

CONSUMER PORTFOLIO SERVICES INC  
Form PRE 14A  
June 09, 2009

PRELIMINARY PROXY MATERIALS

NOTICE OF ANNUAL MEETING OF SHAREHOLDERS

OF

CONSUMER PORTFOLIO SERVICES, INC.

19500 Jamboree Road, Irvine, California 92612

Phone: 949-753-6800

The annual meeting of the shareholders of Consumer Portfolio Services, Inc. (the "Company") will be held at 10:00 a.m., local time, on Wednesday, July 15, 2009 at the Company's principal executive offices, 19500 Jamboree Road, Irvine, California for the following purposes:

- To elect the Company's entire Board of Directors for a one-year term.
- To ratify the appointment of Crowe Horwath, LLP as the Company's independent auditors for the fiscal year ending December 31, 2009.
- To approve an amendment of the Company's 2006 Long-Term Equity Incentive Plan, which will permit an exchange and repricing of outstanding options.
- To transact such other business as may properly come before the meeting.

Only shareholders of record at the close of business on Monday, May 18, 2009 are entitled to notice of and to vote at the meeting.

Whether or not you expect to attend the meeting in person, please complete, date, and sign the enclosed proxy exactly as your name appears thereon and promptly return it in the envelope provided, which requires no postage if mailed in the United States. Proxies may be revoked at any time and, if you attend the meeting in person, your executed proxy will be returned to you upon request.

By Order of the Board of Directors

Mark Creatura, Secretary

Dated: June 19, 2009

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PRELIMINARY PROXY MATERIALS

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CONSUMER PORTFOLIO SERVICES, INC.

19500 Jamboree Road

Irvine, California 92612

949-753-6800

PROXY STATEMENT FOR  
ANNUAL MEETING OF SHAREHOLDERS

TO BE HELD JULY 15, 2009

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INTRODUCTION

This proxy statement is furnished in connection with the solicitation of proxies by the Board of Directors of Consumer Portfolio Services, Inc. (the "Company" or "CPS") for use at the annual meeting of the shareholders to be held at 10:00 A.M. local time on Wednesday, July 15, 2009 at the Company's principal executive offices, 19500 Jamboree Road, Irvine, California 92612, and at any adjournment thereof (the "Annual Meeting").

All shares represented by properly executed proxies received in time will be voted at the Annual Meeting and, where the manner of voting is specified on the proxy, will be voted in accordance with such specifications. Any shareholder who executes and returns a proxy may revoke it at any time prior to the voting of the proxy by giving written notice to the Secretary of the Company, by executing a later-dated proxy, or by attending the meeting and giving oral notice of revocation to the Secretary of the Company.

The Board of Directors of the Company has fixed the close of business on May 18, 2009, as the record date for determining the holders of outstanding shares of the Company's Common Stock, without par value ("CPS Common Stock") entitled to notice of, and to vote at the Annual Meeting. On that date, there were 18,737,141 shares of CPS Common Stock issued and outstanding. Each such share of CPS Common Stock is entitled to one vote on all matters to be voted upon at the meeting, except that holders of CPS Common Stock have the right to cumulative voting in the election of directors, as described herein under the heading "Voting of Shares."

The notice of the Annual Meeting, this proxy statement and the form of proxy are first being mailed to shareholders of the Company on or about June 18, 2009. The Company will pay the expenses incurred in connection with the solicitation of proxies. The proxies are being solicited principally by mail. In addition, directors, officers and regular employees of the Company may solicit proxies personally or by telephone, for which they will receive no payment other than their regular compensation. The Company will also request brokerage houses, nominees, custodians and fiduciaries to forward soliciting material to the beneficial owners of Common Stock of the Company and will reimburse such persons for their expenses so incurred.



PRELIMINARY PROXY MATERIALS

PROPOSAL NO. 1 - ELECTION OF DIRECTORS

Nominations

The individuals named below have been nominated for election as directors of the Company at the Annual Meeting, and each has agreed to serve as a director if elected. The entire board of directors of the Company is elected annually. Directors serve until the next annual meeting of shareholders and until their successors are duly elected and qualified.

The names of the nominees, their principal occupations, and certain other information regarding them set forth below are based upon information furnished to the Company by them. Except as noted below, none of the nominees currently serve on the board of directors of any other publicly-traded companies.

Charles E. Bradley, Jr., 49, has been the President and a director of the Company since its formation in March 1991, and was elected Chairman of the Board of Directors in July 2001. Mr. Bradley has been the Company's Chief Executive Officer since January 1992. From April 1989 to November 1990, he served as Chief Operating Officer of Barnard and Company, a private investment firm. From September 1987 to March 1989, Mr. Bradley, Jr. was an associate of The Harding Group, a private investment banking firm.

Chris A. Adams, 61, has been a director of the Company since August 2007. Since 1982 he has been the owner and chief executive of Latrobe Pattern Company and K Castings Inc., which are firms engaged in the business of fabricating metal parts.

Brian J. Rayhill, 46, has been a director of the Company since August 2006. Mr. Rayhill has been a practicing attorney in New York State since 1988.

William B. Roberts, 71, has been a director of the Company since its formation in March 1991. Since 1981, he has been the President of Monmouth Capital Corp., an investment firm that specializes in management buyouts.

Gregory S. Washer, 47, has been a director of the Company since June 2007. He has been the owner and president of Clean Fun Promotional Marketing LLC, a promotional marketing company, since its founding in 1986.

Daniel S. Wood, 50, has been a director of the Company since July 2001. Mr. Wood was president of Carclo Technical Plastics, a manufacturer of custom injection moldings, until his retirement in April 2007. He now serves as a consultant to that company. Previously, from 1988 to September 2000, he was the chief operating officer and co-owner of Carrera Corporation, the predecessor to the business of Carclo Technical Plastics.

The Board of Directors has established an Audit Committee, a Compensation and Stock Option Committee, and a Nominating Committee. Each of these three committees operates under a written charter, adopted by the Board of Directors of the Company. The charters are available on the Company's website, [www.consumerportfolio.com](http://www.consumerportfolio.com). The Board of Directors has concluded that each member of these three committees (every director other than Mr. Bradley, the Company's chief executive officer), is independent in accordance with the director independence standards prescribed by Nasdaq, and has determined that none of them have a material relationship with the Company that would impair their independence from management or otherwise compromise the ability to act as an independent director.

The members of the Audit Committee are Daniel S. Wood (chairman), Chris A. Adams and Brian J. Rayhill. The Audit Committee is empowered by the Board of Directors to review the financial books and records of the Company

in consultation with the Company's accounting and auditing staff and its independent auditors and to review with the accounting staff and independent auditors any questions that may arise with respect to accounting and auditing policy and procedure.

The Board of Directors has further determined that Mr. Wood has the qualifications and experience necessary to serve as an "audit committee financial expert" as such term is defined in Item 401(h) of Regulation S-K promulgated by the SEC. Such qualifications and experience are described above in this section.

The members of the Compensation and Stock Option Committee are Gregory S. Washer (chairman), William B. Roberts and Mr. Wood. This Committee makes determinations as to general levels of compensation for all employees of the Company and the annual salary of each of the executive officers of the Company, and administers the Company's compensation plans. Those plans include the Company's 1997 Long-Term Stock Incentive Plan, the Executive Management Bonus Plan, and the CPS 2006 Long-Term Equity Incentive Plan.

## PRELIMINARY PROXY MATERIALS

The members of the Nominating Committee are Brian J. Rayhill (chairman), Chris A. Adams and Mr. Washer. Nominations for board positions are made on behalf of the Board of Directors by the nominating committee. Because neither the Board of Directors nor its Nominating Committee has received recommendations from shareholders as to nominees, the Board of Directors and the Nominating Committee believe that it is and remains appropriate to operate without a formal policy with regard to any director candidates who may in the future be recommended by shareholders. The nominating committee would consider such recommendations.

When considering a potential nominee, the nominating committee considers the benefits to the Company of such nomination, based on the nominee's skills and experience related to managing a significant business, the willingness and ability of the nominee to serve, and the nominee's character and reputation.

Shareholders who wish to suggest individuals for possible future consideration for board positions, or to otherwise communicate with the Board of Directors, should direct written correspondence to the corporate secretary at the Company's principal executive offices, indicating whether the shareholder wishes to communicate with the nominating committee or with the Board of Directors as a whole. The present policy of the Company is to forward all such correspondence to the designated members of the Board of Directors. There have been no changes in the procedures regarding shareholder recommendations in the past year.

### Section 16(a) Beneficial Ownership Reporting Compliance

Directors, executive officers and holders of in excess of 10% of the Company's common stock are required to file reports concerning their transactions in and holdings of equity securities of the Company. Based on a review of reports filed by each such person, and inquiry of each regarding holdings and transactions, the Company believes that all reports required with respect to the year 2008 were timely filed.

### Code of Ethics

The Company has adopted a Code of Ethics for Senior Financial Officers, which applies to the Company's chief executive officer, chief financial officer, controller and others. A copy of the Code of Ethics may be obtained at no charge by written request to the Corporate Secretary at the Company's principal executive offices.

### Meetings of the Board

The Board of Directors held seven meetings (including regular and special meetings) and acted twice by written consent during 2008. The Audit Committee met six times during 2008, including at least one meeting per quarter to review the Company's financial statements, and acted one time by written consent, while the Compensation and Stock Option Committee met four times during 2008 and did not act by written consent. The Nominating Committee met once during 2008 and did not act by written consent. Each nominee attended at least 75% of the meetings of the Board of Directors and its committees that such individual was eligible to attend in 2008. The Company does not have a policy of encouraging directors to attend or discouraging directors from attending its annual meetings of shareholders. Other than Mr. Bradley, no directors attended last year's annual meeting of shareholders.



THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" EACH OF THE NOMINEES ABOVE.

## PRELIMINARY PROXY MATERIALS

### PROPOSAL NO. 2 – RATIFICATION OF SELECTION OF INDEPENDENT AUDITORS

The Audit Committee of the Board of Directors has appointed the accounting firm of Crowe Horwath, LLP ("Crowe") to be the Company's independent auditors for the year ending December 31, 2009. Crowe also performed the audit of the Company's financial statements for the year ended December 31, 2008. The Company retained Crowe for that purpose on February 6, 2009. The former principal accountant, McGladrey & Pullen LLP ("McGladrey"), had served as the Company's principal accountant since October 21, 2004, and performed certain attestation services for the Company during the year ended December 31, 2008, notably the review of the financial statements included in the Company's three quarterly reports on Form 10-Q filed in 2008.

A proposal to ratify that appointment will be presented to shareholders at the Annual Meeting. If the shareholders do not ratify the selection of Crowe at the Annual Meeting, the Audit Committee will consider selecting another firm of independent public accountants. Representatives of Crowe are expected to be present at the Annual Meeting. Such representatives will have an opportunity to make a statement if they desire to do so, and will be available to respond to appropriate questions from shareholders in attendance.

Information relating to the fees billed by those firms to the Company appears below.

#### Audit Fees

The aggregate fees billed by Crowe for professional services rendered for the audit of the Company's annual financial statements for the fiscal year ended December 31, 2008 were \$625,000.

The aggregate fees billed by McGladrey for professional services rendered as part of or for the audit of the Company's annual financial statements for the fiscal year ended December 31, 2007, for the review of the financial statements included in the Company's quarterly reports on Form 10-Q filed in 2008 and 2007, and for services that are normally provided by the auditor in connection with statutory or regulatory filings or engagements in those two years were \$325,000 and \$971,000, respectively. It should be noted that McGladrey, though not retained to perform the audit of the Company's annual financial statements for the year ended December 31, 2008, did perform quarterly review of the financial statements included in the Company's three quarterly reports on Form 10-Q filed in 2008.

#### Audit-Related Fees

Crowe performed for the Company no audit-related services in the fiscal years ended December 31, 2008 and 2007.

The aggregate fees billed by McGladrey for audit-related services for the fiscal years ended December 31, 2008 and 2007 were \$52,550 and \$316,000, respectively. These professional services were rendered in conjunction with the Company's securitization and financing transactions, and consultations concerning financial accounting and reporting standards.

#### Tax Fees

Crowe performed for the Company no tax services in the fiscal years ended December 31, 2008 and 2007.

The aggregate fees billed by McGladrey for tax services in the fiscal years ended December 31, 2008 and 2007 were \$600,790 and \$570,000, respectively. Tax services provided by McGladrey consisted of preparation of various state

and federal income tax returns for the Company and its subsidiaries.

#### All Other Fees

No other fees were billed by Crowe or McGladrey in the fiscal years ended December 31, 2008 and December 31, 2007.

#### Audit Committee Supervision of Principal Accountant

The Audit Committee acts pursuant to a written charter adopted by the Board of Directors. Pursuant to the charter, the Audit Committee pre-approves the audit and permitted non-audit fees to be paid to the independent auditor, and authorizes on behalf of the Company the payment of such fees, or refuses such authorization. The Audit Committee has delegated to its chairman and its vice-chairman the authority to approve performance of services on an interim basis. In the fiscal years ended December 31, 2008 and December 31, 2007, all services for which audit fees or audit related fees were paid were preapproved by the Audit Committee as a whole, or pursuant to such delegated authority.

#### PRELIMINARY PROXY MATERIALS

In the course of its meetings, the Audit Committee has considered whether the provision of the non-audit fees outlined above is compatible with maintaining the independence of the respective audit firms, and has concluded that such independence is not impaired.

THE BOARD OF DIRECTORS RECOMMENDS A VOTE "FOR" RATIFICATION OF THE APPOINTMENT OF CROWE HORWATH, LLP.

#### PROPOSAL NO. 3 – APPROVAL OF AN AMENDMENT OF THE COMPANY'S 2006 LONG-TERM INCENTIVE PLAN, WHICH WILL PERMIT AN EXCHANGE AND REPRICING OF OUTSTANDING OPTIONS

##### Introduction

We are seeking shareholder approval of an amendment of the Company's 2006 Long-Term Equity Incentive Plan ("2006 Stock Plan"), which will permit a one-time exchange of eligible stock options that have exercise prices significantly above the current price of our common stock. The exchange would involve surrender of outstanding options and issuance of amended options to purchase, at a reduced exercise price, the same number of shares. The amended options will become exercisable on a vesting schedule that will be based on the vesting schedule of the surrendered options, but will include a bar on exercise within six months following the deemed date of issuance. That date of issuance will be on or about the conclusion of the exchange offer process. The amendment will also add to the 2006 Plan an explicit definition of the term "forfeited," as used in the 2006 Stock Plan, to make clear that options surrendered in the exchange are deemed forfeited, with the result that the shares underlying such surrendered options are made available for re-grant under the 2006 Stock Plan.

Our executive officers, but not our non-employee directors, will be eligible to participate in the exchange. Prior to launching the exchange offer after the annual meeting, our Compensation Committee may determine to exclude any employee or class of employees or adjust the terms of the new options in a manner less favorable to any employee or class of employees.

A critical factor in successfully achieving our business objectives and creating long-term value for our shareholders is the ability to provide long-term equity compensation to our key employees. Participation in our equity plan rewards these employees for the Company's success by giving them an opportunity to participate in our growth, thereby aligning their interests with those of our shareholders. Although all of our employees are eligible for equity compensation under our 2006 Equity Incentive Plan, we have generally limited participation in the 2006 Stock Plan to management employees, whose performance is likely to have an effect on our financial results. Our direct competitors and our peer companies rely on equity compensation to attract and retain top talent in our industry and remain competitive. We believe that if we should fail to offer competitive levels of equity compensation in attracting and retaining important management employees we would put ourselves at a competitive disadvantage, and have an adverse effect on our business.

As of the date of this proxy statement, there are outstanding options to purchase approximately 7,501,999 shares of CPS common stock, held by approximately 79 individuals. However, like other companies in the financial services sector, and business services generally, our stock price has fallen significantly over the past 9 to 18 months. This has caused 100% of the outstanding stock option awards issued prior to this year to be out-of-the-money, or underwater, meaning the exercise or purchase price of the option is greater than the current market price of our common stock. As a result, these options fail to provide adequate performance and retention incentives to our employees and do not achieve our goal of aligning employees' interests with those of our shareholders.

We believe the steep decline in our stock price was mostly driven by factors external to how we operate our business. Since the fourth quarter of 2007, U.S. and global economic activity has progressively weakened. The recession has affected virtually all segments of the economy in 2008 and 2009 as both consumer and business spending dropped sharply. The economic and capital market stresses led to a severe global financial disruption in 2008. This disruption caused a freezing up of credit markets, pervasive loss of investor confidence and significant devaluation of assets of all types, from the riskiest to the most secure. It also resulted in increasingly negative job growth throughout 2008, and a deepening economic contraction in the second half of 2008.

## PRELIMINARY PRIXY MATERIALS

As they affect our business of subprime automotive finance, the severe credit and liquidity disruptions in the market globally and rapid deterioration in general economic circumstances described above have caused it to be increasingly difficult to obtain financing to acquire and hold subprime consumer obligations.

Our management has taken actions to address the unprecedented economic environment. We undertook significant cost-reduction actions in late 2008 and early 2009, across all of our business lines. As of our year-end earnings release, we have taken actions to eliminate a total of approximately \$35 million of annual operating expenses for 2009. Among these actions are (i) reduction in headcount from 873 at May 31, 2008 to 542 at May 31, 2009, (ii) a general freeze on salaries, ceasing our former practice of annual adjustments, and (iii) as to officer-level employees, a 20% reduction in bonuses earned for achieving their personal performance goals in 2008. However, despite the actions we have taken to reinvigorate our business and improve our performance, our efforts have not had a significant impact on our stock price, which remains at a level significantly below that of the years 2006 and 2007. Further, there can be no assurance that our stock price will increase in the near-term.

We believe the best course of action is to replace the deeply under-water stock option awards with amended stock-option awards, with the amended options to carry an exercise price that is well above the currently prevailing price of CPS common stock, but not out of reach. By exchanging such options, we will more cost-effectively provide retention and performance incentives to our key contributors than we would by simply issuing incremental equity or paying additional cash compensation.

### Overview and Summary of Material Terms of Option Exchange Program

Beginning in January, our Compensation Committee began to consider the possibility of a one-time stock option exchange program (the "Option Exchange Program"), subject to shareholder approval. The topic was considered again at a meeting on May 6, 2009. On June 5, 2009, the Compensation Committee approved the detailed terms of the Option Exchange Program as described herein. Under the proposed Option Exchange Program, eligible employees would be able to elect to exchange, through an Exchange Offer (as described below), outstanding eligible options to purchase shares of our common stock issued for new options with reduced exercise prices and modified vesting schedules (the "New Option"). The following describes important features of the Option Exchange Program:

**Who Is Eligible to Participate in the Option Exchange Program?** All employees of the Company who are employed by us on the date we commence the Exchange Offer and who hold Eligible Options (as defined below) will be eligible to participate in the program (such employees, "Eligible Optionholders"). Each New Option will have an exercise price of \$1.50 per share (or, if greater, the closing price of our common stock on the date of the exchange.) Only those Eligible Optionholders who continue to be employed by us through the date on which the Exchange Offer concludes will be granted New Options.

**Who Is Not Eligible to Participate in the Option Exchange Program?** Non-employee members of our Board of Directors, as well as persons whose employment terminates prior to the date on which the Exchange Offer is concluded, will not be eligible to receive New Options. As of May 31, 2009, non-employee directors held options to purchase 670,000 shares of common stock, while terminated employees held options to purchase 223,000 shares of common stock. These options are ineligible for exchange. In addition certain outstanding options with exercise prices below \$2.50 per share are not eligible for exchange. As of May 31, 2009 there were 2,408,433 shares of our common stock subject to outstanding options that are not eligible for exchange because they have exercise prices ranging from \$0.625 to \$2.39.

What Options Are Eligible to be Cancelled in the Option Exchange Program? Options held by Eligible Optionholders that have exercise prices of \$2.50 per share or more are eligible to be surrendered in the Option Exchange Program (such options, "Eligible Options"). As of April 30, 2009 there were 70 Eligible Optionholders, who held 4,200,566 Eligible Options with exercise prices ranging from \$2.50 to \$7.18 per share, a weighted average exercise price of \$4.99 per share and a weighted average remaining term of 6.18 years per share. The Eligible Options constitute approximately 56% of the 7,501,999 shares of our common stock subject to outstanding stock options as of May 31, 2009. The Eligible Options constitute approximately 22% of our total outstanding shares of common stock as of May 31, 2009. As of May 31, 2009, approximately 1.1 million shares remain available for issuance under the 2006 Stock Plan. Because the Exchange Offer will involve a one-for-one correspondence of shares underlying the Eligible Options and New Options, the number of

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## PRELIMINARY PROXY MATERIALS

shares remaining available for future grants will not be affected.

An Eligible Optionholder who desires to participate in the Option Exchange Program must surrender an entire Eligible Option that corresponds to a particular exercise price and will not be given the opportunity to surrender only a portion of such outstanding Eligible Option. An Eligible Optionholder who holds more than one Eligible Option corresponding to different exercise prices will not be required to surrender every Eligible Option he or she holds but may make a participation decision on an Eligible Option-by-Eligible Option basis.

How many shares may be purchased upon the exercise of the New Options by an Eligible Optionholder? The number of shares that may be purchased upon exercise of the New Options will be the same as the number of shares that might be purchased upon exercise of the surrendered Eligible Options. This will result in the New Options having a greater value to the optionholder than the surrendered options.

What Vesting Will Apply? Each New Option will be subject to vesting in a manner that bars any exercise for six months after the new grant, and thereafter becomes exercisable on the same schedule as was applicable to the surrendered option. For example, if an Eligible Option were previously to become exercisable in five annual increments on the first of June of the years 2008 through 2012, so that such option was 40% exercisable at present, then the corresponding New Option would not be exercisable at all at issuance, would become exercisable as to 40% of the underlying shares six months after issuance, and would become exercisable as to three further increments of 20% each on the originally applicable dates: June 1 of 2010, 2011 and 2012.

Why Are We Seeking Shareholder Approval of the Option Exchange Program? Under the listing rules of the Nasdaq Stock Market and the terms of the 2006 Stock Plan, shareholder approval is required in order for us to implement the Option Exchange Program. If our shareholders approve this proposal, we currently intend to launch the Exchange Offer promptly following the Annual Meeting to which this Proxy Statement relates and at which we are seeking shareholder approval, although we may determine to delay the Exchange Offer. If we do not obtain shareholder approval of this proposal, we will not be able to implement the Option Exchange Program. See "Vote Required" on page \_\_\_ for a description of the votes required to approve the Option Exchange Program.

### Reasons for the Option Exchange Program

We believe that an effective and competitive employee incentive program is imperative for the future growth and success of our business. We rely on highly skilled and educated managerial employees to implement our strategic initiatives, expand and develop our business and satisfy our customers. Competition for these types of employees is intense, and many companies use equity awards, including stock options and restricted stock, as a means of attracting, motivating and retaining their employees. Our Board believes that equity compensation encourages employees to act like owners of the business, motivating them to work toward our success and rewarding their contributions by allowing them to benefit from increases in the value of our shares. In the past, stock options have constituted an important part of our incentive and retention programs.

As a result of the recent global credit and liquidity crisis and the subsequent sharp economic slowdown described above, the stock prices of financial companies, including ours, have declined. Because of this decline in price over the past 18 months, many of our employees now hold stock options with exercise prices significantly higher than the current market price of our common stock. For example, on May 31, 2009, the closing price of our common stock on the Nasdaq Stock Market was \$0.98 per share and the weighted average exercise price of Eligible Options was \$4.99 per share. Consequently, as of that date, all of the outstanding stock options issued prior to 2009 under the 2006 Stock Plan and held by Eligible Optionholders were out-of-the-money.



This circumstance has caused our Board and its Compensation Committee to conclude that we may be at risk of losing key contributors across our workforce because, in the absence of an effective equity component, we do not currently have sufficient compensation programs in place to incentivize, retain and ensure the continued commitment of many of our employees. Additionally, the Board considered the following in determining to adopt the Option Exchange Program:

- Reasonable, Balanced and Meaningful Incentives. Under the Option Exchange Program, Eligible Optionholders would be able to surrender certain underwater options for New Options, with exercise

## PRELIMINARY PROXY MATERIALS

prices above the current market price. Employees who no longer have an equity stake due to underwater stock options might seek employment with another company. The cost of replacing a significant fraction of our management employees, or even certain key contributors, could be substantial. Our Board believes that if we do not take steps in the near future to properly incentivize our key employees, it could adversely affect our business, results of operations and future stock price.

- **Enhanced Long-Term Shareholder Value.** We believe that ultimately the Option Exchange Program will enhance long-term shareholder value by restoring competitive incentives to the participants so they are further motivated to achieve our strategic, operational and financial goals, as grant prices significantly in excess of the market price of our stock undermine the effectiveness of stock options as employee performance and retention incentives.
- **Reduced Pressure for Additional Grants.** If we are unable to implement the Option Exchange Program, we may be forced to issue additional equity awards to our employees at current market prices, increasing our equity award overhang. These grants also would more quickly exhaust the current pool of shares available for future grant of options or other equity awards under the 2006 Stock Plan.
- **Equity Award Overhang Unchanged.** Not only do the underwater options have little or no retention value, they cannot be removed from our equity award overhang until they are exercised, expire or the employee who holds them leaves our employment. An exchange, such as the Option Exchange Program, will offer meaningful incentives to option plan participants while eliminating the ineffective options that are currently outstanding. All Eligible Options that are not exchanged will remain outstanding and in effect in accordance with their existing terms.
- **Participation by Our Executive Officers.** Our executive officers are expected to be among the primary drivers of the strategic and operational initiatives we have implemented to advance the creation of long-term shareholder value. As a result, the retention and motivation of our executive officers are critical to our long-term success. Accordingly, we have elected to include executive officers as Eligible Optionholders in the Option Exchange Program.
- **Restore value from compensation costs that we have already incurred and will continue to incur with respect to outstanding underwater stock options.** Options eligible for the Option Exchange Program were granted at the then fair market value of our common stock in accordance with our policies for such grants. Under applicable accounting rules, we have already recognized \$2.7 million in compensation expense for these options. Moreover, we are obligated to recognize approximately \$3.8 million in additional future compensation expense, even if these options are never exercised. We believe it is an inefficient use of the shares made available under our 2006 Stock Plan to recognize compensation expense on options that are not perceived as having value by our employees.

The Option Exchange Program will result in some additional compensation expense. Assuming a market price for our stock of \$1.00 per share on the date of the exchange, if all the options eligible for the Option Exchange Program are exchanged, we will incur additional compensation expense, in accordance with applicable

accounting rules, of approximately \$457,000 at the time of the exchange and approximately \$232,000 over the remaining vesting periods of the exchanged options. The actual amounts of additional compensation expense will vary to the extent the market price for our stock is more or less than \$1.00 per share at the time of the exchange. There will also be additional expense incurred in connection with modification of terms of an outstanding warrant, as discussed below, which expense we estimate to be approximately \$140,789. We believe the amount of additional compensation expense is small relative to the amount of compensation expense already incurred and committed to for the underwater options that are eligible for the Option Exchange Program and that the additional expense is justified by the value restored to the exchanged options.

If the Option Exchange Program is not approved by our shareholders, the original options that would have qualified for exchange will remain outstanding and we will continue to incur the compensation expense associated with those options even though they will no more than minimal retention and incentive value due to their being underwater.

## PRELIMINARY PROXY MATERIALS

In determining to recommend that shareholders approve the Option Exchange Program, the Compensation Committee of the Board considered other alternatives as set forth below. However, the Compensation Committee believes that the Option Exchange Program provides a better opportunity to motivate our employees to create shareholder value at a more reasonable cost to the Company as the Option Exchange Program will allow us to conserve cash resources, as compared to alternative compensation schemes.

### Consideration of Alternatives

When considering how best to continue to retain and incentivize our employees who have underwater stock options, we considered the following alternatives:

**Increase cash compensation.** To replace equity incentives, we considered that we could increase base and target bonus compensation. However, significant increases in cash compensation would substantially increase our compensation expenses and reduce our cash flow from operations, which would adversely affect our business and operating results. We believe that equity awards are an important component of our employees' total target compensation, and that replacing this component with additional cash compensation to remain competitive during a period of financial strain on the Company could have a material adverse effect on the Company. In fact, we instituted a salary freeze in February 2009, and our senior management team received reduced bonuses they would have earned for having achieved their personal strategic objectives in 2008.

**Grant additional equity compensation.** In addition to this year's stock option grants, we considered granting employees special supplemental stock option grants at current market prices or restricted stock units in order to restore the value of previously granted stock options that are now out-of-the-money. However, such supplemental equity grants would substantially increase our equity award overhang and the potential dilution to our shareholders and deplete our already limited remaining equity award pool. In addition, these supplemental grants, like the Option Exchange Program, would increase our stock-based compensation expense.

**Exchange options for cash.** We also considered implementing a program to exchange underwater options for cash payments. However, an exchange program for cash would reduce our cash flow from operations, which could adversely affect our business and operating results. In addition, we do not believe that such a program would provide strong alignment of management's and employees' interests with those of our shareholders.

**Implement Option Exchange Program.** We also considered implementing the Option Exchange Program under which employees could exchange underwater stock options for new options. We determined that this approach was the most attractive for the reasons described above.

### Description of the Option Exchange Program

**Implementing the Option Exchange Program.** If the Option Exchange Program is approved by our shareholders, it is the Board's intent that Eligible Optionholders who are offered the opportunity to participate in the program under a tender offer (an "Exchange Offer") that will be filed with the Securities and Exchange Commission (the "SEC") will be able to complete their exchange following the Annual Meeting at which such shareholder approval is sought. The Company has not commenced the Option Exchange Program and will not do so unless the shareholders approve this proposal. If the Company receives shareholder approval of the Option Exchange Program, the Option Exchange Program may commence at a time determined by the Company, with terms expected to be materially similar to those described in this proposal. Upon the commencement of the Option Exchange Program, Eligible Optionholders will receive written materials explaining the precise terms and timing of the Option Exchange Program. From the time the Exchange Offer commences, the Eligible Optionholders will be given at least 20 business days (or such longer period

as we may elect to keep the Option Exchange Program open) to make an election to surrender for cancellation all or a portion of their Eligible Options, on a grant-by-grant basis, in exchange for New Restricted Stock. They will make this election by completing an election form which will be distributed to them as part of the Option Exchange Program and submitting the form to us within the 20 business day period (or such longer period if we choose to keep the offer to exchange open). Once the Exchange Offer is closed, Eligible Options that were surrendered for exchange will be cancelled, and the Compensation Committee will approve grants of New Options New Options to participating employees. All such New Options will be granted under the 2006 Stock Plan and will be subject to the terms of such 2006 Stock Plan and an option award agreement to be entered

## PRELIMINARY PROXY MATERIALS

into between the Company and each participating employee. At or before commencement of the Option Exchange Program, the Company will file the Exchange Offer and other related documents with the SEC as part of a tender offer statement on Schedule TO.

Even if the Option Exchange Program is approved by our shareholders, our Compensation Committee will retain the authority, in its sole discretion, to amend (including adjusting the terms in a manner less favorable to any employee or class of employees), postpone, or under certain circumstances cancel the Option Exchange Program once it has commenced or to exclude certain Eligible Options or Eligible Optionholders from participating in the Option Exchange Program, due to tax, regulatory or accounting reasons or because participation would be inadvisable or impractical.

Shareholder approval of the proposed amendment to the 2006 Stock Plan would authorize this Option Exchange Program only, and would not disturb the general prohibition on repricing of outstanding options. If we were to propose a stock option exchange program in the future, we would need to seek separate shareholder approval of that subsequent program.

Outstanding Options Eligible for the Option Exchange Program. Options held by Eligible Optionholders that have an exercise price of at least \$2.50 per share and are out-of-the-money on the date the Exchange Offer concludes are eligible to be surrendered in the Option Exchange Program. As of April 30, 2009, options to purchase approximately 5,875,999 shares of our common stock were outstanding, of which options to purchase approximately 4,200,566 shares would be eligible for exchange under the Option Exchange Program.

As of May 31, 2009, there were 70 Eligible Optionholders. The following table shows the number of shares underlying outstanding Eligible Options at each applicable exercise price as of May 31, 2009.

Exercise Price	Maximum Number of Shares Underlying Eligible Options	Remaining Life (in years)
\$2.50	161,283	1.75
\$2.64	236,000	3.96
\$2.77	27,700	3.04
\$2.88	11,000	4.34
\$3.05	5,000	4.43
\$3.18	420,000	8.55
\$3.31	10,000	4.68
\$3.50	17,500	4.75
\$3.64	20,000	4.59
\$4.00	500,000	4.68
\$4.01	40,000	6.07
\$4.25	227,583	2.90
\$4.60	15,000	5.59
\$4.61	57,500	8.40
\$5.00		