Post Office Box 1860 Newport Beach, California 92660 Phone (714) 752-9000 Telex: 4996871 Ronald R. Randall General Counsel Secretary

February 11, 1987

Ida Rose Langord Hall 1711 N. Lambert Lane Provo, Utah 84601

Re: In re Smith International, Inc.;
Agreement and Plan of Merger
(Megadiamond Industries, Inc.)

Dear Ms. Hall:

As you are aware, Smith International, Inc. ("Smith") filed a proceeding under Chapter 11 of the United States Bankruptcy Code on March 7, 1986. Since the commencement of Smith's Chapter 11 case, and at the present time, Smith is operating its business in accordance with, and subject to the protections of, the Bankruptcy Code.

As you are further aware, on January 6, 1987, Smith filed a motion with the Bankruptcy Court seeking authority to assume the Agreement and Plan of Merger ("Merger Agreement") dated January 18, 1985 between Smith, SII Megadiamond Inc., Megadiamond Industries, Inc. ("Megadiamond") and yourselves (the "Former Shareholders" or the "Shareholders"). Smith's Motion was heard before Bankruptcy Judge James R. Dooley on January 26, 1987, at which time the Court granted the motion and authorized Smith to assume the Merger Agreement, subject to curing the defaults described in the Motion. We are pleased to forward to each of you herewith a conformed copy of Judge Dooley's order, entered on January 28, 1987, authorizing Smith to assume the Merger Agreement. The affect of the assumption of the Merger Agreement is to permit Smith to honor any obligation which might arise in the future under the terms of the Agreement including the potential milestone payments of \$7,400,000. We anticipate the first major milestone (\$1,850,000) under Section 3.2(ii)(a)(2) to be met in mid-1987 if the positive field testing results continue.

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At the present time, therefore, Smith proposes, and is prepared to promptly, cure any and all past defaults under the Merger Agreement in accordance with the terms which are set forth below. Smith hereby tenders to each of the Former Shareholders the cure amounts upon the conditions which follow.

#### 1. Past Due Milestone Payment

Initially, as set forth in the Motion, Smith acknowledges the accrual of a past due Milestone Payment in favor of the Former Shareholders in the sum of \$29,893 under section 3.2(ii)(f) of the Merger Agreement. Smith further acknowledges that interest has accrued on such past due amount at the rate of 12% commencing April 1, 1986. Therefore, assuming a settlement of the current accounts of the respective parties as of March 1, 1987, Smith is prepared to acknowledge a credit in favor of the Former Shareholders in the sum of \$33,191 on account of this item.

### 2. First Indemnity Fund

Secondly, certain of the Former Shareholders have made demand upon Smith for a full refund of the First Indemnity Fund as defined in Article Fourteen of the Merger Agreement. Smith rejects such demand, and proposes a distribution of the First Indemnity Fund upon the terms which follow.

During the one-year period following the Closing Date (i.e., February 13, 1985), Smith sustained substantial damages as the result of the breach of covenants, warranties, and representations made by the Former Shareholders as set fourth in Article Five of the Merger Agreement. In particular, Megadiamond's premerger inventory of raw materials, work in process, and finished goods and accounts receivable failed to comply with the Former Shareholders' representations and warranties under paragraphs 5.10 and 5.12, respectively, of the Merger Agreement. With respect to the Former Shareholders' representations and warranties pertaining to Megadiamond's pre-merger accounts receivable (paragraph 5.12), such accounts were not "collectible at their full amounts less the reserve for doubtful accounts, warranty claims, estimated reserves for returned products and trade discounts shown on [the December 31, 1984] balance sheet". Rather,

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in accordance with appropriate accounting procedures, Smith (or more accurately, SII Megadiamond) was compelled to write-off a total of \$258,737 of Megadiamond's pre-merger accounts receivable. After deducting the agreed-upon allowance of \$121,085, Smith's net write-off with respect to the accounts receivable amounted to the sum of \$137,652.

With respect to the Former Shareholders' representations and warranties concerning pre-merger inventory (paragraph 5.10), substantial portions of the December 31, 1984 balance sheet inventory did not "consist of items of a quality and quantity usable or saleable in the ordinary course of business" and were not reflected at the "net realizable market value". Consequently, Smith has sustained total inventory write-offs of \$516,445. After deducting appropriate credits for SICN returns (\$35,623) and salvage value (\$65,000), Smith's net inventory write-off amounted to \$415,822.

As a result of the foregoing, Smith's total net write-off with respect to pre-acquisition accounts receivable and inventory of Megadiamond amounted to \$553,474. Smith's write-offs resulting from a breach of the Former Shareholders' representations and warranties obviously far exceeds the amount of the First Indemnity Fund by \$415,474, less any interest which may have accrued on the Fund. The Fund is therefore clearly "insufficient" within the meaning of paragraph 14.6 of the Agreement. This letter will, therefore, additionally serve as notice that Smith shall setoff the amount of any write-offs described above, in excess of the First Indemnity Fund, against future Milestone Payments to the extent necessary to satisfy such obligation.

### Second Indemnity Fund

With respect to the Second Indemnity Fund, all time limitations specified in the Merger Agreement pertaining to Smith's right of withdrawal have been extended by virtue of Smith's Chapter 11 proceeding and applicable provisions of the Bankruptcy Code. Subject to the foregoing, this letter shall constitute notice to the Shareholders pursuant to paragraph 14.2 of the Merger Agreement that Smith shall withdraw from the Second Indemnity Fund and extend the termination date of the fund.

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As you are aware, the Second Indemnity Fund was reserved out of the purchase price paid by Smith to guarantee payment of one-half of Smith's license fees to General Electric Company, and to the extent of any excess, to guarantee payment of attorneys' fees with respect to the COGEMA contract. See Merger Agreement, paragraph 14.1(ii). Smith has paid \$250,000 to General Electric on account of license fees covered by the Second Indemnity Fund, and has also expended approximately \$12,983 in attorneys' fees with respect to the COGEMA contract. Therefore, at this time Smith claims one-half of the license fees paid to General Electric and full amount of attorneys' fees paid with respect to COGEMA or a total of \$137,983. Smith has also been advised that the patent which was the subject of the licensing agreement with General Electric will reissue March 24, 1987. In accordance with the terms of such license agreement Smith will be required to pay an additional \$250,000 to General Electric. Smith intends to claim and withdraw the balance of the Second Indemnity Fund at such time.

#### 4. Summary

In summary, Smith proposes a settlement of the respective accounts of Smith and the Former Shareholders under the Merger Agreement, as of March 1, 1987, as follows:

- a. From the First Indemnity Fund, Smith shall retain the sum of \$138,000 plus interest accrued on the fund;
- b. From the Second Indemnity Fund Smith shall withdraw \$137,983.
- c. The amount of Smith's write-offs with respect to preacquisition inventory and accounts receivable of
  \$553,474 shall be reduced by the amount of Smith's
  withdrawal from the First Indemnity Fund in the amount
  set forth above; the balance of such write-offs shall be
  setoff against the past due Milestone Payment, leaving a
  credit in favor of Smith against subsequent Milestone
  Payments in the amount of \$415,474 less interest accrued
  on the Fund.

Please indicate your respective acceptance of the terms and conditions of Smith's assumption of the Merger Agreement and the settlement of the parties' respective current accounts under the

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Merger Agreement by signing and returning a copy of this letter to the undersigned. The terms of Smith's assumption of the Merger Agreement shall become effective only upon the execution and delivery to Smith of a copy of this letter by or on behalf of each of the Former Shareholders.

Very truly yours,

SMITH INTERNATIONAL, INC., Debtor and Debtor in Possession

Ronald R. Randall

General Counsel, Secretary

Agreed, acknowledged, and accepted:

Landall

RRR/lh Enclosure R211871