

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

SCHEDULE TO  
(Rule 14d-100)

TENDER OFFER STATEMENT UNDER SECTION 14(d)(1) OR 13(e)(1) OF  
THE SECURITIES EXCHANGE ACT OF 1934.

TEGAL CORPORATION

(Name of Subject Company (Issuer) and Name of Filing Person (Offeror))

Options to Purchase Common Stock, Par Value \$0.01 Per Share  
(Title of Class of Securities)

879008209

(CUSIP Number of Class of Securities)  
(Underlying Common Stock)

CHRISTINE T. HERGENROTHER  
Vice President and Chief Financial Officer  
TEGAL CORPORATION  
2201 South McDowell Boulevard  
Petaluma, CA 94954  
(707) 763-5600

(Name, address, and telephone numbers of person authorized to receive notices and communications on behalf of filing persons)

Copies to:

Robert W. Phillips, Esq.  
Latham & Watkins LLP  
505 Montgomery Street, Suite 2000  
San Francisco, CA 94111  
(415) 391-0600

CALCULATION OF FILING FEE

Transaction Valuation*	Amount of Filing Fee*
\$936,964	\$107.00

\* Estimated solely for purposes of calculating the amount of the filing fee. This amount assumes that options to purchase 310,812 shares of common stock of Tegal Corporation, par value \$0.01 per share ("Common Stock"), having an aggregate value of \$936,964 will be exchanged pursuant to this offer. The aggregate value is calculated based upon the Black-Scholes option pricing model as of November 3, 2006.

\*\* The amount of the filing fee calculated in accordance with Rule 0-11(b) of the Securities Exchange Act of 1934, as amended, equals \$107.00 for each \$1,000,000 of the aggregate transaction valuation.

Check the box if any part of the fee is offset as provided by Rule 0-11(a)(2) and identify the filing with which the offsetting fee was previously paid. Identify the previous filing by registration statement number, or the Form or Schedule and the date of its filing.

Amount Previously Paid: Not Applicable      Filing Party: Not Applicable.

Form or Registration No.: Not Applicable      Date Filed: Not Applicable.

Check the box if the filing relates solely to preliminary communications made before the commencement of a tender offer.

Check the appropriate boxes below to designate any transactions to which the statement relates:

- third-party tender offer subject to Rule 14d-1.
- issuer tender offer subject to Rule 13e-4.
- going-private transaction subject to Rule 13e-3.
- amendment to Schedule 13D under Rule 13d-2.

Check the following box if the filing fee is a final amendment reporting the results of the tender offer:

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## SCHEDULE TO

### ITEM 1. SUMMARY TERM SHEET.

The information set forth under “Summary of Terms” in the Offer to Exchange Outstanding Options to Purchase Common Stock filed as Exhibit (a)(1)(A) hereto (the “Offer”), is incorporated herein by reference.

### ITEM 2. SUBJECT COMPANY INFORMATION.

(a) *Name and Address.* The name of the issuer is Tegal Corporation (together with its subsidiaries, the “Company” or “Tegal”), a Delaware corporation, and the address of its principal executive office is 2201 South McDowell Boulevard, Petaluma, CA 94954. Tegal’s telephone number is (707) 763-5600. As of the close of business on November 3, 2006, 7,072,289 shares of Tegal’s common stock, par value \$0.01 per share, were outstanding. The information set forth in the Offer under Section 15, “Additional Information,” and Schedule A, “Information Concerning the Executive Officers and Directors of Tegal Corporation” is incorporated herein by reference.

(b) *Securities.* This tender offer statement on Schedule TO relates to an offer by Tegal to holders of outstanding options to purchase its common stock under the Eighth Amended and Restated 1998 Equity Participation Plan with an exercise price greater than or equal to \$7.70, two times the closing price of a share of Tegal common stock on November 3, 2006 (“Eligible Options”). The Offer is for holders to cancel their Eligible Options in exchange for a lesser number of either (1) restricted stock units (“RSUs”) or (2) new options to purchase shares of Tegal’s common stock (“New Options”), issued under the Eighth Amended and Restated 1998 Equity Participation Plan (the “Plan”) on the terms and conditions set forth in the Offer.

This Offer is open to all employees of Tegal, provided that such employees remain employees of Tegal at all times up to and through the date the Eligible Options are cancelled. The number of RSUs or shares of common stock subject to the New Options will be equal to the Black-Scholes value of the Eligible Options that are accepted for exchange and cancelled, reduced by ten percent (10%) and divided by the fair market value of a share of common stock, as set forth in the Offer. The information set forth in the Offer under “Summary of Terms,” Section 1 (“Number of Options; Expiration Date”), Section 5 (“Acceptance of Eligible Options for Exchange and Cancellation, and Issuance of RSUs and New Options”) and Section 8 (“Source and Amount of Consideration; Terms of RSUs and New Option Grants”) is incorporated herein by reference.

(c) *Trading Market and Price.* The eligible options are not publicly traded. The information set forth in the Offer under Section 7 (“Price Range of Common Stock”) is incorporated herein by reference.

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### **ITEM 3. IDENTITY AND BACKGROUND OF FILING PERSON.**

(a) *Name and Address.* The Company is the filing person and the subject company. The information set forth under Item 2(a) above and on Appendix A of the Offer (“Information about the Directors and Executive Officers of Tegal”) is incorporated herein by reference.

### **ITEM 4. TERMS OF THE TRANSACTION.**

(a) *Material Terms.* The information set forth in the Offer under “Summary of Terms,” Section 1 (“Number of Options; Expiration Date”), Section 3 (“Procedures”), Section 4 (“Change in Election”), Section 5 (“Acceptance of Eligible Options for Exchange and Cancellation, and Issuance of RSUs and New Options”), Section 6 (“Conditions of this Offer”), Section 8 (“Source and Amount of Consideration; Terms of RSUs and New Option Grants”), Section 10 (“Status of Options Acquired by Us in this Offer; Accounting Consequences of this Offer”), Section 11 (“Legal Matters; Regulatory Approvals”), Section 12 (“Material U.S. Federal Income Tax Consequences”) and Section 13 (“Extension of this Offer; Termination; Amendment”) is incorporated herein by reference.

(b) *Purchases.* The information set forth in the Offer under Section 9 (“Interests of Directors and Executive Officers; Transactions and Arrangements Involving Stock Options”) is incorporated herein by reference.

### **ITEM 5. PAST CONTACTS, TRANSACTIONS, NEGOTIATIONS AND AGREEMENTS.**

(a) *Agreements Involving the Subject Company’s Securities.* The information set forth in the Offer under Section 8 (“Source and Amount of Consideration; Terms of RSUs and New Option Grants”) and Section 9 (“Interests of Directors and Executive Officers; Transactions and Arrangements Involving Stock Options”) is incorporated herein by reference.

### **ITEM 6. PURPOSES OF THE TRANSACTION AND PLANS OR PROPOSALS.**

(a) *Purposes.* The information set forth in the Offer under “Summary of Terms” and Section 2 (“Purpose of this Offer”) is incorporated herein by reference.

(b) *Use of Securities Acquired.* The information set forth in the Offer under Section 5 (“Acceptance of Eligible Options for Exchange and Cancellation, and Issuance of RSUs and New Options”) and Section 10 (“Status of Options Acquired by Us in this Offer; Accounting Consequences of this Offer”) is incorporated herein by reference.

(c) *Plans.* The information set forth in the Offer under Section 2 (“Purpose of this Offer”) is incorporated herein by reference.

### **ITEM 7. SOURCE AND AMOUNTS OF FUNDS OR OTHER CONSIDERATION.**

(a) *Source of Funds.* The information set forth in the Offer under Section 8 (“Source and Amount of Consideration; Terms of RSUs and New Option Grants”) and Section 14 (“Fees and Expenses”) is incorporated herein by reference.

(b) *Conditions.* The information set forth in the Offer under Section 6 (“Conditions of this Offer”) is incorporated herein by reference.

(d) *Borrowed Funds.* Not applicable.

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**ITEM 8. INTEREST IN SECURITIES OF THE SUBJECT COMPANY.**

(a) *Securities Ownership.* The information set forth in the Offer under Section 9 (“Interests of Directors and Executive Officers; Transactions and Arrangements Involving Stock Options”) is incorporated herein by reference.

(b) *Securities Transactions.* The information set forth in the Offer under Section 9 (“Interests of Directors and Executive Officers; Transactions and Arrangements Involving Stock Options”) is incorporated herein by reference.

**ITEM 9. PERSONS/ASSETS, RETAINED, EMPLOYED, COMPENSATED OR USED.**

Not applicable.

**ITEM 10. FINANCIAL STATEMENTS.**

(a) *Financial Information.* The financial information included in Item 8 (“Financial Statements and Supplementary Data”) of Tegal’s Annual Report on Form 10-K for the fiscal year ended March 31, 2006, filed on June 13, 2006, including all material incorporated by reference therein, is incorporated herein by reference. The financial information included in Item 1 of Tegal’s Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 is incorporated herein by reference. The information set forth in the Offer under Section 15 (“Additional Information”) is incorporated herein by reference.

(b) *Pro Forma Financial Information.* Not applicable.

**ITEM 11. ADDITIONAL INFORMATION.**

(a) *Agreements, Regulatory Requirements and Legal Proceedings.* The information set forth in the Offer under Section 9 (“Interests of Directors and Executive Officers; Transactions and Arrangements Involving Stock Options”) and Section 11 (“Legal Matters; Regulatory Approvals”) is incorporated herein by reference.

(b) *Other Material Information.* Not applicable.

**ITEM 12. EXHIBITS.**

See Index of Exhibits below.

**ITEM 13. INFORMATION REQUIRED BY SCHEDULE 13E-3.**

Not applicable.

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**SIGNATURE**

After due inquiry and to the best of my knowledge and belief, I certify that the information set forth in this statement is true, complete and correct.

**TEGAL CORPORATION**

By: /s/ CHRISTINE T. HERGENROTHER

\_\_\_\_\_  
Christine T. Hergenrother  
Its: Chief Financial Officer

Dated: November 8, 2006

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## INDEX OF EXHIBITS

<b>Exhibit Number</b>	<b>Description</b>
99.(a)(1)(A)	Offer to Exchange Certain Outstanding Options to Purchase Common Stock, dated November 8, 2006.
99.(a)(1)(B)	Form of Stock Option Exchange Election Form.
99.(a)(1)(C)	Tegal's Proxy Statement for the 2006 Annual Meeting of Stockholders, filed with the SEC on June 29, 2006 and incorporated herein by reference.
99.(a)(1)(D)	Tegal Corporation's Annual Report on Form 10-K for its fiscal year ended March 31, 2006, filed with the SEC on June 13, 2006, and incorporated herein by reference.
99.(b)	Not applicable.
99.(d)(1)	Eighth Amended and Restated 1998 Equity Participation Plan, incorporated herein by reference to Tegal's Form 10-Q for the period ended June 30, 2006.
99.(d)(2)	Form of Non-Qualified Stock Option Agreement.
99.(d)(3)	Form of Restricted Stock Unit Agreement.
99.(g)	Not applicable.
99.(h)	Not applicable.

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**TEGAL CORPORATION**  
2201 South McDowell Boulevard  
Petaluma, CA 94954  
(707) 763-5600

**OFFER TO EXCHANGE  
CERTAIN OUTSTANDING OPTIONS TO PURCHASE COMMON STOCK  
November 8, 2006**

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TEGAL CORPORATION

OFFER TO EXCHANGE  
CERTAIN OUTSTANDING OPTIONS TO PURCHASE COMMON STOCK

**THIS OFFER EXPIRES AT 11:59 P.M. PACIFIC DAYLIGHT TIME  
ON DECEMBER 7, 2006, UNLESS WE EXTEND THIS OFFER**

We are offering you the opportunity to exchange stock options currently outstanding under the Tegal Corporation (together with its subsidiaries, "Company" or "Tegal") Eighth Amended and Restated 1998 Equity Participation Plan that have an exercise price equal to or greater than \$7.70 ("Eligible Options") for a lesser number of either (1) restricted stock units, each one representing one share of Company common stock to be issued in the future ("RSUs") or (2) new options to purchase Tegal common stock at current fair market value ("New Options"). You may elect whether to exchange your Eligible Options for either RSUs or New Options. The RSUs and New Options will be issued under the Eighth Amended and Restated 1998 Equity Participation Plan (the "Plan") in accordance with a specified exchange formula as described herein (the "Option Exchange Program"), pursuant to the terms and conditions of this Offer to Exchange Certain Outstanding Options to Purchase Common Stock (the "Offer"). **You are eligible to participate in the Offer if you are an employee of Tegal as of November 8, 2006, the date the Offer commenced, and you remain an employee through the Expiration Date of the Offer and you hold Eligible Options.**

The "Expiration Date" of the Offer is 11:59 p.m. Pacific Daylight Time on December 7, 2006. If we extend the period of time during which this Offer remains open, the term "Expiration Date" will refer to the latest time and date at which this Offer expires.

The RSUs and New Options will be granted under the Plan approximately one (1) business day following the Expiration Date, currently anticipated to be December 8, 2006 (the "Grant Date"). The Board retains the discretion to determine the Grant Date.

We are offering to exchange unexercised Eligible Options by determining the value of the Eligible Options using an option pricing model. You may elect whether to exchange your Eligible Options for either RSUs or New Options. The number of either RSUs or New Options that you will be granted in exchange for cancellation of your Eligible Options will be determined by the following formula: the value of your Eligible Options (as determined under the option pricing model) will be reduced by ten percent (10%), then that reduced amount will be divided by the fair market value of a share of Company common stock on the Grant Date. "Fair market value" for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. The option pricing model to be used is the Black-Scholes valuation model (a widely used model for calculating the value of derivative securities).

As an example, if you have an Eligible Option grant representing the right to purchase 100 shares of common stock and you elect to exchange this Eligible Option for RSUs, you will receive RSUs on the Grant Date representing the right to receive the number of shares of Company common stock equal to the Black-Scholes valuation of your Eligible Option rights, reduced by 10%, and divided by the closing price on the last trading date before the Grant Date.

The RSUs and New Options will become vested in two installments, 50% on the first anniversary of the Grant Date, and 100% on the second anniversary of the Grant Date. Vesting is contingent upon your continuous employment with Tegal through the applicable vesting dates. The New Options will become exercisable as they vest, and will have an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market on the last trading day prior to the Grant Date. Shares of our common stock will be delivered in satisfaction of the RSUs upon vesting. If you terminate from employment with the Company prior to full vesting, you will forfeit and have no further rights with respect to any unvested portion of your RSUs or New Options.

Shares of our common stock are quoted on the Nasdaq Capital Market under the symbol "TGAL". On November 3, 2006, the closing price of our common stock as reported on the Nasdaq Capital Market was \$3.85 per share. We recommend that you obtain current market quotations for our common stock before deciding whether to elect to exchange Eligible Options under this Offer. **We can provide no assurance as to the price of our common stock at any time in the future, and nothing contained in this document or the other documents you receive relating to this Offer should be interpreted in any way as a claim relating to the future prospects of the price of our common stock, nor should any inference about such future prospects be drawn from anything contained herein or therein.**

Please note that although you may tender as many or as few of the Eligible Options as you like, you must exchange all shares issuable under each particular grant of Eligible Options you wish to exchange. For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock at, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may tender one or both of these grants of Eligible Options. However, you may not partially tender an Eligible Option grant (e.g., 50 shares of the Eligible Option grant for 100 shares or 25 shares of the Eligible Option grant for 50 shares. In addition, you may elect only one form of exchange per Eligible Option. For example, you can exchange your full Eligible Option to purchase 100 shares for RSUs, but you cannot exchange 1/2 for RSUs and 1/2 for New Options.)

We are making this Offer upon the terms and subject to the conditions described in this Offer, including the Summary of Terms and any other communications by us (which together, as they may be amended from time to time, constitute the “Offer”). This Offer is not conditioned upon a minimum number of option holders accepting this Offer or a minimum number of Eligible Options being exchanged, but is subject to other conditions that we describe in Section 6 of this Offer.

You will need to make your election to exchange Eligible Options in writing using the Stock Option Exchange Election Form that we have provided you.

**This transaction has not been approved or disapproved by the United States Securities and Exchange Commission (the “SEC”), nor has the SEC passed upon the fairness or merits of this transaction or upon the accuracy or adequacy of the information contained in this Offer. Any representation to the contrary is a criminal offense.**

### IMPORTANT

If you wish to tender some or all of your Eligible Options for exchange and cancellation, and receive RSUs or New Options under the terms of this Offer, you must submit your signed Stock Option Exchange Election Form to us no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date. Submission instructions are included on the Form. If you have questions, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com). If we do not receive your signed Stock Option Exchange Election Form by 11:59 p.m. Pacific Daylight Time on the Expiration Date, you will be deemed to have rejected this Offer. Only those stock option agreements for Eligible Options which we accept for exchange will be automatically cancelled.

If your employment with Tegal is terminated for any reason on or before the Grant Date, you will not receive any RSUs or New Options. If you elect to participate in the Option Exchange Program, your Eligible Options will be cancelled on the Expiration Date. If your employment terminates for any reason on or after the Expiration Date and prior to the Grant Date, you will forfeit and not be permitted to exercise your Eligible Options, and you will not receive any RSUs or New Options.

The Board makes no recommendations as to whether or not you should tender your Eligible Options for exchange. The Board recognizes that the decision to accept or reject this Offer is an individual one that may be based on a variety of factors. You should consult your personal outside advisor(s) if you have questions about your financial or tax situation.

**The information about this Offer from Tegal is limited to this Offer, including the Summary of Terms and any other communications we may periodically send to you. We have not authorized any person to make any recommendation on our behalf as to whether or not you should exchange your Eligible Options pursuant to this Offer, nor have we authorized anyone to give you any information or to make any representation in connection with this Offer other than the information and representations contained in this Offer, including the Summary of Terms and any other communication we may periodically send to you. If anyone makes any recommendation or representation to you or gives you any information, you must not rely upon that recommendation, representation or information as having been authorized by Tegal.**

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**TEGAL CORPORATION**  
**SUMMARY OF TERMS**  
**OF**  
**OFFER TO EXCHANGE CERTAIN OUTSTANDING OPTIONS TO PURCHASE COMMON STOCK**

**November 8, 2006**

**Response Due By 11:59 p.m. Pacific Daylight Time**  
**on December 7, 2006, unless this Offer is Extended by Notice**

The following information should answer most of the questions that you may have about this Offer. Please read the remainder of the Offer and the accompanying documents carefully and in their entirety as they contain information relevant to your decision as to whether or not to participate in this Offer. We have included references to the relevant sections of the Offer where you can find a more complete description of the topics discussed in this Summary of Terms.

**GENERAL QUESTIONS ABOUT THE TERMS OF THE OFFER**

***Q1. What is the Option Exchange Program?***

We are offering Eligible Employees (as defined below) the opportunity to exchange stock options currently outstanding under the Eighth Amended and Restated 1998 Equity Participation Plan that have an exercise price equal to or greater than \$7.70 per share (“Eligible Options”) for a lesser number of either (1) restricted stock units, each of which representing a share of Tegal Corporation common stock to be issued in the future (“RSUs”) or (2) new options to purchase Tegal Corporation common stock (“New Options”). The RSUs and New Options will be granted under the Eighth Amended and Restated 1998 Equity Participation Plan in accordance with a specified exchange formula (see Question 9 below for additional information on the specified exchange formula) approximately one (1) business day following expiration of the Offer, currently anticipated to be December 8, 2006 (the “Grant Date”), although for administrative processing reasons, you may not receive notice of your new RSU or New Option grant for a period of time following the Grant Date. The Board retains the discretion to determine the Grant Date. (See Section 1 of the Offer.)

***Q2. Who can participate in this Offer?***

You are eligible to participate in this Offer if you are an employee of Tegal Corporation (together with its subsidiaries, the “Company”, or “Tegal”) as of November 8, 2006, you continue to be employed by Tegal through the Expiration Date of this Offer, and you hold Eligible Options (an “Eligible Employee”). An employee of Tegal must either be on active status or on an approved leave of absence on the Expiration Date of this Offer in order to be eligible to participate, unless otherwise required under local law. An employee whose employment with Tegal terminates for any reason at any time before the Expiration Date of this Offer will not be an Eligible Employee. (See Section 1 of the Offer.)

***Q3. What if I leave Tegal after the Offer begins but before my New Options or RSUs are granted?***

To receive RSUs or New Options, you must be employed by Tegal at the time the Option Exchange Program commences through the time the RSUs or New Options are granted. If you elect to participate in the Option Exchange Program and your employment terminates for any reason before the Grant Date, you would not receive any RSUs or New Options. If you terminate from employment prior to the Expiration Date, you would be permitted to exercise your old options within the usual post-termination periods set forth in the Plan, to the extent that they were exercisable at the time of termination. Otherwise, any Eligible Option that you tendered will be cancelled on the Expiration Date, and if you terminate from employment on or after the Expiration Date and before the Grant Date, you will forfeit and not be permitted to exercise your old options and you will not receive RSUs or New Options. (See Section 1 of the Offer.)

This Offer will not change or modify any terms of your employment with Tegal.

**Q4. Why is Tegal making this offer to employees?**

We are making this Offer because, as a result of the volatility in our stock price, many outstanding options have exercise prices significantly higher than the current market price of our common stock. In many cases, these “out-of-the-money” stock options no longer serve as effective incentives to retain, motivate and reward our employees. We believe the Option Exchange Program is an effective means of recognizing employee contributions to our success and aligning employee and stockholder interests. (See Section 2 of the Offer.)

**Q5. Why do I have to give up my old options? Can't Tegal just grant new options at a current price?**

We designed the Option Exchange Program to avoid the dilution in ownership to our stockholders that would result if we granted employees additional options to supplement their out-of-the-money options. In addition, issuing new stock options might cause some stockholders consider our “overhang” (the ratio of our outstanding options to total outstanding shares) to be too high. The Option Exchange Program will help avoid this problem.

**Q6. How can I tell which of my outstanding options are Eligible Options?**

If you are either an active employee or an employee on authorized leave of absence, and one of your outstanding options has an exercise price equal to or greater than \$7.70, that option is an Eligible Option. You will be provided with a Stock Option Exchange Election Form which contains a summary of your Eligible Option grants.

**Q7. Are there any conditions to this Offer?**

Yes. This Offer is subject to the conditions described in Section 6 of the Offer. If any of these events occur, Tegal may terminate, postpone or amend this Offer. However, this Offer is not conditioned on a minimum number of Eligible Employees accepting this Offer or a minimum number of Eligible Options being exchanged. (See Section 6 of the Offer.)

**SPECIFIC QUESTIONS ABOUT THE ELIGIBLE OPTIONS TO BE EXCHANGED**

**Q8. If I participate, how many RSUs or New Options will I receive?**

Under this Offer, you may make an election to exchange your unexercised Eligible Options for a number of either RSUs or New Options to be granted in accordance with the following exchange formula:

Value of your Eligible Options (as determined using an option pricing model),  
Minus ten percent (10%),  
Divided by the fair market value of a share of Company common stock on the Grant Date.

“Fair market value” for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. If any fractional numbers result from the exchange formula calculation, RSU and New Option grants will be rounded down for any fractional option to the next whole share on a grant-by-grant basis.

**Q9. Why are only options with an exercise price equal to or greater than \$7.70 per share eligible for exchange?**

We believe that options that are only moderately out-of-the-money continue to provide valuable incentives for employees. We set the \$7.70 “floor” to provide significant benefits to employees while continuing to be mindful of the interests of our stockholders.

**Q10. Why isn't the exchange formula simply a one-to-one ratio with my Eligible Options?**

We believe the exchange ratios must balance the interests of both our employees and our stockholders. Therefore, in order to make the program fair, we have designed it to be approximately “value for value.” This means that, in the aggregate, the value of the stock options being exchanged will be approximately the same as the value of the RSUs or New Options to be granted. Under our pricing model, this requires that more stock options be surrendered than new grants received in the exchange. The exchange formula was determined with advice from third-party compensation consultants and on the basis of valuations under the Black-Scholes valuation model (a widely used derivative securities pricing model).

**Q11. *If I elect to participate and exchange my Eligible Options, do I have to exchange all of my Eligible Options, or can I just exchange some of them?***

You are not obligated to exchange all of your Eligible Option grants and will be free to exchange as few or as many of your individual Eligible Option grants as you wish. However, if you elect to exchange shares from any Eligible Option grant, you must elect to exchange all shares issuable under such Eligible Option grant.

For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may tender one or both of these grants of Eligible Options. However, you may not partially tender an Eligible Option grant (e.g., 50 shares of the Eligible Option grant for 100 shares at or 25 shares of the Eligible Option grant for 50 shares).

**Q12. *If I elect to participate and exchange my Eligible Options, do I have to exchange all of my Eligible Options for either only RSUs or only New Options, or can I elect to receive both types of awards?***

If you elect to exchange shares from any Eligible Option grant, you must elect to exchange all shares issuable under such Eligible Option grant for one type of award, either RSUs or New Options. However, if you have more than one Eligible Option grant, you may elect different types of awards for each Eligible Option grant.

For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may elect to tender one of these grants of Eligible Options for RSUs and the other grant for New Options. However, you may not tender one Eligible Option grant for both RSUs and New Options (e.g., you may not tender the Eligible Option grant for 100 shares in exchange for 2/3 RSUs and 1/3 New Options).

**Q13. *If I choose to participate in the Option Exchange Program can I exchange partial grants?***

No, we are not accepting partial tenders of particular Eligible Option grants. You can elect to exchange as few or as many of your Eligible Option grants as you wish. However, if you elect to exchange any Eligible Options, you must exchange all of the options from the same grant.

**Q14. *My Eligible Options are already vested. Will my RSUs and New Options also be fully vested?***

No. All RSUs and New Options issued through the Option Exchange Program will vest in annual installments over a period of two (2) years. New Options will become exercisable upon vesting. Shares will be delivered upon vesting in RSUs.

**Q15. *Can I exchange Eligible Option grants that I have already fully or partially exercised?***

If you previously exercised an option grant in its entirety, that option grant is no longer outstanding and is therefore not eligible for exchange under this Offer. However, if you previously exercised an Eligible Option grant in part, the remaining unexercised portion of the Eligible Option grant may be exchanged under this Offer.

**Q16. *What happens to Eligible Option grants that I choose not to exchange?***

Eligible Option grants that you choose not to exchange will retain all of their current terms and conditions, including their current exercise price, expiration date and vesting schedule.

**Q17. Does the Company recommend employees participate in the program?**

Tegal cannot make a recommendation to employees whether or not to accept the Offer and no one from Tegal has been, or will be, authorized to provide you with additional information in this regard. However, Tegal is providing as much information as is allowable by the SEC to assist you to make your informed decision. For questions regarding investment-related issues, you should talk to your own advisors.

**SPECIFIC QUESTIONS ABOUT THE RSUS AND NEW OPTIONS**

**Q18. When will I receive my RSUs and New Options?**

The RSUs and New Options will be granted on the Grant Date, which is currently anticipated to be December 8, 2006, although for administrative processing reasons, you may not receive notice of your new grant for a period of time following the Grant Date. (See Section 5 of the Offer.) The Board retains the discretion to determine the Grant Date. (See Section 1 of the Offer.)

**Q19. What will the purchase price of my RSUs and New Options be?**

One share of Company common stock will be delivered to you for each RSU that vests. The purchase price of the shares of common stock to be issued upon settlement of your RSUs will be the par value of our common stock, which is equal to one-tenth of one cent (\$0.01) and the par value will be deemed paid by your past services rendered to Tegal. As a result, you do not have to make a payment to Tegal to receive the shares of common stock to be issued upon your settlement of your RSUs.

All New Options will be granted with an exercise price equal to the closing price of Tegal's common stock as reported on the Nasdaq Capital Market as of the last trading date prior to the Grant Date. (See Section 7 of the Offer for a historical view of the price range of our common stock.)

**Q20. What will the vesting schedule of my RSUs and New Options be?**

The RSUs and New Options will vest on a different schedule than your tendered Eligible Options. The RSUs and New Options will vest in annual installments over a period of two (2) years, 50% on the first anniversary of the Grant Date, and 100% on the second anniversary of the Grant Date. For all RSUs and New Options, vesting is contingent upon your continued employment with Tegal through the applicable vesting dates. If you terminate from service with Tegal, you will forfeit and have no further rights with respect to any unvested portion of your RSUs and New Options. (See Section 8 of the Offer.)

**Q21. What will the term of my New Options be?**

The New Options will have a term equal to the remaining term of your Eligible Options exchanged, as long as you remain employed by Tegal. (See Section 8 of the Offer.) For example, if you decide to exchange an Eligible Option which would otherwise expire in 2009 for New Options, your New Options will also expire in 2009.

**Q22. What will the other terms and conditions of my RSUs and New Options be?**

The other terms and conditions of your RSUs and New Options not described in the Offer will be generally comparable to the other terms and conditions of other award agreements under the Plan. If you exchange your Eligible Options for New Options, such options will have the same exercise period as the Eligible Option you exchanged; *e.g.*, if your Eligible Options provided that you can exercise your vested options within 3 months following your termination of employment date, your New Options will also allow you to exercise vested options for 3 months following termination.

However, all New Options will be nonqualified stock options under the U.S. Internal Revenue Code, regardless of the tax status of the Eligible Options exchanged, and will be granted pursuant to the Plan.

**Q23. *If the exercise price of the New Options is higher than the exercise price of the Eligible Options I exchanged, can I revert back to my original Eligible Options with their original exercise price?***

No. Once your Eligible Options have been surrendered for exchange, it is not possible to re-grant them. The fair market value of Tegal's common stock on the last trading day prior to Grant Date of the New Options cannot be predicted at this time, and it is possible that your New Options may have a higher exercise price than your Eligible Options.

**Q24. *If the New Options granted to me end up being out-of-the-money, will there be another offer to exchange?***

We do not expect to implement another option exchange program.

#### **SPECIFIC QUESTIONS ABOUT THE POTENTIAL CONSEQUENCES OF ACCEPTING OR REJECTING THIS OFFER**

**Q25. *What happens if I accept this Offer?***

If you accept this Offer, the Eligible Option grants you choose to exchange will be cancelled promptly after 11:59 p.m. Pacific Daylight Time on the Expiration Date, and you will have no further right or interest in these Eligible Options. If you choose to accept this Offer, you will receive notice of your RSUs and/or New Options as promptly as possible following the Grant Date.

**Q26. *Will I owe taxes if I participate in the Option Exchange Program?***

The exchange of Eligible Options pursuant to this Offer should be treated as a non-taxable exchange, such that no income should be recognized for U.S. Federal or state income tax purposes upon grant of the RSUs and New Options. However, you may recognize income for U.S. Federal income tax purposes upon vesting of the RSUs or upon exercise of New Options (See Section 12 of the Offer), at which time the Company will also generally have a tax withholding obligation. Although not required to do so, the Company intends to automatically withhold a sufficient number of otherwise distributable shares of common stock when RSUs vest to satisfy its tax withholding obligation. You may also have taxable income when you sell the shares issued upon settlement of your awards.

If you are a tax resident or subject to the tax laws in more than one country, you should be aware that there might be additional tax and social insurance consequences in more than one country that may apply to you. For additional information about your personal tax situation, you should talk to your own financial or tax advisor.

**Q27. *Do I have to participate in the Option Exchange Program?***

No. Participation in this Offer is completely voluntary. If you choose not to participate, no changes will be made to the terms of your current option grants.

#### **SPECIFIC QUESTIONS ABOUT THE PROCESS OF EXCHANGING ELIGIBLE OPTIONS**

**Q28. *When does this Offer expire? Can this Offer be extended, and if so, how will I know if it is extended?***

The "Expiration Date" of the Offer is 11:59 p.m. Pacific Daylight Time on December 7, 2006, unless we extend it. Although we do not currently intend to do so, we may, in our sole discretion, extend this Offer at any time prior to the Expiration Date. If we extend this Offer, we will announce the extension no later than 9:00 a.m. Pacific Daylight Time on the day following the last previously scheduled or announced Expiration Date. (See Section 13 of the Offer.)

**Q29. *If I decide to accept this Offer, what do I need to do?***

If you wish to accept this Offer, you must submit your Stock Option Exchange Election Form to us pursuant to its instructions no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date. The Stock Option Exchange Election Form is provided in the packet regarding this Offer. If you have questions, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com). If we do not receive your signed, written Stock Option Exchange Election Form by 11:59 p.m. Pacific Daylight Time on the Expiration Date, you will be deemed to have rejected this Offer.



**Q30. Under what circumstances would Tegal not accept my Eligible Option grant for exchange?**

We currently expect that we will accept promptly after the Expiration Date all Eligible Option grants for which written elections are properly completed, signed and submitted and have not been validly changed or withdrawn. We may, however, reject any or all written election forms to the extent we determine they were not properly completed, signed or submitted, to the extent we determine it is unlawful to accept the exchanged Eligible Option grants or to the extent that any condition described in Section 6 of the Offer makes it inadvisable in our reasonable judgment to proceed with this Offer. (See Sections 3, 5 and 6 of the Offer.)

**Q31. Can I change my previous election prior to the Expiration Date?**

Yes. You may change your previous election or withdraw from the Offer by properly completing, executing and submitting a new Stock Option Exchange Election Form before the Expiration Date. You may change your election more than once. Your last properly submitted written Stock Option Exchange Election Form will supersede any prior election forms you may have completed, signed and submitted. (See Section 4 of the Offer.)

**Q32. If I elect to participate in the Offer, do I have to return any stock option agreements for the Eligible Options I wish to exchange?**

No. You do not need to return any stock option agreements as they will automatically be cancelled when we accept your Eligible Options for exchange.

**Q33. Who can I talk to if I have questions about the Offer?**

For general assistance, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com). You should consult your personal outside advisor(s) if you have questions about your financial or tax situation.

## THE OFFER

### 1. NUMBER OF OPTIONS; EXPIRATION DATE.

We are offering Eligible Employees of Tegal Corporation (together with its subsidiaries, the “Company” or “Tegal”) the opportunity to exchange stock options currently outstanding under the Eighth Amended and Restated 1998 Equity Participation Plan (the “Plan”) that have an exercise price equal to or greater than \$7.70 per share (“Eligible Options”) for a lesser number of either: (1) restricted stock units, each one representing one share of Company common stock to be issued in the future (“RSUs”) or (2) new options to purchase Company common stock (“New Options”). The RSUs and New Options will be granted on the next business day following expiration of the Offer, currently anticipated to be December 8, 2006 (the “Grant Date”), under the Eighth Amended and Restated 1998 Equity Participation Plan (the “Plan”) in accordance with a specified exchange formula as described herein (the “Option Exchange Program”), and pursuant to the terms and conditions of this Offer to Exchange Certain Outstanding Options to Purchase Common Stock (the “Offer”).

“Eligible Employees” are employees of Tegal as of November 8, 2006 who hold Eligible Options and continue to be employed by Tegal through 11:59 p.m. Pacific Daylight Time on December 7, 2006 (the “Expiration Date”). If we extend the period of time during which this Offer remains open, the term “Expiration Date” will refer to the latest time and date at which this Offer expires. See Section 13 of this Offer for a description of our rights to extend, delay, terminate and amend this Offer.

If you wish to accept this Offer, you are free to elect to exchange as many or as few of the Eligible Option grants as you like; however, you must exchange all shares issuable under each particular Eligible Option grant you wish to exchange. For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may tender one or both of these Eligible Option grants. However, you may not partially tender an Eligible Option grant (e.g., 50 shares of the Eligible Option grant for 100 shares or 25 shares of the Eligible Option grant for 50 shares). Also, you may elect to exchange each Eligible Option for either RSUs or New Options, but not both. If you have more than one Eligible Option, you may elect different types of awards for exchange with each (e.g., exchange an Eligible Option grant for 100 shares for RSUs, and exchange an Eligible Option grant for 50 shares for New Options).

This Offer is subject to the terms and conditions described herein, including the Summary of Terms, the Stock Option Exchange Election Form and any other communications periodically sent to you by us. We will only accept Eligible Option grants that are properly exchanged and not validly withdrawn, in accordance with Section 5 of this Offer, by 11:59 p.m. Pacific Daylight Time on the Expiration Date. If we do not receive your written election to participate by such date and time, you will be deemed to have rejected this Offer. If your employment with Tegal is terminated for any reason on or before the Grant Date, you will not receive any RSUs or New Options. If you terminate prior to the Expiration Date, you would be permitted to exercise your old options within the usual post-termination periods set forth in the Plan, to the extent that they were exercisable at the time of termination. Otherwise, on the Expiration Date your tendered old options will be cancelled, and if you terminate on or after the Expiration Date and before the Grant Date, you will forfeit and not be permitted to exercise your old options and you will not receive RSUs or New Options.

In this Offer, each Eligible Option grant may be exchanged for RSUs or New Options, as elected, to be granted in accordance with the following exchange formula (rounded down to the next whole share):

Value of your Eligible Options (as determined using an option pricing model),

Minus ten percent (10%),

Divided by the fair market value of a share of Company common stock on the Grant Date

“Fair market value” for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. The option pricing model to be used is the Black-Scholes valuation model (a widely used model for calculating the value of derivative securities).

As an example, if you have an Eligible Option grant representing the right to purchase 100 shares of common stock and you elect to exchange this Eligible Option for New Options, you will receive on the Grant Date a New Option grant representing the right to purchase the number of shares of common stock equal to the Black-Scholes valuation of your Eligible Option reduced by 10%, then divided by the closing price on the last trading date before the Grant Date.

The RSUs and New Options will become 50% vested on the first anniversary of the Grant Date, and 100% vested on the second anniversary of the Grant Date. Vesting is contingent upon your continuous employment with Tegal through the applicable vesting dates. The New Options will become exercisable as they vest, and will have an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market on the last trading day prior to the Grant Date. We cannot guarantee that the New Options will have a lower exercise price than the Eligible Options for which they are exchanged, because we cannot provide any assurance as to the price of our common stock in the future. If you terminate from employment with the Company prior to full vesting, you will forfeit and have no further rights with respect to any unvested portion of your RSUs or New Options.

All RSUs and New Options will be granted under the Plan. One share of Company common stock will be delivered to you for each RSU that vests. All New Options will be granted with an exercise price equal to the closing price of Tegal's common stock as reported on the Nasdaq Capital Market as of the last trading date prior to the Grant Date. The New Options will have a term equal to the remaining term of your Eligible Options exchanged, as long as you remain employed by Tegal. For example, if you decide to exchange an Eligible Option which would otherwise expire in 2009 for New Options, your New Options will also expire in 2009.

We will issue a press release or otherwise notify each Eligible Employee and keep the Offer open for at least ten (10) business days after the date of such notification if we decide to take any of the following actions prior to the Expiration Date:

- increase or decrease what we will give you in exchange for your Eligible Options; or
- increase or decrease the number of Eligible Options to be exchanged in this Offer.

A "business day" means any day other than a Saturday, Sunday or U.S. federal holiday and consists of the time period from 12:00 midnight through 11:59 p.m. Pacific Daylight Time.

## 2. PURPOSE OF THIS OFFER.

Many of our outstanding options have exercise prices that are significantly higher than the current market price of our common stock as a result of volatility in our stock price. In many cases, these "out-of-the-money" stock options no longer serve as effective incentives to retain, motivate and reward our employees. Accordingly, our Board adopted the Option Exchange Program to revitalize the stock options held by our employees. We believe the Option Exchange Program is an effective means of recognizing employee contributions to our success and aligning employee and stockholder interests.

In order to balance the interests of both our employees and our stockholders, we have designed it to be an approximate "value-for-value" program. This means that, in the aggregate, the value of the stock options being exchanged is approximately the same as the value of the RSUs and New Options to be issued. Under our option pricing model, this requires that more stock options be surrendered than received in the exchange. The exchange formula was determined on the basis of a Black-Scholes model, a commonly used option valuation model, with advice from third-party compensation consultants. We cannot guarantee that, if you choose to exchange your Eligible Options for New Options, your New Options will have a lower exercise price than your Eligible Options. The Board makes no recommendation as to whether or not you should tender your Eligible Options for exchange. The Board recognizes that the decision to accept or reject this Offer is an individual one that should be based on a variety of factors. You should consult with your personal outside advisor(s) if you have questions about your financial or tax situation.

## 3. PROCEDURES.

*Making Your Election.* **If you wish to accept this Offer, you must submit your Stock Option Exchange Election Form to us pursuant to the instructions on the Form no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date.** The Stock Option Exchange Election Form is provided in the packet regarding this Offer. If we do not receive your signed, written Stock Option Exchange Election Form by 11:59 p.m. Pacific Daylight Time on the Expiration Date, you will be deemed to have rejected this Offer. If we extend the period of time during which this Offer remains open, the term "Expiration Date" will refer to the latest time and date at which this Offer expires. You do not need to return any stock option agreements as they will be automatically cancelled if we accept your Eligible Options for exchange.

If you have questions, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com).

*Determination of Validity; Rejection of Elections; Waiver of Defects; No Obligation to Give Notice of Defects.* We will resolve, in our sole discretion, all questions as to the number of shares subject to Eligible Options and the validity, form, eligibility (including time of receipt) and acceptance of written election forms. Our determination of these matters will be final and binding on all parties. We may reject any or all submissions to the extent that we determine they were not properly completed, signed and submitted, to the extent that we determine it is unlawful to accept the Eligible Options tendered for exchange or to the extent that any condition described in Section 6 of this Offer makes it inadvisable in our reasonable judgment to proceed with this Offer. Otherwise, we will properly accept and timely exchange Eligible Options that are not validly withdrawn. We may waive any of the conditions of this Offer or any error in any written election form with respect to any particular Eligible Options or any particular Eligible Employee. No Eligible Options will be accepted for exchange until all errors have been cured by the Eligible Employee exchanging the Eligible Options or waived by us. Neither we nor any other person is obligated to give notice of any errors involved in the exchange of any Eligible Options, and no one will be liable for failing to give notice of any errors.

*Our Acceptance Constitutes an Agreement.* If you elect to exchange any of your Eligible Option grants and you tender those Eligible Options according to the procedures described above, you will have accepted this Offer. However, only our acceptance of your Eligible Options that are properly exchanged will form a binding agreement between us and you on the terms and subject to the conditions of this Offer.

Subject to our right to extend, terminate and amend this Offer, we currently expect that we will accept promptly after the Expiration Date all properly and timely tendered Eligible Options that have not been validly withdrawn.

#### **4. CHANGE IN ELECTION.**

You may only change your election by following the procedures described in this Section 4.

You may change your election at any time prior to 11:59 p.m. Pacific Daylight Time on the Expiration Date. If we extend this Offer beyond that time, you may change your election at any time until the extended Expiration Date. Additionally, in accordance with the legal requirements for tender offers, you may withdraw any options you elected to exchange if after forty (40) business days after the commencement of this Offer, we have not yet closed this Offer and we have not accepted for exchange all Eligible Option grants you elected to exchange. The date of the fortieth (40th) business day after the commencement of this Offer is January 6, 2007.

You may change your election more than once. Your last completed, signed and properly submitted Stock Option Exchange Election Form will supersede any prior elections you may have submitted.

If you have questions regarding the process for changing your election, you may contact Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com).

Neither we nor any other person is obligated to give notice of any errors you may make to your election form, and no one will be liable for failing to give notice of any errors. We will resolve, in our sole discretion, all questions as to the form and validity, including time of receipt, of any change to the documentation concerning this Offering. Our determinations of these matters will be final and binding on all parties.

#### **5. ACCEPTANCE OF ELIGIBLE OPTIONS FOR EXCHANGE, AND THE CANCELLATION AND ISSUANCE OF RSUs AND NEW OPTIONS.**

On the terms and subject to the conditions of this Offer, promptly following the Expiration Date we will accept for exchange and cancellation all Eligible Options properly tendered and not validly withdrawn as of the Expiration Date. The RSUs and New Options will be granted approximately one (1) business day following expiration of the Offer, currently anticipated to be December 8, 2006, although for administrative processing reasons, you may not receive notice of your New Option grant for a period of time after the Grant Date. The Board retains the discretion to determine the Grant Date.

## 6. CONDITIONS OF THIS OFFER.

We will not be required to accept any Eligible Options that you elect to exchange, upon the occurrence of one or more of the conditions described below. We may terminate or amend this Offer, or postpone our acceptance and cancellation of any Eligible Options that you elect to exchange, in each case, if, at any time on or after the date hereof, and by 11:59 p.m. Pacific Daylight Time on the Expiration Date, we determine that any condition described below has occurred that, in our reasonable judgment, makes it inadvisable for us to proceed with this Offer or to accept and cancel Eligible Options that you elect to exchange. These conditions are as follows:

- if any action or proceeding by any government agency, authority or tribunal or any other person, domestic or foreign, is threatened or pending before any court, authority, agency or tribunal that directly or indirectly challenges the making of this Offer, the acquisition of some or all of the exchanged Eligible Options, the issuance of RSUs and/or New Options, or otherwise relates to this Offer or that, in our reasonable judgment, could materially and adversely affect our business, condition (financial or other), income, operations or prospects;
- if any action is threatened, pending or taken, or any approval is withheld, by any court or any authority, agency or tribunal, domestic or foreign, that, in our reasonable judgment, would or might directly or indirectly:

(a) make it illegal for us to accept some or all of the Eligible Options or to issue some or all of the RSUs and/or New Options or otherwise restrict or prohibit consummation of this Offer or otherwise relate to this Offer;

(b) delay or restrict our ability, or render us unable, to accept the Eligible Options for exchange and cancellation or to issue RSUs and/or New Options for some or all of the exchanged Eligible Options; or

(c) materially and adversely affect our business, condition (financial or other), income, operations or prospects;

- if there is:

(a) any general suspension of trading in, or limitation on prices for, securities on any national securities exchange or in the over-the-counter market; or

(b) the declaration of a banking moratorium or any suspension of payments in respect of banks in the United States, whether or not mandatory;

- if another person publicly makes or proposes a tender or exchange offer for some or all of our common stock, or an offer to merge with or acquire us;

- if any of the following change or changes occur in our business, condition (financial or other), assets, income, operations, prospects or stock ownership:

(a) litigation or other proceedings are instituted against us, or any of our officers or members of our Board in their capacities as such, before or by any federal, state or local court, commission, regulatory body, administrative agency or other governmental or legislative body, domestic or foreign, in which an unfavorable ruling, decision, action, order, decree or finding resulting from such litigation or proceeding would materially and adversely affect Tegal collectively with our subsidiaries;

(b) a material loss or interference with our business or properties from fire, explosion, flood or other casualty, whether or not covered by insurance;

(c) the suspension of trading in our equity securities by the SEC or by the Nasdaq Stock Market; or

(d) a material change in the prospects for our business resulting from any number of factors such as a material adverse change in the financial or securities markets in the United States or elsewhere, or in political, financial or economic conditions in the United States or elsewhere, or any outbreak or material escalation of foreign or domestic hostilities or other calamity or crisis that could, in our reasonable judgment, have a material adverse effect on the business, condition (financial or other), operations or prospects of Tegal or our subsidiaries or on the trading in our common stock;

- if we are required to extend the Expiration Date beyond January 6, 2007 as a result of action or determination by the SEC or other regulatory authority.

We may assert these conditions in our sole discretion at any time before the Expiration Date and we may waive them at any time before the Expiration Date, whether or not we waive any other condition to this Offer. Should we decide to waive or assert any of the conditions to this Offer, we must do so by 11:59 p.m. Pacific Daylight Time on the Expiration Date.

Our failure to exercise any of these rights is not a waiver of any of these rights. The waiver of any particular right is not, and will not be construed as, the waiver of any other right. However, once we choose to waive a particular right, we may not reassert that particular right again in this Offer. Any determination we make concerning the events described in this Section 6 will be final and binding on all Eligible Employees.

We currently expect that we will accept all Eligible Options that are properly submitted to be exchanged and have not been validly withdrawn.

## 7. PRICE RANGE OF COMMON STOCK.

There is no established trading market for the Eligible Options. The securities underlying the Eligible Options are shares of our common stock. Our common stock is quoted on the Nasdaq Capital Market under the symbol "TGAL". The following table shows, for the periods indicated, the high and low sale prices per share of our common stock as reported by the Nasdaq Capital Market.

	High	Low
<b>Year ended March 31, 2005</b>		
First Quarter	\$ 34.20	\$ 15.24
Second Quarter	24.12	9.84
Third Quarter	23.52	12.60
Fourth Quarter	20.4	10.44
<b>Year ended March 31, 2006</b>		
First Quarter	\$ 17.52	\$ 11.64
Second Quarter	12.00	7.56
Third Quarter	9.48	6.00
Fourth Quarter	8.40	5.76
<b>Year ended March 31, 2007</b>		
First Quarter	\$ 8.64	\$ 3.96
Second Quarter	5.04	2.62
Third Quarter (through November 3, 2006)	4.79	3.61

As of November 3, 2006, the last reported sale price of our common stock as reported on the Nasdaq Capital Market was \$3.85 per share.

The number of shares of our common stock outstanding as of November 3, 2006 was 7,072,289.

If you elect to receive New Options, we cannot guarantee that the New Options will have a lower exercise price than the Eligible Options. We recommend that you obtain and consider current market quotations for our common stock among other factors, before deciding whether to exchange your Eligible Options.

## 8. SOURCE AND AMOUNT OF CONSIDERATION; TERMS OF RSUs AND NEW OPTION GRANTS.

*Consideration.* In this Offer, each Eligible Option may be exchanged for either RSUs or a New Option to be granted in accordance with the following exchange formula (rounded down to the next whole share): the value of your Eligible Options (as determined under an option pricing model) will be reduced by ten percent (10%), then that reduced amount will be divided by the fair market value of a share of Company common stock on the Grant Date. "Fair market value" for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. The option pricing model to be used is the Black-Scholes valuation model (a widely used model for calculating the value of derivative securities).

As of November 3, 2006, there were outstanding Eligible Options to purchase 310,812 shares of Company common stock. If we receive and accept for exchange all outstanding Eligible Options and all participants in the Offer elect to receive RSUs, we will grant RSUs representative of approximately 219,089 shares of our common stock, equaling approximately 3 percent of the total shares of our common stock outstanding as of November 3, 2006.

*Exercise Price of New Options.* All New Options will be granted with an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market the last trading day prior to the Grant Date. We cannot guarantee that the New Options will have a lower exercise price than the Eligible Options for which they are exchanged, because we can provide no assurance as to the price of our common stock in the future.

*Vesting of RSUs and New Options.* The RSUs and New Options will be completely unvested at the time of grant, regardless of the vesting schedule of the tendered Eligible Options, and the RSUs and New Options will vest in two annual installments: 50% vested on the first anniversary of the Grant Date, and 100% vested on the second anniversary of the Grant Date. Vesting is contingent upon your continuous employment with the Company through the applicable vesting dates. The New Options will become exercisable as they vest, and will have an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market on the last trading day prior to the Grant Date. One share of Company common stock will be delivered to you for each RSU that vests. The purchase price of the shares of common stock to be issued upon settlement of your RSUs will be the par value of our common stock, which is equal to one-tenth of one cent (\$0.01) and the par value will be deemed paid by your past services rendered to Tegal. As a result, you do not have to make a payment to Tegal to receive the shares of common stock to be issued upon your settlement of your RSUs.

If you terminate from employment with the Company prior to full vesting, you will forfeit and have no further rights with respect to any unvested portion of your RSUs and/or New Options.

For example, a fully vested Eligible Option grant would be exchangeable for a New Option grant with an exercise price set at the current market price on the trading day before the Grant Date and vesting over two years in annual installments, with vesting beginning on the first anniversary following the Grant Date.

*Term of the New Options.* The New Options will have a term equal to the remaining term of your Eligible Options exchanged, as long as you remain employed by Tegal. (See Section 8 of the Offer.) For example, if you decide to exchange an Eligible Option which would otherwise expire in 2009 for New Options, your New Options will also expire in 2009.

*Other Terms and Conditions of the RSUs and New Options.* All RSUs and New Options will be issued under and subject to the terms of the Plan. The New Options will not be exercisable prior to vesting. Shares of common stock will not be delivered under the RSUs until vesting. The other terms and conditions of the RSUs and New Options will be set forth in an award agreement to be entered into as of the Grant Date. Such other terms and conditions will be generally comparable to the other terms and conditions of other similar awards issued under the Plan. All New Options will be nonstatutory stock options granted under the Plan regardless of the tax status of the Eligible Options tendered for exchange. The shares of common stock that the RSUs represent and for which the New Options will be exercised are registered with the SEC.

## **9. INTEREST OF DIRECTORS AND EXECUTIVE OFFICERS; TRANSACTIONS AND ARRANGEMENTS INVOLVING STOCK OPTIONS.**

A list of executive officers and members of our Board is attached to this Offer as Appendix A. Our executive officers are eligible to participate in this Offer. The members of our board of directors, however are not eligible to participate in this offer.

As of November 3, 2006, all of our executive officers as a group (6 persons) held options outstanding under the Plan to purchase a total of 301,736 shares of our common stock. This represented approximately 44% of the shares subject to all options outstanding under the Plan and the Fifth Amended and Restated Stock Option Plan for Outside Directors.

Since September 3, 2006, none of our executive officers have engaged in transactions which involved options to purchase our common stock or involved a purchase or sale of our common stock.

There is no agreement, arrangement or understanding between Tegal or, to the best of our knowledge, any of our executive officers or members of our Board, and any other person for the purchase or acquisition from Tegal of any of our securities, except for the following as of November 3, 2006:

- outstanding options granted to executive officers to purchase an aggregate of 217,581 shares of common stock pursuant to the Plan; and
- outstanding options granted to members of our Board to purchase an aggregate of 84,155 shares of common stock pursuant to our Fifth Amended and Restated Stock Option Plan for Outside Directors.



## 10. STATUS OF OPTIONS ACQUIRED BY US IN THIS OFFER; ACCOUNTING CONSEQUENCES OF THIS OFFER.

We will cancel the difference between Eligible Options surrendered and RSUs and New Options issued and the shares of stock underlying such Eligible Options will be added to the number of shares reserved for issuance under the Eighth Amended and Restated 1998 Equity Participation Plan. Assuming exchange of all of the Eligible Options for RSUs and New Options, an aggregate of 65,013 options will be returned to the reserved share pool.

Under Statement of Financial Accounting Standards No. 123 (Revised), *Share-Based Payment* (“SFAS 123R”), we would be required to recognize an expense as a result of the grant of New Options in exchange for Eligible Options to the extent the fair value of the New Options exceeds the fair value of the Eligible Options surrendered under an applicable option valuation model. We would be required to recognize an expense of the grant of RSUs to the extent that the number of shares underlying the RSUs multiplied by the last reported sales price of Company common stock on the Grant Date exceeds the fair value of the Eligible Options immediately before their cancellation. Because the Offer has been designed as an approximate value-for-value exchange, we expect to incur little or no charge to earnings for financial accounting purposes as a result of this Offer. However, due to a number of factors, including but not limited to our inability to predict which or how many Eligible Options will be exchanged, or what the future market price of our common stock will be on the Grant Date, we cannot predict what exact charge to earnings might result from the Option Exchange Program.

## 11. LEGAL MATTERS; REGULATORY APPROVALS.

We are not aware of any license or regulatory permit material to our business that might be adversely affected by this Offer, or of any approval or other action by any government or regulatory authority or agency, other than SEC review and certain exemption or notice filings that may be required in certain countries outside the United States, that is required for the exchange of Eligible Options for RSUs and New Options. If any other approval, exemptive filing, notice filing or action should be required, we presently intend to seek the approval, make such filing or take the action. This could require us to delay the acceptance of any Eligible Options that you elect to exchange. We cannot assure you that we would be able to obtain any required approval, make such filing or take any other required action. Our obligation under this Offer to accept exchanged Eligible Options and to issue RSUs and New Options is subject to the conditions described in Section 6 of this Offer.

## 12. MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES.

The following is a summary of the material U.S. federal income tax consequences of the exchange of eligible options for RSUs and New Options pursuant to the Offer for those Eligible Employees subject to U.S. Federal income tax. This discussion is based on the Internal Revenue Code, its legislative history, treasury regulations thereunder and administrative and judicial interpretations as of the date of this offering circular, all of which are subject to change, possibly on a retroactive basis. This summary does not discuss all of the tax consequences that may be relevant to you in light of your particular circumstances, nor is it intended to be applicable in all respects to all categories of option holders. If you are a citizen or a resident of the United States, but are also subject to the tax laws of another country, you should be aware that there might be other tax and social security consequences in more than one country that may apply to you.

***We recommend that you consult your own tax advisor with respect to the United States federal, state and local tax consequences of participating in the offer, as the tax consequences to you are dependent on your individual tax situation.***

*U.S. Federal Income Tax Consequences of Restricted Stock Units (RSUs).* The exchange of Eligible Options should be treated as a non-taxable exchange and no income should be recognized for U.S. federal or state income tax purposes upon grant of RSUs. Instead, you will recognize ordinary income when the RSU vests and no longer can be forfeited, and the shares of stock are delivered, at which time Tegal will also generally have a tax withholding obligation. The amount of ordinary income you recognize will equal the fair market value of the shares on the vesting date, less the amount, if any, you paid for the shares. Although not obligated to do so, Tegal intends to automatically withhold a sufficient number of otherwise distributable shares of common stock when RSUs vest to satisfy all tax withholding obligations.

*U.S. Federal Income Tax Consequences of New Options.* The exchange of Eligible Options, whether non-qualified options or incentive stock options under Section 422 of the Internal Revenue Code, should be treated as a non-taxable exchange and no income should be recognized for U.S. federal or state income tax purposes upon grant of the New Options. However, when you exercise a New Option, the difference between the exercise price of such option and the fair market value of the shares subject to the option on the date of exercise will be treated as taxable compensation income to you, and you will be subject to withholding of income and employment taxes at that time.

All of the New Options you will be issued in exchange for your Eligible Options will be nonqualified stock options. The subsequent sale of the shares acquired pursuant to the exercise of a nonqualified stock option generally will give rise to capital gain or loss equal to the difference between the sale price and the sum of the exercise price paid for the shares plus the ordinary income previously recognized with respect to the shares, and these capital gains or losses will be treated as long-term capital gains or losses if you held the shares for more than one year following exercise of the option.

*U.S. Federal Income Tax Consequences of Incentive Stock Options.* So that you are able to compare the tax consequences of RSUs and New Options to those of any of your Eligible Options that are incentive stock options under Section 422 of the Internal Revenue Code, we have included the following summary as a reminder of the tax consequences generally applicable to incentive stock options under U.S. Federal income tax law:

Under current U.S. tax law, an option holder will not realize taxable income upon the grant of an incentive stock option. In addition, an option holder generally will not realize taxable income upon the exercise of an incentive stock option. However, an option holder's alternative minimum taxable income will be increased by the amount that the aggregate fair market value of the shares underlying the option, which is generally determined as of the date of exercise, exceeds the aggregate exercise price of the option. Except in the case of an option holder's death or disability, if an option is exercised more than three (3) months after the option holder's termination of employment, the option ceases to be treated as an incentive stock option and is subject to taxation under the rules that apply to nonstatutory stock options.

If an option holder sells the option shares acquired upon exercise of an incentive stock option, the tax consequences of the disposition depend upon whether the disposition is qualifying or disqualifying. The disposition of the option shares is qualifying if it is made:

- more than 2 years after the date the incentive stock option was granted; and
- more than 1 year after the date the incentive stock option was exercised.

If the disposition of the option shares is qualifying, any excess of the sale price of the option shares over the exercise price of the option will be treated as long-term capital gain taxable to the option holder at the time of the sale. Any such capital gain will be taxed at the long-term capital gain rate in effect at the time of sale.

If the disposition is not qualifying, which we refer to as a "disqualifying disposition," the excess of the fair market value of the option shares on the date the option was exercised (or, if less, the amount realized on the disposition of the shares) over the exercise price will be taxable income to the option holder at the time of the disposition.

Of that income, the amount up to the excess of the fair market value of the shares at the time the option was exercised over the exercise price will be ordinary income for income tax purposes and the balance, if any, will be long-term or short-term capital gain, depending upon whether or not the shares were sold more than 1 year after the option was exercised.

Unless an option holder engages in a disqualifying disposition, we will not be entitled to a deduction with respect to an incentive stock option. If an option holder engages in a disqualifying disposition, we will be entitled to a deduction equal to the amount of compensation income taxable to the option holder.

If you exchange an Eligible Option that is an incentive stock option, the New Options you receive will be nonqualified stock options. Accordingly, you would be giving up the tax treatment of incentive stock options if you participate in this Offer.

**The above descriptions are only a summary of the U.S. federal income tax consequences of the exchange of Eligible Options under this Offer, and is not intended to provide you with any tax advice in connection with this summary or this Offer. We recommend that you consult your own tax advisor with respect to the federal, state, local and foreign tax consequences of participating in this Offer.** Also, please note that as a result of the American Jobs Creation Act of 2004, options amended in a certain manner or granted with an exercise price that was lower than the fair market value of the underlying shares at the time of grant may be taxable to you before you exercise your option. As of the date of this Offer, how such options will be taxed is unclear.

### **13. EXTENSION OF THIS OFFER; TERMINATION; AMENDMENT.**

We may, at any time prior to the Expiration Date, extend the period of time during which this Offer is open and delay accepting any tendered Eligible Options by announcing the extension and giving oral or written notice of the extension to Eligible Employees.

You may withdraw your options at any time before the Expiration Date by following the procedures described in Section 3.

Additionally, in accordance with the legal requirements for tender offers, you may withdraw any options you elected to exchange if after forty (40) business days after the commencement of this Offer, we have not yet closed this Offer and we have not accepted for exchange all Eligible Option grants you elected to exchange. The date of the fortieth (40th) business day after the commencement of this Offer is January 6, 2007.

We may, at any time prior to the Expiration Date, terminate, postpone or amend this Offer. To postpone accepting or canceling Eligible Options, we must announce the postponement and give oral or written notice of the postponement to the Eligible Employees. Our right to postpone accepting and canceling Eligible Options may be limited by Rule 13e-4(f)(5) under the Securities Exchange Act of 1934 (the "Exchange Act"), which requires that we pay the consideration offered or return the Eligible Options promptly after we terminate or withdraw this Offer.

Subject to applicable law, we may amend this Offer in any way, including decreasing or increasing the consideration offered in this Offer to Eligible Employees or by decreasing or increasing the number of Eligible Options to be exchanged or surrendered in this Offer.

We may amend this Offer at any time prior to the expiration of this Offer by announcing the amendment. If we extend the length of time during which this Offer is open, the amendment must be announced no later than 9:00 a.m. Pacific Daylight Time on the next business day after the last previously scheduled or announced Expiration Date. Any announcement relating to this Offer will be sent promptly to Eligible Employees in a manner reasonably designed to inform Eligible Employees of the change.

If we materially change the terms of the Offer or the information concerning the Offer, or if we waive a material condition of the Offer, we will extend the Offer to the extent required by Rules 13e-4(d)(2) and 13e-4(e)(3) under the Exchange Act. These rules require that the minimum period during which a tender or exchange offer must remain open following material changes in the terms of the offer or information concerning the offer, other than a change in price or a change in percentage of securities sought, will depend on the facts and circumstances, including the relative materiality of such terms or information.

In addition, if we decide to take any of the following actions, we will publish a notice electronically or otherwise inform you in writing of such action and keep the exchange offer open for at least 10 business days after the date of such notification: (a) we increase or decrease the amount of consideration offered for the Eligible Options; or (b) we increase or decrease the number of Eligible Options that may be tendered in the Offer.

### **14. FEES AND EXPENSES.**

We will not pay any fees or commissions to any broker, dealer or other person pursuant to this Offer.

### **15. ADDITIONAL INFORMATION.**

This Offer document is part of a Tender Offer Statement on Schedule TO that we have filed with the Securities and Exchange Commission ("SEC"). This Offer does not contain all of the information contained in the Schedule TO and the exhibits to the Schedule TO. We recommend that you review the Schedule TO, including its exhibits, and the following materials that we have filed with the SEC before making a decision on whether to exchange your Eligible Options:

(a) our Annual Report on Form 10-K for our fiscal year ended March 31, 2006, filed with the SEC on June 13, 2006;

(b) our Quarterly Report on Form 10-Q for our quarter ended June 30, 2006, filed with the SEC on August 14, 2006;

(c) our Definitive Proxy Statement for our 2006 Annual Meeting of Stockholders, filed with the SEC on June 20, 2006; and

(d) the description of the common stock contained in our Registration Statement on Form 8-A (File No. 01-26824), which was declared effective by the Commission on October 18, 1995, including any subsequently filed amendments and related reports.

We are subject to the information requirements of the Securities Exchange Act of 1934, as amended. Accordingly, we file annual, quarterly and periodic reports, proxy statements and other information with the SEC relating to our business, financial statements and other matters. You may read and copy any documents we have filed with the SEC at prescribed rates at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Our SEC filings are also available to you free of charge at the SEC's web site at [www.sec.gov](http://www.sec.gov) and our Exchange Act filings are also available at our web site at [www.tegal.com](http://www.tegal.com).

You may obtain information on the operation of the public reference rooms by calling the SEC at 1-800-SEC-0330. Our SEC filings are also available to the public on the SEC's Internet site at <http://www.sec.gov>.

Our common stock is currently quoted on the Nasdaq Capital Market under the symbol "TGAL".

We will also provide without charge to each person to whom we deliver a copy of this Offer, upon their written or oral request, a copy of any or all of the documents to which we have referred you, other than exhibits to these documents (unless the exhibits are specifically incorporated by reference into the documents). Requests should be directed to:

Tegal Investor Relations  
2201 South McDowell Boulevard  
Petaluma, CA 94954

or the investor relations portion of our website at <http://www.Tegal.com> or by telephoning us at (707) 763-5600.

As you read the documents listed above, you may find some inconsistencies in information from one document to another. If you find inconsistencies between the documents, or between a document and this offer to exchange, you should rely on the statements made in the most recent document.

The information contained in this Offer about us should be read together with the information contained in the documents to which we have referred you, in making your decision as to whether or not to participate in this Offer.

## 16. FINANCIAL STATEMENTS

Attached as Appendix B to this Offer are our financial statements included in our Annual Report on Form 10-K for our fiscal year ended March 31, 2006 and our financial statements included in our most recent Quarterly Report on Form 10-Q for the quarter ended June 30, 2006. In addition, set forth below is our ratio of earnings to fixed charges for the fiscal years ended March 31, 2004, 2005, and 2006 and for the quarter ended June 30, 2006, and the book value per share information as of June 30, 2006.

	Fiscal Year Ended March 31,			Three Months
	2004	2005	2006	Ended June 30, 2006
Ratio of earnings to fixed charges <sup>(1)</sup>	—	—	—	—

<sup>(1)</sup> For purposes of computing the ratio of earnings to fixed charges, fixed charges consist of interest expense on capital leases and interest on debenture financing. Earnings were insufficient to cover fixed charges by \$41,463, \$4,000, \$0, and \$0 in fiscal years 2004, 2005, 2006 and the three months ended June 30, 2006.

The book value per share of the Company at June 30, 2006 was \$.29, based on 7,023,000 shares (on a post-reverse split basis) outstanding as of June 30, 2006.

More complete financial information may be obtained by accessing our public filings with the SEC by following the instructions in Section 15 of this Offer.

## 17. MISCELLANEOUS

We are not aware of any jurisdiction where the making of the Offer is not in compliance with applicable law. If we become aware of any jurisdiction where the making of the Offer is not in compliance with any valid applicable law, we will make a good faith effort to comply with such law. If, after such good faith effort, we cannot comply with such law, the offer will not be made to, nor will options be

accepted from the option holders residing in such jurisdiction.

**We have not authorized any person to make any recommendation on our behalf as to whether you should elect to exchange your Eligible Options through the Offer. You should rely only on the information in this document or documents to which we have referred you. We have not authorized anyone to give you any information or to make any representations in connection with the offer other than the information and representations contained in this offer to exchange and in the related option exchange program documents. If anyone makes any recommendation or representation to you or gives you any information, you must not rely upon that recommendation, representation or information as having been authorized by us.**

**APPENDIX A**

**INFORMATION ABOUT THE DIRECTORS AND EXECUTIVE OFFICERS OF TEGAL**

The executive officers and members of the board of directors of Tegal and their positions and offices as of November 3, 2006, are set forth in the following table:

Name	Position and Offices Held
Thomas R Mika	President, Chief Executive Officer and Chairman of the Board
Christine T Hergenrother	VP, Chief Financial Officer, Secretary and Treasurer
Scott L Brown	Vice President
Murali Narasimhan	Vice President
Steve Selbrede	Vice President, Chief Technology Officer
Vahan Tchakerian	Vice President
Edward Dohring	Director
Jeffrey Krauss	Director
Duane Wadsworth	Director

The business address of each director and executive officer is: c/ o Tegal Corporation, 2201 South McDowell Boulevard, Petaluma, CA, 94954. The business telephone number of each director and executive officer is (707) 763-5600.

Name	Shares Beneficially	
	Owned	Percent of Class (%)
Thomas R Mika	85,541	1.20
Christine T Hergenrother	7,862	*
Scott L Brown	0	—
Murali Narasimhan	10,417	*
Steve Selbrede	35,416	*
Vahan Tchakerian	17,461	*
Edward Dohring	30,064	*
Jeffrey Krauss	30,898	*
Duane Wadsworth	<u>15,900</u>	*
<u>Total</u>	233,559	3.28

\* Less than one percent.

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2006

or

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

Commission File Number: 0-26824

**TEGAL CORPORATION**  
(Exact Name of Registrant as Specified in Its Charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

68-0370244  
(I.R.S. Employer Identification  
No.)

2201 South McDowell Blvd.  
Petaluma, California 94954  
(Address of Principal Executive  
Offices)

Telephone Number (707) 763-  
5600  
(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 reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

As of August 11, 2006 there were 7,038,957 shares of our common stock outstanding. The number of shares outstanding reflects a 1 to 12 reverse stock split effected by the Registrant on July 25, 2006.

TEGAL CORPORATION AND SUBSIDIARIES

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**PART I — FINANCIAL INFORMATION**

**Item 1. Condensed Consolidated Financial Statements**

**TEGAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(Unaudited)  
(In thousands, except share data)

	<u>June 30,</u> <u>2006</u>	<u>March 31,</u> <u>2006</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 12,640	\$ 13,787
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$356 and \$205 at June 30, 2006, and March 31, 2006, respectively	6,344	5,265
Inventories	6,974	7,700
Prepaid expenses and other current assets	1,284	1,270
Total current assets	27,242	28,022
Property and equipment, net	1,692	1,849
Intangible assets, net	1,396	1,474
Other assets	148	146
Total assets	\$ 30,478	\$ 31,491
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable and bank lines of credit	\$ 107	\$ 27
Accounts payable	2,708	2,458
Accrued product warranty	668	506
Deferred revenue	564	477
Accrued expenses and other current liabilities	2,264	1,975
Total current liabilities	6,311	5,443
Long-term portion of capital lease obligations	—	2
Other long term obligations	—	6
Total long term liabilities	—	8
Total liabilities	\$ 6,311	\$ 5,451
Stockholders' equity:		
Preferred stock; \$ 0.01 par value; 5,000,000 shares authorized; none issued and outstanding	\$ —	\$ —
Common stock; \$ 0.01 par value; 200,000,000 shares authorized; 7,039,173 and 7,021,088 shares issued and outstanding at June 30, 2006 and March 31, 2006 respectively	844	842
Restricted Share Units	840	1,034
Deferred Compensation	(224)	(224)
Additional paid-in capital	119,471	119,010
Accumulated other comprehensive income	192	532
Accumulated deficit	(96,956)	(95,154)
Total stockholders' equity	24,167	26,040
Total liabilities and stockholders' equity	\$ 30,478	\$ 31,491

See accompanying notes.

**TEGAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(Unaudited)  
(In thousands, except per share data)

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>
Revenue	\$ 6,576	\$ 3,052
Cost of sales	4,078	2,377
Gross profit (loss)	<u>2,498</u>	<u>675</u>
Operating expenses:		
Research and development	996	1,176
Sales and marketing	1,044	644
General and administrative	2,302	1,240
Total operating expenses	<u>4,342</u>	<u>3,060</u>
Operating loss	(1,844)	(2,385)
Other income (expense), net	42	(122)
Net loss	<u>\$ (1,802)</u>	<u>\$ (2,507)</u>
Net loss per share, basic and diluted	\$ (0.26)	\$ (0.57)
Shares used in per share computation:		
Basic	7,023	4,409
Diluted	7,023	4,409

Note: Shares used in per share computation for Basic and Diluted reflect a 1 to12 reverse stock split effected by the Company on July 25, 2006

See accompanying notes.

**TEGAL CORPORATION AND SUBSIDIARIES**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)  
(In thousands)

	Three Months Ended June 30,	
	2006	2005
Cash flows from operating activities:		
Net loss	\$ (1,802)	\$ (2,507)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation and amortization	232	339
Stock Compensation Expense	230	
Fair value of warrants issued for services rendered	26	84
Provision for doubtful accounts and sales return allowances	152	(3)
Excess and obsolete inventory provision	(2,089)	
Changes in operating assets and liabilities:		
Receivables	(1,017)	(778)
Inventories	2,324	(733)
Prepaid expenses and other assets	(13)	(46)
Accounts payable	211	53
Accrued expenses and other liabilities	224	(392)
Accrued product warranty	112	(5)
Deferred revenue	87	156
Net cash used in operating activities	\$ (1,322)	\$ (3,832)
Cash flows used in investing activities:		
Purchases of property and equipment	\$ (20)	\$ (84)
Loss on disposal of property and equipment	23	
Net cash used in investing activities:	3	(84)
Cash flows provided by financing activities:		
Net proceeds from issuance of common stock	4	126
Borrowings under lines of credit	94	34
Repayment of borrowings under lines of credit		(110)
Proceeds from and (payments on) capital lease financing	(2)	(3)
Net cash provided by financing activities	96	47
Effect of exchange rates on cash and cash equivalents	76	(26)
Net increase (decrease) in cash and cash equivalents	(1,147)	(3,895)
Cash and cash equivalents at beginning of period	13,787	7,093
Cash and cash equivalents at end of period	\$ 12,640	\$ 3,198

See accompanying notes.

**TEGAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**  
**(All amounts in thousands, except share data)**

**1. Basis of Presentation:**

In the opinion of management, the unaudited condensed consolidated interim financial statements have been prepared on the same basis as the March 31, 2006 audited consolidated financial statements and include all adjustments, consisting only of normal recurring adjustments, necessary to fairly state the information set forth herein. The statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (the "SEC"), but omit certain information and footnote disclosures necessary to present the statements in accordance with generally accepted accounting principles. These interim financial statements should be read in conjunction with the consolidated financial statements and footnotes included in the Company's Annual Report on Form 10-K for the fiscal year ended March 31, 2006. The results of operations for the three months ended June 30, 2006 are not necessarily indicative of results to be expected for the entire year.

The condensed consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of \$1,802 and \$2,507 for the periods ended June 30, 2006 and 2005, respectively. The Company generated negative cash flows from operations of \$1,322 and \$3,832 for the period ended June 30, 2006 and 2005, respectively. During the Fiscal Year 2006 the Company raised a net of \$18,161 through a private investment placement of equity. Management believes that these proceeds, combined with projected sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal 2007. However, projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, the Company's ability to achieve its intended business objectives may be adversely affected. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern.

On July 21, 2006, Tegal Corporation filed with the Secretary of State of the State of Delaware a Certificate of Amendment to the Company's Certificate of Incorporation to affect a 1-for-12 reverse stock split of the Company's common. The condensed consolidated financial statements for current and prior periods have been adjusted to reflect the change in number of shares.

**Concentration of Credit Risk**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of temporary cash investments and accounts receivable. Substantially all of the Company's temporary investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the U.S., Europe and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains reserves for potential credit losses. Write-offs during the periods presented have been insignificant.

During the three months ending June 30, 2006, three (3) customers (ST Microelectronics, FlipChip, and RF Micro Devices) accounted for 83% of total revenues. During the three months ending June 30, 2005, three (3) customers accounted for 63% of total revenues.

During the three months ended June 30, 2006 and June 30, 2005, three customers accounted for approximately 80% and 70%, respectively of the accounts receivable balance

**Stock Based Compensation**

**Adoption of SFAS 123R**

The Company has adopted several stock plans that provide equity instruments to our employees and non-employee directors. Our plans include incentive and non-statutory stock options and restricted stock awards. Stock options generally vest ratably over a four-year period on the anniversary date of the grant, and expire ten years after the grant date. Restricted stock awards generally vest on the achievement of specific performance targets. The Company also has employee stock purchase plans that allow qualified employees to purchase Company shares at 85% of the fair market value on specified dates.

Prior to April 1, 2006 we accounted for these stock-based employee compensation plans under the measurement and recognition provisions of Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" or APB 25, and related Interpretations, as permitted by SFAS No. 123, "Accounting for Stock Based Compensation," or SFAS 123. With the exception of grants of restricted stock awards, we generally recorded no stock-based compensation expense during periods prior to April 1, 2006 as all stock-based grants had exercise prices equal to the fair market value of our common stock on the date of grant. We also recorded no compensation expense in connection with our employee stock purchase plans as they qualified as non-compensatory plans following the guidance provided by APB 25. In accordance with SFAS 123 and SFAS 148 "Accounting for Stock-Based Compensation-Transition and Disclosure," later in this Note we disclose our net loss and net loss per share for the quarter ended June 30, 2005 as if we had applied the fair value-based method in measuring compensation expense for our stock-based compensation plans.



Effective April 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123R using the modified prospective transition method. Under that transition method, compensation expense that we recognized for the three months ended June 30, 2006 included: (a) compensation expense for all share-based payments granted prior to but not yet vested as of April 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of SFAS 123, and (b) compensation expense for all share-based payments granted or modified on or after April 1, 2006, based on the grant date fair value estimated in accordance with the provisions of SFAS 123R. Compensation expense is recognized only for those awards that are expected to vest, whereas prior to the adoption of SFAS 123R, we recognized forfeitures as they occurred. In addition, we elected the straight-line attribution method as our accounting policy for recognizing stock-based compensation expense for all awards that are granted on or after April 1, 2006. Results in prior periods have not been restated.

Total stock compensation expense for the period ended June 30, 2006 was \$230. The total compensation expense related to nonvested awards not yet recognized is \$1,019. The weighted average period for which it is expected to be recognized is 2.3 years.

Had the Company adopted SFAS No 123R during the fiscal year ended March 31, 2006, compensation expense of approximately \$1,770 would have been recognized in the consolidated statements of operations for the year ended March 31, 2006.

The following assumptions are included in the estimated grant date fair value calculations for the Company's stock option awards and Employee Qualified Stock Purchase Plan ("ESPP"):

	<b>Three Months Ended</b>	
	<b>June 30,</b>	
	<b>2006</b>	<b>2005</b>
Expected life (years):		
Stock options	4.0	4.0
ESPP	0.5	0.5
Volatility:		
Stock options	82.40%	71.00%
ESPP	82.40%	71.00%
Risk-free interest rate	5.25%	3.21%
Dividend yield	0.00%	0.00%

During the three months ended June 30, 2006, there were no stock option grants.

The following table illustrates on a post reverse stock split basis, the effect on net income (loss) and net income (loss) per share if the Company had applied the fair value recognition provisions of SFAS No. 123R to stock-based compensation (in thousands, except per share data):

	<b>Three Months Ended</b>	
	<b>June 30, 2005</b>	
Net loss as reported	\$	(2,507)
Add: Stock-based employee compensation expense included in reported net loss		
Deduct: Total stock-based employee compensation expense determined under fair value method for all awards		(546)
Proforma net loss	\$	(3,053)
Basic net loss per share:		
As reported	\$	( 0.57)
Proforma	\$	(0.69)

The disclosure provisions of SFAS No. 123R and SFAS No. 148 require judgments by management as to the estimated lives of the outstanding options. Management has based the estimated life of the options on historical option exercise patterns. If the estimated life of the options increases, the valuation of the options will increase as well.

### Stock Options & Warrants

A summary of stock option and warrant activity during the quarter ended June 30, 2006 is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in Years)	Aggregate Intrinsic Value
<b>BEGINNING OUTSTANDING</b>	2,304,522	\$ 13.70		
<b>GRANTED</b>	0			
<b>EXERCISED</b>	0			
<b>CANCELLED:</b>				
<b>Forfeited</b>	(260)	\$ 15.60		
<b>Expired</b>	(23,945)	\$ 29.10		
<b>Total</b>	<u>(24,206)</u>	<u>\$ 28.96</u>		
<b>ENDING OUTSTANDING</b>	<u>2,280,317</u>	<u>\$ 13.54</u>	<u>5.12</u>	<u>5,884</u>
<b>ENDING VESTED + EXPECTED TO VEST</b>	<u>2,260,139</u>	<u>\$ 13.56</u>	<u>0.10</u>	<u>5,884</u>
<b>ENDING EXERCISABLE</b>	<u>2,081,878</u>	<u>\$ 13.76</u>	<u>4.84</u>	<u>5,884</u>

The aggregate intrinsic value of options and warrants outstanding at June 30, 2006 is calculated as the difference between the exercise price of the underlying options and the market price of our common stock for the 16,344 warrants that had an exercise price that was lower than the market price of our common stock as of June 30, 2006.

The following table summarizes information with respect to stock options and warrants outstanding as of June 30, 2006:

Range of Exercise Prices		Number Outstanding As of June 30, 2006	Weighted Average Remaining Contractual Term (in Years)	Weighted Average Exercise Price	Number Exercisable As of June 30, 2006
\$ 4.20	\$ 8.28	353,839	7.09	\$ 6.99	244,152
9.60	9.96	13,554	3.82	9.74	13,207
12.00	12.00	1,285,000	4.18	12.00	1,285,000
12.36	12.96	243,191	7.52	12.43	194,162
13.20	25.68	245,833	6.82	16.65	206,458
27.00	82.56	130,150	1.61	37.61	130,150
92.26	92.26	417	3.69	92.26	417
92.52	92.52	4,167	3.63	92.52	4,167
99.00	99.00	2,500	3.74	99.00	2,500
105.00	105.00	1,667	2.48	105.00	1,667
<u>\$ 4.20</u>	<u>\$ 105.00</u>	<u>2,280,317</u>	<u>5.12</u>	<u>\$ 46.71</u>	<u>2,081,878</u>

## Restricted Stock Units

The following table summarizes our restricted stock award activity for the three ended June 30, 2006:

	Number of Shares	Weighted Average Grant Date Fair Value
Balance, March 31, 2006	79,167	\$ 10.20
Granted	—	—
Vested	—	—
Forfeited	—	—
Released	16,667	11.64
Balance, June 30, 2006	<u>62,500</u>	<u>\$ 9.82</u>

## Unvested restricted stock at June 30, 2006

As of June 30, 2006, there was \$224 of total unrecognized compensation cost related to restricted stock which is expected to be recognized during the current fiscal year. As of June 30, 2006, there were a total of 54,167 restricted shares subject to performance conditions that will result in forfeiture if the conditions are not realized.

## 2. Inventories:

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. We estimate the effects of excess and obsolescence on the carrying values of our inventories based upon estimates of future demand and market conditions. We establish provisions for related inventories in excess of production demand. Should actual production demand differ from our estimates, additional inventory write-downs may be required, as was the case in the fourth quarter of fiscal 2005. Any excess and obsolete provision is released only if and when the related inventory is sold or scrapped. During the three months ending June 30, 2006 and June 30, 2005, the Company sold or scrapped previously reserved inventory of \$2,088 and \$155 respectively. The inventory provision at June 30, 2006 and June 30, 2005 was \$5,047 and \$8,126, respectively.

Inventories for the periods presented consisted of:

	June 30 2006	March 31 2006
Raw materials	\$ 586	\$ 1,692
Work in progress	4,435	4,173
Finished goods and spares	1,953	1,835
	<u>\$ 6,974</u>	<u>\$ 7,700</u>

We periodically analyze any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, our policy is that, if after approximately 18 months, we determine that a sale will not take place within the next 12 months and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

## 3. Product Warranty:

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is affected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Should actual product failure rates, material usage rates and labor efficiencies differ from estimates, revisions to the estimated warranty liability may be required.



Warranty activity for the three-month periods ended June 30, 2006 and 2005 was:

	<b>Warranty Activity for the Three Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Balance at the beginning of the period	\$ 506	\$ 252
Additional warranty accruals for warranties issued during the period	384	45
Accruals related to pre-existing warranties	(62)	
Less settlements made during the period	(160)	(59)
<b>Balance at the end of the period</b>	<b>\$ 668</b>	<b>\$ 238</b>

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

#### 4. Net Loss Per Common Share:

Basic net loss per common share is computed using the weighted-average number of shares of common stock outstanding. The following table represents the calculation of basic and diluted net loss per common share (in thousands, except per share data):

	<b>Three Months Ended June 30,</b>	
	<b>2006</b>	<b>2005</b>
Net loss applicable to common stockholders	\$ (1,802)	\$ (2,507)
Basic and diluted:		
Weighted-average common shares outstanding (adjusted to reflect 1 to 12 reverse stock split)	7,023	4,409
Less weighted-average common shares subject to repurchase...	0	0
<b>Weighted-average common shares used in computing basic and diluted net loss per common share</b>	<b>7,023</b>	<b>4,409</b>
Basic and diluted net loss per common share	\$ (0.26)	\$ (0.57)

Outstanding options, warrants and restricted stock equivalent of 2,342,817 and 9,749 shares of common stock at a weighted-average exercise price of \$13.54 and \$6.84 per share on June 30, 2006 and 2005 respectively, were not included in the computation of diluted net loss per common share for the periods presented as a result of their anti-dilutive effect. Such securities could potentially dilute earnings per share in future periods.

#### 5. Stock-Based Transactions:

##### *Issuance of Warrants to Consultants*

The Company is party to a contract with certain consultants pursuant to which the Company will issue warrants on a monthly basis in lieu of cash payments through August 2006, depending upon the continuation of the contract and the achievement of certain performance goals. The maximum number of warrants to be issued under these agreements is 82,500 shares. During the three months ended June 30, 2006 and June 30, 2005 6,667 and 7,083, respectively, were issued valued at \$32 and \$84, respectively, using the Black Scholes model with an exercise price at the market value on the day of the grant. The life of the warrants is five and seven years with an interest rate of 2.225% and volatility of 118% and 115% respectively. None of these warrants have been exercised as of June 30, 2006.

## 6. Lines of Credit:

As of June 30, 2006, our Japanese subsidiary had \$107 outstanding under its lines of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The two credit lines have a total borrowing capacity of 150 million yen (approximately \$1,304 at exchange rates prevailing on June 30, 2006), which are secured by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The two Japanese bank lines bear interest at Japanese prime (1.375% as of June 30, 2006) plus 0.875%. As of June 30, 2005, the Company's Japanese subsidiary had borrowed 3.9 million Yen (approximately \$35 at exchange rates prevailing on June 30, 2005) under its Japanese bank line of credit. The credit line has a total borrowing capacity of 150 million Yen (approximately \$1,351 at exchange rates prevailing on June 30, 2005).

Notes payable as of June 30, 2006 consisted of capital lease obligations on fixed assets totaling \$11.

## 7. Legal Proceedings

Sputtered Films, Inc. v. Advanced Modular Sputtering, et al., filed in Santa Barbara County Superior Court.

On December 22, 2003, Sputtered Films, Inc. ("SFI"), a wholly owned subsidiary of the Company, filed an action against two former employees, Sergey Mishin and Rose Stuart-Curran, and a company they formed after leaving their employment with SFI named Advanced Modular Sputtering, Inc. ("AMS"). Sergey Mishin and Rose Stuart-Curran had each signed confidentiality and non-disclosure agreements regarding information obtained while employed by SFI. The action contains causes of action for specific performance, breach of contract, breach of the covenant of good faith and fair dealing, misappropriation of trade secrets, unfair competition, unfair business practices, and interference with prospective economic advantage, conversion, unjust enrichment, and declaratory relief. These claims arise out of information SFI received evidencing that AMS possessed and used SFI's confidential, proprietary and trade secret drawings, specifications and technology to manufacture the sputtering tool marketed by AMS.

During 2004 and 2005, this litigation was largely stalled while AMS and Agilent Technologies, Inc. contested SFI's right to conduct discovery. This dispute was resolved in late 2005 when the California Court of Appeal affirmed SFI's trade secret identification as statutorily sufficient. On November 18, 2005, SFI requested leave to add Agilent Technologies, Inc. ("Agilent") as a defendant based on evidence that Agilent and AMS co-developed the machines which SFI contends were built using SFI proprietary information. The Court granted SFI's request and Agilent was served as a Doe defendant on December 12, 2005. In early December, SFI learned that Agilent transferred its Semiconductor Products Group to a number of Avago entities effective December 1, 2005, and accordingly SFI sought and received court approval to add Avago Technologies U.S., Inc. and Avago Technologies Wireless (U.S.A.) Manufacturing, Inc (collectively the "Avago Entities") as defendant in this action. On April 25, 2006, the Avago Entities filed a Cross-Complaint against SFI and Tegal Corporation alleging causes of action for breach of contract, trade secret misappropriation, unfair competition, conversion, unjust enrichment and declaratory relief. The Cross-Complaint alleges on information and belief that SFI misused information obtained from Hewlett-Packard in connection with Hewlett-Packard's request to purchase SFI machines or to upgrade SFI machines Hewlett-Packard already owned. SFI and Tegal Corporation intend to vigorously contest all such allegations. Trial is currently set for November 8, 2006, although the Court has indicated that it may bifurcate the Avago Entities' cross-claims. The Court severed from SFI's action the Cross-Complaint filed by the Avago Entities, and all matters regarding the Avago Cross-Complaint, including discovery, are stayed until after completion of the trial on SFI's Complaint.

## 8. Geographical Information

Tegal operates in one segment for the manufacture, marketing and servicing of integrated circuit fabrication equipment. In accordance with SFAS No. 131 (SFAS 131) "Disclosures About Segments of an Enterprise and Related Information," Tegal's chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. All material operating units qualify for aggregation under SFAS 131 due to their identical customer base and similarities in: economic characteristics; nature of products and services; and procurement, manufacturing and distribution processes. Since Tegal operates in one segment and in one group of similar products and services, all financial segment and product line information required by SFAS 131 can be found in the consolidated financial statements.

For geographical reporting, revenues are attributed to the geographic location in which the customers' facilities are located. Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Net sales and long-lived assets by geographic region were as follows:

	Revenue for the Three Months Ended June 30,	
	2006	2005
Sales to customers located in:		
United States	\$ 5,044	\$ 327
Asia, excluding Japan	179	140
Japan	524	578
Europe	829	2,007

Total sales	\$	<u>6,576</u>	\$	<u>3,052</u>
-------------	----	--------------	----	--------------

	<b>Long-lived Assets</b>	
	<b>as of June 30,</b>	
	<b>2006</b>	<b>2005</b>
Long-lived assets at period-end:		
United States	\$ 4,336	\$ 4,857
Europe	14	5
Japan	10	19
Asia, excluding Japan	2	2
Total long-lived assets	<u>\$ 4,362</u>	<u>\$ 4,883</u>

## 9. Comprehensive Income (Loss):

The components of comprehensive loss for the three months ended June 30, 2006 and 2005 are as follows:

	Three Months Ended June 30,	
	2006	2005
Net loss	\$ (1,802)	\$ (2,507)
Foreign currency translation adjustment	(331)	174
Total comprehensive loss	<u>\$ (2,133)</u>	<u>\$ (2,333)</u>

## 10. Subsequent Events

### *Reverse Stock Split*

On July 21, 2006, Tegal Corporation filed with the Secretary of State of the State of Delaware a Certificate of Amendment to the Company's Certificate of Incorporation to effect a 1-for-12 reverse stock split of the Company's common stock (the "Reverse Stock Split"). The Reverse Stock Split received the required approval of the Company's stockholders at the Company's annual meeting held on July 21, 2006. The reverse stock split took effect before trading began on Tuesday, July 25, 2006, at which time the symbol will changed to TGALD. The symbol will return to the normal TGAL at the open of the market on August 22, 2006. In lieu of any fractional shares to which a holder of common stock would otherwise be entitled as a result of the Reverse Stock Split, the Company will pay cash equal to such fraction multiplied by \$4.68, which is the average of the high and low trading prices of our common stock on the Nasdaq Capital Market during regular trading hours for the five trading day period ending on July 21, 2006.

On August 8, 2006, the Company received notice from the Nasdaq Stock Market that it had regained compliance with its listing requirements.

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

**Form 10-K**

For Annual and Transition Reports Pursuant to Sections 13 or #15D of the Securities and Exchange Act of 1934

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

For the fiscal year ended March 31, 2006

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

Commission file number: 0-26824

**Tegal Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of incorporation or organization)

**68-0370244**

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

**2201 South McDowell Boulevard**

**Petaluma, California**

(Address of principal executive offices)

**94954**

(Zip Code)

**Registrant's Telephone Number, Including Area Code: (707) 763-5600**

**Securities Registered Pursuant to Section 12(b) of the Act: None**

**Securities Registered Pursuant to Section 12(g) of the Act:  
Common Stock, \$0.01 Par Value**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes  No

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 reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

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

Yes  No

Indicate by check mark if the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes  No



The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the closing sale price of the common stock on September 30, 2005 as reported on the NASDAQ Smallcap Market, was \$59,593,820. As of May 19, 2006, 84,253,058 shares of the registrant's common stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for registrant's 2006 Annual Meeting of Stockholders to be held July 21, 2006 will be filed with the Commission within 120 days after the close of the registrant's fiscal year and are incorporated by reference in Part III.

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## PART I

### Item 8. *Financial Statements and Supplementary Data*

#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Tegal Corporation

We have audited the accompanying consolidated balance sheets of Tegal Corporation as of March 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. We have also audited the information presented in Schedule II that is listed in the index and appearing under Item 15(a)(2), for the years ended March 31, 2006 and 2005. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Tegal Corporation as of March 31, 2006 and 2005, and the consolidated results of its operations and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the information presented in Schedule II for the years ended March 31, 2006 and 2005, when considered in relation to the March 31, 2006 and 2005, consolidated financial statements, taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Moss Adams LLP

Santa Rosa, California  
June 9, 2006

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders  
of Tegal Corporation:

In our opinion, the consolidated statements of operations, stockholders' equity and cash flows for the year ended March 31, 2004 listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the results of operations and cash flows of Tegal Corporation and its subsidiaries for the year ended March 31, 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule for the year ended March 31, 2004 listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring net losses and has generated negative cash flows from operations. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

PricewaterhouseCoopers LLP  
San Jose, California  
June 25, 2004

**TEGAL CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

	March 31,	
	2006	2005
	(In thousands, except share and per share data)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 13,787	\$ 7,093
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$205 and \$533 at March 31, 2006 and 2005, respectively	5,265	1,897
Inventories, net	7,700	5,140
Prepaid expenses and other current assets	1,270	641
<b>Total current assets</b>	<b>28,022</b>	<b>14,771</b>
Property and equipment, net	1,849	3,342
Intangible assets, net	1,474	1,796
Other assets	146	183
<b>Total assets</b>	<b>\$ 31,491</b>	<b>\$ 20,092</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable and bank lines of credit	\$ 27	\$ 159
Accounts payable	2,458	3,607
Accrued product warranty	506	252
Deferred revenue	477	122
Accrued expenses and other current liabilities	1,975	2,575
<b>Total current liabilities</b>	<b>5,443</b>	<b>6,715</b>
Long-term portion of capital lease obligations	2	13
Other long term obligations	6	64
<b>Total long term liabilities</b>	<b>8</b>	<b>77</b>
<b>Total liabilities</b>	<b>\$ 5,451</b>	<b>6,792</b>
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Preferred stock; \$0.01 par value; 5,000,000 shares authorized; none issued and outstanding	—	—
Common stock; \$0.01 par value; 200,000,000 shares authorized; 84,253,058 and 52,843,520 shares issued and outstanding at March 31, 2006 and 2005, respectively	842	528
Restricted Stock Units	1,034	
Deferred Compensation	(224)	
Additional paid-in capital	119,010	99,156
Accumulated other comprehensive income (loss)	532	(110)
Accumulated deficit	(95,154)	(86,274)
<b>Total stockholders' equity</b>	<b>26,040</b>	<b>13,300</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 31,491</b>	<b>\$ 20,092</b>

See accompanying notes to consolidated financial statements.

TEGAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended March 31,		
	2006	2005	2004
	(In thousands, except share and per share data)		
Revenue	\$ 21,757	\$ 14,888	\$ 16,528
Cost of revenue	15,741	11,621	11,881
Gross profit	6,016	3,267	4,647
Operating expenses:			
Research and development expenses	4,753	5,772	3,305
Sales and marketing expenses	2,963	2,905	2,347
General and administrative expenses	7,139	6,459	3,973
In-process research and development		1,653	2,202
Total operating expenses	14,855	16,789	11,827
Operating loss	(8,839)	(13,522)	(7,180)
Interest income (expense), net	291	(2,064)	(5,521)
Other income (expense), net	(864)	223	99
Total other expense, net	(573)	(1,841)	(5,422)
Income Taxes	532		
Net loss	\$ (8,880)	\$ (15,363)	\$ (12,602)
Net loss per share:			
Basic and diluted	\$ (0.13)	\$ (0.33)	\$ (0.56)
Weighted average shares used in per share computations:			
Basic and diluted	70,831	46,879	22,442

See accompanying notes to consolidated financial statements.

TEGAL CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional	Accumulated	Accumulated	Total	Compre-
	Shares	Amount	Paid-in Capital	Other Comprehensive Income	Deficit	Stock- Holders' Equity	hensive Loss
(In thousands, except share and per share data)							
Balances at March 31, 2003	16,091,762	161	68,806	465	(58,309)	11,123	—
Common stock issued under option and stock purchase plans	90,269	1	68	—	—	69	—
Common stock issued for acquisition	1,499,994	15	2,327	—	—	2,342	—
Restricted stock issued for services rendered	158,311	—	332	—	—	332	—
Options and warrants, issued in previous years, exercised for services rendered	470,899	6	399	—	—	405	—
Warrants and options to purchase common stock issued for services rendered	—	—	756	—	—	756	—
Debentures – value of Beneficial conversion feature	—	—	5,190	—	—	5,190	—
Debentures – fair value of warrants issued to investors and brokers	—	—	1,724	—	—	1,724	—
Debentures – interest & accelerated discount	—	—	4,033	—	—	4,033	—
Debentures – debt issuance in form of warrants	—	—	784	—	—	784	—
Debentures – converted to shares	15,685,769	157	(157)	—	—	—	—
Debentures – interest converted to shares	95,609	1	(1)	—	—	—	—
Debentures – investor warrants exercised	892,497	9	437	—	—	446	—
Debentures – broker warrants exercised	1,536,605	15	522	—	—	537	—
Private Institutional Offering December 2001 – warrants exercised	62,135	1	156	—	—	157	—
Net loss	—	—	—	—	(12,602)	(12,602)	\$ (12,602)
Cumulative translation adjustment	—	—	—	(341)	—	(341)	(341)
Total comprehensive loss	—	—	—	—	—	—	\$ (12,943)
Balances at March 31, 2004	36,583,850	366	85,376	124	(70,911)	14,955	—
Common stock issued under option and stock purchase plans	89,183	1	97	—	—	98	—
Common stock issued for acquisition	1,410,632	14	2,328	—	—	2,342	—
Options and Warrants issued for services rendered	—	—	—	—	—	—	—
Warrants and options to purchase common stock issued for services rendered	—	—	339	—	—	339	—
Debentures – value of Beneficial conversion feature	—	—	1,811	—	—	1,811	—
Debentures – interest & accelerated discount	—	—	—	—	—	—	—
Debentures – converted to shares	4,785,659	48	(48)	—	—	—	—
Debentures – interest converted to shares	39,459	—	—	—	—	—	—
Debentures – investor & advisor warrants exercised	1,426,720	14	338	—	—	352	—
Private Institutional Offering December 2001 – warrants exercised	1,686	—	—	—	—	—	—
Kingsbridge	8,506,331	85	8,915	—	—	9,000	—
Net loss	—	—	—	—	(15,363)	(15,363)	\$ (15,363)
Cumulative translation adjustment	—	—	—	(234)	—	(234)	(234)
Total comprehensive loss	—	—	—	—	—	—	\$ (15,597)
Balances at March 31, 2005	52,843,520	\$ 528	\$ 99,156	\$ (110)	\$ (86,274)	\$ 13,300	—

	<u>Common Stock</u>		<u>Additional</u>	<u>Accumulated</u>	<u>Accumulated</u>	<u>Total</u>	<u>Compre-</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u>	<u>Other</u>	<u>Deficit</u>	<u>Stock-</u>	<u>hensive</u>
			<u>Capital</u>	<u>Income</u>		<u>Holders'</u>	<u>Loss</u>
						<u>Equity</u>	
(In thousands, except share and per share data)							
Common stock issued under option and stock purchase plans	113,974	2	94	—	—	96	—
Common stock issued for PIPE	30,840,000	308	19,738	—	—	20,046	—
Common stock issued for services rendered	176,360	1	102	—	—	103	—
Warrants and options to purchase common stock issued for services rendered	—	—	953	—	—	953	—
Restricted Stock Units - Granted/Vested	279,204	3	1,228	—	—	1,231	—
Deferred Compensation	—	—	(224)	—	—	(224)	—
Cost of Equity	—	—	(1,662)	—	—	(1,662)	—
Valuation of Warrants for 2005 PIPE	—	—	435	—	—	435	—
Net loss	—	—	—	—	(8,880)	(8,880)	\$ (8,880)
Cumulative translation adjustment	—	—	—	642	—	642	<u>642</u>
Total comprehensive loss	—	—	—	—	—	—	<u>\$ (8,238)</u>
Balance at March 31, 2006	<u>84,253,058</u>	<u>\$ 842</u>	<u>\$ 119,820</u>	<u>\$ 532</u>	<u>\$ (95,154)</u>	<u>\$ 26,040</u>	

See accompanying notes to consolidated financial statements.

**TEGAL CORPORATION**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Year Ended March 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net loss	\$ (8,880)	\$ (15,363)	\$ (12,602)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,193	1,452	1,338
In-process research and development		1,653	2,202
Provision for doubtful accounts and sales returns allowances	(338)	273	56
Non cash interest expense - accretion of debt discount and amortization of debt issuance costs		2,019	5,480
Fair value of warrants and options issued for services rendered	1,958	381	332
Non Cash Mark to Market Warrants	435		
Excess and obsolete inventory provision	(1,146)	778	967
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(2,718)	2,402	(2,362)
Inventories	(618)	(2,093)	2,508
Prepaid expenses and other assets	(532)	24	(286)
Accounts payable	(1,112)	1,916	(311)
Accrued expenses and other current liabilities	(601)	(470)	(190)
Accrued product warranty	300	(173)	(411)
Customer deposits	—	—	(15)
Deferred revenue	355	(318)	115
Net cash used in operating activities	<u>(11,704)</u>	<u>(7,519)</u>	<u>(3,179)</u>
Cash flows from investing activities:			
Purchases of property and equipment	(231)	(315)	(254)
Loss of property and equipment	128	—	—
Net cash used in investing activities	<u>(103)</u>	<u>(315)</u>	<u>(254)</u>
Cash flows from financing activities:			
Gross proceeds from the issuance of 2% convertible debentures	—	—	7,165
2% convertible debentures cash issuance costs	—	—	(982)
Net proceeds from issuance of common stock	18,583	10,206	1,613
Borrowings under notes payable and bank lines of credit		1,303	2,474
Repayments of notes payable and bank lines of credit	(134)	(3,594)	(527)
Payments on capital lease financing	(24)	(11)	(9)
Net cash provided by financing activities	<u>18,425</u>	<u>7,904</u>	<u>9,734</u>
Effect of exchange rates on cash and cash equivalents	76	(26)	(164)
Net increase in cash and cash equivalents	6,694	44	6,137
Cash and cash equivalents at beginning of year	7,093	7,049	912
Cash and cash equivalents at end of year	<u>\$ 13,787</u>	<u>\$ 7,093</u>	<u>\$ 7,049</u>
Supplemental disclosures of cash paid during the year for:			
Interest	<u>\$ 10</u>	<u>\$ 27</u>	<u>\$ 119</u>
Supplemental disclosure of non-cash investing and financing activities			
Transfer of demo lab equipment between inventory and fixed assets	<u>\$ 725</u>		

**Supplemental Schedule of Non Cash Investing Activities (amounts in thousands, except shares):**

On November 11, 2003, the Company purchased certain assets and assumed certain liabilities of Simplus Systems. Consideration totaled \$2,522 and consisted of 1,499,994 shares of the Company's common stock valued at \$2,310, fully vested Tegal employee stock options to purchase 58,863 shares of the Company's common stock at an exercise price of \$3.09 per share, valued at \$32 and transaction costs of \$180. The purchase price was allocated as follows:

Assets acquired:	
Fixed assets	48
Identifiable intangible assets	389
In-process research and development	<u>2,202</u>
Total assets	2,639
Liabilities assumed:	
Current liabilities	<u>(117)</u>
Net assets acquired	<u>\$ 2,522</u>

On May 28, 2004, Tegal purchased substantially all of the assets and assumed certain liabilities of First Derivative Systems, Inc. ("FDSI"), a development stage company, for 1,410,632 shares of common stock valued at \$2,342, \$150 in debt forgiveness, approximately \$50 in assumed liabilities, and \$158 in acquisition costs, pursuant to a purchase agreement dated April 28, 2004. The following table represents the allocation of the purchase price for FDSI. In estimating the fair value of assets acquired and liabilities assumed management considered various factors, including an independent appraisal.

Fair value fixed assets acquired	\$ 111
Non compete agreements	203
Patents	733
In-process research and development	1,653
Debt forgiveness	(150)
Assumed liabilities	<u>(50)</u>
	<u>\$ 2,500</u>

See accompanying notes to consolidated financial statements.



## TEGAL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(All amounts in thousands, except per share data and share data, unless otherwise noted)

#### Note 1. Description of Business and Summary of Significant Accounting Policies

##### Description of Business

Tegal Corporation, a Delaware corporation (“Tegal” or the “Company”), designs, manufactures, markets and services plasma etch and deposition systems that enable the production of integrated circuits (“ICs”), memory and related microelectronics devices used in personal computers, wireless voice and data telecommunications, contact-less transaction devices, radio frequency identification devices (“RFIDs”), smart cards, data storage and micro-level actuators. Etching and deposition constitute two of the principal IC and related device production process steps and each must be performed numerous times in the production of such devices.

On August 30, 2002, the Company acquired all of the outstanding common stock of Sputtered Films, Incorporated (“SFI”), a privately held California corporation. SFI is a leader in the design, manufacture and service of high performance physical vapor deposition sputtering systems for the semiconductor and semiconductor packaging industry. SFI was founded in 1967 with the development of its core technology, the S-Gun. . SFI continues to operate as a wholly-owned subsidiary of Tegal. The majority of the SFI operations have been moved to the Company’s headquarters operations in Petaluma, California, and its operations are now fully integrated with those of Tegal.

On November 11, 2003, the Company acquired substantially all of the assets and certain liabilities of Simplus Systems Corporation (“Simplus”), a development stage company. Simplus had developed a deposition cluster tool and certain patented processes for barrier, copper seed and high-K dielectric applications. Simplus had coined the term “nano-layer deposition” or “NLD” to describe its unique approach to MOCVD. Immediately following the acquisition of the assets of Simplus, its employees and technology were integrated into the development programs of the Company. The Company is continuing to develop these NLD processes and related tools, and is in the process of marketing them to a limited number of key customers and joint development partners.

On May 28, 2004, the Company purchased substantially all of the assets and assumed certain liabilities of First Derivative Systems, Inc. (“FDSI”). FDSI, a privately held development stage company, was founded in 1999 as a spin-off of SFI. FDSI had developed a high-throughput, low cost-of-ownership physical vapor deposition (“PVD”) system with highly differentiated technology for leading edge memory and logic device production on 200 and 300 millimeter wafers. FDSI’s operations and development programs were fully absorbed into the Company following the acquisition, and Tegal has continued to develop systems for addressing these markets.

##### Basis of Presentation

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of \$8,880, \$15,363 and \$12,602 for fiscal years 2006, 2005 and 2004, respectively. The Company generated negative cash flows from operations of \$11,704, \$7,519 and \$3,179 for fiscal years 2006, 2005 and 2004, respectively. To finance its operations during 2004, the Company raised approximately \$6,183 in net proceeds from the sale of 2% convertible debentures and exercise of warrants (see Note 7). During 2005, the Company raised \$10,380 from stock issued to Kingsbridge. Management believes that these proceeds, combined with a projected increase in sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal year 2006. However, projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, the Company will need to reduce expenses further and raise additional capital through the issuance of debt or equity securities. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of common stock, and debt covenants could impose restrictions on the Company's operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to the Company on acceptable terms, if at all. The failure to raise additional funds may adversely affect the Company’s ability to achieve its intended business objectives. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern.

The consolidated financial statements include the accounts of the Company and all of its subsidiaries. Intercompany transactions and balances are eliminated in consolidation. Accounts denominated in foreign currencies are translated using the foreign currencies as the functional currencies. Assets and liabilities of foreign operations are translated to U.S. dollars at current rates of exchange and revenues and expenses are translated using weighted average rates. The effects of translating the financial statements of foreign subsidiaries into U.S. dollars are reported as accumulated other comprehensive income, a separate component of stockholders' equity. Gains and losses from foreign currency transactions are included in the statements of operations as a separate component of other expense, net.

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could vary from those estimates.

### **Cash and Cash Equivalents**

The Company considers all highly liquid debt instruments having a maturity of three months or less on the date of purchase to be cash equivalents.

At March 31, 2006 and 2005 all of the Company's investments are classified as cash equivalents in the consolidated balance sheets. The investment portfolio at March 31, 2006 and 2005 is comprised of money market funds. At March 31, 2006 and 2005, the fair value of the Company's investments approximated cost.

### **Financial Instruments**

The carrying amount of the Company's financial instruments, including cash and cash equivalents, accounts receivable and accounts payable, bank lines of credit, notes payable, accrued expenses and other liabilities approximates fair value due to their relatively short maturity. The Company has foreign subsidiaries, which operate and sell the Company's products in various global markets. As a result, the Company is exposed to changes in foreign currency exchange rates. The Company utilizes hedge instruments, primarily forward contracts, to manage its exposure associated with firm third-party transactions denominated in non-functional currencies. The Company does not hold derivative financial instruments for speculative purposes. Realized and unrealized gains and losses related to forward contracts considered to be effective hedges are deferred until settlement of the hedged items. They are recognized as other gains or losses when a hedged transaction is no longer expected to occur. Realized and unrealized gains and losses on ineffective hedges are recorded to other expense, net. Foreign currency gains and losses included in other expense, net were not significant for the years ended March 31, 2006, 2005 and 2004.

At March 31, 2006, the Company had forward exchange contracts maturing at various dates throughout fiscal 2007 to exchange 277.7 million Japanese Yen into \$2.4million.

### **Concentration of Credit Risk**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of temporary cash investments and accounts receivable. Substantially all of the Company's temporary investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the U.S., Europe and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains reserves for potential credit losses. Write-offs during the periods presented have been insignificant. As of March 31, 2006 one customer accounted for approximately 63.4% of the accounts receivable balance. As of March 31, 2005 two customers accounted for approximately 40% of the accounts receivable balance. As of March 31, 2004, three customers accounted for approximately 43% of the accounts receivable balance.

### **Inventories**

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. We estimate the effects of excess and obsolescence on the carrying values of our inventories based upon estimates of future demand and market conditions. We establish a provision for inventories in excess of production demand. Should actual production demand differ from our estimates, additional inventory provision may be required, as was the case in the third quarter of fiscal 2004. The excess and obsolete provision is only released if and when the related inventory is sold or scrapped. The inventory provision balance at March 31, 2006 and 2005 was \$7,136 and \$8,282. The inventory provision expense for the year March 31, 2006 and 2005 was (\$1,146) and \$778, respectively.

We periodically analyze any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, our policy is that, if after approximately 18 months, we determine that a sale will not take place within the next 12 months and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

The carrying value of systems used for demonstrations or training is determined by assessing the cost of the components that are suitable for sale. Any parts that may be rendered unsaleable as a result of such use are removed from the system and are not included in finished goods inventory. The remaining saleable parts are valued at the lower of cost or market, representing the system's net realizable value. The depreciation period for systems that are transferred to fixed assets is determined based on the age of the system and its remaining useful life (typically five to eight years).

### Warranty Costs

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is effected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Should actual product failure rates, material usage rates and labor efficiencies differ from estimates, revisions to the estimated warranty liability may be required (see Note 2 to accompanying notes to the consolidated financial statements).

### Property and Equipment

Property and equipment are recorded at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, ranging from three to seven years. Leasehold improvements are stated at cost and are amortized using the straight-line method over the shorter of the estimated useful life of the improvements or the lease term. When assets are disposed of, the cost and related accumulated depreciation are removed from the accounts and the resulting gains or losses are included in the results of operations. The Company generally depreciates its assets over the following periods:

	<u>Years</u>
Furniture and machinery and equipment	7
Computer and software	3 - 5
Leasehold improvements	5 or remaining lease life

Identified Intangible Assets Acquisition -related intangibles include non-compete agreements, patents, unpatented technology, and trade name that are amortized on a straight-line basis over periods ranging from 5 years to 15 years. Also included in acquisition-related intangibles is workforce-in-place related to acquisitions that did not qualify as business combinations. The Company performs ongoing review of its identified intangible assets to determine if facts and circumstances exist that indicate the useful life is shorter than originally estimated or the carrying amount may not be recoverable. If such facts and circumstances exist, the Company assesses the recoverability of identified intangible assets by comparing the projected undiscounted net cash flow associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

### Impairment of Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss is recognized based on the excess of the carrying amount over the fair value of the assets. No impairment charge has been recorded for the years-ended 2006, 2005 and 2004, respectively.

### Accounts Receivable - Allowance for Sales Returns and Doubtful Accounts

The Company maintains an allowance for doubtful accounts receivable for estimated losses resulting from the inability of the Company's customers to make required payments. If the financial condition of the Company's customers were to deteriorate, or even a single customer was otherwise unable to make payments, additional allowances may be required.

The Company's return policy is for spare parts and components only. A right of return does not exist for systems. Customers are allowed to return spare parts if they are defective upon receipt. The potential returns are offset against gross revenue on a monthly basis. Management reviews outstanding requests for returns on a quarterly basis to determine that the reserves are adequate.

## **Revenue Recognition**

Each sale of our equipment is evaluated on an individual basis in regard to revenue recognition. We have integrated in our evaluation the related interpretative guidance included in Topic 13 of the codification of staff accounting bulletins, and recognize the role of the EITF consensus on Issue 00-21. We first refer to EITF 00-21 in order to determine if there is more than one unit of accounting and then we refer to SAB104 for revenue recognition topics for the unit of accounting. We recognize revenue when persuasive evidence of an arrangement exists, the seller's price is fixed or determinable and collectibility is reasonably assured.

For products produced according to our published specifications, where no installation is required or installation is deemed perfunctory and no substantive customer acceptance provisions exist, revenue is recognized when title passes to the customer, generally upon shipment. Installation is not deemed to be essential to the functionality of the equipment since installation does not involve significant changes to the features or capabilities of the equipment or the building of complex interfaces and connections. In addition, the equipment could be installed by the customer or other vendors and generally the cost of installation approximates only 1% of the sales value of the related equipment.

For products produced according to a particular customer's specifications, revenue is recognized when the product has been tested and it has been demonstrated that it meets the customer's specifications and title passes to the customer. The amount of revenue recorded is reduced by the amount (generally 10%), which is not payable by the customer until installation is completed and final customer acceptance is achieved.

For new products, new applications of existing products, or for products with substantive customer acceptance provisions where performance cannot be fully assessed prior to meeting customer specifications at the customer site, 100% of revenue is recognized upon completion of installation and receipt of final customer acceptance. Since title to goods generally passes to the customer upon shipment and 90% of the contract amount becomes payable at that time, inventory is relieved and accounts receivable is recorded for the entire contract amount. The revenue on these transactions is deferred and recorded as deferred revenue. As of March 31, 2006 and March 31, 2005, deferred revenue as related to systems was \$455 and \$80, respectively. We reserve for warranty costs at the time the related revenue is recognized.

Revenue related to sales of spare parts is recognized upon shipment. Revenue related to maintenance and service contracts is recognized ratably over the duration of the contracts. Unearned maintenance and service revenue is included in deferred revenue. At March 31, 2006 and March 31, 2005, respectively, \$22 and \$42 of deferred revenue was related to service contracts.

## **Accounting for Freight Charged to Customers**

Spares and systems are typically shipped "freight collect," therefore no shipping revenue or cost is associated with the sale. When freight is charged, it is booked to revenue and offset for the cost of that freight in the cost of revenue accounts pursuant to FASB's Emerging Issues Task Force ("EITF") 00-10.

## **Income Taxes**

Deferred income taxes are recognized for the differences between the tax bases of assets and liabilities and their financial reporting amounts based on enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

## **Earnings Per Share**

Basic earnings per share ("EPS") is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS is computed using the weighted average number of common shares outstanding plus any potentially dilutive securities, except when the effect of including such changes is antidilutive.

## **Stock-Based Compensation**

The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, including FASB Interpretation No. 44 ("FIN 44"), "Accounting for Certain Transactions Involving Stock Compensation — an interpretation of APB Opinion No. 25." The Company's policy is to grant options with an exercise price equal to the closing market price of the Company's stock on the grant date. Accordingly, no compensation cost for stock option grants has been recognized in the Company's statements of operations. Additional proforma disclosures assuming the Company applied the fair value method of accounting for employee stock compensation under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" are as follows.



As required by SFAS No. 123 for proforma disclosure purposes only, the Company has calculated the estimated grant date fair value of its stock option awards using the Black-Scholes model. The Black-Scholes model, as well as other currently accepted option valuation models, was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated grant date fair value.

The following assumptions are included in the estimated grant date fair value calculations for the Company's stock option awards and Employee Qualified Stock Purchase Plan ("Employee Stock Purchase Plan"):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Expected life (years):			
Stock options	4.0	4.0	4.0
Employee stock purchase plan	0.5	0.5	0.5
Volatility:			
Stock options	63%	90%	119%
Employee stock purchase plan	63%	90%	119%
Risk-free interest rate	4.61%	2.84%	2.62%
Dividend yield	0%	0%	0%

The weighted average estimated grant date fair value, as defined by SFAS No. 123, for stock option awards granted during fiscal 2006, 2005 and 2004 was \$0.41, \$0.85 and \$0.90 per option, respectively.

The following table summarizes information with respect to stock options and warrants outstanding as of March 31, 2006 (number of shares in thousands):

Range of Exercise Prices	<u>Outstanding Options as of March 31, 2006</u>				<u>Exercisable at March 31, 2006</u>	
	Number of Options & Warrants	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Number of Options & Warrants	Weighted Average Exercise Price	
\$0.35 — \$1.50	24,863,303	\$ 0.95	5.61	22,216,608	\$ 0.96	
\$1.51 — \$2.14	975,778	1.75	5.33	782,028	1.65	
\$2.15 — \$3.00	984,667	2.50	1.29	984,667	2.50	
\$3.01 — \$3.25	190,632	3.20	3.28	190,632	3.20	
\$3.26 — \$3.88	55,000	3.75	4.09	55,000	3.75	
\$3.89 — \$4.25	305,000	4.11	2.85	305,000	4.11	
\$4.26 — \$6.88	161,700	4.94	2.39	161,700	4.94	
\$6.89 — \$8.00	65,188	7.71	3.88	65,188	7.71	
\$8.01 — \$8.75	53,000	8.47	3.37	53,000	8.47	
\$ 0.35 — \$8.75	<u>27,654,268</u>	\$ 1.14	5.37	<u>24,813,823</u>	\$ 1.16	

The weighted average estimated grant date fair values per share, as defined by SFAS No. 123, for rights granted under the employee stock purchase plan during fiscal 2006, 2005 and 2004 were \$0.40, \$0.82 and \$0.35, respectively.

Had the Company recorded compensation costs based on the estimated grant date fair value (as defined by SFAS 123) for awards granted under its stock option plans and Employee Plan, the Company's net loss and loss per share would have been increased to the proforma amounts below for the years ended March 31, 2006, 2005 and 2004:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net loss as reported	\$ (8,880)	\$ (15,363)	\$ (12,602)
Net loss per share as reported	\$ (.13)	\$ (.33)	\$ (.56)
Proforma compensation expense at fair Value	\$ (1,770)	\$ (1,244)	\$ (458)
Proforma net loss	<u>\$ (10,650)</u>	<u>\$ (16,607)</u>	<u>\$ (13,060)</u>
Proforma net loss per share:			
Basic and diluted	\$ (0.15)	\$ (0.36)	\$ (0.58)

During the current fiscal year, the Company awarded 1,000,000 restricted stock units to Brad Mattson, the Company's Chairman, and 150,000 restricted stock units to Thomas Mika, the Company's President and Chief Executive Officer at the close of the 2005 PIPE, see note 9. These restricted stock units were accounted for as compensation expense of \$1,004.

During the current fiscal year, the Company awarded four employees 325,000 restricted shares. These shares are valued at \$224, are not vested, and were accounted for as Restricted Share Units and Deferred Compensation in the equity section of the balance sheet.

On September 13, 2005 the Company issued 500,000 warrants at \$0.69 as consideration for an amendment to the current lease of the Company's headquarters to reduce the termination fee. The value of the warrants of \$655 was based on the fair value of the termination penalty reduction offset by the exercise price of the warrant and recorded as rent expense.

During the current fiscal year, the Company issued 79,204 shares of restricted stock to a consultant of the Company in lieu of a cash payment for spares commission. The value of the restricted stock of \$47 was based on the market price of the stock on the date of grant.

The disclosure provisions of SFAS No. 123 and SFAS No. 148 require judgments by management as to the estimated lives of the outstanding options. Management has based the estimated life of the options on historical option exercise patterns. If the estimated life of the options increases, the valuation of the options will increase as well.

In December 2004 the Financial Accounting Standards Board issued SFAS No. 123R, "Share-Based Payment," that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, "Accounting for Stock Issued to Employees," and requires instead that such transactions be accounted for using a fair-value-based method. The Company will be required to adopt SFAS No 123R beginning April 1, 2006. Had the Company adopted SFAS No 123R during the fiscal year ended March 31, 2006, compensation expense of approximately \$1,770 would have been recognized in the consolidated statements of operations for the year ended March 31, 2006. The Company will adopt SFAS 123(R) beginning April 1, 2006.

### **Comprehensive Loss**

Comprehensive loss is defined as the change in equity of the Company during a period from transactions and other events and circumstances excluding transactions resulting from investments by owners and distributions to owners. The primary difference between net loss and comprehensive loss for the Company is attributable to foreign currency translation adjustments. Comprehensive loss is shown in the statement of stockholders' equity.

### **New Accounting Pronouncements**

In November 2004 the FASB issued SFAS No. 151 "Inventory Costs - An Amendment of ARB No. 43, Chapter 4" (SFAS 151). SFAS 151 clarifies that abnormal amounts of idle facility expense freight handling costs and spoilage should be expensed as incurred and not included in overhead. Further SFAS 151 requires that allocation of fixed and production facilities overheads to conversion costs should be based on normal capacity of the production facilities. The provisions in SFAS 151 are effective for inventory costs incurred during the fiscal years beginning April 1, 2006. The adoption of SFAS 151 will have no material impact on the consolidated financial statements.

**Note 2. Balance Sheet and Statement of Operations Detail**

Inventories, net consisted of:

	March 31,	
	2006	2005
Raw materials	\$ 1,692	\$ 1,044
Work in process	4,173	2,976
Finished goods and spares	1,835	1,120
	<u>\$ 7,700</u>	<u>\$ 5,140</u>

The inventory provision at March 31, 2006 and 2005 was \$7,136 and \$8,282, respectively.

Property and equipment, net, consisted of:

	March 31,	
	2006	2005
Machinery and equipment	\$ 3,481	\$ 4,266
Demo lab equipment	2,028	3,489
Computer and software	1,623	1,436
Leasehold improvements	3,528	3,182
	10,660	12,373
Less accumulated depreciation and amortization	(8,811)	(9,031)
	<u>\$ 1,849</u>	<u>\$ 3,342</u>

Machinery and equipment at March 31, 2006 and 2005, includes approximately \$56 of assets under leases that have been capitalized. Accumulated amortization for such equipment approximated \$ 42 and \$37, respectively.

A summary of accrued expenses and other current liabilities follows:

	March 31,	
	2006	2005
Accrued compensation costs	\$ 1,261	\$ 910
Income taxes payable	13	502
Other	701	1,163
	<u>\$ 1,975</u>	<u>\$ 2,575</u>

Product warranty and guarantees:

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is affected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Warranty activity for the years ended March 31, 2006 and 2005 is as follows:

	Year ended March 31,	
	2006	2005
Balance at the beginning of the period	\$ 252	\$ 366
Additional warranty accruals for warranties issued during the year	496	465
Settlements made during the year	(242)	(579)
Balance at the end of the year	<u>\$ 506</u>	<u>\$ 252</u>

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

**Note 3. Earnings Per Share**



SFAS No. 128, "Earnings Per Share," requires dual presentation of basic and diluted net income (loss) per share on the face of the statement of operations. Basic EPS is computed by dividing loss available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted EPS uses the average market prices during the period. All amounts in the following table are in thousands except per share data.

Basic net loss per common share is computed using the weighted-average number of shares of common stock outstanding.

The following table represents the calculation of basic and diluted net loss per common share (in thousands, except per share data):

	Year Ended March 31,		
	2006	2005	2004
Net loss applicable to common stockholders	\$ (8,880)	\$ (15,363)	\$ (12,602)
<b>Basic and diluted:</b>			
Weighted-average common shares outstanding	70,831	46,879	22,442
Less weighted-average common shares subject to repurchase...	—	—	----
Weighted-average common shares used in computing basic and diluted net loss per common share	70,831	46,879	22,442
<b>Basic and diluted net loss per common share</b>	<b>\$ (0.13)</b>	<b>\$ (0.33)</b>	<b>\$ (.56)</b>

Outstanding options, warrants and restricted stock equivalent to 28,929,268,11,964,208, and 12,396,879 shares of common stock at a weighted-average exercise price of \$1.16, \$2.15, and \$1.73 per share on March 31, 2006, 2005, and 2004 were not included in the computation of diluted net loss per common share for the periods presented as a result of their anti-dilutive effect. Such securities could potentially dilute earnings per share in future periods.

#### **Note 4. Notes Payable and Bank Lines of Credit**

As of March 31, 2006, the Company's Japanese subsidiary had \$13 outstanding under its lines of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The two credit lines have a total borrowing capacity of 200 million Yen (approximately \$1,282 at exchange rates prevailing on March 31, 2006), which are secured by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The two Japanese bank lines bear interest at Japanese prime (1.375% as of March 31, 2006) plus 0.875% and 1.5%, respectively.

#### **Note 5. Income Taxes**

Components of Income before income taxes are as follows:

Year ended March 31,	2006	2005	2004
Domestic	(6,884)	(14,478)	(12,396)
Foreign	(2,528)	(885)	(206)
	<u>(9,412)</u>	<u>(15,363)</u>	<u>(12,602)</u>

Components of the provision for income taxes are as follows:

Year ended March 31	2006	2005	2004
<b>Current:</b>			
U.S. Federal	—	—	
State & Local	—	—	
Foreign	(532)	—	
	<u>(532)</u>	<u>—</u>	
<b>Deferred:</b>			
U.S. Federal	—	—	
State & Local	—	—	
Foreign	—	—	
Total	(532)	—	

The income tax provision differs from the amount computed by applying the statutory U.S. federal income tax rate as follows:

Year ended March 31,	2006	2005	2004
Income tax provision at U.S. Statutory Rate	(3,200)	(4,651)	(4,285)
State taxes net of federal benefit	(295)	(303)	(265)
Foreign differential	860	301	—
Current year tax credits	(441)	—	—
Transfer price reserve no longer required	(532)	—	—
Change In Valuation Allowance	2,080	4,739	4,367
Change in deferred state tax rate	600	—	—
Other	396	(86)	183
<b>Income tax expense/(income)</b>	<b>(532)</b>	<b>—</b>	<b>—</b>

Components of deferred taxes are as follows:

Year ended March 31,	2006	2005
Revenue recognition for tax & deferred for book	57	45
Non-deductible accruals and reserves	3,459	4,322
Net operating loss carryforward	26,997	24,356
Credits	3,549	3,004
Uniform cap adjustment	457	566
Other	108	254
<b>Total</b>	<b>34,627</b>	<b>32,547</b>
Valuation Allowance	(34,627)	(32,547)
<b>Net Deferred Tax Asset</b>	<b>—</b>	<b>—</b>

We have recorded no net deferred tax assets for the years ended March 31, 2006 and 2005, respectively. The Company has provided a valuation allowance of \$34.6 million and \$32.5 million at March 31, 2006 and March 31, 2005, respectively, since it is more likely than not the deferred taxes will not be realized. The valuation allowance increased by \$2.1 million and \$4.7 million during the years ended March 31, 2006 and 2005, respectively.

At March 31, 2006, the Company has net operating loss carryforwards of approximately \$73.7 million and \$33.3 million for federal and state respectively, which begin to expire in the year ended March 31, 2008.

At March 31, 2006, the Company also has research and experimentation credit carryforwards of \$2.6 million and \$1.4 million for federal and state income tax purposes, respectively, which begin to expire in the year ended March 31, 2010.

The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carry-forwards in certain situations where changes occur in the stock ownership of a corporation during a certain time period. In the event the company has incurred a change in ownership, utilization of the carry-forwards could be significantly restricted.

#### **Note 6. Accounting for Restructure Expense**

During the fiscal year ended March 31, 2006, we recorded a severance charge of approximately \$271 related to staff reductions of 17 employees, of which approximately \$168 was classified as cost of sales, \$81 as engineering, process and development and \$22 sales, marketing and general and administrative expenses. We had an outstanding severance liability of approximately \$15 as of March 31, 2006.

During the fiscal year ended March 31, 2005, we recorded a severance charge of approximately \$129 related to staff reductions of 19 employees, of which approximately \$19 was classified as cost of sales, \$18 as research and development and \$92 as sales, marketing and general and administrative expenses. We had an outstanding severance liability of approximately \$63 as of March 31, 2005.

There were no severance charges and no outstanding liability during fiscal year ended March 31, 2004

**Note 7. Commitments and Contingencies**

The Company has several non-cancelable operating leases and capital leases, primarily for general office, production and warehouse facilities, that expire over the next five years. Future minimum lease payments under these leases are as follows:

Year Ending March 31, 2006	Capital Leases	Operating Leases
	As of March 31, 2006	
2007	\$ 12	\$ 779
2008	2	272
2009		210
2010		160
2011		8
Thereafter		33
Total minimum lease payments		1,462
Less amount representing interest		
Present value of minimum lease payments	14	
Less current portion	12	
Long term capital lease obligation	2	

Most leases provide for the Company to pay real estate taxes and other maintenance expenses. Rent expense for operating leases, net of sublease income, was \$2,671, \$1,426 and \$1,007, during the years ended March 31, 2006, 2005 and 2004, respectively.

The Company maintains our headquarters, encompassing our executive office, manufacturing, engineering and research and development operations, in one leased 57,418 square foot facility in Petaluma, California. On February 1, 2006, the landlord of these facilities was given notice of our intention to vacate by July, 31, 2006. We have office space in a leased 13,300 square foot facility in San Jose, California. Our headquarters will be moved to this location during fiscal year 2007.

Sputtered Films, Inc. v. Advanced Modular Sputtering, et al., filed in Santa Barbara County Superior Court.

On December 22, 2003, Sputtered Films, Inc. ("SFI"), a wholly owned subsidiary of the Company, filed an action against two former employees, Sergey Mishin and Rose Stuart-Curran, and a company they formed after leaving their employment with SFI named Advanced Modular Sputtering, Inc. ("AMS"). Sergey Mishin and Rose Stuart-Curran had each signed confidentiality and non-disclosure agreements regarding information obtained while employed by SFI. The action contains causes of action for specific performance, breach of contract, breach of the covenant of good faith and fair dealing, misappropriation of trade secrets, unfair competition, unfair business practices, interference with prospective economic advantage, conversion, unjust enrichment, and declaratory relief. These claims arise out of information SFI received evidencing that AMS possessed and used SFI's confidential, proprietary and trade secret drawings, specifications and technology to manufacture the sputtering tool marketed by AMS.

During 2004 and 2005, this litigation was largely stalled while AMS and Agilent Technologies, Inc. contested SFI's right to conduct discovery. This dispute was resolved in late 2005 when the California Court of Appeal affirmed SFI's trade secret identification as statutorily sufficient. On November 18, 2005, SFI requested leave to add Agilent Technologies, Inc. ("Agilent") as a defendant based on evidence that Agilent and AMS co-developed the machines which SFI contends were built using SFI proprietary information. The Court granted SFI's request and Agilent was served as a Doe defendant on December 12, 2005. In early December, SFI learned that Agilent transferred its Semiconductor Products Group to a number of Avago entities effective December 1, 2005, and accordingly SFI sought and received court approval to add Avago Technologies U.S., Inc. and Avago Technologies Wireless (U.S.A.) Manufacturing, Inc (collectively the "Avago Entities") as defendant in this action. On April 25, 2006, the Avago Entities filed a Cross-Complaint against SFI and Tegal Corporation alleging causes of action for breach of contract, trade secret misappropriation, unfair competition, conversion, unjust enrichment and declaratory relief. The Cross-Complaint alleges on information and belief that SFI misused information obtained from Hewlett-Packard in connection with Hewlett-Packard's request to purchase SFI machines or to upgrade SFI machines Hewlett-Packard already owned. SFI and Tegal Corporation intend to vigorously contest all such allegations. Trial is currently set for November 8, 2006, although the Court has indicated that it may bifurcate the Avago Entities' cross-claims.

**Note 8. 2% Convertible Debentures:**

On June 30, 2003, the Company signed definitive agreements with investors to raise up to \$7,165 in a private placement of convertible debt financing to be completed in two tranches. The first tranche, which closed on June 30, 2003, involved the sale of debentures in the principal amount of \$929. The Company received \$424 in cash on June 30, 2003 and the remaining balance of \$505 on July 1, 2003, which was recorded as an other receivable as of June 30, 2003. The closing of the second tranche, which occurred on September 9, 2003 following shareholder approval on September 8, 2003, resulted in the receipt of approximately \$6,236 in gross

proceeds on September 10, 2003.

The Company was required to pay a cash fee of up to 6.65% of the gross proceeds of the debentures to certain financial advisors upon the closing of the second tranche. A fee of \$448 has been recorded as a debt issuance cost and was paid in September 2003. The financial advisors also were granted warrants to purchase 1,756,127 shares of the Company's common stock at an exercise price of \$0.35 per share. These warrants were valued at \$1,387 using the Black-Scholes option pricing model with the following variables: stock fair value of \$0.93, term of five years, volatility of 95% and risk-free interest rate of 2.5%. During fiscal year ended March 31, 2006, no financial advisors exercised their warrants, leaving advisor warrants for 196,129 shares unexercised at the end of the year.

The debentures accrued interest at the rate of 2% per annum. Both the principal and accrued interest thereon of these debentures were convertible at the rate of \$0.35 per share. The principal of the debentures converted into 20,471,428 shares of the Company's common stock. The closing prices of the Company's common stock on June 30, 2003 and September 9, 2003, the closing dates for the first and second tranches, were \$0.55 and \$1.49. Therefore, a beneficial conversion feature existed which was accounted for under the provisions of EITF 00-27, *Application of Issue 98-5 to Certain Convertible Instruments*. A beneficial feature also existed in connection with the conversion of the interest on the debentures into shares of common stock.

As of June 30, 2004, debenture holders had converted all the debentures in the principal amount of \$7,165 into 20,471,428 shares of the Company's common stock. Of the 3,542,436 shares that were registered for payment of interest in-kind, 135,068 shares had been issued for such interest payments, and the interest obligation to the debenture holders had been satisfied in full.

In addition, the debenture holders were granted warrants to purchase 4,094,209 shares of the Company's common stock at an exercise price of \$0.50. The warrants expire after eight years. The warrants were valued using the Black-Scholes model with the following variables: fair value of common stock of \$0.35 for the first tranche debentures and \$0.93 for the second tranche debentures, volatility of 37% and risk-free interest rate of 2.5%. The debenture holders had exercised warrants to purchase 2,239,832 shares (plus 168,695 warrants remitted as payments for stock under a cash-less exercise provision of the warrant agreement) of the Company's common stock. As of March 31, 2006, there remained unexercised warrants held by the debenture holders for 1,514,940 shares of the Company's common stock.

The relative fair value of the warrants has been classified as equity with the beneficial conversion feature because it meets all the equity classification criteria of EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*.

The value of the beneficial conversion feature, warrants and debt issuance costs were amortized as interest expense over the life of the debt using the effective interest method. Related interest expense for fiscal 2005 amounted to \$2,019. This amount is comprised of nominal interest, amortization of beneficial conversion feature and amortization of debt issuance costs.

The debt issuance costs associated with the debentures amounted to \$2,369 and are comprised of \$982 in cash issuance costs and \$1,387 associated with warrants issued to financial advisors. Approximately \$603 of these costs were allocable to the warrants and charged to equity. The remaining balance of \$1,766 was recorded as an asset and was amortized over the life of the debt. As of March 31, 2005 the debentures have been fully converted; and these costs have been fully expensed.

The following table presents the amounts originally allocated to the beneficial conversion feature and warrants and the outstanding balance of debt at March 31, 2004 after accounting for these two equity instruments and conversions (in thousands):

	<b>First Tranche</b>	<b>Second Tranche</b>	<b>Total</b>
Debentures - principal amount	\$ 929	\$ 6,236	\$ 7,165
Beneficial conversion feature (included in equity)	(605)	(4,585)	(5,190)
Warrants (included in equity)	(73)	(1,651)	(1,724)
Conversions to common stock	(846)	(3,203)	(4,049)
Accretion of debt discount	599	3,273	3,872
Net amount of 2% convertible debentures	<u>\$ 4</u>	<u>\$ 70</u>	<u>\$ 74</u>

The value of the beneficial conversion feature, warrants and debt issuance costs was amortized as interest expense during fiscal 2005. Related interest expense for fiscal 2004 amounted to \$5,480. This amount is comprised of nominal interest, amortization of beneficial conversion feature and amortization of debt issuance costs.

During fiscal 2005, the principal and interest amount of the debentures converted was \$1,688, which converted into 4,825,118 shares of the Company's common stock. All debt issuance costs were fully amortized at March 31, 2005.

## Note 9. Acquisition and Intangible Assets

### First Derivative Systems, Inc.:

On May 28, 2004, Tegal purchased substantially all of the assets and assumed certain liabilities of First Derivative Systems, Inc. ("FDSI"), a development stage company, for 1,410,632 shares of common stock valued at \$2,342, \$150 in debt forgiveness, approximately \$50 in assumed liabilities, and \$158 in acquisition costs. All of the shares of common stock were registered with the Securities and Exchange Commission through the filing of a S-3 in October 2004. In addition, the Company entered into employment agreements with key FDSI personnel. FDSI, a development stage company, had developed a high-throughput, low cost-of-ownership physical vapor deposition ("PVD") system with highly differentiated technology for leading edge memory and logic device production on 200 and 300 millimeter wafers. This transaction was accounted for as a purchase of assets in accordance with EITF Issue No. 98-3, "Determining whether a nonmonetary transaction involves receipt of productive assets or of a business."

The following table represents the allocation of the purchase price for FDSI. The purchase price of this acquisition has been allocated to the acquired assets and assumed liabilities on the basis of their fair values as of the date of the acquisition. In estimating the fair value of the assets acquired and liabilities assumed, management considered various factors, including an independent appraisal.

Fair value fixed assets acquired	\$	111
Non compete agreements		203
Patents		733
In-process research and development		1653
Debt forgiveness		(150)
Assumed liabilities		(50)
	\$	<u>2,500</u>

The assets will be amortized over a period of years shown on the following table:

Fixed assets acquired	3 to 5 years
Non compete agreements	3 years
Patents	15 years

The fair value underlying the \$1,653 assigned to acquired IPR&D in the FDSI acquisition was charged to the Company's results of operations during the quarter ended June 30, 2004, and was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category were primarily certain design change improvements, software integration and hardware modifications, which are estimated to cost approximately \$1 - \$2 million.

The IPR&D value of \$1,653 was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over a seven-year period were discounted at a rate of 35% in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact expected return on investment and future results of operations. In addition, the Company's operating results would be adversely affected if the value of other intangible assets acquired became impaired.

All of these projects have completion risks related to functionality, architecture, performance, process technology, continued availability of key technical personnel, product reliability and software integration. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

### Simplus Systems Corporation:

On November 11, 2003, the Company acquired substantially all of the assets and certain liabilities of Simplus Systems Corporation, ("Simplus"), a development stage company. Simplus had developed a deposition cluster tool and certain processes for barrier, copper seed and high-K dielectric applications. The purchase consideration of \$2,522 includes 1,499,994 shares of the Company's common stock valued at \$2,310, 58,863 fully vested employee stock options to purchase Tegal common stock at an exercise price of \$3.09 per share valued at \$32, and acquisition costs of \$180. This transaction was accounted for as a purchase of assets in accordance with EITF Issue No. 98-3, Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.

The Company completed the allocation of the purchase price of Simplus. The following table represents the allocation of the purchase price for Simplus. The purchase price of this acquisition has been allocated to the acquired assets and assumed liabilities on the basis of their fair values as of the date of the acquisition. In estimating the fair value of the assets acquired and liabilities assumed, management considered various factors, including an independent appraisal.

Fair value fixed assets acquired	\$	48
Work Force		50
Patents		339
In-process research and development		2,202
Assumed liabilities		(117)
	<u>\$</u>	<u>2,522</u>

The assets will be amortized over a period of years shown on the following table:

Fixed assets acquired	1 year
Work Force	2 years
Patents	5 years

The fair value underlying the \$2,202 assigned to acquired IPR&D in the Simplus acquisition was charged to the Company's results of operations during the quarter ended December 31, 2003 and was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category are certain design change improvements on the existing 150 mm and 200 mm systems and the development of a 300 mm system. The design change improvements on the existing systems are estimated to cost approximately \$500,000 to \$1 million, are approximately 90% complete and will be completed by December 31, 2005. The development of a 300 mm system is estimated to be approximately 10% complete, and to cost between \$2 and \$4 million over the next two to four years, as market demand materializes.

The IPR&D value of \$2,202 was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over a seven-year period were discounted at a rate of 32% in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact expected return on investment and future results of operations.

All of these projects have completion risks related to functionality, architecture performance, process technology availability, continued availability of key technical personnel, product reliability and availability of software support. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

Intangibles:

As of March 31, 2006, intangible assets, net consisted of the following:

	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Technology	\$ 782	\$ (350)	\$ 432
Trade name	253	(114)	139
Non compete agreements	254	(175)	79
Patents	1,072	(248)	824
Total	<u>\$ 2,361</u>	<u>\$ (886)</u>	<u>\$ 1,474</u>



As of March 31, 2005, intangible assets, net consisted of the following:

	Gross	Accumulated Amortization	Net
Technology	\$ 782	\$ (253)	\$ 529
Trade name	253	(82)	171
Workforce	254	(99)	155
Patents	1,072	(131)	941
Total	<u>\$ 2,361</u>	<u>\$ (565)</u>	<u>\$ 1,796</u>

The estimated future amortization expense of intangible assets as of March 31, 2006 is as follows:

2007	\$ 314
2008	257
2009	223
2010	178
2011	102
Thereafter	400
	<u>\$ 1,474</u>

#### **Note 10. Sale of Common Stock and Warrants**

Effective July 6, 2005, the Company entered into a Purchase Agreement with certain accredited investors pursuant to which it sold to them an aggregate of 30,840,000 shares of our common stock at a purchase price of \$0.65 per share and warrants to purchase an aggregate of 15,420,001 shares of our common stock at an exercise price of \$1.00 per share. All of these securities were sold in a private placement pursuant to Regulation D of the Securities Act of 1933, as amended, solely to accredited investors, as defined in Rule 501 of the Act. This financing transaction is referred to herein as the “2005 PIPE”.

In the initial closing of the 2005 PIPE on July 12, 2005, the Company sold 6,300,000 shares at a purchase price of \$0.65 per share and five-year warrants to purchase an aggregate of 3,150,000 shares of common stock at an exercise price of \$1.00 per share to the investors at an aggregate purchase price of \$4,095. In connection with the 2005 PIPE, the Company granted to the investors registration rights. The effective date of the Form S-3 registration statement registering the shares issued in the initial closing was August 25, 2005.

In the second closing of the 2005 PIPE on September 19, 2005, the Company sold 24,540,000 shares at a purchase price of \$.65 per share and five-year warrants to purchase an aggregate of 12,270,001 shares of common stock at an exercise price of \$1.00 per share to the investors at an aggregate purchase price of \$15,951. The effective date of the Form S-3 registration statement registering the shares issued in the second closing was October 24, 2005.

In accordance with EITF 00-19, “Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled In a Company’s Own Stock,” the fair value of the warrants in the second closing of the 2005 PIPE on the date of grant was estimated to be \$6,621 using the Black-Scholes option-pricing model with the following assumptions: no dividends; risk-free interest rate of 3.5%, the contractual life of 5 years and volatility of 115%. The warrants’ fair value was reported as a liability at the time of grant, with a corresponding charge to common stock. At September 30, 2005, the fair value of the warrants was estimated to be \$6,295 using the Black-Scholes option pricing model with the same assumptions. At March 31, 2006, the impact of this transaction was \$435 recorded as other expense and there is no longer a contingent liability.

The Company paid a placement fee of \$1,453 (equal to 7% of the Company’s gross proceeds for both transactions) to Dahlman Rose & Company LLC, the Company’s financial advisor for the 2005 PIPE.

On September 13, 2005 the Company issued 500,000 warrants at \$0.69 as consideration for an amendment to the current lease of the Company’s headquarters to reduce the termination fee. The value of the warrants of \$655 was based on the fair value of the termination penalty reduction offset by the exercise price of the warrant and recorded as rent expense.

During the previous fiscal year, the Company entered into a contract with certain consultants of the Company pursuant to which the Company will issue warrants on a monthly basis in lieu of cash payments for two years, dependant upon the continuation of the contract and the achievement of certain performance goals. These warrants are valued and expensed on a monthly basis upon issuance. During the fiscal year March 31, 2006, the Company issued warrants to purchase 483,204 shares of the Company's common stock to service providers for services rendered. During the fiscal year ended March 31, 2006, the warrants were valued at \$253 using the Black-Scholes model with an exercise price at the market value on the day of the grant and an average interest rate of 3.99% and 3.11% respectively. The life of the warrants is five and seven years with the volatility of 115% and 118%, respectively.

On February 11, 2004, the Company signed a \$25 million equity facility with Kingsbridge Capital, a firm that specializes in the financing of small to medium sized technology-based companies. The arrangement allowed the Company to sell shares of its common stock to Kingsbridge at its sole discretion over a 24-month period on a "when and if needed" basis. Kingsbridge Capital was required under the terms of the arrangement to purchase Tegal's stock following the effectiveness of a registration statement. The price of the common shares issued under the agreement was based on a discount to the volume-weighted average market price during a specified drawdown period. The Company had no obligation to draw down all or any portion of the commitment.

In connection with the agreement, the Company issued fully vested warrants to Kingsbridge Capital to purchase 300,000 shares of the Company's common stock at an exercise price of \$4.11 per share. The fair value of such options, which amounted to approximately \$756 was capitalized as a transaction cost. The following variables were used to determine the fair value of such instruments under the Black-Scholes option pricing model: volatility of 114%, term of five years, risk free interest of 3.91% and underlying stock price equal to fair market value at the time of grant.

During the fiscal year end March 31, 2005, the Company issued to Kingsbridge Capital, Ltd. a total of 8,506,331 shares of its common stock. Gross proceeds from the sale of stock were \$10,380. The discount to the volume-weighted average market price was \$1,153 that was charged against equity as stock issuance cost. In addition to \$623 in cash payments, the Company issued warrants to purchase 23,727, 21,686 24,092 and 15,549 shares of common stock at \$1.45, \$1.56, \$1.92 and \$1.35 respectively, to advisors, in connection with the sale of stock to Kingsbridge which were charged against equity as stock issuance costs. Pursuant to our agreement, broker fees of 6% in cash and 1% of stock in the form of warrants were paid upon each drawdown of the facility. Additionally, warrants issued at the time of the agreement were held in current assets and have been fully amortized as of March 31, 2005 and charged against equity as stock issuance costs. The Company does not anticipate any further sales of shares to Kingsbridge.

The selling price of the stock was negotiated as a function of market price based on a specific formula. The discount was accounted for as a cost of capital and netted against Additional Paid in Capital. Since the transaction was related to the sale of our own common stock, it was excluded from the determination of net income.

During fiscal 2004 the Company granted 578,311 options to purchase shares of the Company's common stock to certain non-employees. The fair value of such shares amounted to approximately \$332, was recorded as an operating expense using Black Scholes model for the period of services rendered.

#### **Note 11. *Employee Benefit Plans***

##### **Equity Incentive Plan**

Pursuant to the Amended and Restated Equity Incentive Plan ("Equity Incentive Plan"), options and stock purchase rights to purchase 3,500,000 shares of common stock could be granted to management and consultants. The exercise price of options and the purchase price of stock purchase rights generally has been the fair value of the Company's common stock on the date of grant. At the date of issuance of the stock options, all options are exercisable; however the Company has the right to repurchase any stock acquired pursuant to the exercise of stock options upon termination of employment or consulting agreement at the original exercise price for up to four years from the date the options were granted, with the repurchase rights ratably expiring over that period of time. Incentive stock options are exercisable for up to ten years from the grant date of the option. Nonqualified stock options are exercisable for up to 15 years from the grant date of the option. The Equity Incentive Plan expired in December 1999. Consequently no shares were available for issuance under the Equity Incentive Plan as of March 31, 2006.

##### **1990 Stock Option Plan**

Pursuant to the terms of the Company's 1990 Stock Option Plan ("1990 Option Plan"), options and stock purchase rights to purchase 550,000 shares of common stock could be granted to employees of the Company or its affiliates. Incentive stock options are exercisable for a period of up to ten years from the date of grant of the option and nonqualified stock options are exercisable for a period of up to ten years and two days from the date of grant of the option. At the date of issuance of the stock options, all options are exercisable; however, the Company has the right to repurchase any stock acquired pursuant to the exercise of stock options upon termination of employment at the original exercise price for up to four years from the date the options were granted, with the repurchase rights ratably expiring over that period of time. The 1990 Option Plan expired on March 10, 2000. Consequently no shares were available for issuance under the 1990 Option Plan as of March 31, 2006.

## **1998 Equity Participation Plan**

Pursuant to the terms of the Company's Amended 1998 Equity Participation Plan ("Equity Plan"), which was authorized as a successor plan to the Company's Equity Incentive Plan and 1990 Option Plan, 20,000,000 shares of common stock may be granted upon the exercise of options and stock appreciation rights or upon the vesting of restricted stock awards. The exercise price of options generally will be the fair value of the Company's common stock on the date of grant. Options are generally subject to vesting at the discretion of the Compensation Committee of the Board of Directors (the "Committee"). At the discretion of the Committee, vesting may be accelerated when the fair market value of the Company's stock equals a certain price established by the Committee on the date of grant. Incentive stock options will be exercisable for up to ten years from the grant date of the option. Non-qualified stock options will be exercisable for a maximum term to be set by the Committee upon grant. As of March 31, 2006, 10,824,676 shares were available for issuance under the Equity Plan.

## **Directors Stock Option Plan**

Pursuant to the terms of the Stock Option Plan for Outside Directors, as amended, ("Directors Plan"), up to 4,000,000 shares of common stock may be granted to outside directors. Under the Directors Plan, each outside director who was elected or appointed to the Board on or after September 15, 1998 shall be granted an option to purchase 100,000 shares of common stock and on each second anniversary after the applicable election or appointment shall receive an additional option to purchase 50,000 shares, provided that such outside director continues to serve as an outside director on that date. For each outside director, 1/12<sup>th</sup> of the total number of shares will vest on the first day of each calendar month following the date of Option grant, contingent upon continued service as a director. Vesting may be accelerated, at the discretion of the Board, when the fair market value of the Company's stock equals a certain price set by the Board on the date of grant of the option. The Directors Plan allows for additional grants at the discretion of the Compensation Committee. As of March 31, 2006, 2,975,000 shares were available for issuance under the Directors Plan.

The following table summarizes the Company's stock option activity for the four plans described above and weighted average exercise price within each transaction type for each of the years ended March 31, 2006, 2005 and 2004 (number of shares in thousands):

	2006		2005		2004	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Options outstanding at beginning of year	7,651	\$ 1.97	7,007	\$ 2.05	3,196	\$ 3.39
Options cancelled	(2,652)	3.00	(1,602)	1.18	(497)	3.23
Options granted	3,050	0.81	2,300	1.16	4,613	1.14
Options exercised	(166)	0.80	(54)	0.93	(305)	0.67
Options outstanding March 31	<u>7,883</u>	\$ 1.20	<u>7,651</u>	\$ 1.97	<u>7,007</u>	\$ 2.05

The number of vested options for the years ended March 31, 2006, 2005, and 2004 are 5,217,219, 4,320,270 and 2,849,531 respectively.

#### Awards

The Company granted 158,311 shares of restricted stock from the Company's Equity Plan to consultants during fiscal year 2004 in exchange for services rendered. For fiscal year 2005, no shares of restricted stock were granted. For fiscal year 2006, 79,204 shares of restricted stock was issued to consultants in exchange for services rendered. Non-employee awards were booked as operating expenses using Black Scholes model for the period of services rendered as required by EITF 96-18 in fiscal 2004. All restricted stock issued in fiscal 2006 were recorded at the current market price on the date of grant.

#### Employee Qualified Stock Purchase Plan

The Company has offered an Employee Qualified Stock Purchase Plan ("Employee Plan") under which rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at the beginning of a six month offering period or at the end of that six month period. Under the Employee Plan, the Company is authorized to issue up to 1,000,000 shares of common stock. 33,350 common stock shares were purchased in fiscal 2006 and 30,100 common shares were purchased in fiscal 2005. Shares available for future purchase under the Employee Plan were 507,602 at March 31, 2006.

#### Savings and Investment Plan

The Company has established a defined contribution plan that covers substantially all U.S. employees. Employee contributions of up to 4% of each U.S. employee's compensation will be matched by the Company based upon a percentage to be determined annually by the Board. Employees may contribute up to 15% of their compensation, not to exceed a prescribed maximum amount. The Company made contributions to the plan of \$13, \$15 and \$8 in the years ended March 31, 2006, 2005 and 2004, respectively.

#### Note 12. Stockholder Rights Plan

On June 11, 1996, the Board adopted a Preferred Shares Rights Agreement ("Rights Agreement") and pursuant to the Rights Agreement authorized and declared a dividend of one preferred share purchase right ("Right") for each common share of the Company's outstanding shares at the close of business on July 1, 1996. The Rights are designed to protect and maximize the value of the outstanding equity interests in the Company in the event of an unsolicited attempt by an acquirer to take over the Company in a manner or under terms not approved by the Board. Each Right becomes exercisable to purchase one one-hundredth of a share of Series A Junior Participating Preferred Stock at an exercise price of \$45.00 upon certain circumstances associated with an unsolicited takeover attempt and expires on June 11, 2006. The Company may redeem the Rights at a price of \$0.01 per Right.

### Note 13. Geographical Information

Tegal operates in one segment for the manufacture, marketing and servicing of integrated circuit fabrication equipment. In accordance with SFAS No. 131 (SFAS 131) "Disclosures About Segments of an Enterprise and Related Information," Tegal's chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. All material operating units qualify for aggregation under SFAS 131 due to their identical customer base and similarities in: economic characteristics; nature of products and services; and procurement, manufacturing and distribution processes. Since Tegal operates in one segment and in one group of similar products and services, all financial segment and product line information required by SFAS 131 can be found in the consolidated financial statements.

For geographical reporting, revenues are attributed to the geographic location in which the customers' facilities are located. Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Net sales and long-lived assets by geographic region were as follows:

Revenues:	Years Ended March 31,		
	2006	2005	2004
Sales to customers located in:			
United States	\$ 5,142	\$ 4,445	\$ 5,538
Asia, excluding Japan	5,624	1,372	1,241
Japan	2,312	6,312	6,485
Germany	2,313	397	170
Italy	386	498	1,480
Europe, excluding Germany and Italy	5,980	1,864	1,614
Total sales	<u>\$ 21,757</u>	<u>\$ 14,888</u>	<u>\$ 16,528</u>

Long-lived assets at year-end:	March 31,	
	2006	2005
United States	\$ 3,296	\$ 5,112
Europe	16	7
Japan	8	16
Asia, excluding Japan	3	3
Total long-lived assets	<u>\$ 3,323</u>	<u>\$ 5,138</u>

The Company's sales are primarily to domestic and international semiconductor manufacturers. The composition of the Company's top five customers has changed from year to year, but net system sales to its top five customers in each of fiscal 2006, 2005, and 2004 accounted for 68.9%, 80.0% and 84.8%, respectively, of total net system sales. ST Microelectronics accounted for 54.3% of the Company's total revenue in fiscal 2006. Fujitsu, Western Digital, and RF Micro Devices accounted for 38.2%, 12.8% and 10.1% respectively, of the Company's net system sales in 2005. Intel, Fuji Film, and Matsushita accounted for 31.4%, 22.9% and 12.6% respectively, of the Company's net system sales in 2004. Other than the previously listed customers, no single customer represented more than 10% of the Company's total revenue in fiscal 2006, 2005, and 2004.

**TEGAL CORPORATION**  
2201 South McDowell Boulevard  
Petaluma, CA 94954  
(707) 763-5600

**OFFER TO EXCHANGE**  
**CERTAIN OUTSTANDING OPTIONS TO PURCHASE COMMON STOCK**  
**November 8, 2006**

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TEGAL CORPORATION

OFFER TO EXCHANGE  
CERTAIN OUTSTANDING OPTIONS TO PURCHASE COMMON STOCK

**THIS OFFER EXPIRES AT 11:59 P.M. PACIFIC DAYLIGHT TIME  
ON DECEMBER 7, 2006, UNLESS WE EXTEND THIS OFFER**

We are offering you the opportunity to exchange stock options currently outstanding under the Tegal Corporation (together with its subsidiaries, "Company" or "Tegal") Eighth Amended and Restated 1998 Equity Participation Plan that have an exercise price equal to or greater than \$7.70 ("Eligible Options") for a lesser number of either (1) restricted stock units, each one representing one share of Company common stock to be issued in the future ("RSUs") or (2) new options to purchase Tegal common stock at current fair market value ("New Options"). You may elect whether to exchange your Eligible Options for either RSUs or New Options. The RSUs and New Options will be issued under the Eighth Amended and Restated 1998 Equity Participation Plan (the "Plan") in accordance with a specified exchange formula as described herein (the "Option Exchange Program"), pursuant to the terms and conditions of this Offer to Exchange Certain Outstanding Options to Purchase Common Stock (the "Offer"). **You are eligible to participate in the Offer if you are an employee of Tegal as of November 8, 2006, the date the Offer commenced, and you remain an employee through the Expiration Date of the Offer and you hold Eligible Options.**

The "Expiration Date" of the Offer is 11:59 p.m. Pacific Daylight Time on December 7, 2006. If we extend the period of time during which this Offer remains open, the term "Expiration Date" will refer to the latest time and date at which this Offer expires.

The RSUs and New Options will be granted under the Plan approximately one (1) business day following the Expiration Date, currently anticipated to be December 8, 2006 (the "Grant Date"). The Board retains the discretion to determine the Grant Date.

We are offering to exchange unexercised Eligible Options by determining the value of the Eligible Options using an option pricing model. You may elect whether to exchange your Eligible Options for either RSUs or New Options. The number of either RSUs or New Options that you will be granted in exchange for cancellation of your Eligible Options will be determined by the following formula: the value of your Eligible Options (as determined under the option pricing model) will be reduced by ten percent (10%), then that reduced amount will be divided by the fair market value of a share of Company common stock on the Grant Date. "Fair market value" for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. The option pricing model to be used is the Black-Scholes valuation model (a widely used model for calculating the value of derivative securities).

As an example, if you have an Eligible Option grant representing the right to purchase 100 shares of common stock and you elect to exchange this Eligible Option for RSUs, you will receive RSUs on the Grant Date representing the right to receive the number of shares of Company common stock equal to the Black-Scholes valuation of your Eligible Option rights, reduced by 10%, and divided by the closing price on the last trading date before the Grant Date.

The RSUs and New Options will become vested in two installments, 50% on the first anniversary of the Grant Date, and 100% on the second anniversary of the Grant Date. Vesting is contingent upon your continuous employment with Tegal through the applicable vesting dates. The New Options will become exercisable as they vest, and will have an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market on the last trading day prior to the Grant Date. Shares of our common stock will be delivered in satisfaction of the RSUs upon vesting. If you terminate from employment with the Company prior to full vesting, you will forfeit and have no further rights with respect to any unvested portion of your RSUs or New Options.

Shares of our common stock are quoted on the Nasdaq Capital Market under the symbol "TGAL". On November 3, 2006, the closing price of our common stock as reported on the Nasdaq Capital Market was \$3.85 per share. We recommend that you obtain current market quotations for our common stock before deciding whether to elect to exchange Eligible Options under this Offer. **We can provide no assurance as to the price of our common stock at any time in the future, and nothing contained in this document or the other documents you receive relating to this Offer should be interpreted in any way as a claim relating to the future prospects of the price of our common stock, nor should any inference about such future prospects be drawn from anything contained herein or therein.**

Please note that although you may tender as many or as few of the Eligible Options as you like, you must exchange all shares issuable under each particular grant of Eligible Options you wish to exchange. For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock at, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may tender one or both of these grants of Eligible Options. However, you may not partially tender an Eligible Option grant (e.g., 50 shares of the Eligible Option grant for 100 shares or 25 shares of the Eligible Option grant for 50 shares. In addition, you may elect only one form of exchange per Eligible Option. For example, you can exchange your full Eligible Option to purchase 100 shares for RSUs, but you cannot exchange 1/2 for RSUs and 1/2 for New Options.)

We are making this Offer upon the terms and subject to the conditions described in this Offer, including the Summary of Terms and any other communications by us (which together, as they may be amended from time to time, constitute the "Offer"). This Offer is not conditioned upon a minimum number of option holders accepting this Offer or a minimum number of Eligible Options being exchanged, but is subject to other conditions that we describe in Section 6 of this Offer.

You will need to make your election to exchange Eligible Options in writing using the Stock Option Exchange Election Form that we have provided you.

**This transaction has not been approved or disapproved by the United States Securities and Exchange Commission (the "SEC"), nor has the SEC passed upon the fairness or merits of this transaction or upon the accuracy or adequacy of the information contained in this Offer. Any representation to the contrary is a criminal offense.**

### IMPORTANT

If you wish to tender some or all of your Eligible Options for exchange and cancellation, and receive RSUs or New Options under the terms of this Offer, you must submit your signed Stock Option Exchange Election Form to us no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date. Submissions instructions are included on the Form. If you have questions, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com). If we do not receive your signed Stock Option Exchange Election Form by 11:59 p.m. Pacific Daylight Time on the Expiration Date, you will be deemed to have rejected this Offer. Only those stock option agreements for Eligible Options which we accept for exchange will be automatically cancelled.

If your employment with Tegal is terminated for any reason on or before the Grant Date, you will not receive any RSUs or New Options. If you elect to participate in the Option Exchange Program, your Eligible Options will be cancelled on the Expiration Date. If your employment terminates for any reason on or after the Expiration Date and prior to the Grant Date, you will forfeit and not be permitted to exercise your Eligible Options, and you will not receive any RSUs or New Options.

The Board makes no recommendations as to whether or not you should tender your Eligible Options for exchange. The Board recognizes that the decision to accept or reject this Offer is an individual one that may be based on a variety of factors. You should consult your personal outside advisor(s) if you have questions about your financial or tax situation.

**The information about this Offer from Tegal is limited to this Offer, including the Summary of Terms and any other communications we may periodically send to you. We have not authorized any person to make any recommendation on our behalf as to whether or not you should exchange your Eligible Options pursuant to this Offer, nor have we authorized anyone to give you any information or to make any representation in connection with this Offer other than the information and representations contained in this Offer, including the Summary of Terms and any other communication we may periodically send to you. If anyone makes any recommendation or representation to you or gives you any information, you must not rely upon that recommendation, representation or information as having been authorized by Tegal.**



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**TEGAL CORPORATION**  
**SUMMARY OF TERMS**  
**OF**  
**OFFER TO EXCHANGE CERTAIN OUTSTANDING OPTIONS TO PURCHASE COMMON STOCK**

**November 8, 2006**

**Response Due By 11:59 p.m. Pacific Daylight Time**  
**on December 7, 2006, unless this Offer is Extended by Notice**

The following information should answer most of the questions that you may have about this Offer. Please read the remainder of the Offer and the accompanying documents carefully and in their entirety as they contain information relevant to your decision as to whether or not to participate in this Offer. We have included references to the relevant sections of the Offer where you can find a more complete description of the topics discussed in this Summary of Terms.

**GENERAL QUESTIONS ABOUT THE TERMS OF THE OFFER**

***Q1. What is the Option Exchange Program?***

We are offering Eligible Employees (as defined below) the opportunity to exchange stock options currently outstanding under the Eighth Amended and Restated 1998 Equity Participation Plan that have an exercise price equal to or greater than \$7.70 per share (“Eligible Options”) for a lesser number of either (1) restricted stock units, each of which representing a share of Tegal Corporation common stock to be issued in the future (“RSUs”) or (2) new options to purchase Tegal Corporation common stock (“New Options”). The RSUs and New Options will be granted under the Eighth Amended and Restated 1998 Equity Participation Plan in accordance with a specified exchange formula (see Question 9 below for additional information on the specified exchange formula) approximately one (1) business day following expiration of the Offer, currently anticipated to be December 8, 2006 (the “Grant Date”), although for administrative processing reasons, you may not receive notice of your new RSU or New Option grant for a period of time following the Grant Date. The Board retains the discretion to determine the Grant Date. (See Section 1 of the Offer.)

***Q2. Who can participate in this Offer?***

You are eligible to participate in this Offer if you are an employee of Tegal Corporation (together with its subsidiaries, the “Company”, or “Tegal”) as of November 8, 2006, you continue to be employed by Tegal through the Expiration Date of this Offer, and you hold Eligible Options (an “Eligible Employee”). An employee of Tegal must either be on active status or on an approved leave of absence on the Expiration Date of this Offer in order to be eligible to participate, unless otherwise required under local law. An employee whose employment with Tegal terminates for any reason at any time before the Expiration Date of this Offer will not be an Eligible Employee. (See Section 1 of the Offer.)

***Q3. What if I leave Tegal after the Offer begins but before my New Options or RSUs are granted?***

To receive RSUs or New Options, you must be employed by Tegal at the time the Option Exchange Program commences through the time the RSUs or New Options are granted. If you elect to participate in the Option Exchange Program and your employment terminates for any reason before the Grant Date, you would not receive any RSUs or New Options. If you terminate from employment prior to the Expiration Date, you would be permitted to exercise your old options within the usual post-termination periods set forth in the Plan, to the extent that they were exercisable at the time of termination. Otherwise, any Eligible Option that you tendered will be cancelled on the Expiration Date, and if you terminate from employment on or after the Expiration Date and before the Grant Date, you will forfeit and not be permitted to exercise your old options and you will not receive RSUs or New Options. (See Section 1 of the Offer.)

This Offer will not change or modify any terms of your employment with Tegal.

**Q4. Why is Tegal making this offer to employees?**

We are making this Offer because, as a result of the volatility in our stock price, many outstanding options have exercise prices significantly higher than the current market price of our common stock. In many cases, these “out-of-the-money” stock options no longer serve as effective incentives to retain, motivate and reward our employees. We believe the Option Exchange Program is an effective means of recognizing employee contributions to our success and aligning employee and stockholder interests. (See Section 2 of the Offer.)

**Q5. Why do I have to give up my old options? Can't Tegal just grant new options at a current price?**

We designed the Option Exchange Program to avoid the dilution in ownership to our stockholders that would result if we granted employees additional options to supplement their out-of-the-money options. In addition, issuing new stock options might cause some stockholders consider our “overhang” (the ratio of our outstanding options to total outstanding shares) to be too high. The Option Exchange Program will help avoid this problem.

**Q6. How can I tell which of my outstanding options are Eligible Options?**

If you are either an active employee or an employee on authorized leave of absence, and one of your outstanding options has an exercise price equal to or greater than \$7.70, that option is an Eligible Option. You will be provided with a Stock Option Exchange Election Form which contains a summary of your Eligible Option grants.

**Q7. Are there any conditions to this Offer?**

Yes. This Offer is subject to the conditions described in Section 6 of the Offer. If any of these events occur, Tegal may terminate, postpone or amend this Offer. However, this Offer is not conditioned on a minimum number of Eligible Employees accepting this Offer or a minimum number of Eligible Options being exchanged. (See Section 6 of the Offer.)

**SPECIFIC QUESTIONS ABOUT THE ELIGIBLE OPTIONS TO BE EXCHANGED**

**Q8. If I participate, how many RSUs or New Options will I receive?**

Under this Offer, you may make an election to exchange your unexercised Eligible Options for a number of either RSUs or New Options to be granted in accordance with the following exchange formula:

Value of your Eligible Options (as determined using an option pricing model),  
  
Minus ten percent (10%),  
  
Divided by the fair market value of a share of Company common stock on the Grant Date.

“Fair market value” for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. If any fractional numbers result from the exchange formula calculation, RSU and New Option grants will be rounded down for any fractional option to the next whole share on a grant-by-grant basis.

**Q9. Why are only options with an exercise price equal to or greater than \$7.70 per share eligible for exchange?**

We believe that options that are only moderately out-of-the-money continue to provide valuable incentives for employees. We set the \$7.70 “floor” to provide significant benefits to employees while continuing to be mindful of the interests of our stockholders.

**Q10. Why isn't the exchange formula simply a one-to-one ratio with my Eligible Options?**

We believe the exchange ratios must balance the interests of both our employees and our stockholders. Therefore, in order to make the program fair, we have designed it to be approximately “value for value.” This means that, in the aggregate, the value of the stock options being exchanged will be approximately the same as the value of the RSUs or New Options to be granted. Under our pricing model, this requires that more stock options be surrendered than new grants received in the exchange. The exchange formula was determined with advice from third-party compensation consultants and on the basis of valuations under the Black-Scholes valuation model (a widely used derivative securities pricing model).

**Q11. *If I elect to participate and exchange my Eligible Options, do I have to exchange all of my Eligible Options, or can I just exchange some of them?***

You are not obligated to exchange all of your Eligible Option grants and will be free to exchange as few or as many of your individual Eligible Option grants as you wish. However, if you elect to exchange shares from any Eligible Option grant, you must elect to exchange all shares issuable under such Eligible Option grant.

For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may tender one or both of these grants of Eligible Options. However, you may not partially tender an Eligible Option grant (e.g., 50 shares of the Eligible Option grant for 100 shares at or 25 shares of the Eligible Option grant for 50 shares).

**Q12. *If I elect to participate and exchange my Eligible Options, do I have to exchange all of my Eligible Options for either only RSUs or only New Options, or can I elect to receive both types of awards?***

If you elect to exchange shares from any Eligible Option grant, you must elect to exchange all shares issuable under such Eligible Option grant for one type of award, either RSUs or New Options. However, if you have more than one Eligible Option grant, you may elect different types of awards for each Eligible Option grant.

For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may elect to tender one of these grants of Eligible Options for RSUs and the other grant for New Options. However, you may not tender one Eligible Option grant for both RSUs and New Options (e.g., you may not tender the Eligible Option grant for 100 shares in exchange for 2/3 RSUs and 1/3 New Options).

**Q13. *If I choose to participate in the Option Exchange Program can I exchange partial grants?***

No, we are not accepting partial tenders of particular Eligible Option grants. You can elect to exchange as few or as many of your Eligible Option grants as you wish. However, if you elect to exchange any Eligible Options, you must exchange all of the options from the same grant.

**Q14. *My Eligible Options are already vested. Will my RSUs and New Options also be fully vested?***

No. All RSUs and New Options issued through the Option Exchange Program will vest in annual installments over a period of two (2) years. New Options will become exercisable upon vesting. Shares will be delivered upon vesting in RSUs.

**Q15. *Can I exchange Eligible Option grants that I have already fully or partially exercised?***

If you previously exercised an option grant in its entirety, that option grant is no longer outstanding and is therefore not eligible for exchange under this Offer. However, if you previously exercised an Eligible Option grant in part, the remaining unexercised portion of the Eligible Option grant may be exchanged under this Offer.

**Q16. *What happens to Eligible Option grants that I choose not to exchange?***

Eligible Option grants that you choose not to exchange will retain all of their current terms and conditions, including their current exercise price, expiration date and vesting schedule.

**Q17. Does the Company recommend employees participate in the program?**

Tegal cannot make a recommendation to employees whether or not to accept the Offer and no one from Tegal has been, or will be, authorized to provide you with additional information in this regard. However, Tegal is providing as much information as is allowable by the SEC to assist you to make your informed decision. For questions regarding investment-related issues, you should talk to your own advisors.

**SPECIFIC QUESTIONS ABOUT THE RSUS AND NEW OPTIONS**

**Q18. When will I receive my RSUs and New Options?**

The RSUs and New Options will be granted on the Grant Date, which is currently anticipated to be December 8, 2006, although for administrative processing reasons, you may not receive notice of your new grant for a period of time following the Grant Date. (See Section 5 of the Offer.) The Board retains the discretion to determine the Grant Date. (See Section 1 of the Offer.)

**Q19. What will the purchase price of my RSUs and New Options be?**

One share of Company common stock will be delivered to you for each RSU that vests. The purchase price of the shares of common stock to be issued upon settlement of your RSUs will be the par value of our common stock, which is equal to one-tenth of one cent (\$0.01) and the par value will be deemed paid by your past services rendered to Tegal. As a result, you do not have to make a payment to Tegal to receive the shares of common stock to be issued upon your settlement of your RSUs.

All New Options will be granted with an exercise price equal to the closing price of Tegal's common stock as reported on the Nasdaq Capital Market as of the last trading date prior to the Grant Date. (See Section 7 of the Offer for a historical view of the price range of our common stock.)

**Q20. What will the vesting schedule of my RSUs and New Options be?**

The RSUs and New Options will vest on a different schedule than your tendered Eligible Options. The RSUs and New Options will vest in annual installments over a period of two (2) years, 50% on the first anniversary of the Grant Date, and 100% on the second anniversary of the Grant Date. For all RSUs and New Options, vesting is contingent upon your continued employment with Tegal through the applicable vesting dates. If you terminate from service with Tegal, you will forfeit and have no further rights with respect to any unvested portion of your RSUs and New Options. (See Section 8 of the Offer.)

**Q21. What will the term of my New Options be?**

The New Options will have a term equal to the remaining term of your Eligible Options exchanged, as long as you remain employed by Tegal. (See Section 8 of the Offer.) For example, if you decide to exchange an Eligible Option which would otherwise expire in 2009 for New Options, your New Options will also expire in 2009.

**Q22. What will the other terms and conditions of my RSUs and New Options be?**

The other terms and conditions of your RSUs and New Options not described in the Offer will be generally comparable to the other terms and conditions of other award agreements under the Plan. If you exchange your Eligible Options for New Options, such options will have the same exercise period as the Eligible Option you exchanged; *e.g.*, if your Eligible Options provided that you can exercise your vested options within 3 months following your termination of employment date, your New Options will also allow you to exercise vested options for 3 months following termination.

However, all New Options will be nonqualified stock options under the U.S. Internal Revenue Code, regardless of the tax status of the Eligible Options exchanged, and will be granted pursuant to the Plan.

**Q23.** *If the exercise price of the New Options is higher than the exercise price of the Eligible Options I exchanged, can I revert back to my original Eligible Options with their original exercise price?*

No. Once your Eligible Options have been surrendered for exchange, it is not possible to re-grant them. The fair market value of Tegal's common stock on the last trading day prior to Grant Date of the New Options cannot be predicted at this time, and it is possible that your New Options may have a higher exercise price than your Eligible Options.

**Q24.** *If the New Options granted to me end up being out-of-the-money, will there be another offer to exchange?*

We do not expect to implement another option exchange program.

#### **SPECIFIC QUESTIONS ABOUT THE POTENTIAL CONSEQUENCES OF ACCEPTING OR REJECTING THIS OFFER**

**Q25.** *What happens if I accept this Offer?*

If you accept this Offer, the Eligible Option grants you choose to exchange will be cancelled promptly after 11:59 p.m. Pacific Daylight Time on the Expiration Date, and you will have no further right or interest in these Eligible Options. If you choose to accept this Offer, you will receive notice of your RSUs and/or New Options as promptly as possible following the Grant Date.

**Q26.** *Will I owe taxes if I participate in the Option Exchange Program?*

The exchange of Eligible Options pursuant to this Offer should be treated as a non-taxable exchange, such that no income should be recognized for U.S. Federal or state income tax purposes upon grant of the RSUs and New Options. However, you may recognize income for U.S. Federal income tax purposes upon vesting of the RSUs or upon exercise of New Options (See Section 12 of the Offer), at which time the Company will also generally have a tax withholding obligation. Although not required to do so, the Company intends to automatically withhold a sufficient number of otherwise distributable shares of common stock when RSUs vest to satisfy its tax withholding obligation. You may also have taxable income when you sell the shares issued upon settlement of your awards.

If you are a tax resident or subject to the tax laws in more than one country, you should be aware that there might be additional tax and social insurance consequences in more than one country that may apply to you. For additional information about your personal tax situation, you should talk to your own financial or tax advisor.

**Q27.** *Do I have to participate in the Option Exchange Program?*

No. Participation in this Offer is completely voluntary. If you choose not to participate, no changes will be made to the terms of your current option grants.

#### **SPECIFIC QUESTIONS ABOUT THE PROCESS OF EXCHANGING ELIGIBLE OPTIONS**

**Q28.** *When does this Offer expire? Can this Offer be extended, and if so, how will I know if it is extended?*

The "Expiration Date" of the Offer is 11:59 p.m. Pacific Daylight Time on December 7, 2006, unless we extend it. Although we do not currently intend to do so, we may, in our sole discretion, extend this Offer at any time prior to the Expiration Date. If we extend this Offer, we will announce the extension no later than 9:00 a.m. Pacific Daylight Time on the day following the last previously scheduled or announced Expiration Date. (See Section 13 of the Offer.)

**Q29.** *If I decide to accept this Offer, what do I need to do?*

If you wish to accept this Offer, you must submit your Stock Option Exchange Election Form to us pursuant to its instructions no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date. The Stock Option Exchange Election Form is provided in the packet regarding this Offer. If you have questions, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com). If we do not receive your signed, written Stock Option Exchange Election Form by 11:59 p.m. Pacific Daylight Time on the Expiration Date, you will be deemed to have rejected this Offer.

**Q30. Under what circumstances would Tegal not accept my Eligible Option grant for exchange?**

We currently expect that we will accept promptly after the Expiration Date all Eligible Option grants for which written elections are properly completed, signed and submitted and have not been validly changed or withdrawn. We may, however, reject any or all written election forms to the extent we determine they were not properly completed, signed or submitted, to the extent we determine it is unlawful to accept the exchanged Eligible Option grants or to the extent that any condition described in Section 6 of the Offer makes it inadvisable in our reasonable judgment to proceed with this Offer. (See Sections 3, 5 and 6 of the Offer.)

**Q31. Can I change my previous election prior to the Expiration Date?**

Yes. You may change your previous election or withdraw from the Offer by properly completing, executing and submitting a new Stock Option Exchange Election Form before the Expiration Date. You may change your election more than once. Your last properly submitted written Stock Option Exchange Election Form will supersede any prior election forms you may have completed, signed and submitted. (See Section 4 of the Offer.)

**Q32. If I elect to participate in the Offer, do I have to return any stock option agreements for the Eligible Options I wish to exchange?**

No. You do not need to return any stock option agreements as they will automatically be cancelled when we accept your Eligible Options for exchange.

**Q33. Who can I talk to if I have questions about the Offer?**

For general assistance, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com). You should consult your personal outside advisor(s) if you have questions about your financial or tax situation.

## THE OFFER

### 1. NUMBER OF OPTIONS; EXPIRATION DATE.

We are offering Eligible Employees of Tegal Corporation (together with its subsidiaries, the “Company” or “Tegal”) the opportunity to exchange stock options currently outstanding under the Eighth Amended and Restated 1998 Equity Participation Plan (the “Plan”) that have an exercise price equal to or greater than \$7.70 per share (“Eligible Options”) for a lesser number of either: (1) restricted stock units, each one representing one share of Company common stock to be issued in the future (“RSUs”) or (2) new options to purchase Company common stock (“New Options”). The RSUs and New Options will be granted on the next business day following expiration of the Offer, currently anticipated to be December 8, 2006 (the “Grant Date”), under the Eighth Amended and Restated 1998 Equity Participation Plan (the “Plan”) in accordance with a specified exchange formula as described herein (the “Option Exchange Program”), and pursuant to the terms and conditions of this Offer to Exchange Certain Outstanding Options to Purchase Common Stock (the “Offer”).

“Eligible Employees” are employees of Tegal as of November 8, 2006 who hold Eligible Options and continue to be employed by Tegal through 11:59 p.m. Pacific Daylight Time on December 7, 2006 (the “Expiration Date”). If we extend the period of time during which this Offer remains open, the term “Expiration Date” will refer to the latest time and date at which this Offer expires. See Section 13 of this Offer for a description of our rights to extend, delay, terminate and amend this Offer.

If you wish to accept this Offer, you are free to elect to exchange as many or as few of the Eligible Option grants as you like; however, you must exchange all shares issuable under each particular Eligible Option grant you wish to exchange. For example, if you received one grant of Eligible Options with the right to purchase 100 shares of our common stock, and another grant of Eligible Options with the right to purchase 50 shares of our common stock, you may tender one or both of these Eligible Option grants. However, you may not partially tender an Eligible Option grant (e.g., 50 shares of the Eligible Option grant for 100 shares or 25 shares of the Eligible Option grant for 50 shares). Also, you may elect to exchange each Eligible Option for either RSUs or New Options, but not both. If you have more than one Eligible Option, you may elect different types of awards for exchange with each (e.g., exchange an Eligible Option grant for 100 shares for RSUs, and exchange an Eligible Option grant for 50 shares for New Options).

This Offer is subject to the terms and conditions described herein, including the Summary of Terms, the Stock Option Exchange Election Form and any other communications periodically sent to you by us. We will only accept Eligible Option grants that are properly exchanged and not validly withdrawn, in accordance with Section 5 of this Offer, by 11:59 p.m. Pacific Daylight Time on the Expiration Date. If we do not receive your written election to participate by such date and time, you will be deemed to have rejected this Offer. If your employment with Tegal is terminated for any reason on or before the Grant Date, you will not receive any RSUs or New Options. If you terminate prior to the Expiration Date, you would be permitted to exercise your old options within the usual post-termination periods set forth in the Plan, to the extent that they were exercisable at the time of termination. Otherwise, on the Expiration Date your tendered old options will be cancelled, and if you terminate on or after the Expiration Date and before the Grant Date, you will forfeit and not be permitted to exercise your old options and you will not receive RSUs or New Options.

In this Offer, each Eligible Option grant may be exchanged for RSUs or New Options, as elected, to be granted in accordance with the following exchange formula (rounded down to the next whole share):

Value of your Eligible Options (as determined using an option pricing model),

Minus ten percent (10%),

Divided by the fair market value of a share of Company common stock on the Grant Date

“Fair market value” for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. The option pricing model to be used is the Black-Scholes valuation model (a widely used model for calculating the value of derivative securities).

As an example, if you have an Eligible Option grant representing the right to purchase 100 shares of common stock and you elect to exchange this Eligible Option for New Options, you will receive on the Grant Date a New Option grant representing the right to purchase the number of shares of common stock equal to the Black-Scholes valuation of your Eligible Option reduced by 10%, then divided by the closing price on the last trading date before the Grant Date.



The RSUs and New Options will become 50% vested on the first anniversary of the Grant Date, and 100% vested on the second anniversary of the Grant Date. Vesting is contingent upon your continuous employment with Tegal through the applicable vesting dates. The New Options will become exercisable as they vest, and will have an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market on the last trading day prior to the Grant Date. We cannot guarantee that the New Options will have a lower exercise price than the Eligible Options for which they are exchanged, because we cannot provide any assurance as to the price of our common stock in the future. If you terminate from employment with the Company prior to full vesting, you will forfeit and have no further rights with respect to any unvested portion of your RSUs or New Options.

All RSUs and New Options will be granted under the Plan. One share of Company common stock will be delivered to you for each RSU that vests. All New Options will be granted with an exercise price equal to the closing price of Tegal's common stock as reported on the Nasdaq Capital Market as of the last trading date prior to the Grant Date. The New Options will have a term equal to the remaining term of your Eligible Options exchanged, as long as you remain employed by Tegal. For example, if you decide to exchange an Eligible Option which would otherwise expire in 2009 for New Options, your New Options will also expire in 2009.

We will issue a press release or otherwise notify each Eligible Employee and keep the Offer open for at least ten (10) business days after the date of such notification if we decide to take any of the following actions prior to the Expiration Date:

- increase or decrease what we will give you in exchange for your Eligible Options; or
- increase or decrease the number of Eligible Options to be exchanged in this Offer.

A "business day" means any day other than a Saturday, Sunday or U.S. federal holiday and consists of the time period from 12:00 midnight through 11:59 p.m. Pacific Daylight Time.

## 2. PURPOSE OF THIS OFFER.

Many of our outstanding options have exercise prices that are significantly higher than the current market price of our common stock as a result of volatility in our stock price. In many cases, these "out-of-the-money" stock options no longer serve as effective incentives to retain, motivate and reward our employees. Accordingly, our Board adopted the Option Exchange Program to revitalize the stock options held by our employees. We believe the Option Exchange Program is an effective means of recognizing employee contributions to our success and aligning employee and stockholder interests.

In order to balance the interests of both our employees and our stockholders, we have designed it to be an approximate "value-for-value" program. This means that, in the aggregate, the value of the stock options being exchanged is approximately the same as the value of the RSUs and New Options to be issued. Under our option pricing model, this requires that more stock options be surrendered than received in the exchange. The exchange formula was determined on the basis of a Black-Scholes model, a commonly used option valuation model, with advice from third-party compensation consultants. We cannot guarantee that, if you choose to exchange your Eligible Options for New Options, your New Options will have a lower exercise price than your Eligible Options. The Board makes no recommendation as to whether or not you should tender your Eligible Options for exchange. The Board recognizes that the decision to accept or reject this Offer is an individual one that should be based on a variety of factors. You should consult with your personal outside advisor(s) if you have questions about your financial or tax situation.

## 3. PROCEDURES.

***Making Your Election.*** **If you wish to accept this Offer, you must submit your Stock Option Exchange Election Form to us pursuant to the instructions on the Form no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date.** The Stock Option Exchange Election Form is provided in the packet regarding this Offer. If we do not receive your signed, written Stock Option Exchange Election Form by 11:59 p.m. Pacific Daylight Time on the Expiration Date, you will be deemed to have rejected this Offer. If we extend the period of time during which this Offer remains open, the term "Expiration Date" will refer to the latest time and date at which this Offer expires. You do not need to return any stock option agreements as they will be automatically cancelled if we accept your Eligible Options for exchange.

If you have questions, please call Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com).

*Determination of Validity; Rejection of Elections; Waiver of Defects; No Obligation to Give Notice of Defects.* We will resolve, in our sole discretion, all questions as to the number of shares subject to Eligible Options and the validity, form, eligibility (including time of receipt) and acceptance of written election forms. Our determination of these matters will be final and binding on all parties. We may reject any or all submissions to the extent that we determine they were not properly completed, signed and submitted, to the extent that we determine it is unlawful to accept the Eligible Options tendered for exchange or to the extent that any condition described in Section 6 of this Offer makes it inadvisable in our reasonable judgment to proceed with this Offer. Otherwise, we will properly accept and timely exchange Eligible Options that are not validly withdrawn. We may waive any of the conditions of this Offer or any error in any written election form with respect to any particular Eligible Options or any particular Eligible Employee. No Eligible Options will be accepted for exchange until all errors have been cured by the Eligible Employee exchanging the Eligible Options or waived by us. Neither we nor any other person is obligated to give notice of any errors involved in the exchange of any Eligible Options, and no one will be liable for failing to give notice of any errors.

*Our Acceptance Constitutes an Agreement.* If you elect to exchange any of your Eligible Option grants and you tender those Eligible Options according to the procedures described above, you will have accepted this Offer. However, only our acceptance of your Eligible Options that are properly exchanged will form a binding agreement between us and you on the terms and subject to the conditions of this Offer.

Subject to our right to extend, terminate and amend this Offer, we currently expect that we will accept promptly after the Expiration Date all properly and timely tendered Eligible Options that have not been validly withdrawn.

#### **4. CHANGE IN ELECTION.**

You may only change your election by following the procedures described in this Section 4.

You may change your election at any time prior to 11:59 p.m. Pacific Daylight Time on the Expiration Date. If we extend this Offer beyond that time, you may change your election at any time until the extended Expiration Date. Additionally, in accordance with the legal requirements for tender offers, you may withdraw any options you elected to exchange if after forty (40) business days after the commencement of this Offer, we have not yet closed this Offer and we have not accepted for exchange all Eligible Option grants you elected to exchange. The date of the fortieth (40<sup>th</sup>) business day after the commencement of this Offer is January 6, 2007.

You may change your election more than once. Your last completed, signed and properly submitted Stock Option Exchange Election Form will supersede any prior elections you may have submitted.

If you have questions regarding the process for changing your election, you may contact Adam LaVigna @ 707-765-5656 or send an e-mail to [alavigna@tegal.com](mailto:alavigna@tegal.com).

Neither we nor any other person is obligated to give notice of any errors you may make to your election form, and no one will be liable for failing to give notice of any errors. We will resolve, in our sole discretion, all questions as to the form and validity, including time of receipt, of any change to the documentation concerning this Offering. Our determinations of these matters will be final and binding on all parties.

#### **5. ACCEPTANCE OF ELIGIBLE OPTIONS FOR EXCHANGE, AND THE CANCELLATION AND ISSUANCE OF RSUs AND NEW OPTIONS.**

On the terms and subject to the conditions of this Offer, promptly following the Expiration Date we will accept for exchange and cancellation all Eligible Options properly tendered and not validly withdrawn as of the Expiration Date. The RSUs and New Options will be granted approximately one (1) business day following expiration of the Offer, currently anticipated to be December 8, 2006, although for administrative processing reasons, you may not receive notice of your New Option grant for a period of time after the Grant Date. The Board retains the discretion to determine the Grant Date.

## 6. CONDITIONS OF THIS OFFER.

We will not be required to accept any Eligible Options that you elect to exchange, upon the occurrence of one or more of the conditions described below. We may terminate or amend this Offer, or postpone our acceptance and cancellation of any Eligible Options that you elect to exchange, in each case, if, at any time on or after the date hereof, and by 11:59 p.m. Pacific Daylight Time on the Expiration Date, we determine that any condition described below has occurred that, in our reasonable judgment, makes it inadvisable for us to proceed with this Offer or to accept and cancel Eligible Options that you elect to exchange. These conditions are as follows:

- if any action or proceeding by any government agency, authority or tribunal or any other person, domestic or foreign, is threatened or pending before any court, authority, agency or tribunal that directly or indirectly challenges the making of this Offer, the acquisition of some or all of the exchanged Eligible Options, the issuance of RSUs and/or New Options, or otherwise relates to this Offer or that, in our reasonable judgment, could materially and adversely affect our business, condition (financial or other), income, operations or prospects;
- if any action is threatened, pending or taken, or any approval is withheld, by any court or any authority, agency or tribunal, domestic or foreign, that, in our reasonable judgment, would or might directly or indirectly:

(a) make it illegal for us to accept some or all of the Eligible Options or to issue some or all of the RSUs and/or New Options or otherwise restrict or prohibit consummation of this Offer or otherwise relate to this Offer;

(b) delay or restrict our ability, or render us unable, to accept the Eligible Options for exchange and cancellation or to issue RSUs and/or New Options for some or all of the exchanged Eligible Options; or

(c) materially and adversely affect our business, condition (financial or other), income, operations or prospects;

- if there is:

(a) any general suspension of trading in, or limitation on prices for, securities on any national securities exchange or in the over-the-counter market; or

(b) the declaration of a banking moratorium or any suspension of payments in respect of banks in the United States, whether or not mandatory;

- if another person publicly makes or proposes a tender or exchange offer for some or all of our common stock, or an offer to merge with or acquire us;

- if any of the following change or changes occur in our business, condition (financial or other), assets, income, operations, prospects or stock ownership:

(a) litigation or other proceedings are instituted against us, or any of our officers or members of our Board in their capacities as such, before or by any federal, state or local court, commission, regulatory body, administrative agency or other governmental or legislative body, domestic or foreign, in which an unfavorable ruling, decision, action, order, decree or finding resulting from such litigation or proceeding would materially and adversely affect Tegal collectively with our subsidiaries;

(b) a material loss or interference with our business or properties from fire, explosion, flood or other casualty, whether or not covered by insurance;

(c) the suspension of trading in our equity securities by the SEC or by the Nasdaq Stock Market; or

(d) a material change in the prospects for our business resulting from any number of factors such as a material adverse change in the financial or securities markets in the United States or elsewhere, or in political, financial or economic conditions in the United States or elsewhere, or any outbreak or material escalation of foreign or domestic hostilities or other calamity or crisis that could, in our reasonable judgment, have a material adverse effect on the business, condition (financial or other), operations or prospects of Tegal or our subsidiaries or on the trading in our common stock;

- if we are required to extend the Expiration Date beyond January 6, 2007 as a result of action or determination by the SEC or other regulatory authority.

We may assert these conditions in our sole discretion at any time before the Expiration Date and we may waive them at any time before the Expiration Date, whether or not we waive any other condition to this Offer. Should we decide to waive or assert any of the conditions to this Offer, we must do so by 11:59 p.m. Pacific Daylight Time on the Expiration Date.

Our failure to exercise any of these rights is not a waiver of any of these rights. The waiver of any particular right is not, and will not be construed as, the waiver of any other right. However, once we choose to waive a particular right, we may not reassert that particular right again in this Offer. Any determination we make concerning the events described in this Section 6 will be final and binding on all Eligible Employees.

We currently expect that we will accept all Eligible Options that are properly submitted to be exchanged and have not been validly withdrawn.

## 7. PRICE RANGE OF COMMON STOCK.

There is no established trading market for the Eligible Options. The securities underlying the Eligible Options are shares of our common stock. Our common stock is quoted on the Nasdaq Capital Market under the symbol "TGAL". The following table shows, for the periods indicated, the high and low sale prices per share of our common stock as reported by the Nasdaq Capital Market.

	High	Low
<b>Year ended March 31, 2005</b>		
First Quarter	\$ 34.20	\$ 15.24
Second Quarter	24.12	9.84
Third Quarter	23.52	12.60
Fourth Quarter	20.4	10.44
<b>Year ended March 31, 2006</b>		
First Quarter	\$ 17.52	\$ 11.64
Second Quarter	12.00	7.56
Third Quarter	9.48	6.00
Fourth Quarter	8.40	5.76
<b>Year ended March 31, 2007</b>		
First Quarter	\$ 8.64	\$ 3.96
Second Quarter	5.04	2.62
Third Quarter (through November 3, 2006)	4.79	3.61

As of November 3, 2006, the last reported sale price of our common stock as reported on the Nasdaq Capital Market was \$3.85 per share.

The number of shares of our common stock outstanding as of November 3, 2006 was 7,072,289.

If you elect to receive New Options, we cannot guarantee that the New Options will have a lower exercise price than the Eligible Options. We recommend that you obtain and consider current market quotations for our common stock among other factors, before deciding whether to exchange your Eligible Options.

## 8. SOURCE AND AMOUNT OF CONSIDERATION; TERMS OF RSUs AND NEW OPTION GRANTS.

*Consideration.* In this Offer, each Eligible Option may be exchanged for either RSUs or a New Option to be granted in accordance with the following exchange formula (rounded down to the next whole share): the value of your Eligible Options (as determined under an option pricing model) will be reduced by ten percent (10%), then that reduced amount will be divided by the fair market value of a share of Company common stock on the Grant Date. "Fair market value" for this purpose is the closing price of a share of Company common stock as reported on the Nasdaq Capital Market on the last trading day before the Grant Date. The option pricing model to be used is the Black-Scholes valuation model (a widely used model for calculating the value of derivative securities).

As of November 3, 2006, there were outstanding Eligible Options to purchase 310,812 shares of Company common stock. If we receive and accept for exchange all outstanding Eligible Options and all participants in the Offer elect to receive RSUs, we will grant RSUs representative of approximately 219,089 shares of our common stock, equaling approximately 3 percent of the total shares of our common stock outstanding as of November 3, 2006.

*Exercise Price of New Options.* All New Options will be granted with an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market the last trading day prior to the Grant Date. We cannot guarantee that the New Options will have a lower exercise price than the Eligible Options for which they are exchanged, because we can provide no assurance as to the price of our common stock in the future.

*Vesting of RSUs and New Options.* The RSUs and New Options will be completely unvested at the time of grant, regardless of the vesting schedule of the tendered Eligible Options, and the RSUs and New Options will vest in two annual installments: 50% vested on the first anniversary of the Grant Date, and 100% vested on the second anniversary of the Grant Date. Vesting is contingent upon your continuous employment with the Company through the applicable vesting dates. The New Options will become exercisable as they vest, and will have an exercise price equal to the closing price of our common stock as reported on the Nasdaq Capital Market on the last trading day prior to the Grant Date. One share of Company common stock will be delivered to you for each RSU that vests. The purchase price of the shares of common stock to be issued upon settlement of your RSUs will be the par value of our common stock, which is equal to one-tenth of one cent (\$0.01) and the par value will be deemed paid by your past services rendered to Tegal. As a result, you do not have to make a payment to Tegal to receive the shares of common stock to be issued upon your settlement of your RSUs.

If you terminate from employment with the Company prior to full vesting, you will forfeit and have no further rights with respect to any unvested portion of your RSUs and/or New Options.

For example, a fully vested Eligible Option grant would be exchangeable for a New Option grant with an exercise price set at the current market price on the trading day before the Grant Date and vesting over two years in annual installments, with vesting beginning on the first anniversary following the Grant Date.

*Term of the New Options.* The New Options will have a term equal to the remaining term of your Eligible Options exchanged, as long as you remain employed by Tegal. (See Section 8 of the Offer.) For example, if you decide to exchange an Eligible Option which would otherwise expire in 2009 for New Options, your New Options will also expire in 2009.

*Other Terms and Conditions of the RSUs and New Options.* All RSUs and New Options will be issued under and subject to the terms of the Plan. The New Options will not be exercisable prior to vesting. Shares of common stock will not be delivered under the RSUs until vesting. The other terms and conditions of the RSUs and New Options will be set forth in an award agreement to be entered into as of the Grant Date. Such other terms and conditions will be generally comparable to the other terms and conditions of other similar awards issued under the Plan. All New Options will be nonstatutory stock options granted under the Plan regardless of the tax status of the Eligible Options tendered for exchange. The shares of common stock that the RSUs represent and for which the New Options will be exercised are registered with the SEC.

## **9. INTEREST OF DIRECTORS AND EXECUTIVE OFFICERS; TRANSACTIONS AND ARRANGEMENTS INVOLVING STOCK OPTIONS.**

A list of executive officers and members of our Board is attached to this Offer as Appendix A. Our executive officers are eligible to participate in this Offer. The members of our board of directors, however are not eligible to participate in this offer.

As of November 3, 2006, all of our executive officers as a group (6 persons) held options outstanding under the Plan to purchase a total of 301,736 shares of our common stock. This represented approximately 44% of the shares subject to all options outstanding under the Plan and the Fifth Amended and Restated Stock Option Plan for Outside Directors.

Since September 3, 2006, none of our executive officers have engaged in transactions which involved options to purchase our common stock or involved a purchase or sale of our common stock.

There is no agreement, arrangement or understanding between Tegal or, to the best of our knowledge, any of our executive officers or members of our Board, and any other person for the purchase or acquisition from Tegal of any of our securities, except for the following as of November 3, 2006:

- outstanding options granted to executive officers to purchase an aggregate of 217,581 shares of common stock pursuant to the Plan; and
- outstanding options granted to members of our Board to purchase an aggregate of 84,155 shares of common stock pursuant to our Fifth Amended and Restated Stock Option Plan for Outside Directors.

## 10. STATUS OF OPTIONS ACQUIRED BY US IN THIS OFFER; ACCOUNTING CONSEQUENCES OF THIS OFFER.

We will cancel the difference between Eligible Options surrendered and RSUs and New Options issued and the shares of stock underlying such Eligible Options will be added to the number of shares reserved for issuance under the Eighth Amended and Restated 1998 Equity Participation Plan. Assuming exchange of all of the Eligible Options for RSUs and New Options, an aggregate of 65,013 options will be returned to the reserved share pool.

Under Statement of Financial Accounting Standards No. 123 (Revised), *Share-Based Payment* (“SFAS 123R”), we would be required to recognize an expense as a result of the grant of New Options in exchange for Eligible Options to the extent the fair value of the New Options exceeds the fair value of the Eligible Options surrendered under an applicable option valuation model. We would be required to recognize an expense of the grant of RSUs to the extent that the number of shares underlying the RSUs multiplied by the last reported sales price of Company common stock on the Grant Date exceeds the fair value of the Eligible Options immediately before their cancellation. Because the Offer has been designed as an approximate value-for-value exchange, we expect to incur little or no charge to earnings for financial accounting purposes as a result of this Offer. However, due to a number of factors, including but not limited to our inability to predict which or how many Eligible Options will be exchanged, or what the future market price of our common stock will be on the Grant Date, we cannot predict what exact charge to earnings might result from the Option Exchange Program.

## 11. LEGAL MATTERS; REGULATORY APPROVALS.

We are not aware of any license or regulatory permit material to our business that might be adversely affected by this Offer, or of any approval or other action by any government or regulatory authority or agency, other than SEC review and certain exemption or notice filings that may be required in certain countries outside the United States, that is required for the exchange of Eligible Options for RSUs and New Options. If any other approval, exemptive filing, notice filing or action should be required, we presently intend to seek the approval, make such filing or take the action. This could require us to delay the acceptance of any Eligible Options that you elect to exchange. We cannot assure you that we would be able to obtain any required approval, make such filing or take any other required action. Our obligation under this Offer to accept exchanged Eligible Options and to issue RSUs and New Options is subject to the conditions described in Section 6 of this Offer.

## 12. MATERIAL U.S. FEDERAL INCOME TAX CONSEQUENCES.

The following is a summary of the material U.S. federal income tax consequences of the exchange of eligible options for RSUs and New Options pursuant to the Offer for those Eligible Employees subject to U.S. Federal income tax. This discussion is based on the Internal Revenue Code, its legislative history, treasury regulations thereunder and administrative and judicial interpretations as of the date of this offering circular, all of which are subject to change, possibly on a retroactive basis. This summary does not discuss all of the tax consequences that may be relevant to you in light of your particular circumstances, nor is it intended to be applicable in all respects to all categories of option holders. If you are a citizen or a resident of the United States, but are also subject to the tax laws of another country, you should be aware that there might be other tax and social security consequences in more than one country that may apply to you.

***We recommend that you consult your own tax advisor with respect to the United States federal, state and local tax consequences of participating in the offer, as the tax consequences to you are dependent on your individual tax situation.***

*U.S. Federal Income Tax Consequences of Restricted Stock Units (RSUs).* The exchange of Eligible Options should be treated as a non-taxable exchange and no income should be recognized for U.S. federal or state income tax purposes upon grant of RSUs. Instead, you will recognize ordinary income when the RSU vests and no longer can be forfeited, and the shares of stock are delivered, at which time Tegal will also generally have a tax withholding obligation. The amount of ordinary income you recognize will equal the fair market value of the shares on the vesting date, less the amount, if any, you paid for the shares. Although not obligated to do so, Tegal intends to automatically withhold a sufficient number of otherwise distributable shares of common stock when RSUs vest to satisfy all tax withholding obligations.

*U.S. Federal Income Tax Consequences of New Options.* The exchange of Eligible Options, whether non-qualified options or incentive stock options under Section 422 of the Internal Revenue Code, should be treated as a non-taxable exchange and no income should be recognized for U.S. federal or state income tax purposes upon grant of the New Options. However, when you exercise a New Option, the difference between the exercise price of such option and the fair market value of the shares subject to the option on the date of exercise will be treated as taxable compensation income to you, and you will be subject to withholding of income and employment taxes at that time.

All of the New Options you will be issued in exchange for your Eligible Options will be nonqualified stock options. The subsequent sale of the shares acquired pursuant to the exercise of a nonqualified stock option generally will give rise to capital gain or loss equal to the difference between the sale price and the sum of the exercise price paid for the shares plus the ordinary income previously recognized with respect to the shares, and these capital gains or losses will be treated as long-term capital gains or losses if you held the shares for more than one year following exercise of the option.

*U.S. Federal Income Tax Consequences of Incentive Stock Options.* So that you are able to compare the tax consequences of RSUs and New Options to those of any of your Eligible Options that are incentive stock options under Section 422 of the Internal Revenue Code, we have included the following summary as a reminder of the tax consequences generally applicable to incentive stock options under U.S. Federal income tax law:

Under current U.S. tax law, an option holder will not realize taxable income upon the grant of an incentive stock option. In addition, an option holder generally will not realize taxable income upon the exercise of an incentive stock option. However, an option holder's alternative minimum taxable income will be increased by the amount that the aggregate fair market value of the shares underlying the option, which is generally determined as of the date of exercise, exceeds the aggregate exercise price of the option. Except in the case of an option holder's death or disability, if an option is exercised more than three (3) months after the option holder's termination of employment, the option ceases to be treated as an incentive stock option and is subject to taxation under the rules that apply to nonstatutory stock options.

If an option holder sells the option shares acquired upon exercise of an incentive stock option, the tax consequences of the disposition depend upon whether the disposition is qualifying or disqualifying. The disposition of the option shares is qualifying if it is made:

- more than 2 years after the date the incentive stock option was granted; and
- more than 1 year after the date the incentive stock option was exercised.

If the disposition of the option shares is qualifying, any excess of the sale price of the option shares over the exercise price of the option will be treated as long-term capital gain taxable to the option holder at the time of the sale. Any such capital gain will be taxed at the long-term capital gain rate in effect at the time of sale.

If the disposition is not qualifying, which we refer to as a "disqualifying disposition," the excess of the fair market value of the option shares on the date the option was exercised (or, if less, the amount realized on the disposition of the shares) over the exercise price will be taxable income to the option holder at the time of the disposition.

Of that income, the amount up to the excess of the fair market value of the shares at the time the option was exercised over the exercise price will be ordinary income for income tax purposes and the balance, if any, will be long-term or short-term capital gain, depending upon whether or not the shares were sold more than 1 year after the option was exercised.

Unless an option holder engages in a disqualifying disposition, we will not be entitled to a deduction with respect to an incentive stock option. If an option holder engages in a disqualifying disposition, we will be entitled to a deduction equal to the amount of compensation income taxable to the option holder.

If you exchange an Eligible Option that is an incentive stock option, the New Options you receive will be nonqualified stock options. Accordingly, you would be giving up the tax treatment of incentive stock options if you participate in this Offer.

**The above descriptions are only a summary of the U.S. federal income tax consequences of the exchange of Eligible Options under this Offer, and is not intended to provide you with any tax advice in connection with this summary or this Offer. We recommend that you consult your own tax advisor with respect to the federal, state, local and foreign tax consequences of participating in this Offer.** Also, please note that as a result of the American Jobs Creation Act of 2004, options amended in a certain manner or granted with an exercise price that was lower than the fair market value of the underlying shares at the time of grant may be taxable to you before you exercise your option. As of the date of this Offer, how such options will be taxed is unclear.



### **13. EXTENSION OF THIS OFFER; TERMINATION; AMENDMENT.**

We may, at any time prior to the Expiration Date, extend the period of time during which this Offer is open and delay accepting any tendered Eligible Options by announcing the extension and giving oral or written notice of the extension to Eligible Employees.

You may withdraw your options at any time before the Expiration Date by following the procedures described in Section 3.

Additionally, in accordance with the legal requirements for tender offers, you may withdraw any options you elected to exchange if after forty (40) business days after the commencement of this Offer, we have not yet closed this Offer and we have not accepted for exchange all Eligible Option grants you elected to exchange. The date of the fortieth (40th) business day after the commencement of this Offer is January 6, 2007.

We may, at any time prior to the Expiration Date, terminate, postpone or amend this Offer. To postpone accepting or canceling Eligible Options, we must announce the postponement and give oral or written notice of the postponement to the Eligible Employees. Our right to postpone accepting and canceling Eligible Options may be limited by Rule 13e-4(f)(5) under the Securities Exchange Act of 1934 (the "Exchange Act"), which requires that we pay the consideration offered or return the Eligible Options promptly after we terminate or withdraw this Offer.

Subject to applicable law, we may amend this Offer in any way, including decreasing or increasing the consideration offered in this Offer to Eligible Employees or by decreasing or increasing the number of Eligible Options to be exchanged or surrendered in this Offer.

We may amend this Offer at any time prior to the expiration of this Offer by announcing the amendment. If we extend the length of time during which this Offer is open, the amendment must be announced no later than 9:00 a.m. Pacific Daylight Time on the next business day after the last previously scheduled or announced Expiration Date. Any announcement relating to this Offer will be sent promptly to Eligible Employees in a manner reasonably designed to inform Eligible Employees of the change.

If we materially change the terms of the Offer or the information concerning the Offer, or if we waive a material condition of the Offer, we will extend the Offer to the extent required by Rules 13e-4(d)(2) and 13e-4(e)(3) under the Exchange Act. These rules require that the minimum period during which a tender or exchange offer must remain open following material changes in the terms of the offer or information concerning the offer, other than a change in price or a change in percentage of securities sought, will depend on the facts and circumstances, including the relative materiality of such terms or information.

In addition, if we decide to take any of the following actions, we will publish a notice electronically or otherwise inform you in writing of such action and keep the exchange offer open for at least 10 business days after the date of such notification: (a) we increase or decrease the amount of consideration offered for the Eligible Options; or (b) we increase or decrease the number of Eligible Options that may be tendered in the Offer.

### **14. FEES AND EXPENSES.**

We will not pay any fees or commissions to any broker, dealer or other person pursuant to this Offer.

### **15. ADDITIONAL INFORMATION.**

This Offer document is part of a Tender Offer Statement on Schedule TO that we have filed with the Securities and Exchange Commission ("SEC"). This Offer does not contain all of the information contained in the Schedule TO and the exhibits to the Schedule TO. We recommend that you review the Schedule TO, including its exhibits, and the following materials that we have filed with the SEC before making a decision on whether to exchange your Eligible Options:

(a) our Annual Report on Form 10-K for our fiscal year ended March 31, 2006, filed with the SEC on June 13, 2006;

(b) our Quarterly Report on Form 10-Q for our quarter ended June 30, 2006, filed with the SEC on August 14, 2006;

(c) our Definitive Proxy Statement for our 2006 Annual Meeting of Stockholders, filed with the SEC on June 20, 2006; and

(d) the description of the common stock contained in our Registration Statement on Form 8-A (File No. 01-26824), which was declared effective by the Commission on October 18, 1995, including any subsequently filed amendments and related reports.

We are subject to the information requirements of the Securities Exchange Act of 1934, as amended. Accordingly, we file annual, quarterly and periodic reports, proxy statements and other information with the SEC relating to our business, financial statements and other matters. You may read and copy any documents we have filed with the SEC at prescribed rates at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC 20549. You can obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Our SEC filings are also available to you free of charge at the SEC's web site at [www.sec.gov](http://www.sec.gov) and our Exchange Act filings are also available at our web site at [www.tegal.com](http://www.tegal.com).

You may obtain information on the operation of the public reference rooms by calling the SEC at 1-800-SEC-0330. Our SEC filings are also available to the public on the SEC's Internet site at <http://www.sec.gov>.

Our common stock is currently quoted on the Nasdaq Capital Market under the symbol "TGAL".

We will also provide without charge to each person to whom we deliver a copy of this Offer, upon their written or oral request, a copy of any or all of the documents to which we have referred you, other than exhibits to these documents (unless the exhibits are specifically incorporated by reference into the documents). Requests should be directed to:

Tegal Investor Relations  
2201 South McDowell Boulevard  
Petaluma, CA 94954

or the investor relations portion of our website at <http://www.Tegal.com> or by telephoning us at (707) 763-5600.

As you read the documents listed above, you may find some inconsistencies in information from one document to another. If you find inconsistencies between the documents, or between a document and this offer to exchange, you should rely on the statements made in the most recent document.

The information contained in this Offer about us should be read together with the information contained in the documents to which we have referred you, in making your decision as to whether or not to participate in this Offer.

## 16. FINANCIAL STATEMENTS

Attached as Appendix B to this Offer are our financial statements included in our Annual Report on Form 10-K for our fiscal year ended March 31, 2006 and our financial statements included in our most recent Quarterly Report on Form 10-Q for the quarter ended June 30, 2006. In addition, set forth below is our ratio of earnings to fixed charges for the fiscal years ended March 31, 2004, 2005, and 2006 and for the quarter ended June 30, 2006, and the book value per share information as of June 30, 2006.

	Fiscal Year Ended March 31,			Three Months Ended
	2004	2005	2006	June 30, 2006
Ratio of earnings to fixed charges <sup>(1)</sup>	—	—	—	—

<sup>(1)</sup> For purposes of computing the ratio of earnings to fixed charges, fixed charges consist of interest expense on capital leases and interest on debenture financing. Earnings were insufficient to cover fixed charges by \$41,463, \$4,000, \$0, and \$0 in fiscal years 2004, 2005, 2006 and the three months ended June 30, 2006.

The book value per share of the Company at June 30, 2006 was \$.29, based on 7,023,000 shares (on a post-reverse split basis) outstanding as of June 30, 2006.

More complete financial information may be obtained by accessing our public filings with the SEC by following the instructions in Section 15 of this Offer.

## 17. MISCELLANEOUS

We are not aware of any jurisdiction where the making of the Offer is not in compliance with applicable law. If we become aware of any jurisdiction where the making of the Offer is not in compliance with any valid applicable law, we will make a good faith effort to comply with such law. If, after such good faith effort, we cannot comply with such law, the offer will not be made to, nor will options be

accepted from the option holders residing in such jurisdiction.

**We have not authorized any person to make any recommendation on our behalf as to whether you should elect to exchange your Eligible Options through the Offer. You should rely only on the information in this document or documents to which we have referred you. We have not authorized anyone to give you any information or to make any representations in connection with the offer other than the information and representations contained in this offer to exchange and in the related option exchange program documents. If anyone makes any recommendation or representation to you or gives you any information, you must not rely upon that recommendation, representation or information as having been authorized by us.**

**APPENDIX A**

**INFORMATION ABOUT THE DIRECTORS AND EXECUTIVE OFFICERS OF TEGAL**

The executive officers and members of the board of directors of Tegal and their positions and offices as of November 3, 2006, are set forth in the following table:

Name	Position and Offices Held
Thomas R Mika	President, Chief Executive Officer and Chairman of the Board
Christine T Hergenrother	VP, Chief Financial Officer, Secretary and Treasurer
Scott L Brown	Vice President
Murali Narasimhan	Vice President
Steve Selbrede	Vice President, Chief Technology Officer
Vahan Tchakerian	Vice President
Edward Dohring	Director
Jeffrey Krauss	Director
Duane Wadsworth	Director

The business address of each director and executive officer is: c/ o Tegal Corporation, 2201 South McDowell Boulevard, Petaluma, CA, 94954. The business telephone number of each director and executive officer is (707) 763-5600.

Name	Shares Beneficially	
	Owned	Percent of Class (%)
Thomas R Mika	85,541	1.20
Christine T Hergenrother	7,862	*
Scott L Brown	0	—
Murali Narasimhan	10,417	*
Steve Selbrede	35,416	*
Vahan Tchakerian	17,461	*
Edward Dohring	30,064	*
Jeffrey Krauss	30,898	*
Duane Wadsworth	<u>15,900</u>	*
<u>Total</u>	233,559	3.28

\* Less than one percent.

**Form of STOCK OPTION EXCHANGE ELECTION FORM**

Employee Name:

Employee I.D.

Number:

**Instructions**

In order to participate in the Offer (as defined below), you will need to:

1. Read this Stock Option Exchange Election Form (the "Election Form") carefully;
2. Indicate your election by selecting the "RSUs", "New Options", or "Do Not Exchange" box for each of your Eligible Option grants listed below;
3. Fill in all other required information (marked with two asterisks \*\*);
4. Sign and date this Election Form, keeping a copy for your records; and
5. Send the original of this Election Form to: Adam LaVigna, Tegal Corporation, 2201 South McDowell Boulevard, Petaluma, CA, 94954, **to be received by the Company no later than December 7, 2006 ( the "Expiration Date")**.

If the original of this Election Form cannot be sent by you so that it is assured delivery by the Expiration Date, you must send a copy of this completed and signed Election Form to Adam LaVigna by facsimile to 707-763-0436 (FAX) or send a scanned version of this Election Form by email to [alavigna@tegal.com](mailto:alavigna@tegal.com). Such copy **must be received by fax or by email no later than 11:59 p.m. Pacific Daylight Time on the Expiration Date and you must also send the original by courier or other express delivery service** at the address listed above.

**To make changes to your election:** You may submit another version of this Election Form at any time prior to 11:59 p.m. Pacific Daylight Time on the Expiration Date (or a later Expiration Date if the Company extends the Offer). If you are changing a previous election, you will need to update your selection of Eligible Option grants below, fill out all other required information and sign and date a new copy of this Election Form. If your new Election Form is received by the Company on or prior to the Expiration Date and is properly completed and signed, it will supersede and replace in full any previously submitted Election Form(s). You will be bound by your last properly submitted Election Form received by 11:59 p.m. Pacific Daylight Time on December 7, 2006 (or a later Expiration Date if the Company extends the Offer).

**My Election :**

1. I have received and carefully read the Offer to Exchange Certain Outstanding Options to Purchase Common Stock (the "Offer"), including the Summary of Terms in Question and Answer format, dated November 8, 2006, sent to the employees of the Company who hold Eligible Options to purchase common stock of the Company that have exercise prices equal to or greater than \$7.70 per share. Terms not explicitly defined in this Election Form will have the same definitions as used in the Offer.

2. Pursuant to the terms of the Offer, I elect to have one or more Eligible Option grants held by me, as specified below, cancelled in exchange for a right to receive RSUs and/or New Options, as indicated, in accordance with the specified exchange formula described in the Offer. I fully understand and acknowledge that I am accepting all of the terms of the Offer. I hereby agree that, unless I revoke my election on or before 11:59 p.m. Pacific Daylight Time on December 7, 2006 (or a later Expiration Date if the Company extends the Offer), my election will be irrevocable and, if accepted by the Company, the surrendered Eligible Options will be cancelled in their entirety on the Expiration Date. I understand I will have the right to receive RSUs and/or New Options, to be granted approximately one business day following the Expiration Date (the "Grant Date"), subject to my continuous employment through the Grant Date. I understand that should I terminate from employment for any reason following my election to participate in the Offer and prior to the Grant Date, I will not receive an RSU and/or New Option grant. If I terminate on or after the Expiration Date, I will not receive an RSU and/or New Option Grant and will forfeit and will not be permitted to exercise my old options.



**Data Privacy**

To administer this Offer, we must collect, use and transfer certain information regarding you and your Eligible Options, and may have to disclose that information to third parties who are assisting us with this Offer. By submitting this Election Form, you consent to such collection, use and transfer of your personal data by us and third parties assisting us with this Offer, but only for the purpose of administering your participation in this Offer. By submitting this Election Form, you also acknowledge and agree that: (i) the parties receiving this data may be located in a country different from that country in which you are employed, and the recipient's country may have different data privacy laws and protections; (ii) the data will be held only as long as necessary to administer and implement this Offer and as legally required; (iii) you can request from us a list of the parties that may receive your data; (iv) you can request additional information about how the data is stored and processed; and (v) you can request that the data be amended if it is incorrect. You may, at any time, withdraw this data privacy consent in writing by contacting Adam LaVigna @ 707-765-5656 or send an e-mail to alavigna@tegal.com. **You understand that if you withdraw your data privacy consent, however, you will not be able to participate in this Offer.**

Although we intend to send you a confirmation of receipt of this Election Form, any confirmation of receipt of this Election Form sent to you will merely be a notification that we have received your Election Form and does not mean the Eligible Option grants you selected for exchange have been cancelled. We will be deemed to have accepted your Eligible Option grants for exchange at the time we give notice to you that your Eligible Options have been cancelled. Eligible Options accepted for exchange will be cancelled on the first business day following the Expiration Date.

If you need assistance completing this Election Form, please call Adam LaVigna @ 707-765-5656 or send an e-mail to alavigna@tegal.com.

**\*\* Acknowledgement**

- I acknowledge that my participation in the Offer, and my election indicated above, are voluntary. I further acknowledge that, based on the information I have received (e.g., the Offer, Summary of Terms, and this Election Form), I understand the Offer. I also acknowledge that I will be unable to change my election after the Expiration Date.

\*\*Employee Signature: \_\_\_\_\_

\*\*Date: \_\_\_\_\_, 2006

\*\*Employee Name: \_\_\_\_\_



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

**Form 10-K**

For Annual and Transition Reports Pursuant to Sections 13 or #15D of the Securities and Exchange Act of 1934

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

For the fiscal year ended March 31, 2006

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

Commission file number: 0-26824

**Tegal Corporation**

*(Exact name of registrant as specified in its charter)*

**Delaware**

*(State or other jurisdiction of incorporation or organization)*

**68-0370244**

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

**2201 South McDowell Boulevard**

**Petaluma, California**

*(Address of principal executive offices)*

**94954**

*(Zip Code)*

**Registrant's Telephone Number, Including Area Code: (707) 763-5600**

**Securities Registered Pursuant to Section 12(b) of the Act: None**

**Securities Registered Pursuant to Section 12(g) of the Act:  
Common Stock, \$0.01 Par Value**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.  
Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.  
Yes  No

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 reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

Indicate by check mark if the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes  No

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The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, based on the closing sale price of the common stock on September 30, 2005 as reported on the NASDAQ Smallcap Market, was \$59,593,820. As of May 19, 2006, 84,253,058 shares of the registrant's common stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for registrant's 2006 Annual Meeting of Stockholders to be held July 21, 2006 will be filed with the Commission within 120 days after the close of the registrant's fiscal year and are incorporated by reference in Part III.

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**PART I**

**Item 8. Financial Statements and Supplementary Data**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders  
Tegal Corporation

We have audited the accompanying consolidated balance sheets of Tegal Corporation as of March 31, 2006 and 2005, and the related consolidated statements of operations, stockholders' equity, and cash flows for the years then ended. We have also audited the information presented in Schedule II that is listed in the index and appearing under Item 15(a)(2), for the years ended March 31, 2006 and 2005. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Tegal Corporation as of March 31, 2006 and 2005, and the consolidated results of its operations and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, the information presented in Schedule II for the years ended March 31, 2006 and 2005, when considered in relation to the March 31, 2006 and 2005, consolidated financial statements, taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ Moss Adams LLP

Santa Rosa, California  
June 9, 2006

**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and Stockholders  
of Tegal Corporation:

In our opinion, the consolidated statements of operations, stockholders' equity and cash flows for the year ended March 31, 2004 listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the results of operations and cash flows of Tegal Corporation and its subsidiaries for the year ended March 31, 2004, in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule for the year ended March 31, 2004 listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audit. We conducted our audit of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring net losses and has generated negative cash flows from operations. These factors raise substantial doubt about the Company's ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

PricewaterhouseCoopers LLP  
San Jose, California  
June 25, 2004

**TEGAL CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

	March 31,	
	2006	2005
	(In thousands, except share and per share data)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 13,787	\$ 7,093
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$205 and \$533 at March 31, 2006 and 2005, respectively	5,265	1,897
Inventories, net	7,700	5,140
Prepaid expenses and other current assets	1,270	641
<b>Total current assets</b>	<b>28,022</b>	<b>14,771</b>
Property and equipment, net	1,849	3,342
Intangible assets, net	1,474	1,796
Other assets	146	183
<b>Total assets</b>	<b>\$ 31,491</b>	<b>\$ 20,092</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Notes payable and bank lines of credit	\$ 27	\$ 159
Accounts payable	2,458	3,607
Accrued product warranty	506	252
Deferred revenue	477	122
Accrued expenses and other current liabilities	1,975	2,575
<b>Total current liabilities</b>	<b>5,443</b>	<b>6,715</b>
Long-term portion of capital lease obligations	2	13
Other long term obligations	6	64
<b>Total long term liabilities</b>	<b>8</b>	<b>77</b>
<b>Total liabilities</b>	<b>\$ 5,451</b>	<b>\$ 6,792</b>
Commitments and contingencies (Note 6)		
Stockholders' equity:		
Preferred stock; \$0.01 par value; 5,000,000 shares authorized; none issued and outstanding	—	—
Common stock; \$0.01 par value; 200,000,000 shares authorized; 84,253,058 and 52,843,520 shares issued and outstanding at March 31, 2006 and 2005, respectively	842	528
Restricted Stock Units	1,034	
Deferred Compensation	(224)	
Additional paid-in capital	119,010	99,156
Accumulated other comprehensive income (loss)	532	(110)
Accumulated deficit	(95,154)	(86,274)
<b>Total stockholders' equity</b>	<b>26,040</b>	<b>13,300</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 31,491</b>	<b>\$ 20,092</b>

See accompanying notes to consolidated financial statements.

TEGAL CORPORATION

CONSOLIDATED STATEMENTS OF OPERATIONS

	Year Ended March 31,		
	2006	2005	2004
	(In thousands, except share and per share data)		
Revenue	\$ 21,757	\$ 14,888	\$ 16,528
Cost of revenue	15,741	11,621	11,881
Gross profit	6,016	3,267	4,647
Operating expenses:			
Research and development expenses	4,753	5,772	3,305
Sales and marketing expenses	2,963	2,905	2,347
General and administrative expenses	7,139	6,459	3,973
In-process research and development		1,653	2,202
Total operating expenses	14,855	16,789	11,827
Operating loss	(8,839)	(13,522)	(7,180)
Interest income (expense), net	291	(2,064)	(5,521)
Other income (expense), net	(864)	223	99
Total other expense, net	(573)	(1,841)	(5,422)
Income Taxes	532		
Net loss	\$ (8,880)	\$ (15,363)	\$ (12,602)
Net loss per share:			
Basic and diluted	\$ (0.13)	\$ (0.33)	\$ (0.56)
Weighted average shares used in per share computations:			
Basic and diluted	70,831	46,879	22,442

See accompanying notes to consolidated financial statements.

TEGAL CORPORATION

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

	Common Stock		Additional	Accumulated	Accumulated	Total	Compre-
	Shares	Amount	Paid-in	Other	Deficit	Stock-	hensive
			Capital	Comprehensive		Holders'	Loss
				Income		Equity	
(In thousands, except share and per share data)							
Balances at March 31, 2003	16,091,762	161	68,806	465	(58,309)	11,123	—
Common stock issued under option and stock purchase plans	90,269	1	68	—	—	69	—
Common stock issued for acquisition	1,499,994	15	2,327	—	—	2,342	—
Restricted stock issued for services rendered	158,311	—	332	—	—	332	—
Options and warrants, issued in previous years, exercised for services rendered	470,899	6	399	—	—	405	—
Warrants and options to purchase common stock issued for services rendered	—	—	756	—	—	756	—
Debentures – value of Beneficial conversion feature	—	—	5,190	—	—	5,190	—
Debentures – fair value of warrants issued to investors and brokers	—	—	1,724	—	—	1,724	—
Debentures – interest & accelerated discount	—	—	4,033	—	—	4,033	—
Debentures – debt issuance in form of warrants	—	—	784	—	—	784	—
Debentures – converted to shares	15,685,769	157	(157)	—	—	—	—
Debentures – interest converted to shares	95,609	1	(1)	—	—	—	—
Debentures – investor warrants exercised	892,497	9	437	—	—	446	—
Debentures – broker warrants exercised	1,536,605	15	522	—	—	537	—
Private Institutional Offering December 2001 – warrants exercised	62,135	1	156	—	—	157	—
Net loss	—	—	—	—	(12,602)	(12,602)	\$ (12,602)
Cumulative translation adjustment	—	—	—	(341)	—	(341)	(341)
Total comprehensive loss	—	—	—	—	—	—	\$ (12,943)
Balances at March 31, 2004	36,583,850	366	85,376	124	(70,911)	14,955	—
Common stock issued under option and stock purchase plans	89,183	1	97	—	—	98	—
Common stock issued for acquisition	1,410,632	14	2,328	—	—	2,342	—
Options and Warrants issued for services rendered	—	—	—	—	—	—	—
Warrants and options to purchase common stock issued for services rendered	—	—	339	—	—	339	—
Debentures – value of Beneficial conversion feature	—	—	1,811	—	—	1,811	—
Debentures – interest & accelerated discount	—	—	—	—	—	—	—
Debentures – converted to shares	4,785,659	48	(48)	—	—	—	—
Debentures – interest converted to shares	39,459	—	—	—	—	—	—
Debentures – investor & advisor warrants exercised	1,426,720	14	338	—	—	352	—
Private Institutional Offering December 2001 – warrants exercised	1,686	—	—	—	—	—	—
Kingsbridge	8,506,331	85	8,915	—	—	9,000	—
Net loss	—	—	—	—	(15,363)	(15,363)	\$ (15,363)
Cumulative translation adjustment	—	—	—	(234)	—	(234)	(234)
Total comprehensive loss	—	—	—	—	—	—	\$ (15,597)
Balances at March 31, 2005	52,843,520	\$ 528	\$ 99,156	\$ (110)	\$ (86,274)	\$ 13,300	—

	<u>Common Stock</u>		<u>Additional</u>	<u>Accumulated</u>	<u>Accumulated</u>	<u>Total</u>	<u>Compre-</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-in</u>	<u>Other</u>	<u>Deficit</u>	<u>Stock-</u>	<u>hensive</u>
			<u>Capital</u>	<u>Income</u>		<u>Holders'</u>	<u>Loss</u>
(In thousands, except share and per share data)							
Common stock issued under option and stock purchase plans	113,974	2	94	—	—	96	—
Common stock issued for PIPE	30,840,000	308	19,738	—	—	20,046	—
Common stock issued for services rendered	176,360	1	102	—	—	103	—
Warrants and options to purchase common stock issued for services rendered	—	—	953	—	—	953	—
Restricted Stock Units - Granted/Vested	279,204	3	1,228	—	—	1,231	—
Deferred Compensation	—	—	(224)	—	—	(224)	—
Cost of Equity	—	—	(1,662)	—	—	(1,662)	—
Valuation of Warrants for 2005 PIPE	—	—	435	—	—	435	—
Net loss	—	—	—	—	(8,880)	(8,880)	\$ (8,880)
Cumulative translation adjustment	—	—	—	642	—	642	<u>642</u>
Total comprehensive loss	—	—	—	—	—	—	<u>\$ (8,238)</u>
Balance at March 31, 2006	<u>84,253,058</u>	<u>\$ 842</u>	<u>\$ 119,820</u>	<u>\$ 532</u>	<u>\$ (95,154)</u>	<u>\$ 26,040</u>	

See accompanying notes to consolidated financial statements.



TEGAL CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Year Ended March 31,		
	2006	2005	2004
Cash flows from operating activities:			
Net loss	\$ (8,880)	\$ (15,363)	\$ (12,602)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization	1,193	1,452	1,338
In-process research and development		1,653	2,202
Provision for doubtful accounts and sales returns allowances	(338)	273	56
Non cash interest expense - accretion of debt discount and amortization of debt issuance costs		2,019	5,480
Fair value of warrants and options issued for services rendered	1,958	381	332
Non Cash Mark to Market Warrants	435		
Excess and obsolete inventory provision	(1,146)	778	967
Changes in operating assets and liabilities, net of acquisitions:			
Accounts receivable	(2,718)	2,402	(2,362)
Inventories	(618)	(2,093)	2,508
Prepaid expenses and other assets	(532)	24	(286)
Accounts payable	(1,112)	1,916	(311)
Accrued expenses and other current liabilities	(601)	(470)	(190)
Accrued product warranty	300	(173)	(411)
Customer deposits	—	—	(15)
Deferred revenue	355	(318)	115
Net cash used in operating activities	<u>(11,704)</u>	<u>(7,519)</u>	<u>(3,179)</u>
Cash flows from investing activities:			
Purchases of property and equipment	(231)	(315)	(254)
Loss of property and equipment	128	—	—
Net cash used in investing activities	<u>(103)</u>	<u>(315)</u>	<u>(254)</u>
Cash flows from financing activities:			
Gross proceeds from the issuance of 2% convertible debentures	—	—	7,165
2% convertible debentures cash issuance costs	—	—	(982)
Net proceeds from issuance of common stock	18,583	10,206	1,613
Borrowings under notes payable and bank lines of credit		1,303	2,474
Repayments of notes payable and bank lines of credit	(134)	(3,594)	(527)
Payments on capital lease financing	(24)	(11)	(9)
Net cash provided by financing activities	<u>18,425</u>	<u>7,904</u>	<u>9,734</u>
Effect of exchange rates on cash and cash equivalents	76	(26)	(164)
Net increase in cash and cash equivalents	6,694	44	6,137
Cash and cash equivalents at beginning of year	7,093	7,049	912
Cash and cash equivalents at end of year	<u>\$ 13,787</u>	<u>\$ 7,093</u>	<u>\$ 7,049</u>
Supplemental disclosures of cash paid during the year for:			
Interest	<u>\$ 10</u>	<u>\$ 27</u>	<u>\$ 119</u>
Supplemental disclosure of non-cash investing and financing activities			
Transfer of demo lab equipment between inventory and fixed assets	<u>\$ 725</u>		

**Supplemental Schedule of Non Cash Investing Activities (amounts in thousands, except shares):**

On November 11, 2003, the Company purchased certain assets and assumed certain liabilities of Simplus Systems. Consideration totaled \$2,522 and consisted of 1,499,994 shares of the Company's common stock valued at \$2,310, fully vested Tegal employee stock options to purchase 58,863 shares of the Company's common stock at an exercise price of \$3.09 per share, valued at \$32 and transaction costs of \$180. The purchase price was allocated as follows:

Assets acquired:	
Fixed assets	48
Identifiable intangible assets	389
In-process research and development	<u>2,202</u>
Total assets	2,639
Liabilities assumed:	
Current liabilities	<u>(117)</u>
Net assets acquired	<u>\$ 2,522</u>

On May 28, 2004, Tegal purchased substantially all of the assets and assumed certain liabilities of First Derivative Systems, Inc. ("FDSI"), a development stage company, for 1,410,632 shares of common stock valued at \$2,342, \$150 in debt forgiveness, approximately \$50 in assumed liabilities, and \$158 in acquisition costs, pursuant to a purchase agreement dated April 28, 2004. The following table represents the allocation of the purchase price for FDSI. In estimating the fair value of assets acquired and liabilities assumed management considered various factors, including an independent appraisal.

Fair value fixed assets acquired	\$ 111
Non compete agreements	203
Patents	733
In-process research and development	1,653
Debt forgiveness	(150)
Assumed liabilities	<u>(50)</u>
	<u>\$ 2,500</u>

See accompanying notes to consolidated financial statements.

## TEGAL CORPORATION

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(All amounts in thousands, except per share data and share data, unless otherwise noted)

#### Note 1. Description of Business and Summary of Significant Accounting Policies

##### Description of Business

Tegal Corporation, a Delaware corporation (“Tegal” or the “Company”), designs, manufactures, markets and services plasma etch and deposition systems that enable the production of integrated circuits (“ICs”), memory and related microelectronics devices used in personal computers, wireless voice and data telecommunications, contact-less transaction devices, radio frequency identification devices (“RFIDs”), smart cards, data storage and micro-level actuators. Etching and deposition constitute two of the principal IC and related device production process steps and each must be performed numerous times in the production of such devices.

On August 30, 2002, the Company acquired all of the outstanding common stock of Sputtered Films, Incorporated (“SFI”), a privately held California corporation. SFI is a leader in the design, manufacture and service of high performance physical vapor deposition sputtering systems for the semiconductor and semiconductor packaging industry. SFI was founded in 1967 with the development of its core technology, the S-Gun. SFI continues to operate as a wholly-owned subsidiary of Tegal. The majority of the SFI operations have been moved to the Company’s headquarters operations in Petaluma, California, and its operations are now fully integrated with those of Tegal.

On November 11, 2003, the Company acquired substantially all of the assets and certain liabilities of Simplus Systems Corporation (“Simplus”), a development stage company. Simplus had developed a deposition cluster tool and certain patented processes for barrier, copper seed and high-K dielectric applications. Simplus had coined the term “nano-layer deposition” or “NLD” to describe its unique approach to MOCVD. Immediately following the acquisition of the assets of Simplus, its employees and technology were integrated into the development programs of the Company. The Company is continuing to develop these NLD processes and related tools, and is in the process of marketing them to a limited number of key customers and joint development partners.

On May 28, 2004, the Company purchased substantially all of the assets and assumed certain liabilities of First Derivative Systems, Inc. (“FDSI”). FDSI, a privately held development stage company, was founded in 1999 as a spin-off of SFI. FDSI had developed a high-throughput, low cost-of-ownership physical vapor deposition (“PVD”) system with highly differentiated technology for leading edge memory and logic device production on 200 and 300 millimeter wafers. FDSI’s operations and development programs were fully absorbed into the Company following the acquisition, and Tegal has continued to develop systems for addressing these markets.

##### Basis of Presentation

The consolidated financial statements contemplate the realization of assets and the satisfaction of liabilities in the normal course of business. The Company incurred net losses of \$8,880, \$15,363 and \$12,602 for fiscal years 2006, 2005 and 2004, respectively. The Company generated negative cash flows from operations of \$11,704, \$7,519 and \$3,179 for fiscal years 2006, 2005 and 2004, respectively. To finance its operations during 2004, the Company raised approximately \$6,183 in net proceeds from the sale of 2% convertible debentures and exercise of warrants (see Note 7). During 2005, the Company raised \$10,380 from stock issued to Kingsbridge. Management believes that these proceeds, combined with a projected increase in sales, consolidation of certain operations and continued cost containment will be adequate to fund operations through fiscal year 2006. However, projected sales may not materialize and unforeseen costs may be incurred. If the projected sales do not materialize, the Company will need to reduce expenses further and raise additional capital through the issuance of debt or equity securities. If additional funds are raised through the issuance of preferred stock or debt, these securities could have rights, privileges or preferences senior to those of common stock, and debt covenants could impose restrictions on the Company’s operations. The sale of equity or debt could result in additional dilution to current stockholders, and such financing may not be available to the Company on acceptable terms, if at all. The failure to raise additional funds may adversely affect the Company’s ability to achieve its intended business objectives. The consolidated financial statements do not include any adjustments relating to the recoverability and classification of recorded assets or the amount or classification of liabilities or any other adjustments that might be necessary should the Company be unable to continue as a going concern.

The consolidated financial statements include the accounts of the Company and all of its subsidiaries. Intercompany transactions and balances are eliminated in consolidation. Accounts denominated in foreign currencies are translated using the foreign currencies as the functional currencies. Assets and liabilities of foreign operations are translated to U.S. dollars at current rates of exchange and revenues and expenses are translated using weighted average rates. The effects of translating the financial statements of foreign subsidiaries into U.S. dollars are reported as accumulated other comprehensive income, a separate component of stockholders' equity. Gains and losses from foreign currency transactions are included in the statements of operations as a separate component of other expense, net.

The preparation of financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could vary from those estimates.

### **Cash and Cash Equivalents**

The Company considers all highly liquid debt instruments having a maturity of three months or less on the date of purchase to be cash equivalents.

At March 31, 2006 and 2005 all of the Company's investments are classified as cash equivalents in the consolidated balance sheets. The investment portfolio at March 31, 2006 and 2005 is comprised of money market funds. At March 31, 2006 and 2005, the fair value of the Company's investments approximated cost.

### **Financial Instruments**

The carrying amount of the Company's financial instruments, including cash and cash equivalents, accounts receivable and accounts payable, bank lines of credit, notes payable, accrued expenses and other liabilities approximates fair value due to their relatively short maturity. The Company has foreign subsidiaries, which operate and sell the Company's products in various global markets. As a result, the Company is exposed to changes in foreign currency exchange rates. The Company utilizes hedge instruments, primarily forward contracts, to manage its exposure associated with firm third-party transactions denominated in non-functional currencies. The Company does not hold derivative financial instruments for speculative purposes. Realized and unrealized gains and losses related to forward contracts considered to be effective hedges are deferred until settlement of the hedged items. They are recognized as other gains or losses when a hedged transaction is no longer expected to occur. Realized and unrealized gains and losses on ineffective hedges are recorded to other expense, net. Foreign currency gains and losses included in other expense, net were not significant for the years ended March 31, 2006, 2005 and 2004.

At March 31, 2006, the Company had forward exchange contracts maturing at various dates throughout fiscal 2007 to exchange 277.7 million Japanese Yen into \$2.4million.

### **Concentration of Credit Risk**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of temporary cash investments and accounts receivable. Substantially all of the Company's temporary investments are invested in money market funds. The Company's accounts receivable are derived primarily from sales to customers located in the U.S., Europe and Asia. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. The Company maintains reserves for potential credit losses. Write-offs during the periods presented have been insignificant. As of March 31, 2006 one customer accounted for approximately 63.4% of the accounts receivable balance. As of March 31, 2005 two customers accounted for approximately 40% of the accounts receivable balance. As of March 31, 2004, three customers accounted for approximately 43% of the accounts receivable balance.

### **Inventories**

Inventories are stated at the lower of cost or market, reduced by provisions for excess and obsolescence. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis and includes material, labor and manufacturing overhead costs. We estimate the effects of excess and obsolescence on the carrying values of our inventories based upon estimates of future demand and market conditions. We establish a provision for inventories in excess of production demand. Should actual production demand differ from our estimates, additional inventory provision may be required, as was the case in the third quarter of fiscal 2004. The excess and obsolete provision is only released if and when the related inventory is sold or scrapped. The inventory provision balance at March 31, 2006 and 2005 was \$7,136 and \$8,282. The inventory provision expense for the year March 31, 2006 and 2005 was (\$1,146) and \$778, respectively.

We periodically analyze any systems that are in finished goods inventory to determine if they are suitable for current customer requirements. At the present time, our policy is that, if after approximately 18 months, we determine that a sale will not take place within the next 12 months and the system would be useable for customer demonstrations or training, it is transferred to fixed assets. Otherwise, it is expensed.

The carrying value of systems used for demonstrations or training is determined by assessing the cost of the components that are suitable for sale. Any parts that may be rendered unsaleable as a result of such use are removed from the system and are not included in finished goods inventory. The remaining saleable parts are valued at the lower of cost or market, representing the system's net realizable value. The depreciation period for systems that are transferred to fixed assets is determined based on the age of the system and its remaining useful life (typically five to eight years).

### Warranty Costs

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is effected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Should actual product failure rates, material usage rates and labor efficiencies differ from estimates, revisions to the estimated warranty liability may be required (see Note 2 to accompanying notes to the consolidated financial statements).

### Property and Equipment

Property and equipment are recorded at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets, ranging from three to seven years. Leasehold improvements are stated at cost and are amortized using the straight-line method over the shorter of the estimated useful life of the improvements or the lease term. When assets are disposed of, the cost and related accumulated depreciation are removed from the accounts and the resulting gains or losses are included in the results of operations. The Company generally depreciates its assets over the following periods:

	<u>Years</u>
Furniture and machinery and equipment	7
Computer and software	3 - 5
Leasehold improvements	5 or remaining lease life

Identified Intangible Assets Acquisition -related intangibles include non-compete agreements, patents, unpatented technology, and trade name that are amortized on a straight-line basis over periods ranging from 5 years to 15 years. Also included in acquisition-related intangibles is workforce-in-place related to acquisitions that did not qualify as business combinations. The Company performs ongoing review of its identified intangible assets to determine if facts and circumstances exist that indicate the useful life is shorter than originally estimated or the carrying amount may not be recoverable. If such facts and circumstances exist, the Company assesses the recoverability of identified intangible assets by comparing the projected undiscounted net cash flow associated with the related asset or group of assets over their remaining lives against their respective carrying amounts. Impairment, if any, is based on the excess of the carrying amount over the fair value of those assets.

### Impairment of Long-Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss is recognized based on the excess of the carrying amount over the fair value of the assets. No impairment charge has been recorded for the years-ended 2006, 2005 and 2004, respectively.

### Accounts Receivable - Allowance for Sales Returns and Doubtful Accounts

The Company maintains an allowance for doubtful accounts receivable for estimated losses resulting from the inability of the Company's customers to make required payments. If the financial condition of the Company's customers were to deteriorate, or even a single customer was otherwise unable to make payments, additional allowances may be required.

The Company's return policy is for spare parts and components only. A right of return does not exist for systems. Customers are allowed to return spare parts if they are defective upon receipt. The potential returns are offset against gross revenue on a monthly basis. Management reviews outstanding requests for returns on a quarterly basis to determine that the reserves are adequate.

## **Revenue Recognition**

Each sale of our equipment is evaluated on an individual basis in regard to revenue recognition. We have integrated in our evaluation the related interpretative guidance included in Topic 13 of the codification of staff accounting bulletins, and recognize the role of the EITF consensus on Issue 00-21. We first refer to EITF 00-21 in order to determine if there is more than one unit of accounting and then we refer to SAB104 for revenue recognition topics for the unit of accounting. We recognize revenue when persuasive evidence of an arrangement exists, the seller's price is fixed or determinable and collectibility is reasonably assured.

For products produced according to our published specifications, where no installation is required or installation is deemed perfunctory and no substantive customer acceptance provisions exist, revenue is recognized when title passes to the customer, generally upon shipment. Installation is not deemed to be essential to the functionality of the equipment since installation does not involve significant changes to the features or capabilities of the equipment or the building of complex interfaces and connections. In addition, the equipment could be installed by the customer or other vendors and generally the cost of installation approximates only 1% of the sales value of the related equipment.

For products produced according to a particular customer's specifications, revenue is recognized when the product has been tested and it has been demonstrated that it meets the customer's specifications and title passes to the customer. The amount of revenue recorded is reduced by the amount (generally 10%), which is not payable by the customer until installation is completed and final customer acceptance is achieved.

For new products, new applications of existing products, or for products with substantive customer acceptance provisions where performance cannot be fully assessed prior to meeting customer specifications at the customer site, 100% of revenue is recognized upon completion of installation and receipt of final customer acceptance. Since title to goods generally passes to the customer upon shipment and 90% of the contract amount becomes payable at that time, inventory is relieved and accounts receivable is recorded for the entire contract amount. The revenue on these transactions is deferred and recorded as deferred revenue. As of March 31, 2006 and March 31, 2005, deferred revenue as related to systems was \$455 and \$80, respectively. We reserve for warranty costs at the time the related revenue is recognized.

Revenue related to sales of spare parts is recognized upon shipment. Revenue related to maintenance and service contracts is recognized ratably over the duration of the contracts. Unearned maintenance and service revenue is included in deferred revenue. At March 31, 2006 and March 31, 2005, respectively, \$22 and \$42 of deferred revenue was related to service contracts.

## **Accounting for Freight Charged to Customers**

Spares and systems are typically shipped "freight collect," therefore no shipping revenue or cost is associated with the sale. When freight is charged, it is booked to revenue and offset for the cost of that freight in the cost of revenue accounts pursuant to FASB's Emerging Issues Task Force ("EITF") 00-10.

## **Income Taxes**

Deferred income taxes are recognized for the differences between the tax bases of assets and liabilities and their financial reporting amounts based on enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

## **Earnings Per Share**

Basic earnings per share ("EPS") is computed by dividing net income (loss) available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted EPS is computed using the weighted average number of common shares outstanding plus any potentially dilutive securities, except when the effect of including such changes is antidilutive.

## **Stock-Based Compensation**

The Company accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees," and related interpretations, including FASB Interpretation No. 44 ("FIN 44"), "Accounting for Certain Transactions Involving Stock Compensation — an interpretation of APB Opinion No. 25." The Company's policy is to grant options with an exercise price equal to the closing market price of the Company's stock on the grant date. Accordingly, no compensation cost for stock option grants has been recognized in the Company's statements of operations. Additional proforma disclosures assuming the Company applied the fair value method of accounting for employee stock compensation under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation" as amended by SFAS No. 148, "Accounting for Stock-Based Compensation - Transition and Disclosure" are as follows.



As required by SFAS No. 123 for proforma disclosure purposes only, the Company has calculated the estimated grant date fair value of its stock option awards using the Black-Scholes model. The Black-Scholes model, as well as other currently accepted option valuation models, was developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions. These models also require highly subjective assumptions, including future stock price volatility and expected time until exercise, which greatly affect the calculated grant date fair value.

The following assumptions are included in the estimated grant date fair value calculations for the Company's stock option awards and Employee Qualified Stock Purchase Plan ("Employee Stock Purchase Plan"):

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Expected life (years):			
Stock options	4.0	4.0	4.0
Employee stock purchase plan	0.5	0.5	0.5
Volatility:			
Stock options	63%	90%	119%
Employee stock purchase plan	63%	90%	119%
Risk-free interest rate	4.61%	2.84%	2.62%
Dividend yield	0%	0%	0%

The weighted average estimated grant date fair value, as defined by SFAS No. 123, for stock option awards granted during fiscal 2006, 2005 and 2004 was \$0.41, \$0.85 and \$0.90 per option, respectively.

The following table summarizes information with respect to stock options and warrants outstanding as of March 31, 2006 (number of shares in thousands):

Range of Exercise Prices	<u>Outstanding Options as of March 31, 2006</u>				<u>Exercisable at March 31, 2006</u>	
	Number of Options & Warrants	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Number of Options & Warrants	Weighted Average Exercise Price	
\$0.35 — \$1.50	24,863,303	\$ 0.95	5.61	22,216,608	\$ 0.96	
\$1.51 — \$2.14	975,778	1.75	5.33	782,028	1.65	
\$2.15 — \$3.00	984,667	2.50	1.29	984,667	2.50	
\$3.01 — \$3.25	190,632	3.20	3.28	190,632	3.20	
\$3.26 — \$3.88	55,000	3.75	4.09	55,000	3.75	
\$3.89 — \$4.25	305,000	4.11	2.85	305,000	4.11	
\$4.26 — \$6.88	161,700	4.94	2.39	161,700	4.94	
\$6.89 — \$8.00	65,188	7.71	3.88	65,188	7.71	
\$8.01 — \$8.75	53,000	8.47	3.37	53,000	8.47	
\$ 0.35 — \$8.75	<u>27,654,268</u>	\$ 1.14	5.37	<u>24,813,823</u>	\$ 1.16	

The weighted average estimated grant date fair values per share, as defined by SFAS No. 123, for rights granted under the employee stock purchase plan during fiscal 2006, 2005 and 2004 were \$0.40, \$0.82 and \$0.35, respectively.



Had the Company recorded compensation costs based on the estimated grant date fair value (as defined by SFAS 123) for awards granted under its stock option plans and Employee Plan, the Company's net loss and loss per share would have been increased to the proforma amounts below for the years ended March 31, 2006, 2005 and 2004:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Net loss as reported	\$ (8,880)	\$ (15,363)	\$ (12,602)
Net loss per share as reported	\$ (.13)	\$ (.33)	\$ (.56)
Proforma compensation expense at fair Value	\$ (1,770)	\$ (1,244)	\$ (458)
Proforma net loss	<u>\$ (10,650)</u>	<u>\$ (16,607)</u>	<u>\$ (13,060)</u>
Proforma net loss per share:			
Basic and diluted	\$ (0.15)	\$ (0.36)	\$ (0.58)

During the current fiscal year, the Company awarded 1,000,000 restricted stock units to Brad Mattson, the Company's Chairman, and 150,000 restricted stock units to Thomas Mika, the Company's President and Chief Executive Officer at the close of the 2005 PIPE, see note 9. These restricted stock units were accounted for as compensation expense of \$1,004.

During the current fiscal year, the Company awarded four employees 325,000 restricted shares. These shares are valued at \$224, are not vested, and were accounted for as Restricted Share Units and Deferred Compensation in the equity section of the balance sheet.

On September 13, 2005 the Company issued 500,000 warrants at \$0.69 as consideration for an amendment to the current lease of the Company's headquarters to reduce the termination fee. The value of the warrants of \$655 was based on the fair value of the termination penalty reduction offset by the exercise price of the warrant and recorded as rent expense.

During the current fiscal year, the Company issued 79,204 shares of restricted stock to a consultant of the Company in lieu of a cash payment for spares commission. The value of the restricted stock of \$47 was based on the market price of the stock on the date of grant.

The disclosure provisions of SFAS No. 123 and SFAS No. 148 require judgments by management as to the estimated lives of the outstanding options. Management has based the estimated life of the options on historical option exercise patterns. If the estimated life of the options increases, the valuation of the options will increase as well.

In December 2004 the Financial Accounting Standards Board issued SFAS No. 123R, "Share-Based Payment," that addresses the accounting for share-based payment transactions in which an enterprise receives employee services in exchange for equity instruments of the enterprise or liabilities that are based on the fair value of the enterprise's equity instruments or that may be settled by the issuance of such equity instruments. The statement eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, "Accounting for Stock Issued to Employees," and requires instead that such transactions be accounted for using a fair-value-based method. The Company will be required to adopt SFAS No 123R beginning April 1, 2006. Had the Company adopted SFAS No 123R during the fiscal year ended March 31, 2006, compensation expense of approximately \$1,770 would have been recognized in the consolidated statements of operations for the year ended March 31, 2006. The Company will adopt SFAS 123(R) beginning April 1, 2006.

### **Comprehensive Loss**

Comprehensive loss is defined as the change in equity of the Company during a period from transactions and other events and circumstances excluding transactions resulting from investments by owners and distributions to owners. The primary difference between net loss and comprehensive loss for the Company is attributable to foreign currency translation adjustments. Comprehensive loss is shown in the statement of stockholders' equity.

### **New Accounting Pronouncements**

In November 2004 the FASB issued SFAS No. 151 "Inventory Costs - An Amendment of ARB No. 43, Chapter 4" (SFAS 151). SFAS 151 clarifies that abnormal amounts of idle facility expense freight handling costs and spoilage should be expensed as incurred and not included in overhead. Further SFAS 151 requires that allocation of fixed and production facilities overheads to conversion costs should be based on normal capacity of the production facilities. The provisions in SFAS 151 are effective for inventory costs incurred during the fiscal years beginning April 1, 2006. The adoption of SFAS 151 will have no material impact on the consolidated financial statements.

**Note 2. Balance Sheet and Statement of Operations Detail**

Inventories, net consisted of:

	March 31,	
	2006	2005
Raw materials	\$ 1,692	\$ 1,044
Work in process	4,173	2,976
Finished goods and spares	1,835	1,120
	<u>\$ 7,700</u>	<u>\$ 5,140</u>

The inventory provision at March 31, 2006 and 2005 was \$7,136 and \$8,282, respectively.

Property and equipment, net, consisted of:

	March 31,	
	2006	2005
Machinery and equipment	\$ 3,481	\$ 4,266
Demo lab equipment	2,028	3,489
Computer and software	1,623	1,436
Leasehold improvements	3,528	3,182
	10,660	12,373
Less accumulated depreciation and amortization	<u>(8,811)</u>	<u>(9,031)</u>
	<u>\$ 1,849</u>	<u>\$ 3,342</u>

Machinery and equipment at March 31, 2006 and 2005, includes approximately \$56 of assets under leases that have been capitalized. Accumulated amortization for such equipment approximated \$ 42 and \$37, respectively.

A summary of accrued expenses and other current liabilities follows:

	March 31,	
	2006	2005
Accrued compensation costs	\$ 1,261	\$ 910
Income taxes payable	13	502
Other	701	1,163
	<u>\$ 1,975</u>	<u>\$ 2,575</u>

Product warranty and guarantees:

The Company provides warranty on all system sales based on the estimated cost of product warranties at the time revenue is recognized. The warranty obligation is affected by product failure rates, material usage rates, and the efficiency by which the product failure is corrected. Warranty activity for the years ended March 31, 2006 and 2005 is as follows:

	Year ended March 31,	
	2006	2005
Balance at the beginning of the period	\$ 252	\$ 366
Additional warranty accruals for warranties issued during the year	496	465
Settlements made during the year	(242)	(579)
Balance at the end of the year	<u>\$ 506</u>	<u>\$ 252</u>

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

**Note 3. Earnings Per Share**

SFAS No. 128, "Earnings Per Share," requires dual presentation of basic and diluted net income (loss) per share on the face of the statement of operations. Basic EPS is computed by dividing loss available to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) for the period. Diluted EPS gives effect to all dilutive potential common shares outstanding during the period. The computation of diluted EPS uses the average market prices during the period. All amounts in the following table are in thousands except per share data.

Basic net loss per common share is computed using the weighted-average number of shares of common stock outstanding.

The following table represents the calculation of basic and diluted net loss per common share (in thousands, except per share data):

	Year Ended March 31,		
	2006	2005	2004
Net loss applicable to common stockholders	\$ (8,880)	\$ (15,363)	\$ (12,602)
<b>Basic and diluted:</b>			
Weighted-average common shares outstanding	70,831	46,879	22,442
Less weighted-average common shares subject to repurchase...	—	—	-----
Weighted-average common shares used in computing basic and diluted net loss per common share	70,831	46,879	22,442
<b>Basic and diluted net loss per common share</b>	<b>\$ (0.13)</b>	<b>\$ (0.33)</b>	<b>\$ (.56)</b>

Outstanding options, warrants and restricted stock equivalent to 28,929,268,11,964,208, and 12,396,879 shares of common stock at a weighted-average exercise price of \$1.16, \$2.15, and \$1.73 per share on March 31, 2006, 2005, and 2004 were not included in the computation of diluted net loss per common share for the periods presented as a result of their anti-dilutive effect. Such securities could potentially dilute earnings per share in future periods.

#### **Note 4. Notes Payable and Bank Lines of Credit**

As of March 31, 2006, the Company's Japanese subsidiary had \$13 outstanding under its lines of credit which is collateralized by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The two credit lines have a total borrowing capacity of 200 million Yen (approximately \$1,282 at exchange rates prevailing on March 31, 2006), which are secured by Japanese customer promissory notes held by such subsidiary in advance of payment on customers' accounts receivable. The two Japanese bank lines bear interest at Japanese prime (1.375% as of March 31, 2006) plus 0.875% and 1.5%, respectively.

#### **Note 5. Income Taxes**

Components of Income before income taxes are as follows:

Year ended March 31,	2006	2005	2004
Domestic	(6,884)	(14,478)	(12,396)
Foreign	(2,528)	(885)	(206)
	<u>(9,412)</u>	<u>(15,363)</u>	<u>(12,602)</u>

Components of the provision for income taxes are as follows:

Year ended March 31	2006	2005	2004
<b>Current:</b>			
U.S. Federal	—	—	
State & Local	—	—	
Foreign	(532)	—	
	<u>(532)</u>	<u>—</u>	
<b>Deferred:</b>			
U.S. Federal	—	—	
State & Local	—	—	
Foreign	—	—	
Total	(532)	—	

The income tax provision differs from the amount computed by applying the statutory U.S. federal income tax rate as follows:

Year ended March 31,	2006	2005	2004
Income tax provision at U.S. Statutory Rate	(3,200)	(4,651)	(4,285)
State taxes net of federal benefit	(295)	(303)	(265)
Foreign differential	860	301	—
Current year tax credits	(441)	—	—
Transfer price reserve no longer required	(532)	—	—
Change In Valuation Allowance	2,080	4,739	4,367
Change in deferred state tax rate	600	—	—
Other	396	(86)	183
<b>Income tax expense/(income)</b>	<b>(532)</b>	<b>—</b>	<b>—</b>

Components of deferred taxes are as follows:

Year ended March 31,	2006	2005
Revenue recognition for tax & deferred for book	57	45
Non-deductible accruals and reserves	3,459	4,322
Net operating loss carryforward	26,997	24,356
Credits	3,549	3,004
Uniform cap adjustment	457	566
Other	108	254
<b>Total</b>	<b>34,627</b>	<b>32,547</b>
Valuation Allowance	(34,627)	(32,547)
<b>Net Deferred Tax Asset</b>	<b>—</b>	<b>—</b>

We have recorded no net deferred tax assets for the years ended March 31, 2006 and 2005, respectively. The Company has provided a valuation allowance of \$34.6 million and \$32.5 million at March 31, 2006 and March 31, 2005, respectively, since it is more likely than not the deferred taxes will not be realized. The valuation allowance increased by \$2.1 million and \$4.7 million during the years ended March 31, 2006 and 2005, respectively.

At March 31, 2006, the Company has net operating loss carryforwards of approximately \$73.7 million and \$33.3 million for federal and state respectively, which begin to expire in the year ended March 31, 2008.

At March 31, 2006, the Company also has research and experimentation credit carryforwards of \$2.6 million and \$1.4 million for federal and state income tax purposes, respectively, which begin to expire in the year ended March 31, 2010.

The Tax Reform Act of 1986 limits the use of net operating loss and tax credit carry-forwards in certain situations where changes occur in the stock ownership of a corporation during a certain time period. In the event the company has incurred a change in ownership, utilization of the carry-forwards could be significantly restricted.

#### **Note 6. Accounting for Restructure Expense**

During the fiscal year ended March 31, 2006, we recorded a severance charge of approximately \$271 related to staff reductions of 17 employees, of which approximately \$168 was classified as cost of sales, \$81 as engineering, process and development and \$22 sales, marketing and general and administrative expenses. We had an outstanding severance liability of approximately \$15 as of March 31, 2006.

During the fiscal year ended March 31, 2005, we recorded a severance charge of approximately \$129 related to staff reductions of 19 employees, of which approximately \$19 was classified as cost of sales, \$18 as research and development and \$92 as sales, marketing and general and administrative expenses. We had an outstanding severance liability of approximately \$63 as of March 31, 2005.

There were no severance charges and no outstanding liability during fiscal year ended March 31, 2004

**Note 7. Commitments and Contingencies**

The Company has several non-cancelable operating leases and capital leases, primarily for general office, production and warehouse facilities, that expire over the next five years. Future minimum lease payments under these leases are as follows:

Year Ending March 31, 2006	Capital Leases	Operating Leases
	As of March 31, 2006	
2007	\$ 12	\$ 779
2008	2	272
2009		210
2010		160
2011		8
Thereafter		33
Total minimum lease payments		1,462
Less amount representing interest		
Present value of minimum lease payments	14	
Less current portion	12	
Long term capital lease obligation	2	

Most leases provide for the Company to pay real estate taxes and other maintenance expenses. Rent expense for operating leases, net of sublease income, was \$2,671, \$1,426 and \$1,007, during the years ended March 31, 2006, 2005 and 2004, respectively.

The Company maintains our headquarters, encompassing our executive office, manufacturing, engineering and research and development operations, in one leased 57,418 square foot facility in Petaluma, California. On February 1, 2006, the landlord of these facilities was given notice of our intention to vacate by July 31, 2006. We have office space in a leased 13,300 square foot facility in San Jose, California. Our headquarters will be moved to this location during fiscal year 2007.

Sputtered Films, Inc. v. Advanced Modular Sputtering, et al., filed in Santa Barbara County Superior Court.

On December 22, 2003, Sputtered Films, Inc. ("SFI"), a wholly owned subsidiary of the Company, filed an action against two former employees, Sergey Mishin and Rose Stuart-Curran, and a company they formed after leaving their employment with SFI named Advanced Modular Sputtering, Inc. ("AMS"). Sergey Mishin and Rose Stuart-Curran had each signed confidentiality and non-disclosure agreements regarding information obtained while employed by SFI. The action contains causes of action for specific performance, breach of contract, breach of the covenant of good faith and fair dealing, misappropriation of trade secrets, unfair competition, unfair business practices, interference with prospective economic advantage, conversion, unjust enrichment, and declaratory relief. These claims arise out of information SFI received evidencing that AMS possessed and used SFI's confidential, proprietary and trade secret drawings, specifications and technology to manufacture the sputtering tool marketed by AMS.

During 2004 and 2005, this litigation was largely stalled while AMS and Agilent Technologies, Inc. contested SFI's right to conduct discovery. This dispute was resolved in late 2005 when the California Court of Appeal affirmed SFI's trade secret identification as statutorily sufficient. On November 18, 2005, SFI requested leave to add Agilent Technologies, Inc. ("Agilent") as a defendant based on evidence that Agilent and AMS co-developed the machines which SFI contends were built using SFI proprietary information. The Court granted SFI's request and Agilent was served as a Doe defendant on December 12, 2005. In early December, SFI learned that Agilent transferred its Semiconductor Products Group to a number of Avago entities effective December 1, 2005, and accordingly SFI sought and received court approval to add Avago Technologies U.S., Inc. and Avago Technologies Wireless (U.S.A.) Manufacturing, Inc (collectively the "Avago Entities") as defendant in this action. On April 25, 2006, the Avago Entities filed a Cross-Complaint against SFI and Tegal Corporation alleging causes of action for breach of contract, trade secret misappropriation, unfair competition, conversion, unjust enrichment and declaratory relief. The Cross-Complaint alleges on information and belief that SFI misused information obtained from Hewlett-Packard in connection with Hewlett-Packard's request to purchase SFI machines or to upgrade SFI machines Hewlett-Packard already owned. SFI and Tegal Corporation intend to vigorously contest all such allegations. Trial is currently set for November 8, 2006, although the Court has indicated that it may bifurcate the Avago Entities' cross-claims.

**Note 8. 2% Convertible Debentures:**

On June 30, 2003, the Company signed definitive agreements with investors to raise up to \$7,165 in a private placement of convertible debt financing to be completed in two tranches. The first tranche, which closed on June 30, 2003, involved the sale of debentures in the principal amount of \$929. The Company received \$424 in cash on June 30, 2003 and the remaining balance of \$505 on July 1, 2003, which was recorded as an other receivable as of June 30, 2003. The closing of the second tranche, which occurred on September 9, 2003 following shareholder approval on September 8, 2003, resulted in the receipt of approximately \$6,236 in gross proceeds on September 10,



The Company was required to pay a cash fee of up to 6.65% of the gross proceeds of the debentures to certain financial advisors upon the closing of the second tranche. A fee of \$448 has been recorded as a debt issuance cost and was paid in September 2003. The financial advisors also were granted warrants to purchase 1,756,127 shares of the Company's common stock at an exercise price of \$0.35 per share. These warrants were valued at \$1,387 using the Black-Scholes option pricing model with the following variables: stock fair value of \$0.93, term of five years, volatility of 95% and risk-free interest rate of 2.5%. During fiscal year ended March 31, 2006, no financial advisors exercised their warrants, leaving advisor warrants for 196,129 shares unexercised at the end of the year.

The debentures accrued interest at the rate of 2% per annum. Both the principal and accrued interest thereon of these debentures were convertible at the rate of \$0.35 per share. The principal of the debentures converted into 20,471,428 shares of the Company's common stock. The closing prices of the Company's common stock on June 30, 2003 and September 9, 2003, the closing dates for the first and second tranches, were \$0.55 and \$1.49. Therefore, a beneficial conversion feature existed which was accounted for under the provisions of EITF 00-27, *Application of Issue 98-5 to Certain Convertible Instruments*. A beneficial feature also existed in connection with the conversion of the interest on the debentures into shares of common stock.

As of June 30, 2004, debenture holders had converted all the debentures in the principal amount of \$7,165 into 20,471,428 shares of the Company's common stock. Of the 3,542,436 shares that were registered for payment of interest in-kind, 135,068 shares had been issued for such interest payments, and the interest obligation to the debenture holders had been satisfied in full.

In addition, the debenture holders were granted warrants to purchase 4,094,209 shares of the Company's common stock at an exercise price of \$0.50. The warrants expire after eight years. The warrants were valued using the Black-Scholes model with the following variables: fair value of common stock of \$0.35 for the first tranche debentures and \$0.93 for the second tranche debentures, volatility of 37% and risk-free interest rate of 2.5%. The debenture holders had exercised warrants to purchase 2,239,832 shares (plus 168,695 warrants remitted as payments for stock under a cash-less exercise provision of the warrant agreement) of the Company's common stock. As of March 31, 2006, there remained unexercised warrants held by the debenture holders for 1,514,940 shares of the Company's common stock.

The relative fair value of the warrants has been classified as equity with the beneficial conversion feature because it meets all the equity classification criteria of EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*.

The value of the beneficial conversion feature, warrants and debt issuance costs were amortized as interest expense over the life of the debt using the effective interest method. Related interest expense for fiscal 2005 amounted to \$2,019. This amount is comprised of nominal interest, amortization of beneficial conversion feature and amortization of debt issuance costs.

The debt issuance costs associated with the debentures amounted to \$2,369 and are comprised of \$982 in cash issuance costs and \$1,387 associated with warrants issued to financial advisors. Approximately \$603 of these costs were allocable to the warrants and charged to equity. The remaining balance of \$1,766 was recorded as an asset and was amortized over the life of the debt. As of March 31, 2005 the debentures have been fully converted; and these costs have been fully expensed.

The following table presents the amounts originally allocated to the beneficial conversion feature and warrants and the outstanding balance of debt at March 31, 2004 after accounting for these two equity instruments and conversions (in thousands):

	<u>First Tranche</u>	<u>Second Tranche</u>	<u>Total</u>
Debentures - principal amount	\$ 929	\$ 6,236	\$ 7,165
Beneficial conversion feature (included in equity)	(605)	(4,585)	(5,190)
Warrants (included in equity)	(73)	(1,651)	(1,724)
Conversions to common stock	(846)	(3,203)	(4,049)
Accretion of debt discount	599	3,273	3,872
Net amount of 2% convertible debentures	<u>\$ 4</u>	<u>\$ 70</u>	<u>\$ 74</u>

The value of the beneficial conversion feature, warrants and debt issuance costs was amortized as interest expense during fiscal 2005. Related interest expense for fiscal 2004 amounted to \$5,480. This amount is comprised of nominal interest, amortization of beneficial conversion feature and amortization of debt issuance costs.

During fiscal 2005, the principal and interest amount of the debentures converted was \$1,688, which converted into 4,825,118 shares of the Company's common stock. All debt issuance costs were fully amortized at March 31, 2005.



## Note 9. Acquisition and Intangible Assets

### First Derivative Systems, Inc.:

On May 28, 2004, Tegal purchased substantially all of the assets and assumed certain liabilities of First Derivative Systems, Inc. ("FDSI"), a development stage company, for 1,410,632 shares of common stock valued at \$2,342, \$150 in debt forgiveness, approximately \$50 in assumed liabilities, and \$158 in acquisition costs. All of the shares of common stock were registered with the Securities and Exchange Commission through the filing of a S-3 in October 2004. In addition, the Company entered into employment agreements with key FDSI personnel. FDSI, a development stage company, had developed a high-throughput, low cost-of-ownership physical vapor deposition ("PVD") system with highly differentiated technology for leading edge memory and logic device production on 200 and 300 millimeter wafers. This transaction was accounted for as a purchase of assets in accordance with EITF Issue No. 98-3, "Determining whether a nonmonetary transaction involves receipt of productive assets or of a business."

The following table represents the allocation of the purchase price for FDSI. The purchase price of this acquisition has been allocated to the acquired assets and assumed liabilities on the basis of their fair values as of the date of the acquisition. In estimating the fair value of the assets acquired and liabilities assumed, management considered various factors, including an independent appraisal.

Fair value fixed assets acquired	\$ 111
Non compete agreements	203
Patents	733
In-process research and development	1653
Debt forgiveness	(150)
Assumed liabilities	(50)
	<u>\$ 2,500</u>

The assets will be amortized over a period of years shown on the following table:

Fixed assets acquired	3 to 5 years
Non compete agreements	3 years
Patents	15 years

The fair value underlying the \$1,653 assigned to acquired IPR&D in the FDSI acquisition was charged to the Company's results of operations during the quarter ended June 30, 2004, and was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category were primarily certain design change improvements, software integration and hardware modifications, which are estimated to cost approximately \$1 - \$2 million.

The IPR&D value of \$1,653 was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over a seven-year period were discounted at a rate of 35% in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact expected return on investment and future results of operations. In addition, the Company's operating results would be adversely affected if the value of other intangible assets acquired became impaired.

All of these projects have completion risks related to functionality, architecture, performance, process technology, continued availability of key technical personnel, product reliability and software integration. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

### Simplus Systems Corporation:

On November 11, 2003, the Company acquired substantially all of the assets and certain liabilities of Simplus Systems Corporation, ("Simplus"), a development stage company. Simplus had developed a deposition cluster tool and certain processes for barrier, copper seed and high-K dielectric applications. The purchase consideration of \$2,522 includes 1,499,994 shares of the Company's common stock valued at \$2,310, 58,863 fully vested employee stock options to purchase Tegal common stock at an exercise price of \$3.09 per share valued at \$32, and acquisition costs of \$180. This transaction was accounted for as a purchase of assets in accordance with EITF Issue No. 98-3, Determining Whether a Nonmonetary Transaction Involves Receipt of Productive Assets or of a Business.

The Company completed the allocation of the purchase price of Simplus. The following table represents the allocation of the purchase price for Simplus. The purchase price of this acquisition has been allocated to the acquired assets and assumed liabilities on the basis of their fair values as of the date of the acquisition. In estimating the fair value of the assets acquired and liabilities assumed, management considered various factors, including an independent appraisal.

Fair value fixed assets acquired	\$	48
Work Force		50
Patents		339
In-process research and development		2,202
Assumed liabilities		(117)
	\$	<u>2,522</u>

The assets will be amortized over a period of years shown on the following table:

Fixed assets acquired	1 year
Work Force	2 years
Patents	5 years

The fair value underlying the \$2,202 assigned to acquired IPR&D in the Simplus acquisition was charged to the Company's results of operations during the quarter ended December 31, 2003 and was determined by identifying research projects in areas for which technological feasibility had not been established and there was no alternative future use. Projects in the IPR&D category are certain design change improvements on the existing 150 mm and 200 mm systems and the development of a 300 mm system. The design change improvements on the existing systems are estimated to cost approximately \$500,000 to \$1 million, are approximately 90% complete and will be completed by December 31, 2005. The development of a 300 mm system is estimated to be approximately 10% complete, and to cost between \$2 and \$4 million over the next two to four years, as market demand materializes.

The IPR&D value of \$2,202 was determined by an income approach where fair value is the present value of projected free cash flows that will be generated by the products incorporating the acquired technologies under development, assuming they are successfully completed. The estimated net free cash flows generated by the products over a seven-year period were discounted at a rate of 32% in relation to the stage of completion and the technical risks associated with achieving technological feasibility. The net cash flows for such projects were based on management's estimates of revenue, expenses and asset requirements. Any delays or failures in the completion of these projects could impact expected return on investment and future results of operations.

All of these projects have completion risks related to functionality, architecture performance, process technology availability, continued availability of key technical personnel, product reliability and availability of software support. To the extent that estimated completion dates are not met, the risk of competitors' product introductions is greater and revenue opportunity may be permanently lost.

Intangibles:

As of March 31, 2006, intangible assets, net consisted of the following:

	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Technology	\$ 782	\$ (350)	\$ 432
Trade name	253	(114)	139
Non compete agreements	254	(175)	79
Patents	1,072	(248)	824
Total	<u>\$ 2,361</u>	<u>\$ (886)</u>	<u>\$ 1,474</u>

As of March 31, 2005, intangible assets, net consisted of the following:

	<u>Gross</u>	<u>Accumulated Amortization</u>	<u>Net</u>
Technology	\$ 782	\$ (253)	\$ 529
Trade name	253	(82)	171
Workforce	254	(99)	155
Patents	1,072	(131)	941
Total	<u>\$ 2,361</u>	<u>\$ (565)</u>	<u>\$ 1,796</u>

The estimated future amortization expense of intangible assets as of March 31, 2006 is as follows:

2007	\$ 314
2008	257
2009	223
2010	178
2011	102
Thereafter	400
	<u>\$ 1,474</u>

#### **Note 10. Sale of Common Stock and Warrants**

Effective July 6, 2005, the Company entered into a Purchase Agreement with certain accredited investors pursuant to which it sold to them an aggregate of 30,840,000 shares of our common stock at a purchase price of \$0.65 per share and warrants to purchase an aggregate of 15,420,001 shares of our common stock at an exercise price of \$1.00 per share. All of these securities were sold in a private placement pursuant to Regulation D of the Securities Act of 1933, as amended, solely to accredited investors, as defined in Rule 501 of the Act. This financing transaction is referred to herein as the "2005 PIPE".

In the initial closing of the 2005 PIPE on July 12, 2005, the Company sold 6,300,000 shares at a purchase price of \$0.65 per share and five-year warrants to purchase an aggregate of 3,150,000 shares of common stock at an exercise price of \$1.00 per share to the investors at an aggregate purchase price of \$4,095. In connection with the 2005 PIPE, the Company granted to the investors registration rights. The effective date of the Form S-3 registration statement registering the shares issued in the initial closing was August 25, 2005.

In the second closing of the 2005 PIPE on September 19, 2005, the Company sold 24,540,000 shares at a purchase price of \$.65 per share and five-year warrants to purchase an aggregate of 12,270,001 shares of common stock at an exercise price of \$1.00 per share to the investors at an aggregate purchase price of \$15,951. The effective date of the Form S-3 registration statement registering the shares issued in the second closing was October 24, 2005.

In accordance with EITF 00-19, "Accounting for Derivative Financial Instruments Indexed To, and Potentially Settled In a Company's Own Stock," the fair value of the warrants in the second closing of the 2005 PIPE on the date of grant was estimated to be \$6,621 using the Black-Scholes option-pricing model with the following assumptions: no dividends; risk-free interest rate of 3.5%, the contractual life of 5 years and volatility of 115%. The warrants' fair value was reported as a liability at the time of grant, with a corresponding charge to common stock. At September 30, 2005, the fair value of the warrants was estimated to be \$6,295 using the Black-Scholes option pricing model with the same assumptions. At March 31, 2006, the impact of this transaction was \$435 recorded as other expense and there is no longer a contingent liability.

The Company paid a placement fee of \$1,453 (equal to 7% of the Company's gross proceeds for both transactions) to Dahlman Rose & Company LLC, the Company's financial advisor for the 2005 PIPE.

On September 13, 2005 the Company issued 500,000 warrants at \$0.69 as consideration for an amendment to the current lease of the Company's headquarters to reduce the termination fee. The value of the warrants of \$655 was based on the fair value of the termination penalty reduction offset by the exercise price of the warrant and recorded as rent expense.

During the previous fiscal year, the Company entered into a contract with certain consultants of the Company pursuant to which the Company will issue warrants on a monthly basis in lieu of cash payments for two years, dependant upon the continuation of the contract and the achievement of certain performance goals. These warrants are valued and expensed on a monthly basis upon issuance. During the fiscal year March 31, 2006, the Company issued warrants to purchase 483,204 shares of the Company's common stock to service providers for services rendered. During the fiscal year ended March 31, 2006, the warrants were valued at \$253 using the Black-Scholes model with an exercise price at the market value on the day of the grant and an average interest rate of 3.99% and 3.11% respectively. The life of the warrants is five and seven years with the volatility of 115% and 118%, respectively.

On February 11, 2004, the Company signed a \$25 million equity facility with Kingsbridge Capital, a firm that specializes in the financing of small to medium sized technology-based companies. The arrangement allowed the Company to sell shares of its common stock to Kingsbridge at its sole discretion over a 24-month period on a "when and if needed" basis. Kingsbridge Capital was required under the terms of the arrangement to purchase Tegal's stock following the effectiveness of a registration statement. The price of the common shares issued under the agreement was based on a discount to the volume-weighted average market price during a specified drawdown period. The Company had no obligation to draw down all or any portion of the commitment.

In connection with the agreement, the Company issued fully vested warrants to Kingsbridge Capital to purchase 300,000 shares of the Company's common stock at an exercise price of \$4.11 per share. The fair value of such options, which amounted to approximately \$756 was capitalized as a transaction cost. The following variables were used to determine the fair value of such instruments under the Black-Scholes option pricing model: volatility of 114%, term of five years, risk free interest of 3.91% and underlying stock price equal to fair market value at the time of grant.

During the fiscal year end March 31, 2005, the Company issued to Kingsbridge Capital, Ltd. a total of 8,506,331 shares of its common stock. Gross proceeds from the sale of stock were \$10,380. The discount to the volume-weighted average market price was \$1,153 that was charged against equity as stock issuance cost. In addition to \$623 in cash payments, the Company issued warrants to purchase 23,727, 21,686 24,092 and 15,549 shares of common stock at \$1.45, \$1.56, \$1.92 and \$1.35 respectively, to advisors, in connection with the sale of stock to Kingsbridge which were charged against equity as stock issuance costs. Pursuant to our agreement, broker fees of 6% in cash and 1% of stock in the form of warrants were paid upon each drawdown of the facility. Additionally, warrants issued at the time of the agreement were held in current assets and have been fully amortized as of March 31, 2005 and charged against equity as stock issuance costs. The Company does not anticipate any further sales of shares to Kingsbridge.

The selling price of the stock was negotiated as a function of market price based on a specific formula. The discount was accounted for as a cost of capital and netted against Additional Paid in Capital. Since the transaction was related to the sale of our own common stock, it was excluded from the determination of net income.

During fiscal 2004 the Company granted 578,311 options to purchase shares of the Company's common stock to certain non-employees. The fair value of such shares amounted to approximately \$332, was recorded as an operating expense using Black Scholes model for the period of services rendered.

#### **Note 11. *Employee Benefit Plans***

##### **Equity Incentive Plan**

Pursuant to the Amended and Restated Equity Incentive Plan ("Equity Incentive Plan"), options and stock purchase rights to purchase 3,500,000 shares of common stock could be granted to management and consultants. The exercise price of options and the purchase price of stock purchase rights generally has been the fair value of the Company's common stock on the date of grant. At the date of issuance of the stock options, all options are exercisable; however the Company has the right to repurchase any stock acquired pursuant to the exercise of stock options upon termination of employment or consulting agreement at the original exercise price for up to four years from the date the options were granted, with the repurchase rights ratably expiring over that period of time. Incentive stock options are exercisable for up to ten years from the grant date of the option. Nonqualified stock options are exercisable for up to 15 years from the grant date of the option. The Equity Incentive Plan expired in December 1999. Consequently no shares were available for issuance under the Equity Incentive Plan as of March 31, 2006.

##### **1990 Stock Option Plan**

Pursuant to the terms of the Company's 1990 Stock Option Plan ("1990 Option Plan"), options and stock purchase rights to purchase 550,000 shares of common stock could be granted to employees of the Company or its affiliates. Incentive stock options are exercisable for a period of up to ten years from the date of grant of the option and nonqualified stock options are exercisable for a period of up to ten years and two days from the date of grant of the option. At the date of issuance of the stock options, all options are exercisable; however, the Company has the right to repurchase any stock acquired pursuant to the exercise of stock options upon termination of employment at the original exercise price for up to four years from the date the options were granted, with the repurchase rights ratably expiring over that period of time. The 1990 Option Plan expired on March 10, 2000. Consequently no shares were available for issuance under the 1990 Option Plan as of March 31, 2006.

## **1998 Equity Participation Plan**

Pursuant to the terms of the Company's Amended 1998 Equity Participation Plan ("Equity Plan"), which was authorized as a successor plan to the Company's Equity Incentive Plan and 1990 Option Plan, 20,000,000 shares of common stock may be granted upon the exercise of options and stock appreciation rights or upon the vesting of restricted stock awards. The exercise price of options generally will be the fair value of the Company's common stock on the date of grant. Options are generally subject to vesting at the discretion of the Compensation Committee of the Board of Directors (the "Committee"). At the discretion of the Committee, vesting may be accelerated when the fair market value of the Company's stock equals a certain price established by the Committee on the date of grant. Incentive stock options will be exercisable for up to ten years from the grant date of the option. Non-qualified stock options will be exercisable for a maximum term to be set by the Committee upon grant. As of March 31, 2006, 10,824,676 shares were available for issuance under the Equity Plan.

## **Directors Stock Option Plan**

Pursuant to the terms of the Stock Option Plan for Outside Directors, as amended, ("Directors Plan"), up to 4,000,000 shares of common stock may be granted to outside directors. Under the Directors Plan, each outside director who was elected or appointed to the Board on or after September 15, 1998 shall be granted an option to purchase 100,000 shares of common stock and on each second anniversary after the applicable election or appointment shall receive an additional option to purchase 50,000 shares, provided that such outside director continues to serve as an outside director on that date. For each outside director, 1/12<sup>th</sup> of the total number of shares will vest on the first day of each calendar month following the date of Option grant, contingent upon continued service as a director. Vesting may be accelerated, at the discretion of the Board, when the fair market value of the Company's stock equals a certain price set by the Board on the date of grant of the option. The Directors Plan allows for additional grants at the discretion of the Compensation Committee. As of March 31, 2006, 2,975,000 shares were available for issuance under the Directors Plan.

The following table summarizes the Company's stock option activity for the four plans described above and weighted average exercise price within each transaction type for each of the years ended March 31, 2006, 2005 and 2004 (number of shares in thousands):

	2006		2005		2004	
	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price	Options	Weighted Average Exercise Price
Options outstanding at beginning of year	7,651	\$ 1.97	7,007	\$ 2.05	3,196	\$ 3.39
Options cancelled	(2,652)	3.00	(1,602)	1.18	(497)	3.23
Options granted	3,050	0.81	2,300	1.16	4,613	1.14
Options exercised	(166)	0.80	(54)	0.93	(305)	0.67
Options outstanding March 31	<u>7,883</u>	<u>\$ 1.20</u>	<u>7,651</u>	<u>\$ 1.97</u>	<u>7,007</u>	<u>\$ 2.05</u>

The number of vested options for the years ended March 31, 2006, 2005, and 2004 are 5,217,219, 4,320,270 and 2,849,531 respectively.

#### Awards

The Company granted 158,311 shares of restricted stock from the Company's Equity Plan to consultants during fiscal year 2004 in exchange for services rendered. For fiscal year 2005, no shares of restricted stock were granted. For fiscal year 2006, 79,204 shares of restricted stock was issued to consultants in exchange for services rendered. Non-employee awards were booked as operating expenses using Black Scholes model for the period of services rendered as required by EITF 96-18 in fiscal 2004. All restricted stock issued in fiscal 2006 were recorded at the current market price on the date of grant.

#### Employee Qualified Stock Purchase Plan

The Company has offered an Employee Qualified Stock Purchase Plan ("Employee Plan") under which rights are granted to purchase shares of common stock at 85% of the lesser of the market value of such shares at the beginning of a six month offering period or at the end of that six month period. Under the Employee Plan, the Company is authorized to issue up to 1,000,000 shares of common stock. 33,350 common stock shares were purchased in fiscal 2006 and 30,100 common shares were purchased in fiscal 2005. Shares available for future purchase under the Employee Plan were 507,602 at March 31, 2006.

#### Savings and Investment Plan

The Company has established a defined contribution plan that covers substantially all U.S. employees. Employee contributions of up to 4% of each U.S. employee's compensation will be matched by the Company based upon a percentage to be determined annually by the Board. Employees may contribute up to 15% of their compensation, not to exceed a prescribed maximum amount. The Company made contributions to the plan of \$13, \$15 and \$8 in the years ended March 31, 2006, 2005 and 2004, respectively.

#### Note 12. Stockholder Rights Plan

On June 11, 1996, the Board adopted a Preferred Shares Rights Agreement ("Rights Agreement") and pursuant to the Rights Agreement authorized and declared a dividend of one preferred share purchase right ("Right") for each common share of the Company's outstanding shares at the close of business on July 1, 1996. The Rights are designed to protect and maximize the value of the outstanding equity interests in the Company in the event of an unsolicited attempt by an acquirer to take over the Company in a manner or under terms not approved by the Board. Each Right becomes exercisable to purchase one one-hundredth of a share of Series A Junior Participating Preferred Stock at an exercise price of \$45.00 upon certain circumstances associated with an unsolicited takeover attempt and expires on June 11, 2006. The Company may redeem the Rights at a price of \$0.01 per Right.

### Note 13. Geographical Information

Tegal operates in one segment for the manufacture, marketing and servicing of integrated circuit fabrication equipment. In accordance with SFAS No. 131 (SFAS 131) "Disclosures About Segments of an Enterprise and Related Information," Tegal's chief operating decision-maker has been identified as the President and Chief Executive Officer, who reviews operating results to make decisions about allocating resources and assessing performance for the entire company. All material operating units qualify for aggregation under SFAS 131 due to their identical customer base and similarities in: economic characteristics; nature of products and services; and procurement, manufacturing and distribution processes. Since Tegal operates in one segment and in one group of similar products and services, all financial segment and product line information required by SFAS 131 can be found in the consolidated financial statements.

For geographical reporting, revenues are attributed to the geographic location in which the customers' facilities are located. Long-lived assets consist primarily of property, plant and equipment, and are attributed to the geographic location in which they are located. Net sales and long-lived assets by geographic region were as follows:

Revenues:	Years Ended March 31,		
	2006	2005	2004
Sales to customers located in:			
United States	\$ 5,142	\$ 4,445	\$ 5,538
Asia, excluding Japan	5,624	1,372	1,241
Japan	2,312	6,312	6,485
Germany	2,313	397	170
Italy	386	498	1,480
Europe, excluding Germany and Italy	5,980	1,864	1,614
Total sales	<u>\$ 21,757</u>	<u>\$ 14,888</u>	<u>\$ 16,528</u>

Long-lived assets at year-end:	March 31,	
	2006	2005
United States	\$ 3,296	\$ 5,112
Europe	16	7
Japan	8	16
Asia, excluding Japan	3	3
Total long-lived assets	<u>\$ 3,323</u>	<u>\$ 5,138</u>

The Company's sales are primarily to domestic and international semiconductor manufacturers. The composition of the Company's top five customers has changed from year to year, but net system sales to its top five customers in each of fiscal 2006, 2005, and 2004 accounted for 68.9%, 80.0% and 84.8%, respectively, of total net system sales. ST Microelectronics accounted for 54.3% of the Company's total revenue in fiscal 2006. Fujitsu, Western Digital, and RF Micro Devices accounted for 38.2%, 12.8% and 10.1% respectively, of the Company's net system sales in 2005. Intel, Fuji Film, and Matsushita accounted for 31.4%, 22.9% and 12.6% respectively, of the Company's net system sales in 2004. Other than the previously listed customers, no single customer represented more than 10% of the Company's total revenue in fiscal 2006, 2005, and 2004.

**THE EIGHTH AMENDED AND RESTATED  
1998 EQUITY PARTICIPATION PLAN  
OF  
TEGAL CORPORATION\***

*\* This Plan addresses the effect of the Company's 1-to-12 reverse stock split effected on July 25, 2006.*

Tegal Corporation, a Delaware corporation (the "Company"), hereby amends and restates the Eighth Amended and Restated 1998 Equity Participation Plan of Tegal Corporation (as so amended, the "Plan"), incorporating certain amendments adopted by the Board of Directors on May 24, 2006. The Plan shall become effective on the date it is approved by the Company's stockholders. The Plan was initially adopted by the Board of Directors on July 16, 1998 and the stockholders of the Company on September 15, 1998, with an initial effective date of July 16, 1998. The Plan was amended and restated by the Board of Directors on July 21, 1999 and such amendment was approved by the stockholders on September 21, 1999. The Plan was again amended and restated on July 8, 2000 by the Board of Directors and such amendment was approved by the stockholders on September 19, 2000. The Plan was amended and restated a third time on September 25, 2001 by the Board of Directors and such amendment did not require shareholder approval. The Plan was amended and restated a fourth time on September 9, 2002 and was approved by our stockholders on October 22, 2002. The Plan was amended and restated a fifth time on June 30, 2003 and was approved by our stockholders on September 8, 2003. The Plan was amended and restated a sixth time on July 23, 2004 and was approved by our stockholders on September 21, 2004. The Plan was amended and restated a seventh time on July 5, 2005 and was approved by our stockholders on August 8, 2005. The plan was amended and restated an eighth time on May 24, 2006 and was approved by our stockholders on July 21, 2006. The purposes of the Plan are as follows:

- (1) To provide an additional incentive for key Employees and Consultants (as such terms are defined below) to further the growth, development and financial success of the Company by personally benefiting through the ownership of Company stock and/or rights which recognize such growth, development and financial success.
- (2) To enable the Company to obtain and retain the services of key Employees and Consultants considered essential to the long range success of the Company by offering them an opportunity to own stock in the Company and/or rights which will reflect the growth, development and financial success of the Company.

1.

DEFINITIONS

**1.1 General.** *Wherever the following terms are used in the Plan, they shall have the meanings specified below, unless the context clearly indicates otherwise.*

**1.2 Administrator.** *"Administrator" shall mean the entity that conducts the general administration of the Plan as provided herein. With reference to the administration of the Plan with respect to any Award granted under the Plan, the term "Administrator" shall refer to the Committee unless the Board has assumed the authority for administration of the Plan generally as provided in Section 11.1.*

**1.3 Award.** *"Award" shall mean an Option, a Restricted Stock award, a Restricted Stock Unit award, a Dividend Equivalent award or a Stock Appreciation Right which may be awarded or granted under the Plan (collectively, "Awards").*

**1.4 Award Agreement.** *"Award Agreement" shall mean a written agreement executed by an authorized officer of the Company and the Holder which shall contain such terms and conditions with respect to an Award as the Administrator shall determine, consistent with the Plan.*

**1.5 Award Limit.** *"Award Limit" shall mean 333,334 shares of Common Stock, as adjusted pursuant to Section 12.3 of the Plan.*

**1.6 Board.** *"Board" shall mean the Board of Directors of the Company.*



**1.7 Change in Control.** *“Change in Control” shall mean a change in ownership or control of the Company effected through any of the following transactions:*

(a) any person or related group of persons (other than the Company or a person that, prior to such transaction, directly or indirectly controls, is controlled by, or is under common control with, the Company) directly or indirectly acquires beneficial ownership (within the meaning of Rule 13d-3 under the Exchange Act) of securities of the Company (or a successor of the Company) possessing more than twenty-five percent (25%) of the total combined voting power of the then outstanding securities of the Company or such successor; or

(b) at any time that the Company has registered shares under the Exchange Act, at least 40% of the directors of the Company constitute persons who were not at the time of their first election to the Board, candidates proposed by a majority of the Board in office prior to the time of such first election; or

(c) the dissolution of the Company or liquidation of more than 75% in value of the Company or a sale of assets involving 75% or more in value of the assets of the Company, (x) any merger or reorganization of the Company whether or not another entity is the survivor, (y) a transaction pursuant to which the holders, as a group, of all of the shares of the Company outstanding prior to the transaction hold, as a group, less than 50% of the combined voting power of the Company or any successor company outstanding after the transaction, or (z) any other event which the Board determines, in its discretion, would materially alter the structure of the Company or its ownership.

**1.8 Code.** *“Code” shall mean the Internal Revenue Code of 1986, as amended.*

**1.9 Committee.** *“Committee” shall mean the Compensation Committee of the Board, or another committee or subcommittee of the Board, appointed as provided in Section 11.1.*

**1.10 Common Stock.** *“Common Stock” shall mean the common stock of the Company, par value \$.01 per share, and any equity security of the Company issued or authorized to be issued in the future, but excluding any preferred stock and any warrants, options or other rights to purchase Common Stock.*

**1.11 Company.** *“Company” shall mean Tegal Corporation, a Delaware corporation.*

**1.12 Consultant.** *“Consultant” shall mean any consultant or adviser if:*

the consultant or adviser renders bona fide services to the Company;

the services rendered by the consultant or adviser are not in connection with the offer or sale of securities in a capital-raising transaction and do not directly or indirectly promote or maintain a market for the Company’s securities; and

the consultant or adviser is a natural person who has contracted directly with the Company to render such services.

**1.13 Director.** *“Director” shall mean a member of the Board.*

**1.14 Dividend Equivalent.** *“Dividend Equivalent” shall mean a right granted to a Holder pursuant to Section 11.1 to receive the equivalent value (in cash or shares of Common Stock) of dividends paid on Common Stock.*

**1.15 DRO.** *“DRO” shall mean a domestic relations order as defined by the Code or Title I of the Employee Retirement Income Security Act of 1974, as amended, or the rules thereunder.*

**1.16 Employee.** *“Employee” shall mean any officer or other employee (as defined in accordance with Section 3401(c) of the Code) of the Company, or of any corporation which is a Subsidiary.*

**1.17 Exchange Act.** *“Exchange Act” shall mean the Securities Exchange Act of 1934, as amended.*

**1.18 Fair Market Value.** *“Fair Market Value” of a share of Common Stock as of a given date shall be (a) the closing price of a share of Common Stock on the principal exchange on which shares of Common Stock are then trading, if any (or as reported on any composite index which includes such principal exchange), on the trading day previous to such date, or if shares were not traded on the trading day previous to such date, then on the next preceding date on which a trade occurred, or (b) if Common Stock is not traded on an exchange but is quoted on NASDAQ or a successor quotation system, the mean between the closing representative bid and asked prices for the Common Stock on the trading day previous to such date as reported by NASDAQ or such successor quotation system; or (c) if Common Stock is not publicly traded on an exchange and not quoted on NASDAQ or a successor quotation system, the Fair Market Value of a share of Common Stock as established by the Administrator acting in good faith.*

- 1.19 *Holder.* “**Holder**” shall mean a person who has been granted or awarded an Award.
- 1.20 *Incentive Stock Option.* “**Incentive Stock Option**” shall mean an option which conforms to the applicable provisions of Section 422 of the Code and which is designated as an Incentive Stock Option by the Administrator.
- 1.21 *Independent Director.* “**Independent Director**” shall mean a member of the Board who is not an Employee of the Company.
- 1.22 *Non-Qualified Stock Option.* “**Non-Qualified Stock Option**” shall mean an Option which is not designated as an Incentive Stock Option by the Administrator.
- 1.23 *Option.* “**Option**” shall mean a stock option granted under Article IV of the Plan. An Option granted under the Plan shall, as determined by the Administrator, be either a Non-Qualified Stock Option or an Incentive Stock Option; provided, however, that Options granted to Consultants shall be Non-Qualified Stock Options.
- 1.24 *Performance Criteria.* “**Performance Criteria**” shall mean the following business criteria with respect to the Company, any Subsidiary or any division or operating unit: (a) net income, (b) pre-tax income, (c) operating income, (d) cash flow, (e) earnings per share, (f) return on equity, (g) return on invested capital or assets, (h) cost reductions or savings, (i) funds from operations, (j) appreciation in the fair market value of Common Stock and (k) earnings before any one or more of the following items: interest, taxes, depreciation or amortization.
- 1.25 *Plan.* “**Plan**” shall mean The Eighth Amended and Restated 1998 Equity Participation Plan of Tegal Corporation.
- 1.26 *Restricted Stock.* “**Restricted Stock**” shall mean Common Stock awarded under Article VII of the Plan.
- 1.27 *Restricted Stock Unit.* “**Restricted Stock Unit**” shall mean a right to receive a share of Common Stock during specified time periods granted pursuant to Section 11.2
- 1.28 *Rule 16b-3.* “**Rule 16b-3**” shall mean that certain Rule 16b-3 under the Exchange Act, as such Rule may be amended from time to time.
- 1.29 *Section 162(m) Participant.* “**Section 162(m) Participant**” shall mean any key Employee designated by the Administrator as a key Employee whose compensation for the fiscal year in which the key Employee is so designated or a future fiscal year may be subject to the limit on deductible compensation imposed by Section 162(m) of the Code.
- 1.30 *Securities Act.* “**Securities Act**” shall mean the Securities Act of 1933, as amended.
- 1.31 *Stock Appreciation Right.* “**Stock Appreciation Right**” shall mean a stock appreciation right granted under Article VIII of the Plan.
- 1.32 *Subsidiary.* “**Subsidiary**” shall mean any corporation in an unbroken chain of corporations beginning with the Company if each of the corporations other than the last corporation in the unbroken chain then owns stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.
- 1.33 *Substitute Award.* “**Substitute Award**” shall mean an Option granted under this Plan upon the assumption of, or in substitution for, outstanding equity awards previously granted by a company or other entity in connection with a corporate transaction, such as a merger, combination, consolidation or acquisition of property or stock.
- 1.34 *Termination of Consultancy.* “**Termination of Consultancy**” shall mean the time when the engagement of a Holder as a Consultant to the Company or a Subsidiary is terminated for any reason, with or without cause, including, but not by way of limitation, by resignation, discharge, death, disability or retirement; but excluding terminations where there is a simultaneous commencement of employment with the Company or any Subsidiary. The Administrator, in its absolute discretion, shall determine the effect of all matters and questions relating to Termination of Consultancy, including, but not by way of limitation, the question of whether a Termination of Consultancy resulted from a discharge for good cause, and all questions of whether a particular leave of absence constitutes a Termination of Consultancy. Notwithstanding any other provision of the Plan, the Company or any Subsidiary has an absolute and unrestricted right to terminate a Consultant’s service at any time for any reason whatsoever, with or without cause, except to the extent expressly provided otherwise in writing.

1.35 *Termination of Employment.* “**Termination of Employment**” shall mean the time when the employee-employer relationship between a Holder and the Company or any Subsidiary is terminated for any reason, with or without cause, including, but not by way of limitation, a termination by resignation, discharge, death, disability or retirement; but excluding (a) terminations where there is a simultaneous reemployment or continuing employment of a Holder by the Company or any Subsidiary, (b) at the discretion of the Administrator, terminations which result in a temporary severance of the employee-employer relationship, and (c) at the discretion of the Administrator, terminations which are followed by the simultaneous establishment of a consulting relationship by the Company or a Subsidiary with the former employee. The Administrator, in its absolute discretion, shall determine the effect of all matters and questions relating to Termination of Employment, including, but not by way of limitation, the question of whether a Termination of Employment resulted from a discharge for good cause, and all questions of whether a particular leave of absence constitutes a Termination of Employment; provided, however, that, with respect to Incentive Stock Options, unless otherwise determined by the Administrator in its discretion, a leave of absence, change in status from an employee to an independent contractor or other change in the employee-employer relationship shall constitute a Termination of Employment if, and to the extent that, such leave of absence, change in status or other change interrupts employment for the purposes of Section 422(a)(2) of the Code and the then applicable regulations and revenue rulings under said Section. Notwithstanding any other provision of the Plan, the Company or any Subsidiary has an absolute and unrestricted right to terminate an Employee’s service at any time for any reason whatsoever, with or without cause, except to the extent expressly provided otherwise in writing.

2.

SHARES SUBJECT TO PLAN

2.1 *Shares Subject to Plan.*

The shares of stock subject to Awards shall be Common Stock, initially shares of the Company’s Common Stock, par value \$.01 per share. The aggregate number of such shares which may be issued upon exercise of such Options or rights or upon any such awards under the Plan shall not exceed 1,666,667. The shares of Common Stock issuable upon exercise of such Options or rights or upon any such awards may be either previously authorized but unissued shares or treasury shares.

The maximum number of shares which may be subject to Awards, granted under the Plan to any individual in any fiscal year shall not exceed the Award Limit. To the extent required by Section 162(m) of the Code, shares subject to Options which are canceled continue to be counted against the Award Limit.

2.2 *Add-back of Options and Other Rights.* **If any Option, or other right to acquire shares of Common Stock under any other Award under the Plan, expires or is canceled without having been fully exercised, or is exercised in whole or in part for cash as permitted by the Plan, the number of shares subject to such Option or other right but as to which such Option or other right was not exercised prior to its expiration, cancellation or exercise may again be optioned, granted or awarded hereunder, subject to the limitations of Section 2.1. Furthermore, any shares subject to Awards which are adjusted pursuant to Section 12.3 and become exercisable with respect to shares of stock of another corporation shall be considered cancelled and may again be optioned, granted or awarded hereunder, subject to the limitations of Section 2.1. Shares of Common Stock which are delivered by the Holder or withheld by the Company upon the exercise of any Award under the Plan, in payment of the exercise price thereof or tax withholding thereon, may again be optioned, granted or awarded hereunder, subject to the limitations of Section 2.1. If any shares of Restricted Stock are surrendered by the Holder or repurchased by the Company pursuant to Section 7.4 or 7.5 hereof, such shares may again be optioned, granted or awarded hereunder, subject to the limitations of Section 2.1. Notwithstanding the provisions of this Section 2.2, no shares of Common Stock may again be optioned, granted or awarded if such action would cause an Incentive Stock Option to fail to qualify as an incentive stock option under Section 422 of the Code.**

3.

GRANTING OF AWARDS

3.1 *Award Agreement.* **Each Award shall be evidenced by an Award Agreement. Award Agreements evidencing Awards intended to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code shall contain such terms and conditions as may be necessary to meet the applicable provisions of Section 162(m) of the Code. Award Agreements evidencing Incentive Stock Options shall contain such terms and conditions as may be necessary to meet the applicable provisions of Section 422 of the Code.**

### 3.2 Provisions Applicable to Section 162(m) Participants.

The Committee, in its discretion, may determine whether an Award is to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code.

Notwithstanding anything in the Plan to the contrary, the Committee may grant any Award to a Section 162(m) Participant, including Restricted Stock the restrictions with respect to which lapse upon the attainment of performance goals which are related to one or more of the Performance Criteria.

To the extent necessary to comply with the performance-based compensation requirements of Section 162(m)(4)(C) of the Code, with respect to any Award granted under Article VII which may be granted to one or more Section 162(m) Participants, no later than ninety (90) days following the commencement of any fiscal year in question or any other designated fiscal period or period of service (or such other time as may be required or permitted by Section 162(m) of the Code), the Committee shall, in writing, (i) designate one or more Section 162(m) Participants, (ii) select the Performance Criteria applicable to the fiscal year or other designated fiscal period or period of service, (iii) establish the various performance targets, in terms of an objective formula or standard, and amounts of such Awards, as applicable, which may be earned for such fiscal year or other designated fiscal period or period of service and (iv) specify the relationship between Performance Criteria and the performance targets and the amounts of such Awards, as applicable, to be earned by each Section 162(m) Participant for such fiscal year or other designated fiscal period or period of service. Following the completion of each fiscal year or other designated fiscal period or period of service, the Committee shall certify in writing whether the applicable performance targets have been achieved for such fiscal year or other designated fiscal period or period of service. In determining the amount earned by a Section 162(m) Participant, the Committee shall have the right to reduce (but not to increase) the amount payable at a given level of performance to take into account additional factors that the Committee may deem relevant to the assessment of individual or corporate performance for the fiscal year or other designated fiscal period or period of service.

Furthermore, notwithstanding any other provision of the Plan, any Award which is granted to a Section 162(m) Participant and is intended to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code shall be subject to any additional limitations set forth in Section 162(m) of the Code (including any amendment to Section 162(m) of the Code) or any regulations or rulings issued thereunder that are requirements for qualification as performance-based compensation as described in Section 162(m)(4)(C) of the Code, and the Plan shall be deemed amended to the extent necessary to conform to such requirements.

**3.3 Limitations Applicable to Section 16 Persons. Notwithstanding any other provision of the Plan, the Plan, and any Award granted or awarded to any individual who is then subject to Section 16 of the Exchange Act, shall be subject to any additional limitations set forth in any applicable exemptive rule under Section 16 of the Exchange Act (including any amendment to Rule 16b-3 of the Exchange Act) that are requirements for the application of such exemptive rule. To the extent permitted by applicable law, the Plan and Awards granted or awarded hereunder shall be deemed amended to the extent necessary to conform to such applicable exemptive rule.**

**3.4 At-Will Employment. Nothing in the Plan or in any Award Agreement hereunder shall confer upon any Holder any right to continue in the employ of, or as a Consultant for, the Company or any Subsidiary, or shall interfere with or restrict in any way the rights of the Company and any Subsidiary, which are hereby expressly reserved, to discharge any Holder at any time for any reason whatsoever, with or without cause, except to the extent expressly provided otherwise in a written employment agreement between the Holder and the Company and any Subsidiary.**

## 4.

### GRANTING OF OPTIONS TO EMPLOYEES AND CONSULTANTS

**4.1 Eligibility. Any Employee or Consultant selected by the Committee pursuant to Section 4.4(a)(i) shall be eligible to be granted an Option.**

**4.2 Disqualification for Stock Ownership. No person may be granted an Incentive Stock Option under the Plan if such person, at the time the Incentive Stock Option is granted, owns stock possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Company or any then existing Subsidiary or parent corporation (within the meaning of Section 422 of the Code) unless such Incentive Stock Option conforms to the applicable provisions of Section 422 of the Code.**

**4.3** *Qualification of Incentive Stock Options. No Incentive Stock Option shall be granted to any person who is not an Employee.*

**4.4** *Granting of Options to Employees and Consultants.*

The Committee shall from time to time, in its absolute discretion, and subject to applicable limitations of the Plan:

**Determine which Employees are key Employees and select from among the key Employees or Consultants (including Employees or Consultants who have previously received Awards under the Plan) such of them as in its opinion should be granted Options;**

**Subject to the Award Limit, determine the number of shares to be subject to such Options granted to the selected key Employees or consultants;**

**Subject to Section 4.3, determine whether such Options are to be Incentive Stock Options or Non-Qualified Stock Options and whether such Options are to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code; and**

**Determine the terms and conditions of such Options, consistent with the Plan; provided, however, that the terms and conditions of Options intended to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code shall include, but not be limited to, such terms and conditions as may be necessary to meet the applicable provisions of Section 162(m) of the Code.**

Upon the selection of a key Employee or Consultant to be granted an Option, the Committee shall instruct the Secretary of the Company to issue the Option and may impose such conditions on the grant of the Option as it deems appropriate.

Any Incentive Stock Option granted under the Plan may be modified by the Committee, with the consent of the Holder, to disqualify such Option from treatment as an "incentive stock option" under Section 422 of the Code.

## 5.

### TERMS OF OPTIONS

**5.1** *Option Price. The price per share of the shares subject to each Option granted to Employees and Consultants shall be set by the Committee; provided, however, that such price shall be no less than 85% of the Fair Market Value of a share of Common Stock on the date the Option is granted and:*

in the case of Options intended to qualify as performance-based compensation as described in Section 162(m)(4)(C) of the Code, such price shall not be less than 100% of the Fair Market Value of a share of Common Stock on the date the Option is granted;

in the case of Incentive Stock Options such price shall not be less than 100% of the Fair Market Value of a share of Common Stock on the date the Option is granted (or the date the Option is modified, extended or renewed for purposes of Section 424(h) of the Code);

in the case of Incentive Stock Options granted to an individual then owning (within the meaning of Section 424(d) of the Code) more than 10% of the total combined voting power of all classes of stock of the Company or any Subsidiary or parent corporation thereof (within the meaning of Section 422 of the Code), such price shall not be less than 110% of the Fair Market Value of a share of Common Stock on the date the Option is granted (or the date the Option is modified, extended or renewed for purposes of Section 424(h) of the Code); and

with the consent of a Holder whose rights are impaired or altered under an outstanding Option, the exercise price per share of shares subject to a previously granted, outstanding Option may be reduced (i) to the then-current Fair Market Value if the Fair Market Value of the Common Stock has declined since the date the Option was granted, (ii) pursuant to an option exchange program, including a program pursuant to which an outstanding Option is cancelled and any of the following is granted in substitution therefor (A) a new option under the Plan or another equity plan of the Company covering the same or a different number of shares of Common Stock, (B) another Award, (C) cash, or (D) other valuable consideration (as determined by the Committee, in its sole discretion); (iii) pursuant to any other action that is treated as a repricing under generally accepted accounting principles.

**5.2 Option Term.** *The term of an Option granted to an Employee or consultant shall be set by the Committee in its discretion; provided, however, that, in the case of Incentive Stock Options, the term shall not be more than ten (10) years from the date the Incentive Stock Option is granted, or five (5) years from the date the Incentive Stock Option is granted if the Incentive Stock Option is granted to an individual then owning (within the meaning of Section 424(d) of the Code) more than 10% of the total combined voting power of all classes of stock of the Company or any Subsidiary or parent corporation thereof (within the meaning of Section 422 of the Code). Except as limited by requirements of Section 422 of the Code and regulations and rulings thereunder applicable to Incentive Stock Options, the Committee may extend the term of any outstanding Option in connection with any Termination of Employment or Termination of Consultancy of the Holder, or amend any other term or condition of such Option relating to such a termination.*

### 5.3 Option Vesting

The period during which the right to exercise, in whole or in part, an Option granted to an Employee or a Consultant vests in the Holder shall be set by the Committee and the Committee may determine that an Option may not be exercised in whole or in part for a specified period after it is granted; provided, however, that, unless the Committee otherwise provides in the terms of the Award Agreement or otherwise, no Option shall be exercisable by any Holder who is then subject to Section 16 of the Exchange Act within the period ending six months and one day after the date the Option is granted. At any time after grant of an Option, the Committee may, in its sole and absolute discretion and subject to whatever terms and conditions it selects, accelerate the period during which an Option granted to an Employee or Consultant vests.

No portion of an Option granted to an Employee or Consultant which is unexercisable at Termination of Employment or Termination of Consultancy, as applicable, shall thereafter become exercisable, except as may be otherwise provided by the Committee either in the Award Agreement or by action of the Committee following the grant of the Option.

To the extent that the aggregate Fair Market Value of stock with respect to which “incentive stock options” (within the meaning of Section 422 of the Code, but without regard to Section 422(d) of the Code) are exercisable for the first time by a Holder during any calendar year (under the Plan and all other incentive stock option plans of the Company and any parent or subsidiary corporation, within the meaning of Section 422 of the Code) of the Company, exceeds \$100,000, such Options shall be treated as Non-Qualified Options to the extent required by Section 422 of the Code. The rule set forth in the preceding sentence shall be applied by taking Options into account in the order in which they were granted. For purposes of this Section 5.3(c), the Fair Market Value of stock shall be determined as of the time the Option with respect to such stock is granted.

**5.4 Substitute Awards.** *Notwithstanding the foregoing provisions of this Article V to the contrary, in the case of an Option that is a Substitute Award, the price per share of the shares subject to such Option may be less than the Fair Market Value per share on the date of grant, provided, that the excess of:*

the aggregate Fair Market Value (as of the date such Substitute Award is granted) of the shares subject to the Substitute Award; over

the aggregate exercise price thereof; does not exceed the excess of;

the aggregate fair market value (as of the time immediately preceding the transaction giving rise to the Substitute Award, such fair market value to be determined by the Committee) of the shares of the predecessor entity that were subject to the grant assumed or substituted for by the Company; over

the aggregate exercise price of such shares.

**5.5 Termination.** *In the event of a Holder’s Termination of Employment or Termination of Consultancy, such Holder may exercise his or her Option within such period of time as is specified in the Option Agreement to the extent that the Option is vested on the date of termination. If, on the date of termination, the Holder is not vested as to his or her entire Option, the shares covered by the unvested portion of the Option shall immediately cease to be issuable under the Option and shall again become available for issuance under the Plan. If, after termination, the Holder does not exercise his or her Option within the time period specified herein, the Option shall terminate, and the shares covered by such Option shall again become available for issuance under the Plan.*

EXERCISE OF OPTIONS

**6.1 Partial Exercise.** *An exercisable Option may be exercised in whole or in part. However, an Option shall not be exercisable with respect to fractional shares and the Administrator may require that, by the terms of the Option, a partial exercise be with respect to a minimum number of shares.*

**6.2 Manner of Exercise.** *All or a portion of an exercisable Option shall be deemed exercised upon delivery of all of the following to the Secretary of the Company or his office:*

A written notice complying with the applicable rules established by the Administrator stating that the Option, or a portion thereof, is exercised. The notice shall be signed by the Holder or other person then entitled to exercise the Option or such portion of the Option;

Such representations and documents as the Administrator, in its absolute discretion, deems necessary or advisable to effect compliance with all applicable provisions of the Securities Act and any other federal or state securities laws or regulations. The Administrator may, in its absolute discretion, also take whatever additional actions it deems appropriate to effect such compliance including, without limitation, placing legends on share certificates and issuing stop-transfer notices to agents and registrars;

In the event that the Option shall be exercised pursuant to Section 10.1 by any person or persons other than the Holder, appropriate proof of the right of such person or persons to exercise the Option; and

Full cash payment to the Secretary of the Company for the shares with respect to which the Option, or portion thereof, is exercised. However, the Administrator, may in its discretion

**allow a delay in payment up to thirty (30) days from the date the Option, or portion thereof, is exercised;**

**allow payment, in whole or in part, through the delivery of shares of Common Stock which have been owned by the Holder for at least six months, duly endorsed for transfer to the Company with a Fair Market Value on the date of delivery equal to the aggregate exercise price of the Option or exercised portion thereof;**

**allow payment, in whole or in part, through the surrender of shares of Common Stock then issuable upon exercise of the Option having a Fair Market Value on the date of Option exercise equal to the aggregate exercise price of the Option or exercised portion thereof;**

**allow payment, in whole or in part, through the delivery of property of any kind which constitutes good and valuable consideration; (v) allow payment, in whole or in part, through the delivery of a full recourse promissory note bearing interest (at no less than such rate as shall then preclude the imputation of interest under the Code) and payable upon such terms as may be prescribed by the Administrator; (vi) allow payment, in whole or in part, through the delivery of a notice that the Holder has placed a market sell order with a broker with respect to shares of Common Stock then issuable upon exercise of the Option, and that the broker has been directed to pay a sufficient portion of the net proceeds of the sale to the Company in satisfaction of the Option exercise price, provided that payment of such proceeds is then made to the Company upon settlement of such sale; or (vii) allow payment through any combination of the consideration provided in the foregoing subparagraphs (ii), (iii), (iv), (v) and (vi). In the case of a promissory note, the Administrator may also prescribe the form of such note and the security to be given for such note. The Option may not be exercised, however, by delivery of a promissory note or by a loan from the Company when or where such loan or other extension of credit is prohibited by law.**

**6.3** *Conditions to Issuance of Stock Certificates.* **The Company shall not be required to issue or deliver any certificate or certificates for shares of stock purchased upon the exercise of any Option or portion thereof prior to fulfillment of all of the following conditions:**

The admission of such shares to listing on all stock exchanges on which such class of stock is then listed;

The completion of any registration or other qualification of such shares under any state or federal law, or under the rulings or regulations of the Securities and Exchange Commission or any other governmental regulatory body which the Administrator shall, in its absolute discretion, deem necessary or advisable;

The obtaining of any approval or other clearance from any state or federal governmental agency which the Administrator shall, in its absolute discretion, determine to be necessary or advisable;

The lapse of such reasonable period of time following the exercise of the Option as the Administrator may establish from time to time for reasons of administrative convenience; and

The receipt by the Company of full payment for such shares, including payment of any applicable withholding tax, which in the discretion of the Administrator may be in the form of consideration used by the Holder to pay for such shares under Section 6.2(d).

**6.4** *Rights as Stockholders.*  **Holders shall not be, nor have any of the rights or privileges of, stockholders of the Company in respect of any shares purchasable upon the exercise of any part of an Option unless and until certificates representing such shares have been issued by the Company to such Holders.**

**6.5** *Ownership and Transfer Restrictions.* **The Administrator, in its absolute discretion, may impose such restrictions on the ownership and transferability of the shares purchasable upon the exercise of an Option as it deems appropriate. Any such restriction shall be set forth in the respective Award Agreement and may be referred to on the certificates evidencing such shares. The Holder shall give the Company prompt notice of any disposition of shares of Common Stock acquired by exercise of an Incentive Stock Option within (a) two years from the date of granting (including the date the Option is modified, extended or renewed for purposes of Section 424(h) of the Code) such Option to such Holder or (b) one year after the transfer of such shares to such Holder.**

**6.6** *Additional Limitations on Exercise of Options.*  **Holders may be required to comply with any timing or other restrictions with respect to the settlement or exercise of an Option, including a window-period limitation, as may be imposed in the discretion of the Administrator.**

## 7.

### AWARD OF RESTRICTED STOCK

**7.1** *Eligibility.*  **Subject to the Award Limit. Restricted Stock may be awarded to any Employee who the Committee determines is a key Employee or any Consultant who the Committee determines should receive such an Award.**

**7.2** *Award of Restricted Stock.*

The Committee may from time to time, in its absolute discretion:

**Determine which Employees are key Employees and select from among the key Employees or Consultants (including Employees or Consultants who have previously received other awards under the Plan) such of them as in its opinion should be awarded Restricted Stock; and**

**Determine the purchase price, if any, and other terms and conditions applicable to such Restricted Stock, consistent with the Plan.**

The Committee shall establish the purchase price, if any, and form of payment for Restricted Stock; provided, however, that such purchase price shall be no less than the par value of the Common Stock to be purchased, unless otherwise permitted by applicable state law. In all cases, legal consideration shall be required for each issuance of Restricted Stock.



Upon the selection of a key Employee or Consultant to be awarded Restricted Stock, the Committee shall instruct the Secretary of the Company to issue such Restricted Stock and may impose such conditions on the issuance of such Restricted Stock as it deems appropriate.

**7.3 Rights as Stockholders.** *Subject to Section 7.4, upon delivery of the shares of Restricted Stock to the escrow holder pursuant to Section 7.6, the Holder shall have, unless otherwise provided by the Committee, all the rights of a stockholder with respect to said shares, subject to the restrictions in his Award Agreement, including the right to receive all dividends and other distributions paid or made with respect to the shares; provided, however, that in the discretion of the Committee, any extraordinary distributions with respect to the Common Stock shall be subject to the restrictions set forth in Section 7.4.*

**7.4 Restriction.** *All shares of Restricted Stock issued under the Plan (including any shares received by holders thereof with respect to shares of Restricted Stock as a result of stock dividends, stock splits or any other form of recapitalization) shall, in the terms of each individual Award Agreement, be subject to such restrictions as the Committee shall provide, which restrictions may include, without limitation, restrictions concerning voting rights and transferability and restrictions based on duration of employment with the Company, Company performance and individual performance; provided, however, that, unless the Committee otherwise provides in the terms of the Award Agreement or otherwise, no share of Restricted Stock granted to a person subject to Section 16 of the Exchange Act shall be sold, assigned or otherwise transferred until at least six months and one day have elapsed from the date on which the Restricted Stock was issued, and provided, further, that, except with respect to shares of Restricted Stock granted to Section 162(m) Participants, by action taken after the Restricted Stock is issued, the Committee may, on such terms and conditions as it may determine to be appropriate, remove any or all of the restrictions imposed by the terms of the Award Agreement. Restricted Stock may not be sold or encumbered until all restrictions are terminated or expire. If no consideration was paid by the Holder upon issuance, a Holder's rights in unvested Restricted Stock shall lapse, and such Restricted Stock shall be surrendered to the Company without consideration, upon Termination of Employment or, if applicable, upon Termination of Consultancy with the Company; provided, however, that the Committee in its sole and absolute discretion may provide that such rights shall not lapse in the event of a Termination of Employment following a "change of ownership or control" (within the meaning of Treasury Regulation Section 1.162-27(e)(2)(v) or any successor regulation thereto) of the Company or because of the Holder's death or disability; provided, further, except with respect to shares of Restricted Stock granted to Section 162(m) Participants, the Committee in its sole and absolute discretion may provide that no such lapse or surrender shall occur in the event of a Termination of Employment, or a Termination of Consultancy, without cause or following any Change in Control of the Company or because of the Holder's retirement, or otherwise.*

**7.5 Repurchase of Restricted Stock.** *The Committee shall provide in the terms of each individual Award Agreement that the Company shall have the right to repurchase from the Holder the Restricted Stock then subject to restrictions under the Award Agreement immediately upon a Termination of Employment or, if applicable, upon a Termination of Consultancy between the Holder and the Company, at a cash price per share equal to the price paid by the Holder for such Restricted Stock; provided, however, that the Committee in its sole and absolute discretion may provide that no such right of repurchase shall exist in the event of a Termination of Employment following a "change of ownership or control" (within the meaning of Treasury Regulation Section 1.162-27(e)(2)(v) or any successor regulation thereto) of the Company or because of the Holder's death or disability; provided, further, that, except with respect to shares of Restricted Stock granted to Section 162(m) Participants, the Committee in its sole and absolute discretion may provide that no such right of repurchase shall exist in the event of a Termination of Employment or a Termination of Consultancy without cause or following any Change in Control of the Company or because of the Holder's retirement, or otherwise.*

**7.6 Escrow.** *The Secretary of the Company or such other escrow holder as the Committee may appoint shall retain physical custody of each certificate representing Restricted Stock until all of the restrictions imposed under the Award Agreement with respect to the shares evidenced by such certificate expire or shall have been removed.*

**7.7 Legend.** *In order to enforce the restrictions imposed upon shares of Restricted Stock hereunder, the Committee shall cause a legend or legends to be placed on certificates representing all shares of Restricted Stock that are still subject to restrictions under Award Agreements, which legend or legends shall make appropriate reference to the conditions imposed thereby.*

**7.8 Section 83(b) Election.** *If a Holder makes an election under Section 83(b) of the Code, or any successor section thereto, to be taxed with respect to the Restricted Stock as of the date of transfer of the Restricted Stock rather than as of the date or dates upon which the Holder would otherwise be taxable under Section 83(a) of the Code, the Holder shall deliver a copy of such election to the Company immediately after filing such election with the Internal Revenue Service.*

STOCK APPRECIATION RIGHTS

**8.1** *Grant of Stock Appreciation Rights. A Stock Appreciation Right may be granted to any key Employee or Consultant selected by the Committee. A Stock Appreciation Right may be granted (a) in connection and simultaneously with the grant of an Option, (b) with respect to a previously granted Option, or (c) independent of an Option. A Stock Appreciation Right shall be subject to such terms and conditions not inconsistent with the Plan as the Committee shall impose and shall be evidenced by an Award Agreement.*

**8.2** *Coupled Stock Appreciation Rights.*

A Coupled Stock Appreciation Right (“CSAR”) shall be related to a particular Option and shall be exercisable only when and to the extent the related Option is exercisable.

A CSAR may be granted to the Holder for no more than the number of shares subject to the simultaneously or previously granted Option to which it is coupled.

A CSAR shall entitle the Holder (or other person entitled to exercise the Option pursuant to the Plan) to surrender to the Company unexercised a portion of the Option to which the CSAR relates (to the extent then exercisable pursuant to its terms) and to receive from the Company in exchange therefore an amount determined by multiplying the difference obtained by subtracting the Option exercise price from the Fair Market Value of a share of Common Stock on the date of exercise of the CSAR by the number of shares of Common Stock with respect to which the CSAR shall have been exercised, subject to any limitations the Committee may impose.

**8.3** *Independent Stock Appreciation Rights.*

An Independent Stock Appreciation Right (“ISAR”) shall be unrelated to any Option and shall have a term set by the Committee. An ISAR shall be exercisable in such installments as the Committee may determine. An ISAR shall cover such number of shares of Common Stock as the Committee may determine; provided, however, that unless the Committee otherwise provides in the terms of the ISAR or otherwise, no ISAR granted to a person subject to Section 16 of the Exchange Act shall be exercisable until at least six months have elapsed from (but excluding) the date on which the Option was granted. The exercise price per share of Common Stock subject to each ISAR shall be set by the Committee. With the consent of a Holder whose rights are impaired or altered under an outstanding ISAR, the exercise price per share of shares subject to a previously granted, outstanding ISAR may be reduced (i) to the then-current Fair Market Value if the Fair Market Value of the Common Stock has declined since the date the ISAR was granted, (ii) pursuant to a Stock Appreciation Right exchange program, including a program pursuant to which an outstanding ISAR is cancelled and any of the following is granted in substitution therefor (A) a new ISAR under the Plan or another equity plan of the Company covering the same or a different number of shares of Common Stock, (B) another Award, (C) cash, or (D) other valuable consideration (as determined by the Committee, in its sole discretion); (iii) pursuant to any other action that is treated as a repricing under generally accepted accounting principles. An ISAR is exercisable only while the Holder is an Employee or Consultant; provided that the Committee may determine that the ISAR may be exercised subsequent to Termination of Employment or Termination of Consultancy without cause, or following a Change in Control, or because of the Holder’s retirement, death or disability, or otherwise.

An ISAR shall entitle the Holder (or other person entitled to exercise the ISAR pursuant to the Plan) to exercise all or a specified portion of the ISAR (to the extent then exercisable pursuant to its terms) and to receive from the Company an amount determined by multiplying the difference obtained by subtracting the exercise price per share of the ISAR from the Fair Market Value of a share of Common Stock on the date of exercise of the ISAR by the number of shares of Common Stock with respect to which the ISAR shall have been exercised, subject to any limitations the Committee may impose.

**8.4** *Payment and Limitations on Exercise.*

Payment of the amounts determined under Section 8.2(c) and 8.3(b) above shall be in cash, in Common Stock (based on its Fair Market Value as of the date the Stock Appreciation Right is exercised) or a combination of both, as determined by the Committee. To the extent such payment is effected in Common Stock, it shall be made subject to satisfaction of all provisions of Section 6.3 above pertaining to Options.

Holders of Stock Appreciation Rights may be required to comply with any timing or other restrictions with respect to the settlement or exercise of a Stock Appreciation Right, including a window-period limitation, as may be imposed in the discretion of the Committee.

9.  
**OTHER TYPES OF AWARDS**

**9.1** *Dividend Equivalents.*

(a) Any Employee or Consultant selected by the Administrator may be granted Dividend Equivalents based on the dividends on the shares of Common Stock that are subject to any Award, to be credited as of dividend payment dates, during the period between the date the Award is granted and the date the Award is exercised, vests or expires, as determined by the Administrator. Such Dividend Equivalents shall be converted to cash or additional shares of Common Stock by such formula and at such time and subject to such limitations as may be determined by the Administrator.

(b) Dividend Equivalents granted with respect to Options or Stock Appreciation Rights that are intended to qualify as performance-based compensation as described in Section 162(m)(C)(4) of the Code shall be payable, with respect to pre-exercise periods, regardless of whether such Option or Stock Appreciation Right is subsequently exercised.

**9.2** *Restricted Stock Units.* The Administrator is authorized to make Awards of Restricted Stock Units to any Employee or Consultant selected by the Administrator in such amounts and subject to such terms and conditions as determined by the Administrator. At the time of grant, the Administrator shall specify the date or dates on which the Restricted Stock Units shall become fully vested and nonforfeitable, and may specify such conditions to vesting as it deems appropriate. Alternatively, Restricted Stock Units may become fully vested and nonforfeitable pursuant to the satisfaction of one or more Performance Criteria or other specific performance criteria as the Administrator determines to be appropriate at the time of the grant of the Restricted Stock Units or thereafter, in each case on a specified date or dates or over any period or periods determined by the Administrator. At the time of grant, the Administrator shall specify the maturity date applicable to each grant of Restricted Stock Units which shall be no earlier than the vesting date or dates of the Award and may be determined at the election of the Employee or Consultant to whom the Award is granted. On the maturity date, the Company shall transfer to the Holder one unrestricted, fully transferable share of Stock for each Restricted Stock Unit that is vested and scheduled to be distributed on such date and not previously forfeited. The Administrator shall specify the purchase price, if any, to be paid by the Holder to the Company for such shares of Common Stock; provided, however, that such price shall not be less than the par value of a share of Stock on the date of grant, unless otherwise permitted by applicable state law.

**9.3** *Term.* Except as otherwise provided herein, the term of any Award of Dividend Equivalents or Restricted Stock Units shall be set by the Administrator in its discretion.

**9.4** *Form of Payment.* Payments with respect to any Awards granted under Sections 9.1 and 9.2 shall be made in cash, in Common Stock or a combination of both, as determined by the Administrator.

**9.5** *Award Agreement.* All Awards under this Article 9 shall be subject to such additional terms and conditions as determined by the Administrator and shall be evidenced by a written Award Agreement.

10.  
**COMPLIANCE WITH SECTION 409A OF THE CODE**

**10.1** *Awards subject to Code Section 409A.* Any Award that constitutes, or provides for, a deferral of compensation subject to Section 409A of the Code (a "Section 409A Award") shall satisfy the requirements of Section 409A of the Code and this Article 10, to the extent applicable. The Award Agreement with respect to a Section 409A Award shall incorporate the terms and conditions required by Section 409A of the Code and this Article 10.

**10.2** *Distributions under a Section 409A Award.*

(a) Subject to subsection (b), any shares of Common Stock or other property or amounts to be paid or distributed upon the grant, issuance, vesting, exercise or payment of a Section 409A Award shall be distributed in accordance with the requirements of Section 409A(a)(2) of the Code, and shall not be distributed earlier than:

- (i) the Holder's separation from service, as determined by the Secretary of the Treasury;
- (ii) the date the Holder becomes disabled;
- (iii) the Participant's death;
- (iv) a specified time (or pursuant to a fixed schedule) specified under the Award Agreement at the date of the deferral compensation;
- (v) to the extent provided by the Secretary of the Treasury, a change in the ownership or effective control of the Company or a Subsidiary, or in the ownership of a substantial portion of the assets of the Company or a Subsidiary; or
- (vi) the occurrence of an unforeseeable emergency with respect to the Holder.

(b) In the case of a Holder who is a "specified employee," the requirement of paragraph (a)(i) shall be met only if the distributions with respect to the Section 409A Award may not be made before the date which is six months after the Holder's separation from service (or, if earlier, the date of the Holder's death). For purposes of this subsection (b), a Holder shall be a "specified employee" if such Holder is a key employee (as defined in Section 416(i) of the Code without regard to paragraph (5) thereof) of a corporation any stock of which is publicly traded on an established securities market or otherwise, as determined under Section 409A(a)(2)(B)(i) of the Code and the Treasury Regulations thereunder.

(c) The requirement of paragraph (a)(vi) shall be met only if, as determined under Treasury Regulations under Section 409A(a)(2)(B)(ii) of the Code, the amounts distributed with respect to the unforeseeable emergency do not exceed the amounts necessary to satisfy such unforeseeable emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such unforeseeable emergency is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of the Holder's assets (to the extent the liquidation of such assets would not itself cause severe financial hardship).

(d) For purposes of this Section, the terms specified therein shall have the respective meanings ascribed thereto under Section 409A of the Code and the Treasury Regulations thereunder.

***10.3 Prohibition on Acceleration of Benefits. The time or schedule of any distribution or payment of any shares of Stock or other property or amounts under a Section 409A Award shall not be accelerated, except as otherwise permitted under Section 409A(a)(3) of the Code and the Treasury Regulations thereunder.***

**10.4 Elections under Section 409A Awards.**

(a) Any deferral election provided under or with respect to an Award to any Employee or Consultant, or to the Holder holding a Section 409A Award, shall satisfy the requirements of Section 409A(a)(4)(B) of the Code, to the extent applicable, and, except as otherwise permitted under paragraph (i) or (ii) below, any such deferral election with respect to compensation for services performed during a taxable year shall be made not later than the close of the preceding taxable year, or at such other time as provided in Treasury Regulations.

**(i) In the case of the first year in which an Eligible Individual or a Participant holding a Section 409A Award, becomes eligible to participate in the Plan, any such deferral election may be made with respect to services to be performed subsequent to the election with thirty days after the date the Eligible Individual, or the Participant holding a Section 409A Award, becomes eligible to participate in the Plan, as provided under Section 409A(a)(4)(B)(ii) of the Code.**

**(ii) In the case of any performance-based compensation based on services performed by an Eligible Individual, or the Participant holding a Section 409A Award, over a period of at least twelve months, any such deferral election may be made no later than six months before the end of the period, as provided under Section 409A(a)(4)(B)(iii) of the Code.**

(b) In the event that a Section 409A Award permits, under a subsequent election by the Holder holding such Section 409A Award, a delay in a distribution or payment of any shares of Common Stock or other property or amounts under such Section 409A Award, or a change in the form of distribution or payment, such subsequent election shall satisfy the requirements of Section 409A(a)(4)(C) of the Code, and:

(i) such subsequent election may not take effect until at least twelve months after the date on which the election is made,

(ii) in the case such subsequent election relates to a distribution or payment not described in Section 10.2(a)(ii), (iii) or (vi), the first payment with respect to such election may be deferred for a period of not less than five years from the date such distribution or payment otherwise would have been made, and

(iii) in the case such subsequent election relates to a distribution or payment described in Section 10.2(a)(iv), such election may not be made less than twelve months prior to the date of the first scheduled distribution or payment under Section 12.2(a)(iv).

**10.5 Compliance in Form and Operation. A Section 409A Award, and any election under or with respect to such Section 409A Award, shall comply in form and operation with the requirements of Section 409A of the Code and the Treasury Regulations thereunder.**

## 11. ADMINISTRATION

**11.1 Compensation Committee. The Compensation Committee (or another committee or a subcommittee of the Board assuming the functions of the Committee under the Plan) shall consist solely of two or more Independent Directors appointed by and holding office at the pleasure of the Board, each of whom is both a “non-employee director” as defined by Rule 16b-3 and an “outside director” for purposes of Section 162(m) of the Code. Appointment of Committee members shall be effective upon acceptance of appointment. Committee members may resign at any time by delivering written notice to the Board. Vacancies in the Committee may be filled by the Board.**

**11.2 Duties and Powers of Committee. It shall be the duty of the Committee to conduct the general administration of the Plan in accordance with its provisions. The Committee shall have the power to interpret the Plan and the Award Agreements, and to adopt such rules for the administration, interpretation, and application of the Plan as are consistent therewith, to interpret, amend or revoke any such rules and to amend any Award Agreement provided that the rights or obligations of the Holder of the Award that is the subject of any such Award Agreement are not affected adversely. Any such grant or award under the Plan need not be the same with respect to each Holder. Any such interpretations and rules with respect to Incentive Stock Options shall be consistent with the provisions of Section 422 of the Code. In its absolute discretion, the Board may at any time and from time to time exercise any and all rights and duties of the Committee under the Plan except with respect to matters which under Rule 16b-3 or Section 162(m) of the Code, or any regulations or rules issued thereunder, are required to be determined in the sole discretion of the Committee.**

**11.3 Majority Rule; Unanimous Written Consent. The Committee shall act by a majority of its members in attendance at a meeting at which a quorum is present or by a memorandum or other written instrument signed by all members of the Committee.**

**11.4 Compensation; Professional Assistance; Good Faith Actions. Members of the Committee shall receive such compensation, if any, for their services as members as may be determined by the Board. All expenses and liabilities which members of the Committee incur in connection with the administration of the Plan shall be borne by the Company. The Committee may, with the approval of the Board, employ attorneys, consultants, accountants, appraisers, brokers, or other persons. The Committee, the Company and the Company’s officers and Directors shall be entitled to rely upon the advice, opinions or valuations of any such persons. All actions taken and all interpretations and determinations made by the Committee or the Board in good faith shall be final and binding upon all Holders, the Company and all other interested persons. No members of the Committee or Board shall be personally liable for any action, determination or interpretation made in good faith with respect to the Plan or Awards, and all members of the Committee and the Board shall be fully protected by the Company with respect to any such action, determination or interpretation.**

**11.5 Delegation of Authority to Grant Awards. The Committee may, but need not, delegate from time to time some or all of its authority to grant Awards under the Plan to a committee consisting of one or more members of the Committee or of one or more officers of the Company; provided, however, that the Committee may not delegate its authority to grant Awards to individuals (i) who are subject on the date of the grant to the reporting rules under Section 16(a) of the Exchange Act, (ii) who are Section 162(m) Participants or (iii) who are officers of the Company who are delegated authority by the Committee hereunder. Any delegation hereunder shall be subject to the restrictions and limits that the Committee specifies at the time of such delegation of authority and may be rescinded at any time by the Committee. At all times, any committee appointed under this Section 11.5 shall serve in such capacity at the pleasure of the Committee.**

MISCELLANEOUS PROVISIONS

**12.1 Not Transferable.** *No Award under the Plan may be sold, pledged, assigned or transferred in any manner other than by will or the laws of descent and distribution or, subject to the consent of the Administrator, pursuant to a DRO, unless and until such Award has been exercised, or the shares underlying such Award have been issued, and all restrictions applicable to such shares have lapsed; provided, however, that the restrictions set forth in the foregoing clause shall not apply to transfers of Non-Qualified Stock Options, Restricted Stock or Stock Appreciation Rights, subject to the consent of the Administrator, by gift of an Option by an Employee to a Permitted Transferee (as defined below) subject to the following terms and conditions: (i) an Option transferred to a Permitted Transferee shall not be assignable or transferable by the Permitted Transferee other than by DRO or by will or the laws of descent and distribution; (ii) any Option which is transferred to a Permitted Transferee shall continue to be subject to all the terms and considerations of the Option as applicable to the original holder (other than the ability to further transfer the Option); (iii) the Employee and the Permitted Transferee shall execute any and all documents reasonably requested by the Administrator, including, without limitation, documents to (a) confirm the status of the transferee as a Permitted Transferee, (b) satisfy any requirements for an exemption for the transfer under applicable federal and state securities laws and (c) provide evidence of the transfer; (iv) the shares of Common Stock acquired by a Permitted Transferee through exercise of an Option have not been registered under the Securities Act, or any state securities act and may not be transferred, nor will any assignee or transferee thereof be recognized as an owner of such shares of Common Stock for any purpose, unless a registration statement under the Securities Act and any applicable state securities act with respect to such shares shall then be in effect or unless the availability of an exemption from registration with respect to any proposed transfer or disposition of such shares shall be established to the satisfaction of counsel for the Company. As used in this Section 12.1, "Permitted Transferee" shall mean (i) one or more of the following family members of an Employee: spouse, former spouse, child (whether natural or adopted), stepchild, any other lineal descendant of the Employee, (ii) a trust, partnership or other entity established and existing for the sole benefit of, or under the sole control of, one or more of the above family members of the Employee, or (iii) any other transferee specifically approved by the Administrator after taking into account any state or federal tax or securities laws applicable to transferable Options.*

No Award or interest or right therein shall be liable for the debts, contracts or engagements of the Holder or his successors in interest or shall be subject to disposition by transfer, alienation, anticipation, pledge, encumbrance, assignment or any other means whether such disposition be voluntary or involuntary or by operation of law, by judgment, levy, attachment, garnishment or any other legal or equitable proceedings (including bankruptcy), and any attempted disposition thereof shall be null and void and of no effect, except to the extent that such disposition is permitted by the preceding sentence.

Unless an Option has been transferred in accordance with this Section 12.1, (i) during the lifetime of the Holder, only he may exercise an Option or other Award (or any portion thereof) granted to him under the Plan unless it has been disposed of pursuant to a DRO, and (ii) after the death of the Holder, any exercisable portion of an Option or other Award may, prior to the time when such portion becomes unexercisable under the Plan or the applicable Award Agreement, be exercised by his personal representative or by any person empowered to do so under the deceased Holder's will or under the then applicable laws of descent and distribution.

**12.2 Amendment, Suspension or Termination of the Plan.** *Except as otherwise provided in this Section 12.2, the Plan may be wholly or partially amended or otherwise modified, suspended or terminated at any time or from time to time by the Administrator. However, without approval of the Company's stockholders given within twelve months before or after the action by the Administrator, no action of the Administrator may, except as provided in Section 12.3, increase the limits imposed in Section 2.1 on the maximum number of shares which may be issued under the Plan. No amendment, suspension or termination of the Plan shall, without the consent of the Holder, alter or impair any rights or obligations under any Award theretofore granted or awarded, unless the Award itself otherwise expressly so provides. No Awards may be granted or awarded during any period of suspension or after termination of the Plan, and in no event may any Award be granted under the Plan after the first to occur of the following events:*

The expiration of ten years from the date the Plan is adopted by the Board; or

The expiration of ten years from the date the Plan is approved by the Company's stockholders under Section 12.4.

The Plan will terminate on July 14, 2015, unless it is terminated sooner by the Administrator pursuant to this Section 12.2.

**12.3** *Changes in Common Stock or Assets of the Company, Acquisition or Liquidation of the Company and Other Corporate Events.*

Subject to Section 12.3 (d), in the event that the Administrator determines that any dividend or other distribution (whether in the form of cash, Common Stock, other securities, or other property), recapitalization, reclassification, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase, liquidation, dissolution, or sale, transfer, exchange or other disposition of all or substantially all of the assets of the Company, or exchange of Common Stock or other securities of the Company, issuance of warrants or other rights to purchase Common Stock or other securities of the Company, or other similar corporate transaction or event, in the Administrator's sole discretion, affects the Common Stock such that an adjustment is determined by the Administrator to be appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan or with respect to an Award, then the Administrator shall, in such manner as it may deem equitable, adjust any or all of

**the number and kind of shares of Common Stock (or other securities or property) with respect to which Awards may be granted or awarded (including, but not limited to, adjustments of the limitations in Section 2.1 on the maximum number and kind of shares which may be issued and adjustments of the Award Limit),**

**the number and kind of shares of Common Stock (or other securities or property) subject to outstanding Awards, and**

**the grant or exercise price with respect to any Award.**

Subject to Sections 12.3(b)(vii) and 12.3(d), in the event of any transaction or event described in Section 12.3(a) or of changes in applicable laws, regulations, or accounting principles, the Administrator, in its sole and absolute discretion, and on such terms and conditions as it deems appropriate, either by the terms of the Award or by action taken prior to the occurrence of such transaction or event and either automatically or upon the Holder's request, is hereby authorized to take any one or more of the following actions whenever the Administrator determines that such action is appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan or with respect to any Award under the Plan, to facilitate such transactions or events or to give effect to such changes in laws, regulations or principles:

**To provide for either the purchase of any such Award for an amount of cash equal to the amount that could have been attained upon the exercise of such Award or realization of the Holder's rights had such Award been currently exercisable or payable or fully vested or the replacement of such Award with other rights or property selected by the Administrator in its sole discretion;**

**To provide that the Award cannot vest, be exercised or become payable after such event;**

**To provide that such Award shall be exercisable as to all shares covered thereby, notwithstanding anything to the contrary in Section 5.3 or the provisions of such Award;**

**To provide that such Award be assumed by the successor or survivor corporation, or a parent or subsidiary thereof, or shall be substituted for by similar options, rights or awards covering the stock of the successor or survivor corporation, or a parent or subsidiary thereof, with appropriate adjustments as to the number and kind of shares and prices;**

**To make adjustments in the number and type of shares of Common Stock (or other securities or property) subject to outstanding Awards, and in the number and kind of outstanding Restricted Stock and/or in the terms and conditions of, and the criteria included in, outstanding options, rights and awards and options, rights and awards which may be granted in the future;**

**To provide that, for a specified period of time prior to such event, the restrictions imposed under an Award Agreement upon some or all shares of Restricted Stock may be terminated, and some or all shares of such Restricted Stock may cease to be subject to repurchase under Section 7.5 or forfeiture under Section 7.4 after such event; and**

**Notwithstanding any other provision of the Plan, in the event of a Change in Control, each outstanding Award shall, immediately prior to the effective date of the Change in Control, automatically become fully exercisable for all of the shares of Common Stock at the time subject to such rights and may be exercised for any or all of those shares as fully-vested shares of Common Stock.**

Subject to Sections 12.3(d), 3.2 and 3.3, the Administrator may, in its discretion, include such further provisions and limitations in any Award, agreement or certificate, as it may deem equitable and in the best interests of the Company.

With respect to Awards which are granted to Section 162(m) Participants and are intended to qualify as performance-based compensation under Section 162(m)(4)(C), no adjustment or action described in this Section 12.3 or in any other provision of the Plan shall be authorized to the extent that such adjustment or action would cause such Award to fail to so qualify under Section 162(m)(4)(C), or any successor provisions thereto. No adjustment or action described in this Section 12.3 or in any other provision of the Plan shall be authorized to the extent that such adjustment or action would cause the Plan to violate Section 422(b)(1) of the Code. Furthermore, no such adjustment or action shall be authorized to the extent such adjustment or action would result in short-swing profits liability under Section 16 or violate the exemptive conditions of Rule 16b-3 unless the Administrator determines that the Award is not to comply with such exemptive conditions. The number of shares of Common Stock subject to any Award shall always be rounded to the next whole number.

Notwithstanding the foregoing, in the event that the Company becomes a party to a transaction that is intended to qualify for “pooling of interests” accounting treatment and, but for one or more of the provisions of this Plan or any Award Agreement would so qualify, then this Plan and any Award Agreement shall be interpreted so as to preserve such accounting treatment, and to the extent that any provision of the Plan or any Award Agreement would disqualify the transaction from pooling of interests accounting treatment (including, if applicable, an entire Award Agreement), then such provision shall be null and void. All determinations to be made in connection with the preceding sentence shall be made by the independent accounting firm whose opinion with respect to “pooling of interests” treatment is required as a condition to the Company’s consummation of such transaction.

The existence of the Plan, the Award Agreement and the Awards granted hereunder shall not affect or restrict in any way the right or power of the Company or the shareholders of the Company to make or authorize any adjustment, recapitalization, reorganization or other change in the Company’s capital structure or its business, any merger or consolidation of the Company, any issue of stock or of options, warrants or rights to purchase stock or of bonds, debentures, preferred or prior preference stocks whose rights are superior to or affect the Common Stock or the rights thereof or which are convertible into or exchangeable for Common Stock, or the dissolution or liquidation of the Company, or any sale or transfer of all or any part of its assets or business, or any other corporate act or proceeding, whether of a similar character or otherwise.

**12.4 Approval of Plan by Stockholders. The Plan will be submitted for the approval of the Company’s stockholders within twelve months after the date of the Board’s initial adoption of the Plan. Awards may be granted or awarded prior to such stockholder approval, provided that such Awards shall not be exercisable nor shall such Awards vest prior to the time when the Plan is approved by the stockholders, and provided further that if such approval has not been obtained at the end of said twelve-month period, all Awards previously granted or awarded under the Plan shall thereupon be canceled and become null and void. In addition, if the Board determines that Awards other than Options or Stock Appreciation Rights which may be granted to Section 162(m) Participants should continue to be eligible to qualify as performance-based compensation under Section 162(m)(4)(C) of the Code, the Performance Criteria must be disclosed to and approved by the Company’s stockholders no later than the first stockholder meeting that occurs in the fifth year following the year in which the Company’s stockholders previously approved the Performance Criteria.**

**12.5 Tax Withholding. The Company shall be entitled to require payment in cash or deduction from other compensation payable to each Holder of any sums required by federal, state or local tax law to be withheld with respect to the issuance, vesting, exercise or payment of any Award. The Administrator may in its discretion and in satisfaction of the foregoing requirement allow such Holder to elect to have the Company withhold shares of Common Stock otherwise issuable under such Award (or allow the return of shares of Common Stock) having a Fair Market Value equal to the sums required to be withheld.**

**12.6 Loans. The Committee may, in its discretion, extend one or more loans to key Employees in connection with the exercise or receipt of an Award granted or awarded under the Plan, or the issuance of Restricted Stock awarded under the Plan. The terms and conditions of any such loan shall be set by the Committee.**

**12.7 Forfeiture Provisions. Pursuant to its general authority to determine the terms and conditions applicable to Awards under the Plan, the Administrator shall have the right to provide, in the terms of Awards made under the Plan, or to require a Holder to agree by separate written instrument, that (a)(i) any proceeds, gains or other economic benefit actually or constructively received by the Holder upon any receipt or exercise of the Award, or upon the receipt or resale of any Common Stock underlying the Award, must be paid to the Company, and (ii) the Award shall terminate and any unexercised portion of the Award (whether or not vested) shall be forfeited, if (b)(i) a Termination of Employment or Termination of Consultancy occurs prior to a specified date, or within a specified time period following receipt or exercise of the Award, or (ii) the Holder at any time, or during a specified time period, engages in any activity in competition with the Company, or which is inimical, contrary or harmful to the interests of the Company, as further defined by the Administrator or (iii) the Holder incurs a Termination of Employment or Termination of Consultancy for cause.**





**12.8** *Effect of Plan Upon Options and Compensation Plans. The adoption of the Plan shall not affect any other compensation or incentive plans in effect for the Company or any Subsidiary. Nothing in the Plan shall be construed to limit the right of the Company (a) to establish any other forms of incentives or compensation for Employees or Consultants of the Company or any Subsidiary or (b) to grant or assume options or other rights or awards otherwise than under the Plan in connection with any proper corporate purpose including but not by way of limitation, the grant or assumption of options in connection with the acquisition by purchase, lease, merger, consolidation or otherwise, of the business, stock or assets of any corporation, partnership, limited liability company, firm or association.*

**12.9** *Compliance with Laws. The Plan, the granting and vesting of Awards under the Plan and the issuance and delivery of shares of Common Stock and the payment of money under the Plan or under Awards granted or awarded hereunder are subject to compliance with all applicable federal and state laws, rules and regulations (including but not limited to state and federal securities law and federal margin requirements) and to such approvals by any listing, regulatory or governmental authority as may, in the opinion of counsel for the Company, be necessary or advisable in connection therewith. Any securities delivered under the Plan shall be subject to such restrictions, and the person acquiring such securities shall, if requested by the Company, provide such assurances and representations to the Company as the Company may deem necessary or desirable to assure compliance with all applicable legal requirements. To the extent permitted by applicable law, the Plan and Awards granted or awarded hereunder shall be deemed amended to the extent necessary to conform to such laws, rules and regulations.*

**12.10** *Titles. Titles are provided herein for convenience only and are not to serve as a basis for interpretation or construction of the Plan.*

**12.11** *Governing Law. The Plan and any agreements hereunder shall be administered, interpreted and enforced under the internal laws of the State of Delaware without regard to conflicts of laws thereof.*

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I hereby certify that the foregoing Plan was duly adopted by the Board of Directors of Tegal Corporation as of May 24, 2006.

/s/ CHRISTINE HERGENROTHER

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Christine Hergenrother  
Secretary

**FORM OF NON-QUALIFIED STOCK OPTION AGREEMENT (EMPLOYEES)**

THIS AGREEMENT, dated \_\_\_\_\_, is made by and between Tegal Corporation, a Delaware corporation hereinafter referred to as “Company,” and \_\_\_\_\_, an employee of the Company or a Subsidiary of the Company, hereinafter referred to as “Employee”:

WHEREAS, the Company wishes to afford the Employee the opportunity to purchase shares of its \$0.01 par value Common Stock; and

WHEREAS, the Company wishes to carry out The Seventh Amended and Restated 1998 Equity Participation Plan of Tegal Corporation (as so amended, the “Plan”) (the terms of which are hereby incorporated by reference and made a part of this Agreement); and

WHEREAS, the Committee, appointed to administer the Plan, has determined that it would be to the advantage and best interest of the Company and its shareholders to grant the Non-Qualified Stock Option provided for herein to the Employee as an inducement to enter into or remain in the service of the Company or its Subsidiaries and as an incentive for increased efforts during such service, and has advised the Company thereof and instructed the undersigned officers to issue said Option;

NOW, THEREFORE, in consideration of the mutual covenants herein contained and other good and valuable consideration, receipt of which is hereby acknowledged, the parties hereto do hereby agree as follows:

**ARTICLE I.  
DEFINITIONS**

Whenever the following terms are used in this Agreement, they shall have the meaning specified below unless the context clearly indicates to the contrary. The masculine pronoun shall include the feminine and neuter, and the singular the plural, where the context so indicates. All capitalized terms used herein without definition shall have the meanings ascribed to such terms in the Plan.

Section 1.1 Officer

“Officer” shall mean an officer of the Company, as defined in Rule 16a-1(f) under the Exchange Act, as such Rule may be amended in the future.

Section 1.2 Option

“Option” shall mean the non-qualified stock option to purchase Common Stock of the Company granted under this Agreement.

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Section 1.3 Plan

“Plan” shall mean The Seventh Amended and Restated 1998 Equity Participation Plan of Tegal Corporation.

Section 1.4 Secretary

“Secretary” shall mean the Secretary of the Company.

**ARTICLE II.  
GRANT OF OPTION**

Section 2.1 Grant of Option

In consideration of the Employee’s agreement to remain in the employ of the Company or its Subsidiaries and for other good and valuable consideration, on the date hereof the Company irrevocably grants to the Employee the option to purchase any part or all of an aggregate of \_\_\_\_\_ **shares** of its \$0.01 par value Common Stock upon the terms and conditions set forth in this Agreement.

Section 2.2 Purchase Price

The purchase price of the shares of stock covered by the Option shall be \$ \_\_\_\_\_ **per share** without commission or other charge.

Section 2.3 Consideration to Company

In consideration of the granting of this Option by the Company, the Employee agrees to render faithful and efficient services to the Company or a Subsidiary, with such duties and responsibilities as the Company shall from time to time prescribe, for a period of at least one (1) year from the date this Option is granted. Nothing in this Agreement or in the Plan shall confer upon any Optionee any right to continue in the employ of the Company or any Subsidiary, or shall interfere with or restrict in any way the rights of the Company and any Subsidiary, which are hereby expressly reserved, to discharge any Optionee at any time for any reason whatsoever, with or without cause, except to the extent expressly provided otherwise in a written employment agreement between the Optionee and the Company and any Subsidiary.

Section 2.4 Adjustments in Option

The Committee shall make adjustments with respect to the Option in accordance with the provisions of Section 10.3 of the Plan.

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**ARTICLE III.**  
**PERIOD OF EXERCISABILITY**

Section 3.1 Commencement of Exercisability

(a) The Option shall become exercisable as follows:

(i) The first installment shall consist of fifty percent (50%) of the shares covered by the Option and shall become exercisable on the first anniversary of the date the Option is granted.

(ii) The second installment shall consist of fifty (50%) of the shares covered by the Option and shall become exercisable on the second anniversary of the date the Option is granted.

(b) No portion of the Option which is unexercisable at Termination of Employment shall thereafter become exercisable.

Section 3.2 Duration of Exercisability

The installments provided for in Section 3.1 are cumulative. Each such installment which becomes exercisable pursuant to Section 3.1 shall remain exercisable until it becomes unexercisable under Section 3.3.

Section 3.3 Expiration of Option

The Option may not be exercised to any extent by anyone after the first to occur of the following events:

(a) The expiration of the Option; or

(b) The expiration of three (3) years from the date of the Employee's Termination of Employment by reason of his retirement, death or disability (within the meaning of Section 22(e)(3) of the Code); or

(c) The expiration of one (1) year from the date of the Employee's Termination of Employment by reason of his being discharged not for good cause; or

(d) The expiration of three (3) months from the date of the Employee's Termination of Employment by reason of his resignation or by reason of his being discharged for good cause; or

(e) In the event of a Change of Control, unless the Committee waives this provision in connection with such transaction. At least ten (10) days prior to the effective date of such merger, consolidation, acquisition, liquidation or dissolution, the Committee shall give the Employee notice of such event if the Option has then neither been fully exercised nor become unexercisable under this Section 3.3.

Section 3.4 Acceleration of Exercisability

(a) Notwithstanding any other provision of the Plan, in the event of a Change in Control, the Option shall, immediately prior to the effective date of the Change in Control, automatically become fully exercisable for all of the shares of Common Stock at the time subject to the Option and may be exercised for any or all of those shares as fully-vested shares of Common Stock, notwithstanding that this Option may not yet have become fully exercisable under Section 3.1(a); provided, however, that this acceleration of exercisability shall not take place if this Option becomes unexercisable under Section 3.3 prior to said effective date.

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The Committee may make such determinations and adopt such rules and conditions as it, in its absolute discretion, deems appropriate in connection with such acceleration of exercisability, including, but not by way of limitation, provisions to ensure that any such acceleration and resulting exercise shall be conditioned upon the consummation of the contemplated corporate transaction.

**ARTICLE IV.  
EXERCISE OF OPTION**

Section 4.1 Person Eligible to Exercise

Unless the Option has been transferred in accordance with Section 5.2, during the lifetime of the Employee, only he may exercise the Option or any portion thereof. After the death of the Employee, any exercisable portion of the Option may, prior to the time when the Option becomes unexercisable under Section 3.3, be exercised by his personal representative or by any person empowered to do so under the deceased Employee's will or under the then applicable laws of descent and distribution, and subject to the consent of the Committee pursuant to a DRO or by a Permitted Transferee.

Section 4.2 Partial Exercise

Any exercisable portion of the Option or the entire Option, if then wholly exercisable, may be exercised in whole or in part at any time prior to the time when the Option or portion thereof becomes unexercisable under Section 3.3.

Section 4.3 Manner of Exercise

The Option, or any exercisable portion thereof, may be exercised solely by delivery to the Secretary or his office of all of the following prior to the time when the Option or such portion becomes unexercisable under Section 3.3:

(a) A written notice complying with the applicable rules established by the Committee stating that the Option, or a portion thereof, is exercised. The notice shall be signed by the Employee or other person then entitled to exercise the Option or such portion; and

(b)

(i) Full cash payment to the Secretary of the Company for the shares with respect to which such Option or portion is exercised; or

(ii) With the consent of the Committee, (A) shares of the Company's Common Stock owned for at least six months by the Employee, duly endorsed for transfer to the Company, with a Fair Market Value on the date of delivery equal to the aggregate exercise price of the Option or exercised portion thereof, or (B) shares of the Company's Common Stock issuable to the Employee upon exercise of the Option, with a Fair Market Value on the date of delivery equal to the aggregate exercise price of the Option or exercised portion thereof; or

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(iii) With the consent of the Committee, a full recourse promissory note bearing interest (at no less than a market rate of interest which then precludes the imputation of interest under the Code or successor provision) and payable upon such terms as may be prescribed by the Committee. The Committee may also prescribe the form of such note and the security to be given for such note. The Option may not be exercised, however, by delivery of a promissory note or by a loan from the Company when or where such loan or other extension of credit is prohibited by law; or

(iv) With the consent of the Committee, property of any kind which constitutes good and valuable consideration; or

(v) With the consent of the Committee, a notice that the Employee has placed a market sell order with a broker with respect to shares of the Company's Common Stock then issuable upon exercise of the Option, and that the broker has been directed to pay a sufficient portion of the net proceeds of the sale to the Company in satisfaction of the Option exercise price; or

(vi) With the consent of the Committee, any combination of the consideration provided in the foregoing subparagraphs (i), (ii), (iii), (iv) and (v); and

(c) Full payment to the Company (or other employer corporation) of all amounts which, under federal, state or local tax law, it is required to withhold upon exercise of the Option; with the consent of the Committee, (i) shares of the Company's Common Stock owned by the Employee for at least six months, duly endorsed for transfer, with a Fair Market Value equal to the sums required to be withheld, or (ii) shares of the Company's Common Stock issuable to the Employee upon exercise of the Option with a Fair Market Value equal to the sums required to be withheld, may be used to make all or part of such payment; and

(d) In the event the Option or portion thereof shall be exercised pursuant to Section 4.1 by any person or persons other than the Employee, appropriate proof of the right of such person or persons to exercise the Option.

#### Section 4.4 Conditions to Issuance of Stock Certificates

The shares of stock deliverable upon the exercise of the Option, or any portion thereof, may be either previously authorized but unissued shares or issued shares which have then been reacquired by the Company. Such shares shall be fully paid and nonassessable. The Company shall not be required to issue or deliver any certificate or certificates for shares of stock purchased upon the exercise of the Option or portion thereof prior to fulfillment of all of the following conditions:

(a) The admission of such shares to listing on all stock exchanges on which such class of stock is then listed; and

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(b) The completion of any registration or other qualification of such shares under any state or federal law or under rulings or regulations of the Securities and Exchange Commission or of any other governmental regulatory body, which the Committee shall, in its absolute discretion, deem necessary or advisable; and

(c) The obtaining of any approval or other clearance from any state or federal governmental agency which the Committee shall, in its absolute discretion, determine to be necessary or advisable; and

(d) The receipt by the Company of full payment for such shares, including payment of all amounts which, under federal, state or local tax law, the Company (or other employer corporation) is required to withhold upon exercise of the Option; and

(e) The lapse of such reasonable period of time following the exercise of the Option as the Committee may from time to time establish for reasons of administrative convenience.

#### Section 4.5 Rights as Shareholder

The holder of the Option shall not be, nor have any of the rights or privileges of, a shareholder of the Company in respect of any shares purchasable upon the exercise of any part of the Option unless and until certificates representing such shares shall have been issued by the Company to such holder.

### **ARTICLE V. OTHER PROVISIONS**

#### Section 5.1 Administration

The Committee shall have the power to interpret the Plan and this Agreement and to adopt such rules for the administration, interpretation and application of the Plan as are consistent therewith and to interpret, amend or revoke any such rules and to amend this Agreement provided that the rights or obligations of the Employee are not affected adversely. All actions taken and all interpretations and determinations made by the Committee in good faith shall be final and binding upon the Employee, the Company and all other interested persons. No member of the Committee shall be personally liable for any action, determination or interpretation made in good faith with respect to the Plan or the Option. In its absolute discretion, the Board may at any time and from time to time exercise any and all rights and duties of the Committee under the Plan and this Agreement except with respect to matters which under Rule 16b-3 or Section 162(m) of the Code, or any regulations or rules issued thereunder, are required to be determined in the sole discretion of the Committee.

#### Section 5.2 Option Not Transferable

Neither the Option nor any interest or right therein or part thereof shall be sold, pledged, assigned, or transferred in any manner other than by will or the laws of descent and distribution and subject to consent of the Committee, pursuant to a DRO or to a "Permitted Transferee" (as defined below), unless and until such Option has been exercised, or the shares underlying such Option have been issued, and all restrictions applicable to such shares have lapsed. Any transfer to a "Permitted Transferee" shall be subject to the following terms and conditions: (i) an Option transferred to a Permitted Transferee shall not be assignable or transferable by the Permitted Transferee other than by DRO or by will or the laws of descent and distribution; (ii) any Option which is transferred to a Permitted Transferee shall continue to be subject to all the terms and considerations of the Option as applicable to the original holder (other than the ability to further transfer the Option); (iii) the Employee and the Permitted Transferee shall execute any and all documents reasonably requested by the Administrator, including, without limitation, documents to (a) confirm the status of the transferee as a Permitted Transferee, (b) satisfy any requirements for an exemption for the transfer under applicable federal and state securities laws and (c) provide evidence of the transfer; (iv) the shares of Common Stock acquired by a Permitted Transferee through exercise of an Option have not been registered under the Securities Act, or any state securities act and may not be transferred, nor will any assignee or transferee thereof be recognized as an owner of such shares of Common Stock for any purpose, unless a registration statement under the Securities Act and any applicable state securities act with respect to such shares shall then be in effect or unless the availability of an exemption from registration with respect to any proposed transfer or disposition of such shares shall be established to the satisfaction of counsel for the Company. As used in this Section 5.2, "Permitted Transferee" shall mean (i) one or more of the following family members of an Employee: spouse, former spouse, child (whether natural or adopted), stepchild, any other lineal descendant of the Employee, (ii) a trust, partnership or other entity established and existing for the sole benefit of, or under the sole control of, one or more of the above family members of the Employee, or (iii) any other transferee specifically approved by the Administrator after taking into account any state or federal tax or securities laws applicable to transferable Options.

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Neither the Option nor any interest or right therein or part thereof shall be sold, pledged, assigned, or transferred in any manner other than by will or the laws of descent and distribution and subject to consent of the Committee, pursuant to a DRO or by a Permitted Transferee, unless and until such Option has been exercised, or the shares underlying such Option have been issued, and all restrictions applicable to such shares have lapsed. Neither the Option nor any interest or right therein or part thereof shall be liable for the debts, contracts or engagements of the Employee or his successors in interest or shall be subject to disposition by transfer, alienation, anticipation, pledge, encumbrance, assignment or any other means whether such disposition be voluntary or involuntary or by operation of law by judgment, levy, attachment, garnishment or any other legal or equitable proceedings (including bankruptcy), and any attempted disposition thereof shall be null and void and of no effect, except to the extent that such disposition is permitted by the preceding sentence.

Section 5.3      Shares to Be Reserved

The Company shall at all times during the term of the Option reserve and keep available such number of shares of stock as will be sufficient to satisfy the requirements of this Agreement.

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#### Section 5.4 Notices

Any notice to be given under the terms of this Agreement to the Company shall be addressed to the Company in care of its Secretary, and any notice to be given to the Employee shall be addressed to him at the address given beneath his signature hereto. By a notice given pursuant to this Section 5.4, either party may hereafter designate a different address for notices to be given to him. Any notice which is required to be given to the Employee shall, if the Employee is then deceased, be given to the Employee's personal representative if such representative has previously informed the Company of his status and address by written notice under this Section 5.4. Any notice shall be deemed duly given when enclosed in a properly sealed envelope or wrapper addressed as aforesaid, deposited (with postage prepaid) in a post office or branch post office regularly maintained by the United States Postal Service.

#### Section 5.5 Titles

Titles are provided herein for convenience only and are not to serve as a basis for interpretation or construction of this Agreement.

#### Section 5.6 Construction

This Agreement shall be administered, interpreted and enforced under the internal laws of the State of Delaware without regard to conflicts of laws thereof.

#### Section 5.7 Conformity to Securities Laws

The Employee acknowledges that the Plan is intended to conform to the extent necessary with all provisions of the Securities Act and the Exchange Act and any and all regulations and rules promulgated by the Securities and Exchange Commission thereunder, including without limitation Rule 16b-3. Notwithstanding anything herein to the contrary, the Plan shall be administered, and the Option is granted and may be exercised, only in such a manner as to conform to such laws, rules and regulations. To the extent permitted by applicable law, the Plan and this Agreement shall be deemed amended to the extent necessary to conform to such laws, rules and regulations.

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IN WITNESS WHEREOF, this Agreement has been executed and delivered by the parties hereto.

TEGAL CORPORATION

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Christine T. Hergenrother  
Vice President & Chief Financial Officer

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Employee

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Address

Employee's Taxpayer  
Identification Number:

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## NON-QUALIFIED STOCK OPTION AGREEMENT (EMPLOYEES)

### EXERCISE NOTICE

Tegal Corporation  
2201 S. McDowell Blvd.  
Petaluma, CA 94954

1. Exercise of Option. Effective as of today, \_\_\_\_\_, the undersigned (“Optionee”) hereby elects to exercise Optionee’s option to purchase \_\_\_\_\_ shares of the Common Stock (the “Shares”) of Tegal Corporation, a Delaware corporation (the “Company”), under and pursuant to The Sixth Amended and Restated 1998 Equity Participation Plan of Tegal Corporation (the “Plan”) and the Nonstatutory Stock Option Agreement dated \_\_\_\_\_ (the “Option Agreement”).

2. Delivery of Payment. Optionee herewith delivers to the Company the full purchase price for the Shares. I hereby elect to pay the Exercise Price by delivery of cash or check to the Secretary of the Company.

In the event I have elected to exercise options via the same day exercise and sale method, you are hereby authorized to instruct \_\_\_\_\_ (the “Broker”) to accept the proceeds deriving from the sale of the Shares, and to take the following actions: (i) to deduct from the proceeds of the sale any Company expenses; (ii) to deduct from the proceeds any tax withholding requested by the Company and to request in writing from the Company a statement of the tax amounts to be withheld, if no request has been given by the company; (iii) to deliver the above amounts so deducted to the Company ; and (iv) to deliver the remaining proceed to me as I shall direct the Broker.

These instructions shall be construed as authorizing the Broker and the Company to take any other actions reasonably necessary to effect the purposes hereof and the Broker and the Company may rely upon any statements and undertakings made herein by the undersigned, as if said statements and undertakings were made directly to the Broker and the Company.

I further acknowledge that I shall bear sole responsibility for any commissions and fees relating to the performance of these instructions by the Broker or the Company and any other banking activities and will, upon demand, indemnify and defend the Broker or the Company against any amounts which may be owing in this regard.

3. Representations of Optionee. Optionee acknowledges that Optionee has received, read and understood the Plan and the Option Agreement and agrees to abide by and be bound by their terms and conditions.

4. Rights as Shareholder. Until the stock certificate evidencing such Shares is issued (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company), no right to vote or receive dividends or any other rights as a shareholder shall exist with respect to the Shares, notwithstanding the exercise of the Option. In the event Optionee has not sold the Shares in a same day exercise and sale, the Company shall issue (or cause to be issued) such stock certificate promptly after the Option is exercised. No adjustment will be made for a dividend or other right for which the record date is prior to the date the stock certificate is issued, except as provided in the Plan.

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5. Tax Consultation. Optionee understands that Optionee may suffer adverse tax consequences as a result of Optionee's purchase or disposition of the Shares. Optionee represents that Optionee has consulted with any tax consultants Optionee deems advisable in connection with the purchase or disposition of the Shares and that Optionee is not relying on the Company for any tax advice.

Purchaser agrees to satisfy all applicable federal, state and local income and employment tax withholding obligations with respect to the exercise of the Option and, if applicable, the sale of the Shares and will, upon demand, indemnify and defend the Company and if applicable the Broker, against any amounts which may be owing in this regard.

6. Successors and Assigns. The Company may assign any of its rights under this Agreement to single or multiple assignees, and this Agreement shall inure to the benefit of the successors and assigns of the Company. Subject to the restrictions on transfer herein set forth, this Agreement shall be binding upon Optionee and his or her heirs, executors, administrators, successors and assigns.

7. Interpretation. Any dispute regarding the interpretation of this Agreement shall be submitted by Optionee or by the Company forthwith to the Company's Board of Directors or the committee thereof that administers the Plan, which shall review such dispute at its next regular meeting. The resolution of such a dispute by the Board or committee shall be final and binding on the Company and on Optionee.

8. Governing Law; Severability. This Agreement shall be governed by and construed in accordance with the laws of the State of California excluding that body of law pertaining to conflicts of law. Should any provision of this Agreement be determined by a court of law to be illegal or unenforceable, the other provisions shall nevertheless remain effective and shall remain enforceable.

9. Notices. Any notice required or permitted hereunder shall be given in writing and shall be deemed effectively given upon personal delivery or upon deposit in the United States mail by certified mail, with postage and fees prepaid, addressed to the other party at its address as shown below beneath its signature, or to such other address as such party may designate in writing from time to time to the other party.

10. Further Instruments. The parties agree to execute such further instruments and to take such further action as may be reasonably necessary to carry out the purposes and intent of this Agreement.

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11. Delivery of Payment. Optionee herewith delivers to the Company the full Exercise Price for the Shares.

12. Entire Agreement. The Plan and Notice of Grant/Option Agreement are incorporated herein by reference. This Agreement, the Plan and the Option Agreement constitute the entire agreement of the parties and supersede in their entirety all prior undertakings and agreements of the Company and Optionee with respect to the subject matter hereof.

Submitted by:

Accepted by:

OPTIONEE:

TEGAL CORPORATION

\_\_\_\_\_

By:

\_\_\_\_\_

Its:

\_\_\_\_\_

Address:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**THE EIGHTH AMENDED AND RESTATED 1998 EQUITY PARTICIPATION PLAN  
OF TEGAL CORPORATION**

**RESTRICTED STOCK UNIT AWARD GRANT NOTICE AND  
RESTRICTED STOCK UNIT AWARD AGREEMENT**

Tegal Corporation (the “*Company*”), pursuant to The Eighth Amended and Restated 1998 Equity Participation Plan of Tegal Corporation (the “*Plan*”), hereby grants to the holder listed below (“*Holder*”), the number of Restricted Stock Units set forth below (the “*Restricted Stock Units*”). The Restricted Stock Units are subject to all of the terms and conditions as set forth herein and in the Restricted Stock Unit Award Agreement attached hereto as Exhibit A (the “*Restricted Stock Unit Agreement*”) and the Plan, each of which are incorporated herein by reference. Unless otherwise defined herein, the terms defined in the Plan shall have the same defined meanings in this Grant Notice and the Restricted Stock Unit Agreement.

**Holder:** \_\_\_\_\_  
**Grant Date:** \_\_\_\_\_  
**Total Number of Restricted Stock Units:** \_\_\_\_\_

**Vesting Schedule:** The Restricted Stock Units shall fully vest upon the permanent relocation of Holder to Tegal’s headquarters.

**Distribution Schedule:** The Restricted Stock Units shall be distributable in accordance with Section 2.3 of the Restricted Stock Unit Agreement.

By his or her signature and the Company’s signature below, Holder agrees to be bound by the terms and conditions of the Plan, the Restricted Stock Unit Agreement and this Grant Notice. Holder has reviewed the Restricted Stock Unit Agreement, the Plan and this Grant Notice in their entirety, has had an opportunity to obtain the advice of counsel prior to executing this Grant Notice and fully understands all provisions of this Grant Notice, the Restricted Stock Unit Agreement and the Plan. Holder hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Administrator of the Plan upon any questions arising under the Plan, this Grant Notice or the Restricted Stock Unit Agreement.

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**TEGAL CORPORATION**

By: \_\_\_\_\_

Print Name: Thomas R. Mika  
Title: President and Chief Executive Officer  
Address: 2201 South McDowell Boulevard  
Petaluma, California 94954

**HOLDER:**

By: \_\_\_\_\_

Print Name: \_\_\_\_\_  
Address: \_\_\_\_\_  
\_\_\_\_\_



**EXHIBIT A**

**TO RESTRICTED STOCK UNIT AWARD GRANT NOTICE**

**RESTRICTED STOCK UNIT AWARD AGREEMENT**

Pursuant to the Restricted Stock Unit Award Grant Notice (“*Grant Notice*”) to which this Restricted Stock Unit Award Agreement (this “*Agreement*”) is attached, Tegal Corporation (the “*Company*”) has granted to Holder the number of Restricted Stock Units under The Seventh Amended and Restated 1998 Equity Participation Plan of Tegal Corporation (the “*Plan*”) indicated in the Grant Notice.

**ARTICLE I**

**GENERAL**

1.1 Defined Terms. Capitalized terms not specifically defined herein shall have the meanings specified in the Plan and the Grant Notice.

1.2 Incorporation of Terms of Plan. The Restricted Stock Units and the shares of Common Stock issuable with respect thereto are subject to the terms and conditions of the Plan, which are incorporated herein by reference.

**ARTICLE II**

**GRANT, VESTING AND DISTRIBUTION OF RESTRICTED STOCK UNITS**

2.1 Grant of Restricted Stock Units. In consideration of Holder’s past and/or continued employment with or service to the Company or its Subsidiaries and for other good and valuable consideration, effective as of the Grant Date set forth in the Grant Notice (the “*Grant Date*”), the Company irrevocably grants to Holder an award of the number of Restricted Stock Units indicated in the Grant Notice, subject to all of the terms and conditions in the Plan and this Agreement. A Restricted Stock Unit shall represent the right to receive a share of Common Stock at the time the Restricted Stock Unit is available for distribution on a deferred basis in accordance with the terms and conditions of the Plan and this Agreement.

2.2 Vesting of Restricted Stock Units. The Restricted Stock Units shall vest in accordance with the vesting schedule set forth in the Grant Notice. Unless and until the Restricted Stock Units have vested in accordance with the vesting schedule set forth in the Grant Notice, Holder will have no right to any distribution with respect to such Restricted Stock Units. In the event of Holder’s Termination of Consultancy or Termination of Employment prior to the vesting of all of the Restricted Stock Units, any unvested Restricted Stock Units will terminate automatically and be forfeited without further notice and at no cost to the Company.

2.3 Distribution of Common Stock.

(a) Shares of Common Stock shall be distributed to Holder (or in the event of Holder’s death, to his or her estate) with respect to such Holder’s vested Restricted Stock Units granted to Holder pursuant to this Agreement, subject to the terms and provisions of the Plan and this Agreement, commencing following the earliest to occur of the following events (each, a “*Distribution Event*”):

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(i) Holder's "separation from service" within the meaning of Section 409A(2)(A)(i) of the Code and the Treasury Regulations thereunder; *provided, however*, that if Holder is a "specified employee" at the time of Holder's "separation from service," the "Distribution Event" for purposes of this Section 2.3(a)(i) shall be the date that is six months after Holder's "separation from service" (or, if earlier, the date of Holder's death). For purposes of this Section 2.3(a)(i), Holder shall be a "specified employee" if Holder is a key employee (as defined in Section 416(i) of the Code without regard to paragraph (5) thereof) of the Company and any stock of the Company is publicly-traded on an established securities market or otherwise, as determined under Section 409A(a)(2)(B)(i) of the Code and the Treasury Regulations thereunder;

(ii) The date Holder becomes "disabled" within the meaning of Section 409A(2)(C) of the Code and the Treasury Regulations thereunder;

(iii) Holder's death;

(iv) the date immediately prior to a Change in Control, so long as such "Change in Control" constitutes a change in the ownership or effective control of the Company, or in the ownership of a substantial portion of the assets of the Company within the meaning of Section 409A(2)(A)(v) of the Code and the Treasury Regulations thereunder; or

(v) \_\_\_\_\_.

(b) Subject to Sections 2.3(a) and 2.4, following a Distribution Event, the shares of Common Stock issuable with respect to Holder's vested Restricted Stock Units shall be distributed to him or her in one installment on the \_\_\_\_\_.

(c) The installments described in Section 2.3(b) shall commence within thirty (30) days following the occurrence of the Distribution Event. Following the commencement of installments pursuant to this Section 2.3(c), the time for the distribution of the shares of Common Stock issuable with respect to Holder's vested Restricted Stock Units may not be accelerated for any reason. In the event of Holder's death prior to the distribution of all shares of Common Stock issuable with respect to Holder's vested Restricted Stock Units pursuant to Section 2.3(b), any remaining shares of Common Stock shall be distributed to Holder's beneficiary or estate in accordance with the schedule set forth in Section 2.3(b) for such distributions.

(d) All distributions shall be made by the Company in the form of whole shares of Common Stock (and cash in an amount equal to the value of any fractional Restricted Stock Unit, determined based on the Fair Market Value as of the distribution date).

(e) Notwithstanding the foregoing, shares of Common Stock shall be issuable pursuant to a Restricted Stock Unit at such times and upon such events as are specified in this Agreement only to the extent issuance under such terms will not cause the Restricted Stock Units or the shares of Common Stock issuable pursuant to the Restricted Stock Units to be includible in the gross income of Holder under Section 409A of the Code prior to such times or the occurrence of such events, as permitted by the Code and the regulations and other guidance thereunder.

## 2.4 Unforeseeable Emergency.

(a) If Holder experiences an Unforeseeable Emergency (as defined below), Holder may petition the Administrator for the right to receive a partial or full distribution of the shares of Common Stock distributable with respect to his or her vested Restricted Stock Units under this Agreement. If, in the sole discretion of the Administrator, Holder's petition is approved, the Unforeseeable Emergency shall be deemed a "Distribution Event" with respect to the number of shares of Common Stock distributable with respect to Holder's vested Restricted Stock Units as are approved for distribution by the Administrator. Holder shall then be entitled to receive such shares of Common Stock pursuant to Section 2.3(b).

(b) For purposes of this Section 2.4, an "*Unforeseeable Emergency*" shall mean a severe financial hardship to Holder resulting from an illness or accident of Holder, Holder's spouse, or a dependent (as defined in Section 152(a) of the Code) of Holder, loss of Holder's property due to casualty, or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of Holder. The Fair Market Value of the shares of Common Stock distributed to Holder with respect to the Unforeseeable Emergency may not exceed the amounts necessary to satisfy such Unforeseeable Emergency plus amounts necessary to pay taxes reasonably anticipated as a result of the distribution, after taking into account the extent to which such Unforeseeable Emergency is or may be relieved through reimbursement or compensation by insurance or otherwise or by liquidation of Holder's assets (to the extent liquidation of such assets would not itself cause severe financial hardship), as determined under the Treasury Regulations under Section 409A(a)(2)(B)(ii) of the Code.

2.5 Changes to Form or Time of Distribution. Except as provided in Section 2.4, neither the time nor form of distribution of shares of Common Stock with respect to the Restricted Stock Units under this Agreement may be changed, except as may be permitted by the Administrator in accordance with Sections 12.3 and 12.4(b) of the Plan and Section 409A of the Code and the Treasury Regulations thereunder.

2.6 Restrictions on Transfer. Unless otherwise permitted by the Administrator pursuant to the Plan, no Restricted Stock Units or shares of Common Stock issuable with respect thereto or any interest or right therein or part thereof shall be liable for the debts, contracts or engagements of Holder or his or her successors in interest or shall be subject to disposition by transfer, alienation, anticipation, pledge, encumbrance, assignment or any other means whether such disposition be voluntary or involuntary or by operation of law by judgment, levy, attachment, garnishment or any other legal or equitable proceedings (including bankruptcy), and any attempted disposition thereof shall be null and void and of no effect.

2.7 Conditions to Issuance of Stock Certificates. The shares of Common Stock deliverable with respect to the Restricted Stock Units, or any portion thereof, may be either previously authorized but unissued shares or issued shares which have then been reacquired by the Company. Such shares shall be fully paid and nonassessable. The Company shall not be required to issue or deliver any shares of Common Stock with respect to the Restricted Stock Units prior to fulfillment of all of the following conditions:

- (a) The admission of such shares to listing on all stock exchanges on which such Common Stock is then listed; and
- (b) The completion of any registration or other qualification of such shares under any state or federal law or under rulings or regulations of the Securities and Exchange Commission or of any other governmental regulatory body, which the Administrator shall, in its absolute discretion, deem necessary or advisable; and
- (c) The obtaining of any approval or other clearance from any state or federal governmental agency which the Administrator shall, in its absolute discretion, determine to be necessary or advisable; and
- (d) The lapse of such reasonable period of time following the applicable Distribution Event as the Administrator may from time to time establish for reasons of administrative convenience; and
- (e) The receipt by the Company of full payment for such shares, including payment of all amounts which, under federal, state or local tax law, the Company (or other employer corporation) is required to withhold upon issuance of such shares in accordance with Section 10.5 of the Plan.

2.8 Rights as Stockholder. Except as otherwise provided herein, Holder shall not be, nor have any of the rights or privileges of, a stockholder of the Company in respect of any shares of Common Stock issuable pursuant to the Restricted Stock Units unless and until such shares of Common Stock shall have been issued by the Company to Holder.

### ARTICLE III

#### OTHER PROVISIONS

3.1 Adjustment for Stock Split. In the event of any stock dividend, stock split, reverse stock split, recapitalization, combination, reclassification, or similar change in the capital structure of the Company, appropriate adjustments shall be made in the Restricted Stock Units and/or the shares of Common Stock issuable with respect thereto, consistent with any adjustment under Section 10.3 of the Plan. The provisions of this Agreement shall apply, to the full extent set forth herein with respect to the Restricted Stock Units and the shares of Common Stock issuable with respect thereto, to any and all shares of capital stock or other securities which may be issued in respect of, or in exchange for, in substitution of the Restricted Stock Units and the shares of Common Stock issuable with respect thereto, and shall be appropriately adjusted for any stock dividends, splits, reverse splits, combinations, recapitalizations and the like occurring after the date hereof.

3.2 Taxes. Notwithstanding anything to the contrary in this Agreement, the Company shall be entitled to require payment to the Company or any of its Subsidiaries in cash or deduction from other compensation payable to Holder of any sums required by federal, state or local tax law to be withheld with respect to the issuance of the Restricted Stock Units or distribution of shares of Common Stock with respect thereto. The Company shall not be obligated to deliver any new certificate representing shares of Common Stock issuable with respect to the Restricted Stock Units to Holder or his legal representative unless and until Holder or his legal representative shall have paid or otherwise satisfied in full the amount of all federal, state and local taxes applicable to the taxable income of Holder resulting from the grant of the Restricted Stock Units or the distribution of the shares of Common Stock issuable with respect thereto.

3.3 Limitations Applicable to Section 16 Persons. Notwithstanding any other provision of the Plan or this Agreement, if Holder is subject to Section 16 of the Exchange Act, the Plan, the Restricted Stock Units and the shares of Common stock issuable with respect thereto and this Agreement shall be subject to any additional limitations set forth in any applicable exemptive rule under Section 16 of the Exchange Act (including any amendment to Rule 16b-3 of the Exchange Act) that are requirements for the application of such exemptive rule. To the extent permitted by applicable law, this Agreement shall be deemed amended to the extent necessary to conform to such applicable exemptive rule.

3.4 Administration. The Administrator shall have the power to interpret the Plan and this Agreement and to adopt such rules for the administration, interpretation and application of the Plan as are consistent therewith and to interpret, amend or revoke any such rules. All actions taken and all interpretations and determinations made by the Administrator in good faith shall be final and binding upon Holder, the Company and all other interested persons. No member of the Administrator shall be personally liable for any action, determination or interpretation made in good faith with respect to the Plan, this Agreement or the Restricted Stock Units.

3.5 Restrictive Legends and Stop-Transfer Orders.

(a) Any share certificate(s) evidencing the shares of Common Stock issued hereunder shall be endorsed with any legend required by any applicable federal and state securities laws.

(b) Holder agrees that, in order to ensure compliance with the restrictions referred to herein, the Company may issue appropriate "stop transfer" instructions to its transfer agent, if any, and that, if the Company transfers its own securities, it may make appropriate notations to the same effect in its own records.

(c) The Company shall not be required: (i) to transfer on its books any shares of Common Stock that have been sold or otherwise transferred in violation of any of the provisions of this Agreement; or (ii) to treat as owner of such shares of Common Stock or to accord the right to vote or pay dividends to any purchaser or other transferee to whom such shares shall have been so transferred.

3.6 Notices. Any notice to be given under the terms of this Agreement to the Company shall be addressed to the Company in care of the Secretary of the Company, and any notice to be given to Holder shall be addressed to Holder at the address given beneath Holder's signature on the Grant Notice. By a notice given pursuant to this Section 3.6, either party may hereafter designate a different address for notices to be given to that party. Any notice shall be deemed duly given when sent via email or when sent by certified mail (return receipt requested) and deposited (with postage prepaid) in a post office or branch post office regularly maintained by the United States Postal Service.

3.7 Titles. Titles are provided herein for convenience only and are not to serve as a basis for interpretation or construction of this Agreement.

3.8 Governing Law; Severability. This Agreement shall be administered, interpreted and enforced under the laws of the State of Delaware without regard to conflicts of laws thereof. Should any provision of this Agreement be determined by a court of law to be illegal or unenforceable, the other provisions shall nevertheless remain effective and shall remain enforceable.

3.9 Conformity to Securities Laws. Holder acknowledges that the Plan is intended to conform to the extent necessary with all provisions of the Securities Act and the Exchange Act and any and all regulations and rules promulgated by the Securities and Exchange Commission thereunder, and state securities laws and regulations. Notwithstanding anything herein to the contrary, the Plan shall be administered, and the Restricted Stock Units are granted, only in such a manner as to conform to such laws, rules and regulations. To the extent permitted by applicable law, the Plan and this Agreement shall be deemed amended to the extent necessary to conform to such laws, rules and regulations.

3.10 Amendments. This Agreement may not be modified, amended or terminated except by an instrument in writing, signed by Holder and by a duly authorized representative of the Company.

3.11 No Employment Rights. If Holder is an Employee, nothing in the Plan or this Agreement shall confer upon Holder any right to continue in the employ of the Company or any Subsidiary or shall interfere with or restrict in any way the rights of the Company and its Subsidiaries, which are expressly reserved, to discharge Holder at any time for any reason whatsoever, with or without cause, except to the extent expressly provided otherwise in a written agreement between the Company and Holder.

3.12 Successors and Assigns. The Company may assign any of its rights under this Agreement to single or multiple assignees, and this Agreement shall inure to the benefit of the successors and assigns of the Company. Subject to the restrictions on transfer herein set forth, this Agreement shall be binding upon Holder and his or her heirs, executors, administrators, successors and assigns.

3.13 Unfunded, Unsecured Obligations. The obligations of the Company under the Plan and this Agreement shall be unfunded and unsecured, and nothing contained herein shall be construed as providing for assets to be held in trust or escrow or any other form of segregation of the assets of the Company for the benefit of Holder or any other person. Holder shall have only the rights of a general, unsecured creditor of the Company with respect to the Restricted Stock Units, unless and until shares of Common Stock shall be distributed to Holder under the terms and conditions of this Agreement.

3.14 Compliance in Form and Operation. This Agreement and the Restricted Stock Units are intended to comply with Section 409A of the Code and the Treasury Regulations thereunder and shall be interpreted in a manner consistent with that intention.