution constitutes a Change in Control.

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Notwithstanding the foregoing, a Change in Control shall not be deemed to occur solely because any person acquires beneficial ownership of more than 50% of the Company Voting Securities as a result of the acquisition of Company Voting Securities by the Company which reduces the number of Company Voting Securities outstanding; provided, that if after such acquisition by the Company such person becomes the beneficial owner of additional Company Voting Securities that increases the percentage of outstanding Company Voting Securities beneficially owned by such person, a Change in Control of the Company shall then occur.

12. GENERALLY APPLICABLE PROVISIONS

12.1. *Amendment and Termination of the Plan.* The Board may, from time to time, alter, amend, suspend or terminate the Plan as it shall deem advisable, subject to any requirement for stockholder approval imposed by applicable law, including the rules and regulations of the NASDAQ Stock Market (or such other principal U.S. national securities exchange on which the Shares are traded); provided that the Board may not amend the Plan in any manner that would result in noncompliance with Rule 16b-3 of the Exchange Act; and further provided that the Board may not, without the approval of the Company's stockholders to the extent required by such applicable law, amend the Plan to (a) increase the number of Shares that may be the subject of Awards under the Plan (except for adjustments pursuant to Section 12.2); (b) expand the types of awards available under the Plan; (c) materially expand the class of persons eligible to participate in the Plan; (d) amend any provision of Section 5.3 or the last sentence of Section 6.2(d); or (e) increase the maximum permissible term of any Option specified by Section 5.4 or the maximum permissible term of a Stock Appreciation Right specified by Section 6.2(d). The Board may not without the approval of the Company's stockholders cancel an Option or Stock Appreciation Right in exchange for cash or take any action with respect to an Option or Stock Appreciation Right that may be treated as a repricing under the rules and regulations of the NASDAQ Stock Market (or such other principal U.S. national

securities exchange on which the Shares are traded), including a reduction of the exercise price of an Option or the grant price of a Stock Appreciation Right or the exchange of an Option or Stock Appreciation Right for cash or another Award. In addition, no amendments to, or termination of, the Plan shall in any way impair the rights of a Participant under any Award previously granted without such Participant's consent.

12.2. Adjustments. In the event of any merger, reorganization, consolidation, recapitalization, dividend or distribution (whether in cash, shares or other property, other than a regular cash dividend), stock split, reverse stock split, spin-off or similar transaction or other change in corporate structure affecting the Shares or the value thereof, such adjustments and other substitutions shall be made to the Plan and to Awards as the Committee deems equitable or appropriate taking into consideration the accounting and tax consequences, including such adjustments in the aggregate number, class and kind of securities that may be delivered under the Plan, the Limitations, the maximum number of Shares that may be issued pursuant to Incentive Stock Options and, in the aggregate or to any one Participant, in the number, class, kind and option or exercise price of securities subject to outstanding Awards granted under the Plan (including, if the Committee deems appropriate, the substitution of similar options to purchase the shares of, or other awards denominated in the shares of, another company) as the Committee may determine to be appropriate in its sole discretion; provided, however, that the number of Shares subject to any Award shall always be a whole number.

12.3. Transferability of Awards. Except as provided below, no Award and no Shares subject to Awards described in Article 8 that have not been issued or as to which any applicable restriction, performance or deferral period has not lapsed, may be sold, assigned, transferred, pledged or otherwise encumbered, other than by will or the laws of descent and distribution, and such Award may be exercised during the life of the Participant only by the Participant or the Participant's guardian or legal representative. To the extent and under such terms and conditions as determined by the Committee, a Participant may assign or transfer an Award (each transferee thereof, a Permitted Assignee) to a family member as such term is defined in the General

Instructions to Form S-8 (whether by gift or a domestic relations order); provided that such Permitted Assignee shall be bound by and subject to all of the terms and conditions of the Plan and the Award Agreement relating to the transferred Award and shall execute an agreement satisfactory to the Company evidencing such obligations; and provided

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further that such Participant shall remain bound by the terms and conditions of the Plan. The Company shall cooperate with any Permitted Assignee and the Company's transfer agent in effectuating any transfer permitted under this Section.

12.4. Termination of Employment. The Committee shall determine and set forth in each Award Agreement whether any Awards granted in such Award Agreement will continue to be exercisable, continue to vest or be earned and the terms of such exercise, vesting or earning, on and after the date that a Participant ceases to be employed by or to provide services to the Company or any Affiliate (including as a Director), whether by reason of death, disability, voluntary or involuntary termination of employment or services, or otherwise. The date of termination of a Participant's employment or services will be determined by the Committee, which determination will be final.

12.5. Deferral; Dividend Equivalents. The Committee shall be authorized to establish procedures pursuant to which the payment of any Award may be deferred. Subject to the provisions of the Plan and any Award Agreement, the recipient of an Award (including any deferred Award) other than an Option or Stock Appreciation Right may, if so determined by the Committee, be entitled to receive, currently or on a deferred basis, cash, stock or other property dividends, or cash payments in amounts equivalent to cash, stock or other property dividends on Shares (" Dividend Equivalents ") with respect to the number of Shares covered by the Award, as determined by the Committee, in its sole discretion. The Committee may provide that such amounts and Dividend Equivalents (if any) shall be deemed to have been reinvested in additional Shares or otherwise reinvested and may provide that such amounts and Dividend Equivalents are subject to the same vesting or performance conditions as the underlying Award.

13. MISCELLANEOUS

13.1. Tax Withholding. The Company shall have the right to make all payments or distributions pursuant to the Plan to a Participant (or a Permitted Assignee thereof) (any such person, a " Payee ") net of

any applicable federal, state and local taxes required to be paid or withheld as a result of (a) the grant of any Award, (b) the exercise of an Option or Stock Appreciation Right, (c) the delivery of Shares or cash, (d) the lapse of any restrictions in connection with any Award or (e) any other event occurring pursuant to the Plan. The Company or any Affiliate shall have the right to withhold from wages or other amounts otherwise payable to such Payee such withholding taxes as may be required by law, or to otherwise require the Payee to pay such withholding taxes. If the Payee shall fail to make such tax payments as are required, the Company or its Affiliates shall, to the extent permitted by law, have the right to deduct any such taxes from any payment of any kind otherwise due to such Payee or to take such other action as may be necessary to satisfy such withholding obligations. The Committee shall be authorized to establish procedures for election by Participants to satisfy such obligation for the payment of such taxes by tendering previously acquired Shares (either actually or by attestation, valued at their then Fair Market Value), or by directing the Company to retain Shares (up to the Participant's minimum required tax withholding rate or such other rate that will not cause an adverse accounting consequence or cost) otherwise deliverable in connection with the Award.

13.2. *Right of Discharge Reserved; Claims to Awards.* Nothing in the Plan nor the grant of an Award hereunder shall confer upon any Employee, Director or Consultant the right to continue in the employment or service of the Company or any Affiliate or affect any right that the Company or any Affiliate may have to terminate the employment or service of (or to demote or to exclude from future Awards under the Plan) any such Employee, Director or Consultant at any time for any reason. Except as specifically provided by the Committee, the Company shall not be liable for the loss of existing or potential profit from an Award granted in the event of termination of an employment or other relationship. No Employee, Director or Consultant shall have any claim to be granted any Award under the Plan, and there is no obligation for uniformity of treatment of Employees, Directors or Consultants under the Plan.

13.3. *Prospective Recipient.* The prospective recipient of any Award under the Plan shall not, with respect to such Award, be deemed to have become a

Participant, or to have any rights with respect to such Award, until and

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unless such recipient shall have executed an agreement or other instrument evidencing the Award and delivered a copy thereof to the Company, and otherwise complied with the then applicable terms and conditions.

13.4. *Substitute Awards.* Notwithstanding any other provision of the Plan, the terms of Substitute Awards may vary from the terms set forth in the Plan to the extent the Committee deems appropriate to conform, in whole or in part, to the provisions of the awards in substitution for which they are granted.

13.5. *Cancellation of Award.*

(a) Notwithstanding anything to the contrary contained herein, an Award Agreement may provide that the Award shall be canceled if the Participant, without the consent of the Company, while employed by, or providing services to, the Company or any Affiliate or after termination of such employment or services, establishes a relationship with a competitor of the Company or any Affiliate or engages in activity that is in conflict with or adverse to the interest of the Company or any Affiliate (including conduct contributing to any financial restatements or financial irregularities), as determined by the Committee in its sole discretion. The Committee may provide in an Award Agreement that if within the time period specified in the Agreement the Participant establishes a relationship with a competitor or engages in an activity referred to in the preceding sentence, the Participant will forfeit any gain realized on the vesting or exercise of the Award and must repay such gain to the Company.

(b) In the event the Participant ceases to be employed by, or provide services to, the Company on account of a termination for cause (as defined below) by the Company, any Award held by the Participant shall terminate as of the date the Participant ceases to be employed by, or provide services to, the Company. In addition, notwithstanding any other provisions of this Section, if the Committee determines that the Participant has engaged in conduct that constitutes cause at any time while the Participant is employed by, or providing services to, the Company or after the Participant's termination of employment or

services, any Awards held by the Participant shall immediately terminate. In the event a Participant's employment or services is terminated for cause, in addition to the immediate termination of all Awards, the Participant shall automatically forfeit all shares underlying any exercised portion of an Option for which the Company has not yet delivered the share certificates, upon refund by the Company of the option price paid by the Participant for such shares.

(c) For purposes of this Section, cause shall mean, unless otherwise provided in an Award Agreement or another agreement between the Participant and the Company or an Affiliate or a plan maintained by the Company or an Affiliate in which the Participant participates, a determination by the Committee that the Participant has breached his or her employment or service contract with the Company, or has been engaged in disloyalty to the Company, including, without limitation, fraud, embezzlement, theft, commission of a felony or proven dishonesty in the course of his or her employment or service, or has disclosed trade secrets or confidential information of the Company to persons not entitled to receive such information, or has breached any written noncompetition or nonsolicitation agreement between the Participant and the Company or has engaged in such other behavior detrimental to the interests of the Company as the Committee determines

13.6. Stop Transfer Orders. All certificates for Shares delivered under the Plan pursuant to any Award shall be subject to such stop-transfer orders and other restrictions as the Committee may deem advisable under the rules, regulations and other requirements of the Securities and Exchange Commission, any stock exchange upon which the Shares are then listed, and any applicable federal or state securities law, and the Committee may cause a legend or legends to be put on any such certificates to make appropriate reference to such restrictions.

13.7. Nature of Payments. All Awards made pursuant to the Plan are in consideration of services performed or to be performed for the Company or any Affiliate, division or business unit of the Company. Any income or gain realized pursuant to Awards under the Plan constitutes a special incentive payment to the Participant and shall not be taken into

account, to the extent permissible under applicable law, as compensation for purposes of

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any of the employee benefit plans of the Company or any Affiliate except as may be determined by the Committee or by the Board or board of directors of the applicable Affiliate.

13.8. *Other Plans.* Nothing contained in the Plan shall prevent the Board from adopting other or additional compensation arrangements, subject to stockholder approval if such approval is required; and such arrangements may be either generally applicable or applicable only in specific cases.

13.9. *Severability.* The provisions of the Plan shall be deemed severable. If any provision of the Plan shall be held unlawful or otherwise invalid or unenforceable in whole or in part by a court of competent jurisdiction or by reason of a change in a law or regulation, such provision shall (a) be deemed limited to the extent that such court of competent jurisdiction deems it lawful, valid and/or enforceable and as so limited shall remain in full force and effect, and (b) not affect any other provision of the Plan or part thereof, each of which shall remain in full force and effect. If the making of any payment or the provision of any other benefit required under the Plan shall be held unlawful or otherwise invalid or unenforceable by a court of competent jurisdiction, such unlawfulness, invalidity or unenforceability shall not prevent any other payment or benefit from being made or provided under the Plan, and if the making of any payment in full or the provision of any other benefit required under the Plan in full would be unlawful or otherwise invalid or unenforceable, then such unlawfulness, invalidity or unenforceability shall not prevent such payment or benefit from being made or provided in part, to the extent that it would not be unlawful, invalid or unenforceable, and the maximum payment or benefit that would not be unlawful, invalid or unenforceable shall be made or provided under the Plan.

13.10. *Construction.* As used in the Plan, the words *include* and *including*, and variations thereof, shall not be deemed to be terms of limitation, but rather shall be deemed to be followed by the words *without limitation*.

13.11. *Unfunded Status of the Plan.* The Plan is intended to constitute an unfunded plan for incentive and deferred compensation. With respect to any payments not yet made to a Participant by the Company, nothing contained herein shall give any such Participant any rights that are greater than those of a general creditor of the Company. In its sole discretion, the Committee may authorize the creation of trusts or other arrangements to meet the obligations created under the Plan to deliver the Shares or payments in lieu of or with respect to Awards hereunder; provided, however, that the existence of such trusts or other arrangements is consistent with the unfunded status of the Plan.

13.12. *Governing Law.* The Plan and all determinations made and actions taken thereunder, to the extent not otherwise governed by the Code or the laws of the United States, shall be governed by the laws of the State of Delaware, without reference to principles of conflict of laws, and construed accordingly.

13.13. *Effective Date of Plan; Termination of Plan.* The Plan shall be effective on the date of the approval of the Plan by the holders of the shares entitled to vote at a duly constituted meeting of the stockholders of the Company. The Plan shall be null and void and of no effect if the foregoing condition is not fulfilled and in such event each Award shall, notwithstanding any of the preceding provisions of the Plan, be null and void and of no effect. Awards may be granted under the Plan at any time and from time to time on or prior to the tenth anniversary of the effective date of the Plan, on which date the Plan will expire except as to Awards then outstanding under the Plan. Such outstanding Awards shall remain in effect until they have been exercised or terminated, or have expired.

13.14. *Foreign Employees and Consultants.* Awards may be granted to Participants who are foreign nationals or employed or providing services outside the United States, or both, on such terms and conditions different from those applicable to Awards to Employees employed or providing services in the United States as may, in the judgment of the Committee, be necessary or desirable in order to recognize differences in local law or tax policy. The Committee also may impose conditions on

the exercise or vesting of Awards in order to minimize the Company's obligation with respect to tax equalization for Employees or Consultants on assignments outside their home country.

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13.15. Compliance with Section 409A of the Code. This Plan is intended to comply and shall be administered in a manner that is intended to comply with Section 409A of the Code and shall be construed and interpreted in accordance with such intent. To the extent that an Award or the payment, settlement or deferral thereof is subject to Section 409A of the Code, the Award shall be granted, paid, settled or deferred in a manner that will comply with Section 409A of the Code, including regulations or other guidance issued with respect thereto, except as otherwise determined by the Committee. Any provision of this Plan that would cause the grant of an Award or the payment, settlement or deferral thereof to fail to satisfy Section 409A of the Code shall be amended to comply with Section 409A of the Code on a timely basis, which may be made on a retroactive basis, in accordance with regulations and other guidance issued under Section 409A of the Code.

13.16. Captions. The captions in the Plan are for convenience of reference only, and are not intended to narrow, limit or affect the substance or interpretation of the provisions contained herein.

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APPENDIX B

ARENA PHARMACEUTICALS, INC.

**2009 EMPLOYEE STOCK PURCHASE
PLAN**

1. Purpose. The purpose of the Plan is to provide employees of Arena Pharmaceuticals, Inc. (the Company) and its Designated Subsidiaries with an opportunity to purchase Common Stock of the Company through accumulated payroll deductions. It is the intention of the Company to have the Plan qualify as an Employee Stock Purchase Plan under Section 423 of the Internal Revenue Code of 1986, as amended. The provisions of the Plan, accordingly, shall be construed so as to extend and limit participation in a manner consistent with the requirements of that section of the Code.

After the effective date of the Plan, (i) no new Offering Periods shall commence under the Prior Plan and (ii) all Offering Periods existing under the Prior Plan on the effective date of the Plan are intended to continue in effect under the Plan in accordance with the terms of the Prior Plan.

2. Definitions.

(a) Authorization Form shall mean a form established by the Plan Administrator authorizing payroll deductions, as set forth in Section 4, and containing such other terms and conditions as the Company from time to time may determine.

(b) Board shall mean the Board of Directors of the Company.

(c) Code shall mean the Internal Revenue Code of 1986, as amended. References to specific sections of the Code shall be taken to be references to corresponding sections of any successor statute.

(d) Committee shall mean the committee of members of the Board designated as the Committee in Section 14.

(e) Common Stock shall mean the common stock of the Company.

(f) **Company** shall mean Arena Pharmaceuticals, Inc., or any successor by merger or otherwise, and any Designated Subsidiary of the Company.

(g) **Compensation** shall mean all base gross earnings, commissions, overtime, and shift premium before giving effect to any compensation reductions made in connection with plans described in section 401(k) or 125 of the Code, but exclusive of payments for any other compensation.

(h) **Designated Subsidiary** shall mean any Subsidiary that has been designated by the Board from time to time in its sole discretion as eligible to participate in the Plan. For purposes of the Plan, BRL Screening, Inc. shall be deemed to have been designated by the Board as a Designated Subsidiary.

(i) **Employee** shall mean any individual who is an Employee of the Company for tax purposes whose customary employment with the Company is at least twenty (20) hours per week. For purposes of the Plan, the employment relationship shall be treated as continuing intact while the individual is on sick leave or other leave of absence approved by the Company. Where the period of leave exceeds 90 days and the individual's right to reemployment is not guaranteed either by statute or by contract, the employment relationship shall be deemed to have terminated on the 91st day of such leave.

(j) **Enrollment Date** shall mean the first Trading Day of each Offering Period.

(k) **Exercise Date** shall mean the last Trading Day of each Purchase Period.

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(l) Fair Market Value shall mean, as of any date, the value of Common Stock determined as follows:

(1) The per share closing price of the Common Stock as reported on the NASDAQ Stock Market on that date (or if there was no reported closing price on such date, on the last preceding date on which the closing price was reported);

(2) If the Common Stock is not then listed on the NASDAQ Stock Market, the per share closing price of the Common Stock on such other principal U.S. national securities exchange on which the Common Stock is listed (or if there was no reported closing price on such date, on the last preceding date on which the closing price was reported);

(3) If the Common Stock is not listed on any U.S. national securities exchange but is quoted in an inter-dealer quotation system on a last sale basis, the final ask price of the Common Stock reported on such date (or, if there is no such sale on such date, then on the last preceding date on which a sale was reported); or

(4) If the Common Stock is neither listed on a U.S. national securities exchange nor quoted on an inter-dealer quotation system on a last sale basis, the Fair Market Value shall be determined by the Committee in its sole discretion using appropriate criteria.

(m) Offering Periods shall mean the periods established pursuant to Section 4.

(n) Plan shall mean this 2009 Employee Stock Purchase Plan, as amended from time to time.

(o) Plan Administrator shall mean the Company acting through its authorized officers.

(p) Prior Plan shall mean the Company's 2001 Arena Employee Stock Purchase Plan, as amended.

(q) Purchase Period shall mean, except as otherwise determined by the Committee, the three (3) month period commencing on the next Trading Day following the

preceding Exercise Date and ending with the next Exercise Date, except that the first Purchase Period of any Offering Period shall commence on the Enrollment Date and end with the next Exercise Date.

(r) **Purchase Price** shall mean 85% of the Fair Market Value of a share of Common Stock on the Enrollment Date or on the Exercise Date, whichever is lower; provided however, that the Purchase Price may be adjusted by the Board pursuant to Section 20.

(s) **Reserves** shall mean the number of shares of Common Stock covered by each option under the Plan that have not yet been exercised and the number of shares of Common Stock which have been authorized for issuance under the Plan but not yet placed under option.

(t) **Subsidiary** shall mean a corporation, domestic or foreign, of which not less than 50% of the voting shares are held by the Company or a Subsidiary, whether or not such corporation now exists or is hereafter organized or acquired by the Company or a Subsidiary.

(u) **Trading Day** shall mean a day on which the NASDAQ Stock Market (or such other principal U.S. national securities exchange Common Stock is listed) is open for trading.

3. Eligibility.

(a) All Employees who are employed by the Company at least one (1) day before a given Enrollment Date shall be eligible to participate in the Plan.

(b) Any provisions of the Plan to the contrary notwithstanding, no Employee shall be granted an option under the Plan (i) to the extent that, immediately after the grant, such Employee (or any other person whose stock

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would be attributed to such Employee pursuant to Section 424(d) of the Code) would own capital stock of the Company and/or hold outstanding options to purchase such stock possessing five percent (5%) or more of the total combined voting power or value of all classes of the capital stock of the Company or of any parent or subsidiary corporation, or (ii) to the extent that his or her rights to purchase stock under all employee stock purchase plans of the Company and any parent or subsidiary corporation accrues at a rate which exceeds Twenty-Five Thousand Dollars (\$25,000) worth of stock (determined at the fair market value of the shares at the time such option is granted) for each calendar year in which such option is outstanding at any time.

4. Offering Periods.

(a) *Plan Implementation.* The Plan shall be implemented by consecutive, overlapping Offering Periods with a new Offering Period commencing on the first Trading Day on or after January 1, April 1, July 1, and October 1 of each year, or on such other date as the Board or the Committee shall determine, and continuing thereafter until terminated in accordance with Section 20 hereof. All Offering Periods existing under the Prior Plan on the effective date of the Plan shall continue in effect under the Plan, but in accordance with the terms of the Prior Plan, including with respect to their Purchase Price and duration. The shares reserved for issuance under the Plan are available for purchase with respect to Offering Periods existing under the Prior Plan on the effective date of the Plan and those commencing at any time under the Plan. The first new Offering Period under the Plan shall begin on July 1, 2009 and, except as may be otherwise provided for in Section 4(c), shall end on the last Trading Day on or before June 30, 2011.

(b) *Offering Period Duration.* Each Offering Period shall be for a period of twenty-four (24) months during which an option granted pursuant to the Plan may be exercised.

(c) *Automatic Transfer to Lower Price Offering Period.* To the extent permitted by any applicable laws, regulations, rules of

the NASDAQ Stock Market (or such other principal U.S. national securities exchange on which the Common Stock is listed), if the Fair Market Value of the Common Stock on any Exercise Date in an Offering Period is lower than the Fair Market Value of the Common Stock on the Enrollment Date of such Offering Period, then all participants in such Offering Period shall be automatically withdrawn from such Offering Period immediately after the exercise of their option on such Exercise Date and automatically re-enrolled in the immediately following Offering Period as of the first day thereof.

(d) *Changes in Offering Period.* The Board or the Committee shall have the power to change the duration of Offering Periods (including the commencement dates thereof) with respect to future offerings without stockholder approval if notice of such change is announced to Employees prior to the scheduled beginning of the first Offering Period to be affected thereafter.

5. Participation.

(a) An Employee may become a participant in the Plan by completing an Authorization Form and filing it with the Plan Administrator prior to the applicable Enrollment Date.

(b) Payroll deductions for a participant shall commence on the first payroll following the Enrollment Date and shall end on the last payroll in the Offering Period to which such authorization is applicable, unless sooner terminated by the participant as provided in Section 10 hereof.

6. Payroll Deductions.

(a) At the time a participant files his or her Authorization Form, he or she shall elect to have payroll deductions made on each payday during the Offering Period in an amount not exceeding fifteen percent (15%) of the Compensation which he or she receives on each pay day during the Offering Period (or such other percentage as may be established by the Board or the Committee from time to time in its sole discretion).

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(b) All payroll deductions made for a participant shall be credited to his or her account under the Plan and shall be withheld in whole percentages only. A participant may not make any additional payments into such account.

(c) A participant may discontinue his or her participation in the Plan as provided in Section 10 hereof, or may increase or decrease the rate of his or her payroll deductions during the Offering Period by filing with the Plan Administrator a new Authorization Form authorizing a change in payroll deduction rate. The Board or the Committee may, in its discretion, limit the number of participation rate changes during any Offering Period. Any such reduction or increase would be effective beginning with the first Purchase Period that begins no earlier than 5 business days after the Plan Administrator's receipt of a new Authorization Form from the participant, unless otherwise determined by the Plan Administrator. A participant's Authorization Form shall remain in effect for successive Offering Periods unless terminated as provided in Section 10 hereof.

(d) Notwithstanding the foregoing, to the extent necessary to comply with Section 423(b)(8) of the Code and Section 3(b) hereof, a participant's payroll deductions may be decreased to zero percent (0%) at any time during a Purchase Period. Payroll deductions shall recommence at the rate provided in such participant's Authorization Form at the beginning of the first Purchase Period that is scheduled to end in the following calendar year, unless terminated by the participant as provided in Section 10 hereof.

(e) At the time the option is exercised, in whole or in part, or at the time some or all of the Company's Common Stock issued under the Plan is disposed of, the participant must make adequate provision for the Company's federal, state, or other tax withholding obligations, if any, which arise upon the exercise of the option. If the participant makes a disposition, within the meaning of Section 424(c) of the Code and regulations promulgated thereunder, of any shares of Common Stock issued to such participant pursuant to the exercise of an option, and such disposition occurs within

the two-year period commencing on the day after the Offering Date or within the one-year period commencing on the day after the exercise date, such participant shall, within five (5) days of such disposition, notify the Company thereof. In addition, in order to satisfy the requirement to withhold the amount (if any) of federal, state or local taxes that the Company or Subsidiary determines is applicable, the Company and any Subsidiary may deduct such amount from any other compensation payable to the Participant.

7. Grant of Option. On the Enrollment Date of each Offering Period, each Employee participating in such Offering Period shall be granted an option to purchase on each Exercise Date during such Offering Period (at the applicable Purchase Price) up to a number of shares of the Company's Common Stock determined by dividing such Employee's payroll deductions accumulated prior to such Exercise Date and retained in the participant's account as of the Exercise Date by the applicable Purchase Price; provided that in no event shall an Employee be permitted to purchase during each Purchase Period more than Six Hundred Twenty Five (625) shares of the Company's Common Stock (subject to any adjustment pursuant to Section 19), and provided further that such purchase shall be subject to the limitations set forth in Sections 3(b) and 12 hereof. The Board or the Committee may, for future Offering Periods, increase or decrease, in its absolute discretion, the maximum number of shares of the Company's Common Stock an Employee may purchase during each Purchase Period of such Offering Period. Exercise of the option shall occur as provided in Section 8 hereof, unless the participant has withdrawn pursuant to Section 10 hereof. The option shall expire on the last day of the Offering Period.

8. Exercise of Option.

(a) Unless a participant withdraws from the Plan as provided in Section 10 hereof, his or her option for the purchase of shares shall be exercised automatically on the Exercise Date, and the maximum number of full shares subject to the option shall be purchased for such participant at the applicable Purchase Price with the accumulated payroll deductions in his or her account. No fractional shares shall be purchased; any payroll deductions

accumulated in a participant's account which are not sufficient to purchase a full share shall be retained in the participant's account for the subsequent Purchase Period or Offering Period, subject to earlier

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withdrawal by the participant as provided in Section 10 hereof. Any other monies left over in a participant's account after the Exercise Date shall be returned to the participant. During a participant's lifetime, a participant's option to purchase shares hereunder is exercisable only by him or her.

(b) If the Board or the Committee determines that, on a given Exercise Date, the number of shares with respect to which options are to be exercised may exceed (i) the number of shares of Common Stock that were available for sale under the Plan on the Enrollment Date of the applicable Offering Period, or (ii) the number of shares available for sale under the Plan on such Exercise Date, the Board may in its sole discretion (x) provide that the Company shall make a pro rata allocation of the shares of Common Stock available for purchase on such Enrollment Date or Exercise Date, as applicable, in as uniform a manner as shall be practicable and as it shall determine in its sole discretion to be equitable among all participants exercising options to purchase Common Stock on such Exercise Date, and continue all Offering Periods then in effect, or (y) provide that the Company shall make a pro rata allocation of the shares available for purchase on such Enrollment Date or Exercise Date, as applicable, in as uniform a manner as shall be practicable and as it shall determine in its sole discretion to be equitable among all participants exercising options to purchase Common Stock on such Exercise Date, and terminate any or all Offering Periods then in effect pursuant to Section 20 hereof. The Company may make pro rata allocations of the shares available on the Enrollment Date of any applicable Offering Period pursuant to the preceding sentence, notwithstanding any authorization of additional shares for issuance under the Plan by the Company's stockholders subsequent to such Enrollment Date.

9. Delivery. As promptly as practicable after each Exercise Date on which a purchase of shares occurs, the Company shall arrange the delivery to each participant, as appropriate, the shares purchased upon exercise of his or her option in a certificate or uncertificated form.

10. Withdrawal.

(a) A participant may withdraw all but not less than all the payroll deductions credited to his or her account and not yet used to exercise his or her option under the Plan at any time by giving written notice to Plan Administrator which is received at least ten (10) days prior to the Exercise Date (or such other notice period as may be established by the Plan Administrator from time to time in its sole discretion). All of the participant's payroll deductions credited to his or her account shall be paid to such participant promptly after receipt of notice of withdrawal and such participant's option for the Offering Period shall be automatically terminated, and no further payroll deductions for the purchase of shares shall be made for such Offering Period. If a participant withdraws from an Offering Period, payroll deductions shall not resume at the beginning of the succeeding Offering Period unless the participant delivers to the Plan Administrator a new Authorization Form.

(b) A participant's withdrawal from an Offering Period shall not have any effect upon his or her eligibility to participate in any similar plan that may hereafter be adopted by the Company or in succeeding Offering Periods that commence after the termination of the Offering Period from which the participant withdraws.

11. Termination of Employment. Upon a participant's ceasing to be an Employee, for any reason, he or she shall be deemed to have elected to withdraw from the Plan and the payroll deductions credited to such participant's account during the Offering Period but not yet used to exercise the option shall be returned to such participant or, in the case of his or her death, to the person or persons entitled thereto under Section 15 hereof, and such participant's option shall be automatically terminated.

12. Interest. No interest shall accrue on the payroll deductions of a participant in the Plan.

13. Stock.

(a) Subject to adjustment upon changes in capitalization of the Company as provided in Section 19 hereof, the maximum number of shares of the Company's Common Stock which shall be made available for sale under

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the Plan with respect to Exercise Dates (including Exercise Dates with respect to outstanding Offering Periods under the Prior Plan and ones with respect to Offering Periods commencing under the Plan) shall be One Million Five Hundred Thousand (1,500,000) shares, effective as of the date of the effective date of the Plan.

(b) The participant shall have no interest or voting rights in shares covered by his or her option until such option has been exercised.

(c) Shares to be delivered to a participant under the Plan shall be registered in the name of the participant or in the name of the participant and his or her spouse.

14. Administration. The Committee shall mean the Compensation Committee of the Board, a subcommittee thereof formed by the Compensation Committee to act as the Committee hereunder or such other committee of members of the Board as delegated by the Board. The Board or the Committee shall administer the Plan. The Board or the Committee shall have full and exclusive discretionary authority to construe, interpret and apply the terms of the Plan, to determine eligibility and to adjudicate all disputed claims filed under the Plan. Every finding, decision and determination made by the Board or the Committee shall, to the full extent permitted by law, be final and binding upon all parties. The Company will pay all expenses incurred in the administration of the Plan. No member of the Committee or individual acting on behalf of the Plan Administrator shall be personally liable for any action, determination, or interpretation made in good faith with respect to the Plan, and all members of the Committee and individuals acting on behalf of the Plan Administrator shall be fully indemnified by the Company with respect to any such good faith action, determination or interpretation.

15. Designation of Beneficiary.

(a) A participant may file with the Plan Administrator a written designation of a beneficiary who is to receive any shares and cash from the participant's account under the Plan in the event of such participant's death subsequent to an Exercise Date on which the option is exercised but prior to delivery

to such participant of such shares and cash. In addition, a participant may file with the Plan Administrator a written designation of a beneficiary who is to receive any cash from the participant's account under the Plan in the event of such participant's death prior to the exercise of the option. If a participant is married and the designated beneficiary is not the spouse, spousal consent shall be required for such designation to be effective.

(b) Such designation of beneficiary may be changed by the participant at any time by written notice to the Plan Administrator. In the event of the death of a participant and in the absence of a beneficiary validly designated under the Plan who is living at the time of such participant's death, the Company shall deliver such shares and/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 and/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.

16. Transferability. 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 the 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 Section 15 hereof) by the participant. Any such attempt at assignment, transfer, pledge or other disposition shall be without effect, except that the Company may treat such act as an election to withdraw funds from an Offering Period in accordance with Section 10 hereof.

17. Use of Funds. All payroll deductions received or held by the Company under the Plan may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions.

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18. Reports. Individual accounts shall be maintained for each participant in the Plan. Statements of account shall be given to participating Employees at least annually, which statements shall set forth the amounts of payroll deductions, the Purchase Price, the number of shares purchased and the remaining cash balance, if any.

19. Adjustments Upon Changes in Capitalization, Dissolution, Liquidation, Merger or Asset Sale.

(a) *Changes in Capitalization.* Subject to any required action by the stockholders of the Company, the Reserves, the maximum number of shares each participant may purchase each Purchase Period (pursuant to Section 7), as well as the price per share and the number of shares of Common Stock covered by each option under the Plan which have not yet been exercised shall be proportionately adjusted for any increase or decrease in the number of issued shares of Common Stock resulting from a stock split, reverse stock split, stock dividend, extraordinary cash dividend, combination or reclassification of the Common Stock, or any other increase or decrease in the number of shares of Common Stock effected without receipt of consideration by the Company; 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 Board or the Committee, whose determination in that respect shall be final, binding and conclusive. Except as expressly provided herein, no issuance 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 of Common Stock subject to an option.

(b) *Dissolution or Liquidation.* In the event of a proposed dissolution or liquidation of the Company, the Offering Period then in progress shall be shortened by setting a new Exercise Date (the New Exercise Date), and shall terminate immediately prior to the consummation of such proposed dissolution or liquidation, unless provided otherwise by the Board. The New Exercise Date shall be before the date of the Company's proposed

dissolution or liquidation. The Board shall notify each participant in writing, at least ten (10) business days prior to the New Exercise Date, that the Exercise Date for the participant's option has been changed to the New Exercise Date and that the participant's option shall be exercised automatically on the New Exercise Date, unless prior to such date the participant has withdrawn from the Offering Period as provided in Section 10 hereof.

(c) *Merger or Asset Sale.* In the event of a proposed sale of all or substantially all of the assets of the Company, or the merger of the Company with or into another corporation, each outstanding option shall be assumed or an equivalent option substituted by the successor corporation or a parent or subsidiary of the successor corporation. In the event that the successor corporation refuses to assume or substitute for the option, any Purchase Periods then in progress shall be shortened by setting a new Exercise Date (the New Exercise Date) and any Offering Periods then in progress shall end on the New Exercise Date. The New Exercise Date shall be before the date of the Company's proposed sale or merger. The Board shall notify each participant in writing, at least ten (10) business days prior to the New Exercise Date, that the Exercise Date for the participant's option has been changed to the New Exercise Date and that the participant's option shall be exercised automatically on the New Exercise Date, unless prior to such date the participant has withdrawn from the Offering Period as provided in Section 10 hereof.

20. Amendment or Termination.

(a) The Board may at any time and for any reason terminate or amend the Plan. Except as provided in Section 19 hereof, no such termination can affect options previously granted, provided that an Offering Period may be terminated by the Board on any Exercise Date if the Board determines that the termination of the Offering Period or the Plan is in the best interests of the Company and its stockholders. Except as provided in Section 19 and this Section 20 hereof, no amendment may make any change in any option theretofore granted which adversely affects the rights of any participant. To the extent necessary to comply with Section 423 of the Code (or any successor rule or provision or any other applicable law, regulation or rule of the NASDAQ Stock Market or such other

principal U.S. national securities exchange
Common Stock is listed), the Company
shall obtain stockholder approval in such a
manner and to such a degree as required.

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(b) Without stockholder approval and without regard to whether any participant rights may be considered to have been adversely affected, the Board or the Committee shall be entitled to change the Offering Periods, limit the frequency and/or number of changes in the amount withheld during an Offering Period, establish the exchange ratio applicable to amounts withheld in a currency other than U.S. dollars, permit payroll withholding in excess of the amount designated by a participant in order to adjust for delays or mistakes in the Company's processing of properly completed withholding elections, establish reasonable waiting and adjustment periods and/or accounting and crediting procedures to ensure that amounts applied toward the purchase of Common Stock for each participant properly correspond with amounts withheld from the participant's Compensation, and establish such other limitations or procedures as the Board or the Committee determines in its sole discretion advisable which are consistent with the Plan.

(c) In the event the Board determines that the ongoing operation of the Plan may result in unfavorable financial accounting consequences, the Board may, in its discretion and, to the extent necessary or desirable, modify or amend the Plan to reduce or eliminate such accounting consequences including, but not limited to:

(1) altering the Purchase Price for any Offering Period including an Offering Period underway at the time of the change in Purchase Price;

(2) shortening any Offering Period so that the Offering Period ends on a new Exercise Date, including an Offering Period underway at the time of the Board action; and

(3) allocating shares.

Such modifications or amendments shall not require stockholder approval or the consent of any Plan participants.

21. Notices. All notices or other communications by a participant to the Company under or in connection with the 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.

22. Conditions Upon Issuance 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 the NASDAQ Stock Market (or any other principal U.S. national securities exchange on which the Common Stock may then be listed), and shall be further subject to the approval of counsel for the Company with respect to such compliance. As a condition to the exercise of an option, the Company may require the person exercising such option to represent and warrant at the time of any such exercise that the shares are being purchased only for investment and without any present intention to sell or distribute such shares if, in the opinion of counsel for the Company, such a representation is required by any of the aforementioned applicable provisions of law.

23. Term of Plan. The Plan shall become effective upon its approval by the stockholders of the Company and shall continue in effect until June 25, 2019, unless sooner terminated under Section 20 hereof.

24. Miscellaneous.

(a) *Administrative Costs.* The Company shall pay the administrative expenses associated with the operation of the Plan (other than brokerage commissions resulting from sales of Common Stock directed by Employees).

(b) *No Employment Rights.* Participation in the Plan shall not give an Employee any right to continue in the employment of the Company, and shall not affect the right of the Company to terminate the Employee's employment at any time, with or without cause.

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(c) *Repurchase of Stock.* The Company shall not be required to purchase or repurchase from any Employee any of the shares of Common Stock that the Employee acquires under the Plan.

(d) *Internal Revenue Code and ERISA Considerations.* The Plan is intended to constitute an employee stock purchase plan within the meaning of section 423 of the Internal Revenue Code of 1986, as amended, and the regulations thereunder. The provisions of the Plan, accordingly, shall be construed so as to comply with the requirements of that section of the Code or any successor provision, and the regulations thereunder. The Plan is not intended and shall not be construed as constituting an employee benefit plan, within the meaning of section 3(3) of the Employee Retirement Income Security Act of 1974, as amended.

(e) *Headings, Captions, Gender.* The headings and captions herein are for convenience of reference only and shall not be considered as part of the text. The masculine shall include the feminine, and vice versa.

(f) *Severability of Provisions, Prevailing Law.* The provisions of the Plan shall be deemed severable. If any provision of the Plan shall be held unlawful or otherwise invalid or unenforceable in whole or in part by a court of competent jurisdiction or by reason of a change in a law or regulation, such provision shall (a) be deemed limited to the extent that such court of competent jurisdiction deems it lawful, valid and/or enforceable and as so limited shall remain in full force and effect, and (b) not affect any other provision of the Plan or part thereof, each of which shall remain in full force and effect. The Plan shall be governed by the laws of the State of California to the extent such laws are not in conflict with, or superseded by, federal law.

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**Arena
Pharmaceuticals,
Inc.**

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MR A SAMPLE

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DESIGNATION (IF
ANY)

ADD 1

ADD 2

ADD 3

ADD 4

ADD 5

ADD 6

Electronic Voting Instructions
You can vote by Internet or
telephone!
Available 24 hours a day, 7 days a
week!

Instead of mailing your proxy, you
may choose one of the two voting
methods outlined below to vote your
proxy.

VALIDATION DETAILS ARE
LOCATED BELOW IN THE TITLE
BAR.

**Proxies submitted by the Internet
telephone must be received by 11:
p.m. Pacific Time on June 24, 2009**

Vote by Internet

Log on to the Internet and go
www.investorvote.com/ARN
Follow the steps outlined on
secured website.

Vote by telephone

Call toll free 1-800-652-VO
(8683) within the United States
Canada & Puerto Rico any time
on a touch tone telephone. There
is **NO CHARGE** to you for the
call.

Using a **black ink** pen, mark
your votes with an **X** as
shown in this example.
Please do not write outside
the designated areas.

X

Follow the instructions
provided by the recorded
message.

**q IF YOU HAVE NOT VOTED VIA THE
INTERNET OR TELEPHONE, FOLD
ALONG THE PERFORATION, DETACH
AND RETURN THE BOTTOM PORTION
IN THE ENCLOSED ENVELOPE. q**

A **Proposals** The Board of Directors recommends a vote **FOR** all the nominees listed in Proposal 1 and **FOR** Proposals 2 through 5.

1. Election of Directors:	For	Withhold		For	Withhold	
01 - Jack Lief	**	**	02 - Dominic P. Behan, Ph.D.	**	**	03 - Donald D. Belcher
04 - Scott H. Bice	**	**	05 - Harry F. Hixson, Jr., Ph.D.	**	**	06 - J. Clayburn La Force, Jr., Ph.D.
07 - Tina S. Nova, Ph.D.	**	**	08 - Phillip M. Schneider	**	**	09 - Christine A. White, M.D.
10 - Randall E. Woods	**	**				

	For	Against	Abstain		For	Against
2. Approval of the Arena Pharmaceuticals, Inc., 2009 Long-Term Incentive Plan.	**	**	**	3. Approval of the Arena Pharmaceuticals, Inc., 2009 Employee Stock Purchase Plan.	**	**
4. Approval of an amendment to Arena's Fifth Amended and Restated Certificate of Incorporation to increase the total number of authorized shares from 150.0 million to 250.0 million and the number of authorized shares of common stock from 142.5 million to 242.5 million.	**	**	**	5. Ratification of the appointment of Ernst & Young LLP, an independent registered public accounting firm, as Arena's independent auditors for the fiscal year ending December 31, 2009.	**	**

B **Non-Voting Items**

Change of Address Please print new address below. **Meeting Attendance** Mark box to the right if you plan to attend the Annual Meeting.

IF VOTING BY MAIL, YOU MUST COMPLETE SECTIONS A - C ON BOTH SIDES OF THIS CARD.

<STOCK#> 01238B

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q IF YOU HAVE NOT VOTED VIA THE INTERNET OR TELEPHONE, FOLD ALONG THE PERFORATION, DETACH AND RETURN THE BOTTOM PORTION IN THE ENCLOSED ENVELOPE. q

**Proxy Arena
Pharmaceuticals, Inc.**

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**THIS PROXY IS SOLICITED ON
BEHALF OF THE BOARD OF
DIRECTORS FOR**

**THE 2009 ANNUAL MEETING OF
STOCKHOLDERS**

**6154 Nancy Ridge Drive, San Diego,
California 92121**

The undersigned stockholder of ARENA PHARMACEUTICALS, INC., a Delaware corporation (the Company), hereby acknowledges receipt of the Notice of Annual Meeting of Stockholders and Proxy Statement, each dated [_____], and the Annual Report to Stockholders, and hereby appoints Jack Lief and Steven W. Spector, the President and the Secretary,

respectively, of the Company, or each of them, as proxies and attorneys-in-fact, with all powers of substitution, to represent and vote, as set forth on the reverse side, the shares of Common Stock of the Company held of record by the undersigned at the close of business on April 27, 2009, at the 2009 Annual Meeting of Stockholders of the Company, which is being held at the offices of the Company at 6154 Nancy Ridge Drive, San Diego, California 92121, on Thursday, June 25, 2009, at 9:00 a.m. Pacific Time, and at any adjournments or postponements of such meeting, with all powers which the undersigned would possess if personally present at such meeting or at any such postponement or adjournment, and, in their discretion, to vote such shares upon any other business that may properly come before the meeting or any adjournments or postponements thereof.

UNLESS OTHERWISE SPECIFIED BY THE UNDERSIGNED, THE PROXY WILL BE VOTED FOR ALL OF THE NOMINEES LISTED IN PROPOSAL 1 AND FOR PROPOSALS 2 THROUGH 5 AND WILL BE VOTED BY THE PROXYHOLDERS AT THEIR DISCRETION UPON ANY OTHER BUSINESS THAT MAY PROPERLY COME BEFORE THE ANNUAL MEETING OR ANY ADJOURNMENT OR POSTPONEMENTS THEREOF.

(Items to be voted appear on reverse side.)

C Authorized Signatures This section must be completed for your vote to be counted. Date and Sign Below

NOTE: Please sign your name(s) EXACTLY as your name(s) appear(s) on this proxy. All joint holders must sign. When signing as attorney, trustee, executor, administrator, guardian or corporate officer, please provide your FULL title.

Date (mm/dd/yyyy) Please print date below.	Signature 1 Please keep signature within the box.	Signature 2 Please keep signature within the box.
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**IF VOTING BY MAIL,
YOU MUST
COMPLETE
SECTIONS A - C ON
BOTH SIDES OF THIS
CARD.**

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