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

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2009

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
(State of Incorporation)

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

01-0616867
(IRS Employer Identification No.)

94577
(Zip Code)

(510) 483-7370
(Telephone 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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 Smaller reporting company
(Do not check if a smaller reporting company)

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

As of April 30, 2009, there were 50,147,751 shares of the registrant's common stock outstanding.

ENERGY RECOVERY, INC.
QUARTERLY REPORT ON FORM 10-Q FOR THE PERIOD ENDED MARCH 31, 2009
TABLE OF CONTENTS

	<u>Page No.</u>
<u>PART I. FINANCIAL INFORMATION</u>	3
<u>Item 1. Financial Statements (Unaudited)</u>	3
<u>Condensed Consolidated Balance Sheets as of March 31, 2009 and December 31, 2008</u>	3
<u>Condensed Consolidated Statements of Operations for the Three Months Ended March 31, 2009 and 2008</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2009 and 2008</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
<u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	13
<u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u>	18
<u>Item 4(T). Controls and Procedures</u>	19
<u>PART II. OTHER INFORMATION</u>	20
<u>Item 1. Legal Proceedings</u>	20
<u>Item 1A. Risk Factors</u>	20
<u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>	29
<u>Item 3. Defaults Upon Senior Securities</u>	29
<u>Item 4. Submission of Matters to a Vote of Security Holders</u>	29
<u>Item 5. Other Information</u>	30
<u>Item 6. Exhibits</u>	31
<u>Signatures</u>	32
<u>EX-10.19</u>	
<u>EX-10.20</u>	
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	

PART I — FINANCIAL INFORMATION

Item 1. Financial Statements (unaudited)

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

	<u>March 31,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 75,004	\$ 79,287
Restricted cash	5,518	246
Accounts receivable, net of allowance for doubtful accounts of \$39 and \$59 at March 31, 2009 and December 31, 2008, respectively	11,587	20,615
Unbilled receivables, current	4,092	4,948
Inventories	10,080	8,493
Deferred tax assets, net	1,755	1,755
Prepaid expenses and other current assets	1,451	984
Total current assets	<u>109,487</u>	<u>116,328</u>
Unbilled receivables, non-current	2,652	1,929
Restricted cash, non-current	3,526	19
Property and equipment, net	2,605	1,845
Intangible assets, net	315	321
Deferred tax assets, non-current, net	119	119
Other assets, non-current	51	51
Total assets	<u>\$ 118,755</u>	<u>\$ 120,612</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 1,811	\$ 2,270
Accrued expenses and other current liabilities	4,143	4,787
Income taxes payable	111	1,657
Accrued warranty reserve	296	270
Deferred revenue	2,699	4,000
Current portion of long-term debt	128	172
Current portion of capital lease obligations	37	37
Total current liabilities	<u>9,225</u>	<u>13,193</u>
Long-term debt	309	385
Capital lease obligations, non-current	17	27
Other non-current liabilities	6	8
Total liabilities	<u>9,557</u>	<u>13,613</u>
Commitments and Contingencies (Note 6)		
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; 50,121,086 and 50,015,718 shares issued and outstanding at March 31, 2009 and December 31, 2008, respectively	50	50
Additional paid-in capital	99,016	98,527
Notes receivable from stockholders	(168)	(296)
Accumulated other comprehensive loss	(16)	(44)
Retained earnings	10,316	8,762
Total stockholders' equity	<u>109,198</u>	<u>106,999</u>
Total liabilities and stockholders' equity	<u>\$ 118,755</u>	<u>\$ 120,612</u>

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended	
	March 31,	
	2009	2008
Net revenue	\$ 12,646	\$ 9,120
Cost of revenue	4,573	3,674
Gross profit	8,073	5,446
Operating expenses:		
General and administrative	3,154	2,661
Sales and marketing	1,510	1,343
Research and development	804	509
Total operating expenses	5,468	4,513
Income from operations	2,605	933
Other income (expense):		
Interest expense	(14)	(21)
Interest and other income (expense),net	(88)	647
Income before provision for income taxes	2,503	1,559
Provision for income taxes	949	612
Net income	<u>\$ 1,554</u>	<u>\$ 947</u>
Earnings per share:		
Basic	<u>\$ 0.03</u>	<u>\$ 0.02</u>
Diluted	<u>\$ 0.03</u>	<u>\$ 0.02</u>
Number of shares used in per share calculations:		
Basic	<u>50,052</u>	<u>39,804</u>
Diluted	<u>52,580</u>	<u>42,196</u>

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

ENERGY RECOVERY, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Three Months Ended	
	March 31,	
	2009	2008
Cash Flows From Operating Activities		
Net income	\$ 1,554	\$ 947
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	178	121
Interest accrued on notes receivables from stockholders	(2)	(6)
Stock-based compensation	195	221
Net gain on foreign currency transactions	(337)	(619)
Provision for doubtful accounts	4	(14)
Provision for warranty claims	28	87
Provision for excess or obsolete inventory	74	20
Changes in operating assets and liabilities:		
Accounts receivable	9,369	2,797
Unbilled receivables	93	(2,947)
Inventories	(1,661)	(1,624)
Prepaid and other assets	(471)	(2,313)
Accounts payable	(459)	919
Accrued expenses and other liabilities	(568)	1,938
Income taxes payable	(1,463)	(1,136)
Deferred revenue	(1,301)	1,258
Net cash provided by (used in) operating activities	<u>5,233</u>	<u>(351)</u>
Cash Flows From Investing Activities		
Capital expenditures	(933)	(56)
Restricted cash	(8,779)	1,587
Other	—	(1)
Net cash (used in) provided by investing activities	<u>(9,712)</u>	<u>1,530</u>
Cash Flows From Financing Activities		
Repayment of long-term debt	(120)	(43)
Repayment of capital lease obligation	(10)	(10)
Net proceeds from issuance of common stock	212	23
Repayment of notes receivables from stockholders	130	518
Net cash provided by financing activities	<u>212</u>	<u>488</u>
Effect of exchange rate differences on cash and cash equivalents	(16)	(6)
Net change in cash and cash equivalents	<u>(4,283)</u>	<u>1,661</u>
Cash and cash equivalents, beginning of period	<u>79,287</u>	<u>240</u>
Cash and cash equivalents, end of period	<u>\$ 75,004</u>	<u>\$ 1,901</u>
Supplemental disclosure of cash flow information		
Cash paid for interest	<u>\$ 14</u>	<u>\$ 19</u>
Cash paid for income taxes	<u>\$ 3,159</u>	<u>\$ 2,275</u>
Supplemental disclosure of non-cash transactions		
Issuance of common stock in exchange for notes receivable from stockholders	<u>\$ —</u>	<u>\$ 19</u>

See accompanying notes to unaudited Condensed Consolidated Financial Statements.

ENERGY RECOVERY, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Note 1 — The Company and Summary of Significant Accounting Policies

The Company

Energy Recovery, Inc. (“the Company” or “ERI”) develops, manufactures and sells high-efficiency energy recovery devices for use in seawater desalination. Our products are sold under the trademarks ERI®, PX®, Pressure Exchanger® and PX Pressure Exchanger®. They make desalination affordable by recycling up to 98% of the otherwise lost pressure energy from the reject stream of the desalination process. Our products are developed and manufactured in the United States of America (“U.S.”) at ERI’s headquarters located in San Leandro, California. The Company has direct sales offices and technical support centers in Madrid, Dubai, Shanghai and Fort Lauderdale.

The Company was incorporated in Virginia in April 1992 and reincorporated in Delaware in March 2001. 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. ERI became a public company in July 2008.

Use of Estimates

The preparation of condensed 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.

Basis of Presentation

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

The accompanying Condensed Consolidated Financial Statements have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”). Certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. GAAP have been condensed or omitted pursuant to such rules and regulations. The December 31, 2008 Condensed Consolidated Balance Sheet was derived from audited financial statements, but does not include all disclosures required by U.S. GAAP; however, the Company believes that the disclosures are adequate to make the information presented not misleading. Certain prior period amounts have been reclassified to conform to the current period presentation. These unaudited Condensed Consolidated Financial Statements should be read in conjunction with the audited Consolidated Financial Statements and the notes thereto for the fiscal year ended December 31, 2008 included in the Company’s Annual Report on Form 10-K filed with the SEC on March 27, 2009.

In the opinion of management, all adjustments, consisting of only normal recurring adjustments, which are necessary to present fairly the financial position, results of operations and cash flows for the interim periods, have been made. The results of operations for the interim periods are not necessarily indicative of the operating results for the full fiscal year or any future periods.

Recent Accounting Pronouncements

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS 157”) which defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. SFAS No. 157 was effective January 1, 2008 for financial assets and liabilities and January 1, 2009 for non-financial assets and liabilities. The adoption of SFAS No. 157 did not have an effect on the Company’s financial position or results of operations.

Table of Contents

As of March 31, 2009, the Company's financial assets measured at fair value on a consistent basis consist of cash, cash equivalents, and restricted cash, which are valued using market prices in active markets (level 1). Level 1 instrument valuations are obtained from real-time quotes for transactions in active exchange markets involving identical assets.

No other new accounting pronouncement issued or effective during the period had or is expected to have a material impact on the consolidated financial statements.

Note 2 — 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):

	Three Months Ended March 31,	
	2009	2008
Numerator:		
Net income	\$ 1,554	\$ 947
Denominator:		
Weighted average common shares outstanding	50,052	39,804
Effect of dilutive securities:		
Nonvested shares	—	3
Stock options	617	530
Warrants	1,911	1,859
Total shares for purpose of calculating diluted net income per share	52,580	42,196
Earnings per share:		
Basic	\$ 0.03	\$ 0.02
Diluted	\$ 0.03	\$ 0.02

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):

	Three Months Ended March 31,	
	2009	2008
Stock options	1,262	213

Note 3 — Balance Sheet Details

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 and an outstanding equipment promissory note. The standby letters of credit are collateralized by either a line of credit (see Note 4) or restricted cash. At March 31, 2009 and December 31, 2008, the amount of irrevocable standby letters of credit collateralized by restricted cash was \$8.5 million and \$265,000, respectively. At March 31, 2009, restricted cash of \$0.5 million secured the promissory note. The Company has deposited a corresponding amount into non-interest bearing accounts.

Inventories

Inventories consisted of the following (in thousands):

	March 31,	December 31,
	2009	2008
Raw materials	\$ 4,366	\$ 2,894
Work in process	558	139
Finished goods	5,156	5,460
	\$ 10,080	\$ 8,493

Table of Contents

Property and Equipment

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

	<u>March 31,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
Machinery and equipment	\$ 2,571	\$ 2,434
Office equipment, furniture, and fixtures	1,032	772
Automobiles	22	22
Software	268	208
Leasehold improvements	657	466
Construction in progress	286	—
	<u>4,836</u>	<u>3,902</u>
Less: accumulated depreciation and amortization	<u>(2,231)</u>	<u>(2,057)</u>
	<u>\$ 2,605</u>	<u>\$ 1,845</u>

Accrued Expenses and Other Current Liabilities

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

	<u>March 31,</u> <u>2009</u>	<u>December 31,</u> <u>2008</u>
Accrued payroll and commission expenses	\$ 2,679	\$ 2,929
Professional fees	481	193
Inventory in transit	473	251
Collaboration fees	58	916
Other accrued expenses and current liabilities	452	498
	<u>\$ 4,143</u>	<u>\$ 4,787</u>

Note 4 — Long-Term Debt

Promissory Notes

In February 2009, the Company paid the outstanding balance of a fixed promissory note for a total of \$83,000, including accrued interest.

As of March 31, 2009, long term debt consisted of one equipment promissory note payable. Future minimum principal payments due under this long-term debt arrangement consists of the following (in thousands):

	<u>March 31,</u> <u>2009</u>
2009 (remaining nine months)	\$ 96
2010	128
2011	128
2012	85
	<u>\$ 437</u>

Credit Agreements

In February 2009, the Company terminated a March 2008 credit agreement with a financial institution. 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 its termination and as collateral for the outstanding equipment promissory note.

[Table of Contents](#)

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of \$15.0 million. Under the 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 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. As of March 31, 2009, the Company was in compliance with these covenants.

During the periods presented, the Company provided certain customers with irrevocable standby letters of credit to secure its obligations for the delivery of products and performance guarantees in accordance with sales arrangements. These letters of credit were issued under the Company's credit line and generally terminate within 12 to 24 months and, in some instances, up to 36 months from issuance. At March 31, 2009 and December 31, 2008, the amounts outstanding on the letters of credit collateralized by the Company's credit line totaled approximately \$2.0 million and \$8.4 million, respectively.

Note 5 — Income Taxes

The Company's effective tax rate for the three months ended March 31, 2009 and 2008 was 38% and 39%, respectively. These effective tax rates differ from the U.S. statutory rate principally due to the effect of state income taxes and non-deductible stock based compensation, offset by deductions and credits related to manufacturing and research and development, respectively.

There have been no material changes to the Company's income tax position during the three months ended March 31, 2009.

Note 6 — 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):

	March 31, 2009
2009 (remaining nine months)	\$ 902
2010	1,340
2011	1,156
2012	1,127
2013	1,155
Thereafter	6,995
	<u>\$ 12,675</u>

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 the remaining nine months of 2009.

Warranty

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 following table summarizes the activity related to the product warranty liability during the three months ended March 31, 2009 and 2008 (in thousands):

	Three Months Ended March 31,	
	2009	2008
Balance at beginning of period	\$ 270	\$ 868
Warranty costs charged to cost of revenue	28	87
Utilization of warranty	(2)	(9)
Balance at end of period	<u>\$ 296</u>	<u>\$ 946</u>

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.

As of March 31, 2009, the Company had entered into purchase commitments with several vendors for the purchase of ceramics manufacturing equipment. If the orders are canceled, the Company is generally obligated to pay up to 30% of the original purchase order or the total costs incurred by the vendor through the date of cancellation, whichever is greater. As of March 31, 2009, the Company had approximately \$1.3 million of these open purchase commitments.

In addition, the Company had purchase order arrangements related to various key raw materials and components parts with several vendors for which it had not received the related goods or services as of March 31, 2009. 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. As of March 31, 2009, the Company had approximately \$6.2 million of these open 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 March 31, 2009 and December 31, 2008.

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 3). 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 corresponding underlying product warranty period.

Employee Agreements

The Company has an agreement with its chief executive officer governing the terms of his employment. The agreement expires in December 2009.

Litigation

The Company is not currently a 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 7 — Stockholders' Equity

Stock Option Plans

The following table summarizes the stock option activity under the Company's stock option plans for the three months ended March 31, 2009:

	Options Outstanding			
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value (in thousands)(1)
Balance at December 31, 2008	2,531,986	\$ 5.48	8.6	\$ 6,593
Options granted	600	6.84	—	—
Options exercised	(105,368)	2.00	—	—
Options forfeited	(112,188)	5.81	—	—
Balance at March 31, 2009	<u>2,315,030</u>	5.62	8.4	\$ 5,776
Vested and exercisable as of March 31, 2009	<u>678,925</u>	\$ 2.11	7.2	\$ 3,724

(1) The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying options and the fair market value of the Company’s stock as of March 31, 2009 of \$7.60 per share. The aggregate intrinsic value excludes the effect of stock options that have a zero or negative intrinsic value.

Pursuant to Section 3.2 of the Company’s 2008 Equity Incentive Plan (“2008 Plan”), an additional 2,500,000 shares have automatically been reserved for issuance under the 2008 Plan during the first quarter of 2009. Including 43,187 options forfeited or canceled under the 2008 Plan during the first quarter of 2009, total shares available for issuance under the Company’s stock option plans as of March 31, 2009 is 2,689,036. Options forfeited or canceled under prior stock option plans are not made available for issuance due to the cancellation of those plans by the Company in July 2008.

In April 2009, the Company granted an additional 1,190,000 options to various officers and directors. The options vest over a four year period.

Share-based Compensation Expense

For the three months ended March 31, 2009 and 2008, the Company recognized share-based compensation expense related to employees and consultants as follows (in thousands):

	Three Months Ended March 31,	
	2009	2008 (1)
Cost of revenue	\$ 24	\$ 24
General and administrative	92	90
Sales and marketing	60	74
Research and development	19	33
	<u>\$ 195</u>	<u>\$ 221</u>

(1) Share-based compensation expense for the three months ended March 31, 2008 included \$135,000 related to employee share-based compensation arrangements accounted for in accordance with the provisions of Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”).

Note 8 — 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.

Table of Contents

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 the Company's 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):

	Three Months Ended	
	March 31,	
	2009	2008
Domestic revenue	\$ 709	\$ 721
International revenue	11,937	8,399
Total revenue	<u>\$ 12,646</u>	<u>\$ 9,120</u>
Revenue by country:		
Israel	54%	—%
Australia	14	—
Algeria	*	49
Others	32	51
Total	<u>100%</u>	<u>100%</u>

* Less than 1%.

Note 9 — Concentrations

Two customers accounted for approximately 55% of the Company's accounts receivable at March 31, 2009. As of December 31, 2008, five customers accounted for approximately 81% of accounts receivable.

Revenue from customers representing 10% or more of net revenue varies from period to period. For the three months ended March 31, 2009, IDE Technologies, Ltd. accounted for approximately 66% of the Company's net revenue. For the three months ended March 31, 2008, Geida, a consortium of Befesa Agua, Cobra-Tedagua, and Sadyt S.A., accounted for approximately 49% of the Company's net revenue. No other customer accounted for more than 10% of the Company's net revenue during any of these periods.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion contains 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 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 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; and*
- *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*

All forward-looking statements included in this document are subject to additional risks and uncertainties further discussed under "Part II, Item 1A: Risk Factors" and are based on information available to us as of May 8, 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 "Part II, Item 1A: Risk Factors," and our results disclosed from time to time in our reports on Forms 10-K, 10-Q and 8-K and our Annual Reports to Stockholders.

The following should be read in conjunction with the condensed financial statements and related notes included in "Part I, Item 1: Financial Statements" of this quarterly report and the consolidated financial statements and related notes included in our Annual Report on Form 10-K as filed on March 27, 2009.

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 March 31, 2009, we had shipped approximately 6,400 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.

[Table of Contents](#)

A limited number of our customers accounts for a substantial portion of our accounts receivables and net revenue. As of March 31, 2009, two customers accounted for approximately 55% of our accounts receivable.

Revenue from customers representing 10% or more of total revenue varies from year to year. For the three months ended March 31, 2009, one customer, IDE Technologies Ltd., accounted for approximately 66% of our net revenue. For the three months ended March 31, 2008, one customer, Geida, represented approximately 49% of our net revenue.

During the three months ended March 31, 2009 and 2008, 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.

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.

First Quarter of 2009 Compared to First Quarter of 2008

Results of Operations

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

	Three Months Ended March 31,					
	2009		2008		Change	
Results of Operations:*						
Net revenue	\$ 12,646	100.0%	\$ 9,120	100.0%	\$ 3,526	39%
Cost of revenue	4,573	36.2%	3,674	40.3%	899	24%
Gross profit	8,073	63.8%	5,446	59.7%	2,627	48%
Operating expenses:						
General and administrative	3,154	24.9%	2,661	29.2%	493	19%
Sales and marketing	1,510	11.9%	1,343	14.7%	167	12%
Research and development	804	6.4%	509	5.6%	295	58%
Total operating expenses	5,468	43.2%	4,513	49.5%	955	21%
Income from operations	2,605	20.6%	933	10.2%	1,672	179%
Other income (expense):						
Interest expense	(14)	(0.1)%	(21)	(0.2)%	7	(33)%
Interest income and other income (expense)	(88)	(0.7)%	647	7.1%	(735)	(114)%
Income before provision for income taxes	2,503	19.8%	1,559	17.1%	944	61%
Provision for income taxes	949	7.5%	612	6.7%	337	55%
Net income	<u>\$ 1,554</u>	12.3%	<u>\$ 947</u>	10.4%	<u>\$ 607</u>	64%

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

Table of Contents

Our net revenue increased by \$3.5 million, or 39%, to \$12.6 million for the three months ended March 31, 2009 from \$9.1 million for the three months ended March 31, 2008. This increase was primarily due to higher sales of our PX-220 device and the recently 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. To a lesser degree, the increase in net revenue was partially contributable to an increase in the average unit selling price in the first quarter of 2009 compared to the first quarter of 2008.

For the three months ended March 31, 2009, the sales of PX devices accounted for approximately 93% of our revenue, pump sales accounted for approximately 3% and spare parts and service accounted for 4%. For the three months ended March 31, 2008, the sales of PX devices accounted for approximately 91% of revenue, pump sales accounted for approximately 6%, and spare parts and service accounted for 3%.

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.

	Three Months Ended March 31,	
	2009	2008
Domestic revenue	\$ 709	\$ 721
International revenue	11,937	8,399
Total revenue	<u>\$ 12,646</u>	<u>\$ 9,120</u>
Revenue by country:		
Israel	54%	—%
Australia	14	—
Algeria	*	49
Others	32	51
Total	<u>100%</u>	<u>100%</u>

* 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, primarily ceramic materials, which we obtain from multiple suppliers. For the three months ended March 31, 2009, gross profit as a percentage of net revenue was 63.8%, as compared to 59.7% for the three months ended March 31, 2008. The increase of 4.1% in gross margin as a percentage of revenue was primarily due to an increase in the average sales price per unit as well as a decrease in the average cost per unit in the first quarter of 2009 compared to the first quarter of 2008.

Stock compensation expense included in cost of revenue was \$24,000 for the three months ended March 31, 2009 and March 31, 2008.

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 \$493,000, or 19%, to \$3.2 million for the three months ended March 31, 2009 from \$2.7 million for the three months ended March 31, 2008. As a percentage of net revenue, general and administrative expense was 25% for the three months ended March 31, 2009 and 29% for the three months ended March 31, 2008. 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. General and administrative employees increased to 33 at March 31, 2009 from 17 at March 31, 2008.

Table of Contents

Of the \$493,000 increase in general and administrative expense, increases of \$834,000 related to compensation and employee-related benefits and \$58,000 related to occupancy and other administrative costs were partially offset by decreases of \$283,000 related to professional services and \$116,000 related to Value Added Taxes (VAT). Stock-based compensation expense included in general and administrative expense was \$92,000 for the three months ended March 31, 2009 and \$90,000 for the three months ended March 31, 2008.

Sales and Marketing Expense

Sales and marketing expense increased by \$167,000, or 12%, to \$1.5 million for the three months ended March 31, 2009 from \$1.3 million for the three months ended March 31, 2008. This increase was primarily related to growth in our sales that resulted in higher headcount with sales and marketing employees increasing to 20 at March 31, 2009 from 16 at March 31, 2008. 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 12% for the three months ended March 31, 2009 from 15% for the three months ended March 31, 2008. The decrease in 2009 was attributable primarily to the increase in our net revenue that period, which grew at a greater rate than our sales and marketing expense.

Of the \$167,000 net increase in sales and marketing expense for the three months ended March 31, 2009, \$273,000 related to compensation, employee-related benefits and commissions to outside sales representatives and \$32,000 related to occupancy and other administrative costs. The increases were partially offset by a decrease of \$138,000 related to other sales and marketing costs. Stock-based compensation expense included in sales and marketing expense was \$60,000 for the three months ended March 31, 2009 and \$74,000 for the three months ended March 31, 2008.

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 \$295,000, or 58%, to \$804,000 for the three months ended March 31, 2009 from \$509,000 for the three months ended March 31, 2008. Of the \$295,000 increase, compensation and employee-related benefits accounted for \$138,000, research and development direct project costs accounted for \$120,000, consulting and professional service fees accounted for \$34,000, and occupancy and other miscellaneous costs accounted for \$3,000.

Headcount in our research and development department increased to 10 at March 31, 2009 from eight at March 31, 2008. Stock-based compensation expense included in research and development expense was \$19,000 for three months ended March 31, 2009 and \$33,000 for the three months ended March 31, 2008.

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) changed unfavorably by (\$728,000) to (\$102,000) for the three months ended March 31, 2009 from \$626,000 for the three months ended March 31, 2008. The change was primarily due to a reduction in foreign currency denominated contracts and unfavorable changes in foreign currency rates, resulting in net foreign currency transaction losses of (\$134,000) for the three months ended March 31, 2009 compared to net foreign currency transaction gains of \$619,000 for the three months ended March 31, 2008. The unfavorable change in other net income (expense) was slightly offset by an increase in interest earnings of \$18,000 resulting from IPO net proceeds of \$76.7 million received in July 2008 and by a decrease in net interest expense of \$7,000.

Liquidity and Capital Resources

Overview

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 \$83.5 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 March 31, 2009, our principal sources of liquidity consisted of cash and cash equivalents of \$75.0 million, which are invested primarily in money market funds, and accounts receivable of \$11.6 million.

In February 2009, we terminated a March 2008 credit agreement with a financial institution. As a result, we 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 its termination and collateral for the outstanding equipment promissory note.

Upon the termination of the credit agreement, a new loan and security agreement with another financial institution became effective. The new agreement provides a total available credit line of \$15.0 million. Under the new agreement, we are 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 agreement expires on December 31, 2009 and is collateralized by substantially all of the company's assets. As of March 31, 2009, we were in compliance with all financial and administrative covenants under this new agreement.

During the periods presented, we provided certain customers with irrevocable standby letters of credit to secure our obligations for the delivery of products and performance guarantees in accordance with sales arrangements. These letters of credit were issued largely under the our revolving note credit facility. The letters of credit generally terminate within 12 to 36 months, and in some cases up to 65 months from issuance. At March 31, 2009, the amounts outstanding on the letters of credit totaled approximately \$10.2 million of which \$2.0 million were issued and collateralized under our credit agreement.

Cash Flows from Operating Activities

Net cash provided by (used in) operating activities was \$5.2 million and (\$351,000) for the three months ended March 31, 2009 and 2008, respectively. For the three months ended March 31, 2009 and 2008, cash provided by net income of \$1.6 million and \$947,000, respectively, was adjusted to \$1.7 million and \$757,000, 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 \$140,000 and (\$190,000), respectively. The net cash outflow effect from changes in assets and liabilities was \$3.5 million and \$(1.1) million for the three months ended March 31, 2009 and 2008, 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 and unbilled receivables as a result of timing of invoices and collections for large projects, changes in prepaid expenses and accrued liabilities as a result of the timing of payments to employees, vendors and other third parties, and changes in deferred revenue as a result of timing of advance billings and product deliveries.

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 (used in) provided by investing activities was \$(9.7) million and \$1.5 million for three months ended March 31, 2009 and 2008, respectively. The change to net cash used in investing activities from net cash provided by investing activities was primarily attributable to an increase in restricted cash of \$8.8 million during the first quarter of 2009 compared to the release of restricted cash of \$1.6 million during the first quarter of 2008. The remaining portion of the net cash used resulted from an increase in purchases of property and equipment of \$877,000 during the first quarter of 2009 compared to the first quarter of 2008.

[Table of Contents](#)

Cash Flows from Financing Activities

Net cash provided by financing activities decreased \$276,000 to \$212,000 for the three months ended March 31, 2009 from \$488,000 for the three months ended March 31, 2008. The decrease in cash flows from financing activities is primarily attributable to a decrease in the receipt of repayments of promissory notes by stockholders of (\$388,000) and an increase in the repayment of long term debt of (\$77,000) during the three months ended March 31, 2009 versus the three months ended March 31, 2008. The decreases are partially offset by an increase in stock option exercises of \$189,000 during the first quarter of 2009 as compared to the first quarter of 2008.

Liquidity and Capital Resource Requirements

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. The future minimum lease payments under these leases as of March 31, 2009 is \$12.7 million. For additional information, see Note 6 — “Commitments and Contingencies” to the unaudited Condensed Consolidated Financial Statements.

Recently, we entered into purchase commitments with several vendors for the purchase of ceramics manufacturing equipment. If the orders are canceled, we are obligated to pay either 30% of the original purchase order or the total costs incurred by the vendor through the date of cancellation, whichever is greater. As of March 31, 2009, purchase commitments with these vendors totaled approximately \$1.3 million.

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 and we have the right to cancel the arrangements prior to the date of delivery. As of March 31, 2009, these open purchase order totaled approximately \$6.2 million.

We have agreements with guarantees or indemnity provisions that we have entered into with, among others, customers and OEMs in the ordinary course of business. Based on our experience and information known to us as of March 31, 2009, we believe that our exposure related to these guarantees and indemnities as of March 31, 2009 was not material.

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

See Note 1 — “The Company and Summary of Significant Accounting Policies” to the condensed consolidated financial statements regarding the impact of certain recent accounting pronouncements on our condensed consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

The information in this section should be read in connection with the information on financial market risk related to changes in non-U.S. currency exchange rates and interest rates in Part II, Item 7A, “Quantitative and Qualitative Disclosures About Market Risk,” in our Annual Report on Form 10-K for the year ended December 31, 2008. Our market risk profile has not changed significantly during the first three months of 2009.

[Table of Contents](#)

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.

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 primarily 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 \$75.0 million at March 31, 2009. 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 and cash equivalents. Declines in interest rates, however, would reduce future interest 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 4(T). Controls and Procedures.

Under the supervision and with the participation of our management, including the President and Chief Executive Officer and the Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that these disclosure controls and procedures are effective. There were no changes in our internal control over financial reporting during the quarter ended March 31, 2009 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II — OTHER INFORMATION

Item 1. Legal Proceedings

We are not currently a 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. However, in the future, we may be subject to legal proceedings in the ordinary course of business.

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 a high percentage 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 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.

[Table of Contents](#)

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. See “Note 9 — Concentrations” to the condensed consolidated financial statements regarding the impact of customer concentrations on our condensed consolidated financial statements. 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 March 31, 2009, we had approximately \$4.1 million of current unbilled receivables and approximately \$2.7 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. While new 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 new pricing structures. It is also possible that the release of new products 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 a limited number of 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.

[Table of Contents](#)

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 a limited number of 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 three months ended March 31, 2009, two ceramics suppliers represented approximately 57% of our purchases from all 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

Table of Contents

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 offer competing energy recovery solutions. If any of these companies produce superior technology or offer 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 (recently acquired by Flowsolve Corporation), 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 company, 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;

Table of Contents

- 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

[Table of Contents](#)

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 13% of our outstanding common stock as of April 15, 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;

Table of Contents

- 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 2. Unregistered Sales of Equity Securities and Use of Proceeds

(a) Sales of Unregistered Securities

None.

(b) Use of Proceeds from Public Offering of Common Stock

On July 1, 2008, our registration statement (No. 333-150007) on Form S-1 was declared effective for our initial public offering, or IPO, 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. In the first quarter of 2009, we pledged \$9.1 million of the net proceeds as collateral to facilitate the early termination of a credit facility with a financial institution. 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 March 31, 2009. 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).

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

None.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

None.

Item 5. Other Information

None.

Item 6. Exhibits

Exhibit No.	Description
10.19	Loan and Security Agreement dated January 7, 2009, between the Company and Citibank, N.A.
10.20	Pledge and Security Agreement dated February 17, 2009, between the Company and Comerica Bank.
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	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

Registrant: Energy Recovery, Inc.

By:

<u> /s/ G. G. PIQUE </u> G. G. Pique	President and Chief Executive Officer (Principal Executive Officer)	May 8, 2009
<u> /s/ THOMAS D. WILLARDSON </u> Thomas D. Willardson	Chief Financial Officer (Principal Financial Officer)	May 8, 2009

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LOAN AND SECURITY AGREEMENT

dated as of January 7, 2009

between

ENERGY RECOVERY, INC.,
a Delaware corporation,
as Borrower,

and

CITIBANK, N.A.,
as Lender

\$15,000,000

TABLE OF CONTENTS

		Page
SECTION 1	DEFINITIONS	1
1.1	Definitions	1
SECTION 2	LOAN; PAYMENT TERMS	11
2.1	Promise to Pay	11
2.2	Overadvances	12
2.3	Payment of Interest on the Loans	12
2.4	Fees	13
SECTION 3	CONDITIONS OF LOANS	13
3.1	Conditions Precedent to Initial Loan	13
3.2	Conditions Precedent to all Loans	14
3.3	Covenant to Deliver	14
3.4	Procedure for the Borrowing of Advances	15
3.5	Special Provisions Governing LIBOR Advances	15
3.6	Additional Requirements/Provisions Regarding LIBOR Advances	16
3.7	Conversion and Continuation Elections	17
SECTION 4	CREATION OF SECURITY INTEREST	18
4.1	Grant of Security Interest	18
4.2	Authorization to File Financing Statements	19
SECTION 5	REPRESENTATIONS AND WARRANTIES	19
5.1	Due Organization, Authorization; Power and Authority	19
5.2	Collateral	19
5.3	Litigation	20
5.4	No Material Deviation in Financial Statements	20
5.5	Solvency	20
5.6	Regulatory Compliance	20
5.7	Subsidiaries; Investments	20
5.8	Tax Returns and Payments; Pension Contributions	20
5.9	Use of Proceeds	21
5.10	Full Disclosure	21
SECTION 6	AFFIRMATIVE COVENANTS	21
6.1	Government Compliance	21
6.2	Financial Statements, Reports, Certificates	21
6.3	Taxes; Pensions	22
6.4	Insurance	22
6.5	Operating Accounts	22
6.6	Financial Covenants	22
6.7	Protection and Registration of Intellectual Property Rights	23
6.8	Litigation Cooperation	23
6.9	Additional Costs	23
6.10	Subsidiaries	23
6.11	Further Assurances	23
SECTION 7	NEGATIVE COVENANTS	23
7.1	Dispositions	23

TABLE OF CONTENTS
(continued)

	Page	
7.2	Changes in Business; Change in Control; Jurisdiction of Formation	24
7.3	Mergers or Acquisitions	24
7.4	Indebtedness	24
7.5	Encumbrance	24
7.6	Distributions; Investments	24
7.7	Transactions with Affiliates	24
7.8	Subordinated Debt	24
7.9	Compliance	25
SECTION 8	EVENTS OF DEFAULT	25
8.1	Payment Default	25
8.2	Covenant Default	25
8.3	Material Adverse Change	25
8.4	Attachment	25
8.5	Insolvency	26
8.6	Other Agreements	26
8.7	Judgments	26
8.8	Misrepresentations	26
8.9	Subordinated Debt	26
8.10	Guaranty	26
SECTION 9	LENDER'S RIGHTS AND REMEDIES	26
9.1	Rights and Remedies	26
9.2	Power of Attorney	27
9.3	Protective Payments	27
9.4	Application of Payments and Proceeds	27
9.5	Lender's Liability for Collateral	28
9.6	No Waiver; Remedies Cumulative	28
9.7	Demand Waiver	28
SECTION 10	NOTICES	28
SECTION 11	CHOICE OF LAW, VENUE AND JURY TRIAL WAIVER	29
SECTION 12	GENERAL PROVISIONS	29
12.1	Successors and Assigns	29
12.2	Indemnification	29
12.3	Time of Essence	30
12.4	Severability of Provisions	30
12.5	Amendments in Writing; Integration	30
12.6	Counterparts	30
12.7	Survival	30
12.8	Confidentiality	30
12.9	Attorneys' Fees, Costs and Expenses	30

LOAN AND SECURITY AGREEMENT

This LOAN AND SECURITY AGREEMENT (this "*Agreement*") dated as of January 7, 2009 between Citibank, N.A. ("*Lender*"), and Energy Recovery, Inc., a Delaware corporation ("*Borrower*"), provides the terms on which Lender shall lend to Borrower and Borrower shall repay Lender. The parties agree as follows:

SECTION 1

DEFINITIONS

Accounting terms not defined in this Agreement shall be construed following GAAP. Calculations and determinations must be made following GAAP. Capitalized terms not otherwise defined in this Agreement shall have the meanings set forth in Section 1.1. All other terms contained in this Agreement, unless otherwise indicated, shall have the meaning provided by the Code to the extent such terms are defined therein.

1.1 *Definitions.* As used in this Agreement, the following terms have the following meanings:

"*Account*" is any "account" as defined in the Code with such additions to such term as may hereafter be made, and includes, without limitation, all accounts receivable and other sums owing to Borrower.

"*Account Debtor*" is any "account debtor" as defined in the Code with such additions to such term as may hereafter be made.

"*Advance*" or "*Advances*" means an advance (or advances) under the Revolving Line of Credit, including LIBOR Advances and Prime Rate Advances.

"*Affiliate*" of any Person is a Person that owns or controls directly or indirectly the Person, any Person that controls or is controlled by or is under common control with the Person, and each of that Person's senior executive officers, directors, partners and, for any Person that is a limited liability company, that Person's managers and members.

"*Agreement*" is defined in the preamble hereof.

"*Alternative Dispute Resolution Agreements*" means those certain Alternative Dispute Resolution Agreements to be executed by Borrower and by each Guarantor.

"*Base LIBOR*" means the rate per annum, determined by Lender in accordance with its customary procedures and utilizing such electronic or other quotation sources as it considers appropriate (rounded upwards, if necessary, to five decimal places where the sixth digit is five or more), at which Dollar deposits are offered in the London interbank market shortly after 11:00 a.m. (London time) two banking days prior to the commencement of the applicable Interest Period, for a term and in amounts comparable to the Interest Period and amount of the LIBOR Advance. If the Base LIBOR becomes unavailable during the term of this Agreement, Lender may designate a substitute index after notifying Borrower.

"*Borrower*" is defined in the preamble hereof.

"*Borrower's Books*" are all Borrower's books and records including ledgers, federal and state tax returns, records regarding Borrower's assets or liabilities, the Collateral, business operations or financial condition, and all computer programs or storage or any equipment containing such information.

"*Borrowing Resolutions*" are, with respect to any Person, those resolutions adopted by such Person's Board of Directors and delivered by such Person to Lender approving the Loan Documents to which such Person is a party and the transactions contemplated thereby, together with a certificate executed by its secretary (or other authorized officer) on behalf of such Person certifying that (a) such Person has the authority to execute, deliver, and perform its

obligations under each of the Loan Documents to which it is a party, (b) that attached as Exhibit A to such certificate is a true, correct, and complete copy of the resolutions then in full force and effect authorizing and ratifying the execution, delivery, and performance by such Person of the Loan Documents to which it is a party, (c) the name(s) of the Person(s) authorized to execute the Loan Documents on behalf of such Person, together with a sample of the true signature(s) of such Person(s), and (d) that Lender may conclusively rely on such certificate unless and until such Person shall have delivered to Lender a further certificate canceling or amending such prior certificate.

“*Business Day*” means any day that is not a Saturday, Sunday, or other day on which federally chartered banks are authorized or required to close, except that, if a determination of a Business Day shall relate to a LIBOR Advance, the term “Business Day” also shall exclude any day on which banks are closed for dealings in Dollar deposits in the London interbank market.

“*Cash Equivalents*” means (a) marketable direct obligations issued or unconditionally guaranteed by the United States or any agency or any State thereof having maturities of not more than one (1) year from the date of acquisition; (b) commercial paper maturing no more than one (1) year after its creation and having the highest rating from either Standard & Poor’s Ratings Group or Moody’s Investors Service, Inc.; (c) Lender’s certificates of deposit issued maturing no more than one (1) year after issue; and (d) money market funds at least ninety-five percent (95%) of the assets of which constitute Cash Equivalents of the kinds described in clauses (a) through (c) of this definition.

“*Cash Secured Letters of Credit*” means the aggregate face amount of the Permitted Comerica Letters of Credit plus the aggregate face amount of any other cash-secured letters of credit with Borrower or any of its Subsidiaries as the applicant.

“*Change in Control*” means any event, transaction, or occurrence as a result of which (a) any “person” (as such term is defined in Sections 3(a)(9) and 13(d)(3) of the Securities Exchange Act of 1934, as amended (the “*Exchange Act*”), other than a trustee or other fiduciary holding securities under an employee benefit plan of Borrower, is or becomes a beneficial owner (within the meaning Rule 13d-3 promulgated under the Exchange Act), directly or indirectly, of securities of Borrower, representing twenty-five percent (25%) or more of the combined voting power of Borrower’s then outstanding securities; or (b) during any period of twelve consecutive calendar months, individuals who at the beginning of such period constituted the Board of Directors of Borrower (together with any new directors whose election by the Board of Directors of Borrower was approved by a vote of at least two-thirds of the directors then still in office who either were directors at the beginning of such period or whose election or nomination for election was previously so approved) cease for any reason other than death or disability to constitute a majority of the directors then in office. Notwithstanding the foregoing, a “Change in Control” will not be deemed to have occurred by reason of (x) the appointment of two additional members to Borrower’s Board of Directors, consistent with Borrower’s bylaws as in effect on the date hereof, or (y) the shareholders of Borrower as of the date hereof sell securities of Borrower that collectively represent up to 50% of the combined voting power of Borrower’s then outstanding securities, provided that no purchaser of such securities acquires beneficial ownership (as broadly defined under Rule 13d-3 under the Exchange Act) of 25% or more of the combined voting power of Borrower’s then outstanding securities.

“*Code*” is the Uniform Commercial Code, as the same may, from time to time, be enacted and in effect in the State of California; provided, that, to the extent that the Code is used to define any term herein or in any Loan Document and such term is defined differently in different Articles or Divisions of the Code, the definition of such term contained in Article or Division 9 shall govern; provided further, that in the event that, by reason of mandatory provisions of law, any or all of the attachment, perfection, or priority of, or remedies with respect to, Lender’s Lien on any Collateral is governed by the Uniform Commercial Code in effect in a jurisdiction other than the State of California, the term “*Code*” shall mean the Uniform Commercial Code as enacted and in effect in such other jurisdiction solely for purposes on the provisions thereof relating to such attachment, perfection, priority, or remedies and for purposes of definitions relating to such provisions.

“*Collateral*” is any and all properties, rights and assets of Borrower described on Exhibit A.

“*Comerica Control Agreement*” means the Pledge and Security Agreement with respect to the pledge of cash in an account at Comerica Bank to secure the Permitted Comerica Letters of Credit, executed by Borrower in favor of Comerica Bank and acknowledged and approved by Comerica Bank and Citibank, N.A.

“*Communication*” is defined in Section 10.

“*Compliance Certificate*” is that certain certificate in the form attached hereto as Exhibit D.

“*Contingent Obligation*” is, for any Person, any direct or indirect liability, contingent or not, of that Person for (a) any indebtedness, lease, dividend, letter of credit or other obligation of another such as an obligation directly or indirectly guaranteed, endorsed, co-made, discounted or sold with recourse by that Person, or for which that Person is directly or indirectly liable; (b) any obligations for undrawn letters of credit for the account of that Person; and (c) all obligations from any interest rate, currency or commodity swap agreement, interest rate cap or collar agreement, or other agreement or arrangement designated to protect a Person against fluctuation in interest rates, currency exchange rates or commodity prices; but “*Contingent Obligation*” does not include endorsements in the ordinary course of business. The amount of a Contingent Obligation is the stated or determined amount of the primary obligation for which the Contingent Obligation is made or, if not determinable, the maximum reasonably anticipated liability for it determined by the Person in good faith; but the amount may not exceed the maximum of the obligations under any guarantee or other support arrangement.

“*Continuation Date*” means any date on which Borrower elects or is deemed to have elected to continue a LIBOR Advance into another Interest Period.

“*Control Agreement*” is any control agreement entered into between the depository institution at which Borrower maintains a Deposit Account, and between Borrower and Lender, pursuant to which Lender obtains control (within the meaning of the Code) over such Deposit Account.

“*Conversion Date*” means any date on which Borrower elects to convert a Prime Rate Advance to a LIBOR Advance or a LIBOR Advance to a Prime Rate Advance.

“*Credit Party*” means Borrower and each of Borrower’s Subsidiaries.

“*Current Assets*” are amounts that under GAAP should be included on that date as current assets on Borrower’s consolidated balance sheet, less (without duplication) the amount of Borrower’s prepaid expenses.

“*Current Liabilities*” are all obligations and liabilities of Borrower to Lender, plus, without duplication, (i) the amount of all letters of credit outstanding at any one time with Borrower or any of its Subsidiaries as the applicant, including Letters of Credit issued hereunder (including the drawn and unreimbursed amounts of all such letters of credit) and (ii) the aggregate amount of Borrower’s Total Liabilities that mature within one (1) year.

“*Default Rate*” is defined in Section 2.3(b).

“*Deposit Account*” is any “deposit account” as defined in the Code with such additions to such term as may hereafter be made.

“*Designated Deposit Account*” is Borrower’s deposit account, account number [***], maintained with Lender.

“*Diligence Certificate*” is defined in Section 5.1.

“*Diligence Review*” is Lender’s inspection of Borrower’s current consolidated financial statements and financial projections, accounts receivable agings and inventory report.

“*Dollar(s) or \$*” means United States dollars.

“*Effective Amount*” means with respect to any Advances on any date, the aggregate outstanding principal amount thereof after giving effect to any borrowing and prepayments or repayments thereof occurring on such date.

“*Encumbered Cash*” means cash and Cash Equivalents, if any, that have been pledged as collateral to Comerica Bank under the Comerica Control Agreement.

“*Energy International*” means Energy Recovery, Inc. International, a Delaware corporation and a wholly-owned subsidiary of Borrower.

“*Equipment*” is all “equipment” as defined in the Code with such additions to such term as may hereafter be made, and includes without limitation all machinery, fixtures, goods, vehicles (including motor vehicles and trailers), and any interest in any of the foregoing.

“*ERISA*” is the Employee Retirement Income Security Act of 1974, and its regulations.

“*Event of Default*” is defined in Section 8.

“*Foreign Currency*” means lawful money of a country other than the United States of America.

“*Funding Date*” is any date on which a Loan is made to or on account of Borrower which shall be a Business Day.

“*GAAP*” is generally accepted accounting principles set forth in the opinions and pronouncements of the Accounting Principles Board of the American Institute of Certified Public Accountants and statements and pronouncements of the Financial Accounting Standards Board or in such other statements by such other Person as may be approved by a significant segment of the accounting profession, which are applicable to the circumstances as of the date of determination.

“*General Intangibles*” is all “general intangibles” as defined in the Code in effect on the date hereof with such additions to such term as may hereafter be made, and includes without limitation, all copyright rights, copyright applications, copyright registrations and like protections in each work of authorship and derivative work, whether published or unpublished, any patents, trademarks, service marks and, to the extent permitted under applicable law, any applications therefor, whether registered or not, any trade secret rights, including any rights to unpatented inventions, payment intangibles, royalties, contract rights, goodwill, franchise agreements, purchase orders, customer lists, route lists, telephone numbers, domain names, claims, income and other tax refunds, security and other deposits, options to purchase or sell real or personal property, rights in all litigation presently or hereafter pending (whether in contract, tort or otherwise), insurance policies (including without limitation key man, property damage, and business interruption insurance), payments of insurance and rights to payment of any kind.

“*Governmental Approval*” is any consent, authorization, approval, order, license, franchise, permit, certificate, accreditation, registration, filing or notice, of, issued by, from or to, or other act by or in respect of, any Governmental Authority.

“*Governmental Authority*” is any nation or government, any state or other political subdivision thereof, any agency, authority, instrumentality, regulatory body, court, central bank or other entity exercising executive, legislative, judicial, taxing, regulatory or administrative functions of or pertaining to government, any securities exchange and any self-regulatory organization.

“*Guarantor*” is any present or future guarantor of the Obligations, including Osmotic Power and Energy International.

“*Indebtedness*” is (a) indebtedness for borrowed money or the deferred price of property or services, such as reimbursement and other obligations for surety bonds and letters of credit, (b) obligations evidenced by notes, bonds, debentures or similar instruments, (c) capital lease obligations, and (d) Contingent Obligations.

"Index" means an interest rate which is subject to change from time to time based on changes in an independent index, which is The Wall Street Journal Prime Rate. The Index is not necessarily the lowest rate charged by Lender on its loans. If the Index becomes unavailable during the term of this Agreement, Lender may designate a substitute index after notifying Borrower. Lender will tell Borrower the current Index rate upon Borrower's request. The interest rate change will not occur more often than each day. Borrower understands that Lender may make loans based on other rates as well. **The Index currently is 3.25%.** The interest rate to be applied to the unreimbursed amount of drawn Letters of Credit will be at a rate of 3.00 percentage points over the Index, resulting in an initial rate of 6.25%. **NOTICE:** Under no circumstances will the effective rate of interest under this Agreement be more than the maximum rate allowed by applicable law.

"Insolvency Proceeding" is any proceeding by or against any Person under the United States Bankruptcy Code, or any other bankruptcy or insolvency law, including assignments for the benefit of creditors, compositions, extensions generally with its creditors, or proceedings seeking reorganization, arrangement, or other relief.

"Interest Expense" means for any fiscal period, interest expense (whether cash or non-cash) determined in accordance with GAAP for the relevant period ending on such date, including, in any event, interest expense with respect to any Loan and other Indebtedness of Borrower and its Subsidiaries, including, without limitation or duplication, all commissions, discounts, or related amortization and other fees and charges with respect to letters of credit and bankers' acceptance financing and the net costs associated with interest rate swap, cap, and similar arrangements, and the interest portion of any deferred payment obligation (including leases of all types).

"Interest Payment Date" means, with respect to any LIBOR Advance, the last day of each Interest Period applicable to such LIBOR Advance and, with respect to Prime Rate Advances, the first (1st) day of each month (or, if the first day of the month does not fall on a Business Day, then on the first Business Day following such date), and each date a Prime Rate Advance is converted into a LIBOR Advance to the extent of the amount converted to a LIBOR Advance.

"Interest Period" means, with respect to each LIBOR Advance, a period commencing on the date of the making of such LIBOR Advance and ending 1, 2, 3, or 6 months thereafter, in each case as Borrower may elect in the applicable Notice of Borrowing or Notice of Conversion/Continuation or as Borrower may be deemed to have elected; provided, however, that (a) if any Interest Period would end on a day that is not a Business Day, such Interest Period shall be extended (subject to clauses (c) and (d) below) to the next succeeding Business Day, (b) interest shall accrue at the applicable rate based upon the LIBOR Rate from and including the first day of each Interest Period to, but excluding, the day on which any Interest Period expires, (c) with respect to an Interest Period that begins on the last Business Day of a calendar month (or on a day for which there is no numerically corresponding day in the calendar month at the end of such Interest Period), the Interest Period shall end on the last Business Day of the calendar month that is 1, 2, 3 or 6 months after the date on which the Interest Period began, as applicable, and (d) Borrower may not elect an Interest Period which will end after the Revolving Line Maturity Date.

"Interest Rate Determination Date" means each date for calculating the LIBOR Rate for purposes of determining the interest rate in respect of an Interest Period. The Interest Rate Determination Date shall be the second Business Day prior to the first day of the related Interest Period for a LIBOR Advance.

"Inventory" is all "inventory" as defined in the Code in effect on the date hereof with such additions to such term as may hereafter be made, and includes without limitation all merchandise, raw materials, parts, supplies, packing and shipping materials, work in process and finished products, including without limitation such inventory as is temporarily out of Borrower's custody or possession or in transit and including any returned goods and any documents of title representing any of the above.

"Investment" is any beneficial ownership interest in any Person (including stock, partnership interest or other securities), and any loan, advance or capital contribution to any Person.

"Lender" is defined in the preamble hereof.

"*Lender Expenses*" are all audit fees and expenses, costs, and expenses (including reasonable attorneys' fees and expenses) for preparing, amending, negotiating, defending and enforcing the Loan Documents (including, without limitation, those incurred in connection with appeals or Insolvency Proceedings) or otherwise incurred with respect to Borrower.

"*Letter of Credit*" means a standby letter of credit issued by Lender or another institution based upon an application, guarantee, indemnity, warranty or similar agreement on the part of Lender as set forth in Section 2.1.2, which definition specifically excludes the Permitted Comerica Letters of Credit.

"*Letter of Credit Application*" is defined in Section 2.1.2(a).

"*Letter of Credit Availability Amount*" means (i) Fourteen Million Eight Hundred Fifty Thousand Dollars (\$14,850,000) minus (ii) the outstanding principal amount of all Advances minus (iii) the face amount of all outstanding Letters of Credit (including drawn but unreimbursed Letters of Credit).

"*LIBOR Rate*" means, as of the date of determination thereof, the rate per annum determined as the sum of:

(a) the quotient of (i) Base LIBOR for the relevant Interest Period, **divided by** (ii) the number equal to one hundred percent (100%) **minus** the LIBOR Reserve Percentage as of such date; **plus**

(b) 1.3750 percentage points.

The LIBOR Rate shall be adjusted automatically on the effective date of any change in the LIBOR Reserve Percentage, such adjustment to affect any LIBOR Advance outstanding on such effective date. Each determination of a LIBOR Rate by Lender shall be conclusive and final in the absence of manifest error. NOTICE: Under no circumstances will the effective rate of interest under this Agreement be more than the maximum rate allowed by applicable law.

"*LIBOR Advance*" means each Advance that bears interest at the LIBOR Rate. The initial LIBOR Advance must be for a minimum of \$500,000 and in integral multiples of One Hundred Thousand Dollars (\$100,000) in excess thereof. Each subsequent LIBOR Advance must be in a minimum amount of One Hundred Thousand Dollars (\$100,000) and in integral multiples of One Hundred Thousand Dollars (\$100,000) in excess thereof.

"*LIBOR Reserve Percentage*" means, on any day, the maximum percentage prescribed by the Board of Governors of the Federal Reserve System (or any successor governmental authority) for determining the reserve requirements (including any basic, supplemental, marginal, or emergency reserves) that are in effect on such date with respect to eurocurrency funding (currently referred to as "eurocurrency liabilities") of Lender, but so long as Lender is not required or directed under applicable regulations to maintain such reserves, the LIBOR Reserve Percentage shall be zero.

"*Lien*" is a claim, mortgage, deed of trust, levy, charge, pledge, security interest or other encumbrance of any kind, whether voluntarily incurred or arising by operation of law or otherwise against any property.

"*Loan*" means each Advance, loan and financial accommodation from Lender to Borrower, whether now existing or hereafter arising and however evidenced, including those Advances, loans, Letters of Credit and financial accommodations described herein or described on any exhibit or schedule attached to this Agreement from time to time.

"*Loan Documents*" are, collectively, this Agreement, the Comerica Control Agreement, the Diligence Certificate, each Letter of Credit Application and Letter of Credit, the Alternative Dispute Resolution Agreements, the Notice of Insurance Requirements, Agreement to Provide Insurance, Authorized Signatories and MIFT Agreement, any note, or notes or guaranties or security agreement executed by Borrower or any Guarantor, and any other present or future agreement between Borrower any Guarantor and/or for the benefit of Lender in connection with this Agreement, all as amended, restated, or otherwise modified.

“*Material Adverse Change*” is (a) a material impairment in the perfection or priority of Lender’s Lien in the Collateral or in the value of such Collateral; (b) a material adverse change in the business, operations, or condition (financial or otherwise) of Borrower; or (c) a material impairment of the prospect of repayment of any portion of the Obligations.

“*Material Indebtedness*” is any Indebtedness the principal amount of which is equal to or greater than \$1,000,000.

“*Net Income*” means, as calculated on a consolidated basis for Borrower and its Subsidiaries for any period as at any date of determination, the net profit (or loss), after provision for taxes, of Borrower and its Subsidiaries for such period taken as a single accounting period.

“*Notice of Borrowing*” means a notice given by Borrower to Lender in accordance with Section 3.2(a), substantially in the form of Exhibit B, with appropriate insertions.

“*Notice of Conversion/Continuation*” means a notice given by Borrower to Lender in accordance with Section 3.5, substantially in the form of Exhibit C, with appropriate insertions.

“*Obligations*” are any Credit Party’s obligation to pay when due any debts, principal, interest, Lender Expenses and other amounts any Credit Party owes Lender now or later, whether under this Agreement or any other of the Loan Documents, or otherwise, including, without limitation, all obligations relating to letters of credit (including reimbursement obligations for drawn and undrawn letters of credit), deposit accounts, cash management services, and foreign exchange contracts, if any, and including interest accruing after Insolvency Proceedings begin and debts, liabilities, or obligations of any Credit Party assigned to Lender, and the performance of any Credit Party’s duties under the Loan Documents.

“*Organizational Documents*” are, for any Person, such Person’s formation documents, as certified with the Secretary of State of such Person’s state of formation on a date that is no earlier than 30 days prior to the date hereof, and, (a) if such Person is a corporation, its bylaws in current form, (b) if such Person is a limited liability company, its limited liability company agreement (or similar agreement), and (c) if such Person is a partnership, its partnership agreement (or similar agreement), each of the foregoing with all current amendments or modifications thereto.

“*Osmotic Power*” means Osmotic Power, Inc., a Delaware corporation and a wholly-owned subsidiary of Borrower.

“*Permitted Comerica Letters of Credit*” means the standby letters of credit issued by Comerica Bank described on Exhibit F hereto.

“*Permitted Distributions*” means:

- (a) distributions or dividends consisting solely of Borrower’s capital stock;
- (b) purchases of capital stock in connection with the exercise of stock options or stock appreciation rights by way of cashless exercise or in connection with the satisfaction of withholding tax obligations;
- (c) purchases of fractional shares of capital stock arising out of stock dividends, splits or combinations or business combinations;
- (d) distributions or dividends from Borrower’s Subsidiaries to Borrower or to any of Borrower’s Subsidiaries;

(e) purchases of capital stock of Borrower from officers, directors or employees of Borrower and its Subsidiaries under the terms of applicable purchase agreements in an aggregate amount of up to \$250,000 per year; and

(f) other purchases of capital stock of Borrower in the aggregate amount of up to \$5,000,000.

"Permitted Indebtedness" is:

(a) Permitted Comerica Letters of Credit;

(b) Borrower's Indebtedness to Lender under this Agreement and any other Loan Document;

(c) Subordinated Debt;

(d) unsecured Indebtedness to trade creditors incurred in the ordinary course of business;

(e) guaranties of Permitted Indebtedness;

(f) Indebtedness incurred as a result of endorsing negotiable instruments received in the ordinary course of business;

(g) Indebtedness between Borrower and any Guarantor;

(h) capitalized leases and purchase money Indebtedness not to exceed \$1,000,000 in the aggregate in any fiscal year secured by Permitted Liens;

(i) Indebtedness specifically disclosed to, and specifically approved by, Lender in writing on or prior to the date of this Agreement; and

(j) refinanced Permitted Indebtedness, provided that the amount of such Indebtedness is not increased except by an amount equal to a reasonable premium or other reasonable amount paid in connection with such refinancing and by an amount equal to any existing, but unutilized, commitment thereunder.

"Permitted Investments" are:

(a) Investments existing on the date hereof and specifically disclosed in writing to Lender;

(b) (i) marketable direct obligations issued or unconditionally guaranteed by the United States or its agencies maturing within 3 years from its acquisition, (ii) commercial paper maturing no more than 1 year after its creation and having the highest rating from either Standard & Poor's Corporation or Moody's Investors Service, Inc., and (iii) Lender's certificates of deposit maturing no more than 2 years after issue;

(c) Investments in or to Borrower or any Guarantor;

(d) Investments consisting of Deposit Accounts in the name of Borrower or any Guarantor so long as Lender has a first priority, perfected security interest in such Deposit Accounts;

(e) Investments consisting of extensions of credit to Borrower's or a Guarantor's customers in the nature of accounts receivable, prepaid royalties or notes receivable arising from the sale or lease of goods, provision of services or licensing activities of Borrower;

(f) Investments acquired in exchange for any other Investments in connection with or as a result of a bankruptcy, workout, reorganization or recapitalization;

- (g) Investments acquired as a result of a foreclosure with respect to any secured Investment; and
- (h) other Investments, if, on the date of incurring any Investments pursuant to this clause (h), the outstanding aggregate amount of all Investments incurred pursuant to this clause (h) does not exceed \$3,000,000 (not including the value of consideration in transactions under Section 7.3).

“Permitted Liens” are:

- (a) the Lien arising from the pledge of cash pursuant to the Comerica Control Agreement to secure the Permitted Comerica Letters of Credit;
- (b) (i) Liens securing Permitted Indebtedness described under clauses (b) and (i) of the definition of “Permitted Indebtedness” or (ii) Liens arising under this Agreement or other Loan Documents;
- (c) Liens for taxes, fees, assessments or other government charges or levies, either not delinquent or being contested in good faith and for which Borrower maintains adequate reserves on its Books, provided that no notice of any such Lien has been filed or recorded under the Internal Revenue Code of 1986, as amended, and the Treasury Regulations adopted thereunder;
- (d) Liens (including with respect to capital leases) (i) on property (including accessions, additions, parts, replacements, fixtures, improvements and attachments thereto, and the proceeds thereof) acquired or held by Borrower or its Subsidiaries incurred for financing such property (including accessions, additions, parts, replacements, fixtures, improvements and attachments thereto, and the proceeds thereof) other than Accounts, and Inventory, or (ii) existing on property (and accessions, additions, parts, replacements, fixtures, improvements and attachments thereto, and the proceeds thereof) when acquired other than Accounts and Inventory, if the Lien is confined to such property (including accessions, additions, parts, replacements, fixtures, improvements and attachments thereto, and the proceeds thereof);
- (e) Liens incurred in the extension, renewal or refinancing of the indebtedness secured by Liens described in (a) through (c), but any extension, renewal or replacement Lien must be limited to the property encumbered by the existing Lien and the principal amount of the indebtedness it secures may not increase;
- (f) leases or subleases of real property granted in the ordinary course of business, and leases, subleases, non-exclusive licenses or sublicenses of property (other than real property or intellectual property) granted in the ordinary course of Borrower’s business, if the leases, subleases, licenses and sublicenses do not prohibit granting Lender a security interest;
- (g) non-exclusive license of intellectual property granted to third parties in the ordinary course of business;
- (h) leases or subleases granted in the ordinary course of Borrower’s business, including in connection with Borrower’s leased premises or leased property;
- (i) Liens arising from attachments or judgments, orders, or decrees in circumstances not constituting an Event of Default under Sections 8.4 and 8.7;
- (j) Liens in favor of other financial institutions arising in connection with Borrower’s deposit or securities accounts held at such institutions, provided that such accounts are permitted to be established at such institutions under Section 6.5 hereof;
- (k) Liens of carriers, warehousemen, suppliers, or other Persons that are possessory in nature arising in the ordinary course of business so long as such Liens attach only to Inventory and which are not

delinquent or remain payable without penalty or which are being contested in good faith and by appropriate proceedings which proceedings have the effect of preventing the forfeiture or sale of the property subject thereto;

(l) Liens to secure payment of workers' compensation, employment insurance, old-age pensions, social security and other like obligations incurred in the ordinary course of business (other than Liens imposed by ERISA);

(m) Liens not otherwise permitted, provided that (i) the amount of all such Liens is not in excess of \$250,000 (with any such Lien valued as the amount of the obligation secured by such Lien), (ii) such Liens are subordinate in priority to Lender's Lien hereunder and (iii) no Event of Default is otherwise caused thereby.

"*Person*" is any individual, sole proprietorship, partnership, limited liability company, joint venture, company, trust, unincorporated organization, association, corporation, institution, public benefit corporation, firm, joint stock company, estate, entity or government agency.

"*Prime Rate Advance*" means an Advance that bears interest based on the Index, The initial Prime Rate Advance must be for a minimum of \$500,000 and in integral multiples of One Hundred Thousand Dollars (\$100,000) in excess thereof. Each subsequent Prime Rate Advance must be in a minimum amount of One Hundred Thousand Dollars (\$100,000) and in integral multiples of One Hundred Thousand Dollars (\$100,000) in excess thereof.

"*Regulatory Change*" means, with respect to Lender, any change on or after the date of this Agreement in United States federal, state, or foreign laws or regulations, including Regulation D, or the adoption or making on or after such date of any interpretations, directives, or requests applying to a class of lenders including Lender, of or under any United States federal or state, or any foreign laws or regulations (whether or not having the force of law) by any court or governmental or monetary authority charged with the interpretation or administration thereof.

"*Requirement of Law*" is as to any Person, the organizational or governing documents of such Person, and any law (statutory or common), treaty, rule or regulation or determination of an arbitrator or a court or other Governmental Authority, in each case applicable to or binding upon such Person or any of its property or to which such Person or any of its property is subject.

"*Responsible Officer*" is any of the Chief Executive Officer, President, or Chief Financial Officer of Borrower.

"*Revolving Availability Amount*" means Ten Million Dollars (\$10,000,000).

"*Revolving Line of Credit*" is defined in Section 2.1.1(a).

"*Revolving Line Maturity Date*" is December 31, 2009.

"*Security Agreement*" is that certain Security Agreement executed by Guarantors in favor of Lender.

"*Subordinated Debt*" is (a) Indebtedness incurred by Borrower subordinated to Borrower's Indebtedness owed to Lender and which is reflected in a written agreement in a manner and form reasonably acceptable to Lender and approved by Lender in writing, and (b) to the extent the terms of subordination do not change adversely to Lender, refinancings, refundings, renewals, amendments or extensions of any of the foregoing.

"*Subsidiary*" means, with respect to any Person, any Person of which more than 50.0% of the voting stock or other equity interests (in the case of Persons other than corporations) is owned or controlled directly or indirectly by such Person or one or more of Affiliates of such Person.

“*Tangible Net Worth*” is, on any date, the consolidated total assets of Borrower and its Subsidiaries minus (a) any amounts attributable to (i) goodwill, (ii) intangible items including unamortized debt discount and expense, patents, trade and service marks and names, copyrights and research and development expenses except prepaid expenses, (iii) notes, accounts receivable and other obligations owing to Borrower from its officers or other Affiliates, and (iv) reserves not already deducted from assets, minus (b) Total Liabilities.

“*Total Availability Amount*” is \$15,000,000.

“*Total Liabilities*” is on any day, obligations that should, under GAAP, be classified as liabilities on Borrower’s consolidated balance sheet, including all Indebtedness.

“*Transfer*” is defined in Section 7.1.

SECTION 2

LOAN; PAYMENT TERMS

2.1 *Promise to Pay*. Borrower hereby unconditionally promises to pay Lender the outstanding principal amount of all Loans and accrued and unpaid interest thereon as and when due in accordance with this Agreement.

2.1.1 *Revolving Line of Credit*.

(a) *Availability*. Subject to the terms and conditions of this Agreement, Lender shall make Advances not exceeding the Revolving Availability Amount. Each Advance will, at Borrower’s option in accordance with the terms of this Agreement, be either in the form of a Prime Rate Advance or a LIBOR Advance. No more than six (6) LIBOR Advances may be outstanding at any time. Amounts borrowed hereunder may be repaid and, prior to the Revolving Line Maturity Date, reborrowed, subject to the applicable terms and conditions precedent herein. The credit facility described in this Section 2.1.1 is referred to as the “*Revolving Line of Credit*”.

(b) *Termination; Repayment*. The Revolving Line of Credit terminates on the Revolving Line Maturity Date, when the principal amount of all Advances, the unpaid interest thereon, and all other Obligations relating to the Revolving Line of Credit shall be immediately due and payable.

2.1.2 *Letters of Credit Sublimit*.

(a) As part of the Revolving Line of Credit, Lender shall issue or have issued Letters of Credit for Borrower’s account. Such aggregate amounts utilized hereunder shall at all times reduce the amount otherwise available for Advances under the Revolving Line of Credit. The amount of the Letters of Credit outstanding at any one time (including the drawn and unreimbursed amounts of the Letters of Credit) may not exceed the Letter of Credit Availability Amount. If, on the Revolving Line Maturity Date, there are any outstanding Letters of Credit, then on such date Borrower shall provide to Lender cash collateral in an amount equal to 101% of the face amount of all such Letters of Credit plus all interest, fees, and costs due or to become due in connection therewith (as estimated by Lender in its good faith business judgment), to secure all of the Obligations relating to said Letters of Credit. All Letters of Credit shall be in form and substance acceptable to Lender in its sole discretion and shall be subject to the terms and conditions of Lender’s standard application and letter of credit agreement, the forms of which may vary from time to time although a sample form is attached hereto as Exhibit E (the “*Letter of Credit Application*”). Borrower agrees to execute any further documentation in connection with the Letters of Credit as Lender may reasonably request. Borrower further agrees to be bound by the regulations and interpretations of the issuer of any Letters of Credit guaranteed by Lender and opened for Borrower’s account or by Lender’s interpretations of any Letter of Credit issued by Lender for Borrower’s account and Borrower understands and agrees that Lender shall not be liable for any error, negligence, or mistake, whether of omission or commission, in following Borrower’s instructions or those contained in the Letters of Credit or any modifications, amendments, or supplements thereto.

(b) Except as provided in the following sentence, all Letters of Credit will have an initial maturity of no more than one year, renewable annually, if timely requested by Borrower and permitted by Lender in Lender's sole discretion, for additional one-year periods up to a total maximum maturity of five years. A Letter of Credit that is not subject to annual renewal at Lender's discretion may have a maturity longer than one year and less than or equal to five years, but the aggregate face amount of all such Letters of Credit (including the accrued and unreimbursed amounts of such Letters of Credit) may not exceed \$5,000,000.

(c) The obligation of Borrower to immediately reimburse Lender for drawings made under Letters of Credit shall be absolute, unconditional, and irrevocable, and shall be performed strictly in accordance with the terms of this Agreement, such Letters of Credit, and the Letter of Credit Application.

(d) Borrower may request that Lender issue a Letter of Credit payable in a Foreign Currency. If a demand for payment is made under any such Letter of Credit, Lender shall treat such demand as an Advance to Borrower of the equivalent of the amount thereof (plus fees and charges in connection therewith such as wire, cable, SWIFT or similar charges) in Dollars at the then-prevailing rate of exchange in New York, New York, for sales of the Foreign Currency for transfer to the country issuing such Foreign Currency.

(e) Borrower agrees that (i) any sum drawn under a Letter of Credit that has not been immediately repaid when due may, at the option of Lender, be deemed an Advance and added to the principal amount outstanding under this Agreement and (ii) that such Advance will bear interest at a floating rate equal to 3.00 percentage points over the Index, which interest shall be payable monthly in accordance with Section 2.3(f) below.

2.2 Overadvances. If at any time the Loans under Section 2.1.1 exceed the Revolving Availability Amount, then Borrower must immediately pay to Lender in cash such excess and Lender will apply such cash amount to repay outstanding Advances. If at any time the aggregate amount of all Loans outstanding, including drawn and undrawn Letters of Credit, exceeds the Letter of Credit Availability Amount, Borrower must immediately pay to Lender in cash such excess amount (the "*Overadvance Amount*"). Lender will then apply the Overadvance Amount to repay outstanding Advances so that the outstanding Advances are no more than the Revolving Availability Amount and deposit the remaining portion of the Overadvance Amount in a blocked, segregated deposit account as security for the Obligations, including Contingent Obligations. Borrower may apply, no more often than once per calendar month, for a return of the cash on deposit in the blocked account and Lender must return the portion of such cash amount that exceeds the Overadvance Amount, as the Overadvance Amount is calculated by Lender as of the time of Borrower's application.

2.3 Payment of Interest on the Loans.

(a) *Interest Rate.* Subject to Section 2.3(b) and unless otherwise stated, each Advance shall bear interest on the outstanding principal amount thereof from the date when made, continued or converted until paid in full at a rate per annum equal to the Index or the LIBOR Rate, as the case may be. Pursuant to the terms hereof, interest on each Advance shall be paid in arrears on each Interest Payment Date. Interest shall also be paid on the date of any prepayment of any Advance pursuant to this Agreement for the portion of any Advance so prepaid and upon payment (including prepayment) in full thereof. All accrued but unpaid interest on the Advances shall be due and payable on the Revolving Line Maturity Date.

(b) *Default Rate.* If any Event of Default shall occur, including failure to pay upon final maturity, Lender, at its option, may, if permitted under applicable law, increase the interest rate otherwise payable hereunder by 3.000 percentage points. Specifically and without limiting the previous sentence, on and after the expiration of any Interest Period applicable to any LIBOR Advance outstanding on the date of occurrence of an Event of Default or acceleration of the Obligations, the Effective Amount of such LIBOR Advance shall, during the continuance of such Event of Default or after acceleration, bear interest at a rate per annum equal to the Index plus 5.000 percentage points. The interest rate will not exceed the maximum rate permitted by applicable law (the "*Default Rate*"). Payment or acceptance of the increased interest rate provided in this Section 2.3(b) is not a permitted alternative to timely payment and shall not constitute a waiver of any Event of Default or otherwise prejudice or limit any rights or remedies of Lender.

(c) *Adjustment to Interest Rate.* Changes to the interest rate of any Loan based on changes to the Index shall be effective on the effective date of any change to the Index and to the extent of any such change.

(d) *Interest Rate Basis.* The annual interest rate under this Agreement is computed on a 365/360 basis; that is, by applying the ratio of the annual interest rate over a year of 360 days, multiplied by the outstanding principal balance, multiplied by the actual number of days the principal balance is outstanding.

(e) *Debit of Accounts.* Lender may debit any of Borrower's deposit accounts, including the Designated Deposit Account, for principal and interest payments or any other amounts Borrower owes Lender if not paid in full when due, including interest, fees, and costs due or to become due in connection with any Letter of Credit. These debits shall not constitute a set-off.

(f) *Payments.* Unless otherwise provided, interest is payable monthly on the first calendar day of each month. Payments of principal and/or interest received after 12:00 p.m. Pacific time are considered received at the opening of business on the next Business Day. When a payment is due on a day that is not a Business Day, the payment is due the next Business Day and additional fees or interest, as applicable, shall continue to accrue.

2.4 *Fees.* Borrower shall pay to Lender:

(a) *Commitment Fee.* A fully earned, non-refundable commitment fee of \$37,500 equal to one quarter of one percent (0.25%) of the Total Availability Amount, on the date hereof; and

(b) *Letter of Credit Fee.* Lender's customary fees and expenses for the issuance or renewal of Letters of Credit, including, without limitation, local issuance fees, a Letter of Credit Fee of one percent (1.00%) per annum of the face amount of each Letter of Credit issued, upon the issuance, each anniversary of the issuance, and the renewal of such Letter of Credit by Lender; and

(c) *Late Charge.* If a payment is 15 days or more late, Borrower will be charged 5.000 % of the regularly scheduled payment or \$35.00, whichever is greater.

(d) *Dishonored Item Fee.* Borrower will pay a fee to Lender of \$35.00 if Borrower makes a payment on any Loan and the check or preauthorized charge with which Borrower pays is later dishonored.

(e) *Lender Expenses.* All Lender Expenses (including reasonable attorneys' fees and expenses, plus expenses, for documentation and negotiation of this Agreement) incurred through and after the date hereof, when due.

SECTION 3

CONDITIONS OF LOANS

3.1 *Conditions Precedent to Initial Loan.* Lender's obligation to make the initial Loan is subject to the condition precedent that Borrower shall, on or before January 9, 2009, consent to or have delivered, in form and substance satisfactory to Lender, such documents, and completion of such other matters, as Lender may reasonably deem necessary or appropriate, including, without limitation:

(a) duly executed original signatures to the Loan Documents to which it is a party;

(b) duly executed original signatures to the Security Agreement and Alternative Dispute Resolution Agreements;

(c) its Organizational Documents and a good standing certificate of Borrower certified by the Secretary of State of the State of Delaware as of a date no earlier than thirty (30) days prior to the date hereof;

(d) Organizational Documents and a good standing certificate for each Guarantor certified by the Secretary of State of the State of Delaware as of a date no earlier than thirty (30) days prior to the date hereof;

(e) duly executed original signatures to the completed Borrowing Resolutions for Borrower;

(f) the Comerica Control Agreement duly executed by Borrower, Comerica Bank and Lender;

(g) evidence that (i) the Liens (other than the Liens evidenced or authorized by the Comerica Control Agreement) securing Indebtedness owed by Borrower to Comerica Bank will be terminated and (ii) the documents and/or filings evidencing the perfection of such Liens, including without limitation any financing statements and/or control agreements, have or will, concurrently with the initial Loan, be terminated.

(h) certified copies, dated as of a recent date, of financing statement searches, as Lender shall request, accompanied by written evidence (including any UCC termination statements) that the Liens indicated in any such financing statements either constitute Permitted Liens or have been or, in connection with the initial Loan, will be terminated or released;

(i) the Diligence Certificate executed by Borrower;

(j) the duly executed original signatures to the Guaranty, together with the completed Borrowing Resolutions for each Guarantor;

(k) evidence satisfactory to Lender that the insurance policies required by Section 6.4 hereof are in full force and effect, together with appropriate evidence showing loss payable and/or additional insured clauses or endorsements in favor of Lender;

(l) the completion of the Diligence Review with results satisfactory to Lender in its sole and absolute discretion; and

(m) payment of the fees and Lender Expenses then due as specified in Section 2.4 hereof.

3.2 *Conditions Precedent to all Loans.* Lender's obligations to make each Loan, including the initial Loan, is subject to the following:

(a) except as otherwise provided in Section 3.4, timely receipt of an executed Notice of Borrowing (in the case of an Advance) or a Letter of Credit Application (in the case of Letters of Credit);

(b) the representations and warranties in Section 5 shall be true in all material respects on the date of the Notice of Borrowing / Letter of Credit Application and on the Funding Date of each Loan; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date, and no Event of Default shall have occurred and be continuing or result from the Loan. Each Loan is Borrower's representation and warranty on that date that the representations and warranties in Section 5 remain true in all material respects; provided, however, that such materiality qualifier shall not be applicable to any representations and warranties that already are qualified or modified by materiality in the text thereof; and provided, further that those representations and warranties expressly referring to a specific date shall be true, accurate and complete in all material respects as of such date; and

(c) in Lender's sole discretion, there has not been a Material Adverse Change.

3.3 *Covenant to Deliver.* Borrower agrees to deliver to Lender each item required to be delivered to Lender under this Agreement as a condition to any Loan. Borrower expressly agrees that the extension of a Loan

prior to the receipt by Lender of any such item shall not constitute a waiver by Lender of Borrower's obligation to deliver such item, and any such extension in the absence of a required item shall be in Lender's sole discretion.

3.4 *Procedure for the Borrowing of Advances.* Subject to the prior satisfaction of all other applicable conditions to the making of an Advance set forth in this Agreement, each Advance shall be made upon Borrower's irrevocable written notice delivered to Lender in the form of a Notice of Borrowing, each executed by a Responsible Officer of Borrower or his or her designee or without instructions if the Advances are necessary to meet Obligations which have become due. Lender may rely on any telephone notice given by a person whom Lender believes is a Responsible Officer or designee. Borrower will indemnify Lender for any loss Lender suffers due to such reliance. Such Notice of Borrowing must be received by Lender prior to 11:00 a.m. Pacific time, (i) at least three (3) Business Days prior to the requested Funding Date, in the case of LIBOR Advances, and (ii) at least one (1) Business Day prior to the requested Funding Date, in the case of Prime Rate Advances, specifying:

(a) whether the Advance is to be comprised of LIBOR Advances or Prime Rate Advances

(b) the amount of the Advance, which, if such Advance is the initial LIBOR Advance or the initial Prime Rate Advance, such Advance must be in an aggregate minimum principal amount of \$500,000 or in any integral multiple of \$100,000 in excess thereof; otherwise the minimum Advance amount is \$100,000 or in any integral multiple of \$100,000 in excess thereof;

(c) the requested Funding Date; and

(d) the duration of the Interest Period applicable to any such LIBOR Advances included in such notice; *provided* that if the Notice of Borrowing shall fail to specify the duration of the Interest Period for any Advance comprised of LIBOR Advances, such Interest Period shall be one (1) month.

The proceeds of all such Advances will then be made available to Borrower on the Funding Date by Lender by transfer to the Designated Deposit Account and, subsequently, by wire transfer to such other account as Borrower may instruct in the Notice of Borrowing. No Advances shall be deemed made to Borrower, and no interest shall accrue on any such Advance, until the related funds have been deposited in the Designated Deposit Account.

3.5 *Special Provisions Governing LIBOR Advances.* Notwithstanding any other provision of this Agreement to the contrary, the following provisions shall govern with respect to LIBOR Advances as to the matters covered:

(a) *Determination of Applicable Interest Rate.* As soon as practicable on each Interest Rate Determination Date, Lender shall determine (which determination shall, absent manifest error in calculation, be final, conclusive and binding upon all parties) the interest rate that shall apply to the LIBOR Advances for which an interest rate is then being determined for the applicable Interest Period and shall promptly give notice thereof (in writing or by telephone confirmed in writing) to Borrower.

(b) *Inability to Determine Applicable Interest Rate.* In the event that Lender shall have determined (which determination shall be final and conclusive and binding upon all parties hereto), on any Interest Rate Determination Date with respect to any LIBOR Advance, that by reason of circumstances affecting the London interbank market adequate and fair means do not exist for ascertaining the interest rate applicable to such Advance on the basis provided for in the definition of Base LIBOR, Lender shall on such date give notice (by facsimile or by telephone confirmed in writing) to Borrower of such determination, whereupon (i) no Advances may be made as, or converted to, LIBOR Advances until such time as Lender notifies Borrower that the circumstances giving rise to such notice no longer exist, and (ii) any Notice of Borrowing or Notice of Conversion/Continuation given by Borrower with respect to Advances in respect of which such determination was made shall be deemed to be rescinded by Borrower.

(c) *Compensation for Breakage or Non-Commencement of Interest Periods.* Borrower shall compensate Lender, upon written request by Lender (which request shall set forth the manner and method of

computing such compensation), for all reasonable losses, expenses and liabilities, if any (including any interest paid by Lender to lenders of funds borrowed by it to make or carry its LIBOR Advances and any loss, expense or liability incurred by Lender in connection with the liquidation or re-employment of such funds) such that Lender may incur: (i) if for any reason (other than a default by Lender or due to any failure of Lender to fund LIBOR Advances due to impracticability or illegality under Sections 3.6(d) and 3.6(e)) a borrowing or a conversion to or continuation of any LIBOR Advance does not occur on a date specified in a Notice of Borrowing or Notice of Conversion/Continuation, as the case may be, or (ii) if any principal payment of any of its LIBOR Advances occurs on a date prior to the last day of an Interest Period applicable to that Advance.

(d) *Assumptions Concerning Funding of LIBOR Advances.* Calculation of all amounts payable to Lender under this Section 3.5 and otherwise under this Agreement shall be made as though Lender had actually funded each of the relevant LIBOR Advances through the purchase of a Eurodollar deposit bearing interest at the rate obtained pursuant to the definition of LIBOR Rate in an amount equal to the amount of such LIBOR Advance and having a maturity comparable to the relevant Interest Period; *provided, however,* that Lender may fund each of its LIBOR Advances in any manner it sees fit and the foregoing assumptions shall be utilized only for the purposes of calculating amounts payable under this Section 3.5 and otherwise under this Agreement.

(e) *LIBOR Advances After Default.* After the occurrence and during the continuance of an Event of Default, (i) Borrower will have no right to have an Advance be made or continued as, or converted to, a LIBOR Advance after the expiration of any Interest Period then in effect for such Advance and (ii) subject to the provisions of Section 3.5(c), any Notice of Conversion/Continuation given by Borrower with respect to a requested conversion/continuation that has not yet occurred shall be deemed to be rescinded by Borrower and be deemed a request to convert or continue Advances referred to therein as Prime Rate Advances.

3.6 Additional Requirements/Provisions Regarding LIBOR Advances.

(a) If for any reason (including voluntary or mandatory prepayment or acceleration), Lender receives all or part of the principal amount of a LIBOR Advance prior to the last day of the Interest Period for such Advance, Borrower shall immediately notify Borrower's account officer at Lender and, on demand by Lender, pay Lender the amount (if any) by which (i) the additional interest which would have been payable on the amount so received had it not been received until the last day of such Interest Period exceeds (ii) the interest which would have been recoverable by Lender by placing the amount so received on deposit in the certificate of deposit markets, the offshore currency markets, or United States Treasury investment products, as the case may be, for a period starting on the date on which it was so received and ending on the last day of such Interest Period at the interest rate determined by Lender in its reasonable discretion. Lender's determination as to such amount shall be conclusive absent manifest error.

(b) Borrower shall pay Lender, upon demand by Lender, from time to time such amounts as Lender may determine to be necessary to compensate it for any costs incurred by Lender that Lender determines are attributable to its making or maintaining of any amount receivable by Lender hereunder in respect of any Advances relating thereto (such increases in costs and reductions in amounts receivable being herein called "*Additional Costs*"), in each case resulting from any Regulatory Change which:

(i) changes the basis of taxation of any amounts payable to Lender under this Agreement in respect of any Advances (other than changes which affect taxes measured by or imposed on the overall net income of Lender by the jurisdiction in which Lender has its principal office);

(ii) imposes or modifies any reserve, special deposit or similar requirements relating to any extensions of credit or other assets of, or any deposits with, or other liabilities of Lender (including any Advances or any deposits referred to in the definition of Base LIBOR); or

(iii) imposes any other condition affecting this Agreement (or any of such extensions of credit or liabilities).

Lender will notify Borrower of any event occurring after the date of this Agreement which will entitle Lender to compensation pursuant to this Section 3.6 as promptly as practicable after it obtains knowledge thereof and determines to request such compensation. Lender will furnish Borrower with a statement setting forth the basis and amount of each request by Lender for compensation under this Section 3.6. Determinations and allocations by Lender for purposes of this Section 3.6 of the effect of any Regulatory Change on its costs of maintaining its obligations to make Advances, of making or maintaining Advances, or on amounts receivable by it in respect of Advances, and of the additional amounts required to compensate Lender in respect of any Additional Costs, shall be conclusive absent manifest error.

(c) If Lender shall determine that the adoption or implementation of any applicable law, rule, regulation, or treaty regarding capital adequacy, or any change therein, or any change in the interpretation or administration thereof by any governmental authority, central bank, or comparable agency charged with the interpretation or administration thereof, or compliance by Lender (or its applicable lending office) with any respect or directive regarding capital adequacy (whether or not having the force of law) of any such authority, central bank, or comparable agency, has or would have the effect of reducing the rate of return on capital of Lender or any person or entity controlling Lender (a "Parent") as a consequence of its obligations hereunder to a level below that which Lender (or its Parent) could have achieved but for such adoption, change, or compliance (taking into consideration policies with respect to capital adequacy) by an amount deemed by Lender to be material, then from time to time, within fifteen (15) days after demand by Lender, Borrower shall pay to Lender such additional amount or amounts as will compensate Lender for such reduction. A statement of Lender claiming compensation under this Section 3.6(c) and setting forth the additional amount or amounts to be paid to it hereunder shall be conclusive absent manifest error.

(d) If, at any time, Lender, in its sole and absolute discretion, determines that (i) the amount of LIBOR Advances for periods equal to the corresponding Interest Periods are not available to Lender in the offshore currency interbank markets, or (ii) LIBOR Rate does not accurately reflect the cost to Lender of lending the LIBOR Advances, then Lender shall promptly give notice thereof to Borrower. Upon the giving of such notice, Lender's obligation to make the LIBOR Advances shall terminate; *provided, however*, Advances shall not terminate if Lender and Borrower agree in writing to a different interest rate applicable to LIBOR Advances.

(e) If it shall become unlawful for Lender to continue to fund or maintain any LIBOR Advances, or to perform its obligations hereunder, upon demand by Lender, Borrower shall prepay the Advances in full with accrued interest thereon and all other amounts payable by Borrower hereunder (including, without limitation, any amount payable in connection with such prepayment pursuant to Section 3.6(a)).

3.7 Conversion and Continuation Elections.

(a) So long as (i) no Event of Default exists; (ii) Borrower shall not have sent any notice of termination of this Agreement; and (iii) Borrower shall have complied with such customary procedures as Lender has established from time to time for Borrower's requests for LIBOR Advances, Borrower may, upon irrevocable written notice to Lender,

(i) elect to convert on any Business Day, Prime Rate Advances in an amount equal to \$100,000 or any integral multiple of \$100,000 in excess thereof into LIBOR Advances;

(ii) elect to continue on any Interest Payment Date any LIBOR Advances maturing on such Interest Payment Date (or any part thereof in an amount equal to \$100,000 or any integral multiple of \$100,000 in excess thereof); *provided*, that if the aggregate amount of LIBOR Advances shall have been reduced, by payment, prepayment, or conversion of part thereof, to be less than \$100,000, such LIBOR Advances shall automatically convert into Prime Rate Advances, and on and after such date the right of Borrower to continue such Advances as, and convert such Advances into, LIBOR Advances shall terminate; or

(iii) elect to convert on any Interest Payment Date any LIBOR Advances maturing on such Interest Payment Date (or any part thereof in an amount equal to \$100,000 or any integral multiple of \$100,000 in excess thereof) into Prime Rate Advances.

(b) Borrower shall deliver a Notice of Conversion/Continuation in accordance with Section 10 to be received by Lender prior to 11:00 a.m. Pacific time at least (i) three (3) Business Days in advance of the Conversion Date or Continuation Date, if any Advances are to be converted into or continued as LIBOR Advances; and (ii) one (1) Business Day in advance of the Conversion Date, if any Advances are to be converted into Prime Rate Advances, in each case specifying the:

(i) proposed Conversion Date or Continuation Date;

(ii) aggregate amount of the Advances to be converted or continued which, if any Advances are to be converted into or continued as LIBOR Advances, shall be in an aggregate minimum principal amount of \$100,000 or in any integral multiple of \$100,000 in excess thereof;

(iii) nature of the proposed conversion or continuation; and

(iv) duration of the requested Interest Period.

(c) If upon the expiration of any Interest Period applicable to any LIBOR Advances, Borrower shall have timely failed to select a new Interest Period to be applicable to such LIBOR Advances, then at Lender's option, (i) Borrower shall be deemed to have selected the same Interest Period or a one-month Interest Period to apply to those LIBOR Advances or (ii) Borrower shall be deemed to have elected to convert such LIBOR Advances into Prime Rate Advances.

(d) Any LIBOR Advances shall, at Lender's option, convert into Prime Rate Advances in the event that (i) an Event of Default shall exist, or (ii) the aggregate principal amount of the Prime Rate Advances which have been previously converted to LIBOR Advances, or the aggregate principal amount of existing Advances continued, as the case may be, at the beginning of an Interest Period shall at any time during such Interest Period exceed the Revolving Availability Amount. Borrower agrees to pay Lender, upon demand by Lender (or Lender may, at its option, charge the Designated Deposit Account or any other account Borrower maintains with Lender) any amounts required to compensate Lender for any loss (including loss of anticipated profits), cost, or expense incurred by Lender, as a result of the conversion of LIBOR Advances to Prime Rate Advances.

(e) Notwithstanding anything to the contrary contained herein, Lender shall not be required to purchase United States Dollar deposits in the London interbank market or other applicable LIBOR market to fund any LIBOR Advances, but the provisions hereof shall be deemed to apply as if Lender had purchased such deposits to fund the LIBOR Advances.

SECTION 4

CREATION OF SECURITY INTEREST

4.1 *Grant of Security Interest.* Borrower hereby grants Lender, to secure the payment and performance in full of all of the Obligations, a continuing security interest in, and pledges to Lender, the Collateral, wherever located, whether now owned or hereafter acquired or arising, and all proceeds and products thereof. Borrower represents, warrants, and covenants that the security interest granted herein is and shall at all times continue to be a first priority perfected security interest in the Collateral (subject only to Permitted Liens that may have superior priority to Lender's Lien under this Agreement). If Borrower shall acquire a commercial tort claim, Borrower shall promptly notify Lender in a writing signed by Borrower of the general details thereof and grant to Lender in such writing a security interest therein and in the proceeds thereof, all upon the terms of this Agreement, with such writing to be in form and substance reasonably satisfactory to Lender.

If this Agreement is terminated, Lender's Lien in the Collateral shall continue until the Obligations (other than inchoate indemnity obligations) are repaid in full in cash. Upon payment in full in cash of the Obligations and at such time as Lender's obligation to make Loans has terminated, Lender shall, at Borrower's sole cost and expense, release its Liens in the Collateral and all rights therein shall revert to Borrower.

4.2 *Authorization to File Financing Statements.* Borrower hereby authorizes Lender to file financing statements, without notice to Borrower, with all appropriate jurisdictions to perfect or protect Lender's interest or rights hereunder, including a notice that any disposition of the Collateral, by either Borrower or any other Person, shall be deemed to violate the rights of Lender under the Code.

SECTION 5

REPRESENTATIONS AND WARRANTIES

Borrower represents and warrants as follows:

5.1 *Due Organization, Authorization; Power and Authority.* Borrower is duly existing and in good standing in its jurisdiction of formation and is qualified and licensed to do business and is in good standing in any jurisdiction in which the conduct of its business or its ownership of property requires that it be qualified except where the failure to do so could not reasonably be expected to have a material adverse effect on Borrower's business. In connection with this Agreement, Borrower has delivered to Lender a complete certificate signed by Borrower entitled Officer Certificate Legal Due Diligence (the "*Diligence Certificate*"). Borrower represents and warrants to Lender that (a) Borrower's exact legal name is that indicated on the Diligence Certificate and on the signature page hereof; (b) Borrower is an organization of the type and is organized in the jurisdiction set forth in the Diligence Certificate; (c) the Diligence Certificate accurately sets forth Borrower's organizational identification number or accurately states that Borrower has none; (d) the Diligence Certificate accurately sets forth Borrower's place of business, or, if more than one, its chief executive office as well as Borrower's mailing address (if different than its chief executive office); (e) Borrower (and each of its predecessors) has not, in the past five (5) years, changed its jurisdiction of formation, organizational structure or type, or any organizational number assigned by its jurisdiction; and (f) all other information set forth on the Diligence Certificate pertaining to Borrower and each of its Subsidiaries is accurate and complete (it being understood and agreed that Borrower may from time to time update certain information in the Diligence Certificate after the date hereof to the extent permitted by one or more specific provisions in this Agreement).

The execution, delivery and performance by Borrower of the Loan Documents to which it is a party have been duly authorized, and do not (i) conflict with any of Borrower's Organizational Documents, (ii) contravene, conflict with, constitute a default under or violate any material Requirement of Law, (iii) contravene, conflict or violate any applicable order, writ, judgment, injunction, decree, determination or award of any Governmental Authority by which Borrower or any its Subsidiaries or any of their property or assets may be bound or affected, (iv) require any action by, filing, registration, or qualification with, or Governmental Approval from, any Governmental Authority (except such Governmental Approvals which have already been obtained and are in full force and effect or (v) constitute an event of default under any material agreement by which Borrower is bound. Borrower is not in default under any agreement to which it is a party or by which it is bound in which the default could reasonably be expected to have a material adverse effect on Borrower's business.

5.2 *Collateral.* Borrower has good title to, has rights in, and the power to transfer each item of the Collateral upon which it purports to grant a Lien hereunder, free and clear of any and all Liens except Permitted Liens. Borrower has no deposit accounts other than the deposit accounts with Lender, the deposit accounts, if any, described in the Diligence Certificate delivered to Lender in connection herewith, or of which Borrower has given Lender notice and taken such actions as are necessary to give Lender a perfected security interest therein. The Accounts are bona fide, existing obligations of the Account Debtors.

The Collateral is not in the possession of any third party bailee (such as a warehouse) except as otherwise provided in the Diligence Certificate. None of the components of the Collateral shall be maintained at locations other than as provided in the Diligence Certificate or as Borrower has given Lender notice pursuant to Section 7.2. In the event that Borrower, after the date hereof, intends to store or otherwise deliver any portion of the Collateral with a fair market value greater than \$250,000 to a bailee, then Borrower will first receive the written consent of Lender and such bailee must execute and deliver a bailee agreement in form and substance satisfactory to Lender in its sole discretion.

Borrower is the sole owner of its intellectual property, except for non-exclusive licenses granted to its customers in the ordinary course of business. Each patent is valid and enforceable, and no part of the intellectual property has been judged invalid or unenforceable, in whole or in part, and to the best of Borrower's knowledge, no claim has been made that any part of the intellectual property violates the rights of any third party except to the extent such claim could not reasonably be expected to have a material adverse effect on Borrower's business. Except as noted on the Diligence Certificate, Borrower is not a party to, nor is bound by, any material license or other agreement with respect to which Borrower is the licensee (a) that prohibits or otherwise restricts Borrower from granting a security interest in Borrower's interest in such license or agreement or any other property, or (b) for which a default under or termination of could interfere with the Lender's right to sell any Collateral. Borrower shall provide written notice to Lender within thirty (30) days of entering or becoming bound by any such license or agreement (other than over-the-counter software that is commercially available to the public). Borrower shall take such steps as Lender requests to obtain the consent of, or waiver by, any person whose consent or waiver is necessary for Lender to have the ability in the event of a liquidation of any Collateral to dispose of such Collateral in accordance with Lender's rights and remedies under this Agreement and the other Loan Documents.

5.3 *Litigation.* There are no actions or proceedings pending or, to the knowledge of the Responsible Officers, threatened in writing by or against Borrower or any of its Subsidiaries involving more than Five Hundred Thousand Dollars (\$500,000).

5.4 *No Material Deviation in Financial Statements.* All consolidated financial statements for Borrower and any of its Subsidiaries delivered to Lender fairly present in all material respects Borrower's consolidated financial condition and Borrower's consolidated results of operations. There has not been any material deterioration in Borrower's consolidated financial condition since the date of the most recent financial statements submitted to Lender.

5.5 *Solvency.* The fair salable value of Borrower's assets (including goodwill minus disposition costs) exceeds the fair value of its liabilities; Borrower is not left with unreasonably small capital after the transactions in this Agreement; and Borrower is able to pay its debts (including trade debts) as they mature.

5.6 *Regulatory Compliance.* Borrower is not an "investment company" or a company "controlled" by an "investment company" under the Investment Company Act. Borrower is not engaged as one of its important activities in extending credit for margin stock (under Regulations T and U of the Federal Reserve Board of Governors). Borrower has complied in all material respects with the Federal Fair Labor Standards Act. Neither Borrower nor any of its Subsidiaries is a "holding company" or an "affiliate" of a "holding company" or a "subsidiary company" of a "holding company" as each term is defined and used in the Public Utility Holding Company Act of 2005. Borrower has not violated any laws, ordinances or rules, the violation of which could reasonably be expected to have a material adverse effect on its business. None of Borrower's or any of its Subsidiaries' properties or assets has been used by Borrower or any Subsidiary or, to the best of Borrower's knowledge, by previous Persons, in disposing, producing, storing, treating, or transporting any hazardous substance other than legally. Borrower and each of its Subsidiaries have obtained all consents, approvals and authorizations of, made all declarations or filings with, and given all notices to, all Government Authorities that are necessary to continue their respective businesses as currently conducted.

5.7 *Subsidiaries; Investments.* Borrower does not own any stock, partnership interest or other equity securities except for Permitted Investments.

5.8 *Tax Returns and Payments; Pension Contributions.* Borrower has timely filed all required tax returns and reports, and Borrower has timely paid all foreign, federal, state and local taxes, assessments, deposits and contributions owed by Borrower. Borrower may defer payment of any contested taxes, provided that Borrower (a) in good faith contests its obligation to pay the taxes by appropriate proceedings promptly and diligently instituted and conducted, (b) notifies Lender in writing of the commencement of, and any material development in, the proceedings, (c) posts bonds or takes any other steps required to prevent the governmental authority levying such contested taxes from obtaining a Lien upon any of the Collateral that is other than a "Permitted Lien". Borrower is unaware of any claims or adjustments proposed for any of Borrower's prior tax years which could result in additional taxes becoming due and payable by Borrower. Borrower has paid all amounts necessary to fund all

present pension, profit sharing and deferred compensation plans in accordance with their terms, and Borrower has not withdrawn from participation in, and has not permitted partial or complete termination of, or permitted the occurrence of any other event with respect to, any such plan which could reasonably be expected to result in any liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other governmental agency.

5.9 *Use of Proceeds*. Borrower shall use the proceeds of the Loans for purposes of issuing standby letters of credit, working capital and funding of its general business requirements and not for personal, family or household purposes.

5.10 *Full Disclosure*. No written representation, warranty or other statement of Borrower in any certificate or written statement given to Lender, as of the date such representation, warranty, or other statement was made, taken together with all such written certificates and written statements given to Lender, contains any untrue statement of a material fact or omits to state a material fact necessary to make the statements contained in the certificates or statements not misleading (it being recognized by Lender that the projections and forecasts provided by Borrower in good faith and based upon reasonable assumptions are not viewed as facts and that actual results during the period or periods covered by such projections and forecasts may differ from the projected or forecasted results).

SECTION 6

AFFIRMATIVE COVENANTS

Borrower shall do all of the following:

6.1 *Government Compliance*.

(a) Maintain its and all its Subsidiaries' legal existence and good standing in their respective jurisdictions of formation and maintain qualification in each jurisdiction in which the failure to so qualify would reasonably be expected to have a material adverse effect on Borrower's business or operations. Borrower shall comply, and have each Subsidiary comply, with all laws, ordinances and regulations to which it is subject, noncompliance with which could reasonably be expected to have a material adverse effect on Borrower's business.

(b) Obtain all of the Governmental Approvals necessary for the performance by Borrower of its obligations under the Loan Documents to which it is a party and the grant of a security interest to Lender in all of its property. Borrower shall promptly provide copies of any such obtained Governmental Approvals to Lender.

6.2 *Financial Statements, Reports, Certificates*.

(a) Deliver to Lender: (i) as soon as available, but no later than five (5) days after filing with the Securities Exchange Commission, Borrower's 10K, 10Q, and 8K reports; (ii) within 15 days before the end of each fiscal year (except for fiscal year 2008, the forecast for which year may be delivered by January 31, 2009), annual consolidated financial forecast for the following fiscal year (on a quarterly basis) as approved by Borrower's board of directors, together with any related business forecasts used in the preparation of such annual financial forecasts; (iii) a prompt report of any legal actions pending or threatened against Borrower or any Subsidiary that could result in damages or costs to Borrower or any Subsidiary of \$500,000 or more; and (iv) budgets, sales projections, operating plans or other financial information Lender reasonably requests.

Borrower's 10K, 10Q, and 8K reports required to be delivered pursuant to Section 6.2(a)(i) shall be deemed to have been delivered on the date on which Borrower posts such report or provides a link thereto on Borrower's or another website on the Internet; provided, that Borrower shall provide paper copies to Lender of the Compliance Certificates required by Sections 6.2(c) and (d). Borrower need only deliver to Lender those 8K reports that are both relevant and material to any Credit Party's Obligations under this Agreement and/or any of the Loan Documents.

(b) Within forty-five (45) days after the last day of each quarter, deliver to Lender an aged listings of accounts receivable (by invoice date).

(c) Within forty-five (45) days after the last day of each quarter, deliver to Lender its quarterly financial statements together with a duly completed Compliance Certificate signed by a Responsible Officer setting forth calculations showing compliance with the financial covenants set forth in this Agreement.

(d) Within ninety (90) days after Borrower's fiscal year end, deliver to Lender its audited financial statements together with a duly completed Compliance Certificate signed by a Responsible Officer setting forth calculations showing compliance with the financial covenants set forth in this Agreement.

(e) Allow Lender to audit Borrower's Books, including Borrower's Inventory, at Borrower's expense.

(f) Promptly notify Lender of the occurrence of any Event of Default and of any fact or circumstance that does not yet constitute an Event of Default due to the applicability of a grace or cure period.

6.3 *Taxes; Pensions.* Make, and cause each of its Subsidiaries to make, timely payment of all foreign, federal, state, and local taxes or assessments (other than taxes and assessments which Borrower is contesting pursuant to the terms of Section 5.8 hereof) and shall deliver to Lender, on demand, appropriate certificates attesting to such payments, and pay all amounts necessary to fund all present pension, profit sharing and deferred compensation plans in accordance with their terms.

6.4 *Insurance.* Keep its business and the Collateral insured for risks and in amounts standard for companies in Borrower's industry and location and as Lender may reasonably request. Insurance policies shall be in a form, with companies, and in amounts that are satisfactory to Lender. All property policies shall have a loss payable endorsement showing Lender as lender loss payee and waive subrogation against Lender, and all liability policies shall show, or have endorsements showing, Lender as an additional insured. All policies (or the loss payable and additional insured endorsements) shall provide that the insurer shall endeavor to give Lender at least twenty (20) days notice before canceling, amending, or declining to renew its policy. At Lender's request, Borrower shall deliver certified copies of policies and evidence of all premium payments. Proceeds payable under any policy shall, at Lender's option, be payable to Lender on account of the Obligations. Notwithstanding the foregoing, (a) so long as no Event of Default has occurred and is continuing, Borrower shall have the option of applying the proceeds of any casualty policy up to Five Hundred Thousand Dollars (\$500,000) with respect to any loss toward the replacement or repair of destroyed or damaged property; provided that any such replaced or repaired property (i) shall be of equal or like value as the replaced or repaired Collateral and (ii) shall be deemed Collateral in which Lender has been granted a first priority security interest, and (b) after the occurrence and during the continuance of an Event of Default, all proceeds payable under such casualty policy shall, at the option of Lender, be payable to Lender on account of the Obligations. If Borrower fails to obtain insurance as required under this Section 6.4 or to pay any amount or furnish any required proof of payment to third persons and Lender, Lender may make all or part of such payment or obtain such insurance policies required in this Section 6.4, and take any action under the policies Lender deems prudent,

6.5 *Operating Accounts.* Maintain its primary and its Subsidiaries' primary operating and other deposit accounts with Lender, which accounts shall represent at least 75% of the dollar value of Borrower's and such Subsidiaries' deposit accounts at all financial institutions. Borrower is not required to maintain its securities accounts, brokerage accounts or commodities accounts with Lender.

6.6 *Financial Covenants.*

Borrower shall maintain at all times, to be tested as of the last day of each quarter, unless otherwise noted, on a consolidated basis with respect to Borrower and its Subsidiaries:

(a) *Current Ratio*. A ratio of (i) Current Assets less Encumbered Cash to (ii) Current Liabilities less Cash Secured Letters of Credit of at least 2.50 to 1.0.

(b) *Debt/Tangible Net Worth Ratio*. A ratio of Total Liabilities to Tangible Net Worth of not more than 1.0 to 1.0.

(c) *Profitability*. A minimum positive Net Income of \$ 1 for each fiscal year, to be tested as of the last day of each fiscal year.

6.7 *Protection and Registration of Intellectual Property Rights*. Borrower shall: (a) protect, defend and maintain the validity and enforceability of its intellectual property material to Borrower's business; (b) promptly advise Lender in writing of material infringements of its intellectual property material to Borrower's business; and (c) not allow any intellectual property material to Borrower's business to be abandoned, forfeited or dedicated to the public without Lender's written consent.

6.8 *Litigation Cooperation*. From the date hereof and continuing through the termination of this Agreement, make available to Lender, without expense to Lender, Borrower and its officers, employees and agents and Borrower's Books, to the extent that Lender may deem them reasonably necessary to prosecute or defend any third-party suit or proceeding instituted by or against Lender with respect to any Collateral or relating to Borrower.

6.9 *Additional Costs*. The Borrower will pay Lender, on demand, for Lender's costs or losses arising from any statute or regulation or any request or requirement of a regulatory agency, which is applicable to national banks. The costs and losses will be allocated to the Obligations in a manner determined by Lender, using any reasonable method. The costs include the following: (i) any reserve or deposit requirements; and (ii) any capital requirements relating to Lender's assets and commitments for credit.

6.10 *Subsidiaries*. Borrower must cause each Subsidiary organized under the laws of the United States or under the laws of any State thereof and each Subsidiary conducting business primarily within the United States to execute and deliver to Lender either (i) a counterpart signature page to this Agreement or (ii) an unlimited guaranty of the Obligations, which guaranty must be in form and substance acceptable to Lender.

6.11 *Further Assurances*. Execute any further instruments and take further action as Lender reasonably requests to perfect or continue Lender's Lien in the Collateral or to effect the purposes of this Agreement.

SECTION 7 NEGATIVE COVENANTS

Borrower shall not do any of the following without Lender's prior written consent:

7.1 *Dispositions*. Convey, sell, lease, transfer or otherwise dispose of (collectively "*Transfer*"), or permit any of its Subsidiaries to Transfer, all or any part of its business or property, except for the following Transfers, which Transfers (other than the Transfers permitted under subsections (d) and (i) below) may not exceed \$1,000,000, individually or in the aggregate:

(a) Transfers in the ordinary course of business for reasonably equivalent consideration;

(b) Transfers to Borrower or a Guarantor from Borrower or any of its Subsidiaries;

(c) Transfers of property in connection with sale-leaseback transactions;

(d) Transfers of property with an aggregate value of up to \$10,000,000 to the extent such property is exchanged for credit against, or proceeds are promptly applied to, the purchase price of other property used or useful in the business of Borrower or its Subsidiaries;

(e) Transfers constituting non-exclusive licenses and similar arrangements for the use of the property of Borrower or its Subsidiaries in the ordinary course of business and other non-perpetual licenses that may be exclusive in some respects other than territory (and/or that may be exclusive as to territory only in discreet geographical areas outside of the United States), but that could not result in a legal transfer of Borrower's title in the licensed property;

(f) Transfers otherwise permitted by the Loan Documents;

(g) sales or discounting of delinquent accounts in the ordinary course of business;

(h) Transfers associated with the disposition of a Permitted Investment; and

(i) Transfers with an aggregate value of up to \$10,000,000 in connection with a permitted acquisition of a portion of the assets or rights acquired.

7.2 Changes in Business; Change in Control; Jurisdiction of Formation. Engage in any material line of business other than those lines of business conducted by Borrower and its Subsidiaries on the date hereof and any businesses reasonably related, complementary or incidental thereto or reasonable extensions thereof; permit or suffer any Change in Control. Borrower will not, without prior written notice, change its jurisdiction of formation.

7.3 Mergers or Acquisitions. Merge or consolidate, or permit any of its Subsidiaries to merge or consolidate, with any Person other than with Borrower or any Subsidiary, or acquire, or permit any of its Subsidiaries to acquire, all or substantially all of the capital stock or property of a Person other than Borrower or any Subsidiary, except where (a) no Event of Default has occurred and is continuing or would result from such action during the term of this Agreement, (b) Borrower is the surviving entity and (c) the total value of consideration in such transaction, including assumption of debt, together with all other such transactions occurring after the date of this agreement is less than \$10,000,000.

7.4 Indebtedness. Create, incur, assume, or be liable for any Indebtedness, or permit any Subsidiary to do so, other than Permitted Indebtedness.

7.5 Encumbrance. Except for Permitted Liens, create, incur, allow, or suffer any Lien on any of its property, including its intellectual property, or assign or convey any right to receive income, including the sale of any Accounts, or permit any of its Subsidiaries to do so, or permit any Collateral not to be subject to the first priority security interest granted herein, or enter into any agreement, document, instrument or other arrangement (except with or in favor of Lender) with any Person which directly or indirectly prohibits or has the effect of prohibiting Borrower or any Subsidiary from assigning, mortgaging, pledging, granting a security interest in or upon, or encumbering any of Borrower's or any Subsidiary's intellectual property, except as is otherwise permitted in Section 7.1 hereof and the definition of "Permitted Lien" herein.

7.6 Distributions; Investments. (a) Pay any dividends or make any distribution or payment or redeem, retire or purchase any capital stock other than Permitted Distributions; or (b) directly or indirectly acquire or own any Person, or make any Investment in any Person, other than Permitted Investments, or permit any of its Subsidiaries to do so.

7.7 Transactions with Affiliates. Directly or indirectly enter into or permit to exist any material transaction with any Affiliate of Borrower except for (a) transactions that are in the ordinary course of Borrower's business, upon fair and reasonable terms (when viewed in the context of any series of transactions of which it may be a part, if applicable); or (b) transactions among Borrower and Guarantors and among Guarantors so long as no Event of Default exists or could result therefrom.

7.8 Subordinated Debt. Make or permit any payment on or amendments of any Subordinated Debt, except (a) payments pursuant to the terms of the Subordinated Debt; (b) payments made with Borrower's capital stock or other Subordinated Debt; (c) amendments to Subordinated Debt so long as such Subordinated Debt remains

subordinated in right of payment to this Agreement and any Liens securing such Subordinated Debt remain subordinate in priority to Lender's Lien hereunder; or (d) other purchases or payments of Subordinated Debt.

7.9 *Compliance*. Become an "investment company" or a company controlled by an "investment company", under the Investment Company Act of 1940 or undertake as one of its important activities extending credit to purchase or carry margin stock (as defined in Regulation U of the Board of Governors of the Federal Reserve System), or use the proceeds of any Loan for that purpose; fail to meet the minimum funding requirements of ERISA, permit a Reportable Event or Prohibited Transaction, as defined in ERISA, to occur; fail to comply with the Federal Fair Labor Standards Act or violate any other law or regulation, if the violation could reasonably be expected to have a material adverse effect on Borrower's business, or permit any of its Subsidiaries to do so; withdraw or permit any Subsidiary to withdraw from participation in, permit partial or complete termination of, or permit the occurrence of any other event with respect to, any present pension, profit sharing and deferred compensation plan which could reasonably be expected to result in any liability of Borrower, including any liability to the Pension Benefit Guaranty Corporation or its successors or any other governmental agency.

SECTION 8 EVENTS OF DEFAULT

Any one of the following shall constitute an event of default (an "*Event of Default*") under this Agreement:

8.1 *Payment Default*. Borrower fails to (a) make any payment of principal or interest on any Loan on its due date, or (b) pay any other Obligations within three (3) Business Days after such Obligations are due and payable (which three (3) day grace period shall not apply to payments due on the Revolving Line Maturity Date). During the cure period, the failure to cure the payment default is not an Event of Default (but no Loan will be made during the cure period);

8.2 *Covenant Default*.

(a) Borrower fails or neglects to perform any obligation in Section 6 (other than in Sections 6.1, 6.2, 6.3 and/or 6.4) or violates any covenant in Section 7 (other than in Section 7.9); or

(b) Borrower fails or neglects to perform, keep, or observe any other term, provision, condition, covenant or agreement contained in this Agreement or any Loan Documents, and as to any default (other than those specified in this Section 8) under such other term, provision, condition, covenant or agreement that can be cured, has failed to cure the default within ten (10) days after the occurrence thereof; provided, however, that if the default cannot by its nature be cured within the ten (10) day period or cannot after diligent attempts by Borrower be cured within such ten (10) day period, and such default is likely to be cured within a reasonable time, then Borrower shall have an additional period (which shall not in any case exceed thirty (30) days) to attempt to cure such default, and within such reasonable time period the failure to cure the default shall not be deemed an Event of Default (but no Loans shall be made during such cure period). Grace periods provided under this section shall not apply, among other things, to financial covenants or any other covenants set forth in subsection (a) above;

8.3 *Material Adverse Change*. A Material Adverse Change occurs;

8.4 *Attachment*. (a) Any material portion of Borrower's assets is attached, seized, levied on, or comes into possession of a trustee or receiver; (b) the service of process seeking to attach, by trustee or similar process, any funds of Borrower or of any entity under control of Borrower (including a Subsidiary) on deposit with Lender or any Lender Affiliate; (c) Borrower is enjoined, restrained, or prevented by court order from conducting any part of its business; or (d) a notice of lien, levy, or assessment is filed against any of Borrower's assets by any government agency, and the same under clauses (a) through (d) hereof are not, within twenty (20) days after the occurrence thereof, discharged or stayed (whether through the posting of a bond or otherwise) or otherwise being contested in good faith (with adequate reserves) by Borrower; provided, however, no Loans shall be made during any twenty (20) day cure period;

8.5 *Insolvency.* (a) Borrower is unable to pay its debts (including trade debts) as they become due; (b) Borrower begins an Insolvency Proceeding; or (c) an Insolvency Proceeding is begun against Borrower and not dismissed or stayed within thirty (30) days (but no Loans shall be made while of any of the conditions described in clause (a) exist and/or until any Insolvency Proceeding is dismissed);

8.6 *Other Agreements.* If Borrower fails to (a) make any payment that is due and payable with respect to any Material Indebtedness and such failure continues after the applicable grace or notice period, if any, specified in the agreement or instrument relating thereto, or (b) perform or observe any other condition or covenant, or any other event shall occur or condition exist under any agreement or instrument relating to any Material Indebtedness, and such failure continues after the applicable grace or notice period, if any, specified in the agreement or instrument relating thereto and the effect of such failure, event or condition is to cause the holder or holders of such Material Indebtedness to accelerate the maturity of such Material Indebtedness or cause the mandatory repurchase of any Material Indebtedness;

8.7 *Judgments.* One or more judgments, orders, or decrees for the payment of money in an amount, individually or in the aggregate, of at least Five Hundred Thousand Dollars (\$500,000) (not covered by independent third-party insurance as to which liability has been accepted by such insurance carrier) shall be rendered against Borrower and shall remain unsatisfied, unvacated, or unstayed for a period of ten (10) days after the entry thereof (provided that no Loans will be made prior to the satisfaction, vacation, or stay of such judgment, order, or decree);

8.8 *Misrepresentations.* Borrower or any Person acting for Borrower makes any representation, warranty, or other statement now or later in this Agreement, any Loan Document or in any writing delivered to Lender or to induce Lender to enter this Agreement or any Loan Document, and such representation, warranty, or other statement is incorrect in any material respect when made;

8.9 *Subordinated Debt.* A default or breach occurs under any agreement between Borrower and any creditor of Borrower that signed a subordination, intercreditor, or other similar agreement with Lender, or any creditor that has signed such an agreement with Lender breaches any terms of such agreement; or

8.10 *Guaranty.* (a) Any guaranty of any Obligations terminates or ceases for any reason to be in full force and effect; (b) any Guarantor does not perform any obligation or covenant under any guaranty of the Obligations; (c) any circumstance described in Sections 8.3, 8.4, 8.5, 8.7, or 8.8 occurs with respect to any Guarantor, or (d) the liquidation, winding up, or termination of existence of any Guarantor; or (e) (i) a material impairment in the perfection or priority of Lender's Lien in the collateral provided by Guarantor or in the value of such collateral or (ii) a material adverse change in the general affairs, management, results of operation, condition (financial or otherwise) or the prospect of repayment of the Obligations occurs with respect to any Guarantor.

SECTION 9

LENDER'S RIGHTS AND REMEDIES

9.1 *Rights and Remedies.* While an Event of Default occurs and continues Lender may, without notice or demand, do any or all of the following:

(a) declare all Obligations immediately due and payable (but if an Event of Default described in Section 8.5 occurs all Obligations are immediately due and payable without any action by Lender);

(b) stop advancing money or extending credit for Borrower's benefit under this Agreement or under any other agreement between Borrower and Lender;

(c) demand that Borrower (i) deposit cash with Lender in an amount equal to the aggregate amount of any Letters of Credit remaining undrawn, as collateral security for the repayment of any future drawings under such Letters of Credit, and Borrower shall forthwith deposit and pay such amounts, and (ii) pay in advance all Letter of Credit fees scheduled to be paid or payable over the remaining term of any Letters of Credit;

(d) settle or adjust disputes and claims directly with Account Debtors for amounts on commercially reasonable terms and in any order that Lender considers advisable, notify any Person owing Borrower money of Lender's security interest in such funds, and verify the amount of such account;

(e) make any payments and do any acts it considers necessary or reasonable to protect the Collateral and/or its security interest in the Collateral. Borrower shall assemble the Collateral if Lender requests and make it available as Lender designates. Lender may enter premises where the Collateral is located, take and maintain possession of any part of the Collateral, and pay, purchase, contest, or compromise any Lien which appears to be prior or superior to its security interest and pay all expenses incurred. Borrower grants Lender a license to enter and occupy any of its premises, without charge, to exercise any of Lender's rights and remedies;

(f) apply to the Obligations any (i) balances and deposits of Borrower it holds, or (ii) any amount held by Lender owing to or for the credit or the account of Borrower;

(g) ship, reclaim, recover, store, finish, maintain, repair, prepare for sale, advertise for sale, and sell the Collateral. Solely to the extent necessary in connection with its exercise of its remedies hereunder and without acquiring any other right, title or interest in or to the Borrower's intellectual property and related rights, Lender is hereby granted a non-exclusive, royalty-free license or other right to use, without charge, Borrower's labels, patents, copyrights, mask works, rights of use of any name, trade secrets, trade names, trademarks, service marks, and advertising matter, or any similar property as it pertains to the Collateral, in completing production of, advertising for sale, and selling any Collateral and, solely for purposes of Lender's exercise of its rights under this Section, Borrower's rights under all licenses and all franchise agreements inure to Lender's benefit;

(h) demand and receive possession of Borrower's Books; and

(i) exercise all rights and remedies available to Lender under the Loan Documents or at law or equity, including all remedies provided under the Code (including disposal of the Collateral pursuant to the terms thereof).

9.2 Power of Attorney. Borrower hereby irrevocably appoints Lender as its lawful attorney-in-fact, exercisable upon the occurrence and during the continuance of an Event of Default, to: (a) endorse Borrower's name on any checks or other forms of payment or security; (b) sign Borrower's name on any invoice or bill of lading for any Account or drafts against Account Debtors; (c) settle and adjust disputes and claims about the Accounts directly with Account Debtors, for amounts and on terms Lender determines reasonable; (d) make, settle, and adjust all claims under Borrower's insurance policies; (e) pay, contest or settle any Lien, charge, encumbrance, security interest, and adverse claim in or to the Collateral, or any judgment based thereon, or otherwise take any action to terminate or discharge the same; and (f) transfer the Collateral into the name of Lender or a third party as the Code permits. Borrower hereby appoints Lender as its lawful attorney-in-fact to sign Borrower's name on any documents necessary to perfect or continue the perfection of Lender's security interest in the Collateral regardless of whether an Event of Default has occurred until all Obligations have been satisfied in full and Lender is under no further obligation to make Loans hereunder. Lender's foregoing appointment as Borrower's attorney in fact, and all of Lender's rights and powers, coupled with an interest, are irrevocable until all Obligations have been fully repaid and performed and Lender's obligation to provide Loans terminates.

9.3 Protective Payments. If Borrower fails to obtain the insurance called for by Section 6.4 or fails to pay any premium thereon or fails to pay any other amount which Borrower is obligated to pay under this Agreement or any other Loan Document, Lender may obtain such insurance or make such payment, and all amounts so paid by Lender are Lender Expenses and immediately due and payable, bearing interest at the then highest applicable rate, and secured by the Collateral. Lender will make reasonable efforts to provide Borrower with notice of Lender obtaining such insurance at the time it is obtained or within a reasonable time thereafter. No payments by Lender are deemed an agreement to make similar payments in the future or Lender's waiver of any Event of Default.

9.4 Application of Payments and Proceeds. Borrower shall have no right to specify the order or the accounts to which Lender shall allocate or apply any payments required to be made by Borrower to Lender or otherwise received by Lender under this Agreement when any such allocation or application is not specified

elsewhere in this Agreement. If an Event of Default has occurred and is continuing, Lender may apply any funds in its possession, whether from Borrower account balances, payments, proceeds realized as the result of any collection of Accounts or other disposition of the Collateral, or otherwise, to the Obligations in such order as Lender shall determine in its sole discretion. Any surplus shall be paid to Borrower or other Persons legally entitled thereto; Borrower shall remain liable to Lender for any deficiency. If Lender, in its good faith business judgment, directly or indirectly enters into a deferred payment or other credit transaction with any purchaser at any sale of Collateral, Lender shall have the option, exercisable at any time, of either reducing the Obligations by the principal amount of the purchase price or deferring the reduction of the Obligations until the actual receipt by Lender of cash therefor.

9.5 *Lender's Liability for Collateral.* So long as Lender complies with reasonable banking practices regarding the safekeeping of the Collateral in the possession or under the control of Lender, Lender shall not be liable or responsible for: (a) the safekeeping of the Collateral; (b) any loss or damage to the Collateral; (c) any diminution in the value of the Collateral; or (d) any act or default of any carrier, warehouseman, bailee, or other Person. Borrower bears all risk of loss, damage or destruction of the Collateral.

9.6 *No Waiver; Remedies Cumulative.* Lender's failure, at any time or times, to require strict performance by Borrower of any provision of this Agreement or any other Loan Document shall not waive, affect, or diminish any right of Lender thereafter to demand strict performance and compliance herewith or therewith. No waiver hereunder shall be effective unless signed by Lender and then is only effective for the specific instance and purpose for which it is given. Lender's rights and remedies under this Agreement and the other Loan Documents are cumulative. Lender has all rights and remedies provided under the Code, by law, or in equity. Lender's exercise of one right or remedy is not an election, and Lender's waiver of any Event of Default is not a continuing waiver. Lender's delay in exercising any remedy is not a waiver, election, or acquiescence.

9.7 *Demand Waiver.* Borrower waives demand, notice of default or dishonor, notice of payment and nonpayment, notice of any default, nonpayment at maturity, release, compromise, settlement, extension, or renewal of accounts, documents, instruments, chattel paper, and guarantees held by Lender on which Borrower is liable.

SECTION 10

NOTICES

All notices, consents, requests, approvals, demands, or other communication (collectively, "*Communication*") by any party to this Agreement or any other Loan Document must be in writing and shall be deemed to have been validly served, given, or delivered: (a) upon the earlier of actual receipt and three (3) Business Days after deposit in the U.S. mail, first class, registered or certified mail return receipt requested, with proper postage prepaid; (b) upon transmission, when sent by electronic mail or facsimile transmission; (c) one (1) Business Day after deposit with a reputable overnight courier with all charges prepaid; or (d) when delivered, if hand-delivered by messenger, all of which shall be addressed to the party to be notified and sent to the address, facsimile number, or email address indicated below. Lender or Borrower may change its address or facsimile number by giving the other party written notice thereof in accordance with the terms of this Section 10.

If to Borrower: Energy Recovery, Inc.
1908 Doolittle Drive
San Leandro, CA 94577
Attn: Thomas Willardson, Chief Financial Officer
Fax: (510) 483-7371
Tel: (510) 746-7370
Email: twillardson@energy-recovery.com

If to Lender: Citibank, N.A.
3950 Regent Blvd.
Mailstop S2A-267
Irving, TX 75063

and to: Robert Hurley
Citibank, N.A.
One Sansome Street, 21st Floor
San Francisco, CA 94104
Tel: (415) 658-4236
Fax: (415) 658-4555

and to: Citibank, N.A.
One Sansome Street, 21st Floor
San Francisco, CA 94104
Attn: Paula Turney
Fax: (415) 658-4555
Tel: (415) 658-4558

SECTION 11

CHOICE OF LAW, VENUE AND JURY TRIAL WAIVER

This Agreement and the Loan Documents will be governed by federal law applicable to Lender and, to the extent not preempted by federal law, the laws of the State of California, without regard to its conflicts of law provisions. Borrower and Lender each submit to the exclusive jurisdiction of the State and Federal courts in San Francisco County, California; provided, however, that nothing in this Agreement shall be deemed to operate to preclude Lender from bringing suit or taking other legal action in any other jurisdiction to realize on the Collateral or any other security for the Obligations, or to enforce a judgment or other court order in favor of Lender. Borrower expressly submits and consents in advance to such jurisdiction in any action or suit commenced in any such court, and Borrower hereby waives any objection that it may have based upon lack of personal jurisdiction, improper venue, or forum non conveniens and hereby consents to the granting of such legal or equitable relief as is deemed appropriate by such court. Borrower hereby waives personal service of the summons, complaints, and other process issued in such action or suit and agrees that service of such summons, complaints, and other process may be made by registered or certified mail addressed to Borrower at the address set forth in Section 10 of this Agreement and that service so made shall be deemed completed upon the earlier to occur of Borrower's actual receipt thereof or three (3) days after deposit in the U.S. mails, proper postage prepaid.

TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, BORROWER AND LENDER EACH WAIVE THEIR RIGHT TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION ARISING OUT OF OR BASED UPON THIS AGREEMENT, THE LOAN DOCUMENTS OR ANY CONTEMPLATED TRANSACTION, INCLUDING CONTRACT, TORT, BREACH OF DUTY AND ALL OTHER CLAIMS. THIS WAIVER IS A MATERIAL INDUCEMENT FOR BOTH PARTIES TO ENTER INTO THIS AGREEMENT. EACH PARTY HAS REVIEWED THIS WAIVER WITH ITS COUNSEL.

SECTION 12

GENERAL PROVISIONS

12.1 *Successors and Assigns.* This Agreement binds and is for the benefit of the successors and permitted assigns of each party. Borrower may not assign this Agreement or any rights or obligations under it without Lender's prior written consent (which may be granted or withheld in Lender's discretion). Lender has the right, without the consent of or notice to Borrower, to sell, transfer, negotiate, or grant participation in all or any part of, or any interest in, Lender's obligations, rights, and benefits under this Agreement and the other Loan Documents.

12.2 *Indemnification.* Borrower agrees to indemnify, defend and hold Lender and its directors, officers, employees, agents, attorneys, or any other Person affiliated with or representing Lender harmless against: (a) all obligations, demands, claims, and liabilities (collectively, "*Claims*") asserted by any other party in connection with the transactions contemplated by the Loan Documents; and (b) all losses or Lender Expenses incurred, or paid by

Lender from, following, or arising from transactions between Lender and Borrower (including reasonable attorneys' fees and expenses), except for Claims and/or losses directly caused by Lender's gross negligence or willful misconduct or breach of any material obligation under this Agreement or any other Loan Document.

12.3 *Time of Essence.* Time is of the essence for the performance of all Obligations in this Agreement.

12.4 *Severability of Provisions.* Each provision of this Agreement is severable from every other provision in determining the enforceability of any provision.

12.5 *Amendments in Writing; Integration.* All amendments to this Agreement must be in writing and signed by both Lender and Borrower. This Agreement and the Loan Documents represent the entire agreement about this subject matter and supersede prior negotiations or agreements. All prior agreements, understandings, representations, warranties, and negotiations between the parties about the subject matter of this Agreement and the Loan Documents merge into this Agreement and the Loan Documents.

12.6 *Counterparts.* This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, are an original, and all taken together, constitute one Agreement.

12.7 *Survival.* All covenants, representations and warranties made in this Agreement continue in full force until this Agreement has terminated pursuant to its terms and all Obligations (other than inchoate indemnity obligations and any other obligations which, by their terms, are to survive the termination of this Agreement) have been satisfied. The obligation of Borrower in Section 12.2 to indemnify Lender shall survive until the statute of limitations with respect to such claim or cause of action shall have run.

12.8 *Confidentiality.* In handling any confidential information, Lender shall exercise the same degree of care that it exercises for its own proprietary information, but disclosure of information may be made: (a) to Lender's Subsidiaries or Affiliates; (b) to prospective transferees or purchasers of any interest in the Loans (provided, however, Lender shall use commercially reasonable efforts to obtain such prospective transferee's or purchaser's agreement to the terms of this provision); (c) as required by law, regulation, subpoena, or other order; (d) to Lender's regulators or as otherwise required in connection with Lender's examination or audit; and (e) as Lender considers appropriate in exercising remedies under this Agreement. Confidential information does not include information that either: (i) is in the public domain or in Lender's possession when disclosed to Lender, or becomes part of the public domain after disclosure to Lender; or (ii) is disclosed to Lender by a third party, if Lender does not know that the third party is prohibited from disclosing the information.

12.9 *Attorneys' Fees, Costs and Expenses.* In any action or proceeding between Borrower and Lender arising out of or relating to the Loan Documents, the prevailing party shall be entitled to recover its reasonable attorneys' fees and other costs and expenses incurred, in addition to any other relief to which it may be entitled.

[Signature page follows.]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed as of the date set forth on the first page hereof.

BORROWER:

Energy Recovery, Inc., a Delaware corporation

By /s/ Tom Willardson

Name: Thomas Willardson

Title: Chief Financial Officer

LENDER:

CITIBANK, N.A.

By /s/ Robert Hurley

Name: Robert Hurley

Title: Vice President

[Signature page to Loan and Security Agreement]

Exhibit A

[**]

Exhibit B

[***]

Exhibit C

[***]

Exhibit D

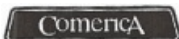
[***]

Exhibit E

[***]

Exhibit F

[***]



PLEDGE AND SECURITY AGREEMENT

THIS PLEDGE AND SECURITY AGREEMENT ("Agreement") is made as of February 17, 2009, by the undersigned ("Pledgor") in favor of Comerica Bank ("Bank").

RECITALS

Bank has issued the letters of credit with Pledgor as the applicant described on Exhibit B hereto (each, a "Letter of Credit" and collectively, the "Letters of Credit") pursuant to letter of credit applications and agreements dated the dates set forth on Exhibit B and the Promissory Note executed by Pledgor to the order of Bank in the original principal amount of \$1,000,000 dated March 28, 2007, having a current principal amount of \$457,926.77 as amended by Amendment to Note dated June 13, 2007 (the "Equipment Note") (the Equipment Note and the other said agreements as they may hereafter be amended from time to time, being collectively the "Master Agreement"). Pledgor has agreed to secure certain of its obligations with the account(s) described on attached Exhibit A (collectively, the "Collateral Account"). Unless specifically defined in this Agreement, all capitalized terms used herein shall have the meaning set forth in the Master Agreement.

NOW, THEREFORE, Pledgor and Bank agree as follows:

1. Pledge of Collateral.

(a) Pledgor hereby pledges to Bank and grants to Bank a security interest in the Collateral Account, together with all proceeds and substitutions thereof, all interest paid thereon, and all other cash and noncash proceeds of the foregoing (all hereinafter called the "Pledged Collateral"), as security for the prompt performance of all of Pledgor's obligations (the "Obligation(s)") with respect to, or arising out of, the Master Agreement. Bank's security interest hereunder will terminate upon expiry of the Letters of Credit, payment to Bank of all fees and commissions and any amounts for which Borrower has indemnified Bank with respect thereto, and repayment of the indebtedness evidenced by the Equipment Note. Pledgor and Bank hereby also confirm the existence and validity of any prior grant of a security interest in the Pledged Collateral pursuant to the Master Agreement or any other agreement previously entered into between the parties.

(b) Pledgor shall at all times cause the market value of the Pledged Collateral, as determined by Bank in its sole discretion from time to time, to be at least 105% of the total face amounts of the outstanding Letters of Credit plus the total of any unreimbursed draws under any Letters of Credit plus the outstanding indebtedness evidenced by the Equipment Note. For Letters of Credit not denominated in U.S. Dollars, Bank shall determine in its sole discretion from time to time the U.S. Dollar equivalent of such face amounts and unreimbursed draws. For the purposes of this subparagraph (b), the market value of cash denominated in U.S. Dollars shall be the amount of such cash.

(c) Pledgor authorizes Bank to file such financing statements, and take such other actions as Bank determines from time to time may be necessary or appropriate to perfect the security interest granted hereunder.

(d) Prior to the maturity (if any) of any Pledged Collateral held by Bank pursuant hereto, Pledgor and Bank shall agree upon a security or instrument similar in form, quality, and substance to the original Pledged Collateral in which the proceeds of the Pledged Collateral can be reinvested on maturity. Upon maturity of the Pledged Collateral in accordance with its terms, or in the event the Pledged Collateral otherwise becomes payable during the term of this Agreement, such maturing Pledged Collateral may be presented for payment, exchange, or otherwise marketed by Bank on behalf of Pledgor and the proceeds therefrom used to purchase the security or instrument agreed to by Pledgor and Bank in accordance with the immediately preceding sentence. If no agreement has been made, such proceeds shall be placed into an interest bearing account offered by the Bank until such time as an agreement as to the security replacing the original Pledged Collateral can be reached. Bank may retain any such successor collateral and the proceeds therefrom as Pledged Collateral in accordance with the terms of this Agreement.

(e) The pledge of a security interest in the Pledged Collateral hereunder remains in effect for the term of this Agreement notwithstanding any release by Bank of any other collateral in connection with the Master Agreement or any other agreement in effect between the Bank and the Pledgor, now or hereafter arising.

2. Representations, Warranties and Covenants. Pledgor represents and warrants to and covenants with Bank that:

- (a) The Pledged Collateral is owned by Pledgor free and clear of any security interests, liens, encumbrances, options or other restrictions created by Pledgor;
- (b) Pledgor has full power and authority to create a first lien on the Pledged Collateral in favor of Bank and no disability or contractual obligation exists that would prohibit Pledgor from pledging the Pledged Collateral pursuant to this Agreement, and Pledgor will not assign, create or permit to exist any other claim to, lien or encumbrance upon, or security interest in any of the Pledged Collateral;
- (c) The Pledged Collateral is not the subject of any present or threatened suit, action, arbitration, administrative or other proceeding, and Pledgor knows of no reasonable grounds for the institution of any such proceedings; and
- (d) Pledgor shall not transfer, encumber, dispose of, withdraw, or otherwise direct the payment of any proceeds, interest, or amounts payable with respect to the Pledged Collateral for so long as it is subject to this Agreement.

All the above representations and warranties shall survive the making of this Agreement.

3. Events of Default. Each of the following shall constitute an event of default ("Event of Default") hereunder:

- (a) The occurrence and continuance of an Event of Default under the Master Agreement or in any other present or future agreement between Pledgor and Bank; or
- (b) The breach of any provision of this Agreement by Pledgor or the failure by Pledgor to observe or perform any of the provisions of this Agreement.

4. Bank's Remedies Upon Default.

Upon the occurrence of an Event of Default, Bank shall have the right to exercise all such rights as a secured party under the California Uniform Commercial Code as it, in its sole judgment, shall deem necessary or appropriate. After the disposal of any of the Pledged Collateral, Bank may deduct all reasonable legal and other expenses and attorney's fees for protecting its interests and enforcing its remedies under the Master Agreement and this Agreement and shall apply the residue of the proceeds to, or hold as a reserve against, the Obligations in such manner as Bank in its sole discretion shall determine, and shall pay the balance, if any, to Pledgor or otherwise in accordance with applicable law.

5. Waivers: Indemnification.

(a) Demand; Protest. Except as otherwise provided in this Agreement, Pledgor waives demand protest, notice of protest, notice of default or dishonor, notice of payment and nonpayment and any other notices relating to the Obligations.

(b) Indemnification. Pledgor agrees to defend, indemnify and hold harmless Bank and its officers, employees, and affiliates against all losses or expenses in any way suffered, incurred, or paid by Bank as a result of or in any way arising out of, following, or consequential to transactions between Bank and Pledgor, under this Agreement (including without limitation reasonable attorneys' fees and expenses), except for losses caused by Bank's gross negligence or willful misconduct.

6. Notices. Unless otherwise later agreed to in writing, all notices or demands by any party regarding this Agreement shall be in writing and shall be personally delivered or sent by certified mail, postage prepaid, return receipt requested, or by telefacsimile to Pledgor or to Bank, as the case may be, at its addresses set forth in the Master Agreement, with a copy of such document sent to the Bank's account officer at the following address: 1331 N. California Boulevard, Walnut Creek CA, 94596.

7. Choice of Law and Venue: Jury Trial Waiver. This Agreement shall be governed by, and construed in accordance with, the internal laws of the State of California, without regard to principles of conflicts of laws. Each of Pledgor and Bank hereby submits to the exclusive jurisdiction of the state and Federal courts located in California. THE UNDERSIGNED ACKNOWLEDGE THAT THE RIGHT TO TRIAL BY JURY IS A CONSTITUTIONAL ONE, BUT THAT IT MAY BE WAIVED UNDER CERTAIN CIRCUMSTANCES. TO THE EXTENT PERMITTED BY LAW, EACH PARTY, AFTER CONSULTING (OR HAVING HAD THE OPPORTUNITY TO CONSULT) WITH COUNSEL OF ITS, HIS OR HER CHOICE, KNOWINGLY AND VOLUNTARILY, AND FOR THE MUTUAL BENEFIT OF ALL PARTIES, WAIVES ANY RIGHT TO TRIAL BY JURY IN THE EVENT OF LITIGATION ARISING OUT OF OR RELATED TO THIS AGREEMENT OR ANY OTHER DOCUMENT, INSTRUMENT OR AGREEMENT BETWEEN THE UNDERSIGNED PARTIES.

8. General Provisions.

(a) Successors and Assigns. This Agreement shall bind and inure to the benefit of the respective successors and permitted assigns of each of the parties; provided, however, that neither this Agreement nor any rights hereunder may be assigned by Pledgor without Bank's prior written consent, which consent may be granted or withheld in Bank's sole discretion. Bank shall have the right without the consent of or notice to Pledgor to sell, transfer, negotiate, or grant participation in all or any part of, or any interest in, Bank's obligations, rights and benefits hereunder.

(b) Time of Essence. Time is of the essence for the performance of all obligations set forth in this Agreement.

(c) Severability of Provisions. Each provision of this Agreement shall be severable from every other provision of this Agreement for the purpose of determining the legal enforceability of any specific provision.

(d) Amendments in Writing, Integration. This Agreement cannot be amended or terminated orally. All prior agreements, understandings, representations, warranties, and negotiations between the parties hereto with respect to the subject matter of this Agreement, if any, are merged into this Agreement and with any other written agreement concerning the Obligations previously entered into by the parties.

(e) Counterparts. This Agreement may be executed in any number of counterparts and by different parties on separate counterparts, each of which, when executed and delivered, shall be deemed to be an original, and all of which, when taken together, shall constitute but one and the same Agreement.

(f) Survival. All covenants, representations and warranties made in this Agreement shall continue in full force and effect so long as any Obligations remain outstanding. The obligations of Pledgor to indemnify Bank with respect to the expenses, damages, losses, costs and liabilities described in Section 5(b) shall survive until all applicable statute of limitations periods with respect to actions that may be brought against Bank have run.

(g) Term. This Agreement shall remain in effect so long as any Obligation, whether or not contingent or unliquidated, now or hereafter arising, remains in existence.

[signatures on the following page]

IN WITNESS WHEREOF, the parties hereto have executed this Agreement the day and year first above written.

Bank:
Comerica Bank

By: /s/ Darren Santos
Title: Corporate Banking Officer-Western Market

Pledgor:
Energy Recovery, Inc.

By: /s/ Tom Willardson
Title: Chief Financial Officer

**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**

I, G.G. Pique, certify that:

1. I have reviewed this quarterly report on Form 10-Q 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.

Date: May 8, 2009

/s/ G.G. Pique

Name: G.G. Pique
Title: President and Chief Executive Officer
(Principal Executive Officer)

**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**

I, Thomas D. Willardson, certify that:

1. I have reviewed this quarterly report on Form 10-Q 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.

Date: May 8, 2009

/s/ Thomas D. Willardson
Name: Thomas D. Willardson
Title: Chief Financial Officer
(Principal Financial Officer)

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER,
PURSUANT TO 18 U.S.C. SECTION 1350, AS ADOPTED PURSUANT TO SECTION 906 OF THE
SARBANES-OXLEY ACT OF 2002***

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, 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 Quarterly Report on Form 10-Q for the period ended March 31, 2009, to which this Certification is attached as Exhibit 32.1 (the "Quarterly 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 Quarterly Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Quarterly Report and results of operations of the Company for the period covered by the Quarterly Report.

IN WITNESS WHEREOF, the undersigned have set their hands hereto as of the 8th day of May 2009.

/s/ G.G. Pique

President and Chief Executive Officer

/s/ Thomas D. Willardson

Chief Financial Officer

Dated: May 8, 2009

Dated: May 8, 2009

* This certification accompanies the Form 10-Q 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-Q), irrespective of any general incorporation language contained in such filing.