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

Form 10-K

(Mark One)

☑ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2008

or

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to .

Commission File Number: 001-34112

Energy Recovery, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**01-0616867**
(State or Other Jurisdiction of Incorporation or Organization)	*(I.R.S. Employer Identification No.)*

1908 Doolittle Drive, San Leandro, CA 94577
(Address of Principal Executive Offices)

Registrant's telephone number, including area code:
(510) 483-7370

Securities registered pursuant to Section 12(b) of the Securities Exchange Act of 1934:

Title of each class	**Name of exchange on which registered**
Common stock, $0.001 par value	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Securities Exchange Act of 1934:
None

Indicate by check mark whether 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 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 such 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, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer ☐	Accelerated filer ☐	Non-accelerated filer ☑ (Do not check if a smaller reporting company)	Smaller reporting company ☐

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

As of June 30, 2008, the last business day of the registrant's most recently completed second quarter, there was no established trading market for the registrant's common stock.

The number of shares of the registrant's common stock outstanding as of March 24, 2009 was 50,096,887.

DOCUMENTS INCORPORATED BY REFERENCE

Parts of the Proxy Statement for the Registrant's Annual Meeting of Shareholders to be held in June 2009 are incorporated by reference into Part III of this Annual Report on Form 10-K

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PART I

Item 1. ***Business***

Overview

Energy Recovery, Inc. develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products make desalination affordable by reducing energy costs. We have one operating segment, the manufacture and sale of high efficiency energy recovery products and related services. Additional information on segment reporting is contained in Note 10 of Notes to the Consolidated Financial Statements in this Form 10-K.

Our company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. We became a public company in July 2008. The company has three subsidiaries: Osmotic Power, Inc., Energy Recovery, Inc. International, and Energy Recovery Iberia, S.L. They were incorporated in September 2005, July 2006 and September 2006, respectively.

The mailing address of our headquarters is 1908 Doolittle Drive, San Leandro, California 94577. Our main telephone number is (510) 483-7370. Additional information about ERI is available on our website at http://www.energyrecovery.com. Information contained in the website is not part of this report.

Our Annual Report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports and the Proxy Statement for our Annual Meeting of Stockholders are made available, free of charge, on our website, http://www.energyrecovery.com, as soon as reasonably practicable after the reports have been filed with or furnished to the Securities and Exchange Commission.

Our Products

Energy Recovery, Inc. makes energy recovery devices for use in the desalination industry. There are two primary methods of producing drinking water from seawater: thermal distillation and membrane or reverse osmosis desalination. Thermal distillation involves heating seawater, capturing the vapor and condensing it as potable water. Reverse osmosis desalination entails pressurizing seawater and driving it into filtering membranes to produce pure water and a concentrated brine, which is carried away in a high pressure reject stream.

Our energy recovery products are used in reverse osmosis desalination. They reduce energy costs by capturing and reusing up to 98% of the otherwise lost pressure energy from the reject stream, reducing the workload of the high pressure pump. Use of our devices can reduce energy consumption by up to an estimated 60% compared to reverse osmosis plants without energy recovery. By reducing energy costs, our devices increase the cost-competitiveness of reverse osmosis desalination compared to other means of fresh water production, including thermal desalination. Our products are sold under the trademarks ERI®, PX®, Pressure Exchanger® and PX Pressure Exchanger®.

Current Product Lines: We develop and sell different models and sizes of our PX Pressure Exchanger products to address a range of process flow rates, plant designs and sizes. Our products are designed to operate in parallel to accommodate a range of plant sizes. Their modular design also provides system redundancy and minimizes the need for costly plant shut-downs. Our current offerings include:

- *The 65 Series.* Our 65-Series of PX devices is designed for reverse osmosis desalination plants capable of producing more than 120 gallons per minute or 27 cubic meters per hour. The PX-220, introduced in 2002, and the PX-260, introduced in late 2007, are currently our most popular products.

Model	Capacity gallons per minute (cubic meters per hour)
PX-260	180 260 gpm (41 59 m^3/hr)
PX-220	140 220 gpm (32 50 m^3/hr)
PX-180	100 180 gpm (23 41 m^3/hr)

- *The 45 Series.* The smaller 45-Series of PX devices are adapted for plants that process between 25 to 300 gallons per minute or 6 to 68 cubic meters per hour.

Model	Capacity gallons per minute (cubic meters per hour)
PX-140S	90 140 gpm (20 32 m^3/hr)
PX-90S	60 90 gpm (14 20 m^3/hr)
PX-70S	40 70 gpm (9 16 m^3/hr)
PX-45S	30 45 gpm (7 10 m^3/hr)
PX-30S	20 30 gpm (4 7 m^3/hr)

- *PX-30S.* The PX-30S is a smaller PX device designed for pilot desalination projects. It helps municipalities qualify PX technology for use in larger projects. The product was released in October 2007. In addition to serving as a test unit, it has found application in smaller marine-based or solar-powered desalination processes.
- *Brackish PX devices.* Brackish water has a lower concentration of salt than seawater. Given its lower salt content, brackish water typically requires less energy than seawater to desalinate. Our line of PX devices for the desalination of brackish water is designed to reduce energy costs and improve energy consumption in this lower pressure process.

New PX devices. We are in the process of testing two new PX devices designed for different ends of the desalination market.

- The Comp PX. Our new lower-priced Comp PX product is designed for operators of small to medium-sized plants which are sensitive to initial costs and/or are located in regions where energy costs are low. We expect to release the Comp PX device commercially in 2009.
- The Titan PX. The Titan PX product is designed to process up to 1,200 gallons per minute or 273 cubic meters per hour, more than four times the capacity of our PX-260. Field testing began in February 2009. We expect to evaluate the Titan PX device in a production environment for at least two years before releasing it for commercial use.

Technical Support and Replacement Parts. We provide engineering and technical support to customers during product installation and plant commissioning. We have dedicated technical support personnel based in Spain, the United Arab Emirates, China and the United States.

As our installed base of PX devices increases and ages, we expect sales of replacement PX device parts and services to increase. Our PX devices may also be used to retrofit or replace older energy recovery devices in existing desalination plants.

High Pressure Circulation Pumps. We manufacture and sell a line of high pressure circulation pumps for use in small to medium-sized plants. These low-powered pumps are used with our products to move high-pressure water through our energy recovery devices and the membranes array.

Customers

As of December 31, 2008, we had shipped approximately 5,900 PX devices to desalination plants worldwide. Our products are used in approximately 300 plants in operation or under construction including major plants in Australia, Spain, Africa, South America, the Middle East, China, the Caribbean and India. We sell directly to our customers, which include large engineering and construction firms and original equipment manufacturers (OEMs).

Large engineering and construction firms. Most of our revenue comes from sales of our products to the international engineering and construction firms that design and build large desalination plants or

mega-projects. We work with these firms to specify our products for their plants. The time between project tender to product shipment can range from six to 16 months. Each large mega-project typically represents a revenue opportunity of between $2 million to $7 million.

A limited number of these engineering and construction firms account for a substantial portion of our net revenue. In 2008, sales to Hyflux Ltd. and Befesa Agua, S.A. and affiliated joint ventures accounted for approximately 16% and 11%, respectively, of our total revenue. In 2007, sales to Acciona Agua S.A.; Geida and its member companies; and Doosan Heavy Industries & Construction Co., Ltd. represented approximately 20%, 23% and 13%, respectively, of our total sales (Geida is a consortium of Befesa Agua, a subsidiary of Abengoa S.A; Cobra-Tedagua, a subsidiary of ACS Actividades de Construcción y Servicios, S.A.; and Sadyt S.A., a subsidiary of Sacyr Vallehermoso, S. A.). Sales to GE Water and Process Technologies (formerly GE Ionics) and Geida and its member companies represented approximately 18% and 11% respectively of our total sales in 2006. No other customers accounted for more than 10% of our total revenue during any of these periods.

Original Equipment Manufacturers. We also sell our products and services to suppliers of pumps and other water-related equipment for assembly and use in small to medium-sized desalination plants for hotels, power plants, cruise ships, farming operations, island bottlers, and small municipalities. These original equipment manufacturers also purchase our products for "quick water" or emergency water solutions. In this market, the time from project tender to shipment ranges from one to three months.

Competition

The market for energy recovery devices in desalination plants is competitive. As the demand for fresh water increases and the market expands, we expect competition to persist and intensify.

We have three main competitors: Calder AG based in Switzerland; Fluid Equipment Development Company (FEDCO) based in Monroe, Michigan and Pump Engineering Incorporated (PEI) based in Monroe, Michigan. We compete with these companies on the basis of price, technology, materials, efficiency and life cycle maintenance costs. We believe that our products have a competitive advantage, even though these competitors may offer their products at prices lower than ours, because our product is the most cost effective energy recovery device for reverse osmosis desalination over time.

In the market for large desalination projects, our PX devices compete primarily with Calder's DWEER product. Like our products, the DWEER uses isobaric or pressure-equalizing technology to transfer pressure energy directly from the brine reject stream to seawater. We believe that we have a competitive advantage because our products are made with highly durable and corrosion-proof ceramic parts, have a simple design with one moving part and a small physical footprint, provide system redundancy and scaling capability, and offer lower life cycle maintenance costs.

In the market for small to medium-sized desalination plants, we compete with turbine technology from Calder, FEDCO and PEI. Unlike products that use isobaric or pressure-equalizing technology, turbine-based energy recovery products use the reject stream to turn a hydraulic turbine wheel that is coupled to a high-pressure pump. These products reduce energy costs by reducing the workload of the high pressure pump. These devices convert pressure energy to mechanical energy and back to pressure energy, and can recycle the pressure energy from the reject stream with a net transfer efficiency of between 50%-79%. We believe that our products have a competitive advantage because they provide up to 98% energy transfer efficiency, have lower life cycle maintenance costs, are made of highly durable and corrosion-proof ceramic parts and feature a modular design.

Sales and Marketing

Our sales and marketing groups work with companies that design and build desalination plants to specify our PX technology in their plants early in the design phase. We market and sell our products directly to these customers through our regional sales organization. In some countries, we also work with industry consultants.

Our sales organization has two groups, the Mega-Projects Group, which is responsible for sales opportunities for desalination projects exceeding 50,000 cubic meters per day, and our OEM Group, which targets projects designed to produce less than 50,000 cubic meters per day.

Since many of the large engineering and construction firms that specialize in mega-projects are located in Spain and other European countries, we maintain a sales and technical center in Madrid. We have an office in Dubai, United Arab Emirates to serve the Middle East where many desalination plants and key engineering and construction firms are located. We also have an office in China where we have many small and medium projects and opportunities for several large desalination projects. Our China office is located in Shanghai. Our U.S. sales offices are located in California and Florida.

Manufacturing

We assemble, test and package all of our finished products in our manufacturing facility in San Leandro, California. We purchase unfinished ceramic components for our PX products from several suppliers. We depend on three suppliers for our vessel housing and single suppliers for our end covers and stainless steel castings. We perform finish machining and assembly in-house on all ceramic components to protect the proprietary nature of our methods of manufacturing and product designs and to maintain our quality control standards.

For a discussion of risks attendant to our manufacturing activities, see “Risk Factors — We depend on third-party suppliers, and our revenue and gross margin could suffer if we fail to manage supplier issues properly,” in Item 1A, which is incorporated herein by reference.

Research and Development

Design, quality and innovation are key elements of our culture. Our development efforts are focused on designing and testing new PX devices adapted for different niches of the seawater reverse osmosis desalination market and creating new applications for our technology outside of desalination. We are also committed to developing know-how in the material science and manufacturing of ceramics. Research and development expense totaled $2.4 million for 2008, $1.7 million for 2007 and $1.3 million for 2006.

For a discussion of risks attendant to our research and development activities, see “Risk Factors — The success of our business depends in part on our ability to develop new products and services and increase the functionality of our current products,” in Item 1A, which is incorporated herein by reference.

Intellectual Property

We seek patent protection for inventions and improvements that are likely to be incorporated into our products. We rely on trade secret law and contractual safeguards to protect the proprietary tooling, processing techniques and other know-how used in the production of our products.

We have five U.S. patents and eleven patents outside the U.S. that are counterparts to one of the U.S. patents. The U.S. patents expire between 2011 and 2025, and the corresponding international patents expire at various dates through 2021. We have also applied for two additional U.S. patents and seven pending international applications corresponding to the U.S. patents and patent applications.

We have registered the following trademarks with the United States Patent and Trademark office: “ERI,” “PX,” “PX Pressure Exchanger,” “Pressure Exchanger,” the ERI logo, and “Making Desalination Affordable.” We have also applied for and received registrations in international trademark offices.

For a discussion of risks attendant to intellectual property rights, see “Risk Factors — If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.” in Item 1A, which is incorporated herein by reference.

Employees

As of December 31, 2008, we had 89 employees: 26 in manufacturing, 21 in sales and marketing; 34 in corporate services and management; and eight in engineering/research and development. Nine of these employees were located outside of the United States. We also from time to time engage a relatively small number of independent contractors. We have not experienced any work stoppages. Our employees are not unionized.

Item 1A. ***Risk Factors***

We have relied and expect to continue to rely on sales of our PX devices for almost all of our revenue; a decline in demand for desalination, reverse osmosis desalination or our PX devices will reduce demand for our products and will cause our sales and revenue to decline.

Our primary product is the PX device, and sales of our PX device historically have accounted for approximately 95% of our revenue. While we sell a variety of models of the PX device depending on the design of the desalination plant and its desired output, all of our models rely on the same basic technology developed and refined over the past 12 years. We expect that the revenue from our PX devices will continue to account for most of our revenue for the foreseeable future. Any factors adversely affecting the demand for desalination, including changing weather patterns, increased precipitation, new technology for producing fresh water, new energy technology or reduced energy costs, changes in the global economy, and political changes, would reduce the demand for PX devices and would cause a significant decline in our revenue. For example, desalination projects have in the past been cancelled or delayed due to political issues, changes in precipitation and problems with financing. Similarly, any other factors adversely affecting the demand for our PX devices, including new methods of reverse osmosis desalination that reduce pressure and energy requirements, improvements in membrane technology, new energy recovery technology, increased competition, changes in customer spending priorities and industry regulations would also cause a significant decline in our revenue. Some of the factors that may affect sales of our PX device may be out of our control.

We depend on the construction of new desalination plants for revenue, and as a result, our operating results have experienced, and may continue to experience, significant variability due to volatility in capital spending, availability of project financing, and other factors affecting the water desalination industry.

We derive substantially all of our revenue from sales of products and services used in desalination plants for municipalities, hotels and resorts and agricultural operations in dry or drought-ridden regions of the world. The demand for our products may decrease if the construction of desalination plants declines, especially in these regions. Other factors could affect the number and capacity of desalination plants built or the timing of their completion, including the current weak global economy, the current crisis in the credit and banking systems, changes in government priorities, changes in governmental regulations, reduced capital spending for desalination and lower energy costs, which could result in cancelled orders or delays in plant construction and the installation of our products. As a result of these factors, we have experienced and may in the future experience significant variability in our revenue, on both an annual and a quarterly basis. Pronounced variability, extended delays or reductions in spending with respect to the construction of desalination plants could negatively impact our sales and revenue and make it difficult for us to accurately forecast our future sales, which could lead to increased spending by us that is not matched by equivalent or higher revenue.

New planned seawater reverse osmosis projects can be cancelled and/or delayed, and cancellations and/or delays may negatively impact our revenue.

Planned seawater reverse osmosis desalination projects can be cancelled or delayed due to delays in, or failure to obtain, financing or the approval of or permitting for, plant construction because of political factors, adverse and increasingly uncertain financing conditions or other factors, especially in countries with political unrest. Even though we may have a signed contract to provide a certain number of PX devices by a certain date, if a customer requests a delay of shipment and we delay shipment of our PX devices, our results of operations and revenue will be negatively impacted.

We rely on a limited number of engineering and construction firms for a large portion of our revenue. If these customers delay or cancel their commitments or do not purchase our products in connection with future projects, our revenue could significantly decrease, which would adversely affect our financial condition and future growth.

A limited number of our customers can account for a substantial portion of our net revenue. Revenue from engineering and construction firms and other customers representing 10% or more of total revenue varies from year to year. For the twelve months ended December 31, 2008, sales to two customers, Hyflux Ltd and Befesa Agua S.A. represented 27% of our net revenues. For the twelve months ended December 31, 2007, three customers represented approximately 56% of net revenue. No other customer accounted for more than 10% of our net revenue during any of these periods. We do not have long-term contracts with our customers; instead, we sell to them on a purchase order or project basis or under individual stand-alone contracts. Orders may be postponed or delayed by our customers on short or no notice. If these customers reduce their purchases, our projected revenue may significantly decrease, which will adversely affect our financial condition and future growth. If one of our engineering and construction firm customers delays or cancels one or more of its projects, or if it fails to pay amounts due to us or delays its payments, our revenue or operating results could be negatively affected. There are a limited number of engineering and construction firms which are involved in the desalination industry. Thus, if one of them decides not to continue to use our energy recovery devices in its future projects, we may not be able replace such a lost customer with another such customer and our net revenue would be negatively affected.

Our operating results may fluctuate significantly, which makes our future operating results difficult to predict and could cause our operating results to fall below expectations or our guidance.

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. Due to the fact that a single order for our PX devices for a particular desalination plant may represent significant revenue, we have experienced significant fluctuations in revenue from quarter to quarter, and we expect such fluctuations to continue. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on our past results as an indication of our future performance. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, the price of our common stock would likely decline substantially.

In addition, factors that may affect our operating results include, among others:

- fluctuations in demand, adoption, sales cycles and pricing levels for our products and services;
- the cyclical nature of purchasing for seawater reverse osmosis desalination plant construction, which typically reflects a seasonal increase in shipments of PX devices in the fourth quarter;
- changes in customers' budgets for desalination plants and the timing of their purchasing decisions;
- adverse changes in the local or global financing conditions facing our customers;
- delays or postponements in the construction of desalination plants;
- our ability to develop, introduce and ship in a timely manner new products and product enhancements that meet customer demand, certification requirements and technical requirements;
- the ability of our customers to obtain other key components of a plant such as high pressure pumps or membranes;
- our ability to implement scalable internal systems for reporting, order processing, product delivery, purchasing, billing and general accounting, among other functions;
- unpredictability of governmental regulations and political decision-making as to the approval or building of a desalination plant;
- our ability to control costs, including our operating expenses;
- our ability to purchase key PX components, principally ceramics, from third party suppliers;

- our ability to compete against other companies that offer energy recovery solutions;
- our ability to attract and retain highly skilled employees, particularly those with relevant industry experience; and
- general economic conditions in our domestic and international markets.

If we are unable to collect unbilled receivables, our operating results will be adversely affected.

Our customer contracts generally contain holdback provisions pursuant to which the final installments to be paid under such sales contracts are due up to 24 months after the product has been shipped to the customer and revenue has been recognized. Typically, between 10 and 20%, and in some instances up to 30% of the revenue we receive pursuant to our customer contracts are subject to such holdback provisions and are accounted for as unbilled receivables until we deliver invoices for payment. As of December 31, 2008, we had approximately $4.9 million of current unbilled receivables and approximately $1.9 million of non-current unbilled receivables. If we are unable to invoice and collect, or if our customers fail to make payments due under our sales contracts, our results of operations will be adversely affected.

If we lose key personnel upon whom we are dependent, we may not be able to execute our strategies. Our ability to increase our revenue will depend on hiring highly skilled professionals with industry-specific experience, particularly given the unique and complex nature of our devices.

Given the specialized nature of our business, we must hire highly skilled professionals with industry-specific experience. Our ability to successfully grow depends on recruiting skilled and experienced employees. We often compete with larger, better known companies for talented employees. Also, retention of key employees, such as our chief executive officer, who has over 30 years of experience in the water treatment industry, is vital to the successful execution of our growth strategies. Our failure to retain existing or attract future key personnel could harm our business.

The success of our business depends in part on our ability to develop new products and services and increase the functionality of our current products.

Since 2004, we have invested more than $5 million in research and development costs associated with our PX products. From time to time, our customers have expressed a need for greater processing efficiency. In response, and as part of our strategy to enhance our energy recovery solutions and grow our business, we plan to continue to make substantial investments in the research and development of new technologies. For instance, we are in the process of developing the Titan PX as a product for use in increasingly larger desalination plants and the Comp PX for use in smaller desalination operations. While these products have the potential to meet specified needs of key markets, their pricing may not meet customer expectations and they may not perform as well as our other PX devices. It is possible that potential customers may not accept the new pricing structure. It is also possible that the release of this product may be delayed if testing reveals unexpected flaws. Our future success will depend in part on our ability to continue to design and manufacture new products, to enhance our existing products and to provide new value-added services. We may experience unforeseen problems in the performance of our existing and new technologies or products. Furthermore, we may not achieve market acceptance of our new products and solutions. If we are unable to develop competitive new products, or if the market does not accept such products, our business and results of operations will be adversely affected.

Our plans to manufacture a portion of our ceramic components may prove to be more costly or less reliable than outsourcing.

We currently outsource the production of our ceramic components from several ceramic vendors. To diversify our supply of ceramics and retain more control over our intellectual property, we intend to vertically integrate by producing a portion of our ceramic component needs in house. Recent contraction in the ceramics manufacturing business has accelerated our schedule for this initiative. If we are less efficient at producing our ceramic components or are unable to achieve required yields that are equal to or greater than the vendors to

which we outsource, then our cost of revenue may be adversely affected. If we are unable to initiate the production of our ceramics parts on schedule, unable to manufacture these parts in-house efficiently and/or another of our ceramics suppliers goes out of business, we may be exposed to increased risk of supply chain disruption and capacity shortages.

Our revenue and growth model depend upon the continued viability and growth of the seawater reverse osmosis desalination industry using current technology.

If there is a downturn in the seawater reverse osmosis desalination industry, our sales would be directly and adversely impacted. Changes in seawater reverse osmosis desalination technology could also reduce the demand for our devices. For example, a reduction in the operating pressure used in seawater reverse osmosis desalination plants could reduce the need for and viability of our energy recovery devices. Membrane manufacturers are actively working on lower pressure membranes for seawater reverse osmosis desalination that could potentially be used on a large scale to desalinate seawater at a much lower pressure than is currently necessary. Engineers are also evaluating the possibility of diluting seawater prior to reverse osmosis desalination to reduce the required membrane pressure. Similarly, an increase in the recovery rate would reduce the number of energy recovery devices required and would reduce the demand for our product. A significant reduction in the cost of power may reduce demand for our product or favor a less expensive product from a competitor. Any of these changes would adversely impact our revenue and growth.

The durable nature of the PX device may reduce or delay potential aftermarket revenue opportunities.

Our PX devices utilize ceramic components that have to date demonstrated high durability, high corrosion resistance and long life in seawater reverse osmosis desalination applications. Because most of our PX devices have only been installed for several years, it is difficult to accurately predict their performance or endurance over a longer period of time. In the event that our products are more durable than expected, our opportunity for aftermarket revenue may be deferred.

Our sales cycle can be long and unpredictable, and our sales efforts require considerable time and expense. As a result, our sales are difficult to predict and may vary substantially from quarter to quarter, which may cause our operating results to fluctuate.

Our sales efforts involve substantial education of our current and prospective customers about the use and benefits of our PX products. This education process can be time consuming and typically involves a significant product evaluation process. While the sales cycle for our OEM customers, which are involved with smaller desalination plants, averages one to three months, the average sales cycle for our international engineering and construction firm customers, which are involved with larger desalination plants, ranges from nine to 16 months and has, in some cases, extended up to 24 months. In addition, these customers generally must make a significant commitment of resources to test and evaluate our technologies. As a result, our sales process involving these customers is often subject to delays associated with lengthy approval processes that typically accompany the design, testing and adoption of new, technologically complex products. This long sales cycle makes quarter-by-quarter revenue predictions difficult and results in our investing significant resources well in advance of orders for our products.

Since a significant portion of our annual sales typically occurs during the fourth quarter, any delays could affect our fourth quarter and annual revenue and operating results.

A significant portion of our annual sales typically occurs during the fourth quarter, which we believe generally reflects engineering and construction firm customer buying patterns. Any delays or cancellation of expected sales during the fourth quarter would reduce our quarterly and annual revenue from what we anticipated. Such a reduction might cause our quarterly and annual revenue or quarterly and annual operating results to fall below the expectations of investors or securities analysts or below any guidance we may provide to the market, causing the price of our common stock to decline.

We depend on three vendors for our supply of ceramics, which is a key component of our products. If any of our ceramics vendors cancels its commitments or is unable to meet our demand and/or requirements, our business could be harmed.

We rely on a limited number of vendors to produce the ceramics used in our products. For the year ended December 31, 2008, three ceramics suppliers represented approximately 60% of our purchases from all of our suppliers. For the year ended December 31, 2007, two ceramics suppliers represented approximately 52% of our purchases from all of our suppliers. If any of our ceramic suppliers were to have financial difficulties, cancel or materially change their commitments with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition.

We depend on single suppliers for some of our components, including stainless steel castings. If our suppliers are not able to meet our demand and/or requirements, our business could be harmed.

We rely on single suppliers to produce all of our stainless steel castings and some other components for use in our PX products. Our reliance on single manufacturers for these parts involves a number of significant risks, including reduced control over delivery schedules, quality assurance, manufacturing yields, production costs and lack of guaranteed production capacity or product supply. We do not have a long term supply agreement with these suppliers and instead secure manufacturing availability on a purchase order basis. Our suppliers have no obligation to supply products to us for any specific period, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacities of these suppliers and our suppliers may reallocate capacity to other customers, even during periods of high demand for our products. We have in the past experienced and may in the future experience quality control issues and delivery delays with our suppliers due to factors such as high industry demand or the inability of our vendors to consistently meet our quality or delivery requirements. If our suppliers were to cancel or materially change its commitment with us or fail to meet the quality or delivery requirements needed to satisfy customer orders for our products, we could lose time-sensitive customer orders, be unable to develop or sell our products cost-effectively or on a timely basis, if at all, and have significantly decreased revenue, which would harm our business, operating results and financial condition. We may qualify additional suppliers in the future which would require time and resources. If we do not qualify additional suppliers, we may be exposed to increased risk of capacity shortages due to our complete dependence on our current supplier.

We face competition from a number of companies that offers competing energy recovery solutions. If any of these companies produces superior technology or offers more cost effective products, our competitive position in the market could be harmed and our profits may decline.

The market for energy recovery devices for desalination plants is competitive and continually evolving. The PX device competes with slow cycle isobaric, turbine and hydraulic energy recovery devices. Our three primary competitors are Calder AG, Fluid Equipment Development Company and Pump Engineering Incorporated. Other potential competitors may enter the market. We expect competition to persist and intensify as the desalination market opportunity grows. Some of our current and potential competitors may have significantly greater financial, technical, marketing and other resources than we do and may be able to devote greater resources to the development, promotion, sale and support of their products. Also, our competitors may have more extensive customer bases and broader customer relationships than we do, including long-standing relationships or exclusive contracts with our current or potential customers. For instance, we have had difficulties penetrating some of the Caribbean markets because Consolidated Water Co. Ltd., a major builder of seawater reverse osmosis desalination plants in that area, has an exclusive agreement with Calder AG to use Calder's technology. In addition, our competitors may have longer operating histories and greater name recognition than we do. Our competitors may be in a stronger position to respond quickly to new technologies and may be able to market and sell their products more effectively. Moreover, if one or more of our competitors were to merge or partner with another of our competitors or with current or potential customers,

the change in the competitive landscape could adversely affect our ability to compete effectively which would affect our business, operating results and financial condition.

We are subject to risks related to product defects, which could lead to warranty claims in excess of our warranty provisions or result in a large number of warranty claims in any given year.

We warranty our products for a period of one to two years and provide a five year warranty for the ceramic components of our products. We test our products in our manufacturing facilities through a variety of means. However, there can be no assurance that our testing will reveal latent defects in our products, which may not become apparent until after the products have been sold into the market. Accordingly, there is a risk that warranty claims may be filed due to product defects. We may incur additional operating expenses if our warranty provisions do not reflect the actual cost of resolving issues related to defects in our products. If these additional expenses are significant, they could adversely affect our business, financial condition and results of operations. While the number of warranty claims has not been significant to date, we have offered a five year warranty on our ceramic components for new sales agreements executed after August 7, 2007. Accordingly, we cannot quantify the error rate of the ceramic components of our products with statistical accuracy and cannot assure that a large number of warranty claims will not be filed in a given year. As a result, our operating expenses may increase if a large number of warranty claims are filed in any specific year, particularly towards the end of any given warranty period.

If we are unable to protect our technology or enforce our intellectual property rights, our competitive position could be harmed and we could be required to incur significant expenses to enforce our rights.

Our competitive position depends on our ability to establish and maintain proprietary rights in our technology and to protect our technology from copying by others. We rely on trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which may offer only limited protection. We hold five United States patents and eleven patents outside the U.S. that are counterparts to one of the U.S. patents. The expiration terms of the U.S. patents range from 2011 to 2025, at which time we could become more vulnerable to increased competition. In addition, we have applied for two new United States patents and seven pending international applications corresponding to the U.S. patents and patent applications. We do not hold patents in many of the countries into which we sell our PX devices, including Saudi Arabia, Algeria and China, and accordingly, the protection of our intellectual property in those countries may be limited. We also do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, while we believe our remaining issued patents are essential to the protection of the PX technology, the rights granted under any of our issued patents or patents that may be issued in the future may not provide us with proprietary protection or competitive advantages, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future. In addition, our granted patents may not prevent misappropriation of our technology, particularly in foreign countries where intellectual property laws may not protect our proprietary rights as fully as those in the United States. This may render our patents impaired or useless and ultimately expose us to currently unanticipated competition. Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights or to determine the validity and scope of the proprietary rights of others. This litigation could result in substantial costs and diversion of management resources, either of which could harm our business.

Claims by others that we infringe their proprietary rights could harm our business.

Third parties could claim that our technology infringes their proprietary rights. In addition, we may be contacted by third parties suggesting that we obtain a license to certain of their intellectual property rights they may believe we are infringing. We expect that infringement claims against us may increase as the number of products and competitors in our market increases and overlaps occur. In addition, to the extent that we gain greater visibility, we believe that we will face a higher risk of being the subject of intellectual property

infringement claims. Any claim of infringement by a third party, even those without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment against us could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms, or at all. Alternatively, we may be required to develop non-infringing technology, which could require significant effort and expense and may ultimately not be successful. Any of these events could seriously harm our business. Third parties may also assert infringement claims against our customers. Because we generally indemnify our customers if our products infringe the proprietary rights of third parties, any such claims would require us to initiate or defend protracted and costly litigation on their behalf, regardless of the merits of these claims. If any of these claims succeeds, we may be forced to pay damages on behalf of our customers.

If we fail to expand our manufacturing facilities to meet our future growth, our operating results could be adversely affected.

Our existing manufacturing facilities are capable of meeting current demand and demand for the foreseeable future. However, the future growth of our business depends on our ability to successfully expand our manufacturing, research and development and technical testing facilities. Larger products currently under development require a larger manufacturing facility with greater capacity. We have entered into a 10 year lease for a 124,000 square foot facility in San Leandro, California. While this space will be available to accommodate the consolidation of our U.S. operations and the expansion of our manufacturing operations, the space is being built out and will not be available until September 2009 or later. If the build-out is delayed, our production capability could be limited, which could adversely affect our operating results.

If we need additional capital to fund future growth, it may not be available on favorable terms, or at all.

We have historically relied on outside financing to fund our operations, capital expenditures and expansion. In our initial public offering in July 2008, we issued approximately 10,000,000 shares of common equity at $8.50 per share before underwriting discount and issuing expenses. We may require additional capital from equity or debt financing in the future to fund our operations, or respond to competitive pressures or strategic opportunities. We may not be able to secure such additional financing on favorable terms, or at all. The terms of additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer significant dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences or privileges senior to those of existing or future holders of our common stock, including shares of common stock sold in this offering. If we are unable to obtain necessary financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be significantly limited.

If foreign and local government entities no longer guarantee and subsidize, or are willing to engage in, the construction and maintenance of desalination plants and projects, the demand for our products would decline and adversely affect our business.

Our products are used in seawater reverse osmosis desalination plants which are often times constructed and maintained through government guarantees and subsidies. The rate of construction of desalination plants depends on each government's willingness and ability to allocate funds for such projects, which may be affected by the current crisis in the financial system and credit markets and the weak global economy. In addition, some desalination projects in the Middle East and North Africa have been funded by budget surpluses resulting from once high crude oil and natural gas prices. Since prices for crude oil and natural gas have fallen, governments in those countries may not have budget surpluses to fund such projects and may cancel such projects or divert funds allocated for them to other projects. As a result, the demand for our products could decline and negatively affect our revenue base, which could harm the overall profitability of our business.

In addition, various water management agencies could alter demand for fresh water by investing in water reuse initiatives or limiting the use of water for certain agricultural purposes. Certain uses of water considered to be wasteful could be curtailed, resulting in more available water and less demand for alternative solutions such as desalination.

Our products are highly technical and may contain undetected flaws or defects which could harm our business and our reputation and adversely affect our financial condition.

The manufacture of our products is highly technical, and our products may contain latent defects or flaws. We test our products prior to commercial release and during such testing have discovered and may in the future discover flaws and defects that need to be resolved prior to release. Resolving these flaws and defects can take a significant amount of time and prevent our technical personnel from working on other important tasks. In addition, our products have contained and may in the future contain one or more flaws that were not detected prior to commercial release to our customers. Some flaws in our products may only be discovered after a product has been installed and used by customers. Any flaws or defects discovered in our products after commercial release could result in loss of revenue or delay in revenue recognition, loss of customers and increased service and warranty cost, any of which could adversely affect our business, operating results and financial condition. In addition, we could face claims for product liability, tort or breach of warranty. Our contracts with our customers contain provisions relating to warranty disclaimers and liability limitations, which may not be upheld. Defending a lawsuit, regardless of its merit, is costly and may divert management's attention and adversely affect the market's perception of us and our products. In addition, if our business liability insurance coverage proves inadequate or future coverage is unavailable on acceptable terms or at all, our business, operating results and financial condition could be harmed.

Our international sales and operations subject us to additional risks that may adversely affect our operating results.

Historically, we have derived a significant portion of our revenue from customers whose seawater reverse osmosis desalination facilities utilizing the PX device are outside the United States. Many of such customers' projects are in emerging growth countries with relatively young and unstable market economies and volatile political environments. These countries may also be affected significantly by the current crisis in the global financial system and credit markets and the weak global economy. We have sales and technical support personnel stationed in Spain, Asia and the Middle East, among other regions, and we expect to continue to add personnel in other countries. As a result, any governmental changes or reforms or disruptions in the business, regulatory or political environments of the countries in which we operate or sell our products could have a material adverse effect on our business, financial condition and results of operations.

Sales of our products have to date been denominated principally in U.S. dollars. The U.S. dollar has recently strengthened against most other currencies, which has effectively increased the price of our products in the currency of the countries in which our customers are located. This may result in our customers seeking lower-priced suppliers, which could adversely impact our operating results. A larger portion of our international revenue may be denominated in foreign currencies in the future, which would subject us to increased risks associated with fluctuations in foreign exchange rates.

Our international contracts and operations subject us to a variety of additional risks, including:

- political and economic uncertainties, which the current global economic crisis may exacerbate;
- reduced protection for intellectual property rights;
- trade barriers and other regulatory or contractual limitations on our ability to sell and service our products in certain foreign markets;
- difficulties in enforcing contracts, beginning operations as scheduled and collecting accounts receivable, especially in emerging markets;

- increased travel, infrastructure and legal compliance costs associated with multiple international locations;
- competing with non-U.S. companies not subject to the U.S. Foreign Corrupt Practices Act;
- difficulty in attracting, hiring and retaining qualified personnel; and
- increasing instability in the capital markets and banking systems worldwide, especially in developing countries, that may limit project financing availability for the construction of desalination plants.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks successfully could harm our international operations and reduce our international sales, which in turn could adversely affect our business, operating results and financial condition.

Global economic conditions and the current crisis in the financial markets could have an adverse effect on our business and results of operations.

Current economic conditions may negatively impact our business and make forecasting future operating results more difficult and uncertain. A weakening global economy may cause our customers to delay or push out orders for our products or may result in the delay, postponement or cancelling of planned or new desalination projects or retrofits, which would reduce our revenue. Turmoil in the financial and credit markets may also make it difficult for our customers to obtain needed project financing, resulting in lower sales. Negative economic conditions may also affect our suppliers, which could impede their ability to remain in business and supply us with parts, resulting in delays in the availability of our products. In addition, most of our cash and cash equivalents are currently invested in money market funds backed by United States Treasury securities; however, given the current weak global economy and the instability of financial institutions, we cannot be assured that we will not experience losses on our deposits, which would adversely affect our financial condition. If current economic conditions persist or worsen and negatively impact the desalination industry, our business, financial condition or results of operations could be materially and adversely affected.

If we fail to manage future growth effectively, our business would be harmed.

Future growth in our business, if it occurs, will place significant demands on our management, infrastructure and other resources. To manage any future growth, we will need to hire, integrate and retain highly skilled and motivated employees. We will also need to continue to improve our financial and management controls, reporting and operational systems and procedures. If we do not effectively manage our growth, our business, operating results and financial condition would be adversely affected.

Our failure to achieve or maintain adequate internal control over financial reporting in accordance with SEC rules or prevent or detect material misstatements in our annual or interim consolidated financial statements in the future could materially harm our business and cause our stock price to decline.

As a public company, SEC rules require that we maintain internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and preparation of published financial statements in accordance with generally accepted accounting principles. Accordingly, we will be required to document and test our internal controls and procedures to assess the effectiveness of our internal control over financial reporting. In addition, our independent registered public accounting firm will be required to report on the effectiveness of our internal control over financial reporting. In the future, we may identify material weaknesses and deficiencies which we may not be able to remediate in a timely manner. Material weaknesses may exist when we are first required to report on the effectiveness of our internal control over financial reporting in our Annual Report on Form 10-K for the year ending December 31, 2009. If there are material weaknesses or deficiencies in our internal control, we will not be able to conclude that we have maintained effective internal control over financial reporting or our independent registered public accounting firm may not be able to issue an unqualified report on the effectiveness of our internal control over financial reporting. As a result, our ability to report our financial results on a timely and accurate basis may be

adversely affected and investors may lose confidence in our financial information, which in turn could cause the market price of our common stock to decrease. We may also be required to restate our financial statements from prior periods. In addition, testing and maintaining internal control will require increased management time and resources. Any failure to maintain effective internal control over financial reporting could impair the success of our business and harm our financial results and you could lose all or a significant portion of your investment. If we have material weaknesses in our internal control over financial reporting, the accuracy and timing of our financial reporting may be adversely affected.

Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.

We prepare our financial statements to conform to generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the SEC and various other bodies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the interpretation of our current practices may adversely affect our reported financial results or the way we conduct our business.

We may engage in future acquisitions that could disrupt our business, cause dilution to our stockholders and harm our financial condition and operating results.

In the future, we may acquire companies or assets that we believe may enhance our market position. We may not be able to find suitable acquisition candidates and we may not be able to complete acquisitions on favorable terms, if at all. If we do complete acquisitions, we cannot assure you that they will ultimately strengthen our competitive position or that they will not be viewed negatively by customers, financial markets or investors. In addition, any acquisitions that we make could lead to difficulties in integrating personnel and operations from the acquired businesses and in retaining and motivating key personnel from these businesses. Acquisitions may disrupt our ongoing operations, divert management from day-to-day responsibilities, increase our expenses and harm our operating results or financial condition. Future acquisitions may reduce our cash available for operations and other uses and could result in an increase in amortization expense related to identifiable assets acquired, potentially dilutive issuances of equity securities or the incurrence of debt, any of which could harm our business, operating results and financial condition.

Insiders will continue to have substantial control over us after this offering and will be able to influence corporate matters.

Our directors and executive officers and their affiliates beneficially own, in the aggregate, approximately 14% of our outstanding common stock as of March 19, 2009. As a result, these stockholders will be able to exercise significant influence over all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions, such as a merger or other sale of our company or its assets.

Anti-takeover provisions in our charter documents and under Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.

Provisions in our amended and restated certificate of incorporation and bylaws may have the effect of delaying or preventing a change of control or changes in our management. Our amended and restated certificate of incorporation and amended and restated bylaws include provisions that:

- authorize our board of directors to issue, without further action by the stockholders, up to 10,000,000 shares of undesignated preferred stock;
- require that any action to be taken by our stockholders be effected at a duly called annual or special meeting and not by written consent;

- specify that special meetings of our stockholders can be called only by our board of directors, the chairman of the board, the chief executive officer or the president;
- establish an advance notice procedure for stockholder approvals to be brought before an annual meeting of our stockholders, including proposed nominations of persons for election to our board of directors;
- establish that our board of directors is divided into three classes, Class I, Class II and Class III, with each class serving staggered terms;
- provide that our directors may be removed only for cause;
- provide that vacancies on our board of directors may be filled only by a majority vote of directors then in office, even though less than a quorum;
- specify that no stockholder is permitted to cumulate votes at any election of directors; and
- require a super-majority of votes to amend certain of the above-mentioned provisions.

In addition, we are subject to the provisions of Section 203 of the Delaware General Corporation Law regulating corporate takeovers. Section 203 generally prohibits us from engaging in a business combination with an interested stockholder subject certain exceptions.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

We lease approximately 29,000 square feet of space in San Leandro, California, under a lease that expires in June 2010, for product manufacturing, research and development and executive headquarters. We also lease approximately 9,000 square feet for corporate office space in a building located approximately two miles away from our headquarters under a lease that expires in March 2010. In November 2008, we entered into a 10 year lease for approximately 124,000 square feet of space in a building located near our current headquarters and scheduled for occupancy in late 2009. This new building will house all of our manufacturing, research and development and executive staff and allow for the expansion of our manufacturing operations. We also lease sales offices in Spain, the United Arab Emirates, China and Florida. We believe these facilities will be adequate for our purposes for the foreseeable future.

Item 3. ***Legal Proceedings***

We are not party to any material litigation, and we are not aware of any pending or threatened litigation against us that we believe would adversely affect our business, operating results, financial condition or cash flows. In the future, we may be subject to legal proceedings in the ordinary course of our business.

Item 4. ***Submission of Matters to a Vote of Security Holders***

There were no submissions of matters to a vote of security holders in the quarter ended December 31, 2008.

PART II

Item 5. ***Market for the Registrant's Common Stock Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Market Information

Since July 2, 2008, our common stock has been quoted on the Nasdaq Global Market under the symbol "ERII".

The following table sets forth the high and low sales prices of our common stock for the periods indicated.

	High	Low
2008		
Third Quarter (from July 2, 2008)	$ 13.25	$ 6.89
Fourth Quarter	$ 10.12	$ 4.57

Stockholders

As of March 24, 2009, there were approximately 75 stockholders of record of our common stock.

Use of Proceeds

On July 1, 2008, our registration statement (No. 333-150007) on Form S-1 was declared effective for our initial public offering, pursuant to which we registered the offering and sale of an aggregate 16,100,000 shares of common stock, including the underwriters' over-allotment option, at a public offering price of $8.50 per share, or aggregate offering price of $136.9 million, of which $86.5 million related to 10,178,566 shares sold by us and $50.4 million related to 5,921,434 shares sold by selling stockholders. The offering closed on July 8, 2008 with respect to the primary shares and on July 11, 2008 with respect to the over-allotment shares. The managing underwriters were Citigroup Global Markets Inc. and Credit Suisse Securities (USA) LLC.

As a result of the offering, we received net proceeds of approximately $76.7 million, after deducting underwriting discounts and commissions of $6.1 million and additional offering-related expenses of approximately $3.7 million. No payments for such expenses were made directly or indirectly to (i) any of our officers or directors or their associates, (ii) any persons owning 10% or more of any class of our equity securities, or (iii) any of our affiliates. We anticipate that we will use the remaining net proceeds from our IPO for working capital and other general corporate purposes, including to finance our growth, develop new products, fund capital expenditures, or to expand our existing business through acquisitions of other businesses, products or technologies. However, we do not have agreements or commitments for acquisitions at this time. Pending such uses, we have deposited a substantial amount of the net proceeds in a U.S. Treasury based money market fund as of December 31, 2008. There has been no material change in the planned use of proceeds from our IPO from that described in the final prospectus filed with the SEC pursuant to Rule 424(b).

Dividend Policy

We have never declared or paid any cash dividends on our capital stock and we do not currently intend to pay any cash dividends on our capital stock for the foreseeable future. We expect to retain future earnings, if any, to fund the development and growth of our business. Any future determination to pay dividends on our capital stock will be, subject to applicable law, at the discretion of our board of directors and will depend upon, among other factors, our results of operations, financial condition, capital requirements and contractual restrictions in loan agreements or other agreements.

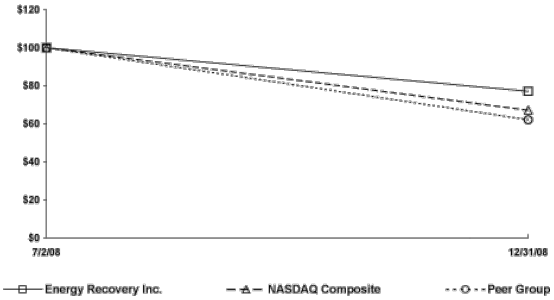
Stock Performance Graph

The following graph shows the cumulative total shareholder return of an investment of $100 on July 2, 2008 in (i) our common stock and (ii) a selected group of peer issuers ("Peer Group") and (iii) on June 30, 2008

in the Nasdaq Composite Index. The total return for our stock and each index and peer group assumes the reinvestment of dividends, although dividends have never been declared on our stock, and is based on the returns of the component companies weighted according to their capitalizations as of the end of each quarterly period. The Nasdaq Composite Index tracks the aggregate price performance of equity securities traded on the Nasdaq. The Peer Group tracks the weighted average price performance of equity securities of seven companies in our industry, including Consolidated Water Company Limited, Flowserve Corporation, Hyflux Ltd, Kurita Water Industries Limited, Pentair Inc., Tetra Tech, Inc. and The Gorman-Rupp Company. The returns of each component issuer of the Peer Group is weighted according to the respective issuer's stock market capitalization at the beginning of each period for which a return is indicated. Our stock price performance shown in the graph below is not indicative of future stock price performance.

The following graph and its related information is not "soliciting material," is not deemed "filed" with the SEC, and is not to be incorporated by reference into any filing of the Company under the 1933 Act or 1934 Act, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing.

COMPARISON OF 6 MONTH CUMULATIVE TOTAL RETURN*
Among Energy Recovery Inc., The NASDAQ Composite Index
And A Peer Group



* $100 invested on 7/2/08 in Energy Recovery, Inc. or peer group stock or on 6/30/08 in index, including reinvestment of dividends. Fiscal year ending December 31.

	6/30/08 or 7/2/08(1)	12/31/08
Energy Recovery, Inc.	**100.00**	**77.11**
NASDAQ Composite	**100.00**	**67.14**
Peer Group	**100.00**	**62.14**

(1) The index measurement date is 6/30/08; stock measurement dates are 7/2/08

Recent Sales of Unregistered Securities

None.

Purchases of Equity Securities by the Issuer and Affiliated Purchasers

Stock repurchase activity during the three months ended December 31, 2008 was as follows:

Period	Total Number of Shares Purchased(1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	Maximum Dollar Value that May Yet be Purchased Under the Programs
October 1, 2008- October 31, 2008	1,667	$ 0.25	—	$ —
November 1, 2008- November 30, 2008	—	$ —	—	$ —
December 1, 2008- December 31, 2008	—	$ —	—	$ —
Total	1,667		—	

(1) The company exercised its rights to repurchase 1,667 unvested shares related to the early exercise of stock options. The unvested shares were repurchased from a shareholder in exchange for cash and were cancelled upon completion of the repurchase.

Item 6. ***Selected Financial Data***

The following selected financial data should be read in conjunction with the "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the financial statements and notes thereto included in this Report on Form 10-K.

	Years Ended December 31,				
	2008(1)	2007(1)	2006(1)	2005	2004
Consolidated Statement of Income Data:					
Net revenue	$ 52,119	$ 35,414	$ 20,058	$ 10,689	$ 4,047
Cost of revenue(2)	18,933	14,852	8,131	4,685	2,015
Gross profit	33,186	20,562	11,927	6,004	2,032
Operating expenses:					
General and administrative(2)	11,321	4,299	3,372	2,458	1,055
Sales and marketing(2)	6,549	5,230	3,648	1,779	1,037
Research and development(2)	2,415	1,705	1,267	630	340
Total operating expenses	20,285	11,234	8,287	4,867	2,432
Income from operations	12,901	9,328	3,640	1,137	(400)
Other income (expense):					
Interest expense	(79)	(105)	(77)	(216)	(54)
Interest and other income	873	517	58	35	1
Income before provision for income taxes	13,695	9,740	3,621	956	(453)
Provision for income taxes	5,032	3,947	1,239	62	53
Net income (loss)	$ 8,663	$ 5,793	$ 2,382	$ 894	$ (506)
Earnings per share-basic	$ 0.19	$ 0.15	$ 0.06	$ 0.02	$ (0.02)
Earnings per share-diluted	$ 0.18	$ 0.14	$ 0.06	$ 0.02	$ (0.02)
Number of shares used in per share calculations:					
Basic	44,848	39,060	38,018	36,790	32,161
Diluted	47,392	41,433	40,244	38,454	32,161

	As of December 31,				
	2008	2007(4)	2006(4)	2005	2004
Consolidated Balance Sheet Data:					
Cash, cash equivalents and short-term investments	$ 79,287	$ 240	$ 42	$ 261	$ 140
Total assets	120,612	28,227	17,937	8,496	3,054
Long-term liabilities	420	620	234	306	11
Total liabilities	13,613	8,166	9,810	3,794	2,061
Total stockholders' equity	106,999	20,061	8,127	4,702	993

(1) Effective January 1, 2006, we adopted the fair value recognition provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123(R), using the prospective transition method, which requires the application of the provisions of SFAS 123(R) only to share-based payment awards granted, modified, repurchased or cancelled on or after the modification date. Under this method, we recognize stock-based compensation expense for all share-based payment awards granted after December 31, 2005 in accordance with SFAS 123(R).

(2) Includes employee and non-employee stock-based compensation as follows:

	Years Ended December 31,				
	2008	2007	2006	2005	2004(3)
Cost of revenue	$ 103	$ 117	$ 143	$ 88	—
General and administrative	512	388	428	731	—
Sales and marketing	279	372	310	86	—
Research and development	140	159	183	98	—
Total stock-based compensation	$ 1,034	$ 1,036	$ 1,064	$ 1,003	—

(3) No stock-based compensation expense was recognized as we used the intrinsic method of accounting and the options were granted with an exercise price equal to the fair market value.

(4) Certain prior period balances have been reclassified to conform to the current period presentation.

Item 7. ***Management's Discussion and Analysis of Financial Condition and Results of Operations***

This Annual Report on Form 10-K and certain information incorporated by reference contain forward-looking statements within the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements in this report include, but are not limited to, statements about our expectations, objectives, anticipations, plans, hopes, beliefs, intentions or strategies regarding the future.

Forward-looking statements represent our current expectations about future events and are based on assumptions and involve risks and uncertainties. If the risks or uncertainties occur or the assumptions prove incorrect, then our results may differ materially from those set forth or implied by the forward-looking statements. Our forward-looking statements are not guarantees of future performance or events.

Forward-looking statements in this report include, without limitation, statements about the following:

- *our belief that our PX devices make seawater reverse osmosis a more affordable means of fresh water production;*
- *our plan to enhance our existing PX devices and to develop and manufacture new PX devices;*
- *our plans to release the Titan and Comp PX devices in the future;*
- *our belief that our ceramics components are highly durable and corrosion-proof;*
- *our objective of finding new applications for our technology outside of desalination and expanding and diversifying our product offerings;*
- *our plan to integrate vertically and manufacture a portion of our ceramics components internally;*

- *our expectation that our expenditures for research and development will increase;*
- *our expectation that we will continue to rely on sales of our PX devices for a substantial portion of our revenue;*
- *our expectation that a significant portion of our annual sales will continue to occur during the fourth quarter;*
- *our belief that our current facilities will be adequate through 2009;*
- *our expectation that sales outside of the United States will remain a significant portion of our revenue;*
- *our expectation that future sales and marketing expense will increase;*
- *our belief that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months; and*
- *our expectation that, as we expand our international sales, a portion of our revenue could continue to be denominated in foreign currencies.*

All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under "Item 1A: Risk Factors" and are based on information available to us as of March 26, 2009. We assume no obligation to update any such forward-looking statements. It is important to note that our actual results could differ materially from the results set forth or implied by our forward-looking statements. The factors that could cause our actual results to differ from those included in such forward-looking statements are set forth under the heading "Item 1A: Risk Factors," and our results disclosed from time to time in our reports on Forms 10-Q and 8-K and our Annual Reports to Stockholders.

The following discussion should be read in conjunction with our Consolidated Financial Statements and related notes included elsewhere in this report.

Overview

We are in the business of designing, developing and manufacturing energy recovery devices for sea water reverse osmosis desalination. Our company was founded in 1992 and we introduced the initial version of our energy recovery device, the PX®, in early 1997. As of December 31, 2008, we had shipped approximately 5,900 PX devices to desalination plants worldwide.

A majority of our net revenue has been generated by sales to large engineering and construction firms, which are involved with the design and construction of larger desalination plants. Sales to these firms often involve a long sales cycle, which can range from six to 16 months. A single large desalination project can generate an order for numerous PX devices and generally represents an opportunity for significant revenue. We also sell PX devices to original equipment manufacturers, or OEMs, which commission smaller desalination plants, order fewer PX devices per plant and have shorter sales cycles.

Due to the fact that a single order for PX devices by a large engineering and construction firm for a particular plant may represent significant revenue, we often experience significant fluctuations in net revenue from quarter to quarter. In addition, our engineering and construction firm customers tend to order a significant amount of equipment for delivery in the fourth quarter and, as a consequence, a significant portion of our annual sales typically occurs during that quarter.

A limited number of our customers accounts for a substantial portion of our net revenue. Five customers accounted for approximately 82% of our accounts receivable at December 31, 2008. As of December 31, 2007, three customers accounted for approximately 74% of accounts receivable.

Revenue from customers representing 10% or more of total revenue varies from year to year. For the year ended December 31, 2008, two customers, Hyflux Ltd. and Befesa Agua, S.A. and affiliated joint ventures accounted for approximately 16% and 11% of our net revenue, respectively. For the year ended December 31, 2007, three customers represented approximately 20%, 23% and 13% of our net revenue — specifically Acciona Agua, Geida and its member companies, and Doosan Heavy Industries, respectively. In 2006, two customers, GE Water and Process Technologies (formerly GE Ionics) and Geida, including its member companies, accounted for approximately 18% and 11% of our net revenue, respectively. No other customer

accounted for more than 10% of net revenue during any of these periods. Geida is a consortium of Befesa Agua S.A., a subsidiary of Abengoa S.A; Cobra-Tedagua, a subsidiary of ACS Actividades de Construcción y Servicios, S.A.; and Sadyt S.A., a subsidiary of Sacyr Vallehermoso, S. A.

During the years ended December 31, 2008, 2007 and 2006 most of our revenue was attributable to sales outside of the United States. We expect sales outside of the United States to remain a significant portion of our revenue for the foreseeable future.

Our revenue is principally derived from the sales of our PX devices. We receive a small amount of revenue from the sale of high pressure circulation pumps, which we manufacture and sell in connection with PX devices to smaller desalination plants. We also receive incidental revenue from services, such as product support, that we provide to our PX customers.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States, or GAAP. These accounting principles require us to make estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements as well as the reported amounts of revenue and expense during the periods presented. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that we make these estimates and judgments. To the extent there are material differences between these estimates and actual results, our consolidated financial results will be affected. The accounting policies that reflect our more significant estimates and judgments and which we believe are the most critical to aid in fully understanding and evaluating our reported financial results are revenue recognition, warranty costs, stock-based compensation, inventory valuation, allowances for doubtful accounts and income taxes.

Revenue Recognition

We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 104, *Revenue Recognition*. Revenue is recognized when the earnings process is complete, as evidenced by an agreement with the customer, transfer of title occurs, fixed pricing is determinable and collection is reasonably assured. Transfer of title typically occurs upon shipment of the equipment pursuant to a written purchase order or contract. Emerging Issues Task Force No. 00-21, *Revenue Arrangements with Multiple Deliverables* requires us to allocate the purchase price between the device and the value of the undelivered services by applying the residual value method. Under this method, revenue allocated to undelivered elements is based on vendor objective evidence of fair value of such undelivered elements, and the residual revenue is allocated to the delivered elements, assuming that the delivered elements have stand-alone value. Vendor objective evidence of fair value for such undelivered elements is based upon the price we charge for such product or service when it is sold separately. We may modify our pricing practices in the future, which could result in changes to our vendor objective evidence of fair value for such undelivered elements. Our purchase agreements typically provide for the provision by us of field services and training for commissioning of a desalination plant. Recognition of the revenue in respect of those services is deferred until provision of those services is complete. The services element of our contracts represent an incidental portion of the total contract price.

Under our revenue recognition policy, evidence of an arrangement has been met when we have an executed purchase order or a stand-alone contract. Typically, our smaller projects utilize purchase orders that conform to our standard terms and conditions that require the customer to remit payment generally within 30 to 90 days from product delivery. In some cases, if credit worthiness cannot be determined, prepayment is required from the smaller customers.

For our large projects, stand-alone contracts are utilized. For these contracts, consistent with industry practice, the customers typically require their suppliers, including our company, to accept contractual holdback provisions whereby the final amounts due under the sales contract are remitted over extended periods of time. These retention payments typically range between 10% and 20%, and in some instances up to 30%, of the total contract amount and are due and payable when the customer is satisfied that certain specified product performance criteria have been met upon commissioning of the desalination plant, which in the case of our PX device may be 12 months to 24 months from the date of product delivery as described further below.

The specified product performance criteria for our PX device generally pertains to the ability of our products to meet our published performance specifications and warranty provisions, which our products have demonstrated on a consistent basis. This factor, combined with our historical performance metrics measured over the past 10 years, provides us with a reasonable basis to conclude that the PX device will perform satisfactorily upon commissioning of the plant. To help ensure this successful product performance, we provide service, consisting principally of advisory, consulting and training services to the customers during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer with the consultation of our personnel. We defer the value of the service and training component of the contract and recognize such revenue as services are rendered. Based on these

factors, we have concluded that delivery and performance have been completed when the product has been delivered (title transfers) to the customer.

We perform an evaluation of credit worthiness on an individual contract basis to assess whether collectability is reasonably assured. As part of this evaluation, we consider many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and our prior history or industry specific knowledge about the customer and its supplier relationships. To date, we have been able to conclude that collectability was reasonably assured on our sales contracts at the time the product was delivered and title has transferred; however, to the extent that we conclude that we are unable to determine that collectability is reasonably assured at the time of product delivery, we will defer all or a portion of the contract amount based on the specific facts and circumstances of the contract and the customer.

Under the stand-alone contracts, the usual payment arrangements are summarized as follows:

- An advance payment, typically 10% to 20% of the total contract amount, is due upon execution of the contract;
- A payment upon delivery of the product, typically in the range of 50% to 70% of the total contract amount, is due on average between 90 and 150 days from product delivery, and in some cases up to 180 days;
- A retention payment, typically in the range of 10% to 20%, and in some cases up to 30%, of the total contract amount is due subsequent to product delivery as described further below.

Under the terms of the retention payment component, we are generally required to issue to the customer a product performance guarantee in the form of an irrevocable standby letter of credit, which is issued to the customer approximately 12 to 24 months after the product delivery date. The letter of credit is either collateralized by restricted cash on deposit with our financial institution (see Restricted Cash under “Summary of Significant Accounting Policies”) or funds available through a credit facility. The letter of credit remains in place for the performance period as specified in the contract, which is generally 12 to 36 months and, in some cases, up to 65 months from issuance. The performance period generally runs concurrent with our standard product warranty period. Once the letter of credit has been put in place, we invoice the customer for this final retention payment under the sales contract. During the time between the product delivery and the issuance of the letter of credit, the amount of the final retention is classified on the balance sheet as unbilled receivable, of which a portion may be classified as long term to the extent that the billable period extends beyond one year. Once the letter of credit is issued, we invoice the customer and reclassify the retention amount from unbilled receivable to accounts receivable where it remains until payment, typically 90 to 150 days after invoicing, and in some cases up to 180 days (see Note 3 — Balance Sheet Information: Unbilled Receivables).

Shipping and handling charges billed to customers are included in sales. The cost of shipping to customers is included in cost of revenue.

We do not provide our customers with a right to return our products. However, we accept returns of products that are deemed to be damaged or defective when delivered, subject to the provisions of the product warranty. Historically, product returns have not been significant.

We sell our products to large engineering and construction firms that are not subject to sales tax. Accordingly, the adoption of EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)*, does not have an impact on our consolidated financial statements.

Warranty Costs

We sell products with a limited warranty generally for a period of one to two years. In August 2007, we modified the warranty to offer a five-year term on the ceramic components for new sales agreements executed after August 7, 2007. We accrue for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. We periodically evaluate and adjust the warranty costs to the extent actual warranty costs vary from the original estimates.

We may offer extended warranties on an exception basis and these are accounted for in accordance with Financial Accounting Standards Board Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts for Sales of Extended Warranties*.

Stock-Based Compensation

Prior to January 1, 2006, we accounted for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25, and FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation*, an Interpretation of APB Opinion No. 25, or FIN 44, and had adopted the disclosure provisions of Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation*, or SFAS 123, and SFAS No. 148, *Accounting for Share-Based Compensation — Transition and Disclosure*, or SFAS 148.

In February 2005, we offered to each of our employees the option to borrow from us an amount equal to the aggregate exercise price for all of their outstanding options pursuant to full recourse promissory notes at 3.76% interest, which are due in February 2010. The interest rate on the notes was deemed to be below market rate, resulting in a change in the deemed exercise price for the options. As a result, we are accounting for these options as variable option awards. For 2008, 2007 and 2006, we recorded $155,000, $783,000, and $1.1 million, respectively, of stock-based compensation related to the options exercised with promissory notes. All of our executive officers and directors have subsequently repaid their notes.

Effective January 1, 2006, we adopted the fair value recognition provisions of SFAS No. 123(R), *Share-Based Payment*, using the prospective transition method, which requires us to apply the provisions of SFAS 123(R) only to awards granted, modified, repurchased or cancelled after the adoption date. Upon adoption of SFAS 123(R), we selected the Black-Scholes option pricing model as the most appropriate method for determining the estimated fair value for stock-based awards. The Black-Scholes model requires the use of highly subjective and complex assumptions to determine the fair value of stock-based awards, including the option's expected term and the price volatility of the underlying stock. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite vesting period on a straight-line basis in our consolidated statements of income. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. For the years ended December 31, 2008, 2007 and 2006 we recognized stock-based compensation under SFAS 123(R) and EITF 96-18 related to employees and consultants of $879,000, $253,000 and $13,000, respectively.

We use the Black-Scholes options pricing model to determine the fair value of stock options. The determination of the fair value of stock-based payment awards on the date of grant is affected by stock price as well as assumptions regarding a number of complex and subjective variables. These variables include expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rates and expected dividends. The estimated grant date fair values of the employee stock options were calculated using the Black-Scholes options pricing model, based on the following assumptions:

	Years Ended December 31,		
	2008	2007	2006
Expected term	5 years	5 years	5 years
Expected volatility	48%	50%	50%
Risk-free interest rate	1.55-3.41%	3.41-4.92%	4.45-5.10%
Dividend yield	0%	0%	0%

Expected Term. Under our option plans, the expected term of options granted is determined using the weighted average period during which the stock options are expected to remain outstanding and is based on the options vesting term, contractual terms and disclosure information from similar publicly traded companies

to develop reasonable expectations about future exercise patterns and post-vesting employment termination behavior.

Expected Volatility. Since we are a newly public entity with limited historical data regarding the volatility of our common stock price, the expected volatility used is based on volatility of a representative industry peer group. In evaluating similarity, we considered factors such as industry, stage of life cycle and size.

Risk-Free Interest Rate. The risk-free rate is based on U.S. Treasury issues with remaining terms similar to the expected term on the options.

Dividend Yield. We have never declared or paid any cash dividends and do not plan to pay cash dividends in the foreseeable future, and, therefore, used an expected dividend yield of zero in the valuation model.

Forfeitures. SFAS No. 123R also requires us to estimate forfeitures at the time of grant, and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

The absence of an active market for our common stock prior to July 2008 required management and the board of directors to estimate the fair value of its common stock for purposes of granting options and for determining stock-based compensation expense for options granted prior to July 2008. In response to these requirements, management and the board of directors estimated the fair market value of common stock based on factors such as the price of the most recent common stock sales to investors, the valuations of comparable companies, the status of development and sales efforts, our cash and working capital amounts, revenue growth, and additional objective and subjective factors relating to our business on an annual basis.

Stock-based compensation expense related to awards granted and or modified to employees was allocated as follows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Cost of revenue	$ 103	$ 117	$ 143
General and administrative	419	383	425
Sales and marketing	274	349	310
Research and development	140	159	183
Total	$ 936	$ 1,008	$ 1,061

To calculate the excess tax benefits available as of the date of adoption for use in offsetting future tax shortfalls, we elected the "short-form" method in accordance with FASB Staff Position FAS No. 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards*.

Stock-Based Compensation — Non-Employees

We account for awards granted to non-employees other than members of our board of directors in accordance with SFAS 123 and the EITF Abstract No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services,* which require such awards to be recorded at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying awards vest. We amortize compensation expense related to non-employee awards in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.*

The fair value of stock options issued to consultants was calculated using the Black-Scholes options pricing model, based on the following assumptions:

	Years Ended December 31,		
	2008	2007	2006
Expected term	1-10 years	1-10 years	10 years
Expected volatility	48%	50%	50%
Risk-free interest rate	1.55% 2.46%	3.45%-4.92%	4.70%
Dividend yield	0%	0%	0%

Stock-based compensation expense related to awards granted and/or modified to non-employees was allocated as follows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
General and administrative	$ 93	$ 23	$ —
Sales and marketing	5	5	3
	$ 98	$ 28	$ 3

Inventories

Inventories are stated at the lower of cost (using the weighted average cost method) or market. We calculate inventory reserves for excess and obsolete inventories based on estimated future demand of the products and spare parts. Cost of inventory is determined in accordance with Statement of Financial Accounting Standards No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4, or SFAS 151.

Allowances for Doubtful Accounts

We record a provision for doubtful accounts based on our historical experience and a detailed assessment of the collectability of our accounts receivable. In estimating the allowance for doubtful accounts, our management considers, among other factors, (1) the aging of the accounts receivable, (2) our historical write-offs, (3) the credit worthiness of each customer and (4) general economic conditions. Our allowance for doubtful accounts was $59,000, $121,000 and $230,000 as of December 31, 2008, 2007 and 2006, respectively. If we were to experience unanticipated collections issues, it could have an adverse affect on our operating results in future periods.

Income Taxes

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, or SFAS 109, issued by the Financial Accounting Standards Board, or FASB. SFAS 109 requires an entity to recognize deferred tax liabilities and assets. Deferred tax assets and liabilities are recognized for the future tax consequence attributable to the difference between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are measured using the enacted tax rate expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that included the enactment date. Valuation allowances are provided if, based upon the available evidence, management believes it is more likely than not that some or all of the deferred assets will not be realized or the use of prior years' net operating losses may be limited.

On July 13, 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109*, or FIN 48. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in any entity's financial statements in accordance with SFAS 109 and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the

income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted the provisions of FIN 48 on January 1, 2007. Measurement under FIN 48 is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority. The total amount of unrecognized tax benefits as of the date of adoption was immaterial. As a result of the implementation of FIN 48, there was no change to our tax liability.

We adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN 48 and penalty recognized in accordance with Paragraph 16 of FIN 48 are classified as part of income taxes. The amounts of interest and penalty recognized in the statement of income and statement of financial position for 2008 and 2007 were insignificant.

Our operations are subject to income and transaction taxes in the United States and in foreign jurisdictions. Significant estimates and judgments are required in determining our worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

We are subject to taxation in the U.S. and various states and foreign jurisdictions. There are no ongoing examinations by taxing authorities at this time. Our various tax years from 1995 through 2008 remain open in various taxing jurisdictions.

Results of Operations

2008 Compared to 2007

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	For The Year Ended December 31,					
	2008		2007		Increase (Decrease)	
Results of Operations:*						
Net revenue	$ 52,119	100.0%	$ 35,414	100.0%	$ 16,705	47.2%
Cost of revenue	18,933	36.3%	14,852	41.9%	4,081	27.5%
Gross profit	33,186	63.7%	20,562	58.1%	12,624	61.4%
Operating expenses:						
General and administrative	11,321	21.7%	4,299	12.1%	7,022	163.3%
Sales and marketing	6,549	12.6%	5,230	14.8%	1,319	25.2%
Research and development	2,415	4.6%	1,705	4.8%	710	41.6%
Total Operating Expenses	20,285	38.9%	11,234	31.7%	9,051	80.6%
Income from operations	12,901	24.8%	9,328	26.3%	3,573	38.3%
Other income (expense):						
Interest expense & finance charges	(79)	(0.2)%	(105)	(0.3)%	(26)	(24.8)%
Interest and other income	873	1.7%	517	1.5%	356	68.9%
Provision for income tax expense	5,032	9.7%	3,947	11.1%	1,085	27.5%
Net Income	$ 8,663	16.6%	$ 5,793	16.4%	$ 2,870	49.5%

* Percentages may not add up to 100% due to rounding.

Net Revenue

Our net revenue increased by $16.7 million, or 47%, to $52.1 million for the year ended December 31, 2008 from $35.4 million for the year ended December 31, 2007. This increase was primarily due to higher sales of our PX-220 device and the newly introduced PX-260 device. Greater market acceptance of the PX devices and the overall growth of the desalination market drove the increased demand for the products. The net revenue increase from the higher sales volume was offset in part by a decrease in our average unit selling price of approximately 6%. For the year ended December 31, 2008, the sales of PX devices accounted for approximately 95% of our revenue, pump sales accounted for approximately 3% and spare parts and service accounted for 2%. For the year ended December 31, 2007, the sales of PX devices accounted for approximately 94% of revenue, pump sales accounted for approximately 4%, and spare parts and service accounted for the remainder.

The following geographic information includes net revenue to our domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use is reflected in the table below instead of the delivery location. The amounts below are in thousands, except percentage data.

	Years Ended December 31,	
	2008	2007
Domestic net revenue	$ 3,517	$ 2,125
International net revenue	48,602	33,289
Total net revenue	$ 52,119	$ 35,414
Revenue by country:		
Algeria	24%	12%
Spain	16	35
China	11	8
United Arab Emirates	7	2
Saudi Arabia	*	13
Others	42	30
Total	100%	100%

* Less than 1%

The impact of the current global economic climate on future demand for our products is uncertain. The weakening global economy may cause our customers to delay or cancel plans for future orders of our products.

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, primarily ceramic materials, which we obtain from several suppliers. For the year ended December 31, 2008, gross profit as a percentage of net revenue was 63.7%, as compared to 58.1% for the year ended December 31, 2007. The increase in gross margin as a percentage of revenue of 5.6% was comprised of the following: (1) the reversal of a warranty provision in the amount of $688,000, or 1.3% of revenue, related to the cancellation of an extended product warranty contract and (2) an increase in

PX-260 and PX-220 devices, which have higher margins than our other product offerings, as a component of our sales mix in 2008 versus 2007.

Stock-based compensation expense included in the cost of revenue was $103,000 for the year ended December 31, 2008 and $117,000 for the year ended December 31, 2007.

Future gross profit is highly dependent on the product and customer mix of our net revenues. Accordingly, we are not able to predict our future gross profit levels with certainty.

General and Administrative Expense

General and administrative expense increased by $7.0 million, or 163%, to $11.3 million for the year ended December 31, 2008 from $4.3 million for the year ended December 31, 2007. As a percentage of net revenue, general and administrative expense was 22% for the year ended December 31, 2008 and 12% for the year ended December 31, 2007. The increase of general and administrative expense was attributable primarily to the increase in general and administrative headcount and professional services to support our growth in operations and to support the requirements for operating as a public company. This increase reflected in part the increase in general and administrative employees to 34 at December 31, 2008 from 13 at December 31, 2007.

Of the $7.0 million increase in general and administrative expense, $2.8 million was related to professional services, $2.6 million was related to compensation and employee-related benefits, $0.4 million was related to Value Added Taxes (VAT), $0.6 million was related to occupancy costs, $0.1 million related to export credit insurance, $0.1 million related to bad debt expense and $0.4 million related to other administrative costs. Stock-based compensation expense included in general and administrative expense was $512,000 for the year ended December 31, 2008 and $388,000 for the year ended December 31, 2007.

Sales and Marketing Expense

Sales and marketing expense increased by $1.3 million, or 25%, to $6.5 million for the year ended December 31, 2008 from $5.2 million for the year ended December 31, 2007. This increase was primarily related to growth in our sales that resulted in higher headcount with sales and marketing employees increasing to 21 at December 31, 2008 from 17 at December 31, 2007. In addition, our sales team is compensated in part by commissions, resulting in increased sales expense as our sales levels increase.

As a percentage of our net revenue, sales and marketing expense decreased to 13% for the year ended December 31, 2008 from 15% for the year ended December 31, 2007. The decrease in 2008 was attributable primarily to the significant increase in our net revenue that period, which grew at a greater rate than our sales and marketing expense.

Of the $1.3 million net increase in sales and marketing expense for the year ended December 31, 2008, $1.1 million related to compensation, employee-related benefits and commissions to outside sales representatives, $0.2 million related to sales and marketing efforts. Stock-based compensation expense included in sales and marketing expense was $279,000 for the year ended December 31, 2008 and $372,000 for the year ended December 31, 2007.

We expect that our future sales and marketing expense will increase in absolute dollars as our revenue increases.

Research and Development Expense

Research and development expense increased by $710,000, or 42%, to $2.4 million for the year ended December 31, 2008 from $1.7 million for the year ended December 31, 2007. Of the $710,000 increase, compensation and employee-related benefits accounted for $340,000, consulting and professional service fees accounted for $160,000, research and development direct project costs accounted for $190,000, and occupancy and other miscellaneous costs accounted for $20,000.

Headcount in our research and development department increased to eight at December 31, 2008 from six at December 31, 2007. Stock-based compensation expense included in research and development expense was $140,000 for year ended December 31, 2008 and $159,000 for the year ended December 31, 2007.

We anticipate that our research and development expenditures will increase in the future as we expand and diversify our product offerings.

Other Income (Expense), Net

Other net income (expense) increased by $382,000 to $794,000 for the year ended December 31, 2008 from $412,000 for the year ended December 31, 2007. The increase from 2007 to 2008 was primarily due to higher interest earnings of $486,000 resulting from IPO net proceeds of $76.7 million received in July 2008 and by a decrease in net interest expense of $27,000 resulting from the reduction of equipment loans outstanding. The increase was in part offset by a reduction in foreign currency transaction gains in the amount of $131,000 related to accounts receivable denominated in foreign currencies.

2007 Compared to 2006

The following table sets forth certain data from our historical operating results as a percentage of revenue for the years indicated:

	For the Year Ended December 31,					
	2007		2006		Increase(decrease)	
Results of Operations:*						
Net revenue	$ 35,414	100.0%	$ 20,058	100.0%	$ 15,356	76.6%
Cost of revenue	14,852	41.9%	8,131	40.5%	6,721	82.7%
Gross profit	20,562	58.1%	11,927	59.5%	8,635	72.4%
Operating expenses:						
General and administrative	4,299	12.1%	3,372	16.8%	927	27.5%
Sales and marketing	5,230	14.8%	3,648	18.2%	1,582	43.4%
Research and development	1,705	4.8%	1,267	6.3%	438	34.6%
Total Operating Expenses	11,234	31.7%	8,287	41.3%	2,947	35.6%
Income from operations	9,328	26.3%	3,640	18.1%	5,688	156.3%
Other income (expense):						
Interest expense & finance charges	(105)	(0.3)%	(77)	(0.4)%	28	36.4%
Interest and other income	517	1.5%	58	0.3%	459	791.4%
Provision for income tax expense	3,947	11.1%	1,239	6.2%	2,708	218.6%
Net Income	$ 5,793	16.4%	$ 2,382	11.9%	$ 3,411	143.2%

* Percentages may not add up to 100% due to rounding.

Net Revenue

Our net revenue increased by $15.4 million, or 77%, to $35.4 million in 2007 from $20.1 million in 2006. These increases were principally due to higher sales of our PX-220 device, which resulted primarily from increased market acceptance of the device and the overall growth of the desalination market. Prices were relatively constant for our PX devices in 2007 and 2006. For the year ended December 31, 2007, the sales of PX devices accounted for approximately 94% of revenue, pump sales accounted for approximately 4%, and spare parts and service accounted for the remainder. For the year ended December 31, 2006, the sales of PX devices accounted for approximately 92% of revenue, pump sales accounted for approximately 4%, and spare parts and service accounted for the remainder.

The following geographic information includes net revenue to our domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed us to deliver our products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use is reflected in the table below instead of the delivery location. The amounts below are in thousands, except percentage data.

	Years Ended December 31,	
	2007	2006
Domestic net revenue	$ 2,125	$ 1,003
International net revenue	33,289	19,055
Total net revenue	$ 35,414	$ 20,058
Revenue by country:		
Algeria	12%	30%
Spain	35	9
China	8	5
United Arab Emirates	2	10
Saudi Arabia	13	*
Others	30	46
Total	100%	100%

* Less than 1%.

Gross Profit

Gross profit represents our net revenue less our cost of revenue. Our cost of revenue consists primarily of raw materials, personnel costs (including stock-based compensation), manufacturing overhead, warranty costs, capital costs, excess and obsolete inventory expense, and manufactured components. The largest component of our cost of revenue is raw materials, principally ceramic materials, which we obtain from several suppliers. Gross profit, as a percentage of net revenue, remained relatively constant at 58.1% in 2007 as compared to 59.5% in 2006. Stock compensation expense included in cost of revenue was $117,000 in 2007 and $143,000 in 2006.

General and Administrative Expense

General and administrative expense increased by $927,000, or 28%, to $4.3 million in 2007 from $3.4 million in 2006. These increases reflected in part the increase in general and administrative employees to 13 at December 31, 2007 from eight at December 31, 2006.

As a percentage of our net revenue, general and administrative expense was 12% in 2007 and 17% in 2006. The decrease of general and administrative expense as a percentage of net revenue was attributable principally to the significant increases in our net revenue.

The primary reason for the increase in general and administrative expense was the growth in our operations that resulted in higher headcount including the recruitment of an officer, renting of additional facility space, increased travel and increased bank fees. With respect to the $927,000 increase in such expense in 2007, $513,000 related to compensation, employee-related benefits and professional services fees, $139,000 related to bank charges, $46,000 related to office supplies and equipment, $89,000 related to occupancy costs, and $324,000 related to other expense (general recruiting, patent amortization and travel), offset by $184,000 related to bad debt. Stock-based compensation expense included in general and administrative expense was $388,000 in 2007 and $428,000 in 2006.

Sales and Marketing Expense

Sales and marketing expense increased by $1.6 million, or 43%, to $5.2 million in 2007 from $3.6 million in 2006. These increases were primarily related to growth in our sales that resulted in higher headcount with sales and marketing employees increasing to 17 at December 31, 2007 from six at December 31, 2006. In addition, our sales team is compensated in part by commissions, resulting in increased sales expense as our sales levels increase.

As a percentage of our net revenue, sales and marketing expense decreased to 15% in 2007 from 18% in 2006. The decrease in 2007 was attributable principally to the significant increase in our net revenue that year, which grew at a greater rate than our sales and marketing expense.

With respect to the $1.6 million increase in sales and marketing expense in 2007, $0.7 million of such increase related to compensation and employee related benefits, $0.3 million related to consultant fees, $0.2 million related to travel and related expense, $0.2 million related to increased occupancy costs and $0.2 million related to sales and marketing efforts. Stock-based compensation expense included in sales and marketing expense was $372,000 in 2007 and $310,000 in 2006.

Research and Development Expense

Research and development expense increased by $438,000, or 35%, to $1.7 million in 2007 from $1.3 million in 2006. As a percentage of our net revenue, research and development expense decreased to 5% in 2007 from 6% in 2006.

Compensation, employee-related benefits, consulting services and depreciation of development equipment accounted for $151,000 of the $438,000 increase from 2006 to 2007. The remainder of the increase in 2007 was attributable to $173,000 in product development costs and $114,000 in travel and other expense. Stock-based compensation expense included in research and development expense was $159,000 in 2007 and $183,000 in 2006.

Other Income (Expense), Net

Other income (expense), net increased by $431,000 to $412,000 in 2007 from $(19,000) in 2006. The increase in net interest and other income from 2006 to 2007 was primarily attributable to gains on foreign currency transactions of $355,000 in 2007 and higher average cash balances, which resulted in higher interest income in 2007.

Liquidity and Capital Resources

Our primary source of cash historically has been proceeds from the issuance of common stock, customer payments for our products and services, and borrowings under our credit facility. From January 1, 2005 through December 31, 2008, we issued common stock for aggregate net proceeds of $83.3 million, excluding common stock issued in exchange for promissory notes. The proceeds from the sales of common stock have been used to fund our operations and capital expenditures.

As of December 31, 2008, our principal sources of liquidity consisted of cash and cash equivalents of $79.3 million, which are invested primarily in money market funds, and accounts receivable of $20.6 million. In July 2008, we received approximately $76.7 million of net proceeds from the IPO.

On March 27, 2008 we entered into a new credit agreement (“credit agreement”) with our existing financial institution that replaced a $2.0 million credit facility and $3.5 million revolving note. In September 2008 and December 2008, we modified the credit agreement to increase the allowable borrowings on the credit facility and to extend the credit facility term. The modified credit agreement allows borrowings of up to $12.0 million on a revolving basis at LIBOR plus 2.75%, expires on March 31, 2009 and is secured by our accounts receivable, inventories, property, equipment and other intangibles except intellectual property. We are subject to certain financial and administrative covenants under the new credit agreement. As of December 31, 2008, we were non-compliant with one financial covenant related to financial reporting. In January 2009, the

lender granted a waiver for this non-compliance. There were no outstanding borrowings under the credit agreement as of December 31, 2008.

During the years ended December 31, 2008 and 2007, we provided certain customers with irrevocable standby letters of credit to secure our obligations for the delivery and performance of products in accordance with sales arrangements. These letters of credit were issued largely under our revolving note credit facility in 2007 and our credit agreement in 2008. The letters of credit generally terminate within 12 to 36 months, and in some cases up to 65 months from issuance. At December 31, 2008, the amounts outstanding on the letters of credit totaled approximately $8.7 million of which $8.4 million were issued under our credit agreement.

In February 2009, the Company terminated the March 2008 credit agreement. As a result, the Company transferred $9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of termination.

In January 2009, the Company entered into a new loan and security agreement with another financial institution which became effective in February 2009 and provides a total available credit line of $15.0 million. Under this new agreement, the Company is allowed to draw advances up to $10.0 million on a revolving line of credit or utilize up to $14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed $15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new loan and security agreement expires on December 31, 2009 and is collateralized by substantially all of the Company's assets. The Company is subject to certain financial and administrative covenants under this new agreement.

We have unbilled receivables pertaining to customer contractual holdback provisions, whereby we invoice the final installment due under a sales contract 12 to 24 months after the product has been shipped to the customer and revenue has been recognized. Long-term unbilled receivables as of December 31, 2008 consisted of unbilled receivables from customers due more than one year subsequent to period end. The customer holdbacks represent amounts intended to provide a form of security for the customer rather than a form of long-term financing; accordingly, these receivables have not been discounted to present value. At December 31, 2008, we had $4.9 million of current unbilled receivables and $1.9 million of non-current unbilled receivables. At December 31, 2007, we had $1.7 million of current unbilled receivables and $2.5 million of non-current unbilled receivables.

On March 28, 2007, we entered into a $1.0 million equipment promissory note. The equipment promissory note bears an interest rate of cost of funds plus 2.75% and matures in September 2012. The amounts outstanding on the equipment promissory note as of December 31, 2008 and 2007 was $468,000 and $596,000, respectively. The interest rate for the equipment promissory note at December 31, 2008 and 2007 was 7.81%.

On December 1, 2005, we entered into a $222,000 fixed rate-installment note, or fixed note, with maturity date of December 15, 2010. The fixed note bears an annual interest rate of 10%. These notes are secured by our accounts receivable, inventories, property, equipment and other general intangibles except for intellectual property. The amounts outstanding on the fixed note as of December 31, 2008 and 2007 was $89,000 and $133,000, respectively. In February 2009, the Company paid the remaining balance of the fixed promissory note for a total of $83,000, including accrued interest.

Cash Flows from Operating Activities

Net cash provided by (used in) operating activities was $1.4 million and $(2.8) million for the years ended December 31, 2008 and 2007, respectively. For the years ended December 31, 2008 and 2007, cash provided by net income of $8.7 million and $5.8 million, respectively, was adjusted to $10.1 million and $7.6 million, respectively, by non-cash items (depreciation, amortization, unrealized gains and losses on foreign exchange, stock-based compensation, provisions for doubtful accounts, warranty reserves and excess and obsolete inventory) totaling $1.4 million and $1.8 million, respectively. The net cash outflow effect from changes in assets and liabilities was $(8.7) million and $(10.4) million for the year ended December 31, 2008 and 2007, respectively. Net changes in assets and liabilities are primarily attributable to increases in inventory

as a result of the growth of our business, changes in accounts receivable, unbilled receivables as a result of timing of invoices and collections for large projects, and changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties.

Net cash provided by (used in) operating activities was $(2.8) million and $822,000 for 2007 and 2006, respectively. The $3.7 million increase in net cash used in operating activities from 2006 to 2007 was primarily attributable to increases in receivables and inventory and decreases in deferred revenue billings.

Within changes in assets and liabilities, changes in accounts and unbilled receivables used $(5.7) million in cash in 2007 compared to $(7.6) million used in 2006 due to the timing of invoices for large projects at the end of 2007, along with a 77%, or $15.4 million, increase in net sales for the year. Changes in inventory used $(2.0) million in cash in 2007 compared to $(960,000) in 2006 primarily as a result of the growth of our business. Changes in accounts payable provided $583,000 in 2007 compared to $270,000 in 2006 due to the timing of payments. Changes in accrued liabilities (including income taxes) used $(29,000) in cash in 2007 compared to provided $2.3 million in 2006, primarily due to timing of payments. Lastly, decreases in deferred revenue used ($2.9) million in cash in 2007 compared to provided $4.0 million in 2006, primarily due to an increase in revenue recognized on product deliveries previously billed in advance.

Cash Flows from Investing Activities

Cash flows used in investing activities primarily relate to capital expenditures to support our growth, as well as increases in our restricted cash used to collateralize our letters of credit.

Net cash provided by (used in) investing activities was $650,000 and $(2.0) million for the years ended December 31, 2008, and 2007, respectively. The increase in net cash provided by investing activities was primarily attributable to the release of restricted cash of $1.3 million in 2008 compared to an increase in restricted cash of $1.0 million in 2007. The remaining portion of the increase resulted from a reduction in property and equipment purchases of $251,000.

Net cash (used in) investing activities was $(2.0) million in 2007 and $(511,000) in 2006. $1.0 million of the increase in net cash used in investing activities from 2006 to 2007 was attributable to the increase in restricted cash balances and the balance of the increase was due largely to an increase in purchases of property and equipment in 2007 compared to 2006.

Cash Flows from Financing Activities

Net cash provided by financing activities increased $72.0 million to $77.1 million for the year ended December 31, 2008 from $5.1 million for the year ended December 31, 2007. The $72.0 million increase in cash flows from financing activities is primarily attributable to the receipt of net proceeds of $76.7 million from the sale of common stock in our IPO during the year ended December 31, 2008 versus the receipt of net proceeds of $5.0 million from a private placement of common stock and $143,000 from the exercise of warrants during the year ended December 31, 2007. Additionally, repayments of promissory notes by stockholders increased $551,000 for the year ended December 31, 2008 over 2007.

Net cash provided by financing activities was $5.1 million in 2007 and net cash used was $(530,000) in 2006. The increase in net cash provided by financing activities in 2007 from 2006 was primarily attributable to our issuance of common stock in a private placement.

We believe that our existing cash balances and cash generated from our operations will be sufficient to meet our anticipated capital requirements for at least the next 12 months. However, we may need to raise additional capital or incur additional indebtedness to continue to fund our operations in the future. Our future capital requirements will depend on many factors, including our rate of revenue growth, if any, the expansion of our sales and marketing and research and development activities, the timing and extent of our expansion into new geographic territories, the timing of introductions of new products and the continuing market acceptance of our products. Although we currently are not a party to any agreement or letter of intent with respect to potential material investments in, or acquisitions of, complementary businesses, services or

technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Contractual Obligations

We lease facilities under fixed non-cancelable operating leases that expire on various dates through 2019. In the course of our normal operations, we also entered into purchase commitments with our suppliers for various key raw materials and component parts. The purchase commitments covered by these arrangements are subject to change based on our sales forecasts for future deliveries.

The following is a summary of our contractual obligations as of December 31, 2008 (in thousands):

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Notes payable	$ 557	$ 172	$ 300	$ 85	$ —
Operating lease obligations (1)	15,828	4,050	2,501	2,282	6,995
Capital lease obligations (including interest) (2)	72	43	29	—	—
Contractual purchase obligations	250	—	250	—	—
Total	$ 16,707	$ 4,265	$ 3,080	$ 2,367	$ 6,995

(1) Includes $3 million for obligations related to tenant improvement costs. Estimates for such costs range from $2 million to $3 million and are expected to be realized in less than one year.

(2) Present value of net minimum capital lease payments is $64, as reflected on the balance sheet.

This table excludes agreements with guarantees or indemnity provisions that we have entered into with customers and others in the ordinary course of business. Based on our historical experience and information known to us as of December 31, 2008, we believe that our exposure related to these guarantees and indemnities as of December 31, 2008 was not material.

Supplier Concentration

Certain of the raw materials and components that we use in the manufacturing of our products are available from a limited number of suppliers. We do not enter into long-term supply contracts with these suppliers. For instance, we purchase the ceramic components for the PX device pursuant to standard purchase orders that specify the quantity and price of various component parts to be delivered over a three-month period. We then update the pricing and quantity of our purchase orders based upon our most current forecast on a quarterly basis. Shortages could occur in these essential materials and components due to an interruption of supply or increased demand in the industry. If we are unable to procure certain of such materials or components, we would be required to reduce our manufacturing operations, which could have a material adverse effect on our results of operations.

For the year ended December 31, 2008, four suppliers (of which three were ceramics suppliers) represented approximately 72% of our total purchases. For the years ended 2007 and 2006, three suppliers (of which two were ceramics suppliers) represented approximately 66% and 71%, respectively, of our total purchases. As of December 31, 2008 and 2007, approximately 68% and 60%, respectively, of our accounts payable were due to these suppliers.

Off-Balance Sheet Arrangements

During the periods presented, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purpose.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*, or SFAS 157. SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. In February 2008, the FASB issued FASB Staff Position 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13, or FSP 157-1, and FSP 157-2, Effective Date of FASB Statement No. 157, or FSP 157-2. FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of 2009. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for us beginning in the first quarter of 2008. The adoption of SFAS 157 for financial assets and financial liabilities in the three months ended March 31, 2008 did not have a significant impact on our consolidated financial statements. We are currently evaluating the impact that SFAS 157 will have on our consolidated financial statements when it is applied to non-financial assets and non-financial liabilities beginning in the first quarter of 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, or SFAS 159. SFAS 159 permits companies to choose to measure certain financial instruments and other items at fair value. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. SFAS 159 is effective for us beginning in the first quarter of 2008. The adoption of SFAS 159 did not have an impact on our consolidated financial statements.

In December 2007, the SEC issued SAB 110 to amend the SEC's views discussed in SAB 107 regarding the use of the simplified method in developing an estimate of expected life of share options in accordance with SFAS 123R. SAB 110 is effective for us beginning in the first quarter of 2008. As of December 31, 2007, we did not use the simplified method and the adoption of SAB 107, as amended by SAB 110, did not have an impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations*, or FAS 141(R). FAS 141(R) will change how business acquisitions are accounted for. FAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. The adoption of FAS 141(R) is not expected to have a material impact on our consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements — an amendment of Accounting Research Bulletin No. 51*. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 160 is not expected to have a material impact on our consolidated financial statements.

In March 2008, the FASB issued FAS No. 161, *"Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133"* (FAS 161). FAS 161 requires us to provide greater transparency about how and why we use derivative instruments, how the instruments and related hedged items are accounted for under FAS No. 133, *"Accounting for Derivative Instruments and Hedging Activities"* (FAS 133), and how the instruments and related hedged items affect our financial position, results of operations, and cash flows. FAS 161 became effective for us on January 1, 2009. We do not expect the adoption of FAS 161 to have an effect on our consolidated financial statements.

In April 2008, the FASB has issued FASB Staff Position 142-3 ("FSP 142-3"), *Determination of the Useful Life of Intangible Assets.* FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under

FASB Statement No. 142, *Goodwill and Other Intangible Asset.* The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under FASB Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under FAS 141(R), and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. We do not expect the adoption of FSP 142-3 to have an effect on our consolidated financial statements.

Item 7A. ***Quantitative and Qualitative Disclosure About Market Risk***

Foreign Currency Risk

Currently, the majority of our revenue contracts have been denominated in United States dollars. In some circumstances, we have priced certain international sales in Euros and to a much lesser degree in Maltese Liras. The amount of revenue transactions denominated in Euros amounted to approximately $7.1 million, $10.0 million and zero in 2008, 2007 and 2006, respectively. In 2006, $1.0 million of our revenue was denominated in Maltese Liras. There were no revenue contracts denominated in Maltese Liras in either 2008 or 2007. We experienced a net foreign currency gain (loss) of approximately a $220,000, $351,000 and $(4,000) related to our revenue contracts for the years ended December 31, 2008, 2007 and 2006, respectively.

As we expand our international sales, we expect that a portion of our revenue could continue to be denominated in foreign currencies. As a result, our cash and cash equivalents and operating results could be increasingly affected by changes in exchange rates. Our international sales and marketing operations incur expense that is denominated in foreign currencies. This expense could be materially affected by currency fluctuations. Our exposures are to fluctuations in exchange rates for the United States dollar versus the Euro. Changes in currency exchange rates could adversely affect our consolidated operating results or financial position. Additionally, our international sales and marketing operations maintain cash balances denominated in foreign currencies. In order to decrease the inherent risk associated with translation of foreign cash balances into our reporting currency, we have not maintained excess cash balances in foreign currencies. We have not hedged our exposure to changes in foreign currency exchange rates because expenses in foreign currencies have been insignificant to date, and exchange rate fluctuations have had little impact on our operating results and cash flows.

Interest Rate Risk

We had cash and cash equivalents totaling $79.3 million, $240,000 and $42,000 at December 31, 2008, 2007 and 2006, respectively. These amounts were invested primarily in money market funds. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash equivalents and short-term investments. Declines in interest rates, however, would reduce future investment income.

Concentration of Credit Rate Risk

The market risk inherent in our financial instruments and in our financial position represents the potential loss arising from disruptions caused by recent financial market conditions. Currently, our cash and cash equivalents are primarily deposited in a money market fund backed by U.S. Treasury securities; however, substantially all of our cash and cash equivalents are in excess of federally insured limits at a very limited number of financial institutions. This represents a high concentration of credit risk.

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

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors and Stockholders of
Energy Recovery, Inc.

We have audited the accompanying consolidated balance sheets of Energy Recovery, Inc. as of December 31, 2008 and 2007 and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the three years in the period ended December 31, 2008. In connection with our audits of the financial statements, we have also audited the financial statement schedule ("schedule") listed in Item 15(a)(2). 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 audit 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 also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements and schedule, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Energy Recovery, Inc. at December 31, 2008 and 2007, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2008, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

/s/ BDO Seidman, LLP
San Jose, California
March 26, 2009

ENERGY RECOVERY, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	December 31, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 79,287	$ 240
Restricted cash	246	366
Accounts receivable, net of allowance for doubtful accounts of $59 and $121 at December 31, 2008 and 2007, respectively	20,615	13,772
Unbilled receivables, current	4,948	1,733
Notes receivable from stockholders	—	20
Inventories	8,493	4,791
Deferred tax assets, net	1,755	1,052
Prepaid expenses and other current assets	984	369
Total current assets	116,328	22,343
Unbilled receivables, non-current	1,929	2,457
Restricted cash, non-current	19	1,221
Property and equipment, net	1,845	1,671
Intangible assets, net	321	345
Deferred tax assets, non-current, net	119	148
Other assets, non-current	51	42
Total assets	$ 120,612	$ 28,227
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 2,270	$ 1,697
Accrued expenses and other current liabilities	4,787	1,868
Liability for early exercise of stock options	—	20
Income taxes payable	1,657	1,154
Accrued warranty reserve	270	868
Deferred revenue	4,000	1,729
Current portion of long-term debt	172	172
Current portion of capital lease obligations	37	38
Total current liabilities	13,193	7,546
Long-term debt	385	557
Capital lease obligations, non-current	27	63
Other non-current liabilities	8	—
Total liabilities	13,613	8,166
Commitments and Contingencies (Note 7)		
Stockholders' equity:		
Preferred stock, $0.001 par value; 10,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, $0.001 par value; 200,000,000 shares authorized; 50,015,718 and 39,777,446 shares issued and outstanding at December 31, 2008 and 2007, respectively	50	40
Additional paid-in capital	98,527	20,762
Notes receivable from stockholders	(296)	(835)
Accumulated other comprehensive loss	(44)	(5)
Retained earnings	8,762	99
Total stockholders' equity	106,999	20,061
Total liabilities and stockholders' equity	$ 120,612	$ 28,227

See accompanying Notes to Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONSOLIDATED STATEMENTS OF INCOME
(in thousands, except per share data)

	Years Ended December 31,		
	2008	2007	2006
Net revenue	$ 52,119	$ 35,414	$ 20,058
Cost of revenue	18,933	14,852	8,131
Gross profit	33,186	20,562	11,927
Operating expenses:			
General and administrative	11,321	4,299	3,372
Sales and marketing	6,549	5,230	3,648
Research and development	2,415	1,705	1,267
Total operating expenses	20,285	11,234	8,287
Income from operations	12,901	9,328	3,640
Other income (expense):			
Interest expense	(79)	(105)	(77)
Interest and other income	873	517	58
Income before provision for income taxes	13,695	9,740	3,621
Provision for income taxes	5,032	3,947	1,239
Net Income	$ 8,663	$ 5,793	$ 2,382
Earnings per share:			
Basic	$ 0.19	$ 0.15	$ 0.06
Diluted	$ 0.18	$ 0.14	$ 0.06
Number of shares used in per share calculations:			
Basic	44,848	39,060	38,018
Diluted	47,392	41,433	40,244

See accompanying Notes to Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME
Years Ended December 31, 2008, 2007 and 2006
(in thousands)

	Common Stock		Additional Paid-in Capital	Notes Receivable from Stockholders	Accumulated Other Comprehensive Income	Retained Earnings (Accumulated Deficit)	Total Stockholders' Equity
	Shares	Amount					
Balance at December 31, 2005	37,769	$ 38	$ 13,313	$ (573)	$ —	$ (8,076)	$ 4,702
Net income	—	—	—	—	—	2,382	2,382
Comprehensive income	—	—	—	—	—	—	2,382
Issuance of common stock	453	—	142	(137)	—	—	5
Interest on notes receivable from stockholders	—	—	—	(31)	—	—	(31)
Repayment of notes receivable from stockholders	—	—	—	5		—	5
Employee stock-based compensation	—	—	1,061	—	—	—	1,061
Non-employee stock-based compensation	—	—	3	—	—	—	3
Balance at December 31, 2006	38,222	38	14,519	(736)	—	(5,694)	8,127
Net income	—	—	—	—	—	5,793	5,793
Foreign currency translation adjustments	—	—	—	—	(5)	—	(5)
Comprehensive income	—	—	—	—	—	—	5,788
Issuance of common stock	1,555	2	5,207	(91)	—	—	5,118
Interest on notes receivable from stockholders	—	—	—	(31)	—	—	(31)
Repayment of notes receivable from stockholders	—	—	—	23	—	—	23
Employee stock-based compensation	—	—	1,008			—	1,008
Non-employee stock-based compensation	—	—	28	—	—	—	28
Balance at December 31, 2007	39,777	40	20,762	(835)	(5)	99	20,061
Net income	—	—	—	—	—	8,663	8,663
Foreign currency translation adjustments	—	—	—	—	(39)	—	(39)
Comprehensive income	—	—	—	—	—	—	8,624
Issuance of common stock	10,238	10	76,717	(20)	—	—	76,707
Interest on notes receivable from stockholders	—	—	—	(15)	—	—	(15)
Repayment of notes receivable from stockholders	—	—	—	574	—	—	574
Stock option income tax benefit	—	—	14	—	—	—	14
Employee stock-based compensation	1	—	936	—	—	—	936
Non-employee stock-based compensation	—	—	98	—	—	—	98
Balance at December 31, 2008	50,016	$ 50	$ 98,527	$ (296)	$ (44)	$ 8,762	$ 106,999

See accompanying Notes to Consolidated Financial Statements

ENERGY RECOVERY, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended December 31,		
	2008	**2007**	**2006**
Cash Flows From Operating Activities			
Net income	$ 8,663	$ 5,793	$ 2,382
Adjustments to reconcile net income to net cash provided by (used in) operating activities:			
Depreciation and amortization	522	323	231
Impairment of intangible assets	—	31	—
Interest accrued on notes receivables from stockholders	(15)	(31)	(31)
Stock-based compensation	1,034	1, 036	1,064
Loss (gain) on foreign currency transactions	373	(351)	4
Provision for doubtful accounts	7	(105)	80
Provision for warranty claims	(495)	850	61
Provision for excess or obsolete inventory	26	47	30
Changes in operating assets and liabilities:			
Accounts receivable	(7,622)	(3,554)	(5,911)
Unbilled receivables	(2,687)	(2,189)	(1,719)
Inventories	(3,728)	(1,950)	(960)
Deferred tax assets, net	(674)	(341)	(859)
Prepaid and other assets	(624)	(49)	(135)
Accounts payable	573	583	270
Accrued expenses and other liabilities	3,223	214	1,002
Income taxes payable	517	(243)	1,334
Deferred revenue	2,271	(2,893)	3,979
Net cash provided by (used in) operating activities	1,364	(2,829)	822
Cash Flows From Investing Activities			
Capital expenditures	(667)	(918)	(328)
Restricted cash	1,322	(1,043)	(109)
Other	(5)	(84)	(74)
Net cash provided by (used in) investing activities	650	(2,045)	(511)
Cash Flows From Financing Activities			
Proceeds from long-term debt	—	639	118
Repayment of long-term debt	(172)	(98)	(164)
Repayment of revolving note, net	—	(438)	(563)
Repayment of capital lease obligation	(37)	(38)	(60)
Net proceeds from issuance of common stock (see Note 9)	76,707	5,118	5
Repayment of notes receivable from stockholders	574	23	5
Other short term financing activities	—	(129)	129
Net cash provided by (used in) financing activities	77,072	5,077	(530)
Effect of exchange rate differences on cash and cash equivalents	(39)	(5)	—
Net change in cash and cash equivalents	79,047	198	(219)
Cash and cash equivalents, beginning of period	240	42	261
Cash and cash equivalents, end of period	$ 79,287	$ 240	$ 42
Supplemental disclosure of cash flow information			
Cash paid for interest	$ 75	$ 97	$ 78
Cash paid for income taxes	$ 5,144	$ 4,555	$ 764
Supplemental disclosure of non-cash transactions			
Issuance of common stock in exchange for notes receivable from stockholders	$ 20	$ 91	$ 137
Equipment purchased under capital leases	$ —	$ —	$ 42

See accompanying Notes to Consolidated Financial Statements

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Description of Business

Energy Recovery, Inc. ("the Company" or "ERI") was established in 1992, and is a leading global developer and manufacturer of highly efficient energy recovery devices utilized in the water desalination industry. The Company operates primarily in the sea water reverse osmosis ("SWRO") segment of the industry, which uses pressure to drive sea water through filtering membranes to produce fresh water. The Company's primary energy recovery device is the PX Pressure Exchanger® ("PX device"), which helps optimize the energy intensive SWRO process by reducing energy consumption. Products are manufactured in the United States of America ("U.S.") at ERI's headquarters located in San Leandro, California, and shipped from this location to specified customer locations worldwide. The Company has direct sales offices and technical support centers in Madrid, Dubai, Shanghai and Fort Lauderdale and the research and development center is located in San Leandro, California.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. The Company incorporated its wholly owned subsidiaries, Osmotic Power, Inc., Energy Recovery, Inc. International and Energy Recovery Iberia, S.L., in September 2005, July 2006 and September 2006, respectively.

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its foreign wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Certain prior period balances have been reclassified to conform to the current period presentation. Specifically, we reclassified $923,000 of contra accounts receivable and $318,000 of customer deposits to deferred revenue as of December 31, 2007, related to advance payments. The Company believes that reclassifying these amounts presents a more useful representation of accounts receivable, unearned revenue and deferred liabilities.

Use of Estimates

The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles ("U.S. GAAP") requires management to make judgments, estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. The Company's most significant estimates and judgments involve the determination of revenue recognition, allowance for doubtful accounts, allowance for product warranty, valuation of the Company's stock and stock-based compensation, reserve for excess and obsolete inventory, deferred taxes and valuation allowances on deferred tax assets. Actual results could materially differ from those estimates.

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original or remaining maturity of three months or less at the time of purchase to be cash equivalents. Cash equivalents are stated at cost, which approximates fair value. Our cash and cash equivalents are maintained in demand deposit accounts with large financial institutions and invested in institutional money market funds. The Company frequently monitors the creditworthiness of the financial institutions and institutional money market funds in which it invests its surplus funds. The Company has not experienced any credit losses from its cash investments.

Restricted Cash

The Company has irrevocable standby letters of credit with two financial institutions securing performance and warranty commitments under contracts with customers and lessors. These standby letters of credit

are collateralized by either a line of credit (see Note 4) or restricted cash. At December 31, 2008 and 2007, the amount of irrevocable standby letters of credit collateralized by restricted cash was $265,000 and $1,587,000, respectively. The company has deposited a corresponding amount into money market accounts and certificates of deposit.

Allowances of Doubtful Accounts

The Company records a provision for doubtful accounts based on its historical experience and a detailed assessment of the collectability of its accounts receivable. In estimating the allowance for doubtful accounts, the Company's management considers, among other factors, (1) the aging of the accounts receivable, (2) the Company's historical write-offs, (3) the credit worthiness of each customer and (4) general economic conditions.

Inventories

Inventories are stated at the lower of cost (using the weighted average cost method) or market. The Company calculates inventory reserves for excess and obsolete inventories based on current inventory levels, expected useful life and estimated future demand of the products and spare parts. Cost of inventory is determined in accordance with Statement of Financial Accounting Standards ("SFAS") No. 151, *Inventory Costs*, an amendment of ARB No. 43, Chapter 4.

Property and Equipment

Property and equipment are stated at cost and depreciated over the estimated useful lives of the assets (generally three to seven years) using the straight-line method. A portion of equipment for the Company's manufacturing facility is acquired under capital lease obligations. These assets are amortized over periods consistent with depreciation of owned assets of similar types, generally five years. Lease improvements represent the remodeling expenses for the leased office space and are depreciated over the shorter of either the estimated useful lives or the term of the lease using the straight-line method. Software purchased for internal use consists primarily of amounts paid for perpetual licenses to third party software providers and are depreciated over the estimated useful lives, generally three to five years.

SFAS No. 143, *Accounting for Asset Retirement Obligations* and Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations*, an interpretation of SFAS 143, requires the recognition of a liability for the fair value of a legally required conditional asset retirement obligation when incurred, if the liability's fair value can be reasonably estimated. Management reviewed the Company's facility lease and concluded that the cost, if any of potential physical reinstatement obligations is not reasonably determinable, and as such, no asset retirement obligation was recorded in the financial statements for the years presented.

Maintenance and repairs are charged directly to expense as incurred, whereas improvements and renewals are generally capitalized in their respective property accounts. When an item is retired or otherwise disposed of, the cost and applicable accumulated depreciation are removed and the resulting gain or loss is recognized in the results of operations.

Intangible Assets

Intangible assets represent patents owned by the Company and are recorded at cost (i.e., the cost of obtaining the patent) and are amortized on a straight-line basis over their expected useful life of 16 to 20 years.

Impairment of Long-Lived Assets

The Company accounts for its long-lived assets, including property and equipment and intangibles, in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. The Company evaluates its long-lived assets for indicators of possible impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. An impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of an asset and its eventual disposition are less than its carrying amount. During 2007, the Company determined that a patent was impaired as a result of the development of a new patent which effectively superseded and replaced an existing patent; accordingly, the Company recorded an impairment reserve of $31,000 for the year ended December 31, 2007, and this amount was included in research and development expense in the consolidated statement of income. No impairment expense was recorded for the years ended December 31, 2008 and 2006.

Revenue Recognition

The Company recognizes revenue in accordance with U.S. Securities and Exchange Commission ("SEC") Staff Accounting Bulletin ("SAB") No. 104, *Revenue Recognition* ("SAB 104"). The Company recognizes revenue when the earnings process is complete, as evidenced by an agreement with the customer, transfer of title occurs, fixed pricing is determinable and collection is reasonably assured. Transfer of title typically occurs upon shipment of the equipment pursuant to a written purchase order or contract. The portion of the sales agreement related to the field services and training for commissioning of a desalination plant is deferred per guidance of Emerging Issues Task Force ("EITF") No. 00-21, *Revenue Arrangements with Multiple Deliverables*, by applying the residual value method. Under this method, revenue allocated to undelivered elements is based on vendor objective evidence of fair value of such undelivered elements, and the residual revenue is allocated to the delivered elements, assuming that the delivered elements have stand-alone value. Vendor objective evidence of fair value for such undelivered elements is based upon the price the Company charges for such product or service when it is sold separately. The Company may modify its pricing in the future, which could result in changes to our vendor objective evidence of fair value for such undelivered elements. The services element of the Company's contracts represents an incidental portion of the total contract price.

Under the Company's revenue recognition policy, evidence of an arrangement has been met when it has an executed purchase order or a stand-alone contract. Typically, smaller projects utilize purchase orders that conform to standard terms and conditions that require the customer to remit payment generally within 30 to 90 days from product delivery. In some cases, if credit worthiness cannot be determined, prepayment is required from the smaller customers.

For large projects, stand-alone contracts are utilized. For these contracts, consistent with industry practice, the customers typically require their suppliers, including the Company, to accept contractual holdback provisions whereby the final amounts due under the sales contract are remitted over extended periods of time. These retention payments typically range between 10% and 20%, and in some instances up to 30%, of the total contract amount and are due and payable when the customer is satisfied that certain specified product performance criteria have been met upon commissioning of the desalinization plant, which in the case of the Company's PX device may be 12 months to 24 months from the date of product delivery as described further below.

The specified product performance criteria for the Company's PX device generally pertains to the ability of the Company's product to meet its published performance specifications and warranty provisions, which the Company's products have demonstrated on a consistent basis. This factor, combined with the Company's historical performance metrics measured over the past 10 years, provides management with a reasonable basis to conclude that its PX device will perform satisfactorily upon commissioning of the plant. To ensure this

successful product performance, the Company provides service, consisting principally of supervision of customer personnel, and training to the customers during the commissioning of the plant. The installation of the PX device is relatively simple, requires no customization and is performed by the customer under the supervision of Company personnel. The Company defers the value of the service and training component of the contract and recognizes such revenue as services are rendered. Based on these factors, management has concluded that delivery and performance have been completed when the product has been delivered (title transfers) to the customer.

The Company performs an evaluation of credit worthiness on an individual contract basis, to assess whether collectability is reasonably assured. As part of this evaluation, management considers many factors about the individual customer, including the underlying financial strength of the customer and/or partnership consortium and management's prior history or industry specific knowledge about the customer and its supplier relationships. To date, the Company has been able to conclude that collectability was reasonably assured on its sales contracts at the time the product was delivered and title has transferred; however, to the extent that management concludes that it is unable to determine that collectability is reasonably assured at the time of product delivery, the Company will defer all or a portion of the contract amount based on the specific facts and circumstances of the contract and the customer.

Under the stand-alone contracts, the usual payment arrangements are summarized as follows:

- an advance payment, typically 10% to 20% of the total contract amount, is due upon execution of the contract;
- a payment upon delivery of the product, typically in the range of 50% to 70% of the total contract amount, is due on average between 90 and 150 days from product delivery, and in some cases up to 180 days; and
- a retention payment, typically in the range of 10% to 20%, and in some cases up to 30%, of the total contract amount is due subsequent to product delivery as described further below.

Under the terms of the retention payment component, the Company is generally required to issue to the customer a product performance guarantee that takes the form of an irrevocable standby letter of credit, which is issued to the customer approximately 12 to 24 months after the product delivery date. The letter of credit is either collateralized by restricted cash on deposit with the Company's financial institution (see Restricted Cash under Summary of Significant Accounting Policies) or funds available through a credit facility (see Note 4). The letter of credit remains in place for the performance period as specified in the contract, which is generally 12 to 36 months and, in some cases, up to 65 months from issuance. The performance period generally runs concurrent with the Company's standard product warranty period. Once the letter of credit has been put in place, the Company invoices the customer for this final retention payment under the sales contract. During the time between the product delivery and the issuance of the letter of credit, the amount of the final retention payment is classified on the balance sheet as an unbilled receivable, of which a portion may be classified as long term to the extent that the billable period extends beyond one year. Once the letter of credit is issued, the Company invoices the customer and reclassifies the retention amount from unbilled receivable to accounts receivable where it remains until payment, typically 90 to 150 days after invoicing, and in some cases up to 180 days. (See Note 3 — Balance Sheet Information: Unbilled Receivables).

The Company does not provide its customers with a right of product return. However, the Company will accept returns of products that are deemed to be damaged or defective when delivered that are covered by the terms and conditions of the product warranty. Product returns have not been significant. Reserves are established for possible product returns related to the advance replacement of products pending the determination of a warranty claim.

Shipping and handling charges billed to customers are included in sales. The cost of shipping to customers is included in cost of revenue.

The Company sells its product to resellers and engineering and construction firms which are not subject to sales tax. Accordingly, the adoption of EITF Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That is, Gross versus Net Presentation)*, does not have an impact on the Company's consolidated financial statements.

Warranty Costs

The Company sells products with a limited warranty for a period ranging from one to five years. The Company accrues for warranty costs based on estimated product failure rates, historical activity and expectations of future costs. The Company periodically evaluates and adjusts the warranty costs to the extent actual warranty costs vary from the original estimates.

The Company may offer extended warranties on an exception basis and these are accounted for in accordance with Financial Accounting Standards Board ("FASB") Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts for Sales of Extended Warranties.*

Income Taxes

The Company accounts for income taxes in accordance with SFAS No. 109, "*Accounting for Income Taxes*" ("SFAS 109"), issued by FASB. SFAS 109 requires an entity to recognize deferred tax assets and liabilities. Deferred tax assets and liabilities are recognized for the future tax consequence attributable to the difference between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are measured using the enacted tax rate expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that included the enactment date. Valuation allowances are provided if, based upon the available evidence, management believes it is more likely than not that some or all of the deferred assets will not be realized or the use of prior years' net operating losses may be limited.

On July 13, 2006, the FASB issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes — An Interpretation of FASB Statement No. 109" ("FIN 48"). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in any entity's financial statements in accordance with SFAS 109 and prescribes a recognition threshold and measurement attributes for financial statement disclosure of tax positions taken or expected to be taken on a tax return. Under FIN 48, the impact of an uncertain income tax position on the income tax return must be recognized at the largest amount that is more likely than not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, FIN 48 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Company adopted the provisions of FIN 48 on January 1, 2007. Measurement under FIN 48 is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority. The total amount of unrecognized tax benefits as of the date of adoption was immaterial. As a result of the implementation of FIN 48, the Company recognized no increase in the liability for unrecognized tax benefits.

The Company adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN 48 and penalty recognized in accordance with Paragraph 16 of FIN 48 are classified as part of its income taxes. The amounts of interest and penalty recognized in the statement of income and statement of financial position for the years ended December 31, 2008 and 2007 were insignificant.

The Company's operations are subject to income and transaction taxes in the U.S. and in foreign jurisdictions. Significant estimates and judgments are required in determining the Company's worldwide provision for income taxes. Some of these estimates are based on interpretations of existing tax laws or regulations. The ultimate amount of tax liability may be uncertain as a result.

Stock-Based Compensation — Employees

Prior to January 1, 2006, the Company accounted for stock-based compensation to employees and members of the Company's board of directors under the recognition and measurement principles of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB 25"), and related interpretations. Under APB 25, compensation expense for stock-based payment awards is based on the difference, if any, on the date of the grant, between the value of the Company's stock and the exercise price and is recognized over the vesting period of the awards. Accordingly, prior to January 1, 2006, no stock-based compensation expense was recognized in the Company's statements of income for stock options granted to employees and directors that had an exercise price equal to the value of the Company's stock on the date of grant. The Company also followed the disclosure requirements of SFAS No. 123, *Accounting for Stock-Based Compensation*, amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure* and used the minimum value method for pro-forma disclosures based on the disclosure provisions that was available for non — public companies.

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), which requires the measurement and recognition of compensation expense in the statement of income for all awards made to employees and members of the Company's board of directors using estimated fair values.

Under the provisions of SFAS 123R, share-based compensation expense is measured at the grant date, based on the fair value of the award, and is recognized as an expense over the employee's requisite service period, generally the vesting period of the awards. Under SFAS 123R, non-public companies that used the minimum value method under disclosure provisions of SFAS 148 shall apply the provisions of SFAS 123R prospectively to new and/or modified awards at the adoption date, and shall continue to account for any portion of awards outstanding at the adoption date, using the accounting principles originally applied to those awards. Accordingly, for awards granted prior to January 1, 2006 for which the requisite service period had not been performed as of December 31, 2005, the Company continued to recognize compensation expense on the remaining unvested awards under the intrinsic-value method of APB 25. In accordance with the requirements of SFAS 123R for non-public companies, the Company has not provided pro-forma disclosures for the year ended December 31, 2005 since the Company used the minimum value method for pro-forma disclosures for awards granted prior to January 1, 2006. For all awards granted or modified after December 31, 2005, the Company began recognizing compensation expense of the fair value, less expected forfeitures, on a straight-line basis over the vesting period.

To determine the inputs for the Black-Scholes options pricing model, the Company is required to develop several assumptions, which are highly subjective. These assumptions include:

- the length of its options' lives, which is based on anticipated future exercises;
- its common stock's volatility;
- the number of shares of common stock pursuant to which options which will ultimately be forfeited;
- the risk-free rate of return; and
- future dividends.

The estimated grant date fair values of the employee stock options were calculated using the Black-Scholes options pricing model, based on the following assumptions:

	Years Ended December 31,		
	2008	2007	2006
Expected term	5 years	5 years	5 years
Expected volatility	48%	50%	50%
Risk-free interest rate	1.55 - 3.41%	3.41 - 4.92%	4.45 - 5.10%
Dividend yield	0%	0%	0%

Expected Term. Under the Company's option plans, the expected term of options granted is determined using the weighted average period during which the stock options are expected to remain outstanding and is based on the options vesting term, contractual terms and disclosure information from similar publicly traded companies to develop reasonable expectations about future exercise patterns and post-vesting employment termination behavior.

Expected Volatility. Since the Company is a newly public entity with limited historical data regarding the volatility of its common stock price, the expected volatility used is based on volatility of a representative industry peer group. In evaluating similarity, the Company considered factors such as industry, stage of life cycle and size.

Risk-Free Interest Rate. The risk-free rate is based on U.S. Treasury issues with remaining terms similar to the expected term on the options.

Dividend Yield. The Company has never declared or paid any cash dividends and does not plan to pay cash dividends in the foreseeable future, and, therefore, used an expected dividend yield of zero in the valuation model.

Forfeitures. SFAS No. 123R also requires the Company to estimate forfeitures at the time of grant, and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and records stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods. If the Company's actual forfeiture rate is materially different from its estimate, the stock-based compensation expense could be significantly different from what the Company has recorded in the current period.

The absence of an active market for its common stock prior to July 2008 required management and the board of directors to estimate the fair value of its common stock for purposes of granting options and for determining stock-based compensation expense for options granted prior to July 2008. In response to these requirements, management and the board of directors estimated the fair market value common stock based on factors such as the price of the most recent common stock sales to investors, the valuations of comparable companies, the status of the Company's development and sales efforts, its cash and working capital amounts, revenue growth, and additional objective and subjective factors relating to its business on an annual basis.

Stock-based compensation expense related to awards granted and or modified to employees was allocated as follows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Cost of revenue	$ 103	$ 117	$ 143
General and administrative	419	383	425
Sales and marketing	274	349	310
Research and development	140	159	183
	$ 936	$ 1,008	$ 1,061

To calculate the excess tax benefits available as of the date of adoption for use in offsetting future tax shortfalls, the Company elected the "short-form" method in accordance with FASB Staff Position FAS No. 123R-3, *Transition Election Related to Accounting for the Tax Effects of Share-Based Payment Awards.*

Stock-Based Compensation — Non-Employees

The Company accounts for awards granted to non-employees other than members of the Company's board of directors in accordance with SFAS 123 and the EITF Abstract No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling Goods or Services* ("EITF 96-18"), which require such awards to be recorded at their fair value on the measurement date. The measurement of stock-based compensation is subject to periodic adjustment as the underlying awards vest. The Company amortizes compensation expense related to non-employee awards in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans.*

The fair value of stock options issued to consultants was calculated using the Black-Scholes options pricing model, based on the following assumptions:

	Years Ended December 31,		
	2008	2007	2006
Expected term	1-10 years	1-10 years	10 years
Expected volatility	48%	50%	50%
Risk-free interest rate	1.55% - 2.46%	3.45% - 4.92%	4.70%
Dividend yield	0%	0%	0%

Stock-based compensation expense related to awards granted and/or modified to non-employees was allocated as follows (in thousands):

	Years Ended December 31,		
	2008	2007	2006
General and administrative	$ 93	$ 5	$ 3
Sales and marketing	5	23	—
	$ 98	$ 28	$ 3

Foreign Currency

The Company's reporting currency is the U.S. dollar, while the functional currencies of the Company's foreign subsidiaries are their respective local currencies. The asset and liability accounts of the Company's foreign

subsidiaries are translated from their local currencies at the rates in effect at the balance sheet date. Revenue and expenses are translated at average rates of exchange prevailing during the period. Translation adjustments are accumulated and reported as a component of stockholders' equity. Foreign currency transaction gains and losses which result from transactions with customers that are denominated in a currency other than the entity's functional currency are recorded in other income and expense in the consolidated statements of income.

Advertising Expense

Advertising expense is charged to operations in the year in which it is incurred. Total advertising expense amounted to $103,000, $118,000, and $68,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

Comprehensive Income

In accordance with SFAS No. 130, *Reporting Comprehensive Income*, the Company is required to display comprehensive income and its components as part of the Company's full set of consolidated financial statements. Comprehensive income is composed of net income and other comprehensive income, including foreign currency translation adjustments.

Fair Value of Financial Instruments

The carrying amount of cash, cash equivalents and restricted cash are reasonable estimates of their fair value because of the short maturity of these items.

The carrying amount of long-term debt reasonably approximates its fair value as the majority of the borrowings are at interest rates that fluctuate with current market conditions.

The Company has determined that it is not practicable to estimate the fair value of its non-current unbilled receivables as there is no ready market for such instruments. See Note 3 — Balance Sheet Information: Unbilled Receivables for additional information.

Earnings Per Share

In accordance with SFAS No. 128, Earnings per Share, the following table sets forth the computation of basic and diluted earnings per share (in thousands, except per share data):

	Years Ended December 31,		
	2008	2007	2006
Numerator:			
Net income	$ 8,663	$ 5,793	$ 2,382
Denominator:			
Weighted average common shares outstanding	44,848	39,060	38,018
Effect of dilutive securities:			
Nonvested shares	5	4	—
Stock options	635	438	318
Warrants	1,904	1,931	1,908
Total shares for purpose of calculating diluted net income per share	47,392	41,433	40,244
Earnings per share:			
Basic	$ 0.19	$ 0.15	$ 0.06
Diluted	$ 0.18	$ 0.14	$ 0.06

The following potential common shares were excluded from the computation of diluted net income per share because their effect would have been anti-dilutive (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Nonvested shares	—	78	481
Stock options	669	283	38

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. In February 2008, the FASB issued FASB Staff Position 157-1, Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13 ("FSP 157-1") and FSP 157-2, Effective Date of FASB Statement No. 157. FSP 157-1 amends SFAS 157 to remove certain leasing transactions from its scope. FSP 157-2 delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of 2009. The measurement and disclosure requirements related to financial assets and financial liabilities are effective for the Company beginning in the first quarter of 2008. The adoption of SFAS 157 for financial assets and financial liabilities in the first quarter of 2008 did not have a significant impact on the Company's consolidated financial statements. The Company is currently evaluating the impact that SFAS 157 will have on its consolidated financial statements when it is applied to non-financial assets and non-financial liabilities beginning in the first quarter of 2009.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ("SFAS 159"). SFAS 159 permits companies to choose to measure certain financial instruments and other items at fair value. The standard requires that unrealized gains and losses are reported in earnings for items measured using the fair value option. SFAS 159 is effective for the Company beginning in the first quarter of 2008. The adoption of SFAS 159 did not have an impact on the Company's consolidated financial statements.

In December 2007, the SEC issued SAB 110 to amend the SEC's views discussed in SAB 107 regarding the use of the simplified method in developing an estimate of expected life of share options in accordance with SFAS 123R. SAB 110 is effective for the Company beginning in the first quarter of 2008. As of December 31, 2007, the Company did not use the simplified method and the adoption of SAB 107, as amended by SAB 110, did not have an impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ("SFAS 141(R)"). SFAS 141(R) will change how business acquisitions are accounted for. SFAS 141(R) is effective for fiscal years beginning on or after December 15, 2008. The adoption of SFAS 141(R) is not expected to have a material impact on the Company's consolidated financial statements.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements — an amendment of Accounting Research Bulletin No. 51*. SFAS No. 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent's ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS No. 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS No. 160 is effective

for fiscal years beginning after December 15, 2008. The adoption of SFAS No. 160 is not expected to have a material impact on the Company's consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *"Disclosures about Derivative Instruments and Hedging Activities, an amendment of FASB Statement No. 133"* (SFAS 161). SFAS 161 requires the Company to provide greater transparency about how and why it uses derivative instruments, how the instruments and related hedged items are accounted for under SFAS No. 133, *"Accounting for Derivative Instruments and Hedging Activities"* (SFAS 133), and how the instruments and related hedged items affect the Company's financial position, results of operations, and cash flows. SFAS 161 became effective on January 1, 2009. The adoption of SFAS 161 is not expected to have a material impact on the Company's consolidated financial statements.

In April 2008, the FASB has issued FASB Staff Position 142-3 ("FSP 142-3"), *Determination of the Useful Life of Intangible Assets.* FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, *Goodwill and Other Intangible Asset.* The intent of FSP 142-3 is to improve the consistency between the useful life of a recognized intangible asset under FASB Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS 141(R), and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. The adoption of FSP 142-3 is not expected to have a material impact on the Company's consolidated financial statements.

Note 3. Balance Sheet Information

Accounts Receivable:

Accounts receivable consisted of the following (in thousands):

	December 31,	
	2008	2007
Accounts receivable	$ 20,674	$ 13,893
Less: allowance for doubtful accounts	(59)	(121)
	$ 20,615	$ 13,772

Unbilled Receivables

The Company has unbilled receivables pertaining to customer contractual holdback provisions, whereby the Company invoices the final retention payment(s) due under its sales contracts in periods generally ranging from 12 to 24 months after the product has been shipped to the customer and revenue has been recognized.

Long-term unbilled receivables as of December 31, 2008 and 2007 consisted of unbilled receivables from customers due more than one year subsequent to period end. The customer holdbacks represent amounts intended to provide a form of security for the customer rather than a form of long-term financing; accordingly, these receivables have not been discounted to present value. At December 31, 2008, the expected payment schedule for these accounts was as follows (in thousands):

	December 31, 2008
2009	$ —
2010	1,929
	$ 1,929

Inventories

Inventories consisted of the following (in thousands):

	December 31, 2008	December 31, 2007
Raw materials	$ 2,894	$ 3,450
Work in process	139	102
Finished goods	5,460	1,239
	$ 8,493	$ 4,791

Excess and obsolete reserves included in inventory at December 31, 2008 and 2007 were $128,000 and $102,000, respectively.

Property and Equipment

Property and equipment consisted of the following (in thousands):

	December 31, 2008	December 31, 2007
Machinery and equipment	$ 2,434	$ 2,209
Office equipment, furniture, and fixtures	772	368
Automobiles	22	22
Software	208	166
Leasehold improvements	466	301
Construction in progress	—	169
	3,902	3,235
Less: accumulated depreciation and amortization	(2,057)	(1,564)
	$ 1,845	$ 1,671

Depreciation and amortization expense was approximately $493,000, $304,000, and $212,000 for the years ended December 31, 2008, 2007, and 2006, respectively. Included in these amounts was depreciation expense related to equipment under capital leases of approximately $35,000, $37,000, and $39,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

Intangible Assets

Intangible assets consisted of the following (in thousands):

	December 31, 2008	December 31, 2007
Patents at cost	$ 578	$ 573
Less: accumulated amortization	(226)	(197)
Less: impairment reserve	(31)	(31)
Net carrying amount	$ 321	$ 345

Amortization of intangibles was approximately $29,000, $19,000 and $19,000 for the years ended December 31, 2008, 2007 and 2006, respectively.

Future estimated amortization expense on intangible assets is as follows (in thousands):

	December 31, 2008
2009	$ 25
2010	25
2011	25
2012	25
2013	25
Thereafter	196
	$ 321

The weighted average remaining life at December 31, 2008 and December 31, 2007 was 13.6 and 14.6 years, respectively.

Accrued Expenses and Other Current Liabilities

Accrued expenses and other current liabilities consisted of the following (in thousands):

	December 31,	
	2008	2007
Accrued payroll and commission expenses	$ 2,929	$ 1,014
Accrued collaboration fees	916	—
Inventory in transit	251	393
Professional fees	193	180
Other accrued expenses and current liabilities	498	281
	$ 4,787	$ 1,868

Note 4. Long-Term Debt

Long-term debt consisted of the following (in thousands):

	December 31,	
	2008	2007
Promissory notes payable	$ 557	$ 729
Less: current portion	(172)	(172)
Long-term debt	$ 385	$ 557

Future minimum principal payments due under long-term debt arrangements consist of the following (in thousands):

	December 31, 2008
2009	$ 172
2010	172
2011	128
2012	85
	$ 557

Revolving Notes Payable and Promissory Note Payable

On December 1, 2005, the Company entered into an agreement with a financial institution for a $2.0 million revolving note ("revolving note") and a $222,000 fixed rate-installment note ("fixed promissory note") with maturity dates of December 1, 2006, subsequently extended to March 1, 2007 and December 15, 2010, respectively. The revolving note bears interest at a base rate or LIBOR-based rate as elected by the Company. The interest rate was amended on April 26, 2006 to modify the definition of base rate and increase the rate to base rate plus 1% or LIBOR plus 2.5%. The fixed promissory note bears an annual interest rate of 10%. These notes are secured by the Company's accounts receivable, inventories, property, equipment and other general intangibles except for intellectual property.

On April 26, 2006, the Company entered into a loan and security agreement ("loan and security agreement") with the financial institution for an additional $2.0 million credit facility ("credit facility") with a maturity date of December 1, 2006, subsequently extended to March 1, 2007. The credit facility advances bear interest rates of base rate plus 1% or LIBOR plus 2.5%. The credit facility is secured by the Company's cash and cash equivalents, accounts receivable, inventory, property and other general intangibles except for intellectual property.

On December 7, 2006, the revolving note was amended to increase the face amount of the note to $3.5 million.

On March 1, 2007, the Company renewed the revolving note and the loan and security agreement ("the first modification") to a maturity date of March 31, 2008. Additional amended terms under the first modification were an interest rate change to base rate or LIBOR plus 2.5%, limitation of advances to a borrowing base, and various reporting requirements and satisfaction of certain financial ratios and covenants by the Company.

On March 28, 2007, the Company modified the loan and security agreement ("the second modification") to add a $1.0 million equipment promissory note ("equipment promissory note"). The equipment promissory note bears an interest rate of cost of funds plus 2.75% and matures September 30, 2012. Additional amended terms under the second modification were changes to the financial ratios and covenants that were to be maintained by the Company.

As of December 31, 2008 and 2007 there were no borrowings under the revolving note and the credit facility. The amounts outstanding on the fixed promissory note and the equipment promissory note were $89,000 and $468,000, respectively, at December 31, 2008 and $133,000 and $596,000, respectively, at December 31, 2007. The interest rate for the equipment promissory note at December 31, 2008 and 2007 was 7.81%. The Company was in compliance with all covenants under the loan and security agreement. In February 2009, the Company paid the remaining balance of the fixed promissory note for a total of $83,000, including accrued interest.

On March 27, 2008 the Company entered into a new credit agreement ("credit agreement") with its existing financial institution that replaces the $2.0 million credit facility and the $3.5 million revolving note. The new credit agreement, as amended in September 2008 and December 2008, allows borrowings of up to $12.0 million on a revolving basis at LIBOR plus 2.75% and expires on March 31, 2009. The credit agreement is secured by the Company's accounts receivable, inventories, property, equipment and other intangibles except intellectual property. The Company is subject to certain financial and administrative covenants under the new credit agreement. As of December 31, 2008, the Company was non-compliant with certain financial reporting covenants under this credit agreement. Subsequent to December 31, 2008, the lender granted a waiver for this non-compliance.

During the periods presented, the Company provided certain customers with irrevocable standby letters of credit to secure its obligations for the delivery of products, performance guarantees and warranty commitments in accordance with sales arrangements. These letters of credit were issued under the Company's revolving note

credit facility up to March 2008 and under the Company's credit agreement beginning in March 2008. The letters of credit generally terminate within 12 to 36 months but, in some instances, up to 65 months from issuance. At December 31, 2008 and December 31, 2007, the amounts outstanding on these letters of credit totaled approximately $8.4 million and $2.2 million, respectively.

In February 2009, the Company terminated the March 2008 credit agreement. As a result, the Company transferred $9.1 million in cash to a restricted cash account as collateral for outstanding irrevocable standby letters of credit that were collateralized by the credit agreement as of the date of termination.

In January 2009, the Company entered into a new loan and security agreement with another financial institution which became effective in February 2009 and provides a total available credit line of $15.0 million. Under this new agreement, the Company is allowed to draw advances up to $10.0 million on a revolving line of credit or utilize up to $14.8 million as collateral for irrevocable standby letters of credit, provided that the aggregate of the advances and the collateral do not exceed $15.0 million. Advances under the revolving line of credit incur interest based on either a prime rate index or LIBOR plus 1.375%. The new loan and security agreement expires on December 31, 2009 and is collateralized by substantially all of the Company's assets. The Company is subject to certain financial and administrative covenants under this new agreement.

Note 5. Capital Leases

The Company leases certain equipment under agreements classified as capital leases. The terms of the lease agreements generally range up to five years. Costs and accumulated depreciation of equipment under capital leases were $175,000 and $115,000 as of December 31, 2008, respectively. As of December 31, 2007, costs and accumulated depreciation of equipment under capital leases were $175,000 and $80,000, respectively.

Future minimum payments under capital leases consist of the following (in thousands):

	December 31, 2008
2009	$ 43
2010	29
Total future minimum lease payments	72
Less: amount representing interest	(8)
Present value of net minimum capital lease payments	64
Less: current portion	(37)
Long-term portion	$ 27

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 6. Income Taxes

The components of the provision for income taxes consist of the following (in thousands):

	Years Ended December 31,		
	2008	2007	2006
Current tax expense:			
Federal	$ 4,817	$ 3,466	$ 1,654
State	803	806	442
Foreign	86	16	2
	$ 5,706	$ 4,288	$ 2,098
Deferred tax benefit:			
Federal	(612)	(327)	(775)
State	(62)	(14)	(84)
	$ (674)	$ (341)	$ (859)
Total provision for income taxes	$ 5,032	$ 3,947	$ 1,239

A reconciliation of income taxes computed at the statutory federal income tax rate to the provision for income taxes included in the accompanying statements of income is as follows (in thousands, except percentages):

	Years Ended December 31,		
	2008	2007	2006
U.S. federal taxes at statutory rate	35%	35%	34%
State income taxes, net of federal benefit	3	5	5
Stock-based compensation	2	3	11
Valuation allowance	—	—	(13)
Extraterritorial income exclusion	—	—	(3)
Other	(3)	(1)	(1)
Effective tax rate	37%	42%	33%

Total deferred tax assets and liabilities consist of the following (in thousands):

	Years Ended December 31,	
	2008	2007
Deferred tax assets:		
Net operating loss carry forwards	$ 206	$ 220
Accruals and reserves	1,941	1,210
Net deferred tax assets	$ 2,147	$ 1,430
Deferred tax liabilities:		
Depreciation on property and equipment	$ (207)	$ (90)
Unrecognized gain on translation of foreign currency receivables	(7)	(140)
§481(a) Adjustment - Unicap	(59)	—
Total deferred tax liabilities	$ (273)	$ (230)
Net deferred tax assets	$ 1,874	$ 1,200
As reported on the balance sheet:		
Current assets, net	$ 1,755	$ 1,052
Non-current assets, net	119	148
Net deferred tax assets	$ 1,874	$ 1,200

In assessing the recoverability of deferred tax assets, management considers whether it is more likely than not that the assets will be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible.

Management considers, among other things, projected future taxable income in making this assessment. Based upon the projections for future taxable income over the periods in which the deferred tax items are recognizable for tax reporting purposes, management has determined it is more likely than not that the Company will realize the benefits of these differences at December 31, 2008 and 2007.

At December 31, 2008 and 2007, the Company had net operating loss carry-forwards of approximately $546,000 and $588,000, respectively, for federal and $252,000 for California. The net operating loss carry-forwards, if not utilized, will expire in 2021 for federal and 2015 for California purposes. Utilization of the net operating loss carry-forwards is subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. The annual limitation will result in the expiration of the net operating loss carry-forwards before utilization. Management has estimated the amount which may ultimately be realized and recorded deferred tax assets accordingly.

The Company adopted the provisions of FIN 48 on January 1, 2007. Measurement under FIN 48 is based on judgment regarding the largest amount that is greater than 50% likely of being realized upon ultimate settlement with a taxing authority. The total amount of unrecognized tax benefits as of the date of adoption was immaterial. As a result of the implementation of FIN 48, the Company recognized no increase in the liability for unrecognized tax benefits, and there were no unrecognized income tax benefits during the tax year ended December 31, 2008.

The Company adopted the accounting policy that interest recognized in accordance with Paragraph 15 of FIN 48 and penalty recognized in accordance with Paragraph 16 of FIN 48 are classified as part of its income taxes. The amounts of interest and penalty recognized in the statements of income and statements of financial position for the years ended December 31, 2008 and 2007 were insignificant.

The Company is subject to taxation in the U.S. and various states and foreign jurisdictions. There are no ongoing examinations by taxing authorities at this time. The Company's various tax years from 1995 to 2008 remain open in various taxing jurisdictions.

Note 7. Commitments and Contingencies

Lease Obligations

The Company leases facilities under fixed non-cancelable operating leases that expire on various dates through July 2019. Future minimum lease payments consist of the following (in thousands):

	December 31, 2008
2009	$ 1,050
2010	1,342
2011	1,159
2012	1,127
2013	1,155
Thereafter	6,995
	$ 12,828

Total rent and lease expense $651,000, $462,000, and $287,000 for the years ended December 31, 2008, 2007, and 2006, respectively.

The Company is obligated under an operating lease to pay for certain tenant improvement costs in excess of a construction allowance. The Company believes that a reasonable estimate of its obligation under this agreement ranges from $2 million to $3 million and expects to incur the costs in 2009.

Warranty

Changes in the Company's accrued warranty reserve and the expenses incurred under its warranties were as follows (in thousands):

	Years Ended December 31,	
	2008	2007
Balance, beginning of period	$ 868	$ 85
Warranty costs charged to cost of revenue, including extended warranty costs	193	850
Utilization of warranty	(103)	(67)
Reduction of extended warranty reserve	(688)	—
Balance, end of period	$ 270	$ 868

Warranty costs during 2007 included costs attributable to estimated service costs under extended service contracts. During 2008, the Company reduced the accrued warranty reserve by $688,000 to reflect the cancellation of an extended product warranty contract and the related elimination of the estimated warranty liability.

Purchase Obligations

In 2008, the Company entered into a supply agreement with a vendor. Under this agreement, the Company is obligated to pay a fee of up to $250,000 if the Company does not meet minimum purchase requirements by 2012. The Company did not have any other non-cancelable contractual purchase obligations with its vendors at December 31, 2008 or December 31, 2007.

The Company had purchase order arrangements with its vendors for which it had not received the related goods or services at December 31, 2008 and at December 31, 2007. These arrangements are subject to change

based on the Company's sales demand forecasts and the Company has the right to cancel the arrangements prior to the date of delivery. The majority of these purchase order arrangements were related to various key raw materials and components parts. As of December 31, 2008 and December 31, 2007, the Company had approximately $7.1 million and $8.1 million, respectively, of open cancelable purchase order arrangements.

Guarantees

The Company enters into indemnification provisions under its agreements with other companies in the ordinary course of business, typically with customers. Under these provisions, the Company generally indemnifies and holds harmless the indemnified party for losses suffered or incurred by the indemnified party as a result of the Company's activities, generally limited to personal injury and property damage caused by the Company's employees at a customer's desalination plant in proportion to the employee's percentage of fault for the accident. Damages incurred for these indemnifications would be covered by the Company's general liability insurance to the extent provided by the policy limitations. The Company has not incurred material costs to defend lawsuits or settle claims related to these indemnification agreements. As a result, the estimated fair value of these agreements is not material. Accordingly, the Company has no liabilities recorded for these agreements as of December 31, 2008 and December 31, 2007.

In certain cases, the Company issues warranty and product performance guarantees to its customers for amounts ranging from 10% to 30% of the total sales agreement to endorse the execution of product delivery and the warranty of design work, fabrication and operating performance of the PX device. These guarantees are issued under the Company's credit facility (see Note 4) or collateralized by restricted cash (see Note 2). These guarantees typically remain in place for periods ranging from 24 to 36 months and, in some cases, up to 65 months, which relate to the underlying product warranty period.

Employee Agreements

The Company had agreements with certain executives governing the terms of their employment for certain periods. All but one of these agreements expired on December 31, 2008. The remaining agreement with the Company's chief executive officer will expire in December 2009.

Litigation

The Company is not party to any material litigation, and the Company is not aware of any pending or threatened litigation against it that the Company believes would adversely affect its business, operating results, financial condition or cash flows. However, in the future, the Company may be subject to legal proceedings in the ordinary course of business.

Note 8. Defined Contribution Plan

The Company has a 401(k) defined contribution plan for all employees over age 18. Generally, employees can defer up to 20% of their compensation through payroll withholdings into the plan. The Company can make discretionary matching contributions. The Company made contributions $105,000, $100,000, and $68,000 during the years ended December 31, 2008, 2007 and 2006, respectively.

Note 9. Stockholders' Equity

Preferred Stock

The Company has the authority to issue 10,000,000 shares of $0.001 par value preferred stock. The Company's board of directors has the authority, without action by the Company's stockholders, to designate and issue shares of preferred stock in one or more series. The board of directors is also authorized to designate the rights, preferences, and voting powers of each series of preferred stock, any or all of which may be greater

than the rights of the common stock including restrictions of dividends on the common stock, dilution of the voting power of the common stock, reduction of the liquidation rights of the common stock, and delaying or preventing a change in control of the Company without further action by the stockholders. To date, the board of directors has not designated any rights, preference or powers of any preferred stock and as of December 31, 2008 and 2007, none was issued or outstanding.

Common Stock

The Company has the authority to issue 200,000,000 shares of $0.001 par value common stock. Subject to the preferred rights of the holders of shares of any class or series of preferred stock as provided by the board of directors with respect to any such class or series of preferred stock, the holders of the common stock shall be entitled to receive dividends, as and when declared by the board of directors. In the event of any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, after the distribution or payment to the holders of shares of any class or series of preferred stock as provided by the board of directors with respect to any such class or series of preferred stock, the remaining assets of the Company available for distribution to stockholders shall be distributed among and paid to the holders of common stock ratably in proportion to the number of shares of common stock held by them respectively. As of December 31, 2008 and 2007, 50,015,718 and 39,777,446 shares were issued and outstanding, respectively.

On July 2, 2008, the Company sold 14,000,000 shares of its common stock in its initial public offering ("IPO") at $8.50 per share, before underwriting discounts and commissions. Of the 14,000,000 shares sold in the offering, 8,078,566 shares were sold by the Company and 5,921,434 shares were sold by stockholders at an offering price of $8.50 per share. On July 9, 2008, the underwriters exercised their option to purchase an additional 2,100,000 shares from the Company at the IPO price to cover overallotments. The Company received net proceeds of approximately $76.7 million from these transactions, after deducting underwriting discounts and commissions of $6.1 million and additional offering-related expenses of approximately $3.7 million.

Private Placement

In June 2007, the Company issued 1,000,000 shares of common stock with an issuance price of $5.00 per share. Net proceeds from the issuance were $5.0 million, less $41,000 in fees.

Stock Option Plans

In April 2001, the Company adopted the 2001 Stock Option Plan under which 2,500,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. In April 2002, the Company adopted the 2002 Stock Option/Stock Issuance Plan under which 1,509,375 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. In January 2004, the Company adopted the 2004 Stock Option/Stock Issuance Plan under which 850,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. In May 2006, the Company adopted the 2006 Stock Option/Stock Issuance Plan under which 800,000 shares of the Company's common stock were reserved for issuance to employees, directors and consultants. During the first quarter of 2008, an additional 60,000 shares of common stock were reserved for issuance under the 2006 plan, resulting in a total of 860,000 shares reserved for issuance under this plan. In 2008, the Company's board of directors passed a resolution that, upon the effectiveness of the IPO in July 2008, no further options would be issued under the 2001 Stock Option Plan and the 2002, 2004, and 2006 Stock Option/Stock Issuance Plans.

In connection with the IPO in July 2008, the Company's board of directors adopted the 2008 Equity Incentive Plan ("2008 Plan") which became effective immediately preceding the effectiveness of the IPO. The 2008 Plan permits the grant of stock options, stock appreciation rights, restricted stock, restricted stock units, performance units, performance shares and other stock-based awards. Under this plan, 1,400,000 shares of

common stock were reserved for issuance in 2008, of which 146,449 shares remain available for issuance as of December 31, 2008. In February 2009, the Company's board of directors approved an additional 2,500,000 shares to reserve for issuance under this plan, as provided for in the plan agreement.

The option plans provide for the issuance of common stock and the granting of incentive stock options and other share-based awards to employees, officers and directors and the granting of non-statutory stock options and other share-based awards to employees, officers and directors or consultants of the Company. The Company has granted stock options under these plans. The Company grants incentive stock options with exercise prices of not less than the estimated fair value of the stock on the date of grant (85% of the estimated fair value for non-statutory stock options). If, at the time the Company grants an option, the optionee directly owns stock possessing more than 10% of the total combined voting power of all classes of stock of the Company, the option price must be at least 110% of the estimated fair value and are not exercisable for more than five years after the date of grant. Options granted under the plans vest generally over four years and generally expire no more than ten years after the date of grant or earlier if employment is terminated.

Early Exercise of Employee Options

Options issued under the 2001 Stock Option Plan and the 2002, 2004, and 2006 Stock Option/Stock Issuance Plans may be exercised prior to vesting, with the underlying shares subject to the Company's right of repurchase, which lapses over the vesting term. The 2008 Plan does not allow options to be exercised prior to vesting. In accordance with EITF Issue No. 23, Issues Related to the Accounting for Stock Compensation under APB 25 and FIN 44, shares purchased by employees pursuant to the early exercise of stock options are not deemed to be issued until all restrictions on such shares lapse (i.e., the employee is vested in the award). Therefore, consideration received in exchange for exercised and restricted shares related to the early exercise of stock options is recorded as a liability for early exercise of stock options in the accompanying consolidated balance sheets and will be transferred into common stock and additional paid-in capital as the restrictions on such shares lapse.

In February 2005, both vested and unvested options to purchase 4,293,958 shares of common stock were exercised by the signing of full recourse promissory notes totaling $948,000. The notes bear interest at 3.76% and are due in February 2010. The interest rate on the notes was deemed to be a below market rate of interest resulting in a deemed modification in exercise price of the options. As a result, the Company accounted for these options as variable option awards until the employees were vested in the award. For the years ended December 31, 2008, 2007 and 2006, the Company recorded $155,000, $783,000, and $1.1 million, respectively, of stock-based compensation related to the options exercised with promissory notes.

As of December 31, 2008, there were no shares outstanding subject to the Company's right of repurchase as a result of the early exercise of options. As of December 31, 2007, 56,879 shares of common stock were outstanding subject to the Company's right of repurchase at prices ranging from $0.20 to $1.00, totaling $20,000 and classified in current liabilities.

The promissory notes related to the exercise of the unvested shares and the corresponding aggregate exercise price for these shares were recorded as notes receivable from stockholders. Of the $948,000 of promissory notes, notes in an aggregate amount of $552,000 were issued by executive officers and directors. As of December 31, 2008, all notes issued by executive officers and directors were paid in full. The remaining outstanding balances of the full recourse promissory notes at December 31, 2008 were $296,000 and were related entirely to vested shares. There were no outstanding balances related to unvested shares at December 31, 2008. The outstanding balances of the full recourse promissory notes at December 31, 2007 were $855,000, of which $835,000 related to vested shares and $20,000 related to unvested shares.

For the years ended December 31, 2008, 2007 and 2006, the Company adopted SFAS 123R and recognized stock-based compensation under SFAS 123R and EITF 96-18 related to employees and consultants of $879,000, $253,000 and $13,000, respectively. See Note 2 — Summary of Significant Accounting Policies.

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes the stock option activity under the Company's stock option plans:

	Options Outstanding			
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)(2)
Balance 12/31/05	**556,042**	**$ 1.00**	**9.8**	**—**
Granted	642,000	$ 2.65	—	—
Exercised	(5,000)	$ 1.00	—	—
Forfeited	(25,730)	$ 1.00	—	—
Balance 12/31/06	**1,167,312**	**$ 1.91**	**9.4**	**—**
Granted	181,900	$ 5.00	—	—
Exercised	(17,083)	$ 1.00	—	—
Forfeited	(51,521)	$ 1.32	—	—
Balance 12/31/07	**1,280,608**	**$ 2.38**	**8.6**	**$ 3,355**
Granted	1,367,078	$ 8.27	—	—
Exercised	(26,511)	$ 1.96	—	—
Forfeited	(89,189)	$ 4.78	—	—
Balance 12/31/08	**2,531,986**	**$ 5.48**	**8.6**	**$ 6,593**
Vested and exercisable as of December 31, 2008	**693,964**	**$ 1.99**	**7.4**	**$ 3,879**
Vested and exercisable as of December 31, 2008 and expected to vest thereafter(1)	**1,896,470**	**$ 5.20**	**8.5**	**$ 5,409**

(1) Options that are expected to vest are net of estimated future option forfeitures in accordance with the provisions of SFAS 123R.

(2) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair value of the Company's stock as of December 31, 2008 of $7.58 per share.

Shares available for grant under the option plans at December 31, 2008 and 2007 were 146,449 and 53,351, respectively.

The weighted average per share fair value of options granted to employees for the years ended December 31, 2008, 2007 and 2006 was $3.87, $2.41 and $1.30, respectively. The aggregate intrinsic value of options exercised for the years ended December 31, 2008, 2007, and 2006 was $108,000, $62,000, and $8,000, respectively. As of December 31, 2008, total unrecognized compensation cost, net of forfeitures, related to non-vested options was $3.3 million, which is expected to be recognized as expense over a weighted-average period of approximately 3.4 years.

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes options outstanding after exercises and cancellations as of December 31, 2008:

Range of Exercise Prices	Outstanding and Exercisable	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Vested and Exercisable	Weighted Average Exercise Price
$1.00 – $2.65	1,039,281	7.4	$ 1.95	643,472	$ 1.75
$5.00 – $7.94	334,854	9.1	$ 5.39	50,492	$ 5.00
$8.50 – $11.05	1,157,851	9.5	$ 8.68	—	$ —
	2,531,986			693,964	

Warrants

As of December 31, 2008, the Company had outstanding warrants to purchase an aggregate of 2,074,122 shares of the Company's common stock at prices ranging from $0.20 to $1.00 per share. The warrants, issued in 2002 through 2005, are fully exercisable over a 10 year term, expiring in 2012 through 2015. The outstanding warrants include a warrant issued in November 2005 to an executive officer of the Company to purchase 150,000 shares of common stock at $1.00 per share.

During the year ended December 31, 2008, no warrants were exercised.

During the year ended December 31, 2007, warrants to purchase 314,950 shares of common stock were exercised for cash and the proceeds received by the Company from these exercises were $143,000.

During the year ended December 31, 2006, no warrants were exercised.

In February 2005, warrants to purchase 315,974 shares of common stock were exercised by the signing of full recourse promissory notes totaling $63,000. The notes bear interest at 3.76% and are due February 2010. As of December 31, 2008, all of the notes have been repaid and, as of December 31, 2007, $43,000 of the notes had been repaid.

A summary of the Company's warrant activity for the years ended (in thousands, except exercise prices and contractual life data):

	Years Ended December 31,		
	2008	2007	2006
Outstanding, beginning of period	2,074	2,389	2,589
Exercised during the period	—	(315)	
Cancelled during the period	—		(200)
Issued during the period	—		
Outstanding, end of period	2,074	2,074	2,389
Weighted average exercise price of warrants outstanding at end of period	$ 0.52	$ 0.52	$ 0.52
Weighted average remaining contractual life, in years, of warrants outstanding at end of period	4.7	5.7	6.7

Note 10. Business Segment and Geographic Information

The Company manufactures and sells high efficiency energy recovery products and related services and operates under one segment. The Company's chief operating decision maker is the chief executive officer ("CEO"). The CEO reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenue by geographic region for purposes of making operating decisions and assessing financial performance. Accordingly, the Company has concluded that it has one reportable segment.

The following geographic information includes net revenue to the Company's domestic and international customers based on the customers' requested delivery locations, except for certain cases in which the customer directed the Company to deliver its products to a location that differs from the known ultimate location of use. In such cases, the ultimate location of use, rather than the delivery location, is reflected in the table below (in thousands, except percentages):

	Years Ended December 31,		
	2008	2007	2006
Domestic revenue	$ 3,517	$ 2,125	$ 1,003
International revenue	48,602	33,289	19,055
Total revenue	$ 52,119	$ 35,414	$ 20,058
Revenue by country:			
Algeria	24%	12%	30%
Spain	16	35	9
China	11	8	5
United Arab Emirates	7	2	10
Saudi Arabia	*	13	*
Others	42	30	46
Total	100%	100%	100%

* Less than 1%.

Approximately 100% of the Company's long-lived assets were located in the United States at December 31, 2008 and 2007.

Note 11. Concentrations

Concentration of Credit Risk

Substantially all of the Company's cash and cash equivalents are placed on deposit and in money market funds at two major financial institutions in the U.S. Amounts located in the U.S. are insured by the Federal Deposit Insurance Corporation, or FDIC, generally up to $250,000. The Company's deposits may be in excess of FDIC insured limits. To date, the Company has not experienced any losses in such accounts.

The Company's accounts receivable are derived from sales to customers in the water desalination industry located around the world. The Company generally does not require collateral to support customer receivables, but frequently requires letters of credit securing payment. The Company performs ongoing evaluations of its customers' financial condition and periodically reviews credit risk associated with receivables. For sales with customers outside the U.S. (see Note 10 — Business Segment and Geographic Information), the Company may also obtain credit risk insurance to minimize credit risk exposure. As of December 31, 2008, approximately 50% of the Company's accounts receivable were insured against credit risk. An allowance for doubtful accounts is determined with respect to receivable amounts that the Company has determined to be doubtful of

collection using specific identification of doubtful accounts and an aging of receivables analysis based on invoice due dates. Actual collection losses may differ from management's estimates, and such differences could be material to the financial position, results of operations and cash flows. Uncollectible receivables are written off against the allowance for doubtful accounts when all efforts to collect them have been exhausted while recoveries are recognized when they are received.

Five customers accounted for approximately 81% of the Company's accounts receivable at December 31, 2008. As of December 31, 2007, three customers accounted for approximately 74% of accounts receivable.

Revenue from customers representing 10% or more of total revenue varies from year to year. For the year ended December 31, 2008, two customers, Hyflux Limited and Befesa Agua S.A. and affiliated joint ventures, accounted for approximately 16% and 11% of the Company's net revenue, respectively. For the year ended December 31, 2007, three customers represented approximately 20%, 23% and 13% of the Company's net revenue — specifically Acciona Agua, Geida and its member companies, and Doosan Heavy Industries, respectively. In 2006, two customers, GE Water and Process Technologies (formerly GE Ionics) and Geida, including its member companies, accounted for approximately 18% and 11% of the Company's net revenue, respectively. No other customer accounted for more than 10% of the Company's net revenue during any of these periods. Geida is a consortium of Befesa Agua, a subsidiary of Abengoa S.A; Cobra-Tedagua, a subsidiary of ACS Actividades de Construcción y Servicios, S.A.; and Sadyt S.A., a subsidiary of Sacyr Vallehermoso, S. A.

Supplier Concentration

Certain of the raw materials and components used by the Company in the manufacture of its products are available from a limited number of suppliers. Shortages could occur in these essential materials and components due to an interruption of supply or increased demand in the industry. If the Company were unable to procure certain of such materials or components, it would be required to reduce its manufacturing operations, which could have a material adverse effect on its results of operations.

For year ended December 31, 2008, four suppliers (of which three were ceramics suppliers) represented approximately 72% of the total purchases of the Company. For the years ended 2007 and 2006, three suppliers (of which two were ceramics suppliers) represented approximately 66% and 71%, respectively, of the total purchases of the Company. As of December 31, 2008 and 2007, approximately 68% and 60%, respectively, of the Company's accounts payable were due to these suppliers.

Note 12. Related Party Transactions

The Company entered into a supply agreement with Piedmont Pacific Corporation, a company owned by James Medanich, a former director of the Company. Expenses incurred under this supply agreement amounted to $14,000, $18,000 and $4,000 for the years ending December 31, 2008, 2007 and 2006, respectively. There were no payments outstanding to this vendor as of December 31, 2008 and $1,000 was outstanding as of December 31, 2007. The Company believes that the transactions under the supply agreement were conducted as if consummated on an arm's-length basis between two independent parties.

The Company entered into a consulting agreement with Darby Engineering, LLC (invoiced as Think Mechanical, LLC), a firm owned by Peter Darby, a former director of the Company. Expenses incurred under this consulting agreement amounted to $119,000 for the year ended December 31, 2008; $27,000 in payments remained outstanding related to the agreement as of December 31, 2008. There were no expenses or payments related to the consulting agreement during the years ended December 31, 2007 or 2006. The Company believes that the transactions under the consulting agreement were conducted as if consummated on an arm's-length basis between two independent parties.

ENERGY RECOVERY, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Note 13. Supplementary Data — Quarterly Financial Data (unaudited)

The following table presents certain unaudited consolidated quarterly financial information for each of the eight fiscal quarters in the period ended December 31, 2008. This quarterly information has been prepared on the same basis as the audited Consolidated Financial Statements and includes all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the information for the periods presented. The results for these quarterly periods are not necessarily indicative of the operating results for a full year or any future period.

QUARTERLY FINANCIAL DATA (unaudited)
(in thousands, except per share amounts)

	Three Months Ended,							
	Dec. 31, 2008	Sept. 30, 2008	June 30, 2008	March 31, 2008	Dec. 31, 2007	Sept. 30, 2007	June 30, 2007	March 31, 2007
Quarterly Results of Operations*								
Net revenue	$ 21,994	$ 9,044	$ 11,961	$ 9,120	$ 13,845	$ 10,978	$ 3,452	$ 7,139
Gross profit	14,183	5,547	8,010	5,446	7,517	6,882	1,878	4,285
Operating expenses:								
General administrative	3,110	2,696	2,854	2,661	1,513	1,053	960	773
Sales and marketing	2,286	1,467	1,453	1,343	1,443	1,372	1,224	1,191
Research and development	692	678	536	509	484	392	440	389
Income (loss) from operations	$ 8,095	$ 706	$ 3,167	$ 933	$ 4,077	$ 4,065	$ (746)	$ 1,932
Net income (loss)	$ 5,264	$ 623	$ 1,829	$ 947	$ 2,701	$ 2,397	$ (424)	$ 1,119
Net income per common share:								
Basic	$ 0.11	$ 0.01	$ 0.05	$ 0.02	$ 0.07	$ 0.06	$ (0.01)	$ 0.03
Diluted	$ 0.10	$ 0.01	$ 0.04	$ 0.02	$ 0.06	$ 0.06	$ (0.01)	$ 0.03

* Quarterly results may not add up to annual results due to rounding.

Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

Item 9A(T). ***Controls and Procedures***

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, or "Exchange Act") pursuant to Rules 13a-15(e) and 15d-15(e) under the Exchange Act as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our chief executive officer and chief financial officer have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

Our disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and our chief executive officer and chief financial officer have concluded that these controls and procedures are effective at the "reasonable assurance" level. Our management, including the chief executive officer and chief financial officer, believes that a control system, no matter how well designed and operated, cannot provide absolute assurance that the objectives of the control system are met, and that no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

Management's Annual Report on Internal Control Over Financial Reporting and Attestation Report of the Registered Accounting Firm

This annual report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for newly public companies. We are required to comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002 for our fiscal year ending December 31, 2009. The management report and auditor attestation on the effectiveness of the Company's internal control over financial reporting must be included in our annual report for the fiscal year ending December 31, 2009.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Item 9B. ***Other Information***

None.

PART III

Item 10. ***Directors, Executive Officers and Corporate Governance***

The information required by this Item is incorporated by reference from the Company's Definitive Proxy Statement related to the Annual Meeting of Shareholders to be held June 12, 2009, to be filed by the Company with the SEC (the "Proxy Statement").

Item 11. ***Executive Compensation***

The information required by this Item is incorporated by reference from the Proxy Statement.

Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item is incorporated by reference from the Proxy Statement.

Item 13. ***Certain Relationships and Related Transactions and Director Independence***

The information required by this Item is incorporated by reference from the Proxy Statement.

Item 14. ***Principal Accountant Fees and Services***

The information required by this item is incorporated by reference from the Proxy Statement.

PART IV

Item 15. ***Exhibits and Financial Statement Schedules***

(a) The following documents are included as part of this Annual Report on Form 10-K.

(1) *Financial Statements.*

(2) *Financial Statement Schedules.*

SCHEDULE II
VALUATION AND QUALIFYING ACCOUNTS
(in thousands)

Description	Balance at Beginning of Period	Additions to Charged Costs and Expenses	Deductions	Balance at End of Period
Year Ended December 31, 2006				
Allowance for doubtful accounts	150	80	—	230
Reserve for obsolete inventory	97	30	(72)	55
Warranty reserve	110	61	(86)	85
Year Ended December 31, 2007				
Allowance for doubtful accounts	230	(105)	(4)	121
Reserve for obsolete inventory	55	47	—	102
Warranty reserve	85	850	(67)	868
Year Ended December 31, 2008				
Allowance for doubtful accounts	121	75	(137)	59
Reserve for obsolete inventory	102	26	—	128
Warranty reserve	868	193	(791)	270

All other schedules have been omitted because the information required to be presented in them is not applicable or is shown in the consolidated financial statements or related notes.

(3) *Exhibits:*

Exhibit		Description
3.1	*	Amended and Restated Certificate of Incorporation, as filed with the Delaware Secretary of State on July 7, 2008.
3.2	*	Amended and Restated Bylaws, effective as of July 8, 2008.
10.1	(2)◆	Form of Indemnification Agreement between the Company and its directors and officers.
10.2	(1)◆	2001 Stock Option Plan of the Company and form of Stock Option Agreement thereunder.
10.3	(1)◆	2002 Stock Option/Stock Issuance Plan of the Company and forms of Stock Option and Stock Purchase Agreements thereunder.
10.4	(1)◆	2004 Stock Option/Stock Issuance Plan of the Company and forms of Stock Option and Stock Purchase Agreements thereunder.
10.5	(1)◆	2006 Stock Option/Stock Issuance Plan of the Company and forms of Stock Option and Stock Purchase Agreements thereunder.
10.5.1	(1)◆	Amendment to 2006 Stock Option/Stock Issuance Plan of the Company.
10.5.2	(1)◆	Second Amendment to 2006 Stock Option/Stock Issuance Plan of the Company.
10.6	(2)◆	2008 Equity Incentive Plan of the Company and form of Stock Option Agreement thereunder.
10.6.1	(4)◆	Amendment to 2008 Equity Incentive Plan of the Company.
10.7	(1)◆	Employment Agreement dated March 1, 2006, between the Company and G.G. Pique.
10.7.1	(1)◆	Amendment to Employment Agreement dated January 1, 2008, between the Company and G.G. Pique.

Exhibit		Description
10.7.2	(3)◆	Amendment to Employment Agreement dated May 28, 2008, between the Company and G.G. Pique.
10.7.3	*◆	Amendment to Employment Agreement dated December 31, 2008, between the Company and G.G. Pique.
10.8	(1)◆	Employment Agreement dated November 1, 2007, between the Company and Tom Willardson.
10.8.1	(1)◆	Amendment to Employment Agreement dated February 25, 2008, between the Company and Tom Willardson.
10.9	(1)◆	Employment Agreement dated July 1, 2006, between the Company and Richard Stover.
10.9.1	(1)◆	Amendment to Employment Agreement dated February 25, 2008, between the Company and Richard Stover.
10.10	(1)◆	Employment Agreement dated July 1, 2006, between the Company and Terrill Sandlin.
10.10.1	(1)◆	Amendment to Employment Agreement dated February 25, 2008, between the Company and Terrill Sandlin.
10.11	(1)◆	Employment Agreement dated July 1, 2006, between the Company and MariaElena Ross.
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10.12	(1)	Independent Contractor Agreement dated January 23, 2008, between the Company and Darby Engineering LLC.
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10.13.1	(1)	Amendment to Lease Agreement dated October 3, 2005, between the Company and 2101 Williams Associates, LLC.
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10.14	(1)	Lease Agreement dated February 15, 2008, between the Company and Beretta Investment Group.
10.15	(1)	Lease Agreement dated August 7, 2006, between Energy Recovery Iberia, S.L. and REGUS Business Centre.
10.16	(2)	Loan and Security Agreement dated March 27, 2008, between the Company and Comerica Bank.
10.16.1	(2)	First Modification to Loan and Security Agreement dated March 27, 2008, between the Company and Comerica Bank.
10.16.2	(3)	Second Modification to Loan and Security Agreement dated May 29, 2008, between the Company and Comerica Bank.
10.16.3	–	Third Modification to Loan and Security Agreement dated September 18, 2008, between the Company and Comerica Bank, incorporated by reference herein to Exhibit 10.16.3 previously filed with the Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2008.
10.16.4	*	Fourth Modification to Loan and Security Agreement dated December 23, 2008, between the Company and Comerica Bank.

Exhibit		Description
10.17	*	Lease Agreement dated November 25, 2008, between the Company and Doolittle Williams, LLC.
10.18	*	Lease Agreement dated September 1, 2008, between Energy Recovery Iberia, S.L. and Lambaesis, S.L.
14.1	*	Code of Ethics.
21.1	*	List of subsidiaries of the Company.
23.1	*	Consent of BDO Seidman, LLP, Independent Registered Public Accounting Firm.
31.1	*	Certification of Principal Executive Officer pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	*	Certification of Principal Financial Officer pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	*	Certification of Principal Executive Officer and Principal Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
(1)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed April 1, 2008.
(2)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed May 12, 2008.
(3)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed June 9, 2008.
(4)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed June 27, 2008.

◆ Indicates management compensatory plan, contract or arrangement.

* Filed or furnished herewith, as applicable.

(b) *Index to Exhibits.*
See Exhibits listed under Item 15(a) (3).

(c) *Financial Statement Schedules.*

All financial statement schedules are omitted because they are not applicable or not required or because the required information is included in the financial statements, or notes there to, or in the Exhibits listed under Item 15(a)(2).

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of San Leandro, State of California, on the 26th day of March 2009.

ENERGY RECOVERY, INC.

By: /s/ G.G. PIQUE
G.G. Pique
President and Chief Executive Officer

Pursuant to the requirements of the Securities and Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ G.G. PIQUE G.G. Pique	President and Chief Executive Officer (Principal Executive Officer) and Director	March 26, 2009
/s/ THOMAS D. WILLARDSON Thomas D. Willardson	Chief Financial Officer (Principal Financial Officer)	March 26, 2009
/s/ DENO G. BOKAS Deno G. Bokas	Vice President Finance and Chief Accounting Officer (Principal Accounting Officer)	March 26, 2009
/s/ HANS PETER MICHELET Hans Peter Michelet	Executive Chairman	March 26, 2009
/s/ ARVE HANSTVEIT Arve Hanstveit	Director	March 26, 2009
/s/ FRED OLAV JOHANNESSEN Fred Olav Johannessen	Director	March 26, 2009
/s/ DOMINIQUE TREMPONT Dominique Trempont	Director	March 26, 2009
/s/ PAUL M. COOK Paul M. Cook	Director	March 26, 2009
/s/ JACKALYNE PFANNESTIEL Jackalyne Pfannestiel	Director	March 26, 2009
Marie-Elisabeth Paté-Cornell	Director	

EXHIBIT INDEX

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(2)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed May 12, 2008.

Exhibit		Description
(3)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed June 9, 2008.
(4)		Incorporated by reference herein to the same numbered exhibit previously filed with the Company's Registration Statement on Form S-1, as amended (Registration No. 333-150007), filed June 27, 2008.

◆ Indicates management compensatory plan, contract or arrangement.

* Filed or furnished herewith, as applicable.

Exhibit 3.1

AMENDED AND RESTATED CERTIFICATE OF INCORPORATION

OF

ENERGY RECOVERY, INC.

Energy Recovery, Inc., a corporation organized and existing under the laws of the State of Delaware (the "Corporation"), hereby certifies as follows:

A. The name of this corporation is Energy Recovery, Inc. The Corporation's original Certificate of Incorporation was filed with the Secretary of State of the State of Delaware on March 8, 2001, under the original name of ERI Acquisition Corp.

B. This Amended and Restated Certificate of Incorporation has been duly approved by the Board of Directors of the Corporation in accordance with Sections 242 and 245 of the General Corporation Law of the State of Delaware (the "DGCL").

C. This Amended and Restated Certificate of Incorporation has been duly approved by written consent of the stockholders of the Corporation in accordance with Sections 228, 242 and 245 of the DGCL.

D. The text of the Certificate of Incorporation of this Corporation is hereby amended and restated to read in its entirety as follows:

ARTICLE I

The name of the corporation is Energy Recovery, Inc. (the "Corporation").

ARTICLE II

The address of the Corporation's registered office in the State of Delaware is 1201 Orange Street, Suite 600, in the City of Wilmington, County of New Castle, Delaware, 19801. The name of its registered agent at such address is Agents and Corporations, Inc.

ARTICLE III

The nature of the business or purposes to be conducted or promoted by the Corporation is to engage in any lawful act or activity for which corporations may be organized under the DGCL.

ARTICLE IV

Section 1. This Corporation is authorized to issue two classes of stock, to be designated, respectively, Common Stock and Preferred Stock. The total number of shares of all classes of stock which this Corporation is authorized to issue is Two Hundred Ten Million (210,000,000) shares, of which Two Hundred Million (200,000,000) shares are Common Stock, $0.001 par value, and Ten Million (10,000,000) shares are Preferred Stock, $0.001 par value (the "Preferred Stock").

Section 2. Each share of Common Stock shall entitle the holder thereof to one (1) vote on any matter submitted to a vote at a meeting of stockholders.

Section 3. The Preferred Stock may be issued from time to time in one or more series pursuant to a resolution or resolutions providing for such issue duly adopted by the Board of Directors (authority to do so being hereby expressly vested in the Board of Directors). The Board of Directors is further authorized, subject to limitations prescribed by law, to fix by resolution or resolutions the designations, powers, preferences and rights, and the qualifications, limitations or restrictions thereof, of any wholly unissued series of Preferred Stock, including without limitation authority to fix by resolution or resolutions the dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), redemption price or prices, and liquidation preferences of any such series, and the number of shares constituting any such series and the designation thereof, or any of the foregoing. The Board of Directors is further authorized to increase (but not above the total number of authorized shares of the class) or decrease (but not below the number of shares of any such series then outstanding) the number of shares of any series, the number of which was fixed by it, subsequent to the issuance of shares of such series then outstanding, subject to the powers, preferences and rights, and the qualifications, limitations and restrictions thereof stated in this Amended and Restated Certificate of Incorporation or the resolution of the Board of Directors originally fixing the number of shares of such series. If the number of shares of any series is so decreased, then the Corporation shall take all such steps as are necessary to cause the shares constituting such decrease to resume the status which they had prior to the adoption of the resolution originally fixing the number of shares of such series.

Section 4. Except as otherwise required by law, holders of Common Stock shall not be entitled to vote on any amendment to this Amended and Restated Certificate of Incorporation (including any certificate of designation filed with respect to any series of Preferred Stock) that relates solely to the terms of one or more outstanding series of Preferred Stock if the holders of such affected series are entitled, either separately or together as a class with the holders of one or more other such series, to vote thereon by law or pursuant to this Amended and Restated Certificate of Incorporation (including any certificate of designation filed with respect to any series of Preferred Stock).

ARTICLE V

Section 1. The number of directors that constitutes the entire Board of Directors shall be determined in the manner set forth in the Bylaws of the Corporation. At each annual meeting of stockholders, directors of the Corporation shall be elected to hold office until the expiration of the term for which they are elected and until their successors have been duly elected and qualified or until their earlier resignation or removal; except that if any such meeting shall not be so held, such election shall take place at a stockholders' meeting called and held in accordance with the DGCL.

Section 2. The directors of the Corporation shall be divided into three classes as nearly equal in size as is practicable, hereby designated Class I, Class II and Class III. Directors shall be assigned to each class in accordance with a resolution or resolutions adopted by the Board of Directors. At the first annual meeting of stockholders following the date hereof, the term of office of the Class I directors shall expire and Class I directors shall be elected for a full term of three years.

At the second annual meeting of stockholders following the date hereof, the term of office of the Class II directors shall expire and Class II directors shall be elected for a full term of three years. At the third annual meeting of stockholders following the date hereof, the term of office of the Class III directors shall expire and Class III directors shall be elected for a full term of three years. At each succeeding annual meeting of stockholders, directors shall be elected for a full term of three years to succeed the directors of the class whose terms expire at such annual meeting. If the number of directors is changed,

any newly created directorships or decrease in directorships shall be so apportioned among the classes as to make all classes as nearly equal in number as is practicable, provided that no decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

ARTICLE VI

Section 1. Any director or the entire Board of Directors may be removed from office at any time, but only for cause, and only by the affirmative vote of the holders of at least a majority of the voting power of the issued and outstanding capital stock of the Corporation entitled to vote in the election of directors.

Section 2. Except as otherwise provided for or fixed by or pursuant to the provisions of Article IV hereof in relation to the rights of the holders of Preferred Stock to elect directors under specified circumstances, newly created directorships resulting from any increase in the number of directors, created in accordance with the Bylaws of the Corporation, and any vacancies on the Board of Directors resulting from death, resignation, disqualification, removal or other cause shall be filled only by the affirmative vote of a majority of the remaining directors then in office, even though less than a quorum of the Board of Directors, or by a sole remaining director, and not by the stockholders. A person so elected by the Board of Directors to fill a vacancy or newly created directorship shall hold office until the next election of the class for which such director shall have been chosen until his or her successor shall have been duly elected and qualified, or until such director's earlier death, resignation or removal. No decrease in the number of directors constituting the Board of Directors shall shorten the term of any incumbent director.

ARTICLE VII

Section 1. The Corporation is to have perpetual existence.

Section 2. The business and affairs of the Corporation shall be managed by or under the direction of the Board of Directors. In addition to the powers and authority expressly conferred upon them by statute or by this Amended and Restated Certificate of Incorporation or the Bylaws of the Corporation, the directors are hereby empowered to exercise all such powers and do all such acts and things as may be exercised or done by the Corporation.

Section 3. In furtherance and not in limitation of the powers conferred by statute, the Board of Directors is expressly authorized to adopt, alter, amend or repeal the Bylaws of the Corporation. The affirmative vote of at least a majority of the Board of Directors then in office shall be required in order for the Board of Directors to adopt, amend, alter or repeal the Corporation's Bylaws. The Corporation's Bylaws may also be adopted, amended, altered or repealed by the stockholders of the Corporation. Notwithstanding the above or any other provision of this Amended and Restated Certificate of Incorporation, the Bylaws of the Corporation may not be amended, altered or repealed except in accordance with Article X of the Bylaws. No Bylaw hereafter legally adopted, amended, altered or repealed shall invalidate any prior act of the directors or officers of the Corporation that would have been valid if such Bylaw had not been adopted, amended, altered or repealed.

Section 4. The election of directors need not be by written ballot unless the Bylaws of the Corporation shall so provide.

Section 5. No stockholder will be permitted to cumulate votes at any election of directors.

ARTICLE VIII

Section 1. Any action required or permitted to be taken by the stockholders of the Corporation must be effected at a duly called annual or special meeting of stockholders of the Corporation and may not be effected by any consent in writing by such stockholders.

Section 2. Special meetings of stockholders of the Corporation may be called only by the Non-Executive Chairperson of the Board of Directors, the Chief Executive Officer, the President or the Board of Directors acting pursuant to a resolution adopted by a majority of the Board of Directors, and any power of stockholders to call a special meeting of stockholders is specifically denied. Only such business shall be considered at a special meeting of stockholders as shall have been stated in the notice for such meeting.

Section 3. Advance notice of stockholder nominations for the election of directors and of business to be brought by stockholders before any meeting of the stockholders of the Corporation shall be given in the manner and to the extent provided in the Bylaws of the Corporation.

ARTICLE IX

Section 1. To the fullest extent permitted by the DGCL as the same exists or as may hereafter be amended, a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. If the DGCL is amended to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of a director of the Corporation shall be eliminated or limited to the fullest extent permitted by the DGCL, as so amended.

Section 2. The Corporation may indemnify to the fullest extent permitted by law any person made or threatened to be made a party to an action or proceeding, whether criminal, civil, administrative or investigative, by reason of the fact that he, she, his or her testator or intestate is or was a director, officer, employee or agent of the Corporation or any predecessor of the Corporation or serves or served at any other enterprise as a director, officer, employee or agent at the request of the Corporation or any predecessor of the Corporation or serves or served at any other enterprise as a director, officer, employee or agent at the request of the Corporation or any predecessor to the Corporation.

Section 3. Neither any amendment nor repeal of any Section of this Article IX, nor the adoption of any provision of this Amended and Restated Certificate of Incorporation or the Bylaws of the Corporation inconsistent with this Article IX, shall eliminate or reduce the effect of this Article IX in respect of any matter occurring, or any cause of action, suit, claim or proceeding accruing or arising or that, but for this Article IX, would accrue or arise, prior to such amendment, repeal or adoption of an inconsistent provision.

ARTICLE X

Meetings of stockholders may be held within or outside of the State of Delaware, as the Bylaws may provide. The books of the Corporation may be kept (subject to any provision contained in the statutes) outside of the State of Delaware at such place or places as may be designated from time to time by the Board of Directors or in the Bylaws of the Corporation.

ARTICLE XI

The Corporation reserves the right to amend or repeal any provision contained in this Amended and Restated Certificate of Incorporation in the manner prescribed by the laws of the State of Delaware and all rights conferred upon stockholders are granted subject to this reservation; *provided*, *however*, that notwithstanding any other provision of this Amended and Restated Certificate of Incorporation, or any provision of law that might otherwise permit a lesser vote or no vote, the Board of Directors acting pursuant to a resolution adopted by a majority of the Board of Directors and the affirmative vote of sixty-six and two-thirds percent (66 2/3%) of the then outstanding voting securities of the Corporation, voting together as a single class, shall be required for the amendment, repeal or modification of the provisions of Section 3 of Article IV, Section 2 of Article V, Article VI, Section 5 of Article VII, Article VIII or Article XI of this Amended and Restated Certificate of Incorporation.

IN WITNESS WHEREOF, Energy Recovery, Inc. has caused this Amended and Restated Certificate of Incorporation to be signed by its President and Chief Executive Officer on this 25th day of June, 2008.

/s/ G. G. Pique

G.G. Pique, President and Chief Executive Officer

Exhibit 3.2

AMENDED AND RESTATED BYLAWS
OF
ENERGY RECOVERY, INC.

(Amended and Restated effective as of July 8, 2008)

ARTICLE I — CORPORATE OFFICES

1.1 REGISTERED OFFICE.

The registered office of Energy Recovery, Inc. shall be fixed in the corporation's certificate of incorporation, as the same may be amended and/or restated from time to time (as so amended and/or restated, the "Certificate").

1.2 OTHER OFFICES.

The corporation's Board of Directors (the "Board") may at any time establish other offices at any place or places where the corporation is qualified to do business.

ARTICLE II — MEETINGS OF STOCKHOLDERS

2.1 PLACE OF MEETINGS.

Meetings of stockholders shall be held at any place within or outside the State of Delaware as designated by the Board. The Board may, in its sole discretion, determine that a meeting of stockholders shall not be held at any place, but may instead be held solely by means of remote communication as authorized by Section 211(a)(2) of the Delaware General Corporation Law (the "DGCL"). In the absence of any such designation or determination, stockholders' meetings shall be held at the corporation's principal executive office.

2.2 ANNUAL MEETING.

The annual meeting of stockholders shall be held each year on a date and at a time designated by the Board. At the annual meeting, directors shall be elected and any other proper business may be transacted.

2.3 SPECIAL MEETING.

Unless otherwise required by law or the Certificate, special meetings of the stockholders may be called at any time, for any purpose or purposes, only by (a) the Board, (b) the Chairperson of the Board, (c) the chief executive officer or (d) the president of the corporation.

No business may be transacted at such special meeting other than the business specified in the notice to stockholders of such meeting.

2.4 NOTICE OF STOCKHOLDERS' MEETINGS.

All notices of meetings of stockholders shall be sent or otherwise given in accordance with either Section 2.5 or Section 8.1 of these bylaws not less than ten (10) nor more than 60 days before the date of the meeting to each stockholder entitled to vote at such meeting, except as otherwise required by applicable law. The notice shall specify the place, if any, date and hour of the meeting, the means of remote communication, if any, by which stockholders and proxy holders may be deemed to be present in person and vote at such meeting, and, in the case of a special meeting, the purpose or purposes for which the meeting is called. Any previously scheduled meeting of stockholders may be postponed, and, unless the Certificate provides otherwise, any special meeting of the stockholders may be cancelled by resolution

duly adopted by a majority of the Board members then in office upon public notice given prior to the date previously scheduled for such meeting of stockholders.

Whenever notice is required to be given, under the DGCL, the Certificate or these bylaws, to any person with whom communication is unlawful, the giving of such notice to such person shall not be required and there shall be no duty to apply to any governmental authority or agency for a license or permit to give such notice to such person. Any action or meeting which shall be taken or held without notice to any such person with whom communication is unlawful shall have the same force and effect as if such notice had been duly given. In the event that the action taken by the corporation is such as to require the filing of a certificate with the Secretary of State of Delaware, the certificate shall state, if such is the fact and if notice is required, that notice was given to all persons entitled to receive notice except such persons with whom communication is unlawful.

Whenever notice is required to be given, under any provision of the DGCL, the Certificate or these bylaws, to any stockholder to whom (A) notice of two (2) consecutive annual meetings, or (B) all, and at least two (2), payments (if sent by first-class mail) of dividends or interest on securities during a 12 month period, have been mailed addressed to such person at such person's address as shown on the records of the corporation and have been returned undeliverable, the giving of such notice to such person shall not be required. Any action or meeting which shall be taken or held without notice to such person shall have the same force and effect as if such notice had been duly given. If any such person shall deliver to the corporation a written notice setting forth such person's then current address, the requirement that notice be given to such person shall be reinstated. In the event that the action taken by the corporation is such as to require the filing of a certificate with the Secretary of State of Delaware, the certificate need not state that notice was not given to persons to whom notice was not required to be given pursuant to Section 230(b) of the DGCL.

The exception in subsection (A) of the above paragraph to the requirement that notice be given shall not be applicable to any notice returned as undeliverable if the notice was given by electronic transmission.

2.5 MANNER OF GIVING NOTICE; AFFIDAVIT OF NOTICE.

Notice of any meeting of stockholders shall be given:

(a) if mailed, when deposited in the United States mail, postage prepaid, directed to the stockholder at his or her address as it appears on the corporation's records;

(b) if electronically transmitted, as provided in Section 8.1 of these bylaws; or

(c) otherwise, when delivered.

An affidavit of the secretary or an assistant secretary of the corporation or of the transfer agent or any other agent of the corporation that the notice has been given shall, in the absence of fraud, be *prima facie* evidence of the facts stated therein.

Notice may be waived in accordance with Section 7.12 of these bylaws.

2.6 QUORUM.

Unless otherwise provided in the Certificate or required by law, stockholders representing a majority of the voting power of the issued and outstanding capital stock of the corporation, present in person or represented by proxy, shall constitute a quorum for the transaction of business at all meetings of the stockholders. If such quorum is not present or represented at any meeting of the stockholders, then the chairperson of the meeting, or the stockholders representing a majority of the voting power of the capital

stock at the meeting, present in person or represented by proxy, shall have power to adjourn the meeting from time to time until a quorum is present or represented. At such adjourned meeting at which a quorum is present or represented, any business may be transacted that might have been transacted at the meeting as originally noticed. The stockholders present at a duly called meeting at which a quorum is present may continue to transact business until adjournment, notwithstanding the withdrawal of enough stockholders to leave less than a quorum unless the number of stockholders who withdrew does not permit action to be taken by the stockholders in accordance with the DGCL.

2.7 ADJOURNED MEETING; NOTICE.

When a meeting is adjourned to another time or place, unless these bylaws otherwise require, notice need not be given of the adjourned meeting if the time, place if any thereof, and the means of remote communications if any by which stockholders and proxy holders may be deemed to be present in person and vote at such adjourned meeting are announced at the meeting at which the adjournment is taken. At the continuation of the adjourned meeting, the corporation may transact any business that might have been transacted at the original meeting. If the adjournment is for more than 30 days, or if after the adjournment a new record date is fixed for the adjourned meeting, a notice of the adjourned meeting shall be given to each stockholder of record entitled to vote at the meeting in accordance with the provisions of Section 2.4 and Section 2.5 of these bylaws.

2.8 ADMINISTRATION OF THE MEETING.

Meetings of stockholders shall be presided over by the Chairperson of the Board and the chief executive officer of the corporation. If both the Chairperson of the Board and the chief executive officer will not be present at a meeting of stockholders, such meeting shall be presided over by such chairperson as the Board shall appoint, or, in the event that the Board shall fail to make such appointment, any officer of the corporation elected by the Board. The secretary of the meeting shall be the secretary of the corporation, or, in the absence of the secretary of the corporation, such person as the chairperson of the meeting appoints.

The Board shall, in advance of any meeting of stockholders, appoint one (1) or more inspector(s), who may include individual(s) who serve the corporation in other capacities, including without limitation as officers, employees or agents, to act at the meeting of stockholders and make a written report thereof. The Board may designate one (1) or more persons as alternate inspector(s) to replace any inspector, who fails to act. If no inspector or alternate has been appointed or is able to act at a meeting of stockholders, the chairperson of the meeting shall appoint one (1) or more inspector(s) to act at the meeting. Each inspector, before discharging his or her duties, shall take and sign an oath to faithfully execute the duties of inspector with strict impartiality and according to the best of his or her ability. The inspector(s) or alternate(s) shall have the duties prescribed pursuant to Section 231 of the DGCL or other applicable law.

The Board shall be entitled to make such rules or regulations for the conduct of meetings of stockholders as it shall deem necessary, appropriate or convenient. Subject to such rules and regulations, if any, the chairperson of the meeting shall have the right and authority to prescribe such rules, regulations and procedures and to do all acts as, in the judgment of such chairperson, are necessary, appropriate or convenient for the proper conduct of the meeting, including without limitation establishing an agenda of business of the meeting, rules or regulations to maintain order, restrictions on entry to the meeting after the time fixed for commencement thereof and the fixing of the date and time of the opening and closing of the polls for each matter upon which the stockholders will vote at a meeting (and shall announce such at the meeting).

2.9 VOTING.

The stockholders entitled to vote at any meeting of stockholders shall be determined in accordance with the provisions of Section 2.11 of these bylaws, subject to Section 217 (relating to voting rights of fiduciaries, pledgors and joint owners of stock) and Section 218 (relating to voting trusts and other voting agreements) of the DGCL.

Except as otherwise provided in the provisions of Section 213 of the DGCL (relating to the fixing of a date for determination of stockholders of record), each stockholder shall be entitled to that number of votes for each share of capital stock held by such stockholder as set forth in the Certificate.

In all matters, other than the election of directors and except as otherwise required by law, the Certificate or these bylaws, the affirmative vote of a majority of the voting power of the shares present or represented by proxy at the meeting and entitled to vote on the subject matter shall be the act of the stockholders. Directors shall be elected by a plurality of the voting power of the shares present in person or represented by proxy at the meeting and entitled to vote on the election of directors.

The stockholders of the corporation shall not have the right to cumulate their votes for the election of directors of the corporation.

2.10 NO STOCKHOLDER ACTION BY WRITTEN CONSENT WITHOUT A MEETING.

Any action required or permitted to be taken by the stockholders of the corporation (if the corporation has more than one stockholder at such time) must be effected at a duly called annual or special meeting of stockholders of the corporation and may not be effected by any consent in writing by such stockholders.

2.11 RECORD DATE FOR STOCKHOLDER NOTICE; VOTING; GIVING CONSENTS.

In order that the corporation may determine the stockholders entitled to notice of or to vote at any meeting of stockholders or any adjournment thereof, or entitled to receive payment of any dividend or other distribution or allotment of any rights, or entitled to exercise any rights in respect of any change, conversion or exchange of stock or for the purpose of any other lawful action, the Board may fix, in advance, a record date, which record date shall not precede the date on which the resolution fixing the record date is adopted and which shall not be more than 60 nor less than ten (10) days before the date of such meeting, nor more than 60 days prior to any other such action.

If the Board does not fix a record date in accordance with these bylaws and applicable law:

(a) The record date for determining stockholders entitled to notice of or to vote at a meeting of stockholders shall be at the close of business on the day next preceding the day on which notice is given, or, if notice is waived, at the close of business on the day next preceding the day on which the meeting is held.

(b) The record date for determining stockholders entitled to consent to corporate action in writing without a meeting, when no prior action by the Board is necessary, shall be the first day on which a signed written consent setting forth the action taken or proposed to be taken is delivered to the corporation.

(c) The record date for determining stockholders for any other purpose shall be at the close of business on the day on which the Board adopts the resolution relating thereto.

A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; provided, however, that the Board may fix a new record date for the adjourned meeting.

2.12 PROXIES.

Each stockholder entitled to vote at a meeting of stockholders may authorize another person or persons to act for such stockholder by proxy authorized by an instrument in writing or by a transmission permitted by law and filed with the secretary of the corporation, but no such proxy shall be voted or acted upon after three (3) years from its date, unless the proxy provides for a longer period. A stockholder may also authorize another person or persons to act for him, her or it as proxy in the manner(s) provided under Section 212(c) of the DGCL or as otherwise provided under Delaware law. The revocability of a proxy that states on its face that it is irrevocable shall be governed by the provisions of Section 212 of the DGCL.

2.13 LIST OF STOCKHOLDERS ENTITLED TO VOTE.

The officer who has charge of the stock ledger of the corporation shall prepare and make, at least ten (10) days before every meeting of stockholders, a complete list of the stockholders entitled to vote at the meeting, arranged in alphabetical order, and showing the address of each stockholder and the number of shares registered in the name of each stockholder. The corporation shall not be required to include electronic mail addresses or other electronic contact information on such list. Such list shall be open to the examination of any stockholder, for any purpose germane to the meeting for a period of at least ten (10) days prior to the meeting: (a) on a reasonably accessible electronic network, provided that the information required to gain access to such list is provided with the notice of the meeting, or (b) during ordinary business hours, at the corporation's principal place of business.

In the event that the corporation determines to make the list available on an electronic network, the corporation may take reasonable steps to ensure that such information is available only to stockholders of the corporation. If the meeting is to be held at a place, then the list shall be produced and kept at the time and place of the meeting during the whole time thereof, and may be inspected by any stockholder who is present. If the meeting is to be held solely by means of remote communication, then the list shall also be open to the examination of any stockholder during the whole time of the meeting on a reasonably accessible electronic network, and the information required to access such list shall be provided with the notice of the meeting. Such list shall presumptively determine the identity of the stockholders entitled to vote at the meeting and the number of shares held by each of them.

2.14 ADVANCE NOTICE OF STOCKHOLDER BUSINESS.

Only such business shall be conducted as shall have been properly brought before a meeting of the stockholders of the corporation. To be properly brought before an annual meeting, and except as otherwise provided in Section 2.15 which governs director nominations, business must be (a) specified in the notice of meeting (or any supplement thereto) given by or at the direction of the Board, (b) otherwise properly brought before the meeting by or at the direction of the Board, or (c) a proper matter for stockholder action under the DGCL that has been properly brought before the meeting by a stockholder (i) who is a stockholder of record on the date of the giving of the notice provided for in this Section 2.14 and on the record date for the determination of stockholders entitled to vote at such annual meeting and (ii) who complies with the notice procedures set forth in this Section 2.14. For such business to be considered properly brought before the meeting by a stockholder such stockholder must, in addition to any other applicable requirements, have given timely notice in proper form of such stockholder's intent to bring such business before such meeting. To be timely, such stockholder's notice must be delivered to or mailed and received by the secretary of the corporation at the principal executive offices of the corporation not later than the close of business on the ninetieth (90th) day, nor earlier than the close of

business on the one hundred twentieth (120th) day, prior to the anniversary date on which the corporation first mailed its proxy statement to stockholders in connection with the immediately preceding annual meeting; provided, however, that in the event that no annual meeting was held in the previous year or the annual meeting is called for a date that is not within thirty (30) days before or after such anniversary date, notice by the stockholder to be timely must be so received not later than the close of business the tenth (10th) day following the day on which such notice of the date of the meeting was mailed or public disclosure of the date of the meeting was made, whichever occurs first. For purposes of this Section 2.14 and Section 2.15, "public disclosure" means disclosure in a press release reported by a national news service or in a document filed by the corporation with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Securities Exchange Act of 1934 (the "Exchange Act") and the rules and regulations promulgated thereunder.

To be in proper form, a stockholder's notice to the secretary shall be in writing and shall set forth:

(a) the name and record address of the stockholder who intends to propose the business and the class or series and number of shares of capital stock of the corporation which are owned beneficially or of record by such stockholder;

(b) a representation that the stockholder is a holder of record of stock of the corporation entitled to vote at such meeting and intends to appear in person or by proxy at the meeting to introduce the business specified in the notice;

(c) a brief description of the business desired to be brought before the annual meeting and the reasons for conducting such business at the annual meeting;

(d) any material interest of the stockholder in such business; and

(e) any other information that is required to be provided by the stockholder pursuant to Regulation 14A under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Notwithstanding the foregoing, in order to include information with respect to a stockholder proposal in the corporation's proxy statement and form of proxy for a stockholders meeting, stockholders must provide notice (earlier than the deadline stated above) as required by, and otherwise comply with the requirements of, the Exchange Act and the regulations promulgated thereunder, and the proposal must be eligible for such inclusion within the meaning of the Exchange Act and those regulations. Without limiting the generality of the foregoing, nothing in this Section 2.14, Section 2.15 or any other provisions of these bylaws shall obligate the corporation to include in the corporation's proxy statement and form of proxy nominations for directors made by stockholders (unless, and except to the extent that, future laws or regulations would obligate the corporation to do so).

No business shall be conducted at the annual meeting of stockholders except business brought before the annual meeting in accordance with the procedures set forth in this Section 2.14 and Section 2.15, as applicable. The chairperson of the meeting may refuse to acknowledge the proposal of any business not made in compliance with the foregoing procedure. The term "business" shall include any nomination of directors and any other proposal by a shareholder or shareholders outside or different from the specific nominations or proposals recommended by the corporation's directors in the corporation's annual meeting proxy statement. Sections 2.14 and Section 2.15 shall apply according to their respective terms whether a shareholder seeks to include a proposal in the corporation's proxy statement or form of proxy, files a separate proxy solicitation in contest with the corporation's proxy statement, or in any other manner attempts to bring business before the annual meeting.

2.15 ADVANCE NOTICE OF DIRECTOR NOMINATIONS.

Only persons who are nominated in accordance with the following procedures shall be eligible for election as directors of the corporation, except as may be otherwise provided in the Certificate with respect to the right of holders of Preferred Stock of the corporation to nominate and elect a specified number of directors, if any. To be properly brought before an annual meeting of stockholders, or any special meeting of stockholders called for the purpose of electing directors, nominations for the election of director must be (a) specified in the notice of meeting (or any supplement thereto), (b) made by or at the direction of the Board (or any duly authorized committee thereof) or (c) made by any stockholder of the corporation (i) who is a stockholder of record on the date of the giving of the notice provided for in this Section 2.15 and on the record date for the determination of stockholders entitled to vote at such meeting and (ii) who complies with the notice procedures set forth in this Section 2.15.

In addition to any other applicable requirements, for a nomination to be made by a stockholder, such stockholder must have given timely notice thereof in proper written form to the secretary of the corporation. To be timely, a stockholder's notice to the secretary must be delivered to or mailed and received at the principal executive offices of the corporation, in the case of an annual meeting, in accordance with the provisions set forth in Section 2.14 of these bylaws, and, in the case of a special meeting of stockholders called for the purpose of electing directors, not later than the close of business on the tenth (10th) day following the day on which notice of the date of the special meeting was mailed or public disclosure of the date of the special meeting was made, whichever first occurs.

To be in proper written form, a stockholder's notice to the secretary must set forth:

(a) as to each person whom the stockholder proposes to nominate for election as a director (i) the name, age, business address and residence address of the person, (ii) the principal occupation or employment of the person, (iii) the class or series and number of shares of capital stock of the corporation which are owned beneficially or of record by the person, (iv) a description of all arrangements or understandings between the stockholder and each nominee and any other person or persons (naming such person or persons) pursuant to which the nominations are to be made by the stockholder, and (v) any other information relating to such person that is required to be disclosed in solicitations of proxies for elections of directors, or is otherwise required, in each case pursuant to Regulation 14A under the Exchange Act (including without limitation such person's written consent to being named in the proxy statement, if any, as a nominee and to serving as a director if elected); and

(b) as to such stockholder giving notice, the information required to be provided pursuant to Section 2.14 of these bylaws.

Subject to the rights of any holders of Preferred Stock of the corporation, if any, no person shall be eligible for election as a director of the corporation unless nominated in accordance with the procedures set forth in this Section 2.15. If the chairperson of the meeting properly determines that a nomination was not made in accordance with the foregoing procedures, the chairperson shall declare to the meeting that the nomination was defective and such defective nomination shall be disregarded.

ARTICLE III — DIRECTORS

3.1 POWERS.

Subject to the provisions of the DGCL and any limitations in the Certificate, the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the Board.

3.2 NUMBER OF DIRECTORS; CHAIRPERSON OR CHAIRMAN.

The authorized number of directors shall be determined from time to time by resolution of the Board, provided the Board shall consist of at least one member. No reduction of the authorized number of directors shall have the effect of removing any director before that director's term of office expires. The Board may, in its discretion, designate one of the directors to serve in the capacity of Chairperson with duties and responsibilities as the Board may from time to time assign to such person. The Board, and the Corporations' documents and public filings, may refer to the Chairperson as the Chairman.

3.3 ELECTION, QUALIFICATION AND TERM OF OFFICE OF DIRECTORS.

Except as provided in Section 3.4 and Section 3.14 of these bylaws, directors shall be elected at each annual meeting of stockholders to hold office until the next annual meeting. Directors need not be stockholders unless so required by the Certificate or these bylaws. The Certificate or these bylaws may prescribe other qualifications for directors. Each director, including a director elected to fill a vacancy, shall hold office until such director's successor is elected and qualified or until such director's earlier death, resignation or removal.

Except as provided in the Certificate or Section 3.4 of these bylaws, directors shall be classified, with respect to the time for which they severally hold office, into three (3) classes, as nearly equal in number as possible, one (1) class to be originally elected for a term expiring at the annual meeting of stockholders to be held in 2009, another class to be originally elected for a term expiring at the annual meeting of stockholders to be held in 2010, and another class to be originally elected for a term expiring at the annual meeting of stockholders to be held in 2011, with each class to hold office until its successor is duly elected and qualified. At each succeeding annual meeting of stockholders, commencing with the first annual meeting (a) directors elected to succeed those directors whose terms then expire shall be elected for a term of office to expire at the third succeeding annual meeting of stockholders after their election, with each director to hold office until his or her successor shall have been duly elected and qualified, and (b) if authorized by a resolution of the Board, directors may be elected to fill any vacancy on the Board, regardless of how such vacancy shall have been created (as set forth in Section 3.4 below).

3.4 RESIGNATION AND VACANCIES.

Any director may resign at any time upon written notice or by electronic transmission to the corporation.

Subject to the rights of the holders of any series of Preferred Stock of the corporation then outstanding, if any, and unless the Board otherwise determines, newly created directorships resulting from any increase in the authorized number of directors, or any vacancies on the Board resulting from the death, resignation, retirement, disqualification, removal from office or other cause shall, unless otherwise required by law, be filled by the affirmative vote of a majority of the remaining directors then in office, even though less than a quorum of the Board, or by a sole remaining director. A person so elected by the directors then in office to fill a vacancy or newly created directorship shall hold office until the next election of the class for which such director shall have been chosen and until his or her successor shall have been duly elected and qualified. When one or more directors resigns and the resignation is effective at a future date, a majority of the directors then in office, including those who have so resigned, shall have power to fill such vacancy or vacancies, the vote thereon to take effect when such resignation or resignations shall become effective, and each director so chosen shall hold office as provided in this Section 3.4 in the filling of other vacancies.

3.5 PLACE OF MEETINGS; MEETINGS BY TELEPHONE.

The Board may hold meetings, both regular and special, either within or outside the State of Delaware.

Unless otherwise restricted by the Certificate or these bylaws, members of the Board, or any committee designated by the Board, may participate in a meeting of the Board, or any committee, by means of conference telephone or other communications equipment by means of which all persons participating in the meeting can hear each other, and such participation in a meeting shall constitute presence in person at the meeting.

3.6 CONDUCT OF BUSINESS.

Meetings of the Board shall be presided over by the Chairperson of the Board, if any, or in his or her absence by a chairperson designated by the Board, or in the absence of such designation by a chairperson chosen at the meeting. The secretary shall act as secretary of the meeting, but in his or her absence the chairperson of the meeting may appoint any person to act as secretary of the meeting.

3.7 REGULAR MEETINGS.

Regular meetings of the Board may be held without notice at such time and at such place as shall from time to time be determined by the Board.

3.8 SPECIAL MEETINGS; NOTICE.

Special meetings of the Board for any purpose or purposes may be called at any time by the Chairperson of the Board, the chief executive officer, the president, the secretary or a majority of the authorized number of directors. The person(s) authorized to call special meetings of the Board may fix the place and time of the meeting.

Notice of the time and place of special meetings shall be:

(a) delivered personally by hand, by courier or by telephone;

(b) sent by United States first-class mail, postage prepaid;

(c) sent by facsimile; or

(d) sent by electronic mail,

directed to each director at that director's address, telephone number, facsimile number or electronic mail address, as the case may be, as shown on the corporation's records.

If the notice is (i) delivered personally by hand, by courier or by telephone, (ii) sent by facsimile or (iii) sent by electronic mail, it shall be delivered or sent at least 24 hours before the time of the holding of the meeting. If the notice is sent by United States mail, it shall be deposited in the United States mail at least four days before the time of the holding of the meeting. Any oral notice may be communicated either to the director or to a person at the office of the director who the person giving notice has reason to believe will promptly communicate such notice to the director. The notice need not specify the place of the meeting if the meeting is to be held at the corporation's principal executive office nor the purpose of the meeting.

3.9 QUORUM.

Except as otherwise required by law or the Certificate, at all meetings of the Board, a majority of the authorized number of directors (as determined pursuant to Section 3.2 of these bylaws) shall constitute a

quorum for the transaction of business, except to adjourn as provided in Section 3.12 of these bylaws. The vote of a majority of the directors present at any meeting at which a quorum is present shall be the act of the Board, except as may be otherwise specifically provided by statute, the Certificate or these bylaws.

A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the directors present at that meeting.

3.10 WAIVER OF NOTICE.

Whenever notice is required to be given under any provisions of the DGCL, the Certificate or these bylaws, a written waiver thereof, signed by the person entitled to notice, or a waiver by electronic transmission by the person entitled to notice, whether before or after the time stated therein, shall be deemed equivalent to notice. Attendance of a person at a meeting shall constitute a waiver of notice of such meeting, except when the person attends a meeting solely for the express purpose of objecting, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or special meeting of the directors, or members of a committee of directors, need be specified in any written waiver of notice or any waiver by electronic transmission unless so required by the Certificate or these bylaws.

3.11 BOARD ACTION BY WRITTEN CONSENT WITHOUT A MEETING.

Unless otherwise restricted by the Certificate or these bylaws, any action required or permitted to be taken at any meeting of the Board, or of any committee thereof, may be taken without a meeting if all members of the Board or committee, as the case may be, consent thereto in writing or by electronic transmission and the writing or writings or electronic transmission or transmissions are filed with the minutes of proceedings of the Board or committee. Such filing shall be in paper form if the minutes are maintained in paper form and shall be in electronic form if the minutes are maintained in electronic form.

3.12 ADJOURNED MEETING; NOTICE.

If a quorum is not present at any meeting of the Board, then a majority of the directors present thereat may adjourn the meeting from time to time, without notice other than announcement at the meeting, until a quorum is present.

3.13 FEES AND COMPENSATION OF DIRECTORS.

Unless otherwise restricted by the Certificate or these bylaws, the Board shall have the authority to fix the compensation of directors.

3.14 REMOVAL OF DIRECTORS.

Unless otherwise restricted by statute, the Certificate or these bylaws, any director, or all of the directors, may be removed from the Board, but only for cause, and only by the affirmative vote of the holders of at least a majority of the voting power of all the then outstanding shares of capital stock of the corporation then entitled to vote at the election of directors, voting together as a single class.

ARTICLE IV — COMMITTEES

4.1 COMMITTEES OF DIRECTORS.

The Board may designate one or more committees, each committee to consist of one or more of the directors of the corporation. The Board may designate one or more directors as alternate members of any committee, who may replace any absent or disqualified member at any meeting of the committee. In the absence or disqualification of a member of a committee, the member or members thereof present at any

meeting and not disqualified from voting, whether or not such member or members constitute a quorum, may unanimously appoint another member of the Board to act at the meeting in the place of any such absent or disqualified member. Any such committee, to the extent provided in the resolution of the Board or in these bylaws, shall have and may exercise such lawfully delegable powers and duties as the Board may confer.

4.2 COMMITTEE MINUTES.

Each committee shall keep regular minutes of its meetings and report to the Board when required.

4.3 MEETINGS AND ACTION OF COMMITTEES.

Meetings and actions of committees shall be governed by, and held and taken in accordance with, the provisions of:

(a) Section 3.5 (relating to place of meetings and meetings by telephone);

(b) Section 3.7 (relating to regular meetings);

(c) Section 3.8 (relating to special meetings and notice);

(d) Section 3.9 (relating to quorum);

(e) Section 3.10 (relating to waiver of notice);

(f) Section 3.11 (relating to action without a meeting); and

(g) Section 3.12 (relating to adjournment and notice of adjournment) of these bylaws, with such changes in the context of those bylaws as are necessary to substitute the committee and its members for the Board and its members.

Notwithstanding the foregoing:

(i) the time of regular meetings of committees may be determined either by resolution of the Board or by resolution of the committee;

(ii) special meetings of committees may also be called by resolution of the Board; and

(iii) notice of special meetings of committees shall also be given to all alternate members, who shall have the right to attend all meetings of the committee. The Board may adopt rules for the government of any committee not inconsistent with the provisions of these bylaws.

ARTICLE V — OFFICERS

5.1 OFFICERS.

The officers of the corporation shall be a president and a secretary. The corporation may also have, at the discretion of the Board, a chief executive officer, a chief financial officer or treasurer, one or more vice presidents, one or more assistant vice presidents, one or more assistant treasurers, one or more assistant secretaries, and any such other officers as may be appointed in accordance with the provisions of these bylaws.

Any number of offices may be held by the same person.

5.2 APPOINTMENT OF OFFICERS.

The Board shall appoint the officers of the corporation, except such officers as may be appointed in accordance with the provisions of Section 5.3 of these bylaws, subject to the rights, if any, of an officer under any contract of employment. Each officer shall hold office until his or her successor is elected and qualified or until his or her earlier resignation or removal. A failure to elect officers shall not dissolve or otherwise affect the corporation.

5.3 SUBORDINATE OFFICERS.

The Board may appoint, or empower the chief executive officer or, in the absence of a chief executive officer, the president of the corporation to appoint, such other officers and agents as the business of the corporation may require. Each of such officers and agents shall hold office for such period, have such authority, and perform such duties as are provided in these bylaws or as the Board may from time to time determine.

5.4 REMOVAL AND RESIGNATION OF OFFICERS.

Any officer may be removed, either with or without cause, by an affirmative vote of the majority of the Board at any regular or special meeting of the Board or, except in the case of an officer appointed by the Board, by any officer upon whom such power of removal may be conferred by the Board.

Any officer may resign at any time by giving written notice to the corporation. Any resignation shall take effect at the date of the receipt of that notice or at any later time specified in that notice. Unless otherwise specified in the notice of resignation, the acceptance of the resignation shall not be necessary to make it effective. Any resignation is without prejudice to the rights, if any, of the corporation under any contract to which the officer is a party.

5.5 VACANCIES IN OFFICES.

Any vacancy occurring in any office of the corporation may only be filled by the Board or as provided in Section 5.3 of these bylaws.

5.6 REPRESENTATION OF SHARES OF OTHER CORPORATIONS.

The chairperson of the Board, the chief executive officer, the president, any vice president, the treasurer, the secretary or assistant secretary of this corporation, or any other person authorized by the Board, the chief executive officer, the president or a vice president, is authorized to vote, represent, and exercise on behalf of this corporation all rights incident to any and all shares or other equity interests of any other corporation or entity standing in the name of this corporation. The authority granted herein may be exercised either by such person directly or by any other person authorized to do so by proxy or power of attorney duly executed by such person having the authority.

5.7 AUTHORITY AND DUTIES OF OFFICERS.

In addition to the foregoing authority and duties, all officers of the corporation shall respectively have such authority and perform such duties in the management of the business of the corporation as may be designated from time to time by the Board.

ARTICLE VI — RECORDS AND REPORTS

6.1 MAINTENANCE AND INSPECTION OF RECORDS.

The corporation shall, either at its principal executive office or at such place or places as designated by the Board, keep a record of its stockholders listing their names and addresses and the number and class

of shares held by each stockholder, a copy of these bylaws, as may be amended to date, minute books, accounting books and other records.

Any such records maintained by the corporation may be kept on, or by means of, or be in the form of, any information storage device or method, provided that the records so kept can be converted into clearly legible paper form within a reasonable time. The corporation shall so convert any records so kept upon the request of any person entitled to inspect such records pursuant to the provisions of the DGCL. When records are kept in such manner, a clearly legible paper form produced from or by means of the information storage device or method shall be admissible in evidence, and accepted for all other purposes, to the same extent as an original paper form accurately portrays the record.

Any stockholder of record, in person or by attorney or other agent, shall, upon written demand under oath stating the purpose thereof, have the right during the usual hours for business to inspect for any proper purpose the corporation's stock ledger, a list of its stockholders, and its other books and records and to make copies or extracts therefrom. A proper purpose shall mean a purpose reasonably related to such person's interest as a stockholder. In every instance where an attorney or other agent is the person who seeks the right to inspection, the demand under oath shall be accompanied by a power of attorney or such other writing that authorizes the attorney or other agent to so act on behalf of the stockholder. The demand under oath shall be directed to the corporation at its registered office in Delaware or at its principal executive office.

6.2 INSPECTION BY DIRECTORS.

Any director shall have the right to examine the corporation's stock ledger, a list of its stockholders, and its other books and records for a purpose reasonably related to his or her position as a director.

ARTICLE VII — GENERAL MATTERS

7.1 CHECKS; DRAFTS; EVIDENCES OF INDEBTEDNESS.

From time to time, the Board shall determine by resolution which person or persons may sign or endorse all checks, drafts, other orders for payment of money, notes or other evidences of indebtedness that are issued in the name of or payable to the corporation, and only the persons so authorized shall sign or endorse those instruments.

7.2 EXECUTION OF CORPORATE CONTRACTS AND INSTRUMENTS.

Except as otherwise provided in these bylaws, the Board, or any officers of the corporation authorized thereby, may authorize any officer or officers, or agent or agents, to enter into any contract or execute any instrument in the name of and on behalf of the corporation; such authority may be general or confined to specific instances.

7.3 STOCK CERTIFICATES; PARTLY PAID SHARES.

The shares of the corporation shall be represented by certificates, provided that the Board may provide by resolution or resolutions that some or all of any or all classes or series of its stock shall be uncertificated shares. Any such resolution shall not apply to shares represented by a certificate until such certificate is surrendered to the corporation. Every holder of stock represented by certificates shall be entitled to have a certificate signed by, or in the name of the corporation by the chairperson or vice-chairperson of the Board, or the president or vice-president, and by the treasurer or an assistant treasurer, or the secretary or an assistant secretary of the corporation representing the number of shares registered in certificate form. Any or all of the signatures on the certificate may be a facsimile. In case any officer, transfer agent or registrar who has signed or whose facsimile signature has been placed upon a certificate has ceased to be such officer, transfer agent or registrar before such certificate is issued, it may be issued

by the corporation with the same effect as if he or she were such officer, transfer agent or registrar at the date of issue.

The corporation may issue the whole or any part of its shares as partly paid and subject to call for the remainder of the consideration to be paid therefor. Upon the face or back of each stock certificate issued to represent any such partly paid shares, and upon the books and records of the corporation in the case of uncertificated partly paid shares, the total amount of the consideration to be paid therefor and the amount paid thereon shall be stated. Upon the declaration of any dividend on fully paid shares, the corporation shall declare a dividend upon partly paid shares of the same class, but only upon the basis of the percentage of the consideration actually paid thereon.

7.4 SPECIAL DESIGNATION ON CERTIFICATES.

If the corporation is authorized to issue more than one class of stock or more than one series of any class, then the powers, designations, preferences, and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights shall be set forth in full or summarized on the face or back of the certificate that the corporation shall issue to represent such class or series of stock; provided, however, that, except as otherwise provided in Section 202 of the DGCL, in lieu of the foregoing requirements there may be set forth on the face or back of the certificate that the corporation shall issue to represent such class or series of stock a statement that the corporation will furnish without charge to each stockholder who so requests the powers, designations, preferences, and relative, participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights.

Within a reasonable time after the issuance or transfer of uncertificated stock, the corporation shall send to the registered owner thereof a written notice containing the information required to be set forth or stated on certificates pursuant to Sections 151, 156, 202(a) or 218(a) of the General Corporation Law of the State of Delaware or, with respect to Section 151 of General Corporation Law of the State of Delaware, a statement that the corporation will furnish without charge to each stockholder who so requests the powers, designations, preferences and relative participating, optional or other special rights of each class of stock or series thereof and the qualifications, limitations or restrictions of such preferences and/or rights. Except as otherwise expressly provided by law, the rights and obligations of the holders of uncertificated stock and the rights and obligations of the holders of certificates representing stock of the same class and series shall be identical.

7.5 LOST CERTIFICATES.

Except as provided in this Section 7.5, no new certificates for shares shall be issued to replace a previously issued certificate unless the latter is surrendered to the corporation and cancelled at the same time. The corporation may issue a new certificate of stock or uncertificated shares in the place of any certificate theretofore issued by it, alleged to have been lost, stolen or destroyed, and the corporation may require the owner of the lost, stolen or destroyed certificate, or such owner's legal representative, to give the corporation a bond sufficient to indemnify it against any claim that may be made against it on account of the alleged loss, theft or destruction of any such certificate or the issuance of such new certificate or uncertificated shares.

7.6 DIVIDENDS.

The Board, subject to any restrictions contained in either (a) the DGCL or (b) the Certificate, may declare and pay dividends upon the shares of its capital stock. Dividends may be paid in cash, in property, or in shares of the corporation's capital stock.

The Board may set apart out of any of the funds of the corporation available for dividends a reserve or reserves for any proper purpose and may abolish any such reserve.

7.7 FISCAL YEAR.

The fiscal year of the corporation shall be fixed by resolution of the Board and may be changed by the Board.

7.8 SEAL.

The corporation may adopt a corporate seal, which shall be adopted and which may be altered by the Board. The corporation may use the corporate seal by causing it or a facsimile thereof to be impressed or affixed or in any other manner reproduced.

7.9 TRANSFER OF STOCK.

Shares of stock of the corporation shall be transferable in the manner prescribed by law and in these Bylaws. Transfers of shares of stock of the corporation shall be made only on the books of the corporation or by transfer agents designated to transfer shares of stock of the corporation. Subject to applicable law, shares of stock represented by certificates shall be transferred only on the books of the corporation by the surrender to the corporation or its transfer agent of the certificate representing such shares properly endorsed or accompanied by a written assignment or power of attorney properly executed, and with such proof of authority or the authenticity of signature as the corporation or its transfer agent may reasonably require.

7.10 STOCK TRANSFER AGREEMENTS.

The corporation shall have power to enter into and perform any agreement with any number of stockholders of any one or more classes or series of stock of the corporation to restrict the transfer of shares of stock of the corporation of any one or more classes or series owned by such stockholders in any manner not prohibited by the DGCL.

7.11 REGISTERED STOCKHOLDERS.

The corporation:

(a) shall be entitled to recognize the exclusive right of a person registered on its books as the owner of shares to receive dividends and to vote as such owner;

(b) shall be entitled to hold liable for calls and assessments on partly paid shares the person registered on its books as the owner of shares; and

(c) shall not be bound to recognize any equitable or other claim to or interest in such share or shares on the part of another person, whether or not it shall have express or other notice thereof, except as otherwise provided by the laws of Delaware.

7.12 WAIVER OF NOTICE.

Whenever notice is required to be given under any provision of the DGCL, the Certificate or these bylaws, a written waiver, signed by the person entitled to notice, or a waiver by electronic transmission by the person entitled to notice, whether before or after the time of the event for which notice is to be given, shall be deemed equivalent to notice. Attendance of a person at a meeting shall constitute a waiver of notice of such meeting, except when the person attends a meeting solely for the express purpose of objecting at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened. Neither the business to be transacted at, nor the purpose of, any regular or

special meeting of the directors, members of a committee of the directors or the stockholders need be specified in any written waiver of notice or any waiver by electronic transmission unless so required by the Certificate or these bylaws.

ARTICLE VIII — NOTICE BY ELECTRONIC TRANSMISSION

8.1 NOTICE BY ELECTRONIC TRANSMISSION.

Without limiting the manner by which notice otherwise may be given effectively to stockholders pursuant to the DGCL, the Certificate or these bylaws, any notice to stockholders given by the corporation under any provision of the DGCL, the Certificate or these bylaws shall be effective if given by a form of electronic transmission consented to by the stockholder to whom the notice is given. Any such consent shall be revocable by the stockholder by written notice to the corporation. Any such consent shall be deemed revoked if:

(a) the corporation is unable to deliver by electronic transmission two consecutive notices given by the corporation in accordance with such consent; and

(b) such inability becomes known to the secretary or an assistant secretary of the corporation or to the transfer agent, or other person responsible for the giving of notice.

However, the inadvertent failure to treat such inability as a revocation shall not invalidate any meeting or other action.

Any notice given pursuant to the preceding paragraph shall be deemed given:

(i) if by facsimile telecommunication, when directed to a number at which the stockholder has consented to receive notice;

(ii) if by electronic mail, when directed to an electronic mail address at which the stockholder has consented to receive notice;

(iii) if by a posting on an electronic network together with separate notice to the stockholder of such specific posting, upon the later of (A) such posting and (B) the giving of such separate notice; and

(iv) if by any other form of electronic transmission, when directed to the stockholder.

An affidavit of the secretary or an assistant secretary or of the transfer agent or other agent of the corporation that the notice has been given by a form of electronic transmission shall, in the absence of fraud, be prima facie evidence of the facts stated therein.

8.2 DEFINITION OF ELECTRONIC TRANSMISSION.

An “electronic transmission” means any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved, and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.

8.3 INAPPLICABILITY.

Notice by a form of electronic transmission shall not apply to Section 164 (relating to failure to pay for stock; remedies), Section 296 (relating to adjudication of claims; appeal), Section 311 (relating to revocation of voluntary dissolution), Section 312 (relating to renewal, revival, extension and restoration of certificate of incorporation) or Section 324 (relating to attachment of shares of stock or any option, right or interest therein) of the DGCL.

ARTICLE IX — INDEMNIFICATION OF DIRECTORS AND OFFICERS

9.1 POWER TO INDEMNIFY IN ACTIONS, SUITS OR PROCEEDINGS OTHER THAN THOSE BY OR IN THE RIGHT OF THE CORPORATION.

Subject to Section 9.3 of these bylaws, the corporation shall indemnify, to the fullest extent permitted by the DGCL, as now or hereafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action, suit or proceeding, whether civil, criminal, administrative or investigative (other than an action by or in the right of the corporation) by reason of the fact that such person (or the legal representative of such person) is or was a director or officer of the corporation or any predecessor of the corporation, or is or was a director or officer of the corporation serving at the request of the corporation as a director or officer, employee or agent of another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise, against expenses (including attorneys' fees), judgments, fines and amounts paid in settlement actually and reasonably incurred by such person in connection with such action, suit or proceeding if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had no reasonable cause to believe such person's conduct was unlawful. The termination of any action, suit or proceeding by judgment, order, settlement, conviction, or upon a plea of *nolo contendere* or its equivalent, shall not, of itself, create a presumption that the person did not act in good faith and in a manner which such person reasonably believed to be in or not opposed to the best interests of the corporation, and, with respect to any criminal action or proceeding, had reasonable cause to believe that such person's conduct was unlawful.

9.2 POWER TO INDEMNIFY IN ACTIONS, SUITS OR PROCEEDINGS BY OR IN THE RIGHT OF THE CORPORATION.

Subject to Section 9.3 of these bylaws, the corporation shall indemnify, to the fullest extent permitted by the DGCL, as now or hereafter in effect, any person who was or is a party or is threatened to be made a party to any threatened, pending or completed action or suit by or in the right of the corporation to procure a judgment in its favor by reason of the fact that such person (or the legal representative of such person) is or was a director or officer of the corporation or any predecessor of the corporation, or is or was a director or officer of the corporation serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection with the defense or settlement of such action or suit if such person acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation; except that no indemnification shall be made in respect of any claim, issue or matter as to which such person shall have been adjudged to be liable to the corporation unless and only to the extent that the Court of Chancery or the court in which such action or suit was brought shall determine upon application that, despite the adjudication of liability but in view of all the circumstances of the case, such person is fairly and reasonably entitled to indemnity for such expenses which the Court of Chancery or such other court shall deem proper.

9.3 AUTHORIZATION OF INDEMNIFICATION.

Any indemnification under this Article IX (unless ordered by a court) shall be made by the corporation only as authorized in the specific case upon a determination that indemnification of the director or officer is proper in the circumstances because such person has met the applicable standard of conduct set forth in Section 9.1 or Section 9.2 of these bylaws, as the case may be. Such determination shall be made, with respect to a person who is either a director or officer at the time of such determination or a former director or officer, (i) by a majority vote of the directors who are not parties to such action, suit or proceeding, even though less than a quorum, or (ii) by a committee of such directors designated by

a majority vote of such directors, even though less than a quorum, or (iii) if there are no such directors, or if such directors so direct, by independent legal counsel in a written opinion or (iv) by the stockholders (but only if a majority of the directors who are not parties to such action, suit or proceeding, if they constitute a quorum of the board of directors, presents the issue of entitlement to indemnification to the stockholders for their determination). To the extent, however, that a present or former director or officer of the corporation has been successful on the merits or otherwise in defense of any action, suit or proceeding described above, or in defense of any claim, issue or matter therein, such person shall be indemnified against expenses (including attorneys' fees) actually and reasonably incurred by such person in connection therewith, without the necessity of authorization in the specific case.

9.4 GOOD FAITH DEFINED.

For purposes of any determination under Section 9.3 of these bylaws, to the fullest extent permitted by applicable law, a person shall be deemed to have acted in good faith and in a manner such person reasonably believed to be in or not opposed to the best interests of the corporation, or, with respect to any criminal action or proceeding, to have had no reasonable cause to believe such person's conduct was unlawful, if such person's action is based on the records or books of account of the corporation or another enterprise, or on information supplied to such person by the officers of the corporation or another enterprise in the course of their duties, or on the advice of legal counsel for the corporation or another enterprise or on information or records given or reports made to the corporation or another enterprise by an independent certified public accountant or by an appraiser or other expert selected with reasonable care by the corporation or another enterprise. The term "another enterprise" as used in this Section 9.4 shall mean any other corporation or any partnership, joint venture, trust, employee benefit plan or other enterprise of which such person is or was serving at the request of the corporation as a director, officer, employee or agent. The provisions of this Section 9.4 shall not be deemed to be exclusive or to limit in any way the circumstances in which a person may be deemed to have met the applicable standard of conduct set forth in Section 9.1 or 9.2 of these bylaws, as the case may be.

9.5 INDEMNIFICATION BY A COURT.

Notwithstanding any contrary determination in the specific case under Section 9.3 of this Article IX, and notwithstanding the absence of any determination thereunder, any director or officer may apply to the Court of Chancery in the State of Delaware for indemnification to the extent otherwise permissible under Section 9.1 and Section 9.2 of these bylaws. The basis of such indemnification by a court shall be a determination by such court that indemnification of the director or officer is proper in the circumstances because such person has met the applicable standards of conduct set forth in Section 9.1 or Section 9.2 of these bylaws, as the case may be. Neither a contrary determination in the specific case under Section 9.3 of these bylaws nor the absence of any determination thereunder shall be a defense to such application or create a presumption that the director or officer seeking indemnification has not met any applicable standard of conduct. Notice of any application for indemnification pursuant to this Section 9.5 shall be given to the corporation promptly upon the filing of such application. If successful, in whole or in part, the director or officer seeking indemnification shall also be entitled to be paid the expense of prosecuting such application.

9.6 EXPENSES PAYABLE IN ADVANCE.

To the fullest extent not prohibited by the DGCL, or by any other applicable law, expenses incurred by a person who is or was a director or officer in defending any civil, criminal, administrative or investigative action, suit or proceeding shall be paid by the corporation in advance of the final disposition of such action, suit or proceeding; provided, however, that if the DGCL requires, an advance of expenses incurred by any person in his or her capacity as a director or officer (and not in any other capacity) shall be made only upon receipt of an undertaking by or on behalf of such person to repay such amount if it

shall ultimately be determined that such person is not entitled to be indemnified by the corporation as authorized in this Article IX.

9.7 NONEXCLUSIVITY OF INDEMNIFICATION AND ADVANCEMENT OF EXPENSES.

The indemnification and advancement of expenses provided by or granted pursuant to this Article IX shall not be deemed exclusive of any other rights to which those seeking indemnification or advancement of expenses may be entitled under the Certificate, any bylaw, agreement, vote of stockholders or disinterested directors or otherwise, both as to action in such person's official capacity and as to action in another capacity while holding such office, it being the policy of the corporation that indemnification of the persons specified in Section 9.1 and Section 9.2 of these bylaws shall be made to the fullest extent permitted by law. The provisions of this Article IX shall not be deemed to preclude the indemnification of any person who is not specified in Section 9.1 or Section 9.2 of these bylaws but whom the corporation has the power or obligation to indemnify under the provisions of the DGCL, or otherwise. The corporation is specifically authorized to enter into individual contracts with any or all of its directors, officers, employees or agents respecting indemnification and advances, to the fullest extent not prohibited by the DGCL, or by any other applicable law.

9.8 INSURANCE.

To the fullest extent permitted by the DGCL or any other applicable law, the corporation may purchase and maintain insurance on behalf of any person who is or was a director, officer, employee or agent of the corporation, or is or was a director, officer, employee or agent of the corporation serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise against any liability asserted against such person and incurred by such person in any such capacity, or arising out of such person's status as such, whether or not the corporation would have the power or the obligation to indemnify such person against such liability under the provisions of this Article IX.

9.9 CERTAIN DEFINITIONS.

For purposes of this Article IX, references to "the corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors or officers, so that any person who is or was a director or officer of such constituent corporation, or is or was a director or officer of such constituent corporation serving at the request of such constituent corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust, employee benefit plan or other enterprise, shall stand in the same position under the provisions of this Article IX with respect to the resulting or surviving corporation as such person would have with respect to such constituent corporation if its separate existence had continued. For purposes of this Article IX, references to "fines" shall include any excise taxes assessed on a person with respect to an employee benefit plan; and references to "serving at the request of the corporation" shall include any service as a director, officer, employee or agent of the corporation which imposes duties on, or involves services by, such director or officer with respect to an employee benefit plan, its participants or beneficiaries; and a person who acted in good faith and in a manner such person reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner "not opposed to the best interests of the corporation" as referred to in this Article IX.

9.10 SURVIVAL OF INDEMNIFICATION AND ADVANCEMENT OF EXPENSES.

The rights to indemnification and advancement of expenses conferred by this Article IX shall continue as to a person who has ceased to be a director or officer and shall inure to the benefit of the heirs, executors, administrators and other personal and legal representatives of such a person.

9.11 LIMITATION ON INDEMNIFICATION.

Notwithstanding anything contained in this Article IX to the contrary, except for proceedings to enforce rights to indemnification (which shall be governed by Section 9.5 of these bylaws), the corporation shall not be obligated to indemnify any director or officer in connection with a proceeding (or part thereof) initiated by such person unless such proceeding (or part thereof) was authorized or consented to by the board of directors of the corporation.

9.12 INDEMNIFICATION OF EMPLOYEES AND AGENTS.

The corporation may, to the extent authorized from time to time by the board of directors, provide rights to indemnification and to the advancement of expenses to employees and agents of the corporation similar to those conferred in this Article IX to directors and officers of the corporation.

9.13 EFFECT OF AMENDMENT OR REPEAL.

Neither any amendment or repeal of any Section of this Article IX, nor the adoption of any provision of the Certificate or the bylaws inconsistent with this Article IX, shall adversely affect any right or protection of any director, officer, employee or other agent established pursuant to this Article IX existing at the time of such amendment, repeal or adoption of an inconsistent provision, including without limitation by eliminating or reducing the effect of this Article IX, for or in respect of any act, omission or other matter occurring, or any action or proceeding accruing or arising (or that, but for this Article IX, would accrue or arise), prior to such amendment, repeal or adoption of an inconsistent provision.

ARTICLE X — MISCELLANEOUS

10.1 PROVISIONS OF CERTIFICATE GOVERN.

In the event of any inconsistency between the terms of these bylaws and the Certificate, the terms of the Certificate will govern.

10.2 CONSTRUCTION; DEFINITIONS.

Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the DGCL shall govern the construction of these bylaws. Without limiting the generality of this provision, the singular number includes the plural, the plural number includes the singular, and the term “person” includes both a corporation and a natural person.

10.3 SEVERABILITY.

In the event that any bylaw or the application thereof becomes or is declared by a court of competent jurisdiction to be illegal, void or unenforceable, the remaining bylaws will continue in full force and effect.

10.4 AMENDMENT.

The bylaws of the corporation may be adopted, amended or repealed by a majority of the voting power of the stockholders entitled to vote; provided, however, that the corporation may, in its Certificate, also confer the power to adopt, amend or repeal bylaws upon the Board. As set forth in the Certificate, the affirmative vote of at least a majority of the Board of Directors then in office shall be required in order for

the Board of Directors to adopt, amend, alter or repeal the Corporation's Bylaws. The fact that such power has been so conferred upon the Board shall not divest the stockholders of the power, nor limit their power to adopt, amend or repeal bylaws. In the case of amendments by stockholders, notwithstanding the foregoing and any provision of law that might otherwise permit a lesser vote or no vote, the affirmative vote of the holders at least sixty-six and two-thirds percent (66 2/3%) of the voting power of the issued and outstanding shares of capital stock of the corporation then entitled to vote shall be required to amend or repeal Section 2.3, the last paragraph of Section 2.9 (relating to no cumulative voting), Section 2.10, Section 2.14, Section 2.15, Section 3.2, Section 3.3, Section 3.4, Section 3.14 and Section 9.13 of these bylaws, or this sentence of this Section 10.4.

ENERGY RECOVERY, INC.

CERTIFICATE OF AMENDMENT OF BYLAWS

The undersigned hereby certifies that he or she is the duly elected, qualified, and acting Secretary or Assistant Secretary of Energy Recovery, Inc., a Delaware corporation (the "**Company**"), and that the foregoing bylaws, comprising twenty (21) pages, were amended and restated effective as of July 8, 2008 by the Company's board of directors.

The undersigned has executed this certificate as of July 8, 2008.

/s/ MariaElena Ross

(*signature*)

MariaElena Ross

(*print name*)

Secretary

(*title*)

Exhibit 10.7.3

THIRD AMENDMENT TO EXECUTIVE EMPLOYMENT AGREEMENT

This Third Amendment to the Executive Employment Agreement of G.G. Pique ("Third Amendment") is made as of December 31, 2008 ("Third Amendment Effective Date") by and between Energy Recovery, Inc., a Delaware corporation, with its principal offices at 1908 Doolittle Drive, San Leandro, CA 94577 (the "Company" and G.G. Pique, an individual (the "Executive") (together, the "Parties") in order to satisfy the requirements of Section 409A of the Internal Revenue Code of 1986, as amended and the Treasury Regulations promulgated thereunder, as amended.

Pursuant to Article 5.8 of the Executive Employment Agreement, the Company hereby amends that Agreement, including any amendment thereto, as follows:

Article 2.2. The Company amends Article 2.2 by adding the following sentence to the end thereof:

All reimbursements shall be made in accordance with the requirements with the short-term deferral exemption to Section 409A of the Code such that all expenses are submitted and reimbursed no later that March 15th of the year following the year in which such expenses are incurred.

Article 3.2(b)(iv). The Company amends Article 3.2(b)(iv) by replacing the last sentence thereof as follows:

However, no amount payable under this Agreement that is non-qualified deferred compensation subject to Section 409A of the Code, as determined in the sole discretion of the Company, shall be paid unless the Executive experiences a termination that is also a "separation from service" within the meaning of Section 409A of the Code (a "Separation from Service"), and, if the Executive is a "specified employee" within the meaning of Section 409A of the Code as of the date of the Separation from Service (as determined in accordance with Section 409A of the Code), such amount shall instead be paid or provided to the Executive on the earlier of first business day after the date that (i) is six months following the Executive's Separation from Service or (ii) of the Executive's death, to the extent such delayed payment is required to avoid a prohibited distribution under Section 409A(a)(2) of the Code, or any successor provision thereof.

Article 3.2(e). The Company amends Article 3.2(e) by adding a new sentence to the end thereof:

However, no amount payable under this Agreement that is non-qualified deferred compensation subject to Section 409A of the Code, as determined in the sole discretion of the Company, shall be paid unless the Executive experiences a termination that is also a Separation from Service, and, if the Executive is a "specified employee" within the meaning of Section 409A of the Code as of the date of the Separation from Service (as determined in accordance with Section 409A of the Code), such amount shall instead be paid or provided to the Executive on the earlier of first business day after the date that (i) is six months following the Executive's Separation from Service or (ii) of the Executive's death, to the extent such delayed payment is required to avoid a prohibited distribution under Section 409A(a)(2) of the Code, or any successor provision thereof.

Article 3.2(e)(iii)(B). The Company amends Article 3.2(e)(iii)(B) by adding a new sentence to the end thereof:

Notwithstanding the foregoing to the contrary, any such reduction and cancellation shall be made in accordance with the requirements of Section 409A of the Code.

Article 3.2(e)(iii)(B). The Company amends Article 3.2(e)(iii)(B) by adding the following phrase "and in all cases in compliance with Section 409A of the Code," after the phrase "Notwithstanding clauses A and B above," and by adding a new sentence to the end thereof:

Notwithstanding the foregoing to the contrary, if the Executive elects to receive 2.99 his or her base amount any such reduction and cancellation shall be made in accordance with the requirements of Section 409A of the Code.

Article 5.1. The Company amends Article 5.1 by adding the following sentence to the end thereof.

Notwithstanding the forgoing to the contrary, the payment of any amounts pursuant to Section 3.2(b)(ii)-(iv) shall be waived to the extent that the Executive does not return an executed release within 45 days of the date of the Executive's termination of employment.

All other terms contained in the Executive Employment Agreement shall continue in full force and effect.

WITNESS, the execution of this Third Amendment as of the date first above written.

"Executive"

G.G. Pique

By: /s/ G.G. PIQUE
G.G. Pique

"Company"

Energy Recovery Inc.

By: /s/ HANS PETER MICHELET
Name: Hans Peter Michelet
Title: Executive Chairman, Board of Directors

FOURTH MODIFICATION TO LOAN AND SECURITY AGREEMENT

This Fourth Modification to Loan and Security Agreement (this "Modification") is entered into by and between**ENERGY RECOVERY, INC.** ("Borrower") and **COMERICA BANK** ("Bank") as of December 23, 2008, at San Jose, California.

RECITALS

This Modification is entered into upon the basis of the following facts and understandings of the parties, which facts and understandings are acknowledged by the parties to be true and accurate:

Bank and Borrower previously entered into a Loan and Security Agreement (Accounts and Inventory) dated March 27, 2008, which was subsequently modified by First Modification to Loan and Security Agreement dated as of March 27, 2008, Second Modification to Loan and Security Agreement dated as of May 29, 2008, and Third Modification to Loan and Security Agreement dated as of September 18, 2008. The Loan and Security Agreement and each modification shall collectively be referred to herein as the "Agreement".

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties agree as set forth below.

AGREEMENT

1. Incorporation by Reference. The Recitals and the documents referred to therein are incorporated herein by this reference. Except as otherwise noted, the terms not defined herein shall have the meaning set forth in the Agreement.

2. Modification to the Agreement. Subject to the satisfaction of the conditions precedent as set forth in Section 3 hereof, the Agreement is hereby modified as set forth below.

(a) Section 3.1 of the Agreement is amended to read in its entirety as follows:

> "3.1 This Agreement shall remain in full force and effect until March 31, 2009, unless earlier terminated by notice by Borrower. Notice of such termination by Borrower shall be effectuated by mailing of a registered or certified letter not less than thirty (30) days prior to the effective date of such termination, addressed to Bank at the address set forth herein and the termination shall be effective as of the date so fixed in such notice."

(b) The Libor Addendum to Loan and Security Agreement attached to the Agreement is replaced with the Amended and Restated LIBOR Addendum to Loan and Security Agreement (Daily Adjusting LIBOR) between Borrower and Bank dated as of the date of this Modification.

3. Recertification of Authority. Borrower certifies to Bank that:

(a) the Restated Certification of Incorporation and Bylaws of Borrower delivered to Bank on or about December 1, 2005 remain in full force and effect and have not been amended, rescinded or repealed in any respect;

(b) the Corporate Resolutions and Incumbency Certification of Borrower delivered to Bank dated on or as of March 7, 2008 remain in full force and effect and the officers shown on such Incumbency Certification as officers authorized to execute and deliver to Bank documents in connection with loan financings: (i) continue to hold, and be duly appointed to, the offices indicated thereon; and (ii) continue to be duly authorized to execute and deliver to Bank this Modification and any and all documents necessary to evidence indebtedness and obligations of Borrower to Bank; and

(c) Borrower is in good standing in the State of Delaware and under each jurisdiction in which it is authorized to do business, including the State of California.

4. Legal Effect. This Modification may be executed in as many counterparts as Bank and Borrower deem convenient, and shall become effective upon: (a) delivery to Bank of all executed counterparts hereof; and (b) payment by Borrower of all costs and expenses of Bank incurred in connection herewith, including without limitation, a non-refundable commitment fee in the amount of Fifteen Thousand Dollars ($15,000) and fees and expenses of Bank's counsel incurred in connection with the preparation and negotiation of this Amendment and the documents contemplated hereby. Except as specifically set forth in this Modification, all of the terms and conditions of the Agreement remain in full force and effect.

5. Integration. This is an integrated Modification and supersedes all prior negotiations and agreements regarding the subject matter hereof. All amendments hereto must be in writing and signed by the parties.

IN WITNESS WHEREOF, the parties have agreed as of the date first set forth above.

ENERGY RECOVERY, INC.

By: /s/ Tom Willardson

Its: CFO

COMERICA BANK

By: /s/ Darren Santos
Darren Santos

Its: Corporate Banking Officer-Western Market

Amended and Restated LIBOR Addendum To Loan and Security Agreement
(Daily Adjusting LIBOR)

This Amended and Restated LIBOR Addendum to Loan and Security Agreement (Daily Adjusting LIBOR) (this "Addendum") is entered into as of December 23, 2008, by and between **Comerica Bank** ("Bank") and **Energy Recovery, Inc.,** a Delaware corporation ("Borrower"). This Addendum supplements the terms of the Loan and Security Agreement (Accounts and Inventory) dated March 27, 2008 (the "Agreement").

This Addendum replaces entirely the LIBOR Addendum To Loan and Security Agreement dated March 27, 2008 between Borrower and Bank.

1. Definitions. As used in this Addendum, the following terms shall have the following meanings. Initially capitalized terms used and not defined in this Addendum shall have the meanings ascribed thereto in the Agreement.

a. "Applicable Margin" means two and three-quarters percent (2.75%) per annum.

b. "Business Day" means any day, other than a Saturday, Sunday or any other day designated as a holiday under Federal or applicable State statute or regulation, on which Bank is open for all or substantially all of its domestic and international business (including dealings in foreign exchange) in Detroit, Michigan and San Jose, California, and, in respect of notices and determinations relating the Daily Adjusting LIBOR Rate, also a day on which dealings in dollar deposits are also carried on in the London interbank market and on which banks are open for business in London, England.

c. "Daily Adjusting LIBOR Rate" means, for any day, a per annum interest rate which is equal to the Applicable Margin plus the quotient of the following:

(1) for any day, the per annum rate of interest determined on the basis of the rate for deposits in United States Dollars for a period equal to one (1) month appearing on Page BBAM of the Bloomberg Financial Markets Information Service as of 8:00 a.m. (California time) (or as soon thereafter as practical) on such day, or if such day is not a Business Day, on the immediately preceding Business Day. In the event that such rate does not appear on Page BBAM of the Bloomberg Financial Markets Information Service (or otherwise on such Service) on any day, the "Daily Adjusting LIBOR Rate" for such day shall be determined by reference to such other publicly available service for displaying eurodollar rates as may be reasonably selected by Bank, or in the absence of such other service, the "Daily Adjusting LIBOR Rate" for such day shall, instead, be determined based upon the average of the rates at which Bank is offered dollar deposits at or about 8:00 a.m. (California time) (or as soon thereafter as practical), on such day, or if such day is not a Business Day, on the immediately preceding Business Day, in the interbank eurodollar market in an amount comparable to the principal amount of the Indebtedness and for a period equal to one (1) month;

divided by

(2) a percentage (expressed as a decimal) equal to 1.00 minus the maximum rate on such day at which Bank is required to maintain reserves on "Euro-currency Liabilities" as defined in and pursuant to Regulation D of the Board of Governors of the Federal Reserve System or, if such regulation or definition is modified, and as long as Bank is required to maintain reserves against a category of liabilities which includes eurodollar deposits or includes a category of assets which includes eurodollar loans, the rate at which such reserves are required to be maintained on such category.

d. "LIBOR Lending Office" means Bank's office located in the Cayman Islands, British West Indies, or such other branch of Bank, domestic or foreign, as it may hereafter designate as its LIBOR Lending Office by notice to Borrower.

e. “Prime Rate” means the per annum interest rate established by Bank as its prime rate for its borrowers, as such rate may vary from time to time, which rate is not necessarily the lowest rate on loans made by Bank at any such time.

f. “Prime-based Rate” means a per annum interest rate which is equal to the sum of the Applicable Marginplus the greater of (i) the Prime Rate; or (ii) the rate of interest equal to the sum of (a) one percent (1%), and (b) the rate of interest equal to the average of the rates on overnight Federal funds transactions with members of the Federal Reserve System arranged by Federal funds brokers (the “Overnight Rates”), as published by the Federal Reserve Bank of New York, or, if the Overnight Rates are not so published for any day, the average of the quotations for the Overnight Rates received by Bank from three (3) Federal funds brokers of recognized standing selected by Bank, as the same may be changed from time to time.

2. Interest Rate Options. Subject to the terms and conditions of this Addendum, the Indebtedness under the Agreement shall bear interest at the Daily Adjusting LIBOR Rate, except during any period of time during which, in accordance with the terms and conditions of this Addendum, the Indebtedness under the Agreement shall bear interest at the Prime-based Rate.

3. Payment of Interest. Accrued and unpaid interest on the unpaid balance of the Indebtedness outstanding under the Agreement shall be payable monthly, in arrears, on the last Business Day of each month, until maturity (whether as stated herein, by acceleration, or otherwise). In the event that any payment under this Addendum becomes due and payable on any day which is not a Business Day, the due date thereof shall be extended to the next succeeding Business Day, and, to the extent applicable, interest shall continue to accrue and be payable thereon during such extension at the rates set forth in this Addendum. Interest accruing hereunder shall be computed on the basis of a year of 360 days, and shall be assessed for the actual number of days elapsed, and in such computation, effect shall be given to any change in the applicable interest rate as a result of any change in the Daily Adjusting LIBOR Rate or, to the extent applicable, the Prime-based Rate on the date of each such change.

4. Bank’s Records. The amount and date of each advance under the Agreement, its applicable interest rate, and the amount and date of any repayment shall be noted on Bank’s records, which records shall be conclusive evidence thereof, absent manifest error; provided, however, any failure by Bank to make any such notation, or any error in any such notation, shall not relieve Borrower of its obligations to repay Bank all amounts payable by Borrower to Bank under or pursuant to this Addendum and the Agreement, when due in accordance with the terms hereof. For any advance under the Agreement bearing interest at the Daily Adjusting LIBOR Rate, if Bank shall designate a LIBOR Lending Office which maintains books separate from those of the rest of Bank, Bank shall have the option of maintaining and carrying such advance on the books of such LIBOR Lending Office.

5. Default Interest Rate. From and after the occurrence of any Event of Default, and so long as any such Event of Default remains unremedied or uncured thereafter, the Indebtedness outstanding under the Agreement shall bear interest at a per annum rate of three percent (3%) above the otherwise applicable interest rate hereunder, which interest shall be payable upon demand. In addition to the foregoing, a late payment charge equal to five percent (5%) of each late payment hereunder may be charged on any payment not received by Bank within ten (10) calendar days after the payment due date therefor, but acceptance of payment of any such charge shall not constitute a waiver of any Event of Default under the Agreement. In no event shall the interest payable under this Addendum and the Agreement at any time exceed the maximum rate permitted by law.

6. Prepayment. Borrower may prepay all or part of the outstanding balance of any Indebtedness at any time without premium or penalty. Any prepayment hereunder shall also be accompanied by the payment of all accrued and unpaid interest on the amount so prepaid. Borrower hereby acknowledges and agrees that the foregoing shall not, in any way whatsoever, limit, restrict, or otherwise affect Bank’s right to make demand for payment of all or any part of the Indebtedness under the Agreement due on a demand basis in Bank’s sole and absolute discretion.

7. Regulatory Developments or Other Circumstances Relating to the Daily Adjusting LIBOR Rate

a. If, at any time, Bank determines that, (1) Bank is unable to determine or ascertain the Daily Adjusting LIBOR Rate, or (2) by reason of circumstances affecting the foreign exchange and interbank markets generally, deposits in eurodollars in the applicable amounts or for the relative maturities are not being offered to Bank, or (3) the Daily Adjusting LIBOR Rate will not accurately or fairly cover or reflect the cost to Bank of maintaining any of the

Indebtedness under this Addendum at the Daily Adjusting LIBOR Rate, then Bank shall forthwith give notice thereof to Borrower. Thereafter, until Bank notifies Borrower that such conditions or circumstances no longer exist, the Prime-based Rate shall be the applicable interest rate for all Indebtedness during such period of time.

b. If, after the date hereof, the introduction of, or any change in, any applicable law, rule or regulation or in the interpretation or administration thereof by any governmental authority charged with the interpretation or administration thereof, or compliance by Bank (or its LIBOR Lending Office) with any request or directive (whether or not having the force of law) of any such authority, shall make it unlawful or impossible for the Bank (or its LIBOR Lending Office) to make or maintain any Indebtedness under the Agreement with interest at the Daily Adjusting LIBOR Rate, Bank shall forthwith give notice thereof to Borrower. Thereafter, until Bank notifies Borrower that such conditions or circumstances no longer exist, the Prime-based Rate shall be the applicable interest rate for all Indebtedness during such period of time.

c. Further, at any time upon prior written notice to the undersigned, Bank may, in its sole discretion based upon its good faith belief that the Prime-based Rate is an appropriate basis for its floating rate loans, suspend use of the Daily Adjusting LIBOR Rate as the applicable interest rate hereunder, at which time, the Prime-based Rate shall thereafter be the applicable interest rate for all Indebtedness outstanding under the Agreement, unless Bank, in its sole discretion based upon its good faith belief that the Prime-based Rate is no longer an appropriate basis for its floating rate loans, rescinds such notice, in which case, the Daily Adjusting LIBOR Rate shall, upon written notice from Bank to the undersigned, again be the applicable interest rate for all Indebtedness outstanding under the Agreement

d. If the adoption after the date hereof, or any change after the date hereof in, any applicable law, rule or regulation (whether domestic or foreign) of any governmental authority, central bank or comparable agency charged with the interpretation or administration thereof, or compliance by Bank (or its LIBOR Lending Office) with any request or directive (whether or not having the force of law) made by any such authority, central bank or comparable agency after the date hereof: (a) shall subject Bank (or its LIBOR Lending Office) to any tax, duty or other charge with respect to this Addendum or any Indebtedness under the Agreement, or shall change the basis of taxation of payments to Bank (or its LIBOR Lending Office) of the principal of or interest under this Addendum or any other amounts due under this Addendum in respect thereof (except for changes in the rate of tax on the overall net income of Bank or its LIBOR Lending Office imposed by the jurisdiction in which Bank's principal executive office or LIBOR Lending Office is located); or (b) shall impose, modify or deem applicable any reserve (including, without limitation, any imposed by the Board of Governors of the Federal Reserve System), special deposit or similar requirement against assets of, deposits with or for the account of, or credit extended by Bank (or its LIBOR Lending Office), or shall impose on Bank (or its LIBOR Lending Office) or the foreign exchange and interbank markets any other condition affecting this Addendum or the Indebtedness; and the result of any of the foregoing is to increase the cost to Bank of maintaining any part of the Indebtedness or to reduce the amount of any sum received or receivable by Bank under this Addendum by an amount deemed by the Bank to be material, then Borrower shall pay to Bank, within fifteen (15) days of Borrower's receipt of written notice from Bank demanding such compensation, such additional amount or amounts as will compensate Bank for such increased cost or reduction. A certificate of Bank, prepared in good faith and in reasonable detail by Bank and submitted by Bank to Borrower, setting forth the basis for determining such additional amount or amounts necessary to compensate Bank shall be conclusive and binding for all purposes, absent manifest error.

e. In the event that any applicable law, treaty, rule or regulation (whether domestic or foreign) now or hereafter in effect and whether or not presently applicable to Bank, or any interpretation or administration thereof by any governmental authority charged with the interpretation or administration thereof, or compliance by Bank with any guideline, request or directive of any such authority (whether or not having the force of law), including any risk-based capital guidelines, affects or would affect the amount of capital required or expected to be maintained by Bank (or any corporation controlling Bank), and Bank determines that the amount of such capital is increased by or based upon the existence of any obligations of Bank hereunder or the maintaining of any Indebtedness, and such increase has the effect of reducing the rate of return on Bank's (or such controlling corporation's) capital as a consequence of such obligations or the maintaining of such Indebtedness to a level below mat which Bank (or such controlling corporation) could have achieved but for such circumstances (taking into consideration its policies with respect to capital adequacy), then Borrower shall pay to Bank, within fifteen (15) days of Borrower's receipt of written notice from Bank demanding such compensation, additional amounts as are sufficient to compensate Bank (or such controlling corporation) for any increase in the amount of capital and reduced rate of return which Bank reasonably determines to be allocable to the existence of any obligations of the Bank hereunder or to maintaining any Indebtedness. A certificate of Bank as to the amount of such

compensation, prepared in good faith and in reasonable detail by the Bank and submitted by Bank to Borrower, shall be conclusive and binding for all purposes absent manifest error.

8. Legal Effect. Except as specifically modified hereby, all of the terms and conditions of the Agreement remain in full force and effect.

9. Conflicts. As to the matters specifically the subject of this Addendum, in the event of any conflict between this Addendum and the Agreement, the terms of this Addendum shall control.

IN WITNESS WHEREOF, the parties have agreed to the foregoing as of the date first set forth above.

ENERGY RECOVERY, INC.	COMERICA BANK
By: /s/ Tom Willardson	By: /s/ Darren Santos
	Darren Santos
Its: CFO	Its: Corporate Banking Officer-Western Market

1717 DOOLITTLE DRIVE
2250 WILLIAMS STREET
MODIFIED INDUSTRIAL GROSS LEASE

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2250 WILLIAMS STREET
MODIFIED INDUSTRIAL GROSS LEASE

THIS LEASE ("Lease"), dated as of November 25, 2008 (the "Effective Date"), is made by and between DOOLITTLE WILLIAMS, LLC, a California limited liability company ("Landlord"), and ENERGY RECOVERY, INC., a Delaware corporation ("Tenant").

1. DEFINED TERMS, EXHIBITS, PREMISES AND LANDLORD'S RESERVED RIGHTS

1.01 Defined Terms.

1. Landlord:	Doolittle Williams, LLC, a California limited liability company
2. Landlord's Address:	c/o McGrath Properties 130 Webster Street, Suite 200 Oakland, CA 94607
3. Tenant:	Energy Recovery, Inc., a Delaware corporation
4. Tenant's Address prior to the Commencement Date:	1908 Doolittle Drive San Leandro, CA 94577
4.a. Tenant's Address as of the Commencement Date:	1717 Doolittle Drive San Leandro, CA 94577
5. Property:	All of the real property and improvements identified in *Exhibit A* attached hereto.
6. Building:	The building located upon the Property and commonly known as 1717 Doolittle Drive, San Leandro, CA, containing approximately 106,250 rentable square feet.
7. Warehouse:	The warehouse building located upon the Property and commonly known as 2250 Williams street, san Leandro, CA, containing approximately 223,125 rentable square feet.
8. Warehouse Premises:	The portion of the Warehouse identified in *Exhibit B* attached hereto containing approximately 17,500 rentable square feet.
9. Premises:	The Building (in its entirety) and the Warehouse Premises.
10. Term:	10 years
11. Scheduled Commencement Date:	August 1, 2009
12. Base Rent:	$0.75 per rentable square foot of the Building per month and $0.50 per rentable square foot of the Warehouse Premises per month.
13. Prepaid Rent:	$88,437.50
14. Rent Escalations:	The Base Rent shall increase by 2.5% upon each anniversary of the Commencement Date (as hereinafter defined).
15. Base Year:	Calendar year 2009
16. Intentionally Deleted:	
17. Tenant's Share of Building Tax Expenses:	100%
17.a. Tenant's Share of Warehouse Tax Expenses:	7.84%
18. Intentionally Deleted:	
19. Tenant's Share of Building Insurance Expenses:	100%
19.a. Tenant's Share of Warehouse Insurance Expenses:	7.84%
20. Commercial General Liability Policy Limit:	Five Million Dollars ($5,000,000)
21. Tenant's Share of Building Operating Expenses:	100%
22. Tenant's Share of Warehouse Operating Expenses:	7.84%
23. Letter of Credit:	See Section 4.06
24. Permitted Uses:	Design, manufacturing, assembly, research and development, testing associated with Tenant's business, and administrative and office use associated with Tenant's business.
25. Landlord's Broker:	CBRE (Michael Barry and Mark Kol)
26. Tenant's Broker:	Jones Development Companies (Don Jones)

The foregoing provisions constitute the defined terms ("Defined Terms"). Each reference in this Lease to Section 1.01 or the Defined Terms shall be construed to incorporate the applicable Defined Terms in this Section 1.01.

1.02. Exhibits. The following Exhibits are attached to this Lease and incorporated herein by reference thereto.

Exhibit A — Legal Description of the Property

Exhibit B — First Floor of the Building and the Warehouse Premises

Exhibit B — 1 — Second Floor of the Building

Exhibit C — Form of commencement Date Memorandum

Exhibit D — Work Letter

Exhibit E — Environmental Disclosure Statement

Exhibit F — Hazardous Materials Notification

1.03. Premises. Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, the Premises, subject to the provisions of this Lease, With respect to the portion of the premises located in the Warehouse, the Premises shall extend from the top surface of the subfloor to the bottom surface of the roof deck, but exclude the portion of the Common Area (as hereinafter defined) located within due warehouse.

1.04. Common Area. Tenant may, as appurtenant to the Premises and subject to the rules made by Landlord of which Tenant is given notice, use the following areas (collectively "Common Area") in common with other tenants or occupants of the Property:

a. Floor Common Area. With respect to the Warehouse, the lobbies, hallways, toilets, refuse facilities, interior utility raceways, and other common facilities located therein, if any; and

b. Lot common Area. The parking area, together with adjoining landscaping, walkways, sidewalks, driveways, and other surfaced areas, fences, drainage and utility lines, exterior lighting and project signage, if any, serving the Premises (the "Lot").

Under no circumstances shall the right herein granted to use the Common Area be deemed to include the right to store any property, temporarily or permanently, in the Common Area. Any such storage shall be permitted only by the prior written consent of Landlord, which consent may be revoked at any time. In the event that any unauthorized storage shall occur then Landlord shall have the right, without notice, in addition to such other rights and remedies that it may have, to remove the property and charge the cost to Tenant, which cost shall be immediately payable upon demand by Landlord.

1.05. Landlord's Reserved Rights .Provided Landlord does not unreasonably interface with Tenant's use of the Premises and given Tenant prior notice thereof if the applicable change will affect Tenant's use of or require access to the premises, Landlord reserves the right to make the following changes:

a. Building / Warehouse Charges. To install, use, maintain, repair, relocate and replace pipes, ducts, conduits, wires and appurtenant meters and equipment included in the Premises or outside the Premises: and to make any alterations to the Premises that, in Landlord's reasonable judgment, are required or authorized by any existing or future governmental codes;

b. Boundary Charges. To change the boundary lines of the Lot or the Property;

c. Common Area Changes. To install, use, maintain, repair, alter or relocate and replace any Common Area; provided, however, that substitutions, if any, shall be equivalent or better in quality; and

d. Closure. To close temporarily any of the common Area for maintenance purposes so long as reasonable access to the Premises remains available.

2. TENANT'S ACCEPTANCE OF PREMISES. Except as set forth inExhibit D, Tenant shall accept the Premises "as is" on the Commencement Date (as hereinafter defined). By taking possession or using the Premises, Tenant shall be deemed to accept the same in their condition existing as of the date of such possession or use and subject to all applicable municipal, county, state and federal statutes, laws, ordinances, including zoning ordinances, and regulations governing and relating to the use, occupancy or possession of the Premises (collectively "Regulations"). Tenant shall, at Tenant's sole cost and expense, comply with all Regulations now in force or which may hereafter be in force relating to the Premises and the use of the Premise. Except for any punchlist items identified pursuant to Exhibit D, the taking of possession or use of the Premises by Tenant shall conclusively establish that the Landlord's Work (as defined in Exhibit D) has been constructed in accordance withExhibit D and that the Tenant Improvements (as defined in Exhibit D) have been constructed in accordance with the Working Drawings (as defined inExhibit D). Nothing in this Section shall limit or expand Landlord's maintenance and repair obligations set forth in Section 7.03. Tenant acknowledges that the only warranties and representations Landlord has made in connection with the physical condition of the Premises or Tenant's use of the same upon which it has relied directly or indirectly are those expressly provided in this Lease, Notwithstanding anything in this Section 2 to the contrary, Landlord warrants for thirty (30) days following the Commencement Date that the mechanical and plumbing systems serving the Premises are in good working order. Landlord shall repair any defective or malfunctioning component of such systems of which Landlord has received written notice from Tenant describing the failure or malfunction; provided such written notice is given within thirty (30) days of the Commencement Date. In addition, and notwithstanding anything in this Section 2 to the contrary, Landlord warrants that to its actual knowledge the buildings constituting the premises comply with applicable Regulations that were in effect at the time that each building, or portion thereof, was constructed. Such warranty does not apply to (i) modifications which may be required as a result of Tenant's use of the Premises or (ii) Tenant's alterations, additions, or improvements to the premises. If the premises do not comply with such warranty, Landlord shall rectify the same at Landlord's expense. Tenant shall make a claim under such warranty (if at all) within thirty (30) days of the Commencement Date and Tenant's failure to deliver a written claim within such time period shall be deemed a waiver of its rights under such warranty.

3. TERM

3.01 Commencement Date, The Term shall commence on the later to occur of the following dates (the "Commencement Date"): (a) the earlier to occur of the following dates: (i) the date of Substantial Completion (as defined in Exhibit D) or (ii) the date on which the Landlord's Work and the Tenant Improvements would have been Substantially Completed but for the occurrence of any Tenant Delay Days (as defined in Exhibit D) and (b) the Scheduled Commencement Date.

3.02. Term. The Term of this Lease shall be for the period as stated in Section 1.01, commencing on the Commencement Date of the Term as provided in Section 3.01. If the last day of the Term falls on a date other than the last day of the month, then the term shall be

extended so that the last day of the Term shall be the last calendar day of the calendar month in which the Term would otherwise end. Upon Landlord's request, Tenant shall execute a memorandum confirming the Term in the form attached hereto as ***Exhibit C*** (the "Commencement Date Memorandum") which Commencement Date Memorandum shall thereupon be deemed a part of this Lease; provided, however, the execution of such Commencement Date Memorandum shall not be a condition precedent to the parties' obligation hereunder.

3.03. *Delay in Possession.* If for any reason the Commencement Date does not occur on or before the Scheduled Commencement Date, Landlord shall not be subject to any liability therefor, and such failure shall not affect the validity of this Lease or the obligations of Tenant hereunder, but in such case, Tenant shall not be obligated to pay Base Rent or Additional Rent (as hereinafter defined) until the Commencement Date has occurred.

3.04. *Renewal Options.*

a. If Tenant has not committed an Event of Default (as hereinafter defined) at any time during the Term, and Energy Recovery, Inc. (or a Permitted Transferee (as hereinafter defined) of Energy Recovery, Inc.) is occupying the entire Premises at the time of such election, Tenant may renew this Lease for two (2) additional periods of five (5) years each (each a "Renewal Term"), by delivering written notice of the exercise thereof to Landlord not later than twelve (12) months before the expiration of the initial Term or the first Renewal Term (as applicable). The Base Rent payable for each month during a Renewal Term shall be ninety-five percent (95%) of the Fair Market Rent (as hereinafter defined); provided, that the Base Rent payable in any Renewal Term shall in no event be lower than the Base Rent payable during the month immediately preceding the commencement of the first Renewal Term. On or before that date which is six (6) months before the expiration of the initial Term or the first Renewal Term (as applicable), Landlord shall deliver to Tenant written notice of Landlord's Fair Market Rent proposal for the Renewal Term ("Landlord's Fair Market Rent Proposal") and shall advise Tenant of the required adjustment to Base Rent, if any. Within fifteen (15) days after receipt of Landlord's Fair Market Rent Proposal, Tenant shall notify Landlord in writing whether Tenant accepts or rejects Landlord's Fair Market Rent Proposal. If Tenant rejects Landlord's Fair Market Rent Proposal, then Tenant's written notice shall include Tenant's determination of the Fair Market Rent. If Tenant does not deliver Tenant's written determination of Fair Market Rent to Landlord within fifteen (15) days after receipt of Landlord's Fair Market Rent Proposal, Tenant will be deemed to have accepted Landlord's Fair Market Rent Proposal. If Tenant and Landlord disagree on the Fair Market Rent, then Landlord and Tenant shall attempt in good faith to agree upon the Fair Market Rent. If by that date which is one hundred and twenty-five (125) days prior to the commencement of the Renewal Term (the "Trigger Date"), Landlord and Tenant have not agreed in writing as to the Fair Market Rent, the parties shall determine the Fair Market Rent for such Renewal Term in accordance with the procedure set forth in Section 3.04.c below.

b. For purposes of this Section 3.04, the term "Fair Market Rent" shall mean the rental rate for comparable space to be used for the Permitted Uses under primary lease (and not sublease) to new tenants, taking into consideration such amenities as existing improvements (but specifically excluding any Tenant Improvements that are not paid from the Construction Allowance (as defined in ***Exhibit D***)), and parking rights, situated in the city of San Leandro, in comparable physical and economic condition, taking into consideration the then-prevailing ordinary rental market practices with respect to tenant concessions. Fair Market Rent shall include the periodic rental increases, if any, that would be included for space leased for the period the space will be covered by the Lease. As used herein, "then-prevailing" shall mean the time period which is five (5) months prior to the commencement of the Renewal Term and not the commencement date of the Renewal Term.

c. If Landlord and Tenant are unable to reach agreement on the Fair Market Rent by the Trigger Date, then within seven (7) days of the Trigger Date, Landlord and Tenant shall each simultaneously submit to the other in a sealed envelope its good faith estimate of the Fair Market Rent for the Renewal Term. If either Landlord or Tenant fails to propose a Fair Market Rent, then the Fair Market Rent for the Renewal Term proposed by the other party shall prevail. If the higher of such estimates is not more than one hundred five percent (105%) of the lower, then the Fair Market Rent shall be the average of the two. Otherwise, the dispute shall be resolved by arbitration in accordance with the remainder of this Section 3.04.c. Within seven (7) days after the exchange of estimates, the parties shall select as an arbitrator either (i) a licensed real estate broker with at least ten (10) years of experience leasing premises in industrial buildings in the San Leandro area or (ii) an independent MAI appraiser with at least five (5) years of experience in appraising industrial buildings in the San Leandro area (a "Qualified Arbitrator"). If the parties cannot agree on a Qualified Arbitrator, then within a second period of seven (7) days, each shall select a Qualified Arbitrator and within ten (10) days thereafter the two appointed Qualified Arbitrators shall select a third Qualified Arbitrator and the third Qualified Arbitrator shall be the sole arbitrator. If one party shall fail to select a Qualified Arbitrator within the second seven (7)-day period, then the Qualified Arbitrator chosen by the other party shall be the sole arbitrator. Within thirty (30) days after submission of the matter to the sole arbitrator, the sole arbitrator shall determine the Fair Market Rent by choosing whichever of the estimates submitted by Landlord and Tenant the arbitrator judges to be more accurate. The sole arbitrator shall notify Landlord and Tenant of his or her decision, which shall be final and binding. If the arbitrator believes that expert advice would materially assist him or her, the arbitrator may retain one or more qualified persons to provide expert advice. The fees of the sole arbitrator and the expenses of the arbitration proceeding, including the fees of any expert witnesses retained by the arbitrator, shall be shared equally by Landlord and Tenant. Each party shall pay the fees of its respective counsel and the fees of any witness called by that party.

d. On or before the commencement date of the applicable Renewal Term, Landlord and Tenant shall execute an amendment to this Lease prepared by Landlord extending the Term on the same terms provided in this Lease, except as follows:

(i) Base Rent shall be adjusted to ninety-five percent (95%) of the Fair Market Rent (which shall be the rental rate set forth in Landlord's Fair Market Rent Proposal or the Fair Market Rent determined by mutual agreement or arbitration, as the case may be); provided, that the Base Rent payable in any Renewal Term shall in no event be lower than the Base Rent payable during the month immediately preceding the commencement of the first Renewal Term; and

(ii) Landlord shall lease to Tenant the Premises in their then-current condition, and Landlord shall not provide to Tenant any allowances (e.g., moving allowance, construction allowance, and the like) or other tenant inducements.

e. In the event that Fair Market Rent is not established prior to the commencement of a Renewal Term, then Tenant shall continue to pay the Base Rent at the rate in effect immediately prior to the expiration of the initial Term or the First Renewal Term (as applicable) and within thirty (30) days of the determination of Fair Market Rent, reimburse Landlord for any difference.

f. Tenant's rights under this Section 3.04 shall terminate if: (i) Tenant assigns any of its interest in this Lease or sublets any portion of the Premises to any entity other than a Permitted Transferee; (ii) Tenant fails to timely exercise either of its options under this Section 3.04, time being of the essence with respect to Tenant's exercise thereof; or (iii) Tenant commits an Event of Default under the Lease. Further if Tenant fails to exercise the option for the first Renewal Term, then the option for the second Renewal Term shall automatically be null and void.

4. RENT

4.01. *Base Rent.* The Base Rent shall be the Base Rent set forth in Section 1.01, payable in equal monthly installments as set forth in Section 1.01 and as confirmed in the Commencement Date Memorandum. Tenant shall pay the monthly Base Rent to Landlord in advance upon the first day of each calendar month of the Term, at Landlord's address or at such other place designated by Landlord in a notice to Tenant, without any prior demand therefor. If the Term shall commence or end on a day other than the first day of a calendar month, then Tenant shall pay, upon the Commencement Date, a pro rata portion of the monthly Base Rent, prorated on a per diem basis, with respect to the portions of the fractional calendar month included in the Term. Upon executing this Lease, Tenant shall pay the Prepaid Rent as set forth in Section 1.01. Base Rent shall be calculated based on the rentable square footage of the Premises set forth in Section 1.01. Landlord and Tenant stipulate that the square footage of the Building and the Warehouse Premises set forth in Section 1.01 shall be conclusive as to the square footage of the Building and the Warehouse Premises for purposes of determining Base Rent and shall be binding upon them.

4.02. *Escalation.* The Base Rent shall be adjusted during the Term as provided in Section 1.01.

4.03. *Additional Rent and Estimated Payments.* "Additional Rent" shall include all monies, except for Base Rent, required to be paid by Tenant to Landlord under the Lease, including without limitation, any late payments, interest, and payments required to be made by Tenant to Landlord on account of costs incurred by Landlord for Building Tax Expenses (as defined in Section 5.01 below), Warehouse Tax Expenses (as defined in Section 5.01 below), Building Insurance Expenses (as defined in Section 6.01 below), Warehouse Insurance Expenses (as defined in Section 6.01 below), Building Operating Expenses and/or Warehouse Operating Expenses. Additional Rent shall be payable by Tenant within thirty (30) days after a reasonably detailed statement of actual expenses is presented to Tenant by Landlord. At Landlord's option, however, an amount may be estimated by Landlord from time to time of Building Tax Expenses, Warehouse Tax Expenses, Building Insurance Expenses, Warehouse Insurance Expenses, Building Operating Expenses and/or Warehouse Operating Expenses payable by Tenant and the same shall be payable monthly during each accounting year of the Term, on the same day as Base Rent is due hereunder. By May 1 of each calendar year, or as soon thereafter as practicable, Landlord shall furnish to Tenant a statement of Building Tax Expenses, Warehouse Tax Expenses, Building Insurance Expenses, Warehouse Insurance Expenses, Building Operating Expenses, and Warehouse Operating Expenses for the previous year (the "Statement"). If Tenant's estimated payments of Building Tax Expenses, Warehouse Tax Expenses, Building Insurance Expenses, Warehouse Insurance Expenses, Building Operating Expenses, and Warehouse Operating Expenses exceed Tenant's shares of such items as indicated in the Statement, then Landlord shall promptly credit or reimburse Tenant for such excess; likewise, if Tenant's estimated payments of Building Tax Expenses, Warehouse Tax Expenses, Building Insurance Expenses, Warehouse Insurance Expenses, Building Operating Expenses, and Warehouse Operating Expenses for such year are less than Tenant's shares of such items as indicated in the Statement, then Tenant shall pay Landlord such deficiency within ten (10) days of demand therefor, notwithstanding that the Term has expired and Tenant has vacated the Premises. Except as set forth to the contrary in this Section 4.03, Tenant's Shares of, respectively, Building Tax Expenses, Warehouse Tax Expenses, Building Insurance Expenses, Warehouse Insurance Expenses, Building Operating Expenses, and Warehouse Operating Expenses, shall be as set forth in Section 1.01. Notwithstanding the foregoing, (a) to the extent Warehouse Operating Expenses vary, as reasonably determined by Landlord, according to the level of occupancy of the Warehouse or the Property, as applicable, Landlord may compute and charge Tenant for such variable expenses an amount greater than Tenant's Share of Warehouse Operating Expenses equal to Landlord's reasonable estimate of the extent to which such variable Warehouse Operating Expenses are attributable to Tenant's occupancy and (b) if the Warehouse is not at least ninety-five percent (95%) occupied on average during any year of the Term, Warehouse Operating Expenses for such year shall be computed as though the Warehouse had been ninety-five percent (95%) occupied on average during such year. In the event that Tenant or any other tenant of the Property has a use, performs acts (including, without limitation, construction at the Property), or whose presence or occupancy results, in Landlord's good faith determination, in an inequitable allocation of Warehouse Operating Expenses, Warehouse Tax Expenses, or Warehouse Insurance Expenses among the tenants of the Property, then Landlord may, without any obligation to do so and notwithstanding any provision to the contrary in this Lease, reallocate one or more of Tenant's Share of, respectively, Warehouse Operating Expenses, Warehouse Tax Expenses, and/or Warehouse Insurance Expenses in such a manner so as to achieve an allocation of such expenses which Landlord determines to be equitable in Landlord's good faith determination.

4.04. *Rent Defined.* Base Rent and Additional Rent shall be deemed to constitute "Rent". Rent shall be paid in lawful money of the United States without any abatement, set off or deduction whatsoever.

4.05. *Interest and Late Charge.* If any installment of Rent is not paid when due, such amount shall bear interest at the rate of ten percent (10%) per annum (the "Default Rate") from the date on which said payment shall be due until the date on which Landlord shall receive said payment regardless of whether or not a notice of default or notice of termination has been given by Landlord. In addition, Tenant shall pay Landlord a late charge of ten percent (10%) of the amount delinquent. Landlord and Tenant recognize that the damage which Landlord shall suffer as a result of Tenant's failure to pay Rent is difficult to ascertain, said late charge being the best estimate of the damage which Landlord shall suffer in the event of Tenant's late payment. This provision shall not relieve Tenant of Tenant's obligation to pay Rent at the time and in the manner herein specified.

4.06. *Letter of Credit.*

(a) Tenant acknowledges that Landlord is unwilling to execute this Lease unless Tenant provides Landlord with additional security for Tenant's obligations under the Lease. Therefore, Tenant shall deliver to Landlord, within five (5) business days of the Commencement Date, an Irrevocable Standby Letter of Credit ("Letter of Credit") which shall (1) be in a form reasonably acceptable to Landlord and based on a draft issued by Tenant's bank prior to issuance thereof and approved by Landlord in its sole discretion, (2) be issued by a bank reasonably acceptable to Landlord with minimum assets of $10,000,000,000, upon which presentment may be made in San Francisco or Oakland, California, (3) be in an amount equal to $1,500,000, (4) allow for partial and multiple draws thereunder, and (5) have an expiration date not earlier than thirty (30) days after the third anniversary of the Commencement Date or in the alternative, have a term of not less than one (1) year and be automatically renewable for an additional one (1) year period unless, on or before the date thirty (30) days prior to the expiration of the term of such Letter of Credit, the issuer of such Letter of Credit gives notice to Landlord of its election not to renew such Letter of Credit for any additional period pursuant thereto. In addition , the Letter of Credit shall provide that, in the event of Landlord's assignment of its interest in this Lease, the Letter of Credit shall be freely transferable by Landlord to the assignee without charge to Landlord. The Letter of Credit shall provide for same day payment to Landlord upon the issuer's receipt of a sight draft from Landlord together with Landlord's certificate (signed by its manager or an officer) certifying that the requested sum is due and payable from Tenant and Tenant has failed to pay, and with no other conditions. Tenant agrees that it shall form time to time, as necessary, whether as a result of a draw on the Letter of Credit by Landlord pursuant to the terms hereof or as a result of the expiration of the Letter of Credit then in effect, renew or replace the original and any subsequent Letter of Credit so that a Letter of Credit, in the amount required hereunder, and satisfying all the conditions thereof, is in effect until a date which is at least thirty (30) days after the third anniversary of the Commencement Date. If Tenant fails to furnish such renewal or replacement at least thirty (30) days prior to the stated expiration date of the Letter of Credit then held by Landlord, Landlord may draw upon such Letter of Credit (and/or Additional Letter(s) of Credit (as hereinafter defined)) and hold the proceeds thereof without payment of interest (and such proceeds need not be segregated) ("Security Proceeds").

(b) If there is an Event of Default under this Lease, then Landlord shall have the right, at any time after the occurrence of such Event of Default, without giving any further notice to Tenant, to draw upon said Letter of Credit (or Additional Letter of Credit, as defined below, as the case may be) (i) the amount necessary to cure such default or (b) if such default cannot reasonably be cured by the expenditure of money, and Landlord exercises any rights and remedies Landlord may have on account of such default, the amount which, in Landlord's opinion, is necessary to satisfy Tenant's liability on account thereof. In the event of any such draw by Landlord, Tenant shall, within fifteen (15) business days of written demand therefor, deliver to Landlord an additional Letter of Credit satisfying the foregoing conditions ("Additional Letter of Credit"), except that the amount of such Additional Letter of Credit shall be the amount of such draw. In addition, in the event of a termination based upon the default of Tenant under this Lease, or a rejection of this Lease pursuant to the provisions of the Federal Bankruptcy Code, Landlord shall have the right to draw upon the Letter of Credit (from time to time, if necessary) to cover the full amount of damages and other amounts due from Tenant to Landlord under this Lease. Any amounts so drawn shall, at Landlord's election, be applied first to any unpaid rent and other charges which were due prior to the filing of the petition for protection under the Federal Bankruptcy Code. Any such draw on the Letter of Credit shall not constitute a waiver of any other rights of Landlord with respect to Tenant's default under this Lease. Tenant hereby covenants and agrees not to oppose, contest or otherwise interfere with any attempt by Landlord to draw upon said Letter of Credit including, without limitation, by commencing an action seeking to enjoin or restrain Landlord from drawing upon said Letter of Credit. Tenant also hereby expressly waives any right or claim it may have to seek such equitable relief. In addition to whatever other rights and remedies it may have against Tenant if Tenant breaches its obligations under this paragraph, Tenant hereby acknowledges that it shall be liable for any and all damages which Landlord may suffer as a result of any such breach.

(c) Upon request of Landlord or any (prospective) purchaser or mortgagee of the Property, Tenant shall, at its expense, cooperate with Landlord in obtaining an amendment to or replacement of any Letter of Credit which Landlord is then holding so that the amended or new Letter of Credit reflects the name of the new owner and/or mortgagee of the Property.

(d) To the extent that Landlord has not previously drawn upon any Letter of Credit, Additional Letter of Credit, or Security Proceeds (collectively, "Collateral") held by Landlord, and to the extent that Tenant is not otherwise in default of its obligations under this Lease, Landlord shall return such Collateral to Tenant within ninety (90) days of the third anniversary of the Commencement Date.

(e) In no event shall the proceeds of any Letter of Credit be deemed to be a prepayment of rent nor shall it be considered as a measure of liquidated damages.

(f) Landlord and Tenant (i) agree that the Letter of Credit shall in no event be deemed or treated as a "security deposit" under any law applicable to security deposits in the commercial context, (ii) further acknowledge and agree that the Letter of Credit is not intended to serve as a security deposit and the laws applicable to security deposits shall have no applicability or relevancy thereto, and (iii) waive any and all rights, duties and obligations either party may now have or, in the future, will have relating to or arising from the laws applicable to security deposits.

(g) Provided that there has not been an Event of Default by Tenant under this Lease during the immediately preceding twelve (12)-month period and that no Event of Default by Tenant under this Lease has occurred and is still continuing as of the effective date of reduction, then Tenant shall be permitted to decrease the Letter of Credit as follows: (i) as of the first anniversary of the Commencement Date, the amount of the Letter of Credit may be reduced to $1,000,000 and (ii) as of the second anniversary of the Commencement Date, the amount of the Letter of Credit may be reduced to $500,000. Upon Landlord's receipt of any replacement letter of credit which is in the amount of the remaining balance set forth above, and which in all other respects is in conformance with the Letter of Credit requirements described in this Section 4.06, Landlord shall promptly return to Tenant the Letter of Credit being replaced. Notwithstanding the foregoing, in no event shall any such reduction be construed as an admission by Landlord that Tenant has performed all of its covenants and obligations hereunder. Moreover, if an Event of Default occurs then Tenant shall be required to restore the Letter of Credit to the originally required amount of $1,500,000.

(h) In consideration of Tenant's provision of the Letter of Credit, Landlord, upon receipt of appropriate invoices or bills and such other documents and information as Landlord may reasonably request, agrees to reimburse Tenant for Tenant's actual cost to provide the Letter of Credit pursuant to this Section 4.06 (the "LC Reimbursement"), provided, however, that (i) the LC Reimbursement shall not exceed Fifteen Thousand Dollars ($15,000) with respect to the Letter of Credit provided during the first twelve (12) months of the Term, (ii) the LC Reimbursement shall not exceed Ten Thousand Dollars ($10,000) with respect to the Letter of Credit provided during the second twelve (12) months of the Term, and (iii) the LC Reimbursement shall not exceed Five Thousand Dollars ($5,000) during the third twelve (12) months of the Term. Landlord shall have no obligation to reimburse Tenant for any costs incurred by Tenant in connection with any letters of credit following the expiration of the third year of the Term.

(i) Rather than deliver a new letter of credit to satisfy Tenant's initial obligation to deliver the Letter of Credit, Tenant may instead, within five (5) business days of the Commencement Date, amend the TI Letter of Credit (as defined in *Exhibit D*) so that it satisfies the requirements of the Letter of Credit (as set forth in this Section 4.06) and continues to satisfy the requirements of the TI Letter of Credit. Tenant's delivery of such amended TI Letter of Credit shall satisfy Tenant's initial obligation to deliver the Letter of Credit.

5. REAL PROPERTY TAXES

5.01. *Tenant's Obligations.* Tenant shall pay to Landlord, pursuant to the terms of Section 4.03, (a) Tenant's Share of Building Tax Expenses multiplied by the amount, if any, by which Building Tax Expenses exceed the Building Tax Expenses allocated to the Base Year and (b) Tenant's Share of Warehouse Tax Expenses multiplied by the amount, if any, by which Warehouse Tax Expenses exceed the Warehouse Tax Expenses allocated to the Base Year. "Tax Expenses" shall mean and include the sum of the following: all real estate taxes and other taxes relating to the Property, governmental and quasi-governmental assessments and charges, commercial rental taxes, fees and levies, general and special, ordinary and extraordinary, unforeseen as well as foreseen, of any kind and nature for public improvements, services, benefits, or otherwise, and all other fees or taxes which may be levied which: (i) are assessed, levied, conformed, imposed or become a lien upon the Property; (ii) are imposed in lien of any of the above and become payable by Landlord during the Term, or (iii) may be assessed after the expiration of the Term for a period during the Term; provided, however, that:

a. The amount owed by Tenant for Tax Expenses, as set forth in this Section 5.01, shall be prorated between Landlord and Tenant so that Tenant shall pay for amounts applicable to the period of time occurring prior to the expiration of the Term; and

b. Any sum payable by Tenant, which would not otherwise be due until after the date of the termination of this Lease, shall be paid by Tenant to Landlord upon such termination.

"Building Tax Expenses" shall mean the portion of Tax Expenses that Landlord equitably allocates to the Building (which allocation shall be consistent with Landlord's allocation as of the Effective Date). "Warehouse Tax Expenses" shall mean the portion of Tax Expenses that Landlord equitably allocates to the Warehouse (which allocation shall be consistent with Landlord's allocation as of the Effective Date).

Notwithstanding anything to the contrary herein, the Building Tax Expenses and Warehouse Tax Expenses allocated to the Base Year shall be established by reference to the Building and the Warehouse, respectively, prior to the installation of the Tenant Improvements. Accordingly, if Building Tax Expenses or Warehouse Tax Expenses increase due to the construction of the Tenant Improvements, Tenant shall reimburse Landlord for all taxes and assessments levied upon the Property due to the construction of the Tenant Improvements and the Building Tax Expenses and the Warehouse Tax Expenses allocated to the Base Year shall not include taxes and assessments levied upon the Property due to the construction of the Tenant Improvements. If any or all of the Tax Expenses hereunder are permitted by applicable Regulations to be paid in installments, notwithstanding how Landlord pays the same, then, for purposes of calculating Tax Expenses, such Tax Expenses shall be deemed to have been divided and paid in the maximum number of installments permitted by applicable Regulations, and there shall be included in Tax Expenses for each year only such installments as are required by applicable Regulations to be paid within such year, together with interest thereon and on future such installments at a commercially reasonable rate. In the event that Warehouse Tax Expenses attributable to particular portions of the Warehouse that are leased (or available for lease) by tenants are materially greater than Warehouse Tax Expenses attributable to other portions of the Warehouse that are leased (or available for lease) by tenants, such that payment of Warehouse Tax Expenses in accordance herewith would result in an inequitable allocation of Warehouse Tax Expenses among the tenants of the Warehouse, then Landlord shall reallocate Tenant's Share of Warehouse Tax Expenses applicable to the Warehouse Premises in such a manner so as to achieve an allocation of such Warehouse Tax Expenses which is equitable in Landlord's good faith determination.

The parties acknowledge that the Building and the Warehouse are part of a multi-tenant, multi-building project and the some Tax Expenses incurred in connection with the Property and not attributable solely to any particular building should be shared among the tenants of the Property. Accordingly, certain Tax Expenses (e.g. certain costs attributable to the Common Areas) are determined annually for the Property as a whole, and a portion of such Tax Expenses, which portion shall be determined by Landlord on an equitable basis, shall be allocated (i) to the Building (as opposed to the other buildings) and such portion shall be included in Building Tax Expenses and (ii) to the Warehouse (as opposed to the other buildings) and such portion shall be included in Warehouse Tax Expenses. Landlord shall have the right, from time to time, to equitably allocate some or all Tax Expenses for the Property among different portions or occupants of the Property, in Landlord's reasonable discretion. Notwithstanding anything in the contrary herein, Tax Expenses shall not include any taxes assessed with respect to improvements made to the Property after the Commencement Date which do not benefit the Premises and/or the Common Areas.

5.02. *Limitation.* Nothing contained in this Lease shall require Tenant to pay any franchise, corporate, estate, inheritance, succession or documentary transfer tax or Landlord, or any income, profits or revenue tax or charge, upon the net income of Landlord; provided, however, that if under the laws of the United States Government or the state, city or county in which the Property is located, or any political subdivision thereof or any improvement district therein, a tax or excise on rent, or any other tax however described, is levied or assessed by any such body against Landlord on account of rentals payable to Landlord from the Property, Tenant shall pay Tenant's Share of such tax or excise on rent as Tenant's Share of Building Tax Expenses or Tenant's Share of Warehouse Tax Expenses (as applicable) as set forth in Section 1.01.

5.03. *Personal Property Taxes.* Prior to delinquency, Tenant shall pay all taxes and assessments levied upon Tenant's trade fixtures, inventories and other personal property located on or about the Premises.

5.04. *Proposition 13.* Notwithstanding any other provision of this Lease to the contrary, if during the initial Term there is a change of ownership (as defined in Cal. Rev. and Taxation Code sections 60-62 or any amendments or successors to those sections) of all or any portion of the Property (a "Disposition") and, as a result, any or all of the Property is reassessed (a "Reassessment") for real estate tax purposes by the appropriate government authority, the terms of this Section 5.04 shall apply. For the purposes of this Section 5.04, the term "Tax Increase" shall mean that portion of Tax Expenses allocable to the Property that are attributable solely to a Reassessment. Accordingly, a Tax Increase shall not include any portion of Tax Expenses that are or would be (a) attributable to the initial assessment of the value of the Property or any portion thereof, (b) attributable to assessments pending immediately before a Reassessment that were conducted during, and included in, such Reassessment or that were rendered unnecessary following such Reassessment, or (c) attributable to the annual inflationary increase in real estate taxes actually permitted under Proposition 13 (as adopted by the voters of the State of California in the June 1978 election). Tax Expenses attributable to a Tax Increase shall be capped such that the increase in Tax Expenses attributable to a Tax Increase shall not cause the total amount of Tax Expenses payable by Tenant under Section 5.01 to increase by more than $0.02 per rentable square foot of the Premises. The benefit to Tenant of the protections provided under this Section 5.04 shall not apply during any extension of the Term beyond the initial Term.

6. INSURANCE

6.01. *Tenant's Obligations.* Tenant shall pay to Landlord, pursuant to the terms of Section 4.03, (a) Tenant's Share of Building Insurance Expenses multiplied by the amount, if any, by which the Building Insurance Expenses in each of Landlord's accounting years of the Term exceed the Building Insurance Expenses allocated to the Base Year and (b) Tenant's Share of Warehouse Insurance Expenses multiplied by the amount, if any, by which the Warehouse Insurance Expenses in each of Landlord's accounting years of the Term exceed Warehouse Insurance Expenses allocated to the Base Year. "Insurance Expenses" shall include the cost of premiums for insurance maintained under this Section 6 and any deductible portion of any insured loss concerning the Building, the Warehouse, or the Common Area; provided, however that Insurance Expenses shall not include the cost of premiums for earthquake or flood insurance. The amount owed by Tenant for Insurance Expenses, as set forth in this Section 6.01, shall be prorated between Landlord and Tenant so that Tenant shall pay that portion attributable to the Term. Notwithstanding anything to the contrary herein, if Insurance Expenses increase due to the construction or existence of the Tenant Improvements, Tenant shall, upon receipt of appropriate premium invoices, reimburse Landlord for such increased amount and the Building Insurance Expenses and Warehouse Insurance Expenses allocated to the Base Year shall not include insurance expenses attributable to the construction or existence of the Tenant Improvements. "Building Insurance Expenses" shall mean the portion of Insurance Expenses that Landlord equitably allocates to the Building (which allocation shall be consistent with Landlord's allocation as of the Effective Date). "Warehouse Insurance Expenses" shall mean the portion of Insurance Expenses that Landlord equitably allocates to the Warehouse (which allocation shall be consistent with Landlord's as allocation of the Effective Date). The parties acknowledge that the Building and the Warehouse are part of a multi-tenant, multi-building project and that some Insurance Expenses incurred in connection with the Property and not attributable solely to any particular building should be shared among the tenants of the Property. Accordingly, certain Insurance Expenses (e.g. certain costs attributable to the Common Areas) are determined annually for the Property as a whole, and a portion of such Insurance Expenses, which portion shall be determined by Landlord on an equitable basis, shall be allocated (i) to the Building (as opposed to the other buildings) and such portion shall be included in Building Insurance Expenses and (ii) to the Warehouse (as opposed to the other buildings) and such portion shall be included in Warehouse Insurance Expenses. Landlord shall have the right, from time to time, to equitably allocate some or all Insurance Expenses for the Property among different portions or occupants of the Property, in Landlord's reasonable discretion.

6.02. *Landlord's Property.* During the Term, Landlord shall procure and maintain in full force and effect with respect to the Property, a policy or policies of all risk insurance (including sprinkler leakage coverage and any other endorsements or types of coverage required by the holder of any fee or leasehold mortgage) in an amount equal to the full insurance replacement value (replacement cost new, including debris removal, and demolition) thereof. If the annual premiums charged Landlord for such casualty insurance exceed the standard

premium rates because the nature of Tenant's operations results in increased exposure, then Tenant shall, upon receipt of appropriate premium invoices, reimburse Landlord for such increased amount.

6.03. *Landlord's Liability Insurance*. During the Term of this Lease, Landlord shall procure and maintain in force a commercial general liability insurance covering the Property in commercially reasonable amounts as determined by Landlord, from time to time in Landlord's reasonable discretion.

6.04. *Tenant's Liability*. Tenant shall, at Tenant's sole cost and expense, procure and maintain in full force throughout the Term a policy or policies of commercial general liability insurance, written by an insurance company approved by Landlord meeting the requirements set forth in Section 6.07 below and in the form customary to the locality in which the Property is located, insuring Tenant's activities and those of Tenant's employees, agents, licensees and invitees with respect to the Property against loss, damage or liability for personal injury or death of any person or loss or damage to property occurring on the Property or as a result of occupancy of the Property in an aggregate amount not less than the Commercial General Liability Policy Limit set forth in Section 1.01, with a combined single occurrence limit for personal injury and property damage of Two Million Dollars ($2,000,000). If Tenant has in full force and effect a blanket policy of liability insurance with the same coverage for the Property as described above, as well as coverage of other premises and properties of Tenant, or in which Tenant has some interest, such blanket insurance shall satisfy the requirement hereof. Such insurance shall include coverage for liability assumed under this Lease as an "insured contract" for the performance of Tenant's indemnity obligations under this Lease. All such policies shall provide that such coverage shall be primary and that any insurance maintained by Landlord shall be excess insurance only. Such coverage shall also contain the following endorsements: (i) deleting any employee exclusion of personal injury coverage; (ii) deleting any liquor liability exclusion, (iii) an "Additional Insured-Managers or Lessors of Premises Endorsement", and (iv) the "Amendment of the Pollution Exclusion Endorsement" for damage caused by heat, smoke or fumes from a hostile fire. All such insurance shall provide for severability of interests; shall provide that an act or omission of one of the named insureds shall not reduce or avoid coverage to the other named insureds; and shall afford coverage for all claims based on acts, omissions, injury and damage, which claims occurred or arose (or the onset of which occurred or arose) in whole or in part during the policy period.

6.05. *Fire and All Risk Coverage Insurance.* Tenant, at Tenant's expense, shall provide and keep in force during the Term of this Lease a policy or polices of broad form or special form property insurance, including sprinkler leakage if the Premises is equipped with an automatic sprinkler system, in an amount not less than one hundred percent (100%) replacement value covering Tenant's merchandise, furniture, equipment, fixtures, and Tenant's improvements that Tenant owns or has installed at Tenant's sole cost and expense to the Premises. Landlord and Tenant agree that proceeds from such insurance policy or policies shall be used for the repair or replacement of Tenant's improvements and Property.

6.06. *Rental Abatement Insurance*. Landlord shall maintain in full force and effect rental abatement insurance against abatement or loss of Rent with respect to the Property in case of fire or other casualty, in an amount and with coverage periods as reasonably determined by Landlord.

6.07. *Insurance Certificates; Other Requirements.* Tenant shall furnish to Landlord on the Commencement Date, and thereafter within thirty (30) days prior to the expiration of each such policy, certificates of insurance issued by the insurance carrier of each policy of insurance required to be carried by Tenant pursuant hereto. Each certificate shall expressly provide that such policies shall not be cancellable or subject to reduction of coverage or otherwise be subject to modification except after thirty (30) days prior written notice to the parties named as insureds in this Section 6.07. Landlord, McGrath Properties, Inc., Landlord's successors and assigns, and any nominee of Landlord holding any interest in the Premises, including, without limitation any ground lessor and holder of any fee or leasehold mortgage, shall be named as additional insureds under each policy of insurance maintained by Tenant. All insurance policies required to be carried by Tenant under this Lease shall: (i) be written by companies rated A-VI or better in "Best's Insurance Guide" and authorized to do business in California; and (ii) name any parties designated by Landlord as additional insureds. Any deductible amounts under any insurance policies required to be carried by Tenant hereunder shall be subject to Landlord's prior written approval. If at any time during the Term the amount or coverage of any insurance which Tenant is required to carry under this Lease is, in Landlord's good faith judgment, materially less than the amount or type of insurance coverage typically carried by owners or lessees or properties located in the same general market area as the Property, Landlord shall have the right to require Tenant to increase the amount or change the types of insurance coverage required under this Section.

6.08. *Tenant's Failure.* If Tenant fails to maintain any insurance required in this Lease, Tenant shall be liable for all losses and costs resulting from said failure. Tenant shall also be responsible for reimbursing Landlord for any costs incurred by Landlord pursuant to Section 16.15. Nothing herein shall be a waiver of any of Landlord's rights and remedies under any other article of this Lease or at law or equity.

6.09. *Waiver of Subrogation.* All policies of property and liability coverage insurance which Tenant obtains in connection with the Property shall include a clause or endorsement denying the insurer any rights of subrogation against Landlord. Tenant waives any rights of recovery against Landlord for injury or loss due to hazards covered by insurance to the extent of the proceeds recovered therefrom.

6.10. *Indemnification of Landlord.* Tenant shall indemnify, defend (by counsel reasonably acceptable to Landlord), protect, and hold Landlord, Landlord's partners, members, managers, employees, authorized agents and contractors (collectively, "Landlord's Authorized Representatives"), and the Property harmless from and against all claims, liabilities, penalties, losses, damages, costs and expenses, claims or judgments (including, without limitation, attorneys' fees) which may be imposed upon Landlord or any Landlord's Authorized Representatives by any third party in connection with or arising out of any injury to persons or damage to property occurring in, on or about the Premises, or any accident or other occurrence on or about the Property occasioned by any act or omission of Tenant, Tenant's officers, managers, employees, agents, sub-tenants, contractors, visitors, or invitees, or arising from Tenant's use, maintenance, occupation or operation of the Premises, the Building, the Warehouse, the Common Area or the Lot or arising as a result of an Event of Default by Tenant under this Lease; provided, however that Tenant shall not be obligated to indemnify Landlord for any injury or damage to the extent arising as the result of the gross negligence or willful misconduct of Landlord or Landlord's Authorized Representatives. Landlord need not have first paid any such claim in order to be defended or indemnified.

6.11. *Intentionally Deleted.*

6.12. *Workers' Compensation Insurance.* Both parties shall procure and maintain throughout the Term at their sole cost and expense Workers' Compensation Insurance in compliance with California law.

6.13. *Business Interruption Insurance*. Tenant shall procure and maintain throughout the Term at Tenant's sole cost and expense a policy of Business Interruption Insurance adequate to insure over a one (1) year period of time.

6.14. *Comprehensive Automobile Liability Insurance*. If Tenant operates owned, hired or nonowned vehicles on the Property then Tenant shall procure and maintain throughout the Term a Comprehensive Automobile Liability Insurance policy, at a limit of liability of not less than One Million Dollars ($1,000,000) combined bodily injury and property damage.

6.15. *Landlord's Disclaimer*. Neither Landlord nor Landlord's Authorized Representatives shall be responsible or liable at any time for damage to Tenant's equipment, fixtures or other personal property or to Tenant's business, and neither Landlord nor Landlord's Authorized Representatives shall be responsible or liable to Tenant or to those claiming by, through or under Tenant for any damage to person or property that may be occasioned by the acts or omissions of third parties and neither Landlord nor Landlord's Authorized Representatives shall be responsible or liable for any defect in any building or Common Area on the Property or any of the equipment, machinery, utilities, appliances or apparatus therein, nor shall they be responsible or liable for any damage to any person or to any property of Tenant or other person caused by bursting, breakage or leakage, steam or the running, seepage or overflow of water or sewage in any part of the Premises or by the use of reclaimed water or for any damage caused by or resulting from acts of God or the elements or for any damage caused by or resulting from any defect or negligence in the occupancy, construction, operation or use of any of the Property, machinery, apparatus or equipment by any other person or by or from the acts or negligence of any occupant of the Property, except to the extent such defect, damage or loss is caused by the gross negligence or willful misconduct of Landlord or Landlord's Authorized Representatives. Notwithstanding Landlord's or Landlord's Authorized Representatives' negligence or breach of this Lease, neither Landlord nor its Authorized Representatives shall be liable for injury to Tenant's business or for any loss of income or profit therefrom.

7. OPERATING EXPENSES, REPAIRS AND MAINTENANCE

7.01. *Operating Expenses.* Tenant shall pay to Landlord, pursuant to the terms of Section 4.03, Tenant's Share of Building Operating Expenses and Tenant's Share of Warehouse Operating Expenses incurred by Landlord (including, without limitation, all expenses incurred by Landlord pursuant to Section 7.03). "Building Operating Expenses" shall include all reasonable and necessary expenses incurred by Landlord for the administration, management, cleaning, maintenance and repair of the Building. "Warehouse Operating Expenses" shall include all reasonable and necessary expenses incurred by Landlord for the administration, management, cleaning, maintenance and repair of the Warehouse. Expenses constituting Building Operating Expenses and Warehouse Operating Expenses shall include, without limitation: the cost of utilities relating to the Property that are not separately metered to the Premises; costs for the maintenance and repair of the Common Areas of the Property including, without limitation, parking areas, landscaping, sprinkler systems, walkways, and fire alarm systems; costs for maintenance and repair of the heating, ventilation and air conditioning equipment and systems serving the Building and the elevators located in the Building; reserves set aside for maintenance and repair of the Common Area; and costs for capital improvements and repairs made to the Building, the Warehouse, the Common Areas and/or the Property, during Tenant's tenancy in the Premises, amortized using a commercially reasonable interest rate over the time period reasonably estimated by Landlord to recover the costs thereof, as determined by Landlord using its good faith, commercially reasonable judgment. Building Operating Expenses and Warehouse Operating Expenses shall not include (a) the costs for capital improvements and repairs made to the Building or the Warehouse which are triggered by the specific and unique use of the Premises by Tenant, which shall be paid in full by Tenant at the time incurred, (b) Insurance Expenses, (c) Tax Expenses, (d) the costs to maintain and repair the foundations, exterior walls, structural condition of interior load-bearing walls, and the exterior roof structure (but excluding the roof membrane), (e) the costs to maintain and repair any utility systems or heating, ventilation and air conditioning equipment and systems that exclusively serve the premises of any tenant other than Tenant, and (f) costs for capital improvements other than as set forth in the preceding sentence. The parties acknowledge that the Building and Warehouse are part of a multi-tenant, multi-building project and that some costs and expenses incurred in connection with the Property and not attributable solely to any particular building should be shared among the tenants of the Property. Accordingly, certain costs and expenses (e.g. certain costs attributable to the Common Areas) are determined annually for the Property as a whole, and a portion of such costs and expenses, which portion shall be determined by Landlord on an equitable basis, shall be allocated (i) to the Building (as opposed to the other buildings) and such portion shall be included in Building Operating Expenses and (ii) to the Warehouse (as opposed to the other buildings) and such portion shall be included in Warehouse Operating Expenses. Landlord shall have the right, from time to time, to equitably allocate some or all operating expenses for the Property among different portions or occupants of the Property, in Landlord's reasonable discretion. In addition to Tenant's Share of Building Operating Expenses and Tenant's Share of Warehouse Operating Expenses, in consideration of Landlord's administration of the Premises and the Property, Tenant shall pay to Landlord as Additional Rent a monthly administrative charge equal to three percent (3%) of the Base Rent.

7.02. *Tenant Repairs and Maintenance.* Subject to the casualty and condemnation provisions of Sections 11 and 12 except for any repair and maintenance obligations of Landlord which are specifically described in Section 7.03, Tenant, at Tenant's sole cost and expense, shall maintain the Premises and every part thereof in good order and in a clean and safe condition, and shall repair and replace (whether or not such portion of the Premises requiring repair, or the means of repairing the same, are reasonably or readily accessible to Tenant, and whether or not the need for such repairs occurs as a result of Tenant's use, any prior use, the elements or the age of such portion of the Premises), without limitation, the following: interior surfaces of walls and ceilings; floors; wall and floor coverings; interior and exterior windows and plate glass; skylights (if any); window coverings; doors, roll up doors, locks on closing devices; window casements and frames; storefronts; signs; awnings (if any); canopies and display windows; plumbing; electrical wiring and systems within the Premises (including replacement of light bulbs, tubes and ballasts); exterior entrances; staircases and elevators; warehouse dock doors; and all switches, fixtures and equipment in the Premises. Tenant shall, at Tenant's sole cost and expenses, immediately replace all broken or damaged glass, in the Premises with glass equal to the specification and quality of the original glass. Upon receipt of reasonable notice from Tenant, Landlord shall perform, at the expense of Tenant, all repairs and maintenance to plumbing, pipes and electrical wiring located within walls, above ceiling surfaces and below floor surfaces resulting from the use of the Warehouse by Tenant. Landlord shall be responsible for any plumbing, pipes, electrical wiring, switches, fixtures or equipment located in the Warehouse but serving another tenant (subject to reimbursement pursuant to Section 7.01). Notwithstanding anything to the contrary herein, Tenant shall at Tenant's sole cost and expense, repair any area, in the Premises or the Common Area, damaged by Tenant, Tenant's agents, employees, contractors, or visitors, provided that Tenant obtains Landlord's prior approval with respect to the method and quality of such repair. Any repair or replacement required of Tenant shall be made with equipment and/or materials at least equal to the specification and quality of the original and shall be made by contractors approved by Landlord. Tenant shall install rug protectors in all carpeted areas in which desk chairs are located. Tenant shall keep all areas immediately adjoining the Premises free from trash, litter and obstructions resulting from Tenant's business at the Premises. Tenant recognizes the use of some chemicals and/or maintenance techniques are potentially harmful to the Premises or the Property, and consequently, Tenant's use of such chemicals and or maintenance techniques shall be subject to Landlord's prior written approval. Tenant hereby waives the provisions of California Civil Code Sections 1941 and 1942 and any similar or successor laws, to the extent applicable, regarding Tenant's right to terminate this lease or make repairs and deduct the cost thereof from Rent.

7.03. *Landlord Repairs and Maintenance.* Landlord shall, subject to the casualty and condemnation provisions of Sections 11 and 12 and Tenant's obligations under Sections 4.03 and 7.02, maintain in good order, condition, and repair the foundations, exterior walls, structural condition of interior load-bearing walls, exterior roof, fire sprinkler system, Common Area fire alarm and/or smoke detection systems, fire hydrants, parking lots, walkways, parkways, driveways, landscaping, fences, signs; utility systems serving the Common Areas and all parts thereof; the heating, ventilation and air conditioning equipment and systems serving the Building; and the elevators located in the Building. Landlord shall not be obligated to paint the exterior or interior surfaces of exterior walls nor shall Landlord be obligated to maintain, repair or replace windows, doors or plate glass of the Premises. There shall be no abatement of Rent during the performance of any work described in this Section 7.03. Landlord shall not be liable to Tenant for injury or damage that may result from any defect in the construction or condition of the Premises, nor for any damage that may result from interruption of Tenant's use of the Premises during any repairs by Landlord.

7.04. *Inspection of Premises.* Landlord may enter the Premises at reasonable times upon advance written or telephonic notice to Tenant in order to inspect the same, to inspect the performance by Tenant of the terms and conditions hereof, to affix reasonable signs and

displays and to show the Premises to prospective purchasers, tenants and leaders. There shall be no abatement of Rent for any such entry of the Premises.

7.05. *Liens.* Tenant shall promptly pay and discharge all claims for labor performed, supplies furnished and services rendered at the request of Tenant and shall keep the Property free of all mechanic's and materialmen's liens in connection therewith. Tenant shall give Landlord not less than ten (10) days notice prior to the commencement of any work, in on or about the Premises. Landlord shall have the right to post in or on the Premises, or in the immediate vicinity thereof, notices of non-responsibility as provided by law. If Tenant shall, in good faith, contest the validity of any such lien, claim or demand, then Tenant shall, as its sole cost and expense, defend and protect itself, Landlord and the Premises against the same and shall pay and satisfy any such adverse judgment that may be rendered thereon before the enforcement thereof against Landlord or the Premises. If Landlord shall require, Tenant shall furnish to Landlord a surety bond satisfactory to Landlord in an amount equal to one and one-half times the amount of such contested lien claim or demand, indemnifying Landlord against liability for the same, as required by law for the holding of the Premises free from the effect of such lien or claim. In addition, Landlord may require Tenant to pay Landlord's attorneys' fees and costs in participating in such action if Landlord shall decide it is in its best interests to do so.

7.06. *Audit Rights.* Tenant may audit Landlord's Building Operating Expenses, Warehouse Operating Expenses, Building Insurance Expenses, Warehouse Insurance Expenses, Building Tax Expenses, and Warehouse Tax Expenses for the immediately preceding accounting year in order to verify the accuracy thereof provided that: (i) Tenant specifically notifies Landlord that it intends to conduct such audit within ninety (90) days after the receipt of the Statement for such year; and (ii) such audit will be conducted only during regular business hours at the office where Landlord maintains such expenses records and only after Tenant gives Landlord fourteen (14) days prior written notice. Any such audit must be completed by Tenant within ninety (90) days after notice of its intent to audit. Tenant shall deliver to Landlord a copy of the results of such audit within fifteen (15) days of its receipt by Tenant. No such audit shall be conducted if any other tenant has conducted an audit for the time period Tenant intends to audit and Landlord furnishes to Tenant a copy of the result of such audit. No audit shall be conducted at any time there is an Event of Default under the terms of this Lease. No subtenant shall have any right to conduct an audit and no assignee shall conduct an audit for any period during which such assignee is not in possession of the Premises. Notwithstanding the preceding, a subtenant that is subleasing all of the Premises may exercise Tenant's right to conduct an audit under this Section 7.06, provided, however, that such subtenant shall be deemed Tenant's agent for such purpose and Tenant shall be liable for subtenant's acts or omissions relating to such audit. In the event that Tenant elects to audit in accordance with this Section, such audit must be conducted by an independent nationally recognized accounting firm that is not being compensated by Tenant on a contingency fee basis. Each Statement shall be final and binding upon Tenant unless Tenant, within ninety (90) days after the receipt of such Statement, shall contest any item therein by giving written notice to Landlord, specifying each item contested and the reason thereof, or notify Landlord of its intention to conduct an audit of such Statement in accordance with this Section 7.06.

8. ALTERATIONS

8.01. *Fixtures and Personal Property.* Tenant, at Tenant's sole cost and expense, may install necessary trade fixtures, equipment and furniture in the Premises, provided that such items are installed and removable without structural damage to the Building or the Warehouse (as applicable). Said trade fixtures, equipment and furniture shall remain Tenant's property and shall be removed by Tenant prior to expiration of the Term or earlier termination of this Lease. Tenant shall assume the risk of damage to any of Tenant's trade fixtures, equipment and furniture. Tenant shall repair, at Tenant's sole cost and expense, all damage caused by the installation or removal of trade fixtures, equipment and furniture. If Tenant fails to remove the foregoing items on termination of this Lease, Landlord may keep and use them or remove any of them and cause them to be stored or sold in accordance with applicable law, at Tenant's sole cost and expense.

8.02. *Alterations.* Tenant shall not make or allow to be made any alterations, additions, or improvements to the Premises, either at the inception of this Lease or subsequently during the Term, without obtaining the prior written consent of Landlord. With respect to any alterations, additions, or improvements approved by Landlord, Tenant shall, at Landlord's election, remove such alterations, additions or improvement at Tenant's expense prior to expiration of the Term or earlier termination of this Lease and repair any damage caused by said removal. All alterations, additions and improvements shall remain the property of Tenant until termination of this Lease, at which time they shall be and become the property of Landlord if Landlord so elects; provided, however, that Landlord may, at Landlord's option, upon written notice to Tenant on or before thirty (30) days prior to termination of this Lease, require that Tenant, at Tenant's expense, immediately remove any or all alterations, additions, and improvements made by Tenant and restore the Premises to their condition existing prior to the construction of any such alterations, additions or improvements, If Tenant fails to timely remove such alterations, additions or improvements or Tenant's trade fixtures, equipment or furniture, Landlord may keep and use them or remove any of them and, in the case of trade fixtures, equipment or furniture, cause them to be stored or sold in accordance with applicable law, all at Tenant's sole cost and expense. The terms of the preceding two sentences shall survive the termination of this Lease. Tenant shall deliver to Landlord full and complete plans and specifications of all such alterations, additions or improvements, and no such work shall be commenced by Tenant until Landlord has given its written approval thereof and Tenant has acquired all applicable permits therefor required by governmental authorities. Landlord does not expressly or implicitly covenant or warrant that any plans or specifications submitted by Tenant and reviewed or approved by Landlord are safe or that the same comply with any Regulations. Further, Tenant shall indemnify, defend (by counsel reasonably acceptable to Landlord) and hold Landlord harmless from any loss, cost or expense, including attorneys' fees and costs, incurred by Landlord as a result of any defects in design, materials or workmanship resulting from Tenant's alterations, additions or improvements to the Premises. All repairs, alterations, additions, and restoration by Tenant hereinafter required or permitted shall be done in a good and workmanlike manner and in compliance with all Regulations and requirements of the insurers of the Property. Tenant shall reimburse Landlord for Landlord's reasonable charges and expenses for reviewing and approving or disapproving plans and specifications and any other documents for any alterations proposed by Tenant. Tenant shall require that any contractors used by Tenant be licensed and carry a commercial general liability insurance policy in such amounts as Landlord may reasonably require. Landlord may require proof of such insurance prior to commencement of any work on the Premises.

9. UTILITIES

9.01. *Utilities.* Tenant shall promptly pay for all utilities and services supplied to the Premises, including, but not limited to, heat, water, reclaimed water, gas, electricity, telephone, internet, communication facilities, sewage, air conditioning, ventilating, refuse removal, cleaning of the Premises, together with any taxes thereon. Landlord shall not be liable to Tenant for interruption in or curtailment of any utility service, nor shall any such interruption or curtailment constitute constructive eviction or grounds for rental abatement. If any such utilities are not separately metered, Tenant shall pay a pro rata share, based on use, as reasonably determined by Landlord; such expenses shall be an element of Building Operating Expenses and/or Warehouse Operating Expenses pursuant to the terms of Section 7.01.

10. USE OF PREMISES

10.01. *General.* Tenant shall use and occupy the Premises only for the Permitted Uses and for no other purpose. Tenant shall not use or permit the use of the Premises in a manner that is unlawful, creates damage, waste or a nuisance, or that disturbs owners and/or occupants of, or causes damage to, neighboring properties. Tenant agrees, by Tenant's entry, that Tenant has conducted an investigation of the Premises and the acceptability of the Premises for Tenant's use, to the extent that such investigation might affect or influence Tenant's execution of this Lease. Tenant acknowledges that Landlord has made no representations or warranties in connection with the physical

condition of the Premises, Tenant's use of the same, or any other matter upon which Tenant has relied directly or indirectly for any purpose. Landlord, at its sole cost and expense, shall obtain all governmental permits necessary to permit Tenant to use and occupy the Premises for the Permitted Uses as of the Commencement Date in accordance with applicable Requirements. Tenant agrees to reasonably cooperate with Landlord in connection with Landlord's procurement of any such permits.

10.02. *Hazardous Materials*. Tenant shall strictly comply with all Regulations now or hereinafter mandated or advised by any federal state, local or other governmental agency with respect to the use, generation, storage, or disposal of hazardous, toxic, or radioactive materials (collectively, "**Hazardous Materials**"). As herein used, Hazardous Materials shall include, but not be limited to, those materials identified in Sections 66680 through 66685 of Title 22 of the California Administrative Code, Division 4, Chapter 30, as amended from time to time, and those substances defined as "hazardous substances," "hazardous materials," "hazardous wastes," "toxic substances," or other similar designations in the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, 42 U.S.C. Section 9601, et seq., the Resource Conservation and Recovery Act, 42 U.S.C. Section 6901, et seq., the Hazardous Materials Transportation Act, 49 U.S.C. Section 1801, et seq., and California Health and Public Safety Code Section 25117. Tenant shall not cause, or allow anyone else to cause, any Hazardous Materials to be used, generated, stored, released or disposed of in, on or about the Property without the prior written consent of Landlord, which consent may be withheld in the sole discretion of Landlord, and which consent may be revoked at any time. Tenant's indemnification of Landlord pursuant to Section 6.10, above, shall extend to all liability, including all foreseeable and unforeseeable consequential damages, directly arising out of the use, generation, storage, release or disposal of Hazardous Materials by Tenant or any person on the Premises during the Term, including, without limitation, the cost of any required or necessary repair, cleanup, or detoxification and the preparation of any closure or other required plans, whether such action is required or necessary prior to or following the termination of this Lease. Neither the written consent by Landlord to the use, generation, storage, or disposal of Hazardous Materials nor the strict compliance by Tenant with all Regulations pertaining to Hazardous Materials shall excuse Tenant from Tenant's indemnification obligation pursuant to this Section, which obligation shall survive the termination of this Lease. Landlord, its lenders and its consultants shall have the right to enter into the Premises at any time, in the case of an emergency, and otherwise at reasonable times, for the purpose of inspecting the condition of the Premises and for verifying compliance by Tenant with this Lease. The cost of any such inspections shall be paid by Landlord, unless a violation of any Regulation, or a contamination is found to exist or be imminent, or the inspection is requested or ordered by a governmental authority. In such case, Tenant shall upon request reimburse Landlord for the cost of such inspections, so long as such inspection is reasonably related to the violation or contamination. Notwithstanding anything to the contrary herein, Tenant's obligations under this Section 10.02 shall not apply to (i) any Hazardous Materials that were located at the Property on the Commencement Date, any Hazardous Materials placed on the Property by Landlord, its employees, agents, or contractors, (except to the extent the release thereof or liability therefor is due to the acts of Tenant or its employees, agents, or contractors), (ii) any Hazardous Materials that migrate onto or under the Property from adjacent properties (except to the extent the release thereof or liability therefor is due to the acts of Tenant or its employees, agents, or contractors), or (iii) any Hazardous Materials placed on the Property by any other tenant of the Property (except to the extent the release thereof or liability therefor is due to the acts of Tenant or its employees, agents, or contractors).

10.03. *Environmental Disclosure.* Should Tenant wish to use, generate or store Hazardous Materials on or about the Property, Tenant shall complete, execute and deliver to Landlord an Environmental Disclosure Statement (the "Environmental Disclosure") in the form of ***Exhibit E*** attached hereto, and Tenant shall certify to Landlord all information contained in the Environmental Disclosure as true and correct to the best of Tenant's knowledge and belief. The completed Environmental Disclosure shall be deemed incorporated into this Lease for all purposes, and Landlord shall be entitled to rely fully on the information contained therein. In the event Tenant provides an Environmental Disclosure, on each anniversary of the Commencement Date (each such date is hereinafter referred to as a "Disclosure Date"), until and including the first Disclosure Date occurring after the expiration or sooner termination of this Lease, Tenant shall disclose to Landlord, in writing, the names and amounts of all Hazardous Materials, or any combination thereof, which were stored, generated, used or disposed of on, under or about the Premises for the twelve-month period prior to and after each Disclosure Date, or which Tenant intends to store, generate, or use on, under or about the Premises. At Landlord's option, Tenant shall execute and deliver to Landlord an Environmental Disclosure as the same may be modified by Landlord from time to time whether or not Tenant wishes to use, generate or store Hazardous Materials on or about the Property.

10.04. *Reclaimed Water*. In the event the Property uses reclaimed water, Tenant acknowledges that Tenant shall comply with all Regulations governing the use thereof. Landlord may periodically conduct such tests as may be reasonably necessary for the use of reclaimed water, including a dual shut down test to establish that there exists no cross over in water systems, and the reasonable costs thereof shall be an operating expense.

10.05. *Signs*. Tenant shall have the exclusive right to signage on the façade of the Building. Any sign placed by Tenant on any portion of the Premises shall contain only Tenant's name and no advertising material, and shall otherwise comply with Landlord's sign criteria (if any). No sign (including, but not limited to, signs advertising an assignment or subletting) shall be placed on the exterior of the Premises without Landlord's written approval of the location, material, size, design and content thereof nor without Tenant's obtaining any necessary permit therefor. If Landlord installs a sign for Tenant, Tenant shall reimburse Landlord for any costs incurred by Landlord within five (5) days of demand by Landlord. Tenant shall remove any sign upon termination of this Lease, using a contractor reasonably acceptable to Landlord, and shall return the Premises to their condition prior to the placement of said sign (including completing all necessary repainting and patching).

10.06. *Parking*. Any monetary obligations imposed relative to parking rights with respect to the Premises shall be considered as Tax Expenses and shall be paid by Tenant under Section 5. Landlord grants Tenant the right to use all of the parking spaces located in the parking area adjacent to the Building (approximately one hundred and ten (110) parking spaces), with the rules regulating the use thereof to be established, from time to time, by Landlord. Tenant shall control Tenant's employees, agents, customers, visitors, invitees, licensees, contractors, assignees and subtenants ("Tenant's Parties") to ensure compliance with such rules. Landlord may take such actions or incur such cost which it deems reasonably necessary to enforce the proper parking on the Property, including the reasonable allocation to Tenant of all costs and expenses to do so. Tenant shall not use the areas outside of the Premises for the placement of dumpsters, refuse collection, outdoor storage or parking of cars and/or pickup trucks which are not in working order. Tenant shall have the right to request that Landlord provide Tenant with the right to use an additional forty (40) parking spaces (the "Additional Parking Spaces"). The Additional Parking Spaces will be located at the property commonly known as 1750 Doolittle Drive, San Leandro, CA, and/or the 3.75 acre parcel located across the street from the Property and directly north of 1750 Doolittle Drive, San Leandro, CA (as determined by Landlord in its sole discretion). If Tenant requests the Additional Parking Spaces, Landlord shall use commercially reasonable efforts to obtain all permits, licenses, and other authorizations necessary to permit Landlord to lease or license the Additional Parking Spaces to Tenant (the "Additional Parking Permits") and if Landlord is able to obtain the Additional Parking Permits, Landlord shall lease or license the Additional Parking Spaces to Tenant pursuant to the terms of this Lease. Further, if the City of San Leandro should determine that Tenant's use of the Premises requires the availability of the Additional Parking Spaces, Landlord shall use commercially reasonable efforts to obtain the Additional Parking Permits and if Landlord is able to obtain the Additional Parking Permits, Landlord shall lease or license the Additional Parking Spaces to Tenant pursuant to the terms of this Lease. Notwithstanding anything to the contrary herein, Landlord's failure to lease or license the Additional Parking Spaces to Tenant due to Landlord's failure to obtain the Additional Parking Permits shall not constitute a default by Landlord under this Lease. In all events, Landlord shall have one hundred eighty (180) days after its receipt of Tenant's request for the Additional Parking Spaces or the City of San Leandro's determination, as applicable, to obtain the Additional Parking Permits and deliver the Additional Parking Spaces to Tenant. Landlord shall pay for its costs incurred with respect to the procurement of the Additional Parking Permits. Landlord and Tenant acknowledge that Landlord has an option to purchase (the "Option") the 3.75 acre parcel located across the

street from the Property and directly north of 1750 Doolittle Drive, San Leandro, CA (the "Option Property"). As of the Effective Date, the Option will expire on November 15, 2010. If Tenant desires to acquire the Option Property for the purpose of obtaining additional parking spaces, it can notify Landlord in writing of the same. If Landlord does not intend to exercise the Option, Landlord shall notify Tenant thereof (which notice Landlord shall provide within thirty (30) days of its receipt of Tenant's notice) and, for a period of ninety (90) days, shall reasonably cooperate at no cost to Landlord with Tenant in connection with Tenant's negotiation of a contract to acquire the Option Property. It shall not be a default by Landlord under this Lease if Tenant is unable to acquire the Option Property. If Landlord intends to exercise the Option, Landlord shall have no obligation to assist Tenant in connection with its acquisition of the Option Property. If the City of San Leandro should determine that Tenant's use of the Premises requires the availability of more than one hundred fifty (150) parking spaces (or if the Additional Parking Spaces are not being leased or licensed to Tenant, one hundred ten (110) parking spaces), and provided that there are parking spaces at the Property that are not then subject to lease or license, Landlord shall grant Tenant the right to use up to fifty (50) additional parking spaces (or if the Additional Parking Spaces are not being leased or licensed to Tenant, up to ninety (90) additional parking spaces) at the Property (in locations to be reasonably agreed upon by Landlord and Tenant). Further, if Tenant should reasonably determine that Tenant's use of the Premises requires the availability of more than one hundred fifty (150) parking spaces (or if the Additional Parking Spaces are not being leased or licensed to Tenant, one hundred ten (110) parking spaces), and provided that there are parking spaces at the Property that are not then subject to lease or license, Landlord shall grant Tenant the right to use up to fifty (50) additional parking spaces (or if the Additional Parking Spaces are not being leased or licensed to Tenant, up to ninety (90) additional parking spaces) at the Property (in locations to be reasonably agreed upon by Landlord and Tenant).

11. DAMAGE AND DESTRUCTION

11.01. *Reconstruction*. If the Building or the Warehouse is damaged or destroyed, Landlord shall, except as hereinafter provided, diligently repair or rebuild the Building or the Warehouse (as applicable) to substantially the condition in which the Building or the Warehouse (as applicable) existed immediately prior to such damage or destruction, provided that insurance is available to pay one hundred percent (100%) or more of the cost of such restoration, excluding the deductible amount. Landlord shall not be obligated to repair any improvements made or paid for by Tenant.

11.02. *Rent Abatement*. Base Rent shall be abated proportionately, but only to the extent of any proceeds received by Landlord from rental abatement insurance described in Section 6.06, during any period when, by reason of such damage or destruction, Landlord reasonably determines that there is substantial interference with Tenant's use of the Premises, having regard to the extent to which Tenant may be required to discontinue Tenant's use of the Premises. Such abatement shall commence upon the date of such damage or destruction and end upon substantial completion by Landlord of the repair or reconstruction which Landlord is obligated or undertakes to do. If Landlord reasonably determines that continuation of business is not practical pending reconstruction, Base Rent shall abate to the extent of proceeds from rental abatement insurance until reconstruction is substantially completed or until business is totally or partially resumed, whichever occurs earlier.

11.03. *Option to Terminate.* (i) If the Building is damaged or destroyed to the extent that Landlord determines in good faith that the Building cannot, with reasonable diligence, be fully repaired or restored by Landlord within two hundred seventy (270) days after the date of the damage or destruction, notwithstanding the fact that the Premises have not been totally damaged or destroyed, the sole right of both Landlord and Tenant shall be the option to terminate this Lease. (ii) If the Warehouse is damaged or destroyed to the extent that Landlord determines in good faith that the Warehouse cannot, with reasonable diligence, be fully repaired or restored by Landlord within two hundred seventy (270) days after the date of the damage or destruction, notwithstanding the fact that the Premises have not been totally damaged or destroyed, the sole right of Landlord shall be the option to terminate this Lease with respect to the Warehouse only. (iii) If the Warehouse is damaged or destroyed to the extent that Landlord determines in good faith that the Warehouse cannot, with reasonable diligence, be fully repaired or restored by Landlord within two hundred seventy (270) days after the date of the damage or destruction, notwithstanding the fact that the Premises have not been totally damaged or destroyed, the sole right of Tenant shall be the option to terminate this Lease. Landlord's determination with respect to the extent of damage or destruction shall be conclusive on Tenant. Landlord shall notify Tenant of Landlord's determination, in writing, within sixty (60) days after the date of the damage or destruction. If Landlord determines that under clause (i) above the Building can be fully repaired or restored within the two hundred seventy (270)-day period, or if Landlord determines that such repair or restoration cannot be made within said period but neither party elects to terminate within thirty (30) days from the date of said determination, this Lease shall remain in full force and effect and Landlord shall diligently repair and restore the damage as soon as reasonably possible. If Landlord determines that under clause (ii) above the Warehouse can be fully repaired or restored within the two hundred seventy (270)-day period, or if Landlord determines that such repair or restoration cannot be made within said period but neither party elects to terminate within thirty (30) days from the date of said determination, this Lease shall remain in full force and effect and Landlord shall diligently repair and restore the damage as soon as reasonably possible. If this Lease is terminated pursuant to this Section 11.03 with respect to the Warehouse only, (a) after the date of such termination the Base Rent, Tenant's Share of Warehouse Tax Expenses, and Tenant's Share of Warehouse Insurance Expenses shall be adjusted as reasonably determined by Landlord and (b) upon Tenant's written request and provided alternative warehouse space at the Property is then vacant and available for lease, Landlord agrees to negotiate in good faith with Tenant with respect to the lease of alternative warehouse space at the Property, either on a temporary basis (pending restoration of the Warehouse Premises) or on a long-term basis, as the parties shall mutually agree.

11.04. *Uninsured Casualty.* In the event the Building is damaged or destroyed and is not fully covered by the insurance proceeds received by Landlord under the insurance policies required under Section 6.02, Landlord may terminate this Lease by written notice to Tenant given within thirty (30) days after the date of Landlord's receipt of written notice from Landlord's insurance company that said damage or destruction is not so covered. In the event the Warehouse is damaged or destroyed and is not fully covered by the insurance proceeds received by Landlord under the insurance policies required under Section 6.02, Landlord may terminate this Lease with respect to the Warehouse only by written notice to Tenant given within thirty (30) days after the date of Landlord's receipt of written notice from Landlord's insurance company that said damage or destruction is not so covered. If Landlord does not elect to terminate this Lease, this Lease shall remain in full force and effect, and the Building or Warehouse (as applicable) shall be repaired and rebuilt in accordance with the provisions for repair set forth in Section 11.01. If this Lease is terminated pursuant to this Section 11.04 with respect to the Warehouse only, after the date of such termination the Base Rent shall be adjusted as reasonably determined by Landlord.

11.05. *Waiver.* With respect to any damage or destruction which Landlord is obligated to repair or may elect to repair under the terms of this Section 11, Tenant waives all rights to terminate this Lease pursuant to rights otherwise presently or hereafter accorded by law to tenants, including, without limitation, any rights arising pursuant to California Civil Code Sections 1932 and 1933.

12. EMINENT DOMAIN

12.01. *Total Condemnation.* If all of the Premises is taken under the power of eminent domain or sold in lieu of condemnation, for any public or quasi-public use or purpose ("Condemned"), this Lease shall terminate as of the date of title vesting in such proceeding, and Rent shall be adjusted to the date of termination.

12.02. *Partial Condemnation.* If any portion of the Premises is Condemned, and such partial condemnation renders the Premises unusable for Tenant's business, or if a substantial portion of the Building is Condemned, as reasonably determined by Landlord, this Lease shall terminate as of the date of title vesting in such proceeding and rent shall be adjusted to the date of termination. If such partial

condemnation does not render the Premises unusable for the business of Tenant or less than a substantial portion of the Building is Condemned, Landlord shall promptly restore the Premises to the extent of any condemnation proceeds recovered by Landlord, less the portion thereof lost in such condemnation, and this Lease shall continue in full force and effect except that after the date of such title vesting the Base Rent, Tenant's Share of Warehouse Tax Expenses, Tenant's Share of Warehouse Insurance Expenses, and Tenant's Share of Warehouse Operating Expenses shall be adjusted as reasonably determined by Landlord. Tenant hereby waives the provisions of California Code of Civil Procedure Section 1265.130 permitting a court of law to terminate this Lease.

12.03. *Landlord's Award.* If the Premises are wholly or partially Condemned, Landlord shall be entitled to the entire award paid for such condemnation, subject to the provisions of Section 12.04, and Tenant waives any claim to any part of the award from Landlord or the condemning authority.

12.04. *Tenant's Award.* Tenant shall have the right to recover from the condemning authority, but not from Landlord, such compensation as may be separately awarded to Tenant in connection with loss of good will and costs in removing Tenant's merchandise, furniture, fixtures, leasehold improvements and equipment to a new location, so long as such award does not diminish the award granted to Landlord.

12.05. *Temporary Condemnation.* In the event the Premises is temporarily Condemned, as reasonably determined by Landlord, this Lease shall remain in effect and Tenant shall receive any award made for such condemnation. If a temporary condemnation remains in effect at the expiration or earlier termination of this Lease, Tenant shall pay Landlord the reasonable cost of performing any obligations required of Tenant by this Lease with respect to the surrender of the Premises, and upon such payment Tenant shall be excused from such obligations. If a temporary condemnation is for a period which extends beyond the Term, this Lease shall terminate as of the date of occupancy by the condemning authority, the award shall be distributed as provided in Sections 12.03 and 12.04 above, and Rent shall be adjusted to the date of such occupancy.

12.06. *Delivery of Documents.* Tenant shall immediately execute and deliver to Landlord all instruments required to effectuate the provisions of this Section 12.

13. DEFAULT

13.01. *Events of Default.* The occurrence of any of the following events shall constitute an "Event of Default" by Tenant with or without notice from Landlord:

a. Vacating or Abandoning. Vacating or abandoning the Premises;

b. Payment. Failure to pay Rent within seven (7) days of Tenant's receipt of Landlord's written notice that the same is due; provided, however, Landlord shall not be obligated to provide written notice of monetary default more than two (2) times in any calendar year, and each subsequent monetary default shall be an Event of Default if not received when the same is due; provided further, such notice shall be in lieu of, and not in addition to, any notice required under Section 1161 et seq. of the California Code of Civil Procedure;

c. Performance. Default in the performance of Tenant's covenants, agreements and obligations hereunder, except default in the payment of Rent, the default continuing for thirty (30) days after notice thereof from Landlord; provided, however, if such default is of the type which cannot reasonably be cured within thirty (30) days, then Tenant shall have such longer time as is reasonably necessary provided Tenant commences to cure within ten (10) days after receipt of written notice from Landlord and diligently prosecutes such cure to completion within sixty (60) days of such notice;

d. Assignment. A general assignment by Tenant for the benefit of creditors;

e. Bankruptcy. The filing of a voluntary petition by Tenant or the filing of an involuntary petition by any of Tenant's creditors seeking the rehabilitation, liquidation or reorganization of Tenant under any law relating to bankruptcy;

f. Receivership. The appointment of a receiver or other custodian to take possession of substantially all of Tenant's assets or this leasehold;

g. Insolvency, Dissolution, Etc. Tenant's insolvency or inability to pay Tenant's debts, or failure generally to pay Tenant's debts when due; or any court entering a decree or order directing the winding up or liquidation of Tenant or of substantially all of Tenant's assets; or Tenant taking any action toward the dissolution or winding up of Tenant's affairs or the cessation or suspension of Tenant's use of the Premises;

h. Attachment. Attachment, execution or other judicial seizure of substantially all of Tenant's assets or this leasehold;

i. Estoppel/Financial Statements. Tenant's failure to deliver to Landlord an Estoppel Certificate mandated by Section 15.01 or a Financial Statement mandated by Section 16.02 within thirty (30) days after Landlord's written request; or

j. False Financial Statements. The discovery that any Financial Statement of Tenant given to Landlord was materially false.

Tenant hereby waives the redemption provisions of California Code of Civil Procedure Sections 1174 and 1179.

13.02. *Landlord's Remedies.* Upon any Event of Default, Landlord may, in addition to all other rights and remedies afforded Landlord hereunder or by law or equity, take any one or more of the following actions:

a. Termination of Lease. Terminate this Lease by giving Tenant written notice thereof, in which event Tenant shall immediately surrender the Premises to Landlord. In the event that Landlord shall elect to so terminate this Lease, then Landlord may recover from Tenant:

(i) The worth at the time of award of any unpaid Rent which had been earned at the time of such termination; plus

(ii) The worth at the time of award of the amount by which the unpaid Rent which would have been earned after termination until the time of award exceeds the amount of such Rent loss Tenant proves reasonably could have been avoided; plus

(iii) The worth at the time of award of the amount by which the unpaid Rent for the balance of the Term after the time of award exceeds the amount of such Rent loss that Tenant proves reasonably could be avoided; plus

(iv) Any other amount necessary to compensate Landlord for all detriment proximately caused by Tenant's failure to perform its obligations under this Lease or which in the ordinary course would be likely to result therefrom; plus

(v) At Landlord's election, such other amounts in addition to or in lieu of the foregoing as may be permitted from time to time by applicable California law.

As used in subparagraphs (i) and (ii) above, the "worth at the time of award" is computed by allowing interest at the Default Rate. As used in subparagraph (iii) above, the "worth at the time of award" is computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%). Forbearance by Landlord to enforce one or more of the remedies herein provided upon an Event of Default shall not be deemed or construed to constitute a waiver of such default. Tenant hereby waives for Tenant and for all those claiming under Tenant all rights now or hereafter existing to redeem by order or judgment of any court or by any legal process or writ, Tenant's right of occupancy of the Premises after any termination of this Lease.

b. Termination of Possession. Terminate Tenant's right to possess the Premises without terminating this Lease by giving written notice thereof to Tenant, in which event Tenant shall pay to Landlord: (1) all Rent and other amounts accrued hereunder to the date of termination of possession and (2) all Rent and other net sums required hereunder to be paid by Tenant during the remainder of the Term, diminished by any net sums thereafter received by Landlord through reletting the Premises during such period, after deducting all costs incurred by Landlord in relating the Premises. Any sums due under the foregoing Section 13.02(b)(2) shall be calculated and due monthly. If Landlord elects to proceed under this Section 13.02(b), Landlord may remove all of Tenant's property from the Premises and store the same in a public warehouse or elsewhere at the cost of, and for the account of, Tenant, without becoming liable for any loss or damage which may be occasioned thereby. If and to the extent required by applicable Regulations, Landlord shall use commercially reasonable efforts to relet the Premises on such terms as Landlord in its sole discretion may determine (including a term different from the Term, rental concessions, and alterations to, and improvement of, the Premises); however, Landlord shall not be obligated to expend funds in connection with reletting the Premises, nor to relet the Premises before leasing other portions of the Property, and Landlord shall not be obligated to accept any prospective tenant proposed by Tenant unless such proposed tenant meets all of Landlord's leasing criteria then in effect. Landlord shall not be liable for, nor shall Tenant's obligations hereunder be diminished because of, Landlord's failure to relet the Premises or to collect rent due for such reletting. Tenant shall not be entitled to the excess of any consideration obtained by reletting over the Rent due hereunder. Reentry by Landlord in the Premises shall not affect Tenant's obligations hereunder for the unexpired Term; rather, Landlord may, from time to time, bring an action against Tenant to collect amounts due by Tenant, without the necessity of Landlord's waiting until the expiration of the Term. Unless Landlord delivers written notice to Tenant expressly stating that it has elected to terminate this Lease, all actions taken by Landlord to dispossess or exclude Tenant from the Premises shall be deemed to be taken under this Section 13.02(b). If landlord elects to proceed under this Section 13.02(b), it may at any time elect to terminate this Lease under Section 13.02(a).

c. Continue Lease in Effect. In addition to all other rights and remedies provided Landlord in this Lease and by Regulations, Landlord shall have the remedy described in California Civil Code Section 1951.4 (Landlord may continue the Lease in effect after Tenant's breach and abandonment and recover Rent as it becomes due if Tenant has the right to sublet or assign the Lease, subject to reasonable limitations).

d. Additional Remedies. In addition to the foregoing remedies and so long as this Lease is not terminated, Landlord shall have the right to remedy any default of Tenant, to maintain or improve the Premises without terminating this Lease, to incur expenses on behalf of Tenant in seeking a new subtenant, to cause a receiver to be appointed to administer the Premises and new or existing subleases and to add to the Rent payable hereunder all of Landlord's reasonable costs in so doing, with interest at the Default Rate from the date of such expenditure until the same is repaid.

e. Alteration of Locks. Additionally, with or without notice, and to the extent permitted by applicable Regulations, Landlord may alter locks or other access control devices at the Premises to deprive Tenant of access thereto, and Landlord shall not be required to provide a new key or right of access to Tenant.

f. Other. If Tenant causes or threatens to cause a breach of any of the covenants, terms or conditions contained in this Lease, Landlord shall be entitled to obtain all sums held by Tenant, by any trustee or in any account provided for herein, to enjoin such breach or threatened breach, and to invoke any remedy allowed at law, in equity, by statute or otherwise as though re-entry, summary proceedings and other remedies were not provided for in this Lease. If a notice and grace period required under Section 13.01 was not previously given, a notice to pay rent or quit, or to perform or quit given to Tenant under the unlawful detainer statute (California Code of Civil Procedure Sections 1161 et seq.) shall also constitute the notice required by Section 13.01. In such case, the applicable grace period required by Section 13.01 and the unlawful detainer statute shall run concurrently, and the failure of Tenant to cure the Event of Default within the greater of the two such grace periods shall constitute both an unlawful detainer and a breach of this Lease entitling Landlord to the remedies provided for in this Lease and/or by said statute.

13.03. *Landlord's Remedies Cumulative*. Each right and remedy of Landlord provided for in this Lease or now or hereafter existing at law, in equity, by statute or otherwise, shall be cumulative and shall not preclude Landlord from exercising any other rights or remedies provided for in this Lease or now or hereafter existing at law or equity, by statute or otherwise. Nothing in this Section 13 shall affect the right of Landlord to indemnification by Tenant in accordance with Section 6.10 for liability arising from personal injuries or property damage prior to the termination of this Lease.

14. ASSIGNMENT AND SUBLETTING

14.01. *Approval*. Tenant shall not assign, sublease, mortgage, pledge or otherwise transfer this Lease, in whole or in part, nor sublet or permit occupancy by any party other than Tenant of all or any part of the Premises without Landlord's prior written consent which shall not be unreasonably withheld, conditioned or delayed. If Tenant is a corporation, limited liability company or a partnership, other than a corporation whose stock is publicly traded, the transfer of fifty percent (50%) or more of the beneficial ownership interest of the corporate stock, membership interests or partnership interests of Tenant, as the case may be, shall constitute an assignment hereunder for which such consent is required. This Lease may not be assigned by operation of law. Any purported assignment or subletting contrary to the provisions hereof shall be void. Notwithstanding that Landlord shall have no legal obligation to do so, if Landlord should decide in the future to permit an assignment or subletting, such consent by Landlord to any assignment or subletting shall not constitute a consent to any subsequent assignment or subletting. Under no circumstances shall this Lease be assigned, sublet, or assumed, in whole or in part, unless Landlord receives adequate assurance of future performance of all the terms and conditions of this Lease. Such adequate assurance shall include adequate assurance: (a) of the source of Rent due under this Lease; (b) that the assignment, subletting, or assumption of this Lease shall not cause any breach in any respect of any provision in any other lease, financing agreement, or master agreement relating to the Building, the Warehouse, or Property; and (c) that the assignment, subletting, or assumption shall not disrupt in any respect any tenant mix or balance in

the Building, the Warehouse, or on the Premises. Tenant shall pay promptly upon billing any and all attorneys' fees and other costs reasonably incurred by Landlord for the review or preparation of any documents in connection with a proposed assignment or sublease.

14.02. *Landlord Option.*

a. Right to Cancel. In connection with any proposed assignment or sublease, Landlord shall have the option to cancel and terminate this Lease if the request is to assign this Lease or to sublet all of the Premises; or, if the request is to sublet a portion of the Premises only, to cancel and terminate this Lease with respect to such portion. Landlord may exercise said option by notifying Tenant in writing within thirty (30) days after Landlord's receipt from Tenant of such request, and in each case such cancellation or termination shall occur as of the date set forth in Landlord's notice of exercise of such option, which shall not be less than sixty (60) days nor more than one hundred twenty (120) days following the giving of such notice.

b. Cancellation. If Landlord exercises Landlord's option to cancel this Lease or any portion thereof, Tenant shall surrender possession of the Premises, or the portion thereof which is the subject of the option, as the case may be, on the date set forth in such notice in accordance with the provisions of this Lease relating to surrender of the Premises at the expiration of the Term. If this Lease is canceled as to a portion of the Premises only, Rent after the date of cancellation shall be abated on a pro rata basis, as determined by Landlord. After any such cancellation, Landlord may directly lease the Premises to any party, including, without limitation, any party with whom Tenant previously discussed an assignment or subletting.

c. Noncancellation. If Landlord does not exercise Landlord's option to cancel this Lease pursuant to the foregoing provisions, Landlord may withhold Landlord's consent to such proposed assignment or subletting, provided such consent is not unreasonably withheld.

14.03. *Bonus Rental.* If Tenant receives rent or other consideration for any assignment or sublease in excess of the Rent or, in case of the sublease of a portion of the Premises, in excess of such Rent that is fairly allocable to such portion, as determined by Landlord, after appropriate adjustments to assure that all other payments required hereunder are appropriately taken into account, Tenant shall pay Landlord fifty percent (50%) of the difference between each such payment of rent or other consideration and the Rent required hereunder. Tenant may deduct from the excess, on a straight-line basis, all reasonable and customary expenses directly incurred by Tenant attributable to the assignment or sublease, including brokerage fees, legal fees, and construction costs.

14.04. *Scope.* If (a) this Lease is assigned, (b) the underlying beneficial interest of Tenant is transferred or (c) the Premises or any part thereof is sublet or occupied by anyone other than Tenant, Landlord may collect rent from the assignee, subtenant or occupant and apply the net amount collected to the Rent herein reserved and apportion any excess rent so collected in accordance with the terms of Section 14.03; provided that no such assignment, subletting, occupancy or collection shall be deemed a waiver of this covenant, or the acceptance of the assignee, subtenant or occupant as tenant, or a release of Tenant from the further performance by Tenant or covenants on the part of Tenant herein contained. No assignment or subletting shall affect the continuing liability of Tenant (which, following assignment, shall be joint and several with the assignee), and Tenant shall not be released from performing any of the terms, covenants and conditions of this Lease.

14.05. *Release.* The term "Landlord" as used herein shall mean the owner or owners at the time in question of the fee title to the Premises, or, if this is a sublease, of the Tenant's interest in the master lease. The obligations and/or covenants in this Lease to be performed by the Landlord shall be binding only upon the Landlord as hereinabove defined.

14.06. *Holding Over.* If Tenant fails to vacate the Premises at the end of the Term, then Tenant shall be a tenant at sufferance and, in addition to all other damages and remedies to which Landlord may be entitled for such holding over: (a) Tenant shall pay, in addition to the other Rent, Base Rent equal to two hundred percent (200%) of the Base Rent payable during the last month of the Term; and (b) Tenant shall otherwise continue to be subject to all of Tenant's obligations under this Lease. The provisions of this Section 14.06 shall not be deemed to limit or constitute a waiver of any other rights or remedies of Landlord provided herein or pursuant to applicable Regulations. If Tenant fails to surrender the Premises upon the termination or expiration of this Lease, in addition to any other liabilities to Landlord accruing therefrom, Tenant shall protect, defend, indemnify and hold Landlord harmless from all loss, costs (including reasonable attorneys' fees) and liability resulting from such failure, including any claims made by any succeeding tenant founded upon such failure to surrender, and any lost profits to Landlord resulting therefrom. Notwithstanding the foregoing, if Tenant holds over with Landlord's express written consent, then Tenant shall be a month-to-month tenant and Tenant shall pay, in addition to the other Rent, Base Rent equal to one hundred twenty-five percent (125%) of the Base Rent payable during the last month of the Term.

14.07. *Waiver.* Tenant waives notice of any default of any assignee or sublessee and agrees that Landlord may, at Landlord's option, proceed against Tenant without having taken action against or joined such assignee or sublessee, except that Tenant shall have the benefit of any indulgences, waivers and extensions of time granted to any such assignee or sublessee.

14.08. *Permitted Transfers.* Notwithstanding Section 14.01, Tenant may transfer its interest in this Lease or all or part of the Premises (a "Permitted Transfer") to the following types of entities (a "Permitted Transferee") without the written consent of Landlord:

(1) any person or entity which, directly or indirectly, through one or more intermediaries, controls, is controlled by, or is under common control with Tenant;

(2) any corporation, limited partnership, limited liability partnership, limited liability company or other business entity in which or with which Tenant, or its corporate successors or assigns, is merged or consolidated, in accordance with applicable statutory provisions governing merger and consolidation of business entities, so long as (A) Tenant's obligations hereunder are assumed by the entity surviving such merger or created by such consolidation; and (B) the Tangible Net Worth of the surviving or created entity is not less than the Tangible Net Worth of Tenant as of the date of execution of this Lease; or

(3) any corporation, limited partnership, limited liability partnership, limited liability company or other business entity acquiring all or substantially all of Tenant's assets if such entity's Tangible Net Worth after such acquisition is not less than the Tangible Net Worth of Tenant as of the date of execution of this Lease.

Tenant shall promptly notify Landlord of any such Permitted Transfer. Tenant shall remain liable for the performance of all of the obligations of Tenant hereunder, or if Tenant no longer exists because of a merger, consolidation, or acquisition, the surviving or acquiring entity shall expressly assume in writing the obligations of Tenant hereunder. Additionally, the Permitted Transferee shall comply with all of the terms and conditions of this Lease, including the Permitted Uses, and the use of the Premises by the Permitted Transferee may not violate any other agreements affecting the Premises, the Building, the Warehouse, or the Property. No later than five (5) business days after the effective date of any Permitted Transfer, Tenant agrees to furnish Landlord with (A) copies of the instrument effecting any of the foregoing transfers, (B) documentation establishing Tenant's satisfaction of the requirements set forth above applicable to any such transfer, and (C) evidence of insurance as required under this Lease with respect to the Permitted Transferee. The occurrence of a Permitted Transfer shall not waive Landlord's rights as to any subsequent transfers. "Tangible Net Worth" means the excess of total assets over total liabilities, in

each case as determined in accordance with generally accepted accounting principles consistently applied ("GAAP"), excluding, however, from the determination of total assets all assets which would be classified as intangible assets under GAAP including goodwill, licenses, patents, trademarks, trade names, copyrights and franchises. Any subsequent transfer by a Permitted Transferee shall be subject to the terms of this Section 14. Landlord's right to cancel under Section 14.02 shall not apply with respect to a Permitted Transfer.

15. ESTOPPEL CERTIFICATE, ATTORNMENT AND SUBORDINATION

15.01. *Estoppel Certificate.* Within ten (10) days after request by Landlord, Tenant shall deliver, in recordable form, an estoppel certificate in the form determined by Landlord or Landlord's mortgagee or purchaser, to any proposed mortgagee, purchaser or Landlord. Tenant's failure to deliver said statement in such time period shall be conclusive upon Tenant that (a) this Lease is in full force and effect, without modification except as may be represented by Landlord; (b) there are no uncured defaults in Landlord's performance and Tenant has no right of offset, counterclaim or deduction against Rent hereunder; and (c) no more than one month's Rent has been paid in advance.

15.02. *Attornment.* Tenant shall, if requested, attorn to the purchaser upon a foreclosure, sale or a grant of a deed in lieu of foreclosure of the Property, and recognize such purchaser as Landlord under this Lease in the event of (a) a foreclosure proceeding (b) the exercise of the power of sale under any mortgage or deed of trust made by Landlord, Landlord's successors or assigns which encumbers the Premises, any part thereof; or (c) the termination of a ground lease; or (d) a sale of the Property.

15.03. *Subordination.* The rights of Tenant hereunder are subject and subordinate to the lien of any mortgage or lien resulting from any other method of financing or refinancing, now or hereafter in force against the Premises, and to all advances made upon the security thereof; provided, however, that notwithstanding such subordination, so long as Tenant is not in default under this Lease, this Lease shall not be terminated or subject to termination by any trustee's sale, action to enforce the security or proceeding or action in foreclosure. If requested, Tenant shall execute whatever documentation may be required to further effect the provisions of this Section 15.03.

16. MISCELLANEOUS

16.01. *Waiver.* No waiver by Landlord of any default or breach of any covenant by Tenant hereunder shall be implied from any omission by Landlord to take action on account of such default if such default persists or is repeated, and no express waiver shall affect any default other than the default specified in the waiver and then said waiver shall be operative only for the time and to the extent therein stated. Waivers of any covenant, term or condition contained herein by Landlord shall not be construed as a waiver of any subsequent breach of the same covenant, term or condition. The consent or. approval by Landlord to any act of Tenant requiring further consent or approval by Landlord shall not be deemed to waive or render unnecessary landlord's consent or approval to any subsequent similar acts. No waiver by Landlord of any provision under this Lease shall be effective unless in writing and signed by Landlord. Landlord's acceptance of full or partial payment of Rent during the continuance of any breach of this Lease shall not constitute a waiver of any such breach of this Lease. Efforts by Landlord to mitigate the damages caused by Tenant's breach of this Lease shall not be construed as a waiver of Landlord's right to recover damages under Section 13.

16.02. *Financial Statements.* Within ten (10) days after Landlord's written request from time to time during the Term, Tenant shall deliver to Landlord current audited financial statements of Tenant. Tenant represents and warrants that all financial statements delivered to Landlord shall be true and complete in all material respects.

16.03. *Accord and Satisfaction.* No payment by Tenant of a lesser amount than the Rent nor any endorsement on any check or letter accompanying any check or payment as Rent shall be deemed an accord and satisfaction of full payment of Rent, and Landlord may accept such payment without prejudice to Landlord's right to recover the balance of such Rent or to pursue other remedies.

16.04. *Limitation of Landlord's Liability.* The obligations of Landlord under this Lease are not personal obligations of the individual partners, directors, members, managers, officers and shareholders of Landlord, and Tenant shall look solely to the Property for satisfaction of any liability and shall not look to other assets of Landlord nor seek recourse against the assets of the individual partners, directors, members, managers, officers and shareholders of Landlord.

16.05. *Entire Agreement.* This Lease sets forth all the covenants, agreements, conditions and understandings between Landlord and Tenant concerning the Property, and there are no covenants, agreements, conditions or understandings, either oral or written, between Landlord and Tenant other than as set forth herein. No alteration, amendment, change or addition to this Lease shall be binding upon Landlord and Tenant unless in writing and signed by both Landlord and Tenant.

16.06. *Time.* Time is of the essence of this Lease.

16.07. *Attorneys' Fees.* In any action which Landlord or Tenant brings to enforce its respective rights hereunder, the unsuccessful party shall pay all costs incurred by the prevailing party including reasonable attorneys' fees, to be fixed by the court, and said costs and attorneys' fees shall be a part of the judgment in said action.

16.08. *Captions and Article Letters.* The captions, article letters and table of contents appearing in this Lease are inserted as a matter of convenience and in no way define or limit the provisions of this Lease.

16.09. *Severability.* If any provision of this Lease or the application of any such provision shall be held by a court of competent jurisdiction to be invalid, void or unenforceable to any extent, the remaining provisions of this Lease and the application thereof shall remain in full force and effect and shall not be affected, impaired or invalidated.

16.10. *Applicable Regulations.* This Lease, and the rights and obligations of the parties hereto, shall be construed and enforced in accordance with the laws of the State of California.

16.11. *Examination of Lease.* Submission of this Lease to Tenant does not constitute an option to Lease, and this Lease is not effective until execution and delivery by both Landlord and Tenant.

16.12. *Surrender.* Upon the expiration or earlier termination of this Lease, Tenant shall surrender the Premises to Landlord in the same condition as existed on the date Tenant originally took possession thereof, reasonable wear and tear excepted, including, but not limited to, all interior walls cleaned, all interior painted surfaces repainted in the original color, all holes in walls repaired, all carpets shampooed and cleaned, and all floors cleaned, waxed, and free of any Tenant-introduced marking or painting, all to the reasonable satisfaction of Landlord. Tenant shall not commit or allow any waste or damage to be committed on any portion of the Premises or the Property. All property that Tenant is required to surrender shall become Landlord's property upon the termination of this Lease. If Tenant fails to timely remove its personal property from the Premises, Landlord may keep and use them or remove any of them and cause them to be stored or sold in accordance with applicable law, all at Tenant's sole cost and expense. All keys to the Premises or any part thereof shall be surrendered to Landlord upon expiration or sooner termination of the Term. Tenant shall give written notice to Landlord at least thirty (30) days prior to vacating the Premises and shall meet with Landlord for a joint inspection of the Premises at the time of vacating, but nothing contained

herein shall be construed as an extension of the Term or as a consent by Landlord to any holding over by Tenant. In the event of Tenant's failure to give such notice or participate in such joint inspection, Landlord's inspection at or after Tenant's vacating the Premises shall conclusively be deemed correct for purposes of determining Tenant's responsibility for repairs and restoration. Notwithstanding anything to the contrary herein, as part of Tenant's surrender obligations Tenant shall return the service corridor in the same condition as existed on the date hereof. Such obligation shall include, if applicable, restoration of the wall separating the Building from the Warehouse and installation of a carbon dioxide ventilation system equivalent to the one located in the Building as of the date hereof.

16.13 *Authority.* If Tenant is a corporation, trust, limited liability company, partnership, or similar entity, each individual executing this Lease on behalf of such entity represents and warrants that he or she is duly authorized to execute and deliver this Lease on its behalf. Tenant shall, within thirty (30) days after request, deliver to Landlord satisfactory evidence of such authority.

16.14. *Broker.* Tenant warrants that it has had no dealings with any real estate broker or agent other than Landlord's Broker and Tenant's Broker set forth in Section 1.01 in connection with the negotiation of this Lease, and that it knows of no other real estate broker or agent who is entitled to any commission or finder's fee in connection with this Lease. Tenant agrees to indemnify Landlord and hold Landlord harmless from and against any and all claims, demands, losses, liabilities lawsuits, judgments, costs and expenses (including without limitation, attorneys' fees and costs) with respect to any leasing commission or equivalent compensation alleged to be owing on account of Tenant's dealings with any real estate broker or agent other than Landlord's Broker and Tenant's Broker. Landlord agrees to indemnify Tenant and hold Tenant harmless from and against any and all claims, demands, losses, liabilities, lawsuits, judgments, costs and expenses (including without limitation, attorneys' fees and costs) with respect to any leasing commission or equivalent compensation alleged to be owing on account of Landlord's dealings with any real estate broker or agent other than Landlord's Broker and Tenant's Broker. Landlord shall pay a commission to Landlord's Broker (to be shared with Tenant's Broker) pursuant to a separate agreement.

16.15. *Landlord's Right to Perform.* Upon Tenant's failure to perform any obligation of Tenant hereunder, including without limitation, payment of Tenant's insurance premiums, charges of contractors who have supplied materials or labor to the Premises, etc., Landlord shall have the right to perform such obligations of Tenant on behalf of Tenant and/or to make payment on behalf of Tenant to such parties. Tenant shall reimburse Landlord the reasonable cost of Landlord's performing such obligations on Tenant's behalf, including reimbursement of any amounts that may be expended by Landlord, plus interest at the Default Rate as Additional Rent.

16.16. *Modification for Lender.* If, in connection with obtaining construction, interim or permanent financing for the Building, the Warehouse, or the Property, Landlord's lender shall request reasonable modifications in this Lease as a condition to such financing. Tenant shall not unreasonably withhold, delay or defer its consent thereto, provided that such modifications do not materially increase the obligations of Tenant hereunder or materially adversely affect the leasehold interest hereby created or Tenant's rights hereunder.

16.17. *Landlord's Lien.* In addition to any statutory lien for Rent in Landlord's favor, Landlord shall have and Tenant hereby grants to Landlord a continuing security interest for all Rent becoming due hereunder from Tenant, upon all goods, wares, equipment, fixtures, furniture, inventory, accounts, contract rights, chattel paper and other personal property of Tenant situated on the Premises, and such property shall not be removed therefrom without the consent of Landlord until all arrearages in Rent shall first have been paid and discharged. In the event of a default under this Lease, Landlord shall have, in addition to any other remedies provided herein or by law, all rights and remedies under the Uniform Commercial Code, including without limitation the right to sell the property described in this Section 16.17 at public or private sale upon ten (10) days notice to Tenant. Tenant hereby agrees to execute a California Form UCC-1 and such other instruments necessary or desirable in Landlord's discretion, from time to time, to perfect the security interest hereby created. Any statutory lien for rent is not hereby waived, the express contractual lien herein granted being in addition and supplementary thereto.

16.18. *Notices.* All notices to be given hereunder shall be in writing and mailed postage prepaid by certified or registered mail, return receipt requested, or delivered by personal delivery (including via a nationally recognized overnight courier service), to Landlord's Address and Tenant's Address, or to such other place as Landlord or Tenant may designate in a written notice given to the other party. Notices shall be deemed served three (3) days after the date of mailing or upon personal delivery, as the case may be.

16.19. *Hazardous Materials Notification* Tenant acknowledges that Tenant has received the notification letter attached to this Lease as*Exhibit F* hereto.

16.20. *Force Majeure.* Other than Tenant's obligations under this Lease that can be performed by the payment of money (e.g., payment of Rent and maintenance of insurance) and Tenant's obligations pursuant to *Exhibit D* hereto, whenever a period of time is herein prescribed for action to be taken by either party hereto, such party shall not be liable or responsible for, and there shall be excluded from the computation of any such period of time, any delays due to strikes, riots, acts of God, shortages of labor or materials, war, acts of terrorism, governmental laws, regulations, or restrictions, or any other causes of any kind whatsoever which are beyond the control of such party.

16.21. *USA Patriot Act and Anti-Terrorism Laws.*

(a) Tenant represents and warrants to, and covenants with, Landlord that neither Tenant nor any of its respective constituent owners or affiliates currently are, or shall be at any time during the Term hereof, in violation of any laws relating to terrorism or money laundering (collectively, the "Anti-Terrorism Laws"), including without limitation Executive Order No. 13224 on Terrorist Financing, effective September 24, 2001 and relating to Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism (the "Executive Order") and/or the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (Public Law 107-56) (the "USA Patriot Act").

(b) Tenant covenants with Landlord that neither Tenant nor any of its respective constituent owners or affiliates is or shall be during the Term hereof a "Prohibited Person," which is defined as follows: (i) a person or entity that is listed in the Annex to, or is otherwise subject to, the provisions of the Executive Order; (ii) a person or entity owned or controlled by, or acting for or on behalf of, any person or entity that is listed in the Annex to, or is otherwise subject to the provisions of, the Executive Order; (iii) a person or entity with whom Landlord is prohibited from dealing with or otherwise engaging in any transaction by any Anti-Terrorism Law, including without limitation the Executive Order and the USA Patriot Act; (iv) a person or entity who commits, threatens or conspires to commit or support "terrorism" as defined in Section 3(d) of the Executive Order; (v) a person or entity that is named as a "specially designated national and blocked person" on the then-most current list published by the U.S. Treasury Department Office of Foreign Assets Control at its official website, http://www.treas.gov/offices/eotffc/ofac/sdn/tllsdn.pdf, or at any replacement website or other replacement official publication of such list; and (vi) a person or entity who is affiliated with a person or entity listed in items (i) through (v) above.

(c) At any time and from time to time during the Term, Tenant shall deliver to Landlord, within ten (10) days after receipt of a written request therefor, a written certification or such other evidence reasonably acceptable to Landlord evidencing and confirming Tenant's compliance with this Section 16.21.

16.22. *Right of First Negotiation.* Landlord grants to Tenant a right of first negotiation to lease additional space in the Warehouse that becomes available upon the vacation thereof by the then-current tenant. As such space becomes available to lease, Landlord shall notify Tenant thereof and offer such space to Tenant for lease. Tenant shall have ten (10) days in which to notify Landlord in writing of its desire to lease the offered space. Landlord and Tenant shall be free to agree on the terms of the lease of the offered space and shall not be bound by the terms of this Lease. If Tenant does not notify Landlord of its intention to lease the offered space within the applicable ten (10) day period, or if Landlord and Tenant cannot agree in writing on the terms for such a lease within ten (10) days of Tenant's notice of its desire to lease the offered space, time being of the essence with respect to each ten (10) day period, Landlord shall be free to lease such space to another party on such terms as Landlord shall determine in its sole discretion and Tenant shall have no further rights with respect to such space.

IN WITNESS WHEREOF, the parties have executed this Lease as of the date and year first above written.

LANDLORD:

DOOLITTLE WILLIAMS, LLC.,
A California limited liability company

By: /s/ TERRENCE McGRATH
Name: Terrence M. McGrath
Title: Managing Member
Date: November 26, 2008

TENANT:

ENERGY RECOVERY, INC.,
A Delaware corporation

By: /s/ CAROLYN F. BOSTICK
Name: Carolyn F. Bostick
Title: General Counsel
Date: November 26, 2008

By: /s/ TOM WILLARDSON
Name: Thomas Willardson
Title: Chief Financial Officer
Date: November 26, 2008

EXHIBIT A

(Legal Description)

[to be attached]

Exhibit A

LEGAL DESCRIPTION

Real property in the City of San Leandro, County of Alameda, State of California, described as follows:

PARCEL 1:

BEGINNING AT THE INTERSECTION OF THE NORTHWESTERN LINE OF WEST AVENUE 129, ALSO KNOWN AS WILLIAMS STREET, SAID NORTHWESTERN LINE BEING THE SOUTHEASTERN LINE OF THAT CERTAIN 129.20 ACRE TRACT OF LAND DESCRIBED IN THE DEED FROM RENE DE TOCQUEVILLE AND HENRIETTA LEROY DE TOCQJEVILLE TO JOSE BERNARDO MENDONCA, DATED NOVEMBER 01, 1901 AND RECORDED NOVEMBER 01, 1901 IN BOOK 799 OF DEEDS, PAGE 273, ALAMEDA COUNTY RECORDS, WITH THE SOUTHWESTERN LINE OF DOOLITTLE DRIVE, ALSO KNOWN AS COUNTY ROAD NO. 7960 (80.00 FEET WIDE) AS DESCRIBED IN GRANT OF RIGHT OF WAY FROM MARY C. SKILLEN TO THE COUNTY OF ALAMEDA, DATED JANUARY 21, 1947 AND RECORDED FEBRUARY 28, 1947 IN BOOK 5091, PAGE 335, SERIES NO. AB/17434, ALAMEDA COUNTY RECORDS, RUNNING THE THENCE ALONG THE SAID LINE OF DOOLITTLE DRIVE, NORTH 26° 31' WEST 50.00 FEET; THENCE SOUTH 63° 29' WEST 1200.00 FEET, THENCE SOUTHWESTERLY AND WESTERLY, ALONG THE ARC OF A CURVE TO THE RIGHT WITH A RADIUS OF 372.204 FEET, TANGENT TO THE SAID LAST MENTIONED COURSE, A DISTANCE OF 327.90 FEET; THENCE NORTH 66° 02' 43" WEST, TANGENT TO THE SAID LAST MENTIONED ARC, 8.64 FEET; THENCE NORTH 26° 31' WEST 800.00 FEET FROM THE INTERSECTION THEREOF WITH THE SAID NORTHWESTERN LINE OF WILLIAMS STREET; THENCE ALONG THE DIRECT PRODUCTION OF THE LINE SO DRAWN SOUTH 63° 29' WEST 122.66 FEET UNTIL INTERSECTED BY A LINE DRAWN NORTH 26° 31' WEST FROM A POINT ON THE SAID SOUTHEASTERN LINE OF THE 129.20 ACRE TRACT OF LAND, DISTANT THEREON SOUTH 62° 30' WEST 1615.51 FEET FROM THE POINT OF INTERSECTION THEREOF WITH THE SAID SOUTHWESTERN LINE OF DOOLITTLE DRIVE; THENCE ALONG THE LINE SO DRAWN SOUTH 26° 31' EAST 827.72 FEET TO A POINT ON THE SAID SOUTHEASTERN LINE OF THE 129.20 ACRE TRACT OF LAND; THENCE ALONG THE SAID LAST MENTIONED LINE NORTH 62° 30' EAST 1615.51 FEET TO THE POINT OF BEGINNING.

EXCEPTING THEREFROM THAT PORTION DESCRIBED IN THE DEED TO THE PACIFIC TELEPHONE AND TELEGRAPH COMPANY RECORDED APRIL 01, 1958, BOOK 8634, PAGE 315, SERIES NO. AP-32149, ALAMEDA COUNTY RECORDS.

ALSO EXCEPTING THEREFROM THE INTEREST CONVEYED TO THE CITY OF SAN LEANDRO IN AND TO THAT PORTION LYING WITHIN AURORA DRIVE AS DESCRIBED IN THE STREET DEDICATION RECORDED JUNE 24, 1954, BOOK 7353, PAGE 471, SERIES NO. AJ-53172, ALAMEDA COUNTY RECORDS.

PARCEL 2:

A NON-EXCLUSIVE PERPETUAL EASEMENT AND RIGHT OF WAY, AS GRANTED TO WESTERN ELECTRIC COMPANY, INCORPORATED IN THE DEED RECORDED DECEMBER 31, 1952, BOOK 6912, PAGE 376, SERIES NO. AG-108216, ALAMEDA COUNTRY RECORDS, APPURTENANT TO AND FOR THE USE OF THE OWNER OR OWNERS OF PARCEL 1 HEREIN DESCRIBED, AND ANY SUBSEQUENT SUBDIVISION OR SUBDIVISIONS THEREOF, FOR RAILROAD PURPOSES OVER THE

FOLLOWING DESCRIBED PARCEL OF LAND:

BEGINNING AT THE INTERSECTION OF THE NORTHWESTERN LINE OF WEST AVENUE 129, ALSO KNOWN AS WILLIAMS STREET, SAID NORTHWESTERN LINE BEING THE SOUTHEASTERN LINE OF THAT CERTAIN 129.20 ACRE TRACT OF LAND DESCRIBED IN THE DEED) FROM RENE DE TOCQUEVILLE AND HENRIETTA LEROY DE TOCQUEVILLE TO JOSE BERNARDO MENDONCA, DATED NOVEMBER 01,1901 AND RECORDED NOVEMBER 01,1901 IN BOOK 799 OF DEEDS, PAGE 273, ALAMEDA COUNTY RECORDS, WITH THE SOUTHWESTERN LINE OF DOOLITTLE DRIVE, ALSO KNOWN AS COUNTY ROAD NO. 7960 (80.00) FEET WIDE) AS DESCRIBED IN GRANT OF RIGHT OF WAY FROM MARY C SKILLEN TO THE COUNTY OF ALAMEDA, DATED JANUARY 21, 1947 AND RECORDED FEBRUARY 28, 1947 IN BOOK 5091, PAGE 335, SERIES NO. AB/17434, ALAMEDA COUNTY RECORDS; RUNNING THENCE ALONG THE SOUTHEASTERN LINE OF THE SAID 129.20 ACRE TRACT OF LAND SOUTH 62° 30’ WEST 1615.51 FEET, THENCE NORTH 26° 31’ WEST 827.72 FEET TO THE ACTUAL POINT OF BEGINNING; THENCE SOUTH 63° 29’ WEST 245.95 FEET; THENCE NORTH 67° 35’ 16” EAST 81.24 FEET; THENCE NORTHEASTERLY AND EASTERLY ALONG THE ARC OF A CURVE TO THE RIGHT WITH A RADIUS OF 372.24 FEET, FROM A TANGENT WHICH BEARS NORTH 69° 51’ EAST A DISTANCE OF 177.17 FEET UNTIL INTERSECTED BY A LINE DRAWN SOUTH 26° 31’ EAST FROM THE ACTUAL POINT OF BEGINNING; THENCE ALONG THE LINE SO DRAWN NORTH 26° 31’ WEST 65.84 FEET TO THE ACTUAL POINT OF BEGINNING.

PARCEL 3:

A NON-EXCLUSIVE PERPETUAL EASEMENT AND RIGHT OF WAY, AS GRANTED TO WESTERN ELECTRIC COMPANY, INCORPORATED IN THE DEED RECORDED DECEMBER 31,1952, BOOK 6912, PAGE 376, SERIES NO. AG-108216, ALAMEDA COUNTY RECORDS, APPURTENANT TO AND FOR THE USE OF THE OWNER OR OWNERS OF PARCEL 1 HEREIN DESCRIBED, AND ANY SUBSEQUENT SUBDIVISION OR SUBDIVISIONS THEREOF, FOR DRAINAGE PURPOSES, WITH THE RIGHT AND PRIVILEGE TO CONSTRUCT, REPAIR, REPLACE, MAINTAIN AND USE A SEWER AND A DRAINAGE DITCH, EACH OF SUCH SEE, TYPE AND CHARACTER AS GRANTEE FROM TIME TO TIME DEEMS NECESSARY, OVER, ACROSS AND UNDER THE FOLLOWING DESCRIBED PARCEL OF LAND:

BEGINNING AT THE INTERSECTION OF THE NORTHWESTERN LINE OF WEST AVENUE 129, ALSO KNOWN AS WILLIAMS STREET, SAID NORTHWESTERN LINE BEING THE SOUTHEASTERN LINE OF THAT CERTAIN 129.20 ACRE TRACT OF LAND DESCRIBED IN THE DEED FROM RENE DE TOCQUEVILLE AND HENRIETT ALEROY DE TOCQUEVILLE TO JOSE BERNARDO MENDONCA, DATED NOVEMBER 01,1901 AND RECORDED NOVEMBER 01,1901 IN BOOK 799 OF DEEDS, PAGE 273, ALAMEDA COUNTY RECORDS, WITH THE SOUTHWESTERN LINE OF DOOLITTLE DRIVE, ALSO KNOWN AS COUNTY ROAD NO. 7960 (80.00 FEET WIDE) AS DESCRIBED IN GRANT OF RIGHT OF WAY FROM MARY C. SKILLEN TO THE COUNTY OF ALAMEDA, DATED JANUARY 21,1947 AND RECORDED FEBRUARY 28,19-17 IN BOOK 5091, PAGE 335, SERIES NO. AB/17434, ALAMEDA COUNTY RECORDS; RUNNING THENCE ALONG THE SOUTHEASTERN LINE OF THE SAID 129.20 ACRE TRACT OF LAND SOUTH 62° 30’ WEST 1615.51 FEET; THENCE NORTH 26° 31’ WEST 735.08 FEET TO THE ACTUAL POINT OF BEGINNING; THENCE CONTINUING NORTH 26° 31’ WEST 26.80 FEET TO THE SOUTHEASTERN CORNER OF PARCEL 2 AS DESCRIBED IN THE DEED TO ALAMEDA COUNTY EAST BAY TITLE INSURANCE COMPANY RECORDED DECEMBER 31,1952, BOOK 6912, PAGE 369, ALAMEDA COUNTY RECORDS; THENCE ALONG THE SOUTHERN BOUNDARY LINE OF SAID PARCEL 2, WESTERLY ALONG THE ARC OF A CURVE TO THE LEFT WITH A RADIUS OF 372.24 FEET, FROM A TANGENT WHICH BEARS NORTH 82° 52’ 48” WEST, A DISTANCE OF 125,91 FEET TO A POINT ON A LINE DRAWN PARALLEL WITH THE NORTHWESTERN BOUNDARY LINE OF SAID PARCEL 2 AND DISTANT

15.00 FEET SOUTHEASTERLY THEREFROM, MEASURED AT RIGHT ANGLES THERETO; THENCE ALONG THE PARALLEL LINE SO DRAWN AND ITS DIRECT PRODUCTION SOUTH 63° 29’ WEST 725.58 FEET; THENCE SOUTH 26° 31’ EAST 22.00 FEET; THENCE NORTH 63° 29’ EAST 722.76 FEET; THENCE EASTERLY ALONG THE ARC OF A CURVE TO THE RIGHT WITH A RADIUS OF 350.24 FEET, FROM A TANGENT WHICH BEARS NORTH 77° 44’ 22’ EAST, A DISTANCE OF 130.53 FEET TO THE ACTUAL POINT OF BEGINNING.

APN: 079A-0541-010

EXHIBIT B

(First Floor of the Building and the Warehouse Premises)

[to be attached]

EXHIBIT B-1

(Second Floor of the Building)

[to be attached]

EXHIBIT C

COMMENCEMENT DATE MEMORANDUM

_____, 200_

_____
_____
_____
_____

Re: 1717 Doolittle Drive / 2250 Williams Street Modified Industrial Gross Lease (the "Lease") dated as of November 21, 2008, between DOOLITTLE WILLIAMS, LLC, a California limited liability company ("Landlord"), and ENERGY RECOVERY, INC., a Delware corporation ("Tenant"). Capitalized terms used herein but not defined shall be given the meanings assigned to them in the Lease.

Ladies and Gentlemen:

1. *Condition of Premises*. Tenant has accepted possession of the Premises pursuant to the Lease. Any improvements required by the terms of the Lease to be made by Landlord have been completed to the full and complete satisfaction of Tenant in all respects except for the punchlist items (if any) described on *Schedule 1* hereto (the "Punchlist Items"), and except for such Punchlist Items (if any), Landlord has fulfilled all of its duties under the Lease with respect to such initial improvements. Furthermore, Tenant acknowledges that the Premises are suitable for the Permitted Uses.

2. *Commencement Date.* The Commencement Date of the Lease is _____, 200__.

3. *Expiration Date.* The Term is scheduled to expire on _____, 20__.

4. *Premises.* The Building contains 106,250 rentable square feet and the Warehouse Premises contain 17,500 rentable square feet. Landlord and Tenant stipulate that the square footage measurements set forth in the preceding sentence are conclusive as to the square footage of the Building and the Warehouse Premises for purpose of determining Base Rent and shall be binding upon them.

5. *Base Rent.* Base Rent shall be the following amounts for the following periods of time:

Lease Year	Monthly Base Rent
1	$ 88,437.50
2	$ 90,648.44
3	$ 92,914.65
4	$ 95,237.51
5	$ 97,618.45
6	$ 100,058.91
7	$ 102,560.39
8	$ 105,124.40
9	$ 107,752.51
10	$ 110,446.32

6. *Contact Person*. Tenant's contact person in the Premises is:

_____
_____
_____
Attention: _____
Telephone: _____
Facsimile: _____

7. *Ratification.* Tenant hereby ratifies and confirms its obligations under the Lease, and represents and warrants to Landlord that it has no defenses thereto. Additionally, Tenant further confirms and ratifies that, as of the date hereof, (a) the Lease is and remains in good standing and in full force and effect, and (b) Tenant has no claims, counterclaims, set-offs or defenses against Landlord arising out of the Lease or in any way relating thereto or arising out of any other transaction between Landlord and Tenant.

8. *Binding Effect; Governing Law.* Except as modified hereby, the Lease shall remain in full effect and this Commencement Date Memorandum shall be binding upon Landlord and Tenant and their respective successors and assigns. If any inconsistency exists or arises between the terms of this Commencement Date Memorandum and the terms of the Lease, the terms of this Commencement Date Memorandum shall prevail. This Commencement Date Memorandum shall be governed by the laws of the State of California.

Please indicate your agreement to the above matters by signing this letter in the space indicated below and returning an executed original to us.

Sincerely,

DOOLITTLE WILLIAMS, LLC,
a California limited liability company,

By: _____
Name: _____
Title: _____

Agreed and accepted:

ENERGY RECOVERY, INC.,
a Delaware corporation

By: _____
Name: _____
Title: _____

Exhibit C

SCHEDULE 1

(Punchlist Items)

Exhibit C

EXHIBIT D

WORK LETTER

1. *Acceptance of Premises.* Except as set forth in this *Exhibit D,* Tenant accepts the Premises in their "AS-IS" condition on the date that this Lease is entered into.

2. *Landlord's Work.* Landlord at its expense shall perform the following work in the Premises (the "Landlord's Work"): (a) removal of any tiles in the Building's stairwell that contain asbestos and that are identified by Tenant prior to the Commencement Date and (b) leveling of the floor slabs in the area identified on *Schedule 1* attached hereto between column lines N2-N5 and P2-P5.

3. *Space Plans.* Landlord and Tenant hereby approve of the space plans prepared by Anthony Tobacco and Associates (the "Architect") depicting tenant improvements to be installed in the Premises and attached hereto as *Schedule 2* (the "Space Plans").

4. *Working Drawings.*

(a) Preparation and Delivery. On or before January 15, 2009, (the "Working Drawings Delivery Deadline"), Tenant shall provide to Landlord for its approval (in its sole and absolute discretion) final working drawings, prepared by the Architect, of all tenant improvements that Tenant proposes to have installed in the Premises; such working drawings shall include the partition layout, ceiling plan, electrical outlets and switches, telephone outlets, drawings for any modifications to the mechanical and plumbing systems of the Building and/or the Warehouse, and detailed plans and specifications for the construction of the tenant improvements called for under this Exhibit in accordance with all applicable Regulations. If Tenant fails to timely deliver such drawings, then each day after the Working Drawings Delivery Deadline that such drawings are not delivered to Landlord shall be a Tenant Delay Day.

(b) Approval Process. Landlord shall notify Tenant whether it approves of the submitted working drawings (in its sole and absolute discretion) within ten (10) business days after Tenant's submission thereof. If Landlord disapproves of such working drawings, then Landlord shall notify Tenant thereof specifying in reasonable detail the reasons for such disapproval, in which case Tenant shall, within five (5) business days after such notice, revise such working drawings in accordance with Landlord's objections and submit the revised working drawings to Landlord for its review and approval. Landlord shall notify Tenant in writing whether it approves of the resubmitted working drawings (in its sole and absolute discretion) within five (5) business days after its receipt thereof. This process shall be repeated until the working drawings have been finally approved by Landlord (in its sole and absolute discretion) and Tenant. If the working drawings are not fully approved by both Landlord and Tenant by the twentieth (20th) business day after the delivery of the initial draft thereof to Landlord, then each day after such time period that such working drawings are not fully approved by both Landlord and Tenant shall constitute a Tenant Delay Day. Further, if the Working Drawings and any related materials are not submitted by the Architect to the City of San Leandro (with a copy to Landlord) by January 15, 2009, then each day thereafter until the occurrence of such submittal shall constitute a Tenant Delay Day.

(c) Landlord's Approval; Performance of the Tenant Improvements. If any of Tenant's proposed construction work will affect the Building's or Warehouse's structure or any of the Building's or Warehouse's systems, then the working drawings pertaining thereto must be approved by Landlord's engineer. As used herein, "Working Drawings" shall mean the final working drawings approved by Landlord, as amended from time to time by any approved changes thereto, and the "Tenant Improvements" shall mean all tenant improvements to be constructed in accordance with and as indicated on the Working Drawings, together with any work required by governmental authorities to be made to other areas of the Property as a result of the improvements indicated by the Working Drawings. Landlord's approval of the Working Drawings shall not be a representation or warranty of Landlord that such drawings are adequate for any use or comply with any applicable Requirements, but shall merely be the consent of Landlord thereto. Tenant shall, at Landlord's request, sign the Working Drawings to evidence its review and approval thereof. After the Working Drawings have been approved, Landlord shall cause the Tenant Improvements to be performed in substantial accordance with the Working Drawings.

5. *Construction Manager.* Landlord and Tenant hereby agree that Landlord shall engage Engineered Construction Services Corporation, or such other construction manager as may be designated by Landlord and Tenant (the "Construction Manager"), to (a) obtain all applicable building permits for construction of the Tenant Improvements and (b) manage the performance of the Tenant Improvements in compliance with such building permits and all applicable Regulations. If Landlord and Tenant elect to designate a construction manager other than Engineered Construction Services Corporation, neither Landlord nor Tenant shall unreasonably withhold their approval of such new construction manager.

6. *Bidding of the Tenant Improvements.* Prior to commencement of the Tenant Improvements, Landlord shall cause the Construction Manager to competitively bid the Tenant Improvements to at least three (3) subcontractors for each of the major trades necessary to perform the Tenant Improvements. Promptly after receipt of the bids for each major trade so bid, Landlord will cause Construction Manager to deliver to Tenant a comparative summary of the bids. Upon request by Tenant, Landlord shall also cause Construction Manager to deliver to Tenant copies of or make available for Tenant's review the bids. If requested by Tenant within three (3) business days after delivery of the comparative summary of the bids to Tenant, Landlord shall inform Tenant of the bids Landlord intends to accept, entertain Tenant's questions, comments and suggestions concerning selection of the successful bidder for each of the major trades, and take Tenant's reasonable comments and suggestions into account in determining which bids to accept.

7. *Change Orders.* Tenant may initiate changes in the Tenant Improvements. Each such change must receive the prior written approval of Landlord, such approval to be granted or withheld in its sole and absolute discretion. Upon completion of the Tenant Improvements, Tenant shall cause the Architect to furnish Landlord with an accurate architectural "as-built" plan of the Tenant Improvements as constructed, which plan shall be incorporated into this *Exhibit D* by this reference for all purposes. If Tenant requests any changes to the Tenant Improvements described in the Space Plans or the Working Drawings, then such increased costs and any additional design costs incurred in connection therewith as the result of any such change shall be added to the Total Construction Costs.

8. *Definitions.* As used herein, a "Tenant Delay Day" shall mean each day of delay in the performance of the Landlord's Work and/or the Tenant Improvements that occurs (a) because of Tenant's failure to timely deliver or approve any required documentation such as the Working Drawings, (b) because Tenant fails to timely furnish any information required for preparation or completion of documents such as the Working Drawings (whether preliminary, interim revisions or final), pricing estimates, construction bids, and the like, (c) because of any change by Tenant to the Space Plans or Working Drawings, (d) because Tenant fails to attend any meeting with Landlord, the Architect, any other design professional, the Construction Manager, or any contractor, or their respective employees or representatives, as may be required or scheduled hereunder or otherwise necessary in connection with the preparation or completion of any construction documents, such as the Working Drawings, or in connection with the performance of the Landlord's Work and/or the Tenant Improvements,

(e) because of any specification by Tenant of materials or installations requiring unusually long lead times, or (f) because Tenant or its agents, employees, contractors, or visitors otherwise delays completion of the Landlord's Work and/or the Tenant Improvements. As used herein "Substantial Completion," "Substantially Completed," and any derivations thereof mean (i) the Landlord's Work in the Premises has been substantially completed (other than any details of construction, mechanical adjustment or other similar matter, the noncompletion of which does not materially interfere with Tenant's use or occupancy of the Premises) and (ii) the Tenant Improvements have been performed in substantial accordance with the Working Drawings, as reasonably determined by the Construction Manager and the Architect (other than any details of construction, mechanical adjustment or other similar matters, the noncompletion of which do not materially interfere with Tenant's use or occupancy of the Premises).

9. *Walk-Through; Punchlist.* When Landlord considers the Tenant Improvements and the Landlord's Work to be Substantially Completed, Landlord will notify Tenant and within three (3) business days thereafter, Landlord's representative and Tenant's representative shall conduct a walk-through of the Premises and identify any necessary touch-up work, repairs and minor completion items that are necessary for final completion of the Tenant Improvements and the Landlord's Work. Neither Landlord's representative nor Tenant's representative shall unreasonably withhold his or her agreement on punchlist items. Landlord shall use reasonable efforts to cause the Construction Manager to complete all punchlist items within thirty (30) days after agreement thereon; however, Landlord shall not be obligated to engage overtime labor in order to complete such items.

10. *Excess Costs.* The entire cost of performing the Tenant Improvements (including costs of construction labor and materials, electrical usage during construction, additional janitorial services, general tenant signage, related taxes and insurance costs, and the Construction Manager's fees and charges are herein collectively called the "Total Construction Costs") in excess of the Construction Allowance (hereinafter defined) shall be paid by Tenant. Notwithstanding the preceding to the contrary, Total Construction Costs shall not include the following costs which costs shall be paid solely by Tenant: preparation of the Space Plans and the Working Drawings, the Architect's fees and charges, and any and all costs related to any Tenant Improvements that are not considered capital improvements (as determined in accordance with GAAP) (collectively, "Tenant's Construction Costs"). Upon approval of the Working Drawings and selection of the subcontractors for each of the major trades necessary to perform the Tenant Improvements, Tenant shall promptly execute a work order agreement prepared by Landlord which identifies such drawings and itemizes the Total Construction Costs and sets forth the Construction Allowance. Once the Construction Allowance has been exhausted, as and when Landlord incurs additional Total Construction Costs Tenant shall pay to Landlord within three (3) days of demand therefor, an amount equal to the Total Construction Costs, less (a) the amounts already paid by Tenant to Landlord on account of the Total Construction Costs, and (b) the amount of the Construction Allowance. In the event of default of payment of such excess costs, Landlord (in addition to all other remedies) shall have the same rights as for an Event of Default under the Lease. Tenant shall pay to Landlord within three (3) days of demand therefor any Tenant's Construction Costs paid by Landlord. In the event of default of payment of Tenant's Construction Costs, Landlord (in addition to all other remedies) shall have the same rights as for an Event of Default under the Lease.

11. *Construction Allowance*. Landlord shall provide to Tenant a construction allowance not to exceed $1,000,000.00 (the "Construction Allowance") to be applied toward the Total Construction Costs. The Construction Allowance shall not be disbursed to Tenant in cash, but shall be applied by Landlord to the payment of the Total Construction Costs, if, as, and when such costs are actually incurred and paid by Landlord.

12. *Construction Representatives.* Landlord's and Tenant's representatives for coordination of construction and approval of change orders will be as follows, provided that either party may change its representative upon written notice to the other:

Landlord's Representative:	Terry McGrath McGrath Properties 130 Webster Street, Suite 200 Oakland, CA 94607 Telephone: (510) 273-2001
Tenant's Representative:	Terry Sandlin Energy Recovery, Inc. 1908 Doolittle Drive San Leandro, CA 94577 Telephone: _____

13. *Miscellaneous*. To the extent not inconsistent with this Exhibit, Sections 8 and 16.12 of the Lease shall govern the performance of the Tenant Improvements and Landlord's and Tenant's respective rights and obligations regarding the improvements installed pursuant thereto.

14. *Security*.

(a) Tenant acknowledges that Landlord in unwilling to execute the Lease unless Tenant provides Landlord with additional security for Tenant's obligations under the Lease. Therefore, Tenant shall either (i) deliver to Landlord, within five (5) business days of the Effective Date, an Irrevocable Standby Letter of Credit (the "TI Letter of Credit") which shall (1) be in a form reasonably acceptable to Landlord and based on a draft issued by Tenant's bank prior to Lease execution and approved by Landlord in its sole discretion, (2) be issued by a bank reasonably acceptable to Landlord with minimum assets of $10,000,000,000, upon which presentment may be made in San Francisco or Oakland, California, (3) be in an amount equal to $1,000,000, (4) allow for partial and multiple draws thereunder, and (5) have an expiration date not earlier than thirty (30) days after the later of (x) the Commencement Date and (y) Tenant's commencement of payment of Base Rent pursuant to Section 4.01 of the Lease or in the alternative, have a term of not less than one (1) year and be automatically renewable for an additional one (1) year period unless, on or before the date thirty (30) days prior to the expiration of the term of such TI Letter of Credit, the issuer of such TI Letter of Credit gives notice to Landlord of its election not to renew such TI Letter of Credit for any additional period pursuant thereto or (ii) deposit $1,000,000 into an escrow account (the "Escrow Account") within five (5) business days of the Effective Date, which escrow account shall (1) be pursuant to an escrow agreement reasonably acceptable to Landlord, (2) be with an escrow agent reasonably acceptable to Landlord, (3) allow for partial and multiple disbursements to Landlord, and (4) have a termination date not earlier than thirty (30) days after the later of (x) the Commencement Date and (y) Tenant's commencement of payment of Base Rent pursuant to Section 4.01 of the Lease.

(b) The TI Letter of Credit shall provide that, in the event of Landlord's assignment of its interest in this Lease, the TI Letter of Credit shall be freely transferable by Landlord to the assignee, without charge to Landlord. The TI Letter of Credit shall provide for same day payment to Landlord upon the issuer's receipt of a sight draft from Landlord together with Landlord's certificate (signed by its manager or an officer) certifying that the requested sum is due and payable from Tenant and Tenant has failed to pay, and with no other conditions. Tenant agrees that it shall from time to time, as necessary, whether as a result of the expiration of the TI Letter of Credit then in effect or otherwise, renew or replace the original and any subsequent TI Letter of Credit

so that a TI Letter of Credit, in the amount required hereunder, and satisfying all the conditions hereof, is in effect until the later of thirty (30) days after the later of (x) the Commencement Date and (y) Tenant's commencement of payment of Base Rent pursuant to Section 4.01 of the Lease. If Tenant fails to furnish such renewal or replacement at least thirty (30) days prior to the stated expiration date of the TI Letter of Credit then held by Landlord, Landlord may draw upon such TI Letter of Credit and hold the proceeds thereof without payment of interest (and such proceeds need not be segregated) ("TI Security Proceeds").

(c) In the event that Tenant is in default of its obligations under the Lease, then Landlord shall have the right, at any time after such event, without giving any further notice to Tenant, to draw upon said TI Letter of Credit or obtain a disbursement from the Escrow Account up to (i) the amount necessary to cure such default (or if such default cannot reasonably be cured by the expenditure of money, and Landlord exercises any rights and remedies Landlord may have on account of such default, the amount which, in Landlord's opinion, is necessary to satisfy Tenant's liability on account thereof) *plus* (ii) the Total Construction Costs. In addition, in the event of a termination based upon the default of Tenant under the Lease, or a rejection of the Lease pursuant to the provisions of the Federal Bankruptcy Code, Landlord shall have the right to draw upon the TI Letter of Credit (from time to time, if necessary) or receive disbursements from the Escrow Account to cover the full amount of damages and other amounts due from Tenant to Landlord under the Lease and the full amount of the Total Construction Costs. Any such draw on the TI Letter of Credit or disbursement from the Escrow Account shall not constitute a waiver of any other rights of Landlord with respect to Tenant's default under the Lease. Tenant hereby covenants and agrees not to oppose, contest or otherwise interfere with any attempt by Landlord to draw upon the TI Letter of Credit or receive a disbursement from the Escrow Account. Including without limitation, by commencing an action seeking to enjoin or restrain Landlord from drawing upon said TI Letter of Credit or receiving a disbursement from the Escrow Account. Tenant also hereby expressly waives any right or claim it may have to seek such equitable relief. In addition to whatever other rights and remedies it may have against Tenant if Tenant breaches its obligations under this paragraph, Tenant hereby acknowledges that it shall be liable for any and all damages which Landlord may suffer as a result of any such breach.

(d) Upon request of Landlord or any (prospective) purchaser or mortgagee of the Property, Tenant shall, at its expense, cooperate with Landlord in obtaining an amendment to or replacement of any TI Letter of Credit which Landlord is then holding so that the amended or new TI Letter of Credit reflects the name of the new owner and/or mortgagee of the Property.

(e) To the extent that (i) Landlord has not previously drawn upon, as applicable, (x) the TI Letter of Credit or (y) the TI Security Proceeds held by Landlord or (ii) Landlord has not sought disbursement of funds from the Escrow Account (as applicable, "Collateral"), and provided that Tenant is not otherwise in default of its obligations under the Lease as of the later of the Commencement Date and Tenant's commencement of payment of Base Rent pursuant to Section 4.01 of the Lease, Landlord shall return such Collateral to Tenant.

(f) In no event shall the proceeds of any TI Letter of Credit or any disbursement from the Escrow Account be deemed to be a prepayment of rent nor shall it be considered as a measure of liquidated damages.

(g) Landlord and Tenant (i) agree that neither the TI Letter of Credit nor the Escrow Account shall be deemed or treated as a "security deposit" under any law applicable to security deposits in the commercial context, (ii) further acknowledge and agree that neither the TI Letter of Credit nor the Escrow Account is intended to serve as a security deposit and the laws applicable to security deposits shall have no applicability or relevancy thereto, and (iii) waive any and all rights, duties and obligations either party may now have or, in the future, will have relating to or arising from the laws applicable to security deposits.

15. *Tenant Access.*

(a) Landlord hereby agrees to permit Tenant access, at Tenant's sole risk and expense, to the Premises 15 days prior to the Commencement Date (as reasonably estimated by Landlord) to commence installation of Tenant's furniture, fixtures, and equipment, provided that such access will not hinder or delay completion of the Landlord's Work or the Tenant Improvements. Notwithstanding the foregoing, Tenant shall have no right to enter onto the Premises or the Property unless and until Tenant shall deliver to Landlord evidence reasonably satisfactory to Landlord demonstrating that any insurance reasonably required by Landlord in connection with such pre-commencement access (including, but not limited to, any insurance that Landlord may require pursuant to the Lease) is in full force and effect. Any entry by Tenant shall comply with all established safety practices of the Construction Manager and Landlord. Upon such entry, all terms and conditions of the Lease shall apply in full except with respect to payment of rent, which obligation shall commence on the Commencement Date.

(b) Tenant shall not interfere with the performance of Landlord's Work or the Tenant Improvements, or with any inspections or issuance of final approvals by applicable governmental authorities, and upon any such interference, Landlord shall have the right to exclude Tenant from the Premises and the Property until Substantial Completion of the Landlord's Work and the Tenant Improvements.

SCHEDULE 1

[to be attached]

Exhibit D

SCHEDULE 2

[to be attached]

Exhibit D

EXHIBIT E

ENVIRONMENTAL DISCLOSURE STATEMENT

This Environmental Disclosure Statement is designed to solicit information concerning your proposed use of Hazardous Materials (as defined in Section 10.02 of the Lease) on property ("the Premises") owned by DOOLITTLE WILLIAMS, LLC, a California limited liability company ("the Landlord"). Please complete the questionnaire and return it to Landlord or its designee for evaluation. If additional space is necessary, please continue your answer on separate paper. In the event your proposed use, generation or storage of Hazardous Materials is considered to be significant, we may require further information. Thank you for your cooperation with this matter.

I. BACKGROUND INFORMATION

_____

Name (Corporation, Partnership, Public Agency or individual)

_____

Street Address

_____

City, State, Zip Code

Contact Person and Title: _____

Telephone Number: (_____) ____-_____

Address of the Premises (property to be leased)

_____

Street Address, City, State, Zip Code

IF NOT APPLICABLE TO YOUR BUSINESS — INITIAL HERE_____

II. DESCRIPTION OF PROPOSED FACILITY

A. Describe in detail your proposed facility and the type of operations to be conducted on the Premises including principal products to be produced and/or services to be performed:

B. What environmental laws (e.g. Resource Conservation and Recovery Act; Clean Air Act; California Occupational Safety and Health Act; California Hazardous Waste Control Law; The Porter-Cologne Water Quality Control Act; The Safe Drinking and Toxic Enforcement Act of 1986) must be complied with in connection with your proposed facility and operations? Identify the governmental agencies responsible for monitoring and evaluating the compliance of the proposed facility with any environmental law:

III. STORAGE OF HAZARDOUS MATERIALS

A. Do you intend to store any Hazardous Materials on the Premises?

If yes, describe (i) the Hazardous Materials to be stored, (ii) the estimated quantity (on an annual basis) of Hazardous Materials to be stored, and (iii) the proposed method of storage (e.g. above-ground storage tanks, underground storage tanks, drums, pipelines):

Hazardous Material	Method of Storage (Describe capacity and composition of container)	Quantity (On an annual basis)

B. Identify any permits and/or licenses which must be obtained in connection with the storage of any Hazardous Materials:

IV. HAZARDOUS WASTE MANAGEMENT

Identify any Hazardous Materials (other than air emissions and wastewater described in V and VI) which will be generated by the facility, the hazard class, and the quantity of generation on a monthly basis:

Hazardous Material	Hazard Class	Quantity (On an monthly basis)

Describe the method(s) of disposal for each Hazardous Material:

Do you intend to treat or process any Hazardous Materials on the Premises? If yes, describe the proposed method(s) of treatment and/or processing:

Identify any permits and/or licenses which must be obtained in connection with (i) the disposal of each Hazardous Material and (ii) any treatment or processing of Hazardous Materials:

V. AIR EMISSIONS

A. Describe air emissions from each source of anticipated air pollutants including fuel burning equipment (described type of fuel burned) on the Premises:

B. Describe the air pollution control equipment to be used to reduce emissions from each source of air emissions:

C. Describe the method(s) to be used to monitor any air emissions:

D. Identify any permits and/or licenses which must be obtained in connection with any air emissions:

VI. WATER DISCHARGES

A. List all sources of wastewater discharges to surface waters, septic systems or holding ponds:

B. List all sources of wastewater discharges to public sewer systems:

C. List the average daily flow for each discharge:

D. Identify any permits and/or licenses which must be obtained in connection with any wastewater discharge:

VII. PAST AND PRESENT OPERATIONS

A. Are there any governmental agency enforcement actions, past, pending or, to the best of your knowledge, threatened administrative or court orders or actions or consent decrees concerning compliance by your company with environmental laws in connection with facilities similar to the proposed facility? If yes, are there any continuing compliance obligations as a result of such orders or decrees?

B. Has your company received requests for information from governmental agencies responsible for regulating compliance with environmental laws? If yes, please explain the basis of such request(s):

C. Has your company been the subject of any administrative inquiries in connection with Hazardous Materials? If yes, please explain the basis of such inquiry:

D. Are there any past, pending or, to the best of your knowledge, threatened private actions against your company concerning compliance with environmental laws? If yes, what is the status and/or result of each action:

As an officer, a general partner or a duly authorized representative of the company, I am familiar with all operations of the company and the operations to be conducted on the Premises. I have made due inquiry in answering the foregoing questions and hereby certify to Landlord that to the best of my knowledge, information and belief the information disclosed above is true and correct and complete.

_____
(Signature)

_____
(Title)

_____
(Date)

Exhibit E

EXHIBIT F

HAZARDOUS MATERIALS NOTIFICATION

1. *Nestle Plume.* Tenant acknowledges that Landlord has disclosed the following and Tenant agrees to accept the Premises and Property with knowledge of the disclosed conditions:

The Property is down gradient of the Nestle Plume which is subject to a 2000 Regional Water Quality Control Board ("RWQCB") cleanup order to remediate groundwater VOC contamination. Landlord's understanding is that the responsible parties for the Nestle Plume have been complying with the RWQCB Order and the remediation is actively proceeding on properties east of the Property with positive results. According to the RWQCB order, the RWQCB expects the remediation to be complete within three to four years of the initiation of remedial efforts.

Landlord engaged Schutze & Associates ("Schutze") to perform a survey of soil vapor, soil and groundwater as well as indoor air sampling to determine the nature and extent of the impact of the Nestle Plume on the Property and to identify any other issues of concern.

Although no soil contamination was identified in the study, Schutze concluded that there is some impact in groundwater from the Nestle Plume on the Property. Schutze concluded that the contamination does not present a health risk and should not impact commercial use of the Premises or the Property. Moreover, the Nestle Plume is being remediated by responsible parties and contamination levels are expected to decrease as that remediation continues.

Schutze also isolated some limited onsite sources of contamination (including PCE, VC and DCE) that will require limited cleanup and monitoring but concluded that this contamination does not present a human health risk.

2. *Proposition 65 Notice.*

WARNING: The Property contains chemicals known to the State of California to cause cancer, birth defects or other reproductive harm.

The following chemicals known to cause cancer and birth defects or other reproductive harm are often found in and around structures and related areas:

- Tobacco products and tobacco smoke;
- Furnishings and buildings materials may contain many chemicals, including formaldehyde and lead;
- Construction and maintenance materials, such as roofing materials, may contain vinyl chloride monomer, benzene and ceramic fibers;
- Construction materials used in walls, floors and outside cladding may contain chemicals such as formaldehyde resin, asbestos, arsenic, cadmium and creosote;
- Cleaning materials may contains chlorinated solvents;
- Certain paints and painted surfaces may contain chemicals such as lead and crystalline silica;
- The operation and maintenance of vehicles and engines involve the use and exhaust of various chemicals, including benzene and carbon monoxide; and
- Pest control and landscaping products used to control insects and weeds may contain resmethrin, mycobutonil, triforine and arsenic trioxide.

It is possible that some or all of the chemicals listed above and additional chemicals may be present in or around the Property. In addition, other tenants of the Property may also use chemicals that are known to the State of California to cause cancer or reproductive harm. This list is not intended to be exhaustive but to alert Tenant generally to the types of chemicals that Landlord understands may be present in structures and related areas. This public disclosure notice is made pursuant to the requirement of Section 25249.6 of the Safe Drinking Water and Toxic Enforcement Act of 1986 (Proposition 65). For a complete list of the chemicals required to be disclosed under Proposition 65, contact the California Office of Environmental Health Hazard Assessment, 1001 I Street, Sacramento, California 95814. For further information call (916)324 7572 or visit their website at www.oehha.ca.gov/pubic_info.html.

En Madrid, a 1 de Septiembre de dos mil ocho

REUNIDOS

DE UNA PARTE:

D. Borja Sánchez-Blanco Carvajal, mayor de edad, casado y con domicilio, a efectos del presente contrato, en Paseo de los Parques, 26, Chalet 23, El Encinar de los Reyes, Alcobendas, 28109, Madrid y con D.N.I. n° 05406047-N

Y DE OTRA PARTE:

D. Francisco Carrasco Houston, mayor de edad, casado y con domicilio a efectos del presente contrato, en la P° de la Castellana numero 123, escalera derecha, 1° A, código postal 28046 de Madrid, y con N.I.F. 52.989.606-K.

INTERVIENEN

El primero, en nombre y representación de la Entidad Mercantil **ENERGY RECOVERY IBERIA S.L UNIPERSONAL.** con C.I.F B-84.798.347 y domicilio en Calle Ribera Del Loira, n° 46, Madrid, constituida por tiempo indefinido en escritura otorgada, ante el Notario de Madrid, D. Alfredo Barrau Moreno el dia 4 de Agosto de 2006 bajo el número 2109 de su orden de protocolo. Inscrita en el Registro Mercantil de Madrid, al Tomo 23.178, Foio 141, Seccion 8ª, Hoja M-415394 Inscripcion 1ª (en io sucesivo "la Arrendataria")

Su intervención resulta de su condición de Apoderado Solidario de la citada sociedad, segun consta en la escritura de protocolización de acuerdos sociales otorgada ante el Notario de Madrid, D. Alfredo Barrau Moreno con fecha 4 de Agosto de 2006 bajo e número 2114 de su orden de protocolo e inscrita en el Registro Mercantil de Madrid al Tomo 23.178, Folio 141. Seccion 8ª, Hoja M-415394, Inscripción 1ª.

Manifiesta D. Borja Sánchez-Blanco Carvajal que sus facultades están vigentes y que no ha sufrido ninguna alteración ni modificación la existencia y capacidad juridica de la Sociedad que representa.

Y segundo en nombre y representación de la entidad mercantil **LAMBAESIS, S.L.,** entidad domiciliada en Madrid, P° de la Castellana, n° 123, escalera derecha, 1°

In Madrid, the 1st of September, two thousand and eight

BY AND BETWEEN

THE PARTY OF THE FIRST PART:

Mr **Borja Sanchez-Blanco Carvajal,** of legal age, married and with a residence for the purposes of the present contract at Paseo de los Parques, 26, Chalet 23, El Encinar de los Reyes, Alcobendas, 28109, Madrid, and holder of national identity card (D.N.I.) no. 05406047-N

AND THE PARTY OF THE SECOND PART:

Mr **Francisco Carrasco Houston,** of legal age, married and with a residence for the purposes of the present contract at P° de la Castellana número 123, escalera derecha, 1° A, código postal 28046 de Madrid, and holder of national identity card (D.N.I.) no. 52.989.606-K.

TAKING PART

The first, on behalf of and representing the trading company **ENERGY RECOVERY IBERIA S.L, a SOLE PROPRIETORSHIP,** with tax identification number (C.I.F) B-84.798.347 and a registered address at Calle Ribera Del Loira, n° 46, Madrid, constituted for an indefinite period by means of an instrument signed before the Madrid Notary Mr. Alfredo Barrau Moreno on the 4th day of August, 2006 and assigned entry number 2109 in his records Registered with the Madrid Trade Registry Office in Volume 23.178, Sheet 141, Section 8ª, Page number M-415394 Entry 1ª (hereinafter the Tenant)

He takes part as a result of his status as Joint Representative of the aforementioned company, as demonstrated by the instrument notarizing the corporate resolutions signed before the Madrid Notary Mr. Alfredo Barrau Moreno on the 4th day of August, 2006 and assigned entry number 2114 in his records, registered with the Madrid Trade Registry Office in Volume 23.178, Sheet 141, Section 8ª, Page number M-415394, Entry 1ª.

Mr. Borja Sánchez-Blanco Carvajal states that his powers are current and that the existence and legal capacity of the company which he represents have not been altered or modified.

And the second, on behalf of and representing the Trading company **LAMBAESIS, S.L.**, with a registered address in Madrid, at P° de la Castellana, n° 123, escalera derecha,

A; fue constituida en virtud de escritura otorgada ante el Notario de Madrid, D Rodrigo Tena Arregui, el 17 de abril de 2006, con el número 895 de su Protocolo: inscrita en el Registro Mercantil de Madrid, al Tomo 22.657, Folio 32, Seccion 8ª, Hoja M-405195. Y con C.I.F. numero B-84687078 (en lo sucesivo "la Arrendadora").

Actúa en su calidad de **ADMINISTRADOR ÚNICO,** cargo para el que fue designado, por tiempo indefinido, en virtud de la escritura de constitución reseñada, que causó la inscripción 1ª en la hoja abierta a nombre de la Sociedad en el Registro Mercantil.
Manifiesta D. Francisco Carrasco Houston que sus facultades están vigentes y que no ha sufrido ninguna alteración ni modificación en la existencia y capacidad juridica de la Sociedad que representa.

Tienen y se reconocen capacidad juridica suficiente para la forma lización del presente **CONTRATO DE ARRENDAMIENTO PARA USO DISTINTO DEL DE VIVIENDA,** a cuyo efecto,

EXPONEN

PRIMERO:

Que la Arrendadora es propietaria de la Oficina 2 localizada en la 5ª planta del edificio **Gamma** dentro del Parque Empresarial Omega ubicado en la carretera Alcobendas Barajas, número 24, Km 1.100 y con una superficie bruta alquilable (sba) total de 316,32 m2, distribuidos en 149,55 m2 en planta 5ª y 166,77 m2 en planta ático **(se adjunta como Anexo I plano detallado de ambas plantas, sus correspondientes accesos y comunicación entre ambos.)**, de 4 plazas de aparcamiento numeradas 23, 24, 26 y 27 en sótano segundo primera entreplanta **(Anexo II)** y el uso exciusivo de la cubierta del edificio a la que se accede a través de la planta ático., en adelante **LA OFICINA.** La Arrendadora es propietarta de la mencionada Oficina en virtud de la escritura pública otorgada por el notario D. Juan Manuel Lozano Carreras el dia 2 de Julio de 2007 con número de protocolo 1.452 e inscrita en el Registro de la Propiedad de Alcobendas número 2, tomo 1.569 libro 1.292 folios 88, 157, 160, 163, 166 fincas registrales numeros 51.455, 51.501, 51.503, 51.505 y 51.507 inscripciones 3ª y 4ª, tomo 1.565 libro 1.289 folios 142, 145, 148, 151, 154, 157, 160, 163, 166, 169, 172, 175, 178, 181. 184, 187, 190, 193, 196, 199, 202, 205, 208, 211, 214, 217, 220 y 223, en el tomo 1.568, libro 1.291, folios 1, 4, 7 y 10 fincas registrales impares consecutivas 51.191 al 51.253.

1° A; constituted by virtue of an instrument signed before the Madrid Notary Mr. Rodrigo Tena Arregui, on the 17th day of April, 2006, and assigned entry number 895 in his records, registered with the Madrid Trade Registry Office in Volume 22.657, Sheet 32, Section 8ª. Page number M-405195. And with tax identification number (C.I.F.) B-84687078 (hereinafter the Lessor).

He acts as **SOLE ADMINISTRATOR,** a position to which he was appointed for an indefinite period by virtue of the constituting instrument described above, which resulted in entry one on the sheet open in the company's name with the Trade Registry Office.
Mr. Francisco Carrasco Houston states that his powers are current and that the existence and legal capacity of the company which he represents have not been altered or modified.

Whereas both have and mutually recognize sufficient legal capacity to formalize the present **RENTAL CONTRACT FOR NON-RESIDENTIAL USE,** to which end they do hereby lay out the following,

REPRESENTATIONS

ONE:

That the Lessor is the owner of Office 2 located on the 5th floor of the **Gamma** building in the Omega Business Park situated on the Alcobendas Barajas road, número 24, Km 1.100. The same has a total grass rentable area (GRA) of 316.32 m^2 divided into 149.55 m2 on the 5th floor and 166. 77 m2 on the top floor **(detailed plan of both floors attached as Appendix I, with their corresponding entrances and how the two are connected),** four parking spaces numbered **23, 24, 26 and 27** on the second basement, first mezzanine level **(Appendix II)** and exclusive use of the building's roof, which is accessible from the top floor, hereinafter **THE OFFICE.** The Lessor is the owner of the aforementioned Office by virtue of the public deed executed by the notary Mr. Juan Manuel Lozano Carreras on the 2nd day of July, 2007, assigned entry number 1.452 in his records and registered with Alcobendas Land Registry Office number 2, in volume 1.569 book 1.292 sheets 88, 157, 160, 163, 166 registered property numbers 51.455, 51.501, 51.503, 51.505 and 51.507 entries 3ª and 4ª, volume 1.565 book 1.289 sheets 142, 145, 148, 151, 154, 157, 160, 163, 166, 169, 172, 175, 178. 181, 184, 187, 190, 193, 196, 199, 202, 205, 208, 211, 214, 217, 220 and 223, in volume 1.568, book 1.291, sheets 1, 4, 7 and 10 consecutive odd-numbered registered properties 51.191 -51.253.

SEGUNDO:

A la firma del presente Contrato de Arrendamiento se siguen realizando obras de instalaciones de climatización, que se prevén aproximadamente finalizaran dentro del plazo de 4 semanas. El contrato queda sujeto a la condición suspensiva de la finalización de dichas obras. La Arrendataria podrá una vez finalizadas las obras de instalación de climatización inspeccionar su correcto funcionamiento. La Arrendadora consultará con la Arrendataria el emplazamiento de los aparatos de climatización de manera que se ubiquen a conveniencia de esta y de acuerdo a su implantación. Por su parte, la Arrendataria se compromete a definir el emplazamiento de los aparatos en un plazo razonable que no demore a la Arrendadora en su obligación de poder cumplir con el plazo de instalación pactado.

TERCERO:

Los comparecientes tienen convenido el arrendamiento de la oficina mencionada, como cuerpo cierto, con todo lo que les sea inherente y accesorio, lo que llevan a cabo de acuerdo con las siguientes:

ESTIPULACIONES

PRIMERA.- Objeto del Arrendamiento

La Arrendadora, cede el arrendamiento a **la Arrendataria,** la oficina identificada en el expositivo Primero de este contrato y en el Anexos I y II (en lo sucesivo **LA OFICINA), como cuerpo cierto,** cuya extension, circunstancias, licencias, usos y caracteristicas fisicas la Arrendataria, declara conocer y aceptar.

SEGUNDA.- Destino y Uso de la Oficina.

La Oficina, sera destinada por la Arrendataria, de forma exclusiva, a actividades propias de su empresa, en concrete a actividad de oficina, no pudiendo, en ningun caso, ser alterado este destino sin contar con la autorizacion previa, escrita y expresa de la Arrendadora, siendo ello causa suficiente para que la Arrendadora pueda resolver el presente Contrato.

Será de cuenta y riesgo de la Arrendataria la obtención de cuantas autorizaciones y permisos sean necesarios para la apertura y utilización de La Oficina Arrendada, asi como el abono de cuantos impuestos, arbitnos y tasas graven su actividad en el mismo, siempre y cuando ésta sea distinta a las licencias y usos que actualmente posee la Oficina.

TWO:

At the time of signing the present Rental Contract, work is continuing on the installation of a heating/cooling system, which is anticipated to be completed with approximately four weeks. The contract is subject to completion of said work as a condition precedent. Upon completion of the work, the Tenant may inspect it to ensure that the system is working properly. The Lessor shall consult the Tenant with regard to the location of the heating/cooling equipment so that it is situated for the latter's convenience and in accordance with its establishment. The Tenant in turn shall undertake to describe the location of the equipment within a reasonable period of time which does not delay the Lessor in the latter's obligation to be meet the agreed upon installation deadline.

THREE:

The parties appearing have agreed upon the rental of the aforementioned Office, as specified, with all that is inherent and accessory to the same, which they carry out in accordance with the following:

STIPULATIONS

ONE.- Object of the Rental

The Lessor grants **the Tenant** rental of the Office identified in Representation One of this Contract and in Appendices I and II (hereinafter **THE OFFICE), as specified,** whose size, circumstances, permits, uses and physical characteristics the Tenant hereby declares knowledge and acceptance of.

SECOND.- Purpose and Use of the Office.

The Office shall be used by the Tenant solely for the company's own activities, specifically office activities Changing this use is not permitted under any circumstances, without obtaining express prior authorization from the Lessor in writing. This is sufficient cause for the Lessor to terminate the present Contract.

Obtaining any authorization and permits necessary to open and use the rented Office shall be at the Tenant's risk and expense, as shall be payment of taxes of any kind due on its activity in the same, provided that these are different from the licenses and uses currently held by the Office.

La denegación de dichas autorizaciones y permisos, no será causa para resolver este contrato de Arrendamiento por la Arrendataria.

La Arrendadora declara que posee un proyecto visado por el Colegio de Arquitectos y permiso de la Comunidad de Propietarios para la apertura del hueco e instalación de una escalera de comunicación entre anbas ptantas. Si el Ayuntamiento de Alcobendas exigiera la obtención de la Licencia de Obras, será responsabilidad de la Arrendadora que correrá con los trámites y costes necesarios para su obtención. Asi mismo, La Arrendadora exime de cualquier responsabilidad a la Arrendataria que pudiera derivarse de la apertura de dicho hueco.

TERCERA.- Duración del Contrato

El presente Contrato de Arrendamiento tendrá una duración de**TRES (3) AÑOS** de obligado cumplimiento a contar desde, la presente fecha, fecha en que la Arrendadora pone a disposición de la Arrendataria La Oficina. La duración podrá ser prorrogada durante **DOS (2)** periodos sucesivos de **UN** (1) **AÑO** a voluntad del Arrendatario, siempre y cuando lo comunique por escrito y de forma fehaciente a la Arrendadora con al menos un preaviso de **TRES (3) MESES** antes de la fecha de finalización del presente Contrato de Arrendamiento o en su caso del primer periodo de prórroga.

CUARTA.- Devolución de La Oficina

Una vez finalizado el Contrato o cualquiera de sus prórrogas, la Arrendataria, deberá poner a disposición de la Arrendadora La Oficina objeto de este Contrato, en el mismo estado en que se entregó, haciendo entrega a aquél de las IIaves de acceso al mismo, sin demora ni excusa alguna, y sin derecho alguno a indemnización por clientela.

La Arrendataria deberá retirar de La Oficina a su costa todos los utensilios, documentos y cualquier otro mueble; todo lo que no desaloje se entenderá abandonado y la Arrendadora será libre para conservarlo, retirarlo o destruirlo a su exclusiva voluntad sin necesidad de consentimiento de la Arrendataria y sin que ésta tenga derecho a reclamar nada por esta causa. La retirada de objetos pertenecientes a la Arrendataria que puedan generar costes de retirada, debera comunicarlo el Arrendador a la Arrendataria dentro de los **cinco (5) dias** siguientes, para que los retire o asuma los costes de retirada de los mismos, dentro de otros **cinco (5) dias.**

En el supuesto de que el Arrendataria incumpliera su obligación de desalojo a la terminación del Contrato o cualquiera de sus prórrogas por cualquier causa, deberá satisfacer a la Arrendadora, por cada dia de demora hasta

Denial of said authorizations and permits shall not be cause for termination of this Rental Contract by the Tenant.

The Lessor hereby states that the same possesses a plan approved by the Architects' Association and permission from the Occupants' Association to open up a stairwell and install stairs connecting the two floors. If the Alcobendas Town Council should require planning permission, this shall be the responsibility of the Lessor, with the same being responsible for all formalities and costs necessary to obtain this. Likewise, The Lessor hereby exempts the Tenant from any liability which may result from opening up said stairwell.

THREE.- Duration of the Contract

The present Rental Contract shall have a mandatory duration of **THREE (3) YEARS** counting from the present date, the date on which the Lessor makes the Office available to the Tenant. The duration may be extended by **TWO (2)** consecutive periods of **ONE (1) YEAR** each should the Tenant so desire, provided that the Lessor is informed of this in writing, verifiably documented, at least **THREE (3) MONTHS** in advance of the completion date of the present Rental Contract or the first extension period, as appropriate.

FOUR.- Return of the Office

Upon completion of the Contract or either of its extensions, the Tenant must place the Office which is the object of this Contract at the Lessor's disposal in the same condition as it was delivered in, delivering to the same the keys to access said Office with no delays or excuses of any kind, and with no rights whatsoever to compensation for customers.

The Tenant must remove from the Office at its expense all equipment, documents and any furniture. All that which is not removed shall be understood to have been abandoned and the Lessor shall be free to retain or destroy it as wished, with no need to obtain the Tenant's consent and without the latter having any right to claim anything for this reason. The Lessor must inform the Tenant of removal of objects belonging to the Tenant which may generate removal costs within the following **five (5) days,** so that the latter may remove these or assume the costs of their removal within another **five (5) days.**

In the event that the Tenant should fail to fulfill the obligation to vacate upon completion of the Contract or either of its extensions for any reason, for each day of delay until the premises is vacated, the same must pay the

el dia en que tenga lugar el efectivo desalojo, una cantidad equivalente al doble de la treintava parte que en concepto de renta viniera satisfaciendo cada mes, en el último periodo de vigencia contractual más la correspondiente participación en los gastos, por la demora en la entrega de La Oficina Arrendada, que tendrá el carácter de cláusula penal de indemnización por dañios y perjuicios.

La Arrendadora queda autorizada desde este momento por la Arrendataria para que durante los **dos (2) meses** anteriores a la finalización de este Contrato por cualquier causa, pueda mostrar La Oficina a otros posibles Arrendatarios, siempre que medie el aviso con **un (1) dia** hábil de antelacion a fin de molestar lo minimo a la Arrendataria, coordinando horarios con la Arrendataria, para no entorpecer posibles reuniones con clientes o actividades de la empresa inaplazables.

QUINTA.- Precio del Arrendamiento

El precio del arrendamiento es una renta de **CINCUENTA Y CINCO MIL DOSCIENTOS CINCUENTA Y TRES EUROS CON OCHENTA Y OCHO CENTIMOS DE EURO (55.253,88 EUROS)** mas **I.V.A.** la cual se compone de **CINCUENTA MIL NOVECIENTOS TREINTA Y TRES EUROS CON OCHENTA Y OCHO CENTIMOS DE EURO (50.933,88 EUROS)** por la superficie de oficinas y **CUATRO MIL TRESCIENTOS VEINTE EUROS (4.320 EUROS)** por cuatro (4) plazas de garaje. La renta anual será satisfecha por la Arrendataria por meses anticipados a razón de **CUATRO MIL DOSCIENTOS CUARENTA Y CUATRO EUROS CON CUARENTA Y NUEVE CÉNTIMOS DE EURO (4.244,49 EUROS)** por la superficie de oficinas y **TRESCIENTOS SESENTA EUROS (360 EUROS)** correspondientes a las plazas de garaje. La renta mensual total será de **CUATRO MIL SEISCIENTOS CUATRO EUROS CON CUARENTA Y NUEVE CENTIMOS DE EURO (4.604,49 EUROS)** más **I.V.A.** dentro de los 5 primeros dias naturales de cada mes. La Arrendataria domiciliará el pago de la renta en la cuenta **0019 0151 96 4010018711,** de Deutsche Bank de la Arrendadora. Las partes pactan un periodo de carencia o gracia en el pago de alquiler de **DOS MESES** desde la fecha de firma del contrato.

En caso de retraso en el pago de la renta o de cualquiera de las cantidades que fueran a cargo de la Arrendataria, se devengará dia a dia desde la fecha del retraso hasta la del pago efectivo de las mismas, un interés de demora a favor de la Arrendadora, calculando en base al tipo de interés legal del dinero al que se añadirá un margen de **dos (2) puntos.** Lo anterior es sin perjuicio del derecho de la Arrendadora a resolver el presente Contrato.

Lessor an amount equivalent to double one thirtieth of the rental amount which had been paid each month during the final period the contract was in force, plus the corresponding share of expenses, for delay in delivering the Office rented. This shall be considered a penalty clause to compensate for damages.

The Lessor is hereby authorized by the Tenant from this moment to show the Office to other possible tenants during the final **two (2) months** prior to completion of this Contract for any reason, provided that **one (1) working day's** notice is given in order to disturb the Tenant as little as possible. This shall be coordinated with the Tenant so as not to obstruct possible meetings with customers or activities of the company which cannot be delayed.

FIVE.- Price of the Rental

The price of the rental is a rent of **FIFTY-FIVE THOUSAND, TWO HUNDRED AND FIFTY-THREE EUROS AND EIGHTY-EIGHT CENTS (55,253.88 EUROS)** plus **VAT,** which is comprised of **FIFTY THOUSAND, NINE HUNDRED AND THIRTY-THREE EUROS AND EIGHTY-EIGHT CENTS (50,933.88 EUROS)** for the office space and **FOUR THOUSAND, THREE HUNDRED AND TWENTY EUROS (4,320 EUROS)** for four (4) spaces in the parking garage. The annual rent shall be paid by the Tenant in advance on a monthly basis at a rate of **FOUR THOUSAND, TWO HUNDRED AND FORTY-FOUR EUROS AND FORTY-NINE CENTS (4,244.49 EUROS)** for the office space and **THREE HUNDRED AND SIXTY EUROS (360 EUROS)** for the parking spaces. The total monthly rent shall be **FOUR THOUSAND, SIX HUNDRED AND FOUR EUROS AND FORTY-NINE CENTS (4,604.49 EUROS)** plus **VAT,** payable within the first five calendar days of each month. The Tenant shall deposit payment directly into the Lessor's Deutsche Bank account, number **0019 0151 96 4010018711.** The parties hereby agree on a grace period for payment of rent of **TWO MONTHS** from the signing of this Contract.

In the event of delay in payment of the rent or any of the amounts which are the responsibility of the Tenant, interest shall accrue in the Lessor's favor for this delay each day from the date the delay begins until effective payment is made. This shall be calculated on the basis of the legal monetary interest rate with an additional margin of **two (2) points.** The preceding does not affect the Lessor's right to terminate the present Contract.

SEXTA.- Estabilización de valór: revision de la renta

Las partes contratantes acuerdan que la renta será objeto de revisión anual, a contar desde la présente fecha. A tal efecto, la renta que estuviera vigente en el momento de cada revisión (incluyendo por tanto las revisiones anteriores) se incrementará o disminuira en la misma proporción en que haya variado el **indice General de Precios al Consumo** (Conjunto Nacional Total) en los **DOCE (12) meses** inmediatamente anteriores a la fecha firma del presente Contrato de Arrendamiento, según información que publique el Instituto Nacional de Estadistica o el Organismo que en un futuro pudiera sustituirle.

Habida cuenta que el indice de Precios al Consumo para el conjunto nacional es publicado con cierto retraso, el aumento que corresponda por el sistema de revisión acordado se aplicará a la fecha en que debe iniciarse el cobro de la renta ya revisada con carácter retroactivo. El no ejercicio por la Arrendadora de la facultad para revisar la renta cuando corresponda no supondrá la renuncia a la facultad de revisión de la renta en ocasiones posteriores.

SÉPTIMA.- Obras

La Arrendataria no podrá ejecutar ninguna obra en La Oficina que arrienda que afecten a la estructura o configuración de la planta en que se encuentra o a cualquiera de sus elementos, servicios o accesorios sin que medie para ello autorización previa, escrita y expresa de la Arrendadora. La Arrendadora consiente desde ya y en este acto a la realización por la Arrendataria y a su costa de las obras que se señalan en el **Anexo III,** por ser las que la Arrendataria considera necesarias o convenientes para la implantación y el desarrollo de sus actividades.

La Arrendadora podrá vigilar o inspeccionar las obras que realice la Arrendataria a través de sus técnicos, tanto durante su realización como una vez acabada las mismas, sin que ello entorpezca o retrase las obras a realizar o la actividad normal de la oficina. El periodo de inspección, una vez terminadas las mismas, no podrá realizarse despues de 15 dias terminadas las obras.

Las obras y los equipos e instalaciones que no sean retirados y que se realicen en virtud de lo anterior, quedarán a expiración del presente Contrato en beneficio de La Oficina, sin derecho alguno por la Arrendataria al reintegro de su importe.

SIX.- Value adjustment: rental review

The contracting parties hereby agree that the rent shall be subject to annual review, counting from the present date. For said purpose, the rent which is currently in force at the time of each review (therefore including previous reviews) shall be increased or decreased in the same proportion as the **Consumer Price Index** (Total National Aggregate) for the **TWELVE (12) months** immediately prior to the date of the signing of the present Rental Contract has varied, according to information published by the National Statistics Institute or the organization which may replace the same in the future.

In consideration of the fact that the national aggregate Consumer Price Index is published with a certain delay, the increase which applies to the agreed upon review system shall be retroactively applied to the date on which the rent already reviewed should have begun being charged. Should the Lessor not exercise the power to review the rent in due course, this shall not imply relinquishment of the power to review the rent on subsequent occasions.

SEVEN.- Work

The Tenant may not carry out any work on the Office rented which affects the structure or layout of the floor on which it is located or any of its elements, services or accessories without obtaining prior express authorization in writing from the Lessor. At the present time, the Lessor hereby agrees that the Tenant may carry out the work indicated in **Appendix III,** at the latter's expense, as this is considered necessary or advisable by the Tenant to implement and carry out its activities.

The Lessor may monitor or inspect the work carried out by the Tenant by means of its technicians, both while work is being carried out and upon completion, without hindering or delaying the work to be carried out or the normal activity of the Office. Upon completion of the same, the inspection period may not extend beyond 15 days from completion of the work.

Upon expiration of the present Contract, the work and equipment or systems which are not removed and which are carried out by virtue of the preceding shall remain to the Office's benefit, with the Tenant having no right whatsoever to reimbursement for their cost.

OCTAVA.- Servicios e instalaciones. Gastos y tributos, Contratación de Suministros

La Arrendataria conoce y acepta todos y cada uno de los servicios, instalaciones y suministros (incluyendo los de agua y electricidad) con los que cuenta La Oficina y su estado actual. Todos los citados servicios, instalaciones y suministros asl como los que se sustituyan o se pongan en marcha en el futuro, son y serán propiedad de la Arrendadora y quedarán en beneficio de la Oficina al finalizar el presente Arrendamiento.

Serán de cuenta exclusiva de la Arrendataria, los gastos de comunidad ordinarios correspondientes a La Oficina (estimados en 2,24€/m2/mes por superficie de oficinas y 27.50€/plaza/mes) y el Impuesto sobre Bienes Inmuebles (IBI) hasta un maximo de 600€/año, asl como el alta, cambio de nombre, domiciliacion y consumo de cualesquiera suministros (incluyendo electricidad y teléfono) asi como cualquier otros gastos derivados del uso de La Oficina y de sus instalaciones, todos los cuales serán pagados directamente por la Arrendataria. En todo caso, si por cualquier motivo la Arrendadora satisficiera cualquiera de dichos gastos o tributos al correspondiente acreedor, podrá repercutirlos de inmediato a la Arrendataria. Serán por cuenta de la Arrendadora los gastos extraordinarios que afecten a La Oficina.

Asimismo, la Arrendataria deberá satisfacer todos cuantos tributos, impuestos arbitnos, tasas y gastos graven o deriven de su actividad, ahora o en el futuro, asi como el Impuesto sobre el Valor Añadido o cualquier otro impuesto de nueva creación que lo sustituya o complemente.

La Arrendataria realizará a su cargo las modificiones que pudieran ser necesarias para adaptar cada instalación a las normas vigentes en cada momento, exigible por cada compañia suministradora, siempre y cuando éstas sean necesarias para la actividad normal de la Arrendataria y hasta un importe máximo equivalente a TRES (3) mensualidades de renta. En caso que dichas modificaciones superasen el importe maximo, la diferencia será abonada por la Arrendadora. Si estas modificaciones afectaran a los elementos comunes o a las instalaciones generales del edificio, serán por cuenta de la Arrendadora.

La Arrendadora no se hace responsable del cese, cortes y/o interrupciones que se produzcan en las instalaciones o servicios de La Oficina, ya sea alumbrado, ascensores, agua, teléfono, gas, calefacción o cualquier otro, por causa alguna.

NOVENA.- Acatamiento de Ley y Ordenanzas. Responsabilidad por actos de terceros.

La Arrendataria acatará expresamente todas las Leyes y

EIGHT.- Services and systems. Charges and taxes. Utilities

The Tenant has knowledge of and accepts each and every one of the services, systems and utilities (including water and electricity) which the Office has and their current status. All of the aforementioned services, systems and utilities, as well as those which replace these or are started up in the future, are and shall be the property of the Lessor and shall remain to the Office's benefit upon completion of the present rental.

The Tenant shall be solely responsible for the ordinary service charges corresponding to the Office (estimated to be €2.24/m2/month for the office space and €27.50/parking space/month) and Property Tax (IBI, in its Spanish acronym) up to a maximum of 600€/year, as well as signup, name change, direct deposit and consumption of any utilities (including electricity and telephone), as well as any other charges deriving from use of the Office and its facilities, all of which shall be paid directly by the Tenant. In any event, if for any reason the Lessor should pay any of said charges or taxes to the corresponding creditor, these may immediately be passed on to the Tenant. Any extraordinary expenses which affect the Office shall be the responsibility of the Lessor.

Likewise, the Tenant must pay all taxes of any kind or charges applied to or resulting from its activity, now or in the future, as well as the value-added tax or any other newly created tax which may replace or supplement it.

The Tenant shall carry out at its expense any modifications which may be necessary to adapt each system to the regulations in force at any given time, which may be required by each utility, provided that these are necessary for the normal activity of the Tenant and up to a maximum amount equivalent to THREE (3) months' rent. In the event that said modifications exceed the maximum amount, the difference shall be paid by the Lessor. If these modifications affect common elements or the building's general systems, they shall be paid for by the Lessor.

The Lessor accepts no responsibility for cessation, cuts and/or interruptions which take place in the Office's systems or services, whether this be lighting, elevators, water, telephone, gas, heating or any other, for any reason.

NINE.- Compliance with the Law and Ordinances. Liability for the actions of third parties.

The Tenant shall expressly comply with all current and

Ordenanzas Municipales actuales o futuras, y no introducirá, almacenará o tendrá en momento alguno, ningún material explosivo o inflamable dentro de La Oficina, y no hará ni permitirá que se haga nada que anule o invalide en todo o en parte el seguro de la planta contratado por la Arrendadora, o que origine un aumento o sobreprima en él, y tampoco hará ni consentirá que se haga nada que sea o pueda llegar a ser motivo de molestias, perjuicios o alteración para la Arrendadora, sus convecinos inmediatos o para cualquier otro vecino o Arrendatario, El citado seguro se adjuntará como **Anexo IV.**

La Arrendataria será responsable de todas las acciones de sus empleados, visitantes y cualquier otra persona, en cuanto estén dentro de La Oficina.

DECIMA.- Permiso de Entrada a la Oficina

La Arrendataria se compromete a permitir la entrada en La Oficina objeto de este Contrato a la Arrendadora y a quién éste designe (incluyendo técnicos y obreros) con los correspondientes materiales y otros elementos, asi como a los operarios de las empresas suministradoras de agua, electricidad y otros servicios, para realizar la inspección de La Oficina y de sus instalaciones o reparaciones y comprobar el funcionamiento de cualquiera de sus servicios y/o el cumplimiento de las obligaciones de la Arrendataria establecidas en este Contrato. La Arrendadora comunicará la fecha de visita por escrito y con preaviso de **DOS (2)** dias hábiles, que deberá llevarse a cabo en el horario normal de oficinas y en presencia de la Arrendataria.

UNDÉCIMA.- Deber de Conservación y Reparación

La Arrendataria vendrá obligada a mantener a su costa en buen estado de uso y conservación La Oficina arrendada y todas las instalaciones en ella existentes. En consecuencia, durante la vigencia de este Contrato, será responsabilidad de la Arrendataria la conservación a su costa de La Oficina y sus servicios e instalaciones. A tal efecto ésta asume la obligación de reparar todas las averias, deterioros y/o desperfectos ordinarios que pudieran producirse en la misma o en sus servicios e instalaciones, salvo aquellos que procedan de vicios ocultos de la construcción del Edificio, de instalaciones generales o de defectos en su estructura o errores conceptuales de construcción en el local, que serán de cuenta de la Arrendadora. En este último caso, la Arrendataria se obliga a notificar a la Arrendadora de la necesidad de la correspondiente reparacion tan pronto como la perciba.

De igual manera, la Arrendataria se obliga a satisfacer las reparaciones necesarias por las averias, deterioros o

future laws and municipal ordinances, and shall not bring in, store or have any explosive or flammable material inside the Office at any time. The Tenant shall not do anything or allow anything to be done which would cancel or invalidate in whole or in part the insurance policy for the property taken out by the Lessor, or which causes an increased or additional premium for the same. Nor shall it do or permit to be done anything which is or which could be the cause of trouble, damage or disturbance for the Lessor, immediate neighbors or any other neighbor or tenant. The aforementioned insurance policy shall be attached as **Appendix IV**.

The Tenant shall be liable for all actions by its employees, visitors or any other person when they are inside the Office.

TEN.- Permission to Enter the Office

The Tenant hereby agrees to allow entry to the Office which is the object of this Contract to the Lessor and to those designated by the same (including technicians and workers), with the corresponding materials and other elements, as well as to employees of the companies supplying water, electricity and other services, to inspect the Office and its systems or to repair or check the operation of any of its services and/or fulfillment of the Tenant's obligations as established in this Contract. The Lessor shall notify the Tenant of the date of the visit in writing with **TWO (2)** working days' advance notice, and this must take place within normal office hours and in the presence of the Tenant.

ELEVEN.- Maintenance and Repair Obligation

The Tenant shall be obligated to keep the Office rented and all its facilities in proper working condition and maintained its own expense. Consequently, during the period this Contract is in force, it shall be the Tenant's responsibility to maintain the Office and its services and facilities at its own expense. To this end, the same hereby accepts the obligation to repair all ordinary breakage and/or damage which may occur in the same or in its services and facilities, except for that which derives from hidden defects in the construction of the building, general facilities or defects in its structure or conceptual errors in construction of the premises, which shall be the responsibility of the Lessor. In the latter case, the Tenant hereby undertakes to notify the Lessor of the need for the corresponding repair as soon as it is realized.

Likewise, the Tenant hereby undertakes to make all necessary repairs for breakage or damage which occurs or

desperfectos que se produzcan o repercutan en las fincas contiguas o colindantes, cuando la causación de tales daños le resulte directamente imputable a la Arrendataria, a su actividad o de la de cualquiera persona, realizada desde La Oficina o derive de la falta de cumplimiento de sus obtigaciones bajo el presente Contrato.

La Arrendataria no podrá colocar en la fachada del Edificio signos, rótulos, anuncios o carteles de cualquier clase, ni ningún otro tipo de decoración exterior sin previa autorización por escrito y expresa de la Arrendadora.

DUODÉCIMA.- Daños. Seguros.

La Arrendadora no responde de los daños y perjuicios que puedan ocasionarse a la Arrendataria o personas que presten sus servicios en La Oficina por casos fortuitos o de fuerza mayor. La Arrendataria contratará y mantendrá en vigor durante toda la vigencia del presente Contrato una póliza de seguro multiriesgo que cubra suficientemente todo tipo de daños que pueda sufrir el contenido de la Oficina, incluido el riesgo por incendio y por aguas, y una póliza de seguro de responsabilidad civil (incluyendo riesgo patronal) que cubra suficientemente la que derive de la actividad desarrollada en La Oficina. La Arrendataria deberá facilitar a la Arrendadora una copia de las citadas pólizas en el plazo máximo de 10 dias naturales desde la fecha del presente Contrato, con efectos desde el dia de hoy, asĪ como, anualmente, una copia de los comprobantes del pago de la prima que corresponda al año en curso en cada momento.

La Arrendadora contratará y mantendrá en vigor durante toda la vigencia del presente Contrato una póliza de seguro nnultiriesgo que cubra los daños que pueda sufrir el continente de La Oficina por actividades propias de la actividad de la Arrendataria.

DECIMOTERCERA.- Entrega de Posesión

La Arrendadora entrega la posesión de La Oficina a la Arrendataria en este acto, mediante la entrega de las correspondientes llaves y mandos del garaje.

La Arrendadora se obliga a mantener a la Arrendataria en el uso pacifico de La Oficina. No obstante, no asume responsabilidad alguna por cualquier impedimento en la posesión o daño en las personas o cosas que pudieran derivar de casos fortuitos o de fuerza mayor. La Arrendadora tampoco es responsable de la seguridad y vigilancia del Edificio, ni asume responsabilidad alguna por los daños que pudieran sufrir las personas o cosas en caso de robo o hurto.

which has an effect on contiguous or adjoining properties when the cause of said damage may be directly attributed to the Tenant, its activity or that of any other person carried out from the Office or which derives from failure to fulfill its obligations according to the present Contract.

The Tenant may not place any signs, advertisements or posters of any kind on the facade of the building, or any other type of exterior decoration, without prior express approval in writing from the Lessor.

TWELVE.- Damage. Insurance.

The Lessor shall not be liable for any damage which may be caused to the Tenant or persons rendering their services in the Office due to acts of chance or force majeure. The Tenant shall take out a multi-risk insurance policy which sufficiently covers any type of damage which may be incurred by the contents of the Office, including coverage for fire and water damage, and a civil liability insurance policy (including employer's risk) which sufficiently covers that which derives from the activity carried out in the Office, which it shall keep current during the entire period the present Contract is in force. The Tenant shall be obligated to provide the Lessor with a copy of the aforementioned policies within a maximum of 10 calendar days from the date of present Contract, effective today, as well as, on an annual basis, a copy of proof of payment of the premium which corresponds to the current year at any given time.

The Lessor shall take a multi-risk insurance policy which covers the damage which may be incurred by the Office's premises due to the Tenant's activities, and keep the same current for the entire period the present Contract is in force.

THIRTEEN.- Delivery into Possession

The Lessor shall deliver the Office into the Tenant's possession at the present time, by handing over the corresponding keys and garage remote controls.

The Lessor hereby undertakes to allow the Tenant peaceful use of the Office. However, the former does not assume any responsibility whatsoever for any impediment to possession or damage to persons and things which may derive from acts of chance or force majeure. Nor is the Lessor responsible for security and guarding the building, nor does it assume any responsibility whatsoever for damages which may be incurred by persons and things in the event of robbery or theft.

DECIMOCUARTA.- Fianza

La Arrendataria entrega en este acto a la Arrendadora la cantidad de**NUEVE MIL DOSCIENTOS OCHO EUROS CON NOVENTA Y OCHO CÉNTIMOS DE EURO (9.208,98EUROS)** equivalentes a **DOS (2) MESES** de alquiler en concepto de Fianza, afecta a las responsabilidades en que pudiera incurrir la Arrendataria. Esta fianza en ningún caso podrá imputarse al pago de mensualidades de renta y será depositada en el IVIMA.

DECIMOQUINTA.- Renuncias

La Arrendataria renuncia expresamente a los derechos de tanteo y retracto que pudieran corresponderle en el supuesto de transmisión de La Oficina que es objeto del presente Contrato de Arrendamiento renunciando por tanto a todo derecho de adquisición preferente reconocido en los articulos 25 y 31 de la vigente Ley de Arrendamientos Urbanos de 24 de Noviembre de 1994, pudiendo la propiedad en cualquier momento de la vida del contrato, enajenar o gravar libremente La Oficina, sin más limitaciones ni consecuencias que la subrogación prevista legalmente del nuevo propietario en los derechos y obligaciones de este contrato.

Asimismo La Arrendataria no podrá ceder ni subarrendar el presente Contrato de Arrendamiento, total ni parcialmente, sin autorización previa, expresa y escrita de la Arrendadora, quien se reserva la facultad de concederla o no, no siendo en consecuencia de aplicación lo dispuesto en el articulo 32 de la Ley 29/1194, de Arrendamientos Urbanos.

DECIMO SEXTA.- Resolución por incumplimiento

El incumpiimiento por la Arrendataria de las obligaciones establecidas en las estipulaciones de este Contrato, dara derecho a la Arrendadora a exigir el cumplimiento de aquellas o bien, a promover la resolucion del presente Contrato con el resarcimiento de daños y abonos de intereses en ambos casos. El mismo derecho asiste la Arrendataria en caso de incumplimiento por la Arrendadora de sus obligaciones contractuales.

De forma particular la Arrendadora podra resolver de pleno derecho el Contrato, entre otras, por las siguientes causas:

1. La falta de pago de la renta durante 30 dias o en su caso de cualquiera de las cantidades cuyo pago haya asumido o corresponda la Arrendataria sin perjuicio del devengo de los intereses de

FOURTEEN.- Deposit

At this time, the Tenant delivers to the Lessor the amount of**NINE THOUSAND, TWO HUNDRED AND EIGHT EUROS AND NINETY-EIGHT CENTS (9,208.98 EUROS),** equivalent to **TWO (2) MONTHS'** rent, as a deposit, covering any liability which the Tenant may incur. This deposit shall under no circumstances be allocated to payment of monthly rent and shall be deposited with the Housing Institute (Instituto de la Vivienda, or IVIMA in its Spanish acronym).

FIFTEEN.- Waivers

The Tenant hereby expressly renounces the rights of first refusal and buy-out to which it may be entitled in the event of transfer of the Office which is the object of the present Rental Contract, therefore renouncing any right to preferential acquisition recognized in articles 25 and 31 of the current Urban Rental Law of 24 November 1994. The owner may at any time during the life of the contract transfer or freely mortgage the Office, without any more limitations or consequences than the legally envisaged subrogation of the new owner to the rights and obligations of this contract.

Likewise, The Tenant may not transfer or sublet the present Rental Contract, in whole or in part, without express prior authorization in writing from the Lessor, who reserves the power to grant this or not. Consequently, the stipulations of article 32 of Law 29/1194, on Urban Rentals, are not applicable.

SIXTEEN.- Termination for breach

The Tenant's failure to fulfill the obligations established in the stipulations of this Contract shall entitle the Lessor to demand fulfillment of these or initiate termination of the present Contract with compensation for damages and payment of interest in both cases. The Tenant has the same right in the event of the Lessor's failure to fulfill its contractual obligations.

Individually, the Lessor is fully entitled to terminate the Contract for the following reasons, among others:

1. Failure to pay rent, or if appropriate, any of the amounts whose payment has been assumed by or is the responsibility of the Tenant for a 30-day period. This does not affect the agreed upon

demora pactados.

2. El subarriendo, cesión o traspaso inconsentidos.
3. La realización de daños causados dolosamente en La Oficina o de obras no consentidas por la Arrendadora cuando el consentimiento sea necesario.
4. Cuando en La Oficina tengan lugar actividades molestas, insalubres, nocivas, peligrosas o ilicitas.
5. Cuando se altere el destino estipulado y pactado en el presente Contrato sin consentimiento expreso y escrito de la Arrendadora.

En caso de resolución del contrato por incumplimiento imputable a una de las partes, todos los gastos, costas judiciales, incluso los de Abogado y Procurador, aunque su intervención no sea preceptiva que por este motivo u otro cualquiera se causen como consecuencia de dicha resolución contractual, serán por cuenta y abonados por la parte incumplidora.

DECIMO SÉPTIMA.- Gastos e Impuestos

Todos cuantos gastos e impuestos puedan derivarse del otorgamiento de este Contrato, de su eventual elevación a escritura pública e inscripción registral serón de cuenta exclusiva de la Arrendataria, siempre y cuando sea la misma Arrendataria la que lo exija.

DECIMO OCTAVA.-Aval Bancario

La Arrendataria se compromete a mantener un Aval Bancario a primer requerimiento por importe de **TRES (3) MENSUALIDADES** de renta durante toda la vigencia del Presente Contrato de Arrendamiento y cualesquiera de sus prórrogas. La Arrendadora concede a la Arrendataria un plazo de **TREINTA (30) DÍAS** desde la firma del presente Contrato de Arrendamiento para presentar el mencionado Aval Bancario. En el supuesto que el mencionado Aval no fuera presentado por la Arrendataria en plazo, la Arrendadora podrá resolver de pleno derecho el presente contrato de Arrendamiento y exigir el cumplimiento de todas la obligaciones derivadas del mismo, incluido el pago de la renta de todo el periodo de obligado cumplimiento.

accrual of interest for delayed payment.

2. Unauthorized subletting, assignment or transfer.
3. Damage caused fraudulently to the Office or carrying out work which has not been authorized by the Lessor when permission is necessary.
4. When annoying, unhealthy, harmful, dangerous or illicit activities take place in the Office.
5. When the purpose stipulated and agreed upon in the present Contract is changed without express written consent from the Lessor.

In the event that the contract is terminated for breach which may be attributed to one of the parties, all expenses, legal costs, including those of lawyers and attorneys, although their involvement may not be required, which for this reason or any other are incurred as a result of said termination of the contract, shall be the responsibility of and paid by the party in breach.

SEVENTEEN.- Expenses and Taxes

All expenses and taxes which may result from the execution of this contract, its possible execution as a public instrument and registration shall be the sole responsibility of the Tenant, provided that it is the Tenant who so requires.

EIGHTEEN.- Bank Guarantee

The Tenant hereby agrees to keep a bank guarantee payable upon demand for the amount of **THREE (3) MONTHS'** rent during the entire period the present Rental Contract and any of its extensions are in force. The Lessor grants the Tenant **THIRTY (30) DAYS** from the signing of the present Rental Contract to present the aforementioned bank guarantee. In the event that the aforementioned bank guarantee is not presented by the Tenant before this deadline, the Lessor is fully entitled to terminate the present Rental Contract and demand fulfillment of all obligations deriving from the same, including payment of rent for the entire mandatory period.

Exhibit 14.1

Code of Ethics
of
Energy Recovery, Inc.

Additional Conduct and Ethics Policies for the
Chief Executive Officer and Senior Financial Officers

The Company has a Code of Business Conduct and Ethics (the **"Code"**) applicable to all directors, officers and employees of the Company. The Chief Executive Officer and all senior financial officers, including the Chief Financial Officer and all principal accounting officers, are bound by the provisions set forth therein. In addition to the Code, the Chief Executive Officer and senior financial officers are subject to the following additional specific policies:

- The Chief Executive Officer and all senior financial officers are responsible for full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the Company with the U.S. Securities and Exchange Commission. Accordingly, it is the responsibility of the Chief Executive Officer and each senior financial officer to promptly bring to the attention of the Chair of the Audit Committee any material information of which he or she may become aware that affects the disclosures made by the Company in its public filings or otherwise assist the Audit Committee in fulfilling its responsibilities as specified in the Audit Committee Charter.
- The Chief Executive Officer and each senior financial officer shall promptly bring to the attention of the Chair of the Audit Committee any information he or she may have concerning (a) significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize and report financial data or (b) any theft or fraud, whether or not material, that involves affiliates who have a significant role in the Company's financial reporting, disclosures or internal controls.
- The Chief Executive Officer and each senior financial officer shall promptly bring to the attention of the Chair of the Audit Committee any information he or she may have concerning any violation of the Code or of these additional policies, including any actual or apparent conflicts of interest between personal and professional relationships, involving any affiliate who has a significant role in the Company's financial reporting, disclosures or internal controls.
- The Chief Executive Officer and each senior financial officer shall promptly bring to the attention of the Chair of the Audit Committee any information he or she may have concerning evidence of a material violation of the securities or other laws, rules or regulations applicable to the Company and the operation of its business, by the Company or any agent thereof.

The Board of Directors shall determine, or designate appropriate persons to determine appropriate actions to be taken in the event of violations of the Code or of these additional policies by the Chief Executive Officer and the Company's senior financial officers. Such actions shall be reasonably designed to deter wrongdoing and to promote accountability for adherence to the Code and to these policies, and shall include written notices to the individual involved that the Board has determined that there has been a violation, censure by the Board, demotion or re-assignment of the individual involved, suspension with or without pay or benefits (as determined by the Board) and termination of the individual's employment.

In determining what action is appropriate in a particular case, the Board of Directors or such designee shall take into account all relevant information, including the nature and severity of the violation, whether the violation was a single occurrence or repeated occurrences, whether the violation appears to have been intentional or inadvertent, whether the individual in question had been advised prior to the violation as to the proper course of action and whether or not the individual in question had committed other violations in the past.

Exhibit 21.1

Energy Recovery, Inc.

List of Subsidiaries

Company Name	**Country/State of Incorporation/Formation**
Osmotic Power, Inc.	Delaware
Energy Recovery Iberia, S.L.	Spain
Energy Recovery, Inc. International	Delaware

EXHIBIT 23.1

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-152142) of Energy Recovery, Inc. of our report dated March 26, 2009, relating to the consolidated financial statements and financial statement schedule of Energy Recovery, Inc. included in this Annual Report on Form 10-K.

/s/ BDO Seidman, LLP

San Jose, California
March 26, 2009

EXHIBIT 31.1

CERTIFICATION

I, G.G. Pique, certify that:

1. I have reviewed this Annual Report on Form 10-K of Energy Recovery, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ G.G. Pique
G.G. Pique
President and Chief Executive Officer

Dated: March 27, 2008

EXHIBIT 31.2

CERTIFICATION

I, Thomas D. Willardson, certify that:

1. I have reviewed this Annual Report on Form 10-K of Energy Recovery, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

c) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ Thomas D. Willardson
Thomas D. Willardson
Chief Financial Officer

Dated: March 27, 2008

EXHIBIT 32.1

CERTIFICATION*

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and Section 1350 of Chapter 63 of Title 18 of the United States Code, V. G.G. Pique, President and Chief Executive Officer of Energy Recovery, Inc. (the "Company"), and Thomas D. Willardson, Chief Financial Officer of the Company, each hereby certify that, to the best of their knowledge:

1. The Company's Annual Report on Form 10-K for the year ended December 31, 2008, to which this Certification is attached as Exhibit 32.1 (the "Annual Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and

2. The information contained in the Annual Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Annual Report and results of operations of the Company for the period covered by the Annual Report.

IN WITNESS WHEREOF, the undersigned have set their hands hereto as of the 27th day of March 2009.

/s/ G.G. Pique	/s/ Thomas D. Willardson
President and Chief Executive Officer	Chief Financial Officer
Dated: March 27, 2009	Dated: March 27, 2009

* This certification accompanies the Form 10-K to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Energy Recovery, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-K), irrespective of any general incorporation language contained in such filing.