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

**FORM 10-Q**

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

**For the period ended June 30, 2006**

**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 0-25508**

**RTW, INC.**

(Exact name of registrant as specified in its charter)

**Minnesota**

(State or other jurisdiction of incorporation or organization)

**41-1440870**

(I.R.S. Employer Identification No.)

**8500 Normandale Lake Boulevard, Suite 1400  
Bloomington, MN 55437**

(Address of principal executive offices and zip code)

**(952) 893-0403**

(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 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act)

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

Yes  No

At July 31, 2006, approximately 5,284,000 shares of Common Stock were outstanding.

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**PART I — FINANCIAL INFORMATION**

**Item 1: FINANCIAL STATEMENTS**

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**RTW, INC. AND SUBSIDIARY  
 CONSOLIDATED BALANCE SHEETS  
 JUNE 30, 2006 AND DECEMBER 31, 2005**  
 (In thousands, except share data)

	<u>June 30, 2006</u>	<u>December 31, 2005</u>
	(Unaudited)	
<b>ASSETS</b>		
Investments at fair value, amortized cost of \$107,531 and \$109,021	\$ 104,058	\$ 107,250
Cash and cash equivalents	21,384	21,914
Accrued investment income	940	857
Premiums receivable, less allowance of \$229 and \$192	2,391	3,382
Reinsurance recoverables:		
On unpaid claim and claim settlement expenses	81,641	83,318
On paid claim and claim settlement expenses	859	751
Deferred policy acquisition costs	932	889
Furniture and equipment, net	1,433	1,444
Other assets	<u>10,558</u>	<u>8,666</u>
 Total assets	 <u>\$ 224,196</u>	 <u>\$ 228,471</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Unpaid claim and claim settlement expenses	\$ 156,925	\$ 160,141
Unearned premiums	8,330	8,341
Accrued expenses and other liabilities	<u>8,552</u>	<u>9,411</u>
Total liabilities	173,807	177,893
Shareholders' equity:		
Undesignated stock, no par value; authorized 4,750,000 shares; none issued or outstanding	—	—
Series A Junior Participating Preferred Stock, no par value; authorized 250,000 shares; none issued or outstanding	—	—
Common Stock, no par value; authorized 12,500,000 shares; issued and outstanding 5,290,000 shares at June 30, 2006 and 5,441,000 at December 31, 2005	19,519	21,365
Retained earnings	33,127	30,364
Accumulated other comprehensive loss	<u>(2,257)</u>	<u>(1,151)</u>
Total shareholders' equity	<u>50,389</u>	<u>50,578</u>
 Total liabilities and shareholders' equity	 <u>\$ 224,196</u>	 <u>\$ 228,471</u>

See notes to consolidated financial statements.

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**RTW, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2006 AND 2005**  
 (Unaudited; in thousands, except share and per share data)

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
<b>Revenues:</b>				
Gross premiums earned	\$ 13,193	\$ 15,002	\$ 26,181	\$ 30,732
Premiums ceded	(2,150)	(2,612)	(4,302)	(5,362)
Premiums earned	11,043	12,390	21,879	25,370
Investment income	1,324	1,108	2,629	2,162
Net realized investment gains	—	445	—	580
Service revenue	1,752	940	3,320	1,535
Total revenues	14,119	14,883	27,828	29,647
<b>Expenses:</b>				
Claim and claim settlement expenses	7,323	8,518	14,482	17,418
Policy acquisition costs	1,298	1,542	2,560	2,967
General and administrative expenses	3,333	2,817	6,987	5,692
Total expenses	11,954	12,877	24,029	26,077
Income before income taxes	2,165	2,006	3,799	3,570
Income tax expense	731	685	1,311	1,200
Net income	<u>\$ 1,434</u>	<u>\$ 1,321</u>	<u>\$ 2,488</u>	<u>\$ 2,370</u>
Net income per share:				
Basic income per share	<u>\$ 0.27</u>	<u>\$ 0.24</u>	<u>\$ 0.46</u>	<u>\$ 0.44</u>
Diluted income per share	<u>\$ 0.26</u>	<u>\$ 0.23</u>	<u>\$ 0.45</u>	<u>\$ 0.42</u>
Weighted average shares outstanding:				
Basic shares outstanding	<u>5,346,000</u>	<u>5,397,000</u>	<u>5,397,000</u>	<u>5,372,000</u>
Diluted shares outstanding	<u>5,538,000</u>	<u>5,655,000</u>	<u>5,585,000</u>	<u>5,641,000</u>

See notes to consolidated financial statements.

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**RTW, INC. AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**SIX MONTH PERIODS ENDED JUNE 30, 2006 AND 2005**  
 (Unaudited, in thousands)

	<b>For the Six Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 2,488	\$ 2,370
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Net realized investment gains	—	(580)
Depreciation and amortization	167	428
Equity-based compensation expense	232	—
Changes in assets and liabilities:		
Reinsurance recoverables	1,569	2,913
Unpaid claim and claim settlement expenses	(3,216)	(812)
Unearned premiums, net of premiums receivable	980	(318)
Accrued expenses and other liabilities	(859)	729
Other, net	(1,422)	(100)
Net cash (used in) provided by operating activities	(61)	4,630
<b>Cash flows from investing activities:</b>		
Proceeds from sales of securities	1,523	7,850
Purchases of securities	(19,542)	(17,909)
Maturities of available-for-sale securities	19,574	—
Purchases of furniture and equipment	(221)	(314)
Net cash provided by (used in) investing activities	1,334	(10,373)
<b>Cash flows from financing activities:</b>		
Stock option exercises	72	261
Issuance of common stock under the Employee Stock Purchase Plan	150	99
Repurchase of common stock	(2,025)	—
Net cash (used in) provided by financing activities	(1,803)	360
Net decrease in cash and cash equivalents	(530)	(5,383)
Cash and cash equivalents at beginning of year	21,914	39,379
Cash and cash equivalents at end of period	\$ 21,384	\$ 33,996
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid (received) during the period for:		
Income taxes	\$ 701	\$ (16)

See notes to consolidated financial statements.



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**RTW, INC. AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**THREE AND SIX MONTH PERIODS ENDED JUNE 30, 2006 AND 2005**  
(Unaudited)

**NOTE A – BASIS OF PRESENTATION**

The accompanying consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles applied on a basis consistent with the financial statements included in the RTW, Inc. 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission, except that the consolidated financial statements included herein were prepared in conformity with the instructions to Form 10-Q for interim financial information and, accordingly, do not include all of the information and notes required by U.S. generally accepted accounting principles for complete financial statements. We have prepared the consolidated financial information included herein, other than the consolidated balance sheet at December 31, 2005, without audit by an independent registered public accounting firm. We derived the consolidated balance sheet at December 31, 2005 from the audited consolidated financial statements for the year ended December 31, 2005; however, this report does not include all the disclosures contained therein.

The information furnished includes all adjustments and accruals, consisting only of normal, recurring accrual adjustments, which are, in our opinion, necessary for a fair statement of results for the interim period. The results of operations for any interim period are not necessarily indicative of results for the full year. The unaudited interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto contained in the 2005 Annual Report on Form 10-K.

**NOTE B – STOCK OPTIONS AND STOCK-BASED BENEFIT PLANS**

We have stock-based compensation plans, including the RTW, Inc. 1995 Employee Stock Purchase Plan and Trust (ESPP), the 1994 Stock Plan and the 2005 Stock Plan, for our directors, officers and certain employees. The ESPP provides employees the opportunity to purchase shares of our stock at 85% of the fair value based on the lesser of the beginning or ending share price for each plan year as set forth in the plan. The 1994 Stock Plan and 2005 Stock Plan permit the grant of stock-based awards as determined by the Compensation Committee (the Comp. Committee) of our Board of Directors (Board). Option price, option term, vesting provisions and other limits and restrictions are determined at the time of grant by the Comp. Committee. Non-qualified and incentive stock options (as defined in Section 422 of the Internal Revenue Code) are granted at the fair market value of our stock on the date of grant.

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 123R, "Share-based Payment," that requires compensation expense related to share-based transactions, including employee stock options, be recognized in the financial statements based on fair value. SFAS No. 123R revises SFAS No. 123, as amended, "Accounting for Stock-Based Compensation," and supersedes APB Opinion No. 25, "Accounting for Stock Issued to Employees."

Effective January 1, 2006, we adopted the provisions of SFAS No. 123R using the modified prospective transition method. Under this transition method, compensation expense recognized beginning January 1, 2006 includes: (i) all share-based options granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123; and (ii) all share-based options granted subsequent to December 31, 2005 based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. Compensation expense is recognized ratably over the requisite vesting period.

**Stock Option Pricing** – The fair value of each option grant is estimated using the Black-Scholes option pricing model. The fair value is then amortized on a straight-line basis over the requisite service period of the award, generally the vesting period. Use of a valuation model requires management to make certain assumptions with respect to selected model inputs. Expected volatility was estimated based on the historical volatility of our stock over a period of years equal to the expected life of the options. The average expected life was estimated based on an analysis of our historical exercise and forfeiture activity. The risk-free interest rate is based on U.S. Treasury issues with a remaining term that approximates the expected life of the option. We have never paid a dividend. The following assumptions were used in estimating the fair value of options granted during the quarter and six months ended June 30, 2006:

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	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Expected stock price volatility	38% to 46%	32% to 34%	38% to 46%	26% to 34%
Expected life of options (in years)	1 to 3.5 years	1 to 3 years	1 to 3.5 years	1 to 3 years
Risk-free interest rate	4.95% to 5.05%	3.26% to 3.79%	4.66% to 5.05%	2.93% to 3.79%

The weighted average grant-date fair values of the options granted during the second quarter of 2006 and 2005 were \$3.69 and \$2.45 per share, respectively and were \$3.73 and \$1.60 per share for the six-month period ended June 30, 2006 and 2005, respectively. Intrinsic value is the difference between the market value of the shares on the date of exercise and the exercise price of the underlying award. The following information relates to option exercises during the three and six months ended June 30, 2006:

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Aggregate intrinsic value of options exercised	\$ 65,000	\$254,000	\$192,000	\$649,000
Income tax benefit realized from options exercised	—	16,000	42,000	132,000
Cash received upon exercise	151,000	149,000	180,000	255,000

As a result of adopting SFAS No. 123R, our results for the three and six month periods ended June 30, 2006 include incremental share-based pre-tax compensation expense of \$34,000 and \$232,000, respectively, related to stock options. This expense has been included in the consolidated statement of income under general and administrative expenses. We have recognized a related tax benefit associated with our share-based compensation arrangements of \$6,000 and \$12,000, respectively, for the three and six months periods ended June 30, 2006. No stock-based employee compensation expense was recognized for options granted for the three and six month periods ended June 30, 2005 in the unaudited condensed Consolidated Statement of Income, as we had historically accounted for share-based compensation under the intrinsic value method of APB 25. The incremental expense, net of the related tax benefit, resulted in a \$0.01 and \$0.04 decrease in both basic and diluted earnings per share for the three and six month periods ending June 30, 2006.

Prior period amounts have not been restated to reflect adopting SFAS No. 123R. Had we calculated compensation expense for our option grants under the 1994 Stock Plan and 2005 Stock Plan and stock issuances under our ESPP based on the fair value method described in SFAS No. 123, our net income and basic and dilutive net income per share for the three and six months ended June 30, 2005 would approximate the following pro forma amounts (in 000's, except per share data):

	Three months ended June 30, 2005	Six months ended June 30, 2005
Net income, as reported:	\$ 1,321	\$ 2,370
Less: Total stock-based compensation expense determined under the fair value based method for all awards, net of related tax expense	(44)	(102)
<b>Pro forma net income</b>	<b>\$ 1,277</b>	<b>\$ 2,268</b>
Basic net income per share:		
As reported	\$ 0.24	\$ 0.44
Pro forma	\$ 0.24	\$ 0.42
Diluted net income per share:		
As reported	\$ 0.23	\$ 0.42
Pro forma	\$ 0.23	\$ 0.40

At June 30, 2006, the total compensation expense related to non-vested stock option awards under the ESPP, 1994 Stock Plan and the 2005 Stock Plan not yet recognized was \$408,000. Compensation expense is recognized on a straight-line basis over the vesting period of the options. Accordingly, we anticipate that we will recognize approximately \$151,000, \$174,000, \$65,000 and \$18,000 of incremental compensation expense in 2006, 2007, 2008 and 2009 respectively related to unvested awards outstanding at June 30, 2006.

**1995 Employee Stock Purchase Plan** - The ESPP provides employees the opportunity to purchase shares of our stock at 85% of the fair value based on the lesser of the beginning or ending share price for each plan year as set forth in the plan. In 2003, the shares reserved for distribution under the plan were increased from 100,000 to 150,000 shares. In 2004, the ESPP was amended to allow the issuance of stock within 10 years of any increase in

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the number of shares authorized to be issued under the plan. In 2005, the shares reserved for distribution under the plan were further increased from 150,000 to 200,000 shares. The ESPP terminates in 2013 and will be carried out in phases, each consisting of one year or a different period of time approved by our Board. Any employee completing two weeks of service prior to commencing a phase of the plan may participate. Employees may elect to contribute from \$10 to 10% of monthly salary to the plan through payroll withholdings. The following summarizes shares purchased and purchase prices for each phase in the most recent two years completed through June 2006:

Phase:	<u>Shares Purchased</u>	<u>Purchase Price</u>
Beginning April 2004, expiring April 2005	17,279	\$5.72
Beginning April 2005, expiring April 2006	17,501	8.61

The twelfth one-year phase began in April 2006 and expires in April 2007. Our liability for employee contributions withheld at June 30, 2006 and December 31, 2005 for the purchase of shares in April 2007 and April 2006 under the ESPP was \$35,000 and \$116,000, respectively.

**1994 Stock Plan** - The 1994 Stock Plan provides for awards of incentive stock options (as defined in section 422 of the Internal Revenue code) and non-qualified stock options. In July 1998, our Board increased the shares reserved for distribution under the plan to 1,000,000. Option price, option term, vesting provisions and other limits and restrictions are determined at the time of grant by our Board or, if established, by a separate committee. The exercise price for all options granted was the market price of the common stock at the date of grant. The ability to award incentive stock options under this Plan terminated in June 2004.

Options granted, exercised, cancelled and outstanding under the 1994 Stock Plan are as follows:

	<u>Qualified</u>		<u>Non-Qualified</u>	
	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>
Balance, January 1, 2006	334,303	\$ 6.85	216,135	\$ 6.18
Exercised	(1,000)	2.19	(14,704)	2.35
Cancelled	(1,875)	38.67	(2,129)	6.45
Balance, March 31, 2006	331,428	6.68	199,302	6.46
Exercised	(2,125)	6.18	—	—
Cancelled	(3,260)	7.30	—	—
Balance, June 30, 2006	<u>326,043</u>	<u>\$ 6.68</u>	<u>199,302</u>	<u>\$ 6.46</u>

Incentive stock options expire ten years from the date of grant and substantially all are subject to continued employment with us. Each of the non-qualified options expires ten years from the date of grant with the exception of certain options granted to our founder that expire five years from the date of grant. Options are generally subject to vesting provisions that restrict exercise of the option.

**2005 Stock Plan** - The 2005 Stock Plan was approved by the shareholders in June 2005 and provides for awards of incentive stock options (as defined in section 422 of the Internal Revenue code) and non-qualified stock options. Option price, option term, vesting provisions and other limits and restrictions are determined at the time of grant by the Board or, if established, by a separate committee. The exercise price for all options granted was the market price of the common stock at the date of grant.

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Options granted, exercised, cancelled and outstanding under the 2005 Stock Plan are as follows:

	<u>Qualified</u>		<u>Non-Qualified</u>	
	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Option Shares</u>	<u>Weighted Average Exercise Price</u>
Balance, January 1, 2006	15,000	\$ 11.72	—	\$ —
Granted	62,500	10.92	—	—
Balance, March 31, 2006	77,500	11.07	—	—
Granted	15,000	12.04	20,000	10.87
Balance, June 30, 2006	<u>92,500</u>	<u>\$ 11.23</u>	<u>20,000</u>	<u>\$ 10.87</u>

Incentive stock options expire ten years from the date of grant and substantially all are subject to continued employment with us. Each of the non-qualified options expires ten years from the date of grant. Options are generally subject to vesting provisions that restrict exercise of the option. The following table summarizes the options outstanding and exercisable under both the 1994 Stock Plan and the 2005 Stock Plan at June 30, 2006:

<u>Exercise Price Range</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number of Options</u>	<u>Weighted Average Contractual Life</u>	<u>Exercise Price</u>	<u>Number of Options</u>	<u>Weighted Average Exercise Price</u>
Incentive stock options:					
\$ 14.00 - \$ 21.50	33,045	1.9 years	\$ 15.43	33,045	\$ 15.43
8.75 - 12.04	127,500	8.0 years	11.04	64,583	10.74
6.00 - 6.18	167,698	7.7 years	6.13	150,419	6.15
2.19 - 4.50	90,300	6.1 years	2.76	90,300	2.76
<u>\$ 2.19 - \$ 21.50</u>	<u>418,543</u>	<u>7.0 years</u>	<u>\$ 7.63</u>	<u>338,347</u>	<u>\$ 7.03</u>
Non-qualified stock options:					
\$ 31.75	5,000	0.6 years	\$ 31.75	5,000	\$ 31.75
6.00 - 9.87	151,802	8.4 years	7.93	96,576	7.66
1.98 - 3.13	62,500	5.9 years	2.25	62,500	2.25
<u>\$ 1.98 - \$ 31.75</u>	<u>219,302</u>	<u>7.5 years</u>	<u>\$ 6.85</u>	<u>164,076</u>	<u>\$ 6.34</u>

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying award and the \$10.73 closing price of our common stock for options that were in-the-money at June 30, 2006. The intrinsic value of the options outstanding and exercisable was \$2.5 million and \$2.2 million, respectively, as of June 30, 2006.

**NOTE C –COMPREHENSIVE INCOME**

Comprehensive income includes unrealized gains and losses on available-for-sale investments. All components of comprehensive income are recorded net of related income taxes. Comprehensive income consists of the following (in 000's):

	<u>Three months ended June 30,</u>		<u>Six months ended June 30,</u>	
	<u>2006</u>	<u>2005</u>	<u>2006</u>	<u>2005</u>
Net income	\$ 1,434	\$ 1,321	\$ 2,488	\$ 2,370
Other comprehensive loss:				
Change in unrealized (loss) gain on investments	(497)	659	(1,106)	(359)
Comprehensive income	<u>\$ 937</u>	<u>\$ 1,980</u>	<u>\$ 1,382</u>	<u>\$ 2,011</u>

[Table of Contents](#)**NOTE D – INVESTMENT SECURITIES AVAILABLE-FOR-SALE**

The following tables present amortized cost, gross unrealized gains and losses and estimated fair values of our available-for-sale securities (000's):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
At June 30, 2006				
U.S. government securities	\$ 61,600	\$ —	\$ (1,845)	\$ 59,756
Commercial paper	1,954	—	—	1,954
Asset-backed securities	2,008	—	(98)	1,910
Municipal securities	18,561	—	(637)	17,924
Mortgage-backed securities	23,408	1	(894)	22,515
Total investments	<u>\$107,531</u>	<u>\$ 1</u>	<u>\$ (3,474)</u>	<u>\$104,058</u>

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
At December 31, 2005				
U.S. government securities	\$ 56,138	\$ 63	\$ (960)	\$ 55,241
Commercial paper	10,167	—	—	10,167
Asset-backed securities	2,009	—	(60)	1,949
Municipal securities	18,658	—	(456)	18,202
Mortgage-backed securities	22,049	45	(403)	21,691
Total investments	<u>\$109,021</u>	<u>\$ 108</u>	<u>\$ (1,879)</u>	<u>\$107,250</u>

The gross unrealized loss in all cases is the result of an increase in interest rates and is not the result of deterioration in the credit quality of the issuers. We believe that the unrealized losses on our fixed maturity securities do not represent other than temporary impairments. All issues carry a credit quality of AAA, AA or A+ (Standard & Poors). We have the ability and intent to hold all of these securities to recovery, which in certain circumstances may extend to maturity. We consider all relevant facts and circumstances in evaluating whether the impairment of a security is other than temporary. Relevant facts and circumstances we consider include: (i) the length of time the fair value has been below cost; (ii) the financial position and access to capital of the issuer, including the current and future effect of any specific events; and (iii) our ability and intent to hold the security until it recovers in value. To the extent we determine that a security is deemed to be other than temporarily impaired, the difference between amortized cost and fair value would be charged to earnings.

**NOTE E – RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement No. 109" (FIN 48), which provides criteria for recognizing, measuring, presenting and disclosing uncertain tax positions. A tax benefit from an uncertain position may be recognized only if it is "more likely than not" that the position is sustainable based on its technical merits. The provisions of FIN 48 were effective for fiscal years beginning after December 15, 2006. We expect that FIN 48 will not have a material effect on our consolidated financial condition or results of operations.

In November 2005, the FASB issued FASB Staff Position 115-1, "The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments" (FSP 115-1). FSP 115-1 provides guidance on recognizing impairments deemed other-than-temporary. FSP 115-1 is effective for other-than-temporary impairment analysis conducted in periods beginning after December 15, 2005. We believe that our policy for other-than-temporary impairments complies with FSP 115-1. Accordingly, the adoption of this standard has not had a material effect on the consolidated financial statements.

In September 2005, the Accounting Standards Executive Committee issued Statement of Position 05-1, "Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts" (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in SFAS No.97, "Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments". SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverage that occurs by the exchange of a

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contract for a new contract, or by amendment, endorsement, or rider to a contract, or by electing a feature or coverage within a contract. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. We only issue workers' compensation insurance policies, which are a statutory coverage and are not subject to internal replacement or modification in product benefits, features, right or coverage. We do not expect the adoption of SOP 05-1 to have a significant effect on operations, financial condition or liquidity.

**NOTE F – SEGMENT INFORMATION**

Prior to January 1, 2006, our Insurance segment was our only reportable operating segment. During the first quarter of 2006, based on growth in our service revenue, we enhanced our financial information concerning our products and services. We currently evaluate our operations through two reportable business segments: Insurance and Service. These segments are distinct operating units that offer different products and require different marketing strategies. Our Insurance segment underwrites workers' compensation insurance for employers through our insurance subsidiaries American Compensation Insurance Company (ACIC) and Bloomington Compensation Insurance Company (BCIC). Our Service segment provides non-insurance services to self-insured employers, state assigned risk plans, other insurance companies and agents through our Absentia<sup>SM</sup> division.

We evaluate segment profitability using income from operations before income taxes. All revenues and expenses are reflected in our reportable segment results. Expense allocations are based on certain assumptions and estimates; stated segment results would change if different methods were applied. We do not allocate depreciation and amortization expense to our service segment, and such disclosure would be impracticable. No single customer provides 10% or more of our total revenue.

The following tables summarize the components of our revenues and income before income taxes and net income by reportable business segment (000's):

	Three Months Ended June 30, 2006			Six Months Ended June 30, 2006		
	Insurance	Service	Consolidated	Insurance	Service	Consolidated
Revenues:						
Premiums earned	\$ 11,043	\$ —	\$ 11,043	\$ 21,879	\$ —	\$ 21,879
Investment income	1,324	—	1,324	2,629	—	2,629
Net realized investment gains	—	—	—	—	—	—
Service revenue	—	1,752	1,752	—	3,320	3,320
Total operating revenues	<u>\$ 12,367</u>	<u>\$ 1,752</u>	<u>\$ 14,119</u>	<u>\$ 24,508</u>	<u>\$ 3,320</u>	<u>\$ 27,828</u>
Income before income taxes	<u>\$ 1,848</u>	<u>\$ 317</u>	<u>\$ 2,165</u>	<u>\$ 3,065</u>	<u>\$ 734</u>	<u>\$ 3,799</u>
Net income	<u>\$ 1,249</u>	<u>\$ 185</u>	<u>\$ 1,434</u>	<u>\$ 2,040</u>	<u>\$ 448</u>	<u>\$ 2,488</u>

	Three Months Ended June 30, 2005			Six Months Ended June 30, 2005		
	Insurance	Service	Consolidated	Insurance	Service	Consolidated
Revenues:						
Premiums earned	\$ 12,390	\$ —	\$ 12,390	\$ 25,370	\$ —	\$ 25,370
Investment income	1,108	—	1,108	2,162	—	2,162
Net realized investment gains	445	—	445	580	—	580
Service revenue	—	940	940	—	1,535	1,535
Total operating revenues	<u>\$ 13,943</u>	<u>\$ 940</u>	<u>\$ 14,883</u>	<u>\$ 28,112</u>	<u>\$ 1,535</u>	<u>\$ 29,647</u>
Income before income taxes	<u>\$ 1,803</u>	<u>\$ 203</u>	<u>\$ 2,006</u>	<u>\$ 3,446</u>	<u>\$ 124</u>	<u>\$ 3,570</u>
Net income	<u>\$ 1,193</u>	<u>\$ 128</u>	<u>\$ 1,321</u>	<u>\$ 2,292</u>	<u>\$ 78</u>	<u>\$ 2,370</u>

The following table summarizes identifiable assets by reportable business segment (amounts in 000's):

	June 30, 2006	December 31, 2005
Insurance	\$ 214,765	\$ 217,915
Service	3,238	1,739
Total identifiable assets by reportable business segment	218,003	219,654
Corporate	6,193	8,817
Consolidated total assets	<u>\$ 224,196</u>	<u>\$ 228,471</u>

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### **Item 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

#### *Overview*

**The Company:** RTW, Inc. (RTW) provides disability and absence management services, directed today primarily at workers' compensation to: (i) employers insured through our wholly-owned insurance subsidiary, American Compensation Insurance Company (ACIC), and its wholly-owned insurance subsidiary, Bloomington Compensation Insurance Company (BCIC); (ii) self-insured employers on a fee-for-service basis; (iii) state-sponsored assigned risk plans on a percent of premium basis; (iv) other insurance companies; and (v) to agents and employers on a consulting basis, charging hourly fees through RTW and its Absentia<sup>SM</sup> division. ACIC offers guaranteed-cost workers' compensation insurance to employers located primarily in Minnesota, Michigan and Colorado and is licensed in twenty-three states. BCIC offers guaranteed-cost workers' compensation insurance to selected employers only in Minnesota. Collectively, "we," "our" and "us" refer to RTW, ACIC and BCIC in this document.

We developed two proprietary systems to manage disability: (i) ID15<sup>®</sup>, designed to quickly identify those injured employees who are likely to become inappropriately dependent on disability system benefits, including workers' compensation; and (ii) The RTW Solution<sup>®</sup>, rapid intervention in and intensive management of potentially high-cost injuries, designed to lower employers' disability costs and improve productivity by returning injured employees to work as soon as safely possible. We support these proprietary management systems with state-of-the-art technology and talented employees dedicated to our vision of transforming people from absent or idle to present and productive. We have historically operated primarily in Minnesota, Michigan and Colorado. Our Absentia business today touches customers in 24 states.

Our approach to managing disability reduces medical expenses and wage-replacement costs, including time away from the job. We: (i) focus our efforts on the 15% of injured employees that drive 80% of the system costs; (ii) control costs by actively managing all participants in the system, including employers, employees, medical care providers, attorneys and the legal system; and (iii) return injured employees to work as soon as safely possible. On May 18, 2006, A.M. Best Co. (Best) upgraded the financial strength rating of ACIC to B++ (Very Good) from B+ (Very Good). Best also assigned an initial financial strength rating of B++ (Very Good) to BCIC. The outlook for both ratings is positive. The ratings reflect our improved capitalization and profitability over the last four years. RTW increased the statutory capital and surplus of its insurance subsidiaries to \$45.4 million at June 30, 2006 and \$43.6 million at December 31, 2005 from \$38.5 million at December 31, 2004 as a result of profitability in 2006 and 2005. Our B++ ratings from Best may be a barrier for selling insurance products in certain circumstances as some employers will only do business with insurers rated "A-" or better.

Additional information about RTW is available on our website, [www.rtwi.com](http://www.rtwi.com).

#### *Significant Accounting Policies*

Our significant accounting policies are summarized in Note 1 – "Summary of Significant Accounting Policies" included in our Consolidated Financial Statements and notes thereto in our 2005 Annual Report on Form 10-K. Our significant accounting policies include those policies related to our accounting for: (i) premiums earned; (ii) investments; (iii) service revenue; (iv) unpaid claim and claim settlement expenses, including reserves for incurred but not reported claims and the related reinsurance recoverables; (v) deferred policy acquisition costs; and (v) income taxes and deferred income taxes. These accounting policies are discussed within each section of this "Management's Discussion and Analysis of Financial Condition and Results of Operations".

#### *Off-Balance Sheet Arrangements*

We do not have any off-balance sheet arrangements.

#### *Financial Summary*

This financial summary presents our discussion and analysis of the consolidated financial condition and results of operations of RTW, Inc. and its subsidiaries. This review should be read in conjunction with our consolidated financial statements and notes thereto at June 30, 2006 and December 31, 2005 and the three and six-month periods ended June 30, 2006 and 2005.

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The following table provides an overview of our key operating results (in 000's except per share data):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Gross premiums earned	\$13,193	\$15,002	\$26,181	\$30,732
Premiums earned	11,043	12,390	21,879	25,370
Service revenue	1,752	940	3,320	1,535
Total revenues	14,119	14,883	27,828	29,647
Claim and claim settlement expenses	7,323	8,518	14,482	17,418
Net income	1,434	1,321	2,488	2,370
Diluted income per share	\$ 0.26	\$ 0.23	\$ 0.45	\$ 0.42

We reported net income of \$1.4 million in the second quarter of 2006 compared to net income of \$1.3 million in the second quarter of 2005 and reported net income of \$2.5 million for the six months ended June 30, 2006 compared to \$2.4 million for the same period in 2005. Diluted net income per share was \$0.26 in the second quarter of 2006 compared to \$0.23 for the second quarter of 2005 and was \$0.45 for the six months ended June 30, 2006 compared to \$0.42 for the same period in 2005. The primary factors affecting our 2006 operating results included the following:

- Our gross premiums earned decreased to \$13.2 million in the second quarter of 2006 from \$15.0 million in the second quarter of 2005 and decreased to \$26.2 million for the six months ended June 30, 2006 from \$30.7 million for the same period in 2005. Our premiums in force decreased to \$51.7 million at June 30, 2006 from \$58.5 million at June 30, 2005 as we focused on writing business at the right price while non-renewing or passing on business that did not meet or pricing criteria in order to maintain profitability in our insurance operations. See further discussion under “Premiums In Force and Gross Premiums Earned”;
- Premiums earned decreased to \$11.0 million in the second quarter of 2006 from \$12.4 million in the second quarter of 2005 and decreased to \$21.9 million for the six months ended June 30, 2006 from \$25.4 million for the same period in 2005 reflecting the decrease in premiums in force from the comparable 2005 period and a decrease in premiums ceded as our cost of excess of loss reinsurance decreased in 2006;
- Investment income increased to \$1.3 million in the second quarter of 2006 from \$1.1 million in the second quarter of 2005 and increased to \$2.6 million for the six months ended June 30, 2006 from \$2.2 million for the same period in 2005, reflecting the increase in the short-term interest rates in 2006 compared to 2005. We had no net realized investment gains in the first six months of 2006 compared to net realized investment gains of \$445,000 in the second quarter of 2005 and \$580,000 for the six months ended June 30, 2005;
- Service revenue from our Absentia<sup>SM</sup> division grew to \$1.8 million in the second quarter of 2006 from \$940,000 in the second quarter 2005 and to \$3.3 million for the six months ended June 30, 2006 from \$1.5 million for the same period in 2005. This growth reflects our continued focus and success in growing our service business;
- Claim and claim settlement expenses decreased to \$7.3 million in the second quarter of 2006 from \$8.5 million for the same period in 2005 and decreased to \$14.5 million for the six months ended June 30, 2006 compared to \$17.4 million for the same period in 2005 due to the decrease in gross premiums earned. Favorable development for prior accident years reduced claim and claim settlement expenses by \$750,000 in the second quarter of 2006 compared to \$500,000 for the second quarter of 2005 and by \$1.6 million for the six months ended June 30, 2006 compared to \$1.0 million for the same period in 2005. See further discussion under “Claim and Claim Settlement Expenses”; and
- Net income includes an after-tax charge of \$28,000, or \$0.01 per diluted share for the second quarter 2006 and \$220,000, or \$0.04 per diluted share for the six months ended June 30, 2006, attributable to implementing SFAS 123R, “Share-Based Payment,” a new accounting pronouncement requiring the expensing of stock-based compensation. There was no comparable charge recorded in the second quarter or first six months of 2005, as we elected prospective implementation.

Premiums in force may decrease from levels reported at June 30, 2006 for the remainder of 2006 as we focus on writing profitable business at the right price. We will focus on increasing profitability in our markets by: (i) aggressively managing and closing claims; (ii) reviewing policy profitability at renewal and non-renewing unprofitable policies; and (iii) aggressively managing policy acquisition costs.



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We expect that service fee revenue will increase for the remainder of 2006 as we continue to add new customers. General and administrative expenses will increase as we grow our service revenue and add staff to service that business.

In the following pages, we discuss the operating results for the three and six-month periods ended June 30, 2006 and 2005 for items in our Consolidated Statements of Income and also explain key Consolidated Balance Sheet accounts in greater detail.

**Results of Operations**

**REVENUES:** Total revenues include premiums earned, investment income, net realized investment gains and service revenue. The following tables summarize the components of our revenues and premiums in force (000's):

	Three months ended		Six months ended	
	June 30,		June 30,	
	2006	2005	2006	2005
Gross premiums earned	\$ 13,193	\$ 15,002	\$ 26,181	\$ 30,732
Premiums ceded	(2,150)	(2,612)	(4,302)	(5,362)
Premiums earned	11,043	12,390	21,879	25,370
Investment income	1,324	1,108	2,629	2,162
Net realized investment gains	—	445	—	580
Service revenue	1,752	940	3,320	1,535
<b>Total revenues</b>	<b>\$ 14,119</b>	<b>\$ 14,883</b>	<b>\$ 27,828</b>	<b>\$ 29,647</b>

  

	June 30,		December 31,
	2006	2005	2005
Premiums in force, by regional office location:			
Minnesota	\$31,200	\$36,100	\$ 32,300
Michigan	12,500	12,900	12,300
Colorado	8,000	9,500	8,300
<b>Total premiums in force</b>	<b>\$51,700</b>	<b>\$58,500</b>	<b>\$ 52,900</b>

**Premiums In Force and Gross Premiums Earned:** Premiums on workers' compensation insurance policies are our largest source of revenue. Premiums earned are the gross premiums earned by us on in-force workers' compensation policies, net of the effects of ceded premiums under reinsurance agreements.

The premium we charge a policyholder is a function of the policyholder's payroll, industry and prior workers' compensation claims experience. In underwriting a policy, we receive policyholder payroll estimates for the ensuing year. We record premiums written on an installment basis matching billing to the policyholder and earn premiums on a daily basis over the life of each insurance policy based on the payroll estimate. We record the excess of premiums billed over premiums earned for each policy as unearned premiums on our balance sheet. When a policy expires, we audit policyholder payrolls for the policy period and adjust the estimated payroll to its actual value. The result is a "final audit" adjustment recorded to premiums earned when the adjustment becomes known. Final audit premiums recognized during the period include billed final audit premiums plus (or minus) the change in estimate for premiums on unexpired and expired unaudited policies.

Our premiums in force decreased to \$51.7 million at June 30, 2006 from \$58.5 million at June 30, 2005 and \$52.9 million at December 31, 2005. The decrease in premiums in force since December 31, 2005 has occurred in our Minnesota and Colorado regions, offset by a slight increase in our Michigan region. In order to continue to maintain profitability, we targeted policies that did not meet our underwriting profit margin standards for non-renewal at policy expiration. We are experiencing significant competition for new business and continue to focus on writing business at a price that gives us a reasonable opportunity for an underwriting profit.

Our gross premiums earned decreased to \$13.2 million in the second quarter of 2006 from \$15.0 million in the second quarter of 2005 and to \$26.2 million for the six months ended June 30, 2006 from \$30.7 million for the same period in 2005 due primarily to the decrease in premiums in force. Final audit premiums increased gross premium earned by \$39,000 and \$244,000 for the three and six-month periods ended June 30, 2006, respectively. Final audit premiums increased gross premium earned by \$110,000 and \$221,000 for the three and six-month periods ended June 30, 2005, respectively.

Renewal premium rates decreased 6.0% for the six months ended June 30, 2006 compared to an increase of 0.5% for the six months ended June 30, 2005. We have traditionally filed ACIC's rates at the high end of the range in each market in which we operate, usually at or near the rates charged by the residual markets in these regions. We believe that even at these higher rate levels, our ID15 and The RTW Solution proprietary systems offer a good value to our customers because of our ability to lower their workers' compensation costs. With the addition of BCIC, we believe we have greater flexibility in setting our prices and retaining customers for whom we have successfully reduced costs.

**Premiums Ceded:** Reinsurance agreements enable us to share certain risks with other insurance companies. We purchase reinsurance to protect us from potential losses in excess of the level we are willing to accept. We expect the companies to which we have ceded reinsurance to honor their obligations. In the event that these companies are unable to honor their obligations to us, we will be required to pay the underlying obligations ourselves. We are not aware of any developments with respect to any of our reinsurers that would result in our reinsurance recoverable balances becoming uncollectible.

Under our excess of loss reinsurance policies, we pay reinsurers to limit our per-incident exposure and record this cost to premiums ceded as a reduction of gross premiums earned. In Minnesota, we are required to purchase excess of loss coverage for our Minnesota policies from the Minnesota Workers' Compensation Reinsurance Association (WCRA). We purchase reinsurance for 2006 in our other regions from three reinsurers. The following table summarizes our reinsurance coverage for 2006 and 2005 (all losses ceded on a per occurrence basis):

		<b>Covers losses per occurrence:</b>	
		<b>In excess of:</b>	<b>Limited to:</b>
<b>Minnesota:</b>			
2006	WCRA	\$390,000	Statutory limit \$390,000
	Various reinsurers	\$200,000	
2005	WCRA	\$380,000	Statutory limit \$380,000
	Various reinsurers	\$200,000	
<b>Other States:</b>			
2006	Various reinsurers	\$200,000	\$20.0 million excluding acts of terrorism
2005	Various reinsurers	\$200,000	\$20.0 million excluding acts of terrorism

Premiums ceded to reinsurers were \$2.2 million in the second quarter of 2006 compared to \$2.6 million in the second quarter of 2005 and were \$4.3 million for the six months ended June 30, 2006 compared to \$5.4 million for the same period in 2005. As a percent of gross premiums earned, premiums ceded decreased to 16.3% for the three months ended June 30, 2006 compared to 17.4% for the same period in 2005 and to 16.4% for the six months ended June 30, 2006 compared to 17.4% for the same period in 2005. The decrease in 2006 corresponds to the decrease in gross premiums earned and the rates we are charged for Minnesota risks decreased slightly in 2006 and are lower than the rates we are charged for our other states' risks.

**Premiums Earned Outlook:** The outlook for premiums in force, gross premiums earned and premiums ceded for the remainder of 2006 include the following factors:

- We expect premium rates to decrease on new and renewal policies as national and regional carriers focus on writing new business and retaining their existing workers' compensation insurance customers;
- Our 2006 gross premiums earned will move in the same direction as our premiums in force, lagging slightly as premiums are earned over the term of the insurance policy. We expect to sacrifice some top line insurance revenue for the remainder of 2006 to retain profit in our insurance operations;
- We signed agreements in the second quarter of 2006 with two partners to enable us to begin leveraging our existing licenses and growing our insurance operation by writing small accounts and selected association business. We expect to grow this business over time; and

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- Premiums ceded under excess of loss policies, as a percent of gross premiums earned in 2006, may increase when compared to the results attained for the first six months of 2006 as we write a greater portion of our business outside of Minnesota. We maintained a \$200,000 per occurrence retention in all our regions in 2006.

**Investment Income and Net Realized Investment Gains:** Investment income includes earnings from our investment portfolio while net realized investment gains include gains from sales of securities. Each is displayed separately on our accompanying Consolidated Statements of Income.

We currently invest entirely in U.S. domiciled investment-grade taxable and tax-exempt fixed maturity investments and classify our investments as available-for-sale. Our primary investment objective is to maintain a diversified, high-quality, fixed-investment portfolio structured to maximize our after-tax investment income without taking inappropriate credit risk. For further discussion of investments, see the "Investments" section of this Management's Discussion and Analysis.

Investment income increased to \$1.3 million in the second quarter of 2006 from \$1.1 million in the second quarter of 2005 and increased to \$2.6 million for the six months ended June 30, 2006 from \$2.2 million for the same period in 2005 as our investment portfolio increased to \$104.0 million at June 30, 2006 from \$96.9 million at June 30, 2005. Our average book investment yield was 4.2% at June 30, 2006 compared to 3.8% at June 30, 2005. In order to reduce the near-term interest rate risk on the portfolio, we built our cash position throughout 2004 by holding cash received on mortgage-backed security pre-payments and through sales or maturities of available-for-sale investments in 2004 expecting that interest rates would rise in 2005. During 2005 and the first six months of 2006, we began to invest a portion of our cash and cash equivalents into longer maturing, fixed-rate securities. Cash and cash equivalents were \$21.4 million at June 30, 2006 compared to \$21.9 million at December 31, 2005 and \$34.0 million at June 30, 2005. Investment income in the first six months of 2006 was favorably affected by the increase in short-term interest rates. In the first six months of 2006, we invested \$19.6 million from maturing securities, pre-payments of mortgage-backed securities and a portion of our cash and cash equivalents into taxable securities. The investment income realized in future periods will be affected by yields attained on new investments.

In 2005, we sold certain securities within the portfolio to take advantage of favorable interest rates. We realized net investment gains of \$445,000 and \$580,000 for the three and six-month periods ended June 30, 2005, respectively, compared to no realized investment gains or losses for the same periods in 2006.

**Investment Income and Net Realized Investment Gains Outlook:** Barring significant changes in interest rates or operational cash flows, we expect that income from our investment portfolio for the remainder of 2006 will be affected by the following:

- We expect interest rates to remain relatively stable for the remainder of 2006;
- We expect that short-term interest rates, on assets classified as cash and cash equivalents, will move with Federal Reserve Board rate changes;
- Our investment in tax-exempt municipal bonds will result in reduced investment yields and will favorably affect net income as the rates will be lower on a pre-tax basis but will be higher on a tax-adjusted basis;
- We expect cash flows for 2006 to be affected by claim payments on claims from 2005 and prior years, offset by cash flows from our premiums earned in 2006;
- Future recognition of realized investment gains and losses will depend on sales of our investments, if any, as we replace securities to manage our portfolio risks and returns; and
- New and renegotiated reinsurance treaties may affect our future cash flow and future investment income.

**Service Revenue:** Service revenue includes revenues for services that are: (i) billed as a percent of premium of insurance policies issued by non-affiliated third party insurers; (ii) billed based on the number and type of claims serviced; (iii) billed on an hourly basis based on direct activity; or (iv) billed based on contract duration. Service revenue earned as a percent of premiums is recognized over the life of the underlying insurance policy. All other service revenue is recognized over the term of the contract. The excess of billed service revenue over earned amounts is recognized as a liability and included in "Accrued expenses and other liabilities" on our Consolidated Balance Sheets. Service revenue increased to \$1.8 million in the second quarter of 2006 from \$940,000 in the same quarter in 2005 and to \$3.3 million in the six months ended June 30, 2006 from \$1.5 million for the same period in 2005 as we continued to grow our service business.

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*Service Revenue Outlook:* Service revenue will increase in 2006 due to the following:

- In March 2004, we were awarded a three-year contract to service 25% of the Minnesota Assigned Risk Plan (ARP). We are paid a fee based on a percent of the premium we service and began new ARP business on July 1, 2004 and renewal ARP business on September 1, 2004. During 2005, we continued to ramp up our servicing of this contract, achieving a full “25%” share in September 2005. The total premium in the ARP at June 30, 2006 is approximately \$71.2 million, which decreased from \$85.1 million at December 31, 2005. We expect the total annual premium in the ARP to continue to decrease during 2006, which will exert downward pressure on our related revenue, offset by being at a full “25%” servicing rate for the entire year; and
- We continue to market our services aggressively inside and outside the regions in which we currently operate our insurance business. We expect service revenue will increase as new customers become aware of and purchase these services.

**EXPENSES:** Our expenses include claim and claim settlement expenses, policy acquisition costs, general and administrative expenses and income taxes.

**Claim and Claim Settlement Expenses:** Claim expenses refer to medical and indemnity benefits that we paid or expect to pay to claimants for past events insured by ACIC or BCIC. The costs of investigating, resolving and processing these claims are referred to as claim settlement expenses. We record these expenses, net of amounts recoverable under reinsurance contracts, to claim and claim settlement expenses in the accompanying Consolidated Statements of Income.

Claim and claim settlement expenses are our largest expense and result in our largest liability. We establish reserves that reflect our estimates of the total claim and claim settlement expenses we will ultimately have to pay under our workers’ compensation insurance policies. These include claims that have been reported but not yet settled and claims that have been incurred but not yet reported to us. For further discussion of reserve determination, see the “Unpaid Claim and Claim Settlement Expenses” section of this Management’s Discussion and Analysis.

Claim and claim settlement expenses decreased to \$7.3 million in the second quarter of 2006 from \$8.5 million in the same period in 2005 and decreased to \$14.5 million for the six months ended June 30, 2006 from \$17.9 million for the same period in 2005. As a percent of gross premiums earned, claim and claim settlement expenses decreased to 55.5% for the second quarter of 2006 from 56.8% for the second quarter of 2005 and to 55.3% for the six months ended June 30, 2006 from 56.7% for the same period in 2005. These changes are due to the following:

- We recorded an \$850,000 and \$750,000 reduction in claim and claim settlement expenses in the first and second quarters of 2006, respectively, to reflect favorable claim development for 2005 and prior accident years. The 2005 results included a \$500,000 reduction in both the first and second quarters to reflect similar experience for 2004 and prior accident years;
- Continued improvements in our ability to effectively and efficiently manage claims; and
- Offsetting these decreases, claim costs continued to reflect increases in medical and indemnity costs in accident year 2006 as compared to accident year 2005 resulting from general inflationary pressures.

*Claim and Claim Settlement Expense Outlook:* We expect that claim and claim settlement expenses will be affected by the following factors:

- Claim costs will continue to be affected by: (i) increases in medical and indemnity costs resulting from inflationary changes; (ii) severity experienced in current and future periods in our policyholder base; (iii) changes resulting from increases in operating efficiency and effectiveness realized through enhancements to our internal processes and procedures, including changes to our proprietary computer systems; and (iv) legislative changes that affect benefits payable under workers’ compensation; and
- Increases (decreases) in premium rates will result in increasing (decreasing) gross premiums earned without a corresponding increase (decrease) in claim and claim settlement expenses, ultimately decreasing (increasing) claim and claim settlement expense as a percent of premiums earned. Legislative changes in estimated loss costs, increased competition and improving customer loss experience may offset or eliminate the effect of any rate improvement.

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The ultimate effect of these factors on claim and claim settlement expenses as a percent of premiums earned for the remainder of 2006 is unknown at this time.

**Policy Acquisition Costs:** Policy acquisition costs are costs directly related to writing insurance policies for ACIC and BCIC and consist of commissions, state premium taxes, underwriting personnel costs and expenses, sales and marketing costs and other underwriting expenses, less ceding commissions received from our reinsurers. Ceding commissions are amounts that reinsurers pay to us for placing reinsurance with them.

The following table summarizes policy acquisition costs (000's):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Commission expense	\$ 869	\$ 985	\$ 1,714	\$ 2,036
Premium tax expense	273	338	423	600
Other policy acquisition costs	693	838	1,493	1,628
Direct policy acquisition costs	1,835	2,161	3,630	4,264
Ceding commissions on excess of loss reinsurance	(537)	(619)	(1,070)	(1,297)
<b>Total policy acquisition costs</b>	<b>\$ 1,298</b>	<b>\$ 1,542</b>	<b>\$ 2,560</b>	<b>\$ 2,967</b>

Under certain of our excess of loss reinsurance policies, the reinsurer returns a portion of the premiums we cede as ceding commissions to reimburse us for our cost of placing and managing these policies. Ceding commissions received under these excess of loss reinsurance policies totaled \$537,000 for the second quarter of 2006 compared to \$619,000 for the second quarter of 2005 and \$1.1 million for the six months ended June 30, 2006 compared to \$1.3 million for the six months ended June 30, 2005. These ceding commissions reduced our policy acquisition costs. Excluding the effect of ceding commissions, policy acquisition costs decreased to \$1.8 million in the second quarter of 2006 from \$2.2 million in the second quarter of 2005 and decreased to \$3.6 million for the first six months of 2006 from \$4.3 million for the same period in 2005. As a percent of gross premiums earned, direct policy acquisition costs decreased to 13.9% in the second quarter of 2006 from 14.4% in the second quarter of 2005 and decreased to 13.9% for the six months ended June 30, 2006 from 16.8% for the same period in 2005. The first six months of 2006 reflects the following:

- Commission expense remained constant at 6.6% of gross premiums earned for the three and six months ended June 30, 2006 compared with 6.6% for the same periods in 2005. We believe the commission rates we pay are marketplace competitive;
- Premium tax expense decreased to 2.1% of gross premiums earned for the second quarter of 2006 from 2.3% in the second quarter of 2005 and to 1.6% for the six months ended June 30, 2006 compared to 2.0% for the same period in 2005. We accrue at the indicated state premium tax rates for the jurisdictions in which we operate and adjust prior years' accruals in the first or second quarter of each year to reflect any retaliatory tax charges or other adjustments that become known when the premium tax returns are completed; and
- Other policy acquisition costs consist of payroll audit vendor costs, various state assessments related to second injury funds, fees paid to state rate-making organizations and the net effect of residual market or "pool" activity in the states in which we have operated. Most other policy acquisition costs are not directly related to current period gross premiums earned. Other policy acquisition costs decreased to 5.3% of gross premiums earned in the second quarter of 2006 compared to 5.6% in the second quarter of 2005 and increased to 5.7% for the six months ended June 30, 2006 from 5.3% for the same period in 2005. We recorded a decrease of \$20,000 and an increase of \$110,000 in other policy acquisition costs in the three and six-month periods ending June 30, 2006, respectively, reflecting a reapportionment of 2005 mandatory reinsurance pools expense compared to increases of \$46,000 and \$103,000 for the same periods in 2005, respectively. Excluding the mandatory pool reallocation, other policy acquisitions costs increased to 5.4% for the three months ended June 30, 2006 compared to 5.3% in the second quarter of 2005 and to 5.3% for the six months ended June 30, 2006 from 5.0% for the same period in 2005.

**Policy Acquisition Cost Outlook:** We expect that policy acquisition costs in 2006 will be affected by the following:

- Our commission expense will continue to be affected by how much new business we write relative to renewal business as we pay higher commissions on new policies;

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- Premium tax accrual rates will remain relatively constant at approximately 2.0% for the balance of 2006; and
- Other underwriting expenses will continue to be affected by pool reimbursements offset by pool disbursements, the effect of which is not known at this time.

**General and Administrative Expenses:** Our general and administrative expenses include personnel costs, office rent, certain state administrative assessments based on premiums and other costs and expenses not specific to claim and claim settlement expenses or policy acquisition costs. All costs associated with our service business are included in general and administrative expenses.

General and administrative expenses increased to \$3.3 million in the second quarter of 2006 from \$2.8 million in the second quarter of 2005 and to \$7.0 million for the six months ended June 30, 2006 from \$5.7 million for the same period in 2005. General and administrative expenses increased due primarily to the following:

- Service revenue increased to \$1.8 million for the second quarter of 2006 from \$940,000 for the same period in 2005 and to \$3.3 million for the six months ended June 30, 2006 from \$1.5 million for the same period in 2005. We added staff and other general and administrative expenses to deliver the services associated with this revenue and we have continued to build the infrastructure necessary to support our service revenue growth;
- Bonus expense totaled \$388,000 through the second quarter of 2006 compared to \$305,000 for the same period in 2005; and
- Share-based compensation expense for the three and six-month periods ending June 30, 2006 was \$34,000 and \$232,000, respectively, due to adopting SFAS 123R, "Share-Based Payment," a new accounting pronouncement requiring the expensing of stock-based compensation. There was no comparable charge recorded for the same periods in 2005.

**General and Administrative Expenses Outlook:** We expect that general and administrative expenses will be affected by the following:

- Growth in our service revenue will require staff additions and increase our general and administrative expense;
- We will make appropriate investments in infrastructure to position us for future growth of our service business and to continue to support and enhance our core insurance operations;
- Although we have no current plans to open additional offices in 2006, if service opportunities warrant opening a new office, we will evaluate opportunities as they present themselves; and
- All expenses will continue to be aggressively managed and reduced where appropriate.

**Income Tax Expense:** We incur federal and state income taxes on our operations. We incur premium taxes in lieu of state income taxes for substantially all of our insurance operations. In certain instances, we may incur state income taxes on our insurance operations. Additionally, certain provisions of the Internal Revenue Code adversely affect our taxable income by accelerating recognition and payment of income taxes. Adjustments to book income generating current tax liabilities include limitations on the deductibility of unpaid claim and claim settlement expenses, limitations on the deductibility of unearned premium reserves and limitations on deductions for bad debt reserves.

In assessing our ability to realize deferred tax assets, we consider whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. We consider recent operating results, the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. We expect our deferred tax assets at June 30, 2006, to be realized as a result of the future income and the reversal of existing taxable temporary differences.

Income tax expense for the second quarter of 2006 was \$731,000, or 33.8% of income before income taxes, compared to \$685,000, or 34.1% of income before income taxes, for the same period in 2005. Income tax expense for the six months ended June 30, 2006 was \$1.3 million, or 34.5% of income before income taxes, compared to \$1.2 million, or 33.6% of income before income taxes for the same period in 2005. The income tax expense percentages in the three and six-months ended June 30, 2006 and 2005 have been affected by: (i) our income from operations; (ii) changes in taxable net income from our insurance subsidiaries (ACIC and BCIC) which is generally

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subject to only federal income taxes; (iii) increases in our service net income which is subject to both federal and state income taxes; (iv) non-deductibility of certain share-based compensation expense; and (v) the amount of municipal bond income that we have earned.

*Income Tax Expense Outlook:* Income tax expense will vary based on: (i) our results from operations for the remainder of 2006; (ii) the amount of tax exempt income we earn in 2006; (iii) the amount of non-deductible share-based compensation expense we incur in 2006; and (iv) growth in our service revenue. The ultimate change is unknown at this time.

### *Investments*

Our portfolio of fixed maturity securities at June 30, 2006 included U.S. government securities (57.4%), mortgage-backed securities (21.6%), municipal securities (17.2%), commercial paper (1.9%) and asset-backed securities (1.8%). Our portfolios are managed by an independent investment manager to maximize our after-tax investment income without taking inappropriate credit risk. In 2005, we sold securities within the portfolio to take advantage of favorable interest rates and realized net investment gains of \$445,000 and \$580,000 for the three and six months ended June 30, 2005, respectively. There were no net investment gains or losses realized during the same periods in 2006. We conservatively manage our fixed maturity portfolio, investing only in investment grade (BBB or better rating from Standard and Poor's) securities of U.S. domiciled issuers. All securities in our portfolio were rated AAA, AA A1+, or P1 at June 30, 2006 and December 31, 2005. We do not invest in derivative securities.

Operating cash flows consist of the deficit or excess of premiums collected over claim and claim settlement expenses paid, reduced by payments for reinsurance premiums as well as other operating expenses paid. Investment cash flows consist of income on existing investments and proceeds from sales and maturities of investments. Our investment portfolios decreased to \$104.1 million at June 30, 2006 from \$107.3 million at December 31, 2005. During 2005 we began to invest a portion of our cash and cash equivalents into longer-maturing, fixed rate securities, primarily U.S. government securities and commercial paper. During 2006, we continued to increase our investment in U.S. government securities and mortgage-backed securities, but decreased our investment in commercial paper, which has maturities of three to twelve months. Cash and cash equivalents were \$21.4 million, \$21.9 million and \$34.0 million at June 30, 2006, December 31, 2005 and June 30, 2005, respectively. We expect that total cash and cash equivalents and commercial paper will decrease for the remainder of 2006 as we continue to invest in additional fixed-income securities maturing in over one year.

We record investments on our balance sheet at fair value, with the corresponding appreciation or depreciation from amortized cost recorded in shareholders' equity as accumulated other comprehensive loss, net of taxes. Because value is based on the relationship between the portfolios' stated yields and prevailing market yields at any given time, interest rate fluctuations can have a swift and significant effect on the carrying value of these securities. As a result of classifying our securities as available-for-sale, and carrying them at fair value, we expect to encounter adjustments in shareholders' equity as market interest rates and other factors change. At June 30, 2006 we had a \$3.5 million net unrealized loss on investments compared to a \$1.8 million net unrealized loss at December 31, 2005 and a \$29,000 net unrealized gain at June 30, 2005.

### *Unpaid Claim and Claim Settlement Expenses*

Unpaid claim and claim settlement expenses relate solely to our insurance operation. Our service division does not bear claim risk for its customers and carries no unpaid claim and claim settlement expenses.

At June 30, 2006, the liability for unpaid claim and claim settlement expenses totaled \$156.9 million, and our reinsurance recoverables on unpaid claim and claim settlement expenses totaled \$81.6 million, resulting in net reserves totaling \$75.3 million. Net reserves at December 31, 2005 totaled \$76.8 million and included the liability for unpaid claim and claim settlement expenses totaling \$160.1 million, net of reinsurance recoverables on unpaid claim and claim settlement expenses of \$83.3 million.

Accounting for workers' compensation insurance operations requires us to estimate the liability for unpaid claim and claim settlement expenses (reserves) and the related reinsurance recoverables, (together, net reserves) at each balance sheet date. Our reserves represent the estimated total unpaid cost of claim and claim settlement expenses, which cover events that occurred to date in 2006 and prior years. These reserves reflect our estimates of the total costs of claims that were reported, but not yet paid, and the cost of claims incurred but not yet reported (IBNR). For reported claims, we establish reserves on a "case" basis. For IBNR claims, we calculate the difference between: (i) projected ultimate claim and claim settlement expenses as determined using generally accepted

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actuarial standards; and (ii) case reserves and carry the difference as an IBNR reserve. By using both estimates of reported claims and IBNR claims, we estimate the ultimate net reserves for unpaid claim and claim settlement expenses.

The amount by which estimated net reserves, measured subsequently by reference to payments and changes in reserve estimates, differ from those originally reported for a period is known as "development." Development is unfavorable (deficient) when losses ultimately settle for more than the levels at which they were reserved or subsequent estimates indicate a basis for reserve increases on open claims. Development is favorable (redundant) when losses ultimately settle for less than the amount reserved or subsequent estimates indicate a basis for reducing loss reserves on open claims. Favorable or unfavorable development of loss reserves is reflected in earnings in the period recognized.

Both internal and independent external actuaries review net reserves for adequacy on a periodic basis. These reviews assume that past experience, adjusted for the effects of current events and anticipated trends, is an appropriate basis for predicting future events. When reviewing net reserves, actuaries analyze historical data and estimate the effect of various factors on estimated ultimate reserves including: (i) trends in general economic conditions, including the effects of inflation; (ii) estimates of trends in claims frequency and severity; (iii) our industry historical loss experience; and (iv) legislative enactments, legal developments and changes in social and political attitudes. Variables in the reserve estimation process can be affected by both internal and external events, including changes in claims handling procedures, economic inflation, legal trends and legislative changes. Many of these items are not directly quantifiable, particularly on a prospective basis. There is no precise method for subsequently evaluating the effect of any specific factor on the adequacy of reserves because the eventual redundancy or deficiency is affected by many factors. Additionally, there may be significant reporting lags between the occurrence of the loss and the time it is actually reported to the insurer. Due to our commencing operations in 1992, we have limited historical data to estimate our reserves for unpaid claim and claim settlement expenses and reinsurance recoverables on unpaid claim and claim settlement expenses and, accordingly, we supplement our experience with external industry data, as adjusted, to reflect anticipated differences between our results and the industry.

Estimating the effect that inflation will have on the ultimate cost of claims is a major risk factor in our workers' compensation reserve estimates. Future earnings will be affected by reserve development associated with any changes in our inflation assumptions. Estimates for the 2006, 2005 and 2004 accident years represent the majority of the uncertainty because these claims have the lowest proportionate amount of paid loss as of June 30, 2006. Each one percent (1%) increase or decrease in the inflation rate for 2005 and 2004 accident years would increase or decrease our net loss reserve estimates at December 31, 2005 by approximately \$477,000. Information about the 2006 accident year is still very immature and any estimate of the effect of a one percent (1%) change would be premature.

Our independent actuary provides management with an opinion annually regarding the acceptable range for adequate statutory reserves based on generally accepted actuarial guidelines. We record our net reserves by considering a range of estimates bounded by the high and low point of the range. Within that range, we record our best estimate. At December 31, 2005, we established recorded reserves in the upper end of the actuary's range and we continue to believe that recorded reserves at June 30, 2006 remain within that range. The ultimate actual liability may be higher or lower than reserves established.

Our reserves are primarily undiscounted; however, we discounted reserves for selected claims that have fixed and determinable future payments at rates ranging from 3.5% to 8.0% in 2006 and 2005. The discount rates are subject to adjustment as market interest rates change. We use the same rates for U.S. generally accepted accounting principles (GAAP) as we do for Statutory Accounting Practices (SAP) in determining our liability. We also reduce the unpaid claim and claim settlement expenses for estimated amounts of subrogation.

We continually monitor loss development trends and data to establish adequate premium rates and to determine reasonable reserve estimates. Reserves that are based on estimates are inherently uncertain and represent a significant risk to the business. We attempt to mitigate this risk by continually improving and refining our workers' compensation claims processing practices and by continual monitoring through actuarial estimation methods.

After taking into account all relevant factors, we believe our reserves for unpaid claim and claim settlement expenses and reinsurance recoverables on unpaid claim and claim settlement expenses at June 30, 2006 are adequate to cover the ultimate net costs of claim and claim settlement expenses at that date. The ultimate cost of claim and claim settlement expenses may differ materially from the established reserves, particularly when claims may not be



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settled for many years. Establishing appropriate reserves is an inherently uncertain process and there can be no certainty that currently established reserves will prove adequate in light of subsequent actual experience.

Income for the three and six months ended June 30, 2006 included a \$750,000 and \$1.6 million, respectively, reduction of projected claim and claim settlement expenses resulting from favorable development of claims for 2005 and prior accident years. Income for the three and six months ended June 30, 2005 included an \$500,000 and \$1.0 million, respectively, reduction of projected claim and claim settlement expenses resulting from favorable development of claims for 2004 and prior accident years.

### *Liquidity and Capital Resources*

Liquidity refers to our ability to generate sufficient cash flows to meet the short- and long-term cash requirements of our operations. Capital resources represent those funds deployed or available to be deployed to support our business operations.

Our primary sources of cash from operations are premiums collected, reimbursements under reinsurance contracts and investment income. Our primary cash requirements consist of payments for: (i) claim and claim settlement expenses; (ii) reinsurance; (iii) policy acquisition costs; (iv) general and administrative expenses; (v) capital expenditures; and (vi) income taxes. We generate cash from or use cash in operations based on timing differences between the receipt of premiums and the payment of claim and claim settlement expenses. Selected reinsurance retention levels also use cash as a result of "pre-funding" premiums under the policies or provide cash upon reimbursement of claim payments. Available cash is invested in either short-term cash and cash equivalents or longer-term available-for-sale securities pending future payments for expenses such as medical and indemnity benefits and other operating expenses. Cash and cash equivalents consist of cash, a money market fund that invests primarily in short-term U.S. Government securities, commercial paper with maturities of three months or less and overnight repurchase agreements secured by U.S. Treasury or U.S. Government Agency securities.

Cash used in operating activities for the six months ended June 30, 2006 was \$61,000. Cash was provided by net income of \$2.5 million, an increase in unearned premiums, net of premiums receivable, of \$1.0 million, a decrease in reinsurance recoverables and receivables of \$1.6 million, share-based compensation expense of \$232,000 and depreciation and amortization of \$167,000, offset by a decrease in accrued expenses and other liabilities of \$2.3 million and a decrease in unpaid claim and claim settlement expenses of \$3.2 million. Net cash provided by investing activities was \$1.3 million due to \$19.5 million in purchases of available-for-sale investments and \$221,000 in purchases of furniture and equipment offset by \$19.6 million in proceeds from the maturities of available-for-sale investments and \$1.5 million in proceeds from sales of available-for-sale investments. Net cash used in financing activities was \$1.8 million from the repurchase of \$2.0 million of our common stock offset by \$72,000 proceeds from the exercise of stock options and \$150,000 proceeds from the issuance of common stock under the Employee Stock Purchase Plan.

Our need for additional capital is primarily the result of regulations that require certain ratios of regulatory or statutory capital to premiums written in our insurance subsidiaries as defined by state regulatory bodies and insurance rating agencies. Raising additional permanent capital, while difficult in the current environment in which we operate, would further reduce our ratio of premium to capital and provide a more solid base for the future growth of our insurance subsidiary. As an alternative to raising additional permanent capital, we could enter into reinsurance contracts on an interim basis. This would have the effect of reducing the ratio of premiums to capital and surplus in ACIC to satisfy state regulatory requirements.

Minnesota state insurance regulations limit distributions, including dividends, from our insurance subsidiaries to us. Under Minnesota insurance law regulating the payment of dividends, in any twelve month period, ACIC can pay a dividend to us from its earned surplus (unassigned surplus) not to exceed the greater of 10% of ACIC's total surplus or ACIC's prior years net income reduced for realized capital gains net of income taxes. At June 30, 2006, ACIC could pay a dividend to RTW of \$4.1 million without the approval of the Minnesota Department of Commerce. ACIC has never paid a dividend to RTW, and we intend to retain capital in our insurance subsidiaries.

Investments held as statutory deposits and pledged as collateral do not currently have an adverse effect on our liquidity because the amount currently pledged is small compared to our overall investments and cash and cash equivalent position. We believe that cash flow generated by our operations and our cash and investment balances will be sufficient to fund continuing operations and capital expenditures for the next twelve months.

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***Repurchase of Common Stock***

On March 30, 2006, we announced that our Board approved resuming our common stock share repurchase program. In September 1998, our Board authorized us to repurchase, from time-to-time pursuant to the program, up to \$4.0 million of common stock. On May 1, 2006, our Board authorized a \$1.0 million increase in the stock share repurchase program.

During the second quarter of 2006, we repurchased 96,000 shares for \$1.0 million, at an average purchase price of \$10.76 per share, under the share repurchase program and an additional 90,000 shares, at \$11.00 per share, in a private transaction outside the program from our founder for \$1.0 million. At June 30, 2006, we had a total of \$1.2 million authorized for additional share re-purchases under the program.

These repurchases will be made in the open market in compliance with the SEC's Rule 10b-18, or through privately negotiated transactions, and are subject to market conditions, share price, trading volume and other factors. The repurchase program has no time limit and may be suspended from time-to-time or discontinued. The share repurchases will be made from available capital.

***Interest Rate Risk***

Our fixed maturity investments are subject to interest rate risk. Increases and decreases in prevailing interest rates generally translate into decreases and increases in the fair value of these instruments. Also, fair values of interest rate sensitive instruments may be affected by the credit worthiness of the issuer, pre-payment options, relative values of alternative instruments, the liquidity of the instrument and other general market conditions. We regularly evaluate interest rate risk in order to evaluate the appropriateness of our investments.

An increase of 100 basis points in prevailing interest rates would reduce the fair value of our interest rate sensitive instruments by approximately \$3.2 million at June 30, 2006.

The effect of interest rate risk on potential near-term fair value was determined based on commonly used models. The models project the impact of interest rate changes on factors such as duration, pre-payments, put options and call options. Fair value was determined based on the net present value of cash flows or duration estimates, using a representative set of likely future interest rate scenarios.

***NAIC Risk-based Capital Standards***

The National Association of Insurance Commissioners (NAIC) has risk-based capital standards to determine the capital requirements of a property and casualty insurance carrier based upon the risks inherent in its operations. These standards require computing a risk-based capital amount that is compared to a carrier's actual total adjusted capital. The computation involves applying factors to various financial data to address four primary risks: asset risk; insurance underwriting risk; credit risk; and off-balance sheet risk. These standards provide for regulatory intervention when the percent of total adjusted capital to authorized control level risk-based capital is below certain levels. Based upon the risk-based capital standards, our percent of total adjusted capital at June 30, 2006 is substantially in excess of authorized control level risk-based capital.

***Regulation***

Our insurance subsidiary is subject to substantial regulation by governmental agencies in the states in which we operate, and will be subject to such regulation in any state in which we provide workers' compensation products and services in the future. State regulatory agencies have broad administrative power with respect to all aspects of our business, including premium rates, benefit levels, policy forms, dividend payments, capital adequacy and the amount and type of investments we may hold. These regulations are primarily intended to protect covered employees and policyholders rather than the insurance company. Both the legislation covering insurance companies and the regulations adopted by state agencies are subject to change. At June 30, 2006, ACIC was licensed to do business in Minnesota, South Dakota, Wisconsin, Colorado, Missouri, Illinois, Kansas, Michigan, Indiana, Massachusetts, Connecticut, Rhode Island, Pennsylvania, Tennessee, Maryland, Arkansas, Iowa, Florida, Georgia, New Jersey, North Carolina, Texas and Oklahoma. BCIC was licensed in only Minnesota.

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***Effect of Recent Accounting Pronouncements***

In June 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes – an interpretation of FASN Statement No. 109” (FIN 48), which provides criteria for recognizing, measuring, presenting and disclosing uncertain tax positions. A tax benefit from an uncertain position may be recognized only if it is “more likely than not” that the position is sustainable based on its technical merits. The provisions of FIN 48 were effective for fiscal years beginning after December 15, 2006. We expect that FIN 48 will not have a material effect on our consolidated financial condition or results of operations.

In November 2005, the FASB issued FASB Staff Position 115-1, “The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments” (FSP 115-1). FSP 115-1 provides guidance on recognizing impairments deemed other-than-temporary. FSP 115-1 is effective for other-than-temporary impairment analysis conducted in periods beginning after December 15, 2005. We believe that our policy for other-than-temporary impairments complies with FSP 115-1. Accordingly, the adoption of this standard has not had a material effect on the consolidated financial statements.

In September 2005, the Accounting Standards Executive Committee issued Statement of Position 05-1, “Accounting by Insurance Enterprises for Deferred Acquisition Costs in Connection with Modifications or Exchanges of Insurance Contracts” (SOP 05-1). SOP 05-1 provides guidance on accounting by insurance enterprises for deferred acquisition costs on internal replacements of insurance and investment contracts other than those specifically described in SFAS No.97, “Accounting and Reporting by Insurance Enterprises for Certain Long-Duration Contracts and for Realized Gains and Losses from the Sale of Investments”. SOP 05-1 defines an internal replacement as a modification in product benefits, features, rights or coverage that occurs by the exchange of a contract for a new contract, or by amendment, endorsement, or rider to a contract, or by electing a feature or coverage within a contract. SOP 05-1 is effective for internal replacements occurring in fiscal years beginning after December 15, 2006, with earlier adoption encouraged. We only issue workers’ compensation insurance policies, that are a statutory coverage and are not subject to internal replacement or modification in product benefits, features, right or coverage. We do not expect the adoption of SOP 05-1 to have a significant effect on operations, financial condition or liquidity.

***Data Management***

We use several proprietary systems developed by us in our operations. These systems include:

Initial Release	System Description	Business Use
1995	Policy management system	Process insurance applications; issue and endorse policies
1996	Case and claims management and medical fee adjudicating systems	Manage claims, audit medical fees, pay claims, provide reports to policyholders and analyze claims data
1999	Client account management system	Billing, cash receipts, collections and agency commission systems

We continue to maintain and upgrade these systems. We also utilize third-party software to maintain financial information, prepare accounting reports and financial statements and pay vendors. We contract with a third-party vendor with national capabilities to receive all of our first notices of injury from our customers. We contract with a third-party provider of payroll services for payroll, benefits and human resource software services. We utilize other licensed software from national vendors to maintain our financial records, file statutory statements with insurance regulators and perform other general business.

***Forward Looking Statements***

Information included in this Report on Form 10-Q which can be identified by the use of forward-looking terminology such as “may,” “will,” “expect,” “anticipate,” “estimate,” or “continue” or the negative thereof or other variations thereon or comparable terminology constitutes “forward-looking information” within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking

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statements. The following important factors, among others, in some cases have affected and in the future could affect our actual results and could cause our actual financial performance to differ materially from that expressed in any forward-looking statement: (i) the ability of our insurance subsidiaries to retain renewing policies and write new business with a B++ (Very Good) rating from A.M. Best; (ii) our ability to extend our workers' compensation services to self-insured employers and other alternative markets and to operate profitably in providing these services; (iii) our ability to expand our insurance solutions to new markets and write small accounts and select association business through ACIC; (iv) our ability to continue to maintain or increase pricing on insured products in the markets in which we remain or alternatively non-renew or turn away improperly priced business; (v) the ability of our reinsurers to honor their obligations to us; (vi) our ability to accurately predict claim development; (vii) our ability to provide our proprietary products and services to customers successfully; (viii) our ability to manage both our existing claims and new claims in an effective manner; (ix) our experience with claims frequency and severity; (x) medical inflation; (xi) competition and the regulatory environment in which we operate; (xii) general economic and business conditions; (xiii) our ability to obtain and retain reinsurance at a reasonable cost; (xiv) changes in workers' compensation regulation by states, including changes in mandated benefits or insurance company regulation; (xv) interest rate changes; and (xvi) other factors as noted in our other filings with the Securities Exchange Commission. This discussion of uncertainties is by no means exhaustive but is designed to highlight important factors that may affect our future performance.

### **Item 3: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Information with respect to Disclosures about Market Risk is contained in the section entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations – Interest Rate Risk" under Item 2 of this Report on Form 10-Q and is incorporated herein by reference.

### **Item 4: CONTROLS AND PROCEDURES**

#### (a) Evaluation of Disclosure Controls and Procedures

Our President and Chief Executive Officer, Jeffrey B. Murphy, and Chief Financial Officer, Alfred L. LaTendresse, have evaluated our disclosure controls and procedures as of the end of the period covered by this report. Based upon that review, they have concluded that these controls and procedures are effective.

#### (b) Changes in Internal Control Over Financial Reporting

There were no changes in internal control over financial reporting that occurred during the fiscal quarter covered by this report that have materially affected, or are reasonably likely to materially affect, the registrant's internal control over financial reporting.

## **PART II — OTHER INFORMATION**

### **Item 1. LEGAL PROCEEDINGS**

In the ordinary course of administering our workers' compensation programs, we are routinely involved in the adjudication of claims resulting from workplace injuries. We are not involved in any other legal or administrative claims that we believe are likely to have a material adverse effect on our financial condition or results of operations.

As previously disclosed, however, we are involved in the matter RTW v. Carolina Casualty pending in United States District Court in Minnesota. As disclosed in our Form 10-Q for the quarter ended March 31, 2006, cross motions for summary judgment were argued in front of the Court on May 8, 2006. The Court has not yet issued a decision on the cross motions. Any final decision by the District Court is subject to appeal to the United States Court of Appeals for the Eighth Circuit.

### **Item 1A. RISK FACTORS**

For a discussion of our potential risks or uncertainties, please see Part I, Item 1A, of our 2005 Annual Report on Form 10-K filed with the Securities and Exchange Commission. There have been no material changes to the risk factors disclosed in Part I, Item 1A, of our 2005 Annual Report on Form 10-K.

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**Item 2. UNREGISTERED SALES OF SECURITIES AND USE OF PROCEEDS**

- (a) Sale of unregistered securities  
None
- (b) Use of proceeds  
Not applicable
- (c) Repurchase of Equity Securities

The table below sets forth information regarding repurchases of our common stock during the periods indicated:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid Per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs <sup>1</sup></u>	<u>Maximum Approximate Dollar Value of Shares That May Yet be Purchased Under the Plans or Programs</u>
April 1, 2006 – April 30, 2006	50,000	\$ 10.66	50,000	\$ 682,000
May 1, 2006 – May 30, 2006	125,112	10.97	35,112	1,300,000
June 1, 2006 – June 30, 2006	11,120	10.81	11,120	\$ 1,180,000
Total	<u>186,232</u>	<u>\$ 10.87</u>	<u>96,232</u>	

<sup>(1)</sup> Included in the table above, in May 2006 we repurchased 90,000 shares at \$11.00 per share in a private transaction outside the program from our founder.

In September 1998, our Board authorized us to repurchase, from time-to-time pursuant to the program, up to \$4.0 million of common stock. On May 1, 2006, our Board authorized a \$1.0 million increase in the share repurchase program to a total of \$5.0 million. These repurchases will be made in the open market in compliance with the SEC's Rule 10b-18, or through privately negotiated transactions, and are subject to market conditions, share price, trading volume and other factors. The repurchase program does not have a specific termination date.

**Item 3. DEFAULTS UPON SENIOR SECURITIES**

None

**Item 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

- (a) We held our Annual Meeting of Shareholders on June 14, 2006.
- (b) We solicited proxies from our shareholders to vote on the following items:
  - To elect two directors to serve until the 2009 Annual Meeting of Shareholders and one director to serve until the 2008 Annual Meeting of Shareholders;
  - To ratify the appointment of Ernst & Young LLP as our independent registered public accountants for the Company for the fiscal year ending December 31, 2006; and
  - To amend the RTW, Inc. 1994 and 2005 Stock Plans to eliminate the automatic annual grant of stock options to non-employee directors.
- (c) A total of 4,953,634 votes were cast in person or by proxy at the annual meeting and the vote counts were as follows:

<u>Proposal</u>	<u>Director until</u>	<u>For</u>	<u>Against</u>	<u>Withhold</u>	<u>Abstain</u>	<u>Broker Non-votes</u>
<b>Election of Directors:</b>						
John O. Goodwyne	2009	4,892,014	—	61,620	—	—
David C. Prosser	2009	4,824,992	—	128,642	—	—
Lyron L. Bentovim	2008	4,944,622	—	9,012	—	—

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Proposal	Director until	For	Against	Withhold	Abstain	Broker Non-votes
Ratification of independent registered public accountants		4,942,445	7,062	—	4,127	—
Amend the RTW, Inc. 1994 and 2005 Stock Plans		3,244,862	1,240	—	—	1,695,621

Accordingly, John O. Goodwyne and David C. Prosser were elected directors of the Company with terms expiring in 2009 and Lyron L. Bentovim was elected director of the Company with a term expiring in 2008, Ernst & Young LLP was ratified as independent registered public accountants for the Company for the fiscal year ending December 31, 2006, and the RTW, Inc. 1994 and 2005 Stock Plans were amended. In addition to the election of John O. Goodwyne, David C. Prosser and Lyron L. Bentovim, Jeffrey B. Murphy, Gregory D. Koschinska and Vina L. Marquart continue as directors of the Company until 2007 and William J. Deters and John W. Prosser continue as directors of the Company until 2008.

**Item 5. OTHER INFORMATION**

None.

**Item 6. EXHIBITS**

- Exhibit 10.1 - 1994 STOCK OPTION PLAN AS AMENDED THROUGH JUNE 14, 2006
- Exhibit 10.2 - 2005 STOCK OPTION PLAN AS AMENDED THROUGH JUNE 14, 2006
- Exhibit 11 - STATEMENT REGARDING COMPUTATION OF BASIC AND DILUTED NET INCOME PER SHARE
- Exhibit 31.1 - CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
- Exhibit 31.2 - CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002
- Exhibit 32 - CERTIFICATION PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

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**SIGNATURES**

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

**RTW, Inc.**

Dated: August 11, 2006

By /s/ Jeffrey B. Murphy  
Jeffrey B. Murphy  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: August 11, 2006

By /s/ Alfred L. LaTendresse  
Alfred L. LaTendresse  
Secretary, Treasurer and Chief Financial Officer  
(Principal Financial and Accounting Officer)



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CRC: 28148  
**EDGAR 2**

**BOC C07742 710.01.01.00 0/2**  


**Exhibit 10.1**

RTW, INC.  
1994 STOCK PLAN  
(as amended through June 14, 2006)

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<u>SECTION</u>		<u>CONTENTS</u>	<u>PAGE</u>
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RTW, INC.  
1994 STOCK PLAN

SECTION 1. General Purpose of Plan; Definitions.

The name of this plan is the RTW, Inc. 1994 Stock Plan (the "Plan"). The purpose of the Plan is to enable RTW, Inc. (the "Company") and its Subsidiaries to retain and attract executives and other key employees, directors and consultants who contribute to the Company's success by their ability, ingenuity and industry, and to enable such individuals to participate in the long-term success and growth of the Company by giving them a proprietary interest in the Company.

For purposes of the Plan, the following terms shall be defined as set forth below:

- a. "Board" means the Board of Directors of the Company as it may be comprised from time to time.
- b. "Cause" means a felony conviction of a participant or the failure of a participant to contest prosecution for a felony, willful misconduct, dishonesty or intentional violation of a statute, rule or regulation, any of which, in the judgment of the Company, is harmful to the business or reputation of the Company.
- c. "Code" means the Internal Revenue Code of 1986, as amended from time to time, or any successor statute.
- d. "Committee" means the Committee referred to in Section 2 of the Plan.
- e. "Consultant" means any person performing services for the Company or any Parent Corporation or Subsidiary of the Company and who is not an employee of the Company or any Parent Corporation or Subsidiary of the Company.
- f. "Company" means RTW, Inc., a corporation organized under the laws of the State of Minnesota (or any successor corporation).
- g. "Deferred Stock" means an award made pursuant to Section 8 below of the right to receive stock at the end of a specified deferral period.
- h. "Disability" means permanent and total disability as determined by the Committee.
- i. "Early Retirement" means retirement, with consent of the Committee at the time of retirement, from active employment with the Company and any Subsidiary or Parent Corporation of the Company.
- j. "Fair Market Value" of Stock on any given date shall be determined by the Committee as follows: (a) if the Stock is listed for trading on one or more national securities exchanges, or is traded on the Nasdaq Stock Market, the last reported sale price on the principal such exchange or the Nasdaq Stock Market on the date in question, or if such Stock shall not have been traded on such principal exchange on such date, the last reported sales price on such principal exchange or the Nasdaq Stock Market on the first day prior thereto on which such Stock was so traded; or (b) if the Stock is not listed for trading on a national securities exchange or the Nasdaq Stock Market, but is traded in the over-the-counter market, including the Nasdaq System, closing bid price for such Stock on the date in question, or if there is no such bid price for such Stock on such date, the closing bid price on the first day prior

thereto on which such price existed; or (c) if neither (a) or (b) is applicable, by any means fair and reasonable by the Committee, which determination shall be final and binding on all parties.

- k. “Incentive Stock Option” means any Stock Option intended to be and designated as an “Incentive Stock Option” within the meaning of Section 422 of the Code.
- l. “Non-Employee Director” means a “Non-Employee Director” within the meaning of Rule 16b-3(b)(3) under the Securities Exchange Act of 1934.
- m. “Non-Qualified Stock Option” means any Stock Option that is not an Incentive Stock Option, and is intended to be and is designated as a “Non-Qualified Stock Option.”
- n. “Normal Retirement” means retirement from active employment with the Company and any Subsidiary or Parent Corporation of the Company on or after age 60.
- o. “Outside Director” means a Director who: (a) is not a current employee of the Company or any member of an affiliated group which includes the Company; (b) is not a former employee of the Company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year; (c) has not been an officer of the Company; (d) does not receive remuneration from the Company, either directly or indirectly, in any capacity other than as a director, except as otherwise permitted under Code Section 162(m) and regulations thereunder. For this purpose, remuneration includes any payment in exchange for good or services. This definition shall be further governed by the provisions of Code Section 162(m) and regulations promulgated thereunder.
- p. “Parent Corporation” means any corporation (other than the Company) in an unbroken chain of corporations ending with the Company if each of the corporations (other than the Company) owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in the chain.
- q. “Restricted Stock” means an award of shares of Stock that are subject to restrictions under Section 7 below.
- r. “Retirement” means Normal Retirement or Early Retirement.
- s. “Stock” means the Common Stock of the Company.
- t. “Stock Appreciation Right” means the right pursuant to an award granted under Section 6 below to surrender to the Company all or a portion of a Stock Option in exchange for an amount equal to the difference between (i) Fair Market Value, as of the date such Stock Option or such portion thereof is surrendered, of the shares of Stock covered by such Stock Option or such portion thereof, and (ii) the aggregate exercise price of such Stock Option or such portion thereof.
- u. “Stock Option” means any option to purchase shares of Stock granted pursuant to Section 5 below.
- v. “Subsidiary” means any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company if each of the corporations (other than the last corporation in the unbroken chain) owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in the chain.

SECTION 2. Administration.

The Plan shall be administered by the Board of Directors or by a Committee appointed by the Board of Directors, consisting of not less than two Directors, all of whom shall be Outside Directors and Non-Employee Directors, and who shall serve at the pleasure of the Board. Any or all of the functions of the Committee specified in the Plan may be exercised by the Board, unless the Plan specifically states otherwise.

The Committee shall have the power and authority to grant to eligible employees, members of the Board of Directors, or Consultants, pursuant to the terms of the Plan: (i) Stock Options, (ii) Stock Appreciation Rights, (iii) Restricted Stock, or (iv) Deferred Stock awards.

In particular, the Committee shall have the authority:

- (i) to select the officers and other key employees of the Company and its Subsidiaries and other eligible persons to whom Stock Options, Stock Appreciation Rights, Restricted Stock and/or Deferred Stock awards may from time to time be granted hereunder;
- (ii) to determine whether and to what extent Incentive Stock Options, Non-Qualified Stock Options, Stock Appreciation Rights, Restricted Stock and/or Deferred Stock awards, or a combination of the foregoing, are to be granted hereunder;
- (iii) to determine the number of shares to be covered by each such award granted hereunder;
- (iv) to determine the terms and conditions, not inconsistent with the terms of the Plan, of any award granted hereunder (including, but not limited to, any restriction on any Stock Option or other award and/or the shares of Stock relating thereto); and
- (v) to determine whether, to what extent and under what circumstances Stock and other amounts payable with respect to an award under this Plan shall be deferred either automatically or at the election of the participant.

The Committee shall have the authority to adopt, alter and repeal such administrative rules, guidelines and practices governing the Plan as it shall, from time to time, deem advisable; to interpret the terms and provisions of the Plan and any award issued under the Plan (and any agreements relating thereto); and to otherwise supervise the administration of the Plan. The Committee may delegate to executive officers of the Company the authority to exercise the powers specified in (i), (ii), (iii), (iv), and (v) above with respect to persons who are not executive officers of the Company.

All decisions made by the Committee pursuant to the provisions of the Plan shall be final and binding on all persons, including the Company and Plan participants.

SECTION 3. Stock Subject to Plan.

The total number of shares of Stock reserved and available for distribution under the Plan shall be 2,000,000 shares.<sup>1</sup> Such shares may consist, in whole or in part, of authorized and unissued shares.

<sup>1</sup> When adopted, the Plan reserved 50,000 shares. The Company effected a 5-for-1 stock split on February 2, 1995 and a subsequent 3-for-2 stock split on May 17, 1996, resulting in 375,000 shares being reserved. On January 23, 1997, the Board of Directors increased the number of shares reserved to 1,500,000 shares. This

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Subject to paragraph (b)(iv) of Section 6 below, if any shares that have been optioned cease to be subject to Stock Options, or if any shares subject to any Restricted Stock or Deferred Stock award granted hereunder are forfeited or such award otherwise terminates without a payment being made to the participant, such shares shall again be available for distribution in connection with future awards under the Plan.

In the event of any merger, reorganization, consolidation, recapitalization, stock dividend, other change in corporate structure affecting the Stock, or spin-off or other distribution of assets to shareholders, such substitution or adjustment shall be made in the aggregate number of shares reserved for issuance under the Plan, in the number and option price of shares subject to outstanding options granted under the Plan, and in the number of shares subject to Restricted Stock or Deferred Stock awards granted under the Plan as may be determined to be appropriate by the Committee, in its sole discretion, provided that the number of shares subject to any award shall always be a whole number. Such adjusted option price shall also be used to determine the amount payable by the Company upon the exercise of any Stock Appreciation Right associated with any Option.

SECTION 4. Eligibility.

Officers, other key employees of the Company and Subsidiaries, Directors and Consultants who are responsible for or contribute to the management, growth and/or profitability of the business of the

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amendment was approved by the share- holders on May 15, 1997. On February 2, 1999, the Board of Directors increased the number of shares reserved to 2,000,000. This amendment was approved by the shareholders on May 27, 1999.

Company and its Subsidiaries are eligible to be granted Stock Options, Stock Appreciation Rights, Restricted Stock or Deferred Stock awards under the Plan. The optionees and participants under the Plan shall be selected from time to time by the Committee, in its sole discretion, from among those eligible, and the Committee shall determine, in its sole discretion, the number of shares covered by each award.

Notwithstanding the foregoing, no person may, during any fiscal year of the Company, receive grants of Stock Options and Stock Appreciation Rights under this Plan which, in the aggregate, exceed 500,000 shares.

**SECTION 5. Stock Options.**

Any Stock Option granted under the Plan shall be in such form as the Committee may from time to time approve.

The Stock Options granted under the Plan may be of two types: (i) Incentive Stock Options and (ii) Non-Qualified Stock Options. No Incentive Stock Options may be granted more than 10 years after the earlier of (i) the date the Plan is adopted by the Board and (ii) the date the Plan is approved by the shareholders. If the Plan is amended to increase the number of shares authorized for issuance, this 10-year period will automatically be extended to allow the granting of Incentive Stock Option for the additional shares for an additional 10 years from the earlier of (i) the date the amendment is adopted by the Board and (ii) the date it the amendment is approved by the shareholders.

The Committee shall have the authority to grant any optionee Incentive Stock Options, Non-Qualified Stock Options, or both types of options (in each case with or without Stock Appreciation Rights). To the extent that any option does not qualify as an Incentive Stock Option, it shall constitute a separate Non-Qualified Stock Option.

Anything in the Plan to the contrary notwithstanding, no term of this Plan relating to Incentive Stock Options shall be interpreted, amended or altered, nor shall any discretion or authority granted under the Plan be so exercised, so as to disqualify either the Plan or any Incentive Stock Option under Section 422 of the Code. The preceding sentence shall not preclude any modification or amendment to an outstanding Incentive Stock Option, whether or not such modification or amendment results in disqualification of such Option as an Incentive Stock Option provided the optionee consents in writing to the modification or amendment.

Options granted under the Plan shall be subject to the following terms and conditions and shall contain such additional terms and conditions, not inconsistent with the terms of the Plan, as the Committee shall deem desirable.

(a) Option Price. The option price per share of Stock purchasable under a Stock Option shall be determined by the Committee at the time of grant. In no event shall the option price per share of Stock purchasable under a Non-Qualified Stock Option be less than 85% of the Fair Market Value of the Stock on the date of the grant of the option or, in the case of an Incentive Stock Option, less than 100% of such Fair Market Value. If an employee owns or is deemed to own (by reason of the attribution rules applicable under Section 424(d) of the Code) more than 10% of the combined voting power of all classes of stock of the Company or any Parent Corporation or Subsidiary and an Incentive Stock Option is granted to such employee, the option price shall be no less than 110% of the Fair Market Value of the Stock on the date the option is granted.

(b) Option Term. The term of each Stock Option shall be fixed by the Committee, but no Incentive Stock Option shall be exercisable more than ten years after the date the option is granted. If an employee owns or is deemed to own (by reason of the attribution rules of Section 424(d) of the Code) more than 10% of the combined voting power of all classes of stock of the Company or any Parent Corporation or Subsidiary and an Incentive Stock Option is granted to such employee, the term of such option shall be no more than five years from the date of grant.

(c) Exercisability. Stock Options shall be exercisable at such time or times as determined by the Committee at or after grant. If the Committee provides, in its discretion, that any option is exercisable only in installments, the Committee may waive such installment exercise provisions at any time. Notwithstanding anything contained in the Plan to the contrary, the Committee may, in its discretion, extend or vary the term of any Stock Option or any installment thereof, whether or not the optionee is then employed by the Company, if such action is deemed to be in the best interests of the Company. Notwithstanding anything contained in the Plan to the contrary, in the event of the sale by the Company of substantially all of its assets and the consequent discontinuance of its business, or in the event of a merger, exchange, consolidation or liquidation of the Company, the Board shall, in its sole discretion, in connection with the Board's adoption of the plan for sale, merger, exchange, consolidation or liquidation, provide for one or more of the following: (i) the acceleration of the exercisability of any or all outstanding Stock Options; (ii) the complete termination of this Plan and cancellation of outstanding Stock Options not exercised prior to a date specified by the Board (which date shall give optionees a reasonable period of time in which to exercise vested options prior to the effectiveness of such sale, merger, exchange, consolidation or liquidation); and (iii) the continuance of the Plan with respect to the exercise of options which were outstanding as of the date of adoption by the Board of such plan for sale, merger, exchange, consolidation or liquidation and provide to optionees holding such options the right to exercise their respective options as to an equivalent number of shares of stock of the corporation succeeding the Company by reason of such sale, merger, exchange, consolidation or liquidation. The grant of an option pursuant to the Plan shall not limit in any way the right or power of the Company to make adjustments, reclassifications, reorganizations or changes of its capital or business structure or to merge, exchange or consolidate or to dissolve, liquidate, sell or transfer all or any part of its business or assets.

(d) Method of Exercise. Stock Options may be exercised in whole or in part at any time during the option period by giving written notice of exercise to the Company specifying the number of shares to be purchased. Such notice shall be accompanied by payment in full of the purchase price, either by check, or by any other form of legal consideration deemed sufficient by the Committee and consistent with the Plan's purpose and applicable law, including promissory notes or a properly executed exercise notice together with irrevocable instructions to a broker acceptable to the Company to promptly deliver to the Company the amount of sale or loan proceeds to pay the exercise price. As determined by the Committee at the time of grant or exercise, in its sole discretion, payment in full or in part may also be made in the form of Stock already owned by the optionee (which have been owned for more than six months on the date of surrender) or, in the case of the exercise of a Non-Qualified Stock Option, by delivery of Restricted Stock or Deferred Stock subject to an award hereunder (based, in each case, on the Fair Market Value of the Stock on the date the option is exercised, as determined by the Committee), provided, however, that, in the case of an Incentive Stock Option, the right to make a payment in the form of already owned shares may be authorized only at the time the option is granted, and provided further that in the event payment is made in the form of shares of Restricted Stock or a Deferred Stock award, the optionee will receive a portion of the option shares in the form of, and in an amount equal to, the Restricted Stock or Deferred Stock award tendered as payment by the optionee. If the terms of an option so permit, an optionee may elect to pay all or part of the option exercise price by having the Company withhold from the shares of Stock that would otherwise be issued upon exercise that number of shares of Stock having a Fair Market Value equal to the aggregate option exercise price for the shares with respect to which such election is made. No shares of Stock shall be issued until full payment therefor has been made. An optionee shall generally have the rights to dividends and other rights of a shareholder with respect to shares subject to the option when the optionee has given written notice of exercise, has paid in full for such shares, and, if requested, has given the representation described in paragraph (a) of Section 12.

(e) Non-transferability of Options. No Stock Option shall be transferable by the optionee otherwise than by will or by the laws of descent and distribution, and all Stock Options shall be exercisable, during the optionee's lifetime, only by the optionee.

(f) Termination by Death. If an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates by reason of death, the Stock Option may thereafter be immediately exercised, to the extent then exercisable, by the legal representative of the estate or by the legatee of the optionee under the will of the optionee, for a period of three years from the date of such death or until the expiration of the stated term of the option, whichever period is shorter.



(g) Termination by Reason of Disability. If an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates by reason of Disability, any Stock Option held by such optionee may thereafter be exercised, to the extent it was exercisable at the time of termination due to Disability, but may not be exercised after one year from the date of such termination of employment or the expiration of the stated term of the option, whichever period is the shorter. In the event of termination of employment by reason of Disability, if an Incentive Stock Option is exercised after the expiration of the exercise periods that apply for purposes of Section 422 of the Code, the option will thereafter be treated as a Non-Qualified Stock Option.

(h) Termination by Reason of Retirement. If an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates by reason of Retirement, any Stock Option held by such optionee may thereafter be exercised to the extent it was exercisable at the time of such Retirement, but may not be exercised after one year from the date of such termination of employment or the expiration of the stated term of the option, whichever period is the shorter. In the event of termination of employment by reason of Retirement, if an Incentive Stock Option is exercised after the expiration of the exercise periods that apply for purposes of Section 422 of the Code, the option will thereafter be treated as a Non-Qualified Stock Option.

(i) Other Termination. Unless otherwise determined by the Committee, if an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates for any reason other than death, Disability or Retirement, the Stock Option shall thereupon terminate, except that, if the optionee is involuntarily terminated without Cause by the Company and any Subsidiary or Parent Corporation, the option may be exercised to the extent it was exercisable at such termination for the lesser of three months or the balance of the option's term.

(j) Annual Limit on Incentive Stock Options. The aggregate Fair Market Value (determined as of the time the Stock Option is granted) of the Common Stock with respect to which an Incentive Stock Option under this Plan or any other plan of the Company and any Subsidiary or Parent Corporation is exercisable for the first time by an optionee during any calendar year shall not exceed \$100,000.

#### SECTION 6. Stock Appreciation Rights.

(a) Grant and Exercise. Stock Appreciation Rights may be granted in conjunction with all or part of any Stock Option granted under the Plan. In the case of a Non-Qualified Stock Option, such rights may be granted either at or after the time of the grant of such Option. In the case of an Incentive Stock Option, such rights may be granted only at the time of the grant of the option.

A Stock Appreciation Right or applicable portion thereof granted with respect to a given Stock Option shall terminate and no longer be exercisable upon the termination or exercise of the related Stock Option, except that a Stock Appreciation Right granted with respect to less than the full number of shares covered by a related stock Option shall not be reduced until the exercise or termination of the related Stock Option exceeds the number of shares not covered by the Stock Appreciation Right.

A Stock Appreciation Right may be exercised by an optionee, in accordance with paragraph (b) of this Section 6, by surrendering the applicable portion of the related Stock Option. Upon such exercise and surrender, the optionee shall be entitled to receive an amount determined in the manner prescribed in paragraph (b) of this Section 6. Stock Options which have been so surrendered, in whole or in part, shall no longer be exercisable to the extent the related Stock Appreciation Rights have been exercised.

(b) Terms and Conditions. Stock Appreciation Rights shall be subject to such terms and conditions, not inconsistent with the provisions of the Plan, as shall be determined from time to time by the Committee, including the following:

(i) Stock Appreciation Rights shall be exercisable only at such time or times and to the extent that the Stock Options to which they relate shall be exercisable in accordance with the provisions of Section 5 and this Section 6 of the Plan.

(ii) Upon the exercise of a Stock Appreciation Right, an optionee shall be entitled to receive up to, but not more than, an amount in cash or shares of Stock equal in value to the excess of the Fair Market Value of one share of Stock over the option price per share specified in the related option multiplied by the number of shares in respect of which the Stock Appreciation Right shall have been exercised, with the Committee having the right to determine the form of payment.

(iii) Stock Appreciation Rights shall be transferable only when and to the extent that the underlying Stock Option would be transferable under Section 5 of the Plan.

(iv) Upon the exercise of a Stock Appreciation Right, the Stock Option or part thereof to which such Stock Appreciation Right is related shall be deemed to have been exercised for the purpose of the limitation set forth in Section 3 of the Plan on the number of shares of Stock to be issued under the Plan, but only to the extent of the number of shares issued or issuable under the Stock Appreciation Right at the time of exercise based on the value of the Stock Appreciation Right at such time.

(v) A Stock Appreciation Right granted in connection with an Incentive Stock Option may be exercised only if and when the market price of the Stock subject to the Incentive Stock Option exceeds the exercise price of such Option.

#### SECTION 7. Restricted Stock.

(a) Administration. Shares of Restricted Stock may be issued either alone or in addition to other awards granted under the Plan. The Committee shall determine the officers, key employees, members of the Board of Directors and Consultants of the Company and Subsidiaries to whom, and the time or times at which, grants of Restricted Stock will be made, the number of shares to be awarded, the time or times within which such awards may be subject to forfeiture, and all other conditions of the awards. The Committee may also condition the grant of Restricted Stock upon the attainment of specified performance goals. The provisions of Restricted Stock awards need not be the same with respect to each recipient.

(b) Awards and Certificates. The prospective recipient of an award of shares of Restricted Stock shall not have any rights with respect to such award, unless and until such recipient has executed an agreement evidencing the award and has delivered a fully executed copy thereof to the Company, and has otherwise complied with the then applicable terms and conditions.

(i) Each participant shall be issued a stock certificate in respect of shares of Restricted Stock awarded under the Plan. Such certificate shall be registered in the name of the participant, and shall bear an appropriate legend referring to the terms, conditions, and restrictions applicable to such award, substantially in the following form:

“The transferability of this certificate and the shares of stock represented hereby are subject to the terms and conditions (including forfeiture) of the RTW, Inc. 1994 Stock Plan and an Agreement entered into between the registered owner and RTW, Inc. Copies of such Plan and Agreement are on file in the offices of RTW, Inc., 8500 Normandale Lake Boulevard, Minneapolis, MN 55437.”

(ii) The Committee shall require that the stock certificates evidencing such shares be held in custody by the Company until the restrictions thereon shall have lapsed, and that, as a condition of any Restricted Stock award, the participant shall have delivered a stock power, endorsed in blank, relating to the Stock covered by such award.

(c) Restrictions and Conditions. The shares of Restricted Stock awarded pursuant to the Plan shall be subject to the following restrictions and conditions:

(i) Subject to the provisions of this Plan and the award agreement, during a period set by the Committee commencing with the date of such award (the "Restriction Period"), the participant shall not be permitted to sell, transfer, pledge or assign shares of Restricted Stock awarded under the Plan. In no event shall the Restriction Period be less than one (1) year. Within these limits, the Committee may provide for the lapse of such restrictions in installments where deemed appropriate.

(ii) Except as provided in paragraph (c)(i) of this Section 7, the participant shall have, with respect to the shares of Restricted Stock, all of the rights of a shareholder of the Company, including the right to vote the shares and the right to receive any cash dividends. The Committee, in its sole discretion, may permit or require the payment of cash dividends to be deferred and, if the Committee so determines, reinvested in additional shares of Restricted Stock (to the extent shares are available under Section 3 and subject to paragraph (f) of Section 12). Certificates for shares of unrestricted Stock shall be delivered to the grantee promptly after, and only after, the period of forfeiture shall have expired without forfeiture in respect of such shares of Restricted Stock.

(iii) Subject to the provisions of the award agreement and paragraph (c)(iv) of this Section 7, upon termination of employment for any reason during the Restriction Period, all shares still subject to restriction shall be forfeited by the participant.

(iv) In the event of special hardship circumstances of a participant whose employment is terminated (other than for Cause), including death, Disability or Retirement, or in the event of an unforeseeable emergency of a participant still in service, the Committee may, in its sole discretion, when it finds that a waiver would be in the best interest of the Company, waive in whole or in part any or all remaining restrictions with respect to such participant's shares of Restricted Stock.

(v) Notwithstanding the foregoing, in the event of the sale by the Company of substantially all of its assets and the consequent discontinuance of its business, or in the event of a merger, exchange, consolidation or liquidation of the Company, the Board shall, in its sole discretion, in connection with the Board's adoption of the plan for sale, merger, exchange, consolidation or liquidation, provide for one or more of the following with respect to Restricted Stock Awards that are, on such date, still subject to a Restriction Period: (i) the removal of the restrictions on any or all outstanding Restricted Stock Awards; (ii) the complete termination of this Plan and forfeiture of outstanding Restricted Stock Awards prior to a date specified by the Board; and (iii) the continuance of the Plan with respect to the Restricted Stock Award which were outstanding as of the date of adoption by the Board of such plan for sale, merger, exchange, consolidation or liquidation and provide to participants holding Restricted Stock Awards the right to an equivalent number of restricted shares of stock of the corporation succeeding the Company by reason of such sale, merger, exchange, consolidation or liquidation. The grant of a Restricted Stock Award pursuant to the Plan shall not limit in any way the right or power of the Company to make adjustments, reclassifications, reorganizations or changes of its capital or business structure or to merge, exchange or consolidate or to dissolve, liquidate, sell or transfer all or any part of its business or assets.

#### SECTION 8. Deferred Stock Awards.

(a) Administration. Deferred Stock may be awarded either alone or in addition to other awards granted under the Plan. The Committee shall determine the officers, key employees, members of the Board of Directors and Consultants of the Company and Subsidiaries to whom and the time or times at which Deferred Stock shall be awarded, the number of Shares of Deferred Stock to be awarded to any participant or group of participants, the duration of the period (the "Deferral Period") during which, and the conditions under which, receipt of the Stock will be deferred, and the terms and conditions of the award in addition to those contained in paragraph (b) of this

Section 8. The Committee may also condition the grant of Deferred Stock upon the attainment of specified performance goals. The provisions of Deferred Stock awards need not be the same with respect to each recipient.

(b) Terms and Conditions.

(i) Subject to the provisions of this Plan and the award agreement, Deferred Stock awards may not be sold, assigned, transferred, pledged or otherwise encumbered during the Deferral Period. In no event shall the Deferral Period be less than one (1) year. At the expiration of the Deferral Period (or Elective Deferral Period, where applicable), share certificates shall be delivered to the participant, or his legal representative, in a number equal to the shares covered by the Deferred Stock award.

(ii) Amounts equal to any dividends declared during the Deferral Period with respect to the number of shares covered by a Deferred Stock award will be paid to the participant currently or deferred and deemed to be reinvested in additional Deferred Stock or otherwise reinvested, all as determined at the time of the award by the Committee, in its sole discretion.

(iii) Subject to the provisions of the award agreement and paragraph (b)(iv) of this Section 8, upon termination of employment for any reason during the Deferral Period for a given award, the Deferred Stock in question shall be forfeited by the participant.

(iv) In the event of special hardship circumstances of a participant whose employment is terminated (other than for Cause) including death, Disability or Retirement, or in the event of an unforeseeable emergency of a participant still in service, the Committee may, in its sole discretion, when it finds that a waiver would be in the best interest of the Company, waive in whole or in part any or all of the remaining deferral limitations imposed hereunder with respect to any or all of the participant's Deferred Stock.

(v) A participant may elect to further defer receipt of the award for a specified period or until a specified event (the "Elective Deferral Period"), subject in each case to the Committee's approval and to such terms as are determined by the Committee, all in its sole discretion. Subject to any exceptions adopted by the Committee, such election must generally be made prior to completion of one half of the Deferral Period for a Deferred Stock award (or for an installment of such an award).

(vi) Each award shall be confirmed by, and subject to the terms of, a Deferred Stock agreement executed by the Company and the participant.

SECTION 9. Transfer, Leave of Absence, etc.

For purposes of the Plan, the following events shall not be deemed a termination of employment:

(a) a transfer of an employee from the Company to a Parent Corporation or Subsidiary, or from a Parent Corporation or Subsidiary to the Company, or from one Subsidiary to another;

(b) a leave of absence, approved in writing by the Committee, for military service or sickness, or for any other purpose approved by the Company if the period of such leave does not exceed ninety (90) days (or such longer period as the Committee may approve, in its sole discretion); and

(c) a leave of absence in excess of ninety (90) days, approved in writing by the Committee, but only if the employee's right to reemployment is guaranteed either by a statute or by contract, and provided that, in the case of any leave of absence, the employee returns to work within 30 days after the end of such leave.

**SECTION 10. Amendments and Termination.**

The Board may amend, alter, or discontinue the Plan, but no amendment, alteration, or discontinuation shall be made (i) which would impair the rights of an optionee or participant under a Stock Option, Restricted Stock or other Stock-based award theretofore granted, without the optionee's or participant's consent, or (ii) which without the approval of the stockholders of the Company would cause the Plan to no longer comply with Rule 16b-3 under the Securities Exchange Act of 1934, Section 422 of the Code or any other regulatory requirements.

The Committee may amend the terms of any award or option theretofore granted, prospectively or retroactively, but no such amendment shall impair the rights of any holder without his or her consent except to the extent authorized under the Plan. The Committee may also substitute new Stock Options for previously granted options, including previously granted options having higher option prices.

**SECTION 11. Unfunded Status of 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 or optionee by the Company, nothing contained herein shall give any such participant or optionee 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 Stock 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.

**SECTION 12. General Provisions.**

(a) The Committee may require each person purchasing shares pursuant to a Stock Option under the Plan to represent to and agree with the Company in writing that the optionee is acquiring the shares without a view to distribution thereof. The certificates for such shares may include any legend which the Committee deems appropriate to reflect any restrictions on transfer.

All certificates for shares of Stock delivered under the Plan pursuant to any Restricted Stock, Deferred Stock or other Stock-based awards shall be subject to such stock-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 Stock is then listed, and any applicable Federal or state securities laws, and the Committee may cause a legend or legends to be put on any such certificates to make appropriate reference to such restrictions.

(b) Subject to paragraph (d) below, recipients of Restricted Stock, Deferred Stock and other Stock-based awards under the Plan (other than Stock Options) are not required to make any payment or provide consideration other than the rendering of services.

(c) Nothing contained in this Plan shall prevent the Board of Directors 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. The adoption of the Plan shall not confer upon any employee of the Company or any Subsidiary any right to continued employment with the Company or a Subsidiary, as the case may be, nor shall it interfere in any way with the right of the Company or a Subsidiary to terminate the employment of any of its employees at any time.

(d) Each participant shall, no later than the date as of which any part of the value of an award first becomes includible as compensation in the gross income of the participant for Federal income tax purposes, pay to the Company, or make arrangements satisfactory to the Committee regarding payment of, any Federal, state, or local taxes of any kind required by law to be withheld with respect to the award. The obligations of the Company under the Plan shall be conditional on such payment or arrangements and the Company and Subsidiaries shall, to the extent permitted by law, have the right to deduct any such taxes from any payment of any kind otherwise due to the participant. With respect to any award under the Plan, if the terms of such award so permit, a participant may elect

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by written notice to the Company to satisfy part or all of the withholding tax requirements associated with the award by (i) authorizing the Company to retain from the number of shares of Stock that would otherwise be deliverable to the participant, or (ii) delivering to the Company from shares of Stock already owned by the participant, that number of shares having an aggregate Fair Market Value equal to part or all of the tax payable by the participant under this Section 12(d). Any such election shall be in accordance with, and subject to, applicable tax and securities laws, regulations and rulings.

(e) At the time of grant, the Committee may provide in connection with any grant made under this Plan that the shares of Stock received as a result of such grant shall be subject to a repurchase right in favor of the Company, pursuant to which the participant shall be required to offer to the Company upon termination of employment for any reason any shares that the participant acquired under the Plan, with the price being the then Fair Market Value of the Stock or, in the case of a termination for Cause, an amount equal to the cash consideration paid for the Stock, subject to such other terms and conditions as the Committee may specify at the time of grant. The Committee may, at the time of the grant of an award under the Plan, provide the Company with the right to repurchase, or require the forfeiture of, shares of Stock acquired pursuant to the Plan by any participant who, at any time within two years after termination of employment with the Company, directly or indirectly competes with, or is employed by a competitor of, the Company.

(f) The reinvestment of dividends in additional Restricted Stock (or in Deferred Stock or other types of Plan awards) at the time of any dividend payment shall only be permissible if the Committee (or the Company's chief financial officer) certifies in writing that under Section 3 sufficient shares are available for such reinvestment (taking into account then outstanding Stock Options and other Plan awards).

**SECTION 13. Effective Date of Plan.**

The Plan shall be effective on the date it is approved by a vote of the holders of a majority of the Stock present and entitled to vote at a meeting of the Company's shareholders.



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**Exhibit 10.2**

RTW, INC.  
2005 STOCK PLAN  
(as amended through June 14, 2006)

SECTION 1. General Purpose of Plan; Definitions.

The name of this plan is the RTW, Inc. 2005 Stock Plan (the "Plan"). The purpose of the Plan is to enable RTW, Inc. (the "Company") and its Subsidiaries to retain and attract executives and other key employees, directors and consultants who contribute to the Company's success by their ability, ingenuity and industry, and to enable these individuals to participate in the long-term success and growth of the Company by giving them a proprietary interest in the Company.

For purposes of the Plan, the following terms are defined as set forth below:

- a. "Board" means the Board of Directors of the Company as it may be comprised from time to time.
- b. "Cause" means a felony conviction of a participant or the failure of a participant to contest prosecution for a felony, willful misconduct, dishonesty or intentional violation of a statute, rule or regulation, any of which, in the judgment of the Company, is harmful to the business or reputation of the Company.
- c. "Code" means the Internal Revenue Code of 1986, as amended from time to time, or any successor statute.
- d. "Committee" means the Committee referred to in Section 2 of the Plan.
- e. "Consultant" means any person performing services for the Company or any Parent Corporation or Subsidiary of the Company and who is not an employee of the Company or any Parent Corporation or Subsidiary of the Company.
- f. "Company" means RTW, Inc., a corporation organized under the laws of the State of Minnesota (or any successor corporation).
- g. "Deferred Stock" means an award made pursuant to Section 8 below of the right to receive stock at the end of a specified deferral period.
- h. "Disability" means permanent and total disability as determined by the Committee.
- i. "Early Retirement" means retirement, with consent of the Committee at the time of retirement, from active employment with the Company and any Subsidiary or Parent Corporation of the Company.
- j. "Fair Market Value" of Stock on any given date will be determined by the Committee as follows: (a) if the Stock is listed for trading on one or more national securities exchanges, or is traded on the Nasdaq Stock Market, the last reported sale price on the principal such exchange or the Nasdaq Stock Market on the date in question, or if the Stock has been traded on such principal exchange on such date, the last reported sales price on such principal exchange or the Nasdaq Stock Market on the first day prior thereto on which such Stock was so traded; or (b) if the Stock is not listed for trading on a national securities exchange or the Nasdaq Stock Market, but is traded in the over-the-counter market, including the Nasdaq System, the closing bid price for such Stock on the date in question, or if there is no such bid price for such Stock on such date, the closing bid price on the first day prior thereto on which such price existed; or (c) if neither (a) or (b) is applicable, by any means fair and reasonable by the Committee, which determination will be final and binding on all parties.
- k. "Incentive Stock Option" means any Stock Option intended to be and designated as an "Incentive Stock Option" within the meaning of Section 422 of the Code.



- l. “Non-Employee Director” means a “Non-Employee Director” within the meaning of Rule 16b-3(b)(3) under the Securities Exchange Act of 1934.
- m. “Non-Qualified Stock Option” means any Stock Option that is not an Incentive Stock Option, and is intended to be and is designated as a “Non-Qualified Stock Option.”
- n. “Normal Retirement” means retirement from active employment with the Company and any Subsidiary or Parent Corporation of the Company on or after age [60].
- o. “Outside Director” means a Director who: (a) is not a current employee of the Company or any member of an affiliated group which includes the Company; (b) is not a former employee of the Company who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year; (c) has not been an officer of the Company; (d) does not receive remuneration from the Company, either directly or indirectly, in any capacity other than as a director, except as otherwise permitted under Code Section 162(m) and regulations thereunder. For this purpose, remuneration includes any payment in exchange for good or services. This definition will be further governed by the provisions of Code Section 162(m) and regulations promulgated thereunder.
- p. “Parent Corporation” means any corporation (other than the Company) in an unbroken chain of corporations ending with the Company if each of the corporations (other than the Company) owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in the chain.
- q. “Restricted Stock” means an award of shares of Stock that are subject to restrictions under Section 7 below.
- r. “Retirement” means Normal Retirement or Early Retirement.
- s. “Stock” means the Common Stock of the Company.
- t. “Stock Appreciation Right” means the right pursuant to an award granted under Section 6 below to surrender to the Company all or a portion of a Stock Option in exchange for an amount equal to the difference between (i) Fair Market Value, as of the date such Stock Option or such portion thereof is surrendered, of the shares of Stock covered by such Stock Option or such portion thereof, and (ii) the aggregate exercise price of such Stock Option or such portion thereof.
- u. “Stock Option” means any option to purchase shares of Stock granted pursuant to Section 5 below.
- v. “Subsidiary” means any corporation (other than the Company) in an unbroken chain of corporations beginning with the Company if each of the corporations (other than the last corporation in the unbroken chain) owns stock possessing 50% or more of the total combined voting power of all classes of stock in one of the other corporations in the chain.

SECTION 2. Administration.

The Plan will be administered by the Board of Directors or by a Committee appointed by the Board of Directors, consisting of not less than two Directors, all of whom must be Outside Directors and Non-Employee Directors, and who serve at the pleasure of the Board. Any or all of the functions of the Committee specified in the Plan may be exercised by the Board, unless the Plan specifically states otherwise.

The Committee has the power and authority to grant to eligible employees, members of the Board of Directors,

or Consultants, pursuant to the terms of the Plan: (i) Stock Options, (ii) Stock Appreciation Rights, (iii) Restricted Stock, or (iv) Deferred Stock awards.

In particular, the Committee has the authority:

- (i) to select the officers and other key employees of the Company and its Subsidiaries and other eligible persons to whom Stock Options, Stock Appreciation Rights, Restricted Stock and Deferred Stock awards may from time to time be granted hereunder;
- (ii) to determine whether and to what extent Incentive Stock Options, Non-Qualified Stock Options, Stock Appreciation Rights, Restricted Stock and Deferred Stock awards, or a combination of the foregoing, are to be granted hereunder;
- (iii) to determine the number of shares to be covered by each such award granted hereunder;
- (iv) to determine the terms and conditions, not inconsistent with the terms of the Plan, of any award granted hereunder (including, but not limited to, any restriction on any Stock Option or other award and the shares of Stock relating thereto); and
- (v) to determine whether, to what extent and under what circumstances Stock and other amounts payable with respect to an award under this Plan may be deferred either automatically or at the election of the participant.

The Committee will have the authority to adopt, alter and repeal such administrative rules, guidelines and practices governing the Plan as it may, from time to time, deem advisable; to interpret the terms and provisions of the Plan and any award issued under the Plan (and any agreements relating thereto); and to otherwise supervise the administration of the Plan. The Committee may delegate to executive officers of the Company the authority to exercise the powers specified in (i), (ii), (iii), (iv), and (v) above with respect to persons who are not executive officers of the Company.

All decisions made by the Committee pursuant to the provisions of the Plan will be final and binding on all persons, including the Company and Plan participants.

**SECTION 3. Stock Subject to Plan.**

The total number of shares of Stock reserved and available for distribution under the Plan will be 300,000 shares. These shares may consist, in whole or in part, of authorized and unissued shares.

Subject to paragraph (b)(iv) of Section 6 below, if any shares that have been optioned cease to be subject to Stock Options, or if any shares subject to any Restricted Stock or Deferred Stock award granted hereunder are forfeited or such award otherwise terminates without a payment being made to the participant, the shares will again be available for distribution in connection with future awards under the Plan.

In the event of any merger, reorganization, consolidation, recapitalization, stock dividend, other change in corporate structure affecting the Stock, or spin-off or other distribution of assets to shareholders, such substitution or adjustment will be made in the aggregate number of shares reserved for issuance under the Plan, in the number and option price of shares subject to outstanding options granted under the Plan, and in the number of shares subject to Restricted Stock or Deferred Stock awards granted under the Plan as may be determined to be appropriate by the Committee, in its sole discretion, with the number of shares subject to any award always being a whole number. Such adjusted option price will also be used to determine the amount payable by the Company upon the exercise of any Stock Appreciation Right associated with any Option.

SECTION 4. Eligibility.

Officers, other key employees of the Company and Subsidiaries, Directors and Consultants who are responsible for or contribute to the management, growth and profitability of the business of the Company and its Subsidiaries are eligible to be granted Stock Options, Stock Appreciation Rights, Restricted Stock or Deferred Stock awards under the Plan. The optionees and participants under the Plan will be selected from time to time by the Committee, in its sole discretion, from among those eligible, and the Committee may determine, in its sole discretion, the number of shares covered by each award.

Notwithstanding the foregoing, no person may, during any fiscal year of the Company, receive grants of Stock Options, Stock Appreciation Rights, Restricted Stock Awards or Deferred Stock Awards under this Plan that, in the aggregate, exceed 100,000 shares.

SECTION 5. Stock Options.

Any Stock Option granted under the Plan will be in such form as the Committee may from time to time approve.

The Stock Options granted under the Plan may be of two types: (i) Incentive Stock Options and (ii) Non-Qualified Stock Options. No Incentive Stock Options may be granted more than 10 years after the earlier of (i) the date the Plan is adopted by the Board and (ii) the date the Plan is approved by the shareholders. If the Plan is amended to increase the number of shares authorized for issuance, this 10-year period will automatically be extended to allow the granting of Incentive Stock Option for the additional shares for an additional 10 years from the earlier of (i) the date the amendment is adopted by the Board and (ii) the date it the amendment is approved by the shareholders.

The Committee has the authority to grant any optionee Incentive Stock Options, Non-Qualified Stock Options, or both types of options (in each case with or without Stock Appreciation Rights). To the extent that any option does not qualify as an Incentive Stock Option, it will constitute a separate Non-Qualified Stock Option.

Anything in the Plan to the contrary notwithstanding, no term of this Plan relating to Incentive Stock Options may be interpreted, amended or altered, nor may any discretion or authority granted under the Plan be so exercised, so as to disqualify either the Plan or any Incentive Stock Option under Section 422 of the Code. The preceding sentence does not preclude any modification or amendment to an outstanding Incentive Stock Option, whether or not such modification or amendment results in disqualification of such Option as an Incentive Stock Option if the optionee consents in writing to the modification or amendment.

Options granted under the Plan will be subject to the following terms and conditions and may contain such additional terms and conditions, not inconsistent with the terms of the Plan, as the Committee deems desirable.

(a) Option Price. The option price per share of Stock purchasable under a Stock Option will be determined by the Committee at the time of grant. In no event may the option price per share of Stock purchasable under a Stock Option be less than 100% of the Fair Market Value of the Stock on the date of the grant. If an employee owns or is deemed to own (by reason of the attribution rules applicable under Section 424(d) of the Code) more than 10% of the combined voting power of all classes of stock of the Company or any Parent Corporation or Subsidiary and an Incentive Stock Option is granted to such employee, the option price may be no less than 110% of the Fair Market Value of the Stock on the date the option is granted.

(b) Option Term. The term of each Stock Option will be fixed by the Committee, but no Incentive Stock Option may be exercisable more than ten years after the date the option is granted. If an employee owns or is deemed to own (by reason of the attribution rules of Section 424(d) of the Code) more than 10% of the combined voting power of all classes of stock of the Company or any Parent Corporation or Subsidiary and an Incentive Stock Option is granted to such employee, the term of such option may be no more than five years from the date of grant.

(c) Exercisability. Stock Options will be exercisable at such time or times as determined by the Committee at or after grant. If the Committee provides, in its discretion, that any option is exercisable only in

installments, the Committee may waive such installment exercise provisions at any time. Notwithstanding anything contained in the Plan to the contrary, the Committee may, in its discretion, extend or vary the term of any Stock Option or any installment thereof, whether or not the optionee is then employed by the Company, if such action is deemed to be in the best interests of the Company. Notwithstanding anything contained in the Plan to the contrary, in the event of the sale by the Company of substantially all of its assets and the consequent discontinuance of its business, or in the event of a merger, exchange, consolidation or liquidation of the Company, the Board may, in its sole discretion, in connection with the Board's adoption of the plan for sale, merger, exchange, consolidation or liquidation, provide for one or more of the following: (i) the acceleration of the exercisability of any or all outstanding Stock Options; (ii) the complete termination of this Plan and cancellation of outstanding Stock Options not exercised prior to a date specified by the Board (which date must give optionees a reasonable period of time in which to exercise vested options prior to the effectiveness of such sale, merger, exchange, consolidation or liquidation); and (iii) the continuance of the Plan with respect to the exercise of options that were outstanding as of the date of adoption by the Board of such plan for sale, merger, exchange, consolidation or liquidation and provide to optionees holding such options the right to exercise their respective options as to an equivalent number of shares of stock of the corporation succeeding the Company by reason of such sale, merger, exchange, consolidation or liquidation. The grant of an option pursuant to the Plan will not limit in any way the right or power of the Company to make adjustments, reclassifications, reorganizations or changes of its capital or business structure or to merge, exchange or consolidate or to dissolve, liquidate, sell or transfer all or any part of its business or assets.

(d) Method of Exercise. Stock Options may be exercised in whole or in part at any time during the option period by giving written notice of exercise to the Company specifying the number of shares to be purchased. The notice must be accompanied by payment in full of the purchase price, either by check, or by any other form of legal consideration deemed sufficient by the Committee and consistent with the Plan's purpose and applicable law, including a properly executed exercise notice together with irrevocable instructions to a broker acceptable to the Company to promptly deliver to the Company the amount of sale or loan proceeds to pay the exercise price. As determined by the Committee at the time of grant or exercise, in its sole discretion, payment in full or in part may also be made in the form of Stock already owned by the optionee (which has been owned for more than six months on the date of surrender) or, in the case of the exercise of a Non-Qualified Stock Option, by delivery of Restricted Stock or Deferred Stock subject to an award hereunder (based, in each case, on the Fair Market Value of the Stock on the date the option is exercised, as determined by the Committee). In the case of an Incentive Stock Option, the right to make a payment in the form of already owned shares may be authorized only at the time the option is granted, and that in the event payment is made in the form of shares of Restricted Stock or a Deferred Stock award, the optionee will receive a portion of the option shares in the form of, and in an amount equal to, the Restricted Stock or Deferred Stock award tendered as payment by the optionee. If the terms of an option so permit, an optionee may elect to pay all or part of the option exercise price by having the Company withhold from the shares of Stock that would otherwise be issued upon exercise that number of shares of Stock having a Fair Market Value equal to the aggregate option exercise price for the shares with respect to which such election is made. No shares of Stock may be issued until full payment for the shares has been made. An optionee will generally have the rights to dividends and other rights of a shareholder with respect to shares subject to the option when the optionee has given written notice of exercise, has paid in full for such shares, and, if requested, has given the representation described in paragraph (a) of Section 12.

(e) Non-transferability of Options. (i) No Incentive Stock Option is transferable by the optionee otherwise than by will or by the laws of descent and distribution, and all Stock Options will be exercisable, during the optionee's lifetime, only by the optionee; and (ii) The Committee may, in its discretion, authorize all or a portion of any Nonqualified Stock Options to be granted to an optionee to be on terms that permit transfer by such optionee to (A) the spouse, children or grandchildren of the optionee ("Immediate Family Members"), (B) a trust or trusts for the exclusive benefit of such Immediate Family Members, or (C) a partnership or partnerships in which such Immediate Family Members are the only partners, if (1) there may be no consideration for any such transfer, (2) the Agreement pursuant to which such options are granted must be approved by the Committee, and must expressly provide for transferability in a manner consistent with this Section 5(f)(ii), and (3) subsequent transfers of transferred options will be prohibited except those in accordance with Section 5(f)(i). Following transfer, any such options will continue to be subject to the same terms and conditions as were applicable immediately prior to transfer, but (i) the term "optionee" will in such event be deemed to refer to the transferee, and (ii) the events of termination

of employment of Sections 5(g), 5(h) and 5(i) hereof will continue to be applied with respect to the original optionee, following which the options will be exercisable by the transferee only to the extent, and for the periods specified in such Sections.

(f) Termination by Death. If an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates by reason of death, the Stock Option may thereafter be immediately exercised, to the extent then exercisable, by the legal representative of the estate or by the legatee of the optionee under the will of the optionee, for a period of three years from the date of such death or until the expiration of the stated term of the option, whichever period is shorter.

(g) Termination by Reason of Disability. If an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates by reason of Disability, any Stock Option held by such optionee may thereafter be exercised, to the extent it was exercisable at the time of termination due to Disability, but may not be exercised after one year from the date of such termination of employment or the expiration of the stated term of the option, whichever period is the shorter. In the event of termination of employment by reason of Disability, if an Incentive Stock Option is exercised after the expiration of the exercise periods that apply for purposes of Section 422 of the Code, the option will thereafter be treated as a Non-Qualified Stock Option.

(h) Termination by Reason of Retirement. If an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates by reason of Retirement, any Stock Option held by such optionee may thereafter be exercised to the extent it was exercisable at the time of such Retirement, but may not be exercised after one year from the date of such termination of employment or the expiration of the stated term of the option, whichever period is the shorter. In the event of termination of employment by reason of Retirement, if an Incentive Stock Option is exercised after the expiration of the exercise periods that apply for purposes of Section 422 of the Code, the option will thereafter be treated as a Non-Qualified Stock Option.

(i) Other Termination. Unless otherwise determined by the Committee, if an optionee's employment by the Company and any Subsidiary or Parent Corporation terminates for any reason other than death, Disability or Retirement, the Stock Option will thereupon terminate, except that, if the optionee is involuntarily terminated without Cause by the Company and any Subsidiary or Parent Corporation, the option may be exercised to the extent it was exercisable at such termination for the lesser of three months or the balance of the option's term.

(j) Annual Limit on Incentive Stock Options. The aggregate Fair Market Value (determined as of the time the Stock Option is granted) of the Common Stock with respect to which an Incentive Stock Option under this Plan or any other plan of the Company and any Subsidiary or Parent Corporation is exercisable for the first time by an optionee during any calendar year may not exceed \$100,000.

#### SECTION 6. Stock Appreciation Rights.

(a) Grant and Exercise. Stock Appreciation Rights may be granted in conjunction with all or part of any Stock Option granted under the Plan. In the case of a Non-Qualified Stock Option, these rights may be granted either at or after the time of the grant of such Option. In the case of an Incentive Stock Option, such rights may be granted only at the time of the grant of the option.

A Stock Appreciation Right or applicable portion thereof granted with respect to a given Stock Option will terminate and no longer be exercisable upon the termination or exercise of the related Stock Option, except that a Stock Appreciation Right granted with respect to less than the full number of shares covered by a related stock Option will not be reduced until the exercise or termination of the related Stock Option exceeds the number of shares not covered by the Stock Appreciation Right.

A Stock Appreciation Right may be exercised by an optionee, in accordance with paragraph (b) of this Section 6, by surrendering the applicable portion of the related Stock Option. Upon such exercise and surrender, the optionee will be entitled to receive an amount determined in the manner prescribed in paragraph (b) of this Section 6. Stock Options that have been so surrendered, in whole or in part, will no longer be exercisable to the extent the

related Stock Appreciation Rights have been exercised.

(b) **Terms and Conditions.** Stock Appreciation Rights will be subject to such terms and conditions, not inconsistent with the provisions of the Plan, as may be determined from time to time by the Committee, including the following:

(i) Stock Appreciation Rights will be exercisable only at such time or times and to the extent that the Stock Options to which they relate are exercisable in accordance with the provisions of Section 5 and this Section 6 of the Plan.

(ii) Upon the exercise of a Stock Appreciation Right, an optionee will be entitled to receive up to, but not more than, an amount in cash or shares of Stock equal in value to the excess of the Fair Market Value of one share of Stock over the option price per share specified in the related option multiplied by the number of shares in respect of which the Stock Appreciation Right has been exercised, with the Committee having the right to determine the form of payment.

(iii) Stock Appreciation Rights will be transferable only when and to the extent that the underlying Stock Option would be transferable under Section 5 of the Plan.

(iv) Upon the exercise of a Stock Appreciation Right, the Stock Option or part thereof to which such Stock Appreciation Right is related will be deemed to have been exercised for the purpose of the limitation set forth in Section 3 of the Plan on the number of shares of Stock to be issued under the Plan, but only to the extent of the number of shares issued or issuable under the Stock Appreciation Right at the time of exercise based on the value of the Stock Appreciation Right at such time.

(v) A Stock Appreciation Right granted in connection with an Incentive Stock Option may be exercised only if and when the market price of the Stock subject to the Incentive Stock Option exceeds the exercise price of such Option.

#### SECTION 7. Restricted Stock.

(a) **Administration.** Shares of Restricted Stock may be issued either alone or in addition to other awards granted under the Plan. The Committee will determine the officers, key employees, members of the Board of Directors and Consultants of the Company and Subsidiaries to whom, and the time or times at which, grants of Restricted Stock will be made, the number of shares to be awarded, the time or times within which such awards may be subject to forfeiture, and all other conditions of the awards. The Committee may also condition the grant of Restricted Stock upon the attainment of specified performance goals. The provisions of Restricted Stock awards need not be the same with respect to each recipient.

(b) **Awards and Certificates.** The prospective recipient of an award of shares of Restricted Stock will not have any rights with respect to such award, unless and until such recipient has executed an agreement evidencing the award and has delivered a fully executed copy thereof to the Company, and has otherwise complied with the then applicable terms and conditions.

(i) Each participant will be issued a stock certificate in respect of shares of Restricted Stock awarded under the Plan. Such certificate will be registered in the name of the participant, and will bear an appropriate legend referring to the terms, conditions, and restrictions applicable to such award, substantially in the following form:

“The transferability of this certificate and the shares of stock represented hereby are subject to the terms and conditions (including forfeiture) of the RTW, Inc. 2005 Stock Plan and an Agreement entered into between the registered owner and RTW, Inc. Copies of such Plan and Agreement are on file in the offices of RTW, Inc., 8500 Normandale Lake Boulevard, Minneapolis, MN 55437.”

(ii) The Committee must require that the stock certificates evidencing such shares be held in custody by the Company until the restrictions thereon have lapsed, and that, as a condition of any Restricted Stock award, the participant must deliver a stock power, endorsed in blank, relating to the Stock covered by such award.

(c) Restrictions and Conditions. The shares of Restricted Stock awarded pursuant to the Plan will be subject to the following restrictions and conditions:

(i) Subject to the provisions of this Plan and the award agreement, during a period set by the Committee commencing with the date of such award (the "Restriction Period"), the participant will not be permitted to sell, transfer, pledge or assign shares of Restricted Stock awarded under the Plan. In no event may the Restriction Period be less than one (1) year. Within these limits, the Committee may provide for the lapse of such restrictions in installments where deemed appropriate.

(ii) Except as provided in paragraph (c)(i) of this Section 7, the participant will have, with respect to the shares of Restricted Stock, all of the rights of a shareholder of the Company, including the right to vote the shares and the right to receive any cash dividends. The Committee, in its sole discretion, may permit or require the payment of cash dividends to be deferred and, if the Committee so determines, reinvested in additional shares of Restricted Stock (to the extent shares are available under Section 3 and subject to paragraph (f) of Section 12). Certificates for shares of unrestricted Stock will be delivered to the grantee promptly after, and only after, the period of forfeiture has expired without forfeiture in respect of such shares of Restricted Stock.

(iii) Subject to the provisions of the award agreement and paragraph (c)(iv) of this Section 7, upon termination of employment for any reason during the Restriction Period, all shares still subject to restriction will be forfeited by the participant.

(iv) In the event of special hardship circumstances of a participant whose employment is terminated (other than for Cause), including death, Disability or Retirement, or in the event of an unforeseeable emergency of a participant still in service, the Committee may, in its sole discretion, when it finds that a waiver would be in the best interest of the Company, waive in whole or in part any or all remaining restrictions with respect to such participant's shares of Restricted Stock.

(v) Notwithstanding the foregoing, in the event of the sale by the Company of substantially all of its assets and the consequent discontinuance of its business, or in the event of a merger, exchange, consolidation or liquidation of the Company, the Board may, in its sole discretion, in connection with the Board's adoption of the plan for sale, merger, exchange, consolidation or liquidation, provide for one or more of the following with respect to Restricted Stock Awards that are, on such date, still subject to a Restriction Period: (i) the removal of the restrictions on any or all outstanding Restricted Stock Awards; (ii) the complete termination of this Plan and forfeiture of outstanding Restricted Stock Awards prior to a date specified by the Board; and (iii) the continuance of the Plan with respect to the Restricted Stock Award that were outstanding as of the date of adoption by the Board of such plan for sale, merger, exchange, consolidation or liquidation and provide to participants holding Restricted Stock Awards the right to an equivalent number of restricted shares of stock of the corporation succeeding the Company by reason of such sale, merger, exchange, consolidation or liquidation. The grant of a Restricted Stock Award pursuant to the Plan will not limit in any way the right or power of the Company to make adjustments, reclassifications, reorganizations or changes of its capital or business structure or to merge, exchange or consolidate or to dissolve, liquidate, sell or transfer all or any part of its business or assets.

#### SECTION 8. Deferred Stock Awards.

(a) Administration. Deferred Stock may be awarded either alone or in addition to other awards granted under the Plan. The Committee will determine the officers, key employees, members of the Board of Directors and Consultants of the Company and Subsidiaries to whom and the time or times at which Deferred Stock will be



awarded, the number of Shares of Deferred Stock to be awarded to any participant or group of participants, the duration of the period (the "Deferral Period") during which, and the conditions under which, receipt of the Stock will be deferred, and the terms and conditions of the award in addition to those contained in paragraph (b) of this Section 8. The Committee may also condition the grant of Deferred Stock upon the attainment of specified performance goals. The provisions of Deferred Stock awards need not be the same with respect to each recipient.

(b) Terms and Conditions.

(i) Subject to the provisions of this Plan and the award agreement, Deferred Stock awards may not be sold, assigned, transferred, pledged or otherwise encumbered during the Deferral Period. In no event may the Deferral Period be less than one (1) year. At the expiration of the Deferral Period (or Elective Deferral Period, where applicable), share certificates will be delivered to the participant, or his legal representative, in a number equal to the shares covered by the Deferred Stock award.

(ii) Amounts equal to any dividends declared during the Deferral Period with respect to the number of shares covered by a Deferred Stock award will be paid to the participant currently or deferred and deemed to be reinvested in additional Deferred Stock or otherwise reinvested, all as determined at the time of the award by the Committee, in its sole discretion.

(iii) Subject to the provisions of the award agreement and paragraph (b)(iv) of this Section 8, upon termination of employment for any reason during the Deferral Period for a given award, the Deferred Stock in question will be forfeited by the participant.

(iv) In the event of special hardship circumstances of a participant whose employment is terminated (other than for Cause) including death, Disability or Retirement, or in the event of an unforeseeable emergency of a participant still in service, the Committee may, in its sole discretion, when it finds that a waiver would be in the best interest of the Company, waive in whole or in part any or all of the remaining deferral limitations imposed hereunder with respect to any or all of the participant's Deferred Stock.

(v) A participant may elect to further defer receipt of the award for a specified period or until a specified event (the "Elective Deferral Period"), subject in each case to the Committee's approval and to such terms as are determined by the Committee, all in its sole discretion. Subject to any exceptions adopted by the Committee, such election must generally be made prior to completion of one half of the Deferral Period for a Deferred Stock award (or for an installment of such an award).

(vi) Each award must be confirmed by, and subject to the terms of, a Deferred Stock agreement executed by the Company and the participant.

SECTION 9. Transfer, Leave of Absence, etc.

For purposes of the Plan, the following events will not be deemed a termination of employment:

(a) a transfer of an employee from the Company to a Parent Corporation or Subsidiary, or from a Parent Corporation or Subsidiary to the Company, or from one Subsidiary to another;

(b) a leave of absence, approved in writing by the Committee, for military service or sickness, or for any other purpose approved by the Company if the period of such leave does not exceed ninety (90) days (or such longer period as the Committee may approve, in its sole discretion); and

(c) a leave of absence in excess of ninety (90) days, approved in writing by the Committee, but only if the employee's right to reemployment is guaranteed either by a statute or by contract, and may, in the case of any leave of absence, the employee returns to work within 30 days after the end of such leave.



**SECTION 10. Amendments and Termination.**

The Board may amend, alter, or discontinue the Plan, but no amendment, alteration, or discontinuation may be made (i) that would impair the rights of an optionee or participant under a Stock Option, Restricted Stock or other Stock-based award theretofore granted, without the optionee's or participant's consent, or (ii) which without the approval of the shareholders of the Company would cause the Plan to no longer comply with Rule 16b-3 under the Securities Exchange Act of 1934, Section 422 of the Code or any other regulatory requirements.

The Committee may amend the terms of any award or option theretofore granted, prospectively or retroactively, but no such amendment may impair the rights of any holder without his or her consent except to the extent authorized under the Plan. The Committee may also substitute new Stock Options for previously granted options, including previously granted options having higher option prices.

**SECTION 11. Unfunded Status of 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 or optionee by the Company, nothing contained herein gives any such participant or optionee 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 Stock or payments in lieu of or with respect to awards hereunder, if the existence of such trusts or other arrangements is consistent with the unfunded status of the Plan.

**SECTION 12. General Provisions.**

(a) The Committee may require each person purchasing shares pursuant to a Stock Option under the Plan to represent to and agree with the Company in writing that the optionee is acquiring the shares without a view to distribution thereof. The certificates for such shares may include any legend that the Committee deems appropriate to reflect any restrictions on transfer.

All certificates for shares of Stock delivered under the Plan pursuant to any Restricted Stock, Deferred Stock or other Stock-based awards will be subject to such stock-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 Stock is then listed, and any applicable Federal or state securities laws, and the Committee may cause a legend or legends to be put on any such certificates to make appropriate reference to such restrictions.

(b) Subject to paragraph (d) below, recipients of Restricted Stock, Deferred Stock and other Stock-based awards under the Plan (other than Stock Options) are not required to make any payment or provide consideration other than the rendering of services.

(c) Nothing contained in this Plan will prevent the Board of Directors from adopting other or additional compensation arrangements, subject to shareholder approval if such approval is required, and such arrangements may be either generally applicable or applicable only in specific cases. The adoption of the Plan will not confer upon any employee of the Company or any Subsidiary any right to continued employment with the Company or a Subsidiary, as the case may be, nor will it interfere in any way with the right of the Company or a Subsidiary to terminate the employment of any of its employees at any time.

(d) Each participant must, no later than the date as of which any part of the value of an award first becomes includible as compensation in the gross income of the participant for Federal income tax purposes, pay to the Company, or make arrangements satisfactory to the Committee regarding payment of, any Federal, state, or local taxes of any kind required by law to be withheld with respect to the award. The obligations of the Company under the Plan will be conditional on such payment or arrangements and the Company and Subsidiaries will, to the extent permitted by law, have the right to deduct any such taxes from any payment of any kind otherwise due to the participant. With respect to any award under the Plan, if the terms of such award so permit, a participant may elect



by written notice to the Company to satisfy part or all of the withholding tax requirements associated with the award by (i) authorizing the Company to retain from the number of shares of Stock that would otherwise be deliverable to the participant, or (ii) delivering to the Company from shares of Stock already owned by the participant, that number of shares having an aggregate Fair Market Value equal to part or all of the tax payable by the participant under this Section 12(d). Any such election must be in accordance with, and subject to, applicable tax and securities laws, regulations and rulings.

(e) At the time of grant, the Committee may provide in connection with any grant made under this Plan that the shares of Stock received as a result of such grant will be subject to a repurchase right in favor of the Company, pursuant to which the participant will be required to offer to the Company upon termination of employment for any reason any shares that the participant acquired under the Plan, with the price being the then Fair Market Value of the Stock or, in the case of a termination for Cause, an amount equal to the cash consideration paid for the Stock, subject to such other terms and conditions as the Committee may specify at the time of grant. The Committee may, at the time of the grant of an award under the Plan, provide the Company with the right to repurchase, or require the forfeiture of, shares of Stock acquired pursuant to the Plan by any participant who, at any time within two years after termination of employment with the Company, directly or indirectly competes with, or is employed by a competitor of, the Company.

(f) The reinvestment of dividends in additional Restricted Stock (or in Deferred Stock or other types of Plan awards) at the time of any dividend payment will only be permissible if the Committee (or the Company's chief financial officer) certifies in writing that under Section 3 sufficient shares are available for such reinvestment (taking into account then outstanding Stock Options and other Plan awards).

**SECTION 13. Effective Date of Plan.**

The Plan will be effective on the date it is approved by a vote of the holders of a majority of the Stock present and entitled to vote at a meeting of the Company's shareholders.

**Approval by Board of Directors on April 29, 2005**

**Approved by the Shareholders on June 15, 2005**

**Amendment No. 1 adopted by Board of Director on March 28, 2006**

**Amendment No. 1 approved by the Shareholders on June 14, 2006**



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<DESCRIPTION> Statement Re: Computation of Basic and Diluted Net Income Per Share  
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**Exhibit 11**

**RTW, INC. AND SUBSIDIARY**  
**Statement Regarding Computation of Basic and Diluted Net Income Per Share**

	For the three months ended:		For the six months ended:	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
<b>Basic weighted average shares outstanding</b>	5,345,665	5,396,938	5,396,825	5,371,970
<b>II. Stock options</b>				
Options at \$10.75	621	—	311	—
Options at \$9.95	—	—	3	—
Options at \$9.87	—	—	—	—
Options at \$9.50	641	176	482	136
Options at \$8.81	6,425	5,345	5,373	3,952
Options at \$8.75	152	85	129	79
Options at \$6.50	2,803	4,264	2,528	4,192
Options at \$6.45	—	3,462	282	3,405
Options at \$6.18	54,481	52,109	52,721	51,343
Options at \$6.00	29,886	39,179	27,359	38,646
Options at \$4.50	2,656	2,447	2,585	2,429
Options at \$3.80	16,349	15,370	16,013	15,286
Options at \$3.13	5,809	8,534	5,719	8,499
Options at \$2.60	1,908	4,645	1,885	7,516
Options at \$2.20	10,396	15,540	10,294	15,501
Options at \$2.19	40,668	53,717	40,328	60,967
Options at \$1.98	19,923	52,831	21,762	57,247
<b>Diluted weighted average shares outstanding</b>	<u>5,538,383</u>	<u>5,654,642</u>	<u>5,584,599</u>	<u>5,641,168</u>
<b>Net income (\$000's)</b>	\$ 1,434	\$ 1,321	\$ 2,488	\$ 2,370
<b>Net income per share:</b>				
<b>Basic income per share</b>	\$ 0.27	\$ 0.24	\$ 0.46	\$ 0.44
<b>Diluted income per share</b>	\$ 0.26	\$ 0.23	\$ 0.45	\$ 0.42



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<FILENAME> c07742exv31w1.htm  
<DESCRIPTION> Certification Pursuant to Section 302  
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Exhibit 31.1

**CERTIFICATION OF PRESIDENT AND CHIEF EXECUTIVE OFFICER**

I, Jeffrey B. Murphy, President and Chief Executive Officer, certify that:

1. I have reviewed this Form 10-Q of RTW, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 11, 2006

By /s/ Jeffrey B. Murphy  
Jeffrey B. Murphy  
President and Chief Executive Officer  
(Principal Executive Officer)



<DOCUMENT>  
<TYPE> EX-31.2  
<FILENAME> c07742exv31w2.htm  
<DESCRIPTION> Certification Pursuant to Section 302  
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**Exhibit 31.2**

**CERTIFICATION OF CHIEF FINANCIAL OFFICER**

I, Alfred L. LaTendresse, Executive Vice President and Chief Financial Officer, certify that:

1. I have reviewed this Form 10-Q of RTW, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Dated: August 11, 2006

By /s/ Alfred L. LaTendresse  
Alfred L. LaTendresse  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)





<DOCUMENT>  
<TYPE> EX-32  
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<DESCRIPTION> Certification Pursuant to Section 906  
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Exhibit 32

**CERTIFICATION PURSUANT TO 18 U.S.C. § 1350,  
AS ADOPTED PURSUANT TO § 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned certify pursuant to 18 U.S.C. § 1350, that:

1. The accompanying Quarterly Report on Form 10-Q for the period ended June 30, 2006, fully complies with the requirements of Section 13 (a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the accompanying Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

**RTW, Inc.**

Dated: August 11, 2006

By /s/ Jeffrey B. Murphy  
Jeffrey B. Murphy  
President and Chief Executive Officer  
(Principal Executive Officer)

Dated: August 11, 2006

By /s/ Alfred L. LaTendresse  
Alfred L. LaTendresse  
Executive Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)