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

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**FORM 10-Q**

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(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, 2005

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: \_\_\_\_\_

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**ACTIVE POWER, INC.**

(Exact name of registrant as specified in its charter)

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

**2128 W. Braker Lane, BK12, Austin, Texas**  
(Address of principal executive offices)

**74-2961657**  
(I.R.S. Employer  
Identification No.)

**78758**  
(Zip Code)

**(512) 836-6464**  
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  Yes  No

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

**The number of shares of common stock, par value of \$0.001 per share, outstanding at April 26, 2005 was 48,579,595.**

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## PART I - FINANCIAL INFORMATION

## Item 1. Financial Statements.

**Active Power, Inc.**  
**Condensed Balance Sheets**  
(in thousands)

	March 31, 2005	December 31, 2004
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 36,913	\$ 17,625
Restricted cash	116	741
Short-term investments in marketable securities	16,732	21,308
Accounts receivable, net	2,340	4,143
Inventories	5,464	3,966
Prepaid expenses and other	649	1,028
	<hr/>	<hr/>
Total current assets	62,214	48,811
Property and equipment, net	7,579	7,829
Intangible assets, net	697	725
Long-term investments in marketable securities	5,941	6,001
Deposits and other	187	—
	<hr/>	<hr/>
Total assets	\$ 76,618	\$ 63,366
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 1,190	\$ 1,649
Accrued expenses	3,596	3,410
Deferred revenue	318	214
	<hr/>	<hr/>
Total liabilities	5,104	5,273
Stockholders' equity:		
Common Stock	49	43
Treasury stock	(2)	(2)
Additional paid-in capital	234,780	215,937
Accumulated deficit	(163,125)	(157,798)
Other accumulated comprehensive income	(188)	(87)
	<hr/>	<hr/>
Total stockholders' equity	71,514	58,093
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 76,618	\$ 63,366
	<hr/>	<hr/>

See accompanying notes.

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**Active Power, Inc.**  
**Condensed Statements of Operations and Comprehensive Loss**  
(in thousands, except per share amounts)  
(Unaudited)

	Three Months Ended March 31,	
	2005	2004
Product revenue	\$ 2,931	\$ 2,749
Service and spares revenue	507	491
<b>Total revenue</b>	<b>3,438</b>	<b>3,240</b>
Operating expenses:		
Cost of product revenue	3,245	3,487
Cost of service and spares revenue	544	564
Research and development	2,231	2,353
Selling, general & administrative	3,574	2,779
Amortization of deferred stock compensation	—	17
<b>Total operating expenses</b>	<b>9,594</b>	<b>9,200</b>
Operating loss	(6,156)	(5,960)
Interest income	378	397
Gain due to change in market value of investment rights	493	—
Other income (expense)	(42)	(61)
<b>Net loss</b>	<b>\$ (5,327)</b>	<b>\$ (5,624)</b>
Net loss per share, basic & diluted	\$ (0.12)	\$ (0.13)
Shares used in computing net loss per share, basic & diluted	46,085	42,233
Comprehensive loss:		
Net loss	\$ (5,327)	\$ (5,624)
Change in unrealized gain(loss) on investments in marketable securities	(101)	28
<b>Comprehensive loss</b>	<b>\$ (5,428)</b>	<b>\$ (5,596)</b>

See accompanying notes.

**Active Power, Inc.**  
**Condensed Statements of Cash Flows**  
(in thousands)  
(Unaudited)

	Three Months Ended March 31,	
	2005	2004
<b>Operating activities</b>		
Net loss	\$ (5,327)	\$ (5,624)
Adjustments to reconcile net loss to cash used in operating activities:		
Depreciation expense	462	602
Amortization of intangible assets	28	28
Accretion of premium / discount on investments	65	25
Amortization of deferred stock compensation	—	17
Changes in operating assets and liabilities:		
Accounts receivable, net	1,803	340
Inventories	(1,498)	(1,298)
Prepaid expenses and other assets	192	145
Accounts payable	(459)	1,390
Accrued expenses	186	(721)
Deferred revenue	104	503
Net cash used in operating activities	(4,444)	(4,593)
<b>Investing activities</b>		
Purchases of marketable securities	(8,140)	(6,837)
Sales/Maturities of marketable securities	12,610	18,222
Purchases of property and equipment	(212)	(63)
Change in restricted cash	625	—
Net cash provided by investing activities	4,883	11,322
<b>Financing activities</b>		
Net proceeds from issuance of common stock	18,849	252
Net cash provided by financing activities	18,849	252
Change in cash and cash equivalents	19,288	6,981
Cash and cash equivalents, beginning of period	17,625	12,073
Cash and cash equivalents, end of period	\$36,913	\$19,054

See accompanying notes.

**Active Power, Inc.**  
**Notes to Condensed Financial Statements**  
**March 31, 2005**  
*(Unaudited)*

**1. Organization**

Active Power, Inc. (“we”, “Active Power” or the “Company”) is a Delaware Corporation. We design, manufacture and market power quality products to provide consistent, reliable electric power required by today’s digital economy. We have commercialized a flywheel energy storage system that provides a highly reliable, low-cost and non-toxic replacement for lead-acid batteries used in conventional power quality installations. We have broadened our product offerings and expanded our available markets by developing additional power quality systems to address customer needs at both higher and lower power levels. During 2004 we developed a battery-free extended runtime technology that utilizes thermal and compressed air storage to provide backup power for minutes to hours depending on the application. We expect to bring this technology to market later this year. We sell our products globally through direct and Original Equipment Manufacturer (“OEM”) channels. Our current principal markets are the United States, Europe and Africa.

**2. Basis of Presentation**

The unaudited interim financial statements included herein have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (“SEC”) including the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. The accompanying interim financial statements reflect all adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary to fairly state our financial position, results of operations and cash flows for the periods presented.

The condensed balance sheet information as of December 31, 2004 has been condensed from the audited financial statements at that date and does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. For further information, refer to the financial statements and footnotes thereto included in our annual report on Form 10-K for the year ended December 31, 2004.

Operating results for the three-month period ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ended December 31, 2005.

Certain prior period amounts have been reclassified to conform to current period presentation.

**3. Inventory**

We state inventories at the lower of cost or market, using the first-in-first-out-method. Inventories consist of the following (in thousands):

	March 31, 2005	December 31, 2004
Raw materials	\$ 2,015	\$ 1,728
Work in process and finished goods	3,449	2,238
	<u>\$ 5,464</u>	<u>\$ 3,966</u>

#### 4. Net Loss Per Share

The following table sets forth the computation of basic and diluted net loss per share (in thousands, except per share data):

	Three Months Ended March 31,	
	2005	2004
Net loss	\$ (5,327)	\$ (5,624)
Basic and diluted:		
Weighted-average shares of common stock outstanding	46,085	42,236
Weighted-average shares of common stock subject to repurchase	—	(3)
Shares used in computing net loss per share, basic and diluted	46,085	42,233
Net loss per share, basic and diluted	\$ (0.12)	\$ (0.13)

Our calculation of diluted loss per share excludes 5,725,105 and 5,200,014 shares of common stock issuable upon exercise of employee stock options as of March 31, 2005 and 2004, respectively, because their inclusion in the calculation would be anti-dilutive. The calculation of diluted loss per share as of March 31, 2005 also excludes 1,636,353 shares of common stock issuable pursuant to the Additional Investment Rights granted in connection with the sale of common stock in February 2005 (see Note 6), as their inclusion in the calculation would be anti-dilutive.

#### 5. Accounting for Stock-Based Compensation

Statement of Financial Accounting Standards (“SFAS”) No. 123, *Accounting for Stock-Based Compensation* (“SFAS 123”) prescribes accounting and reporting standards for all stock-based compensation plans, including employee stock options. As allowed by SFAS 123, we have elected to continue to account for its employee stock-based compensation using the intrinsic value method in accordance with Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB 25”), and related Interpretations. Deferred stock-based compensation is typically amortized using the straight-line method over the vesting period, which is generally four years, utilizing the accelerated method prescribed in Financial Accounting Standards Board (“FASB”) Interpretation No. 28. We have calculated the fair value of options granted in these periods using the Black-Scholes option-pricing model and has determined the pro forma impact on net loss. Where it is not feasible to reasonably estimate fair value at grant date, compensation is measured using fair value and other pertinent data at the first date at which it is possible to reasonably estimate that value. Generally that is the date that the number of shares and exercise price are determinable. This method is used for shares granted pursuant to our Employee Stock Purchase Plan.

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The following table illustrates the effect on net loss and net loss per share if we had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands, except per share data):

	Three Months Ended March 31,	
	2005	2004
Net loss - as reported	\$ (5,327)	\$ (5,624)
Total stock-based compensation cost, net of related tax effects included in the determination of net income as reported	174	17
The stock-based employee compensation cost, net of related tax effects, that would have been included in the determination of net income if the fair value based method had been applied to all awards	(1,609)	(1,531)
Pro forma net loss	<u>\$ (6,762)</u>	<u>\$ (7,138)</u>
Earnings per share:		
Basic and diluted - as reported	\$ (0.12)	\$ (0.13)
Basic and diluted - pro forma	\$ (0.15)	\$ (0.17)

## 6. Common Stock

On February 4, 2005, we completed the private placement of 5,454,510 shares of the Company's Common Stock at a price of \$3.64 per share, for an aggregate offering price of approximately \$19.8 million, to certain institutional investors (the "Purchasers"). We also issued Additional Investment Rights to purchase 1,636,353 shares of Common Stock to the Purchasers (the "Additional Investment Rights"), at an exercise price per share of \$3.64. The Additional Investment Rights are exercisable until the earliest to occur of (1) the date that is three months following the effective date of our registration statement registering the resale of the shares of Common Stock sold to the Purchasers and the shares of Common Stock issuable upon exercise of the Additional Investment Rights, (2) immediately prior to any merger or acquisition of the Company pursuant to which the Company is not the surviving entity, or (3) February 4, 2007. In connection with the transaction, we paid placement agent fees and expenses of approximately \$1.1 million.

The transaction was exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended (the "Securities Act"), and Regulation D promulgated thereunder, as a transaction not involving a public offering, and in reliance on similar exemptions under applicable state laws. We believe that each of the Purchasers qualifies as an "accredited investor" (as defined by Rule 501(a) under the Securities Act).

As part of the transaction, we agreed to register for resale under the Securities Act all of the shares of Common Stock issued in the offering, as well as shares of Common Stock issuable upon exercise of the Additional Investment Rights. We filed a Registration Statement on Form S-3 with the SEC on March 24, 2005. Under the transaction agreements, a failure to have the Registration Statement declared effective within 120 days after the closing (February 4, 2005) may subject us to liquidated damages equal to 1% of the aggregate purchase price paid, per month (increasing to 2% per month in the second month after any delay), until the time that the Registration Statement is declared effective.

In accordance with the requirements of SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, the fair value of the Additional Investment Rights was determined at the time of issuance based on the proceeds of the offering and the relative fair values of the securities and the Additional Investment Rights. We used the Black-Scholes valuation model to determine the fair value of the Additional Investment Right, and accordingly attributed a value of \$964,000 to the Additional Investment Rights, which has been recorded as additional paid in capital. Changes in the fair value of the Additional Investment Rights since the date of issuance due to fluctuations in the value of our stock are required to be reflected in our earnings. The rights were revalued to their market value of \$ 471,000 at March 31, 2005, with a resultant gain of \$493,000 that has been included in other income.



## 7. Recently Issued Accounting Standards

In December 2004, the FASB issued SFAS No. 123R, *Share-based Payments* (“SFAS 123R”), which supersedes APB 25, SFAS 123 and related implementation guidelines. The pronouncement is effective for annual periods beginning after June 15, 2005. Under this pronouncement, stock-based compensation to employees is required to be recognized as a charge to the Statement of Operations and such charge is required to be measured according to the fair value of the stock options. Pro forma disclosure is no longer an alternative. In the absence of an observable market price for the stock awards, the fair value of the stock options would be based upon a valuation methodology that takes into consideration various factors, including the exercise price of the option, the expected term of the option, the current price of the underlying shares, the expected volatility of the underlying shares, the expected dividends on the underlying shares and the risk-free interest rate.

We will adopt the delayed provisions of SFAS 123R beginning January 1, 2006 using a modified version of prospective application, as allowed by the standard. Under this modified prospective application method, SFAS 123R will be applied to new stock awards granted after the date of adoption and to awards modified, repurchased or cancelled after January 1, 2006. Additionally, compensation costs for the portion of stock awards for which the requisite service has not been rendered/vested that are outstanding as of January 1, 2006 shall be recognized as the requisite service is rendered after January 1, 2006. The compensation costs for that portion of stock awards shall be based on the grant-date fair value of those awards as calculated for pro-forma disclosures under SFAS 123.

We anticipate that the impact of adopting SFAS 123R on net income and earnings per share will approximate the impact of the adjustments made to determine pro forma net income and pro forma earnings per share under SFAS 123, as described in Note 5 above. There are certain differences between the requirements of SFAS 123 and SFAS No. 123R that may result in differences from the amounts disclosed in Note 5. SEC Staff Accounting Bulletin No. 107, issued in March 2005, provides further clarification of how to determine the fair value of stock awards.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, An Amendment of Accounting Research Bulletin (“ARB”) No. 43, Chapter 4* (“SFAS 151”). SFAS 151 amends ARB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recognized as current period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe that the adoption of SFAS 151 will have a material impact on our results of operations or financial position.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

*The following discussion should be read in conjunction with, and is qualified in its entirety to, the financial statements and notes thereto included in Item 1 of this Form 10-Q and the financial statements and notes thereto and our Management's Discussion and Analysis of Financial Condition and Results of Operation for the year ended December 31, 2004 included in our Form 10-K. This report contains forward-looking statements, within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, that involve risks and uncertainties. Our expectations with respect to future results of operations that may be embodied in oral and written forward-looking statements, including any forward looking statements that may be included in this report, are subject to risks and uncertainties that must be considered when evaluating the likelihood of our realization of such expectations. Our actual results could differ materially. The words "believe," "expect," "intend," "plan," "project," "will" and similar phrases as they relate to us are intended to identify such forward-looking statements. In addition, please see the "Risk Factors That May Affect Future Results" below for a discussion of items that may affect our future results.*

### **Overview**

We design, manufacture and market power quality products that provide the consistent, reliable electric power required by today's digital economy. We believe that we are the first company to commercialize a flywheel energy storage system that provides a highly reliable, low-cost and non-toxic replacement for the lead-acid batteries used in conventional power quality installations. Our first commercial product was a battery-free DC system ("CleanSource® DC") that is used as a bridging energy source in typical power quality installations and is compatible with all major uninterruptible power supply ("UPS") brands. Leveraging our expertise in this technology, we have also developed a battery-free UPS system that incorporates our flywheel technology. This system is marketed by Caterpillar Inc., the leading maker of engine generators for the power reliability market, under the Caterpillar brand name "Cat® UPS" and is also marketed directly by Active Power as the CleanSource® UPS. In 2003 and 2004, we broadened our product offerings and expanded our available markets by developing additional power quality systems to address customer needs at both higher and lower power levels. Our family of battery-free UPS products currently ranges from 65 kVA – 1200 kVA. By paralleling our 1200 kVA UPS systems together, we will be able to provide up to a 3600 kVA battery-free UPS system to customers.

During 2004, we developed a battery-free extended runtime technology (one that provides backup power for minutes to hours depending on the application) that utilizes thermal and compressed air storage ("TACAS"). We disclosed this TACAS technology in September 2004. In December 2004, we shipped an evaluation unit of our first extended runtime product that is based on the TACAS technology ("CleanSource® XR"). We shipped an additional evaluation unit in March 2005, and intend to ship more CleanSource XR evaluation units in the next quarter and to begin commercial production of this product in the fourth quarter of 2005.

Our products are sold for use in the facilities of companies across many different industries that all share a critical need for reliable, high-quality power, such as broadcasters, hospitals, credit card processing centers, semiconductor manufacturers, pharmaceutical manufacturers, plastics manufacturers, data centers and electric utilities. Sales have been spread across many different countries from all regions of the world. Our primary markets are the United States, Europe and Africa.

As of March 31, 2005, we had generated an accumulated deficit of \$163.1 million and we expect to continue to sustain operating losses for the next several quarters. To date we have funded our operations through private and public sales of shares of common and preferred stock, including most recently in February 2005, from the private placement of common stock that raised a further \$18.7 million in net proceeds. Based on the current spending levels and expectations in our current business plan, we believe that our current cash and investments will be sufficient to meet our cash requirements through the next 24 months. Our cash and investments position at March 31, 2005 was \$59.7 million.

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Some of the uncertainties that could impact our business include the strength of the U.S. and global economies, the success of our direct sales efforts, delays in new product development, the speed of market adoption for our technology and products, global commodity prices and new competitive technologies and products.

### **Critical Accounting Policies and Estimates**

The discussion and analysis of our financial condition and results of operations are based upon our condensed financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Estimates and assumptions are reviewed periodically. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following represent our critical accounting policies:

- Revenue Recognition
- Inventories
- Warranty Liability

We also have other policies that we consider to be key accounting policies. However, we believe that these policies do not meet the definition of critical accounting estimates because they do not generally require us to make estimates or judgments that are difficult or subjective.

#### *Revenue Recognition*

In general, product revenue is recognized when title and risk of loss have transferred as stipulated by the delivery terms in the sales arrangement. In addition, prior to revenue recognition we require persuasive evidence of the arrangement, that the price is fixed or determinable, and that collectibility is reasonably assured.

We also offer various services to customers depending on the type of product the customer has purchased, which may include on-site services or installation and integration services. Such services are not essential to the functionality of the delivered product. Revenue for services is recognized at the time services are provided, or is deferred and recognized over the service period (where applicable). When products and services are contracted under a single arrangement, we allocate the total sales price to the multiple deliverables based on their relative fair values. The fair value of our equipment is based on our average historical selling prices, while the fair value of services is based upon the rates that we charge customers in separately negotiated transactions or based on the market price an independent third party would charge to provide these services. Revenue associated with the sale of extended warranties is recognized ratably over the contract period.

#### *Inventories*

We state inventories at the lower of cost or market, using the first-in-first-out-method. If actual future demand or market conditions are less favorable than those projected by management, or if product design changes result in excess or obsolete components beyond current expectations, additional inventory write-downs may be required. We evaluate our inventory valuation on a quarterly basis.

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### *Warranty Liability*

We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in product quality programs and processes, our warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability may be required. We evaluate the reasonableness of our warranty accrual levels on a quarterly basis.

### **Results of Operations**

**Total Revenue.** Revenue primarily consists of sales of our CleanSource power quality products. The following table summarizes for the periods indicated, a quarter-over-quarter comparison of our total revenue:

<i>(\$ in thousands)</i>	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
Total revenue	\$ 3,438	\$ 3,240	\$ 198	6%

Total revenue in the first quarter of 2005 remained relatively flat compared to the first quarter of 2004, but decreased by \$1.3 million, or 28%, compared to the fourth quarter of 2004. Some of this decrease is attributable to seasonal factors that typically result in a decrease in revenue in our first quarter. There was also a shift in product mix, with an increase in the percentage of DC products sold relative to UPS products during the quarter. However this shift is not expected to continue during 2005 and we anticipate UPS and Continuous Power System (“CPS”) products to continue to represent the vast majority of our total revenue.

During fiscal 2004 we began to significantly benefit from CPS sales, which typically include our 1200 kVA UPS product combined with third party equipment, and installation and start-up services. Sales related to these large system deals were \$497,000 and \$1.4 million in the first quarters of fiscal 2005 and 2004, respectively. These large system sales are governed by strict revenue recognition criteria and may take a long time to close or to fulfill all the requirements for revenue recognition. This delay can result in significant fluctuations in recorded revenue on a quarterly basis, especially if anticipated transactions fail to materialize as planned. We anticipate that CPS related revenue will be a significant contributor to our total revenue in the remainder of 2005.

Stocking units held as inventory at our primary OEM distributor, Caterpillar and its dealer network, declined sequentially by approximately \$840,000, or 21%, during the first three months of 2005. Although we have no obligations to our OEM customers for the products that they hold in their inventory, a significant reduction in our OEM customers’ product levels would negatively impact our future sales if they are able to satisfy orders from their inventory during the quarter rather than purchase new units from us. We are working closely with our OEM customers to assist them in selling these stocking orders over time. During fiscal 2005, we expect current channel inventory to continue to decline and reach an appropriate level of stocking units to enable them to respond quickly to time-sensitive customer orders.

The average selling price of our base products declined slightly by 7% in the first quarter of 2005 as compared to the first quarter of 2004. Our sales prices will vary depending on the power levels of the products sold, and the quantity and type of options purchased by the customers during a particular fiscal period. Sales of Active Power branded products through our direct and manufacturer’s representative channels as a percentage of revenue decreased slightly from 44% of our total revenues in the first quarter of 2004 to 38% of our total revenues in the first quarter of 2005. We believe sales of our Active Power branded products to government facilities and industrial customers in regions not

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previously covered by our OEMs will continue to increase over time and will become a larger percentage of our revenue. Our products perform well in harsh environments where power quality is particularly poor, which makes them a good fit for industrial countries with a poor power infrastructure. Due to the large size of some of our customer orders relative to our current total revenue levels, our quarterly total revenue trend can be expected to fluctuate as these orders ship in various periods.

North American sales increased from 50% of total revenue in the first quarter of 2004 to 62% in the first quarter of 2005. This was primarily driven by the Caterpillar channel, which represented 51% of our total revenues, however we also saw an increase in DC product sales which was driven by another OEM, Eaton Power Quality.

Service and spares revenue primarily relates to revenue generated from repairs or reconfigurations of our products, and includes revenue associated with the costs of travel of our service personnel, replacement parts and labor. Revenue from these sources increased by 3% from the first quarter of 2004 to \$507,000 in the first quarter of 2005. We anticipate that service and spares revenue will grow with product revenue because as more units are sold to customers, more installation and start up services will be required, particularly when those products are sold through our Active Power branded channel.

**Cost of product revenue.** Cost of product revenue includes the cost of component parts of our products that are sourced from suppliers, personnel, equipment and other costs associated with our assembly and test operations, shipping costs, warranty costs, and the costs of manufacturing support functions such as logistics and quality assurance. The following table summarizes for the periods indicated, a quarter-over-quarter comparison of our cost of product revenue:

(\$ in thousands)	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
Cost of product revenue	\$ 3,245	\$ 3,487	\$ (242)	(7)%
Percent of product revenue	111%	127%		

The decrease in cost of product revenue in the first quarter of 2005 compared to the first quarter of 2004 is due to improved efficiency in our manufacturing operations and material costs reductions. We have ongoing programs to reduce product and component costs where feasible, and this has resulted in an improvement in materials costs as a percentage of product revenue. We continue to operate a manufacturing facility that has a capacity level significantly greater than our current product revenue levels. A large portion of the costs involved in operating our facility are fixed in nature, and we incur approximately \$1.2 million in overhead each quarter. We reduced our manufacturing staff levels in 2003 and have continued to reduce our overhead levels where feasible. We also continue to work on reducing our product costs, and we believe that under current circumstances we will achieve gross margin break-even at approximately \$5 million in quarterly revenue. Items that could impact our ability to improve our gross margin include sales product mix, pricing discounts and customer incentives, currency fluctuations, and variations in our product cost and productivity.

The improvement in cost of product revenue as a percentage of product revenue in 2005 compared to 2004 is because 2004 product revenue included sales to a large industrial customer in Northern Africa, where the sales contract required performance guarantees. This impacts the amount of revenue that we can recognize on the sale (a portion must be deferred until the performance guarantee is released), despite incurring all of the costs. In the first quarter of 2005, our sales to this customer required a smaller performance guarantee and also commanded a slightly higher profit margin on third party equipment.

**Cost of service and spares revenue.** Cost of service and spares revenue includes the cost of component parts, as well as labor and overhead of our spare parts, costs associated with travel and labor used in servicing a unit and unabsorbed overhead from the service group. The following table summarizes for the periods indicated, a quarter-over-quarter comparison of our cost of service and spares revenue:

(\$ in thousands)	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
Cost of service and spares revenue	\$ 544	\$ 564	\$ (20)	(4)%
Percent of service and spares revenue	107%	115%		

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The cost of service and spares revenue did not fluctuate significantly in the first quarter of 2005 compared to the first quarter of 2004. It is driven by service and spares revenue.

**Research and development.** Research and development expense primarily consists of compensation and related costs of employees engaged in research, development and engineering activities, third party consulting and development activities, as well as an allocated portion of our occupancy costs. The following table summarizes for the periods indicated, a quarter-over-quarter comparison of our research and development expense:

	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
<i>(\$ in thousands)</i>				
Research and development	\$2,231	\$2,353	\$ (122)	(5)%
Percent of total revenue	65%	73%		

The slight decrease in research and development spending primarily resulted from a decrease in electricity costs as our efforts to parallel our 1200 kVA UPS systems moved from development status to commercial production status. Currently, engineering spending is driven by the development of several evaluation units of our CleanSource XR product that will ship through the third quarter of this year. We believe research and development expenses will increase by approximately \$500,000 during both the second and third quarters of fiscal 2005 due to ongoing development and as the CleanSource XR product nears commercial production status.

**Selling, general and administrative.** Selling, general and administrative expense is primarily comprised of compensation and related costs for sales, service, marketing and administrative personnel, selling and marketing expenses, professional fees, and bad debt costs. The following table summarizes for the periods indicated, a quarter-over-quarter comparison of our selling, general and administrative expense:

	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
<i>(\$ in thousands)</i>				
Selling, general and administrative	\$3,574	\$2,779	\$ 795	29%
Percent of total revenue	104%	86%		

The increase in selling, general and administrative expenses in the first quarter of 2005 as compared to the first quarter of 2004 was attributable to a number of factors including:

- a \$520,000 increase in sales tax expense as a result of multi-year state sales tax audits;
- incremental compensation expense of \$174,000 associated with modifications to stock awards in connection with the resignation of our former chief financial officer;
- higher professional fees of \$369,000 connected with the implementation of the Sarbanes-Oxley Act of 2002, completion of our 2004 annual audit, and recruiting costs; and
- higher salaries in sales and marketing due to the addition of nine employees from March 31, 2004 to March 31, 2005, five of which were added to support our new sales and service operations in Northern Africa.

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The increase was offset by a reduction in legal fees of \$376,000 due to the settlement of the Magnex lawsuit.

**Interest income.** The following table summarizes the quarterly change in our interest income:

	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
<i>(\$ in thousands)</i>				
Interest income	\$ 378	\$ 397	\$ (19)	(5)%

The decrease in interest income in the first quarter of 2005 as compared to the first quarter of 2004 is attributable to a decrease in our average cash and investments balances, offset by slightly higher returns on our investments.

### Liquidity and Capital Resources

Our principal sources of liquidity as of March 31, 2005 consisted of \$59.7 million of cash and investments. We have primarily funded our operations through our initial public offering in August 2000, resulting in net proceeds of \$138.4 million, sales of shares of our preferred stock, which have resulted in gross proceeds of approximately \$42.6 million, as well as \$10 million in development funding received from Caterpillar since 1999, and our product revenue. Additionally, in February 2005, we completed a private placement of our common stock that raised an additional \$18.7 million after expenses.

The following table summarizes the yearly changes in cash used in operating activities:

	Three months ended March 31,		Variance 2005 vs. 2004	
	2005	2004	\$	%
<i>(\$ in thousands)</i>				
Cash used in operating activities	\$(4,444)	\$(4,593)	\$ (149)	(3)%

Cash used in operating activities decreased slightly in the first quarter of 2005 compared to the first quarter of 2004 due to a lower net loss and a decline in accounts receivable, offset by an increase in inventory and the timing of payments to vendors. The decrease in accounts receivable reflects lower sales compared to the prior quarter, including lower sales at the end of the quarter compared to the end of the previous quarter. The increase in inventories is primarily attributable to an increase in finished goods for a specific system that was built and intended for sale during the quarter but which did not sell, and due to higher inventory build-up of materials for our 1200 kVA product in advance of sales expected during the second quarter. We expect cash usage in 2005 to be flat or slightly decrease from 2004 as we continue to position the company for future growth by funding product development, sales and marketing activities, OEM customer support, and manufacturing operations at levels higher than what can be self funded through current product sales.

Investing activities primarily consist of sales and purchases of investments, use of restricted cash and purchases of property and equipment. Fluctuations in the sale and purchase of investments generally reflect our use of these funds to finance our ongoing operations.

Capital expenditures were \$212,000 in the first quarter of 2005 compared to \$63,000 in the first quarter of 2004. In the first quarter of 2004 our expenditures were principally for general corporate purposes. In the first quarter of 2005 our capital expenditures primarily related to the start up of our

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satellite sales and service office in Northern Africa, manufacturing leasehold improvements related to the commercialization of paralleled 1200 kVA products and sustaining our current production facilities and product offerings. We expect capital expenditures to range from \$1 million to \$2 million for the balance of the year to support our development efforts on our extended run-time product and 1200 kVA paralleling project.

Financing activities generally consists of proceeds from sale of equities, employee exercises of stock options and from the Employee Stock Purchase Plan. The significant increase from \$252,000 in the first quarter of 2004 to \$18,849,000 in the first quarter of 2005 was primarily due to the private placement of 5,454,510 shares of our common stock in February 2005 that resulted in net proceeds of \$18,732,000.

We believe our existing cash and investments balances at March 31, 2005 will be sufficient to meet our cash requirements through the next 24 months, although we might elect to seek additional funding prior to that time. Beyond the next 24 months, our cash requirements will depend on many factors, including the rate of sales growth, the market acceptance of our products, the timing and level of development funding, the rate of expansion of our sales and marketing activities, the rate of expansion of our manufacturing processes, and the timing and extent of research and development projects. Although we are not a party to any agreement or letter of intent with respect to a potential acquisition or merger, we may enter into acquisitions or strategic arrangements in the future, which could also require us to seek additional equity or debt financing.

### **Recent Accounting Pronouncements**

In December 2004, the FASB issued SFAS 123R, which supersedes APB 25, SFAS 123 and related implementation guidelines. The pronouncement is effective for annual periods beginning after June 15, 2005. Under this pronouncement, stock-based compensation to employees is required to be recognized as a charge to the Statement of Operations and such charge is required to be measured according to the fair value of the stock options. Pro forma disclosure is no longer an alternative. In the absence of an observable market price for the stock awards, the fair value of the stock options would be based upon a valuation methodology that takes into consideration various factors, including the exercise price of the option, the expected term of the option, the current price of the underlying shares, the expected volatility of the underlying shares, the expected dividends on the underlying shares and the risk-free interest rate.

We will adopt the delayed provisions of SFAS 123R beginning January 1, 2006 using a modified version of prospective application, as allowed by the standard. Under this modified prospective application method, SFAS 123R will be applied to new stock awards granted after the date of adoption and to awards modified, repurchased or cancelled after January 1, 2006. Additionally, compensation costs for the portion of stock awards for which the requisite service has not been rendered/vested that are outstanding as of January 1, 2006 shall be recognized as the requisite service is rendered after January 1, 2006. The compensation costs for that portion of stock awards shall be based on the grant-date fair value of those awards as calculated for pro-forma disclosures under SFAS 123.

We anticipate that the impact of adopting SFAS 123R on net income and earnings per share will approximate the impact of the adjustments made to determine pro forma net income and pro forma earnings per share under SFAS 123, as described in Note 5 of the financial statements included in Item 1 above. There are certain differences between the requirements of SFAS 123 and SFAS 123R that may result in differences from the amounts disclosed in the financial statements. SEC Staff Accounting Bulletin No. 107, issued in March 2005, provides further clarification of how to determine the fair value of stock awards.

In November 2004, the FASB issued SFAS No. 151. SFAS 151 amends ARB No. 43, Chapter 4, to clarify that abnormal amounts of idle facility expense, freight, handling costs and wasted materials (spoilage) be recognized as current period charges. It also requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe that the adoption of SFAS 151 will have a material impact on our results of operations or financial position.



## **Risk Factors That May Affect Future Results**

*You should carefully consider the risks described below before making a decision to invest in our common stock or in evaluating Active Power and our business. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we do not presently know, or that we currently view as immaterial, may also impair our business operations. This report is qualified in its entirety by these risk factors.*

*The actual occurrence of any of the following risks could materially harm our business, financial condition and results of operations. In that case, the trading price of our common stock could decline.*

### **Our financial results may vary significantly from quarter to quarter.**

Our operating results have varied significantly from quarter to quarter at times in the past and may continue to vary significantly from quarter to quarter due to a variety of factors. Many of these factors are outside of our control. These factors include:

- timing of orders from our customers and the possibility that customers may change their order requirements with little or no notice to us;
- rate of adoption of our flywheel-based energy storage system as an alternative to lead-acid batteries;
- ongoing need for short-term power outage protection in traditional UPS systems;
- deferral of customer orders in anticipation of new products from us or other providers of power quality systems;
- uncertainty regarding the adoption of our current and future products, including the CleanSource UPS and CleanSource DC products, as well as our other products that are currently under development, including the CleanSource XR;
- timing of deferred revenue components associated with large orders;
- new product releases, licensing or pricing decisions by our competitors;
- commodity and raw material component prices;
- lack of order backlog;
- loss of a significant customer or distributor;
- impact of changes to our product distribution strategy and pricing policies;
- changes in the mix of domestic and international sales;
- changes in the cost of routine business activities, e.g. the increasing cost of director and officer liability insurance premiums, increasing health insurance premiums, or costs associated with compliance of the requirements of Section 404 of the Sarbanes-Oxley Act of 2002;
- changes in generally accepted accounting principles in the United States;
- rate of growth of the markets for our products; and
- other risks described below.

We derive a significant portion of our revenues from relatively large transactions. The sales cycle for these large transactions tend to be longer than the sales cycle on smaller orders. The longer sales cycle for large transactions makes it difficult to predict the quarter in which these sales will occur. Accordingly, our operating results may fluctuate from quarter to quarter based on the existence and timing of larger transactions. A reduction in large transactions, or a delay in closing of such a sales transaction could materially impact our revenue in a particular quarter.

Our revenue growth and profitability depend on the overall demand for our products and services, which in turn depends on general business and economic conditions as well as acceptance of our products. A softening of demand for our products and services caused by a weakening of the economy may result in decreased revenues or lower growth rates. There can be no assurance that we will be able to

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effectively promote growth rates in all economic conditions. The market for power quality products is evolving and difficult to predict its potential size or future growth rate. Most of the organizations that may purchase our products have invested substantial resources in their existing power systems and, as a result, have been reluctant or slow to adopt a new approach, particularly during a period of reduced capital expenditures. Moreover, our current products are alternatives to existing UPS and battery-based systems and may never be accepted by our customers or may be made obsolete by other advances in power quality technologies.

Significant portions of our expenses are not variable in the short term and cannot be quickly reduced to respond to decreases in revenues. Therefore, if our revenues are below our expectations, our operating results are likely to be adversely and disproportionately affected. In addition, we may change our prices, modify our distribution strategy and policies, accelerate our investment in research and development, sales or marketing efforts in response to competitive pressures or to pursue new market opportunities. Any one of these activities may further limit our ability to adjust spending in response to revenue fluctuations. We use forecasted revenues to establish our expense budget. Because most of our expenses are fixed in the short term or incurred in advance of anticipated revenue, any shortfall in revenues may result in significant losses.

### **We currently operate without a significant backlog.**

We generally operate our business without any significant backlog of orders from customers. Normally our products are shipped and revenue is recognized shortly after the order is received. This lack of backlog makes revenue in any quarter substantially dependent on orders booked and shipped throughout that quarter.

### **Seasonality may contribute to fluctuations in our quarterly operating results.**

Our business has, on occasion, experienced seasonal customer buying patterns. In recent years, we have generally experienced relatively weaker demand in the first calendar quarter of the year. We believe that this pattern will continue. In addition, we anticipate that demand for our products in Europe and Africa may decline in the summer months, as compared to other regions, because of reduced corporate buying patterns during the vacation season.

### **We have incurred significant losses and anticipate losses for at least the next several quarters.**

We have incurred operating losses since our inception and expect to continue to incur losses for at least the next several quarters. As of March 31, 2005, we had an accumulated deficit of \$163.1 million. To date, we have funded our operations principally through the sale of our stock, product revenue and \$10.0 million in development funding payments from Caterpillar. We have generated a total of \$66.0 million in revenues from inception through March 31, 2005. We are uncertain whether our products will achieve market acceptance such that our revenue will increase or whether we will be able to achieve significant revenue. We will need to generate significant additional revenue to achieve profitability, and we cannot assure you that we will ever realize sufficient additional revenue to achieve profitability. We also expect to incur product development, sales and marketing and administrative expenses significantly in excess of our revenue after costs, and, as a result, we expect to continue to incur losses for the next several quarters.

### **We are heavily dependent on our relationship with Caterpillar, our primary OEM customer. If this relationship is unsuccessful, for whatever reason, our business and financial prospects would likely suffer.**

Caterpillar and its dealer network are the primary OEM customer for our flywheel based products. During 2004, 2003 and 2002, Caterpillar and its dealer network accounted for 54%, 60% and 81% of our revenue, respectively. In the first quarter of 2005 Caterpillar and its dealer network accounted for 51% of our revenue. If our relationship with Caterpillar is not successful, or if Caterpillar's

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distribution of the Cat UPS product is not successful, our business and financial prospects would likely suffer. Pursuant to our distribution agreement with Caterpillar, they are the exclusive OEM distributor, subject to limited exceptions, of our CleanSource UPS product. Caterpillar is not obligated to purchase any CleanSource UPS units. Pursuant to our development agreements Caterpillar has provided us with \$10.0 million in funding to support the development of the Cat UPS product line and other development efforts. In exchange for these payments, Caterpillar received co-ownership of the proprietary rights in this product. Either Caterpillar or Active Power may license to others the intellectual property that we jointly own without seeking the consent of the other, and the licensing party will solely retain all licensing revenue generated by licensing this intellectual property. However, we may not license the joint intellectual property to specifically identified competitors of Caterpillar until January 1, 2007. Caterpillar may terminate this agreement at any time by giving us 90 days advance written notice

**There is a substantial amount of product held as inventory by several of our OEM customers. If these OEMs fill their orders from existing stock instead of our factory, our revenue will suffer.**

Several OEMs purchased a substantial number of our CleanSource DC and UPS systems during 2001, many of which have remained in those OEMs' inventories rather than being sold to end-user customers. During 2004, OEM stocking levels declined by approximately \$4.2 million, or 48%. They declined by a further \$840,000, or 21%, during the three months ended March 31, 2005. As our OEMs fill some of their orders with their existing inventory stock, as opposed to placing orders with Active Power, our revenue may suffer for the next few fiscal quarters.

**We depend on international sales and operations.**

We anticipate that for the foreseeable future, we will derive a significant portion of our revenues from outside North America. In the three months ended March 31, 2005, we derived 38% of our total revenues from sales to international customers. Revenue from international sales were 50%, 48% and 37% of revenue for the years ended December 31, 2004, 2003, and 2002, respectively. Our international operations are generally subject to a number of risks. These include:

- foreign laws and business practices that favor local competition;
- dependence on local channel partners;
- compliance with multiple, conflicting and changing government laws and regulations;
- longer sales cycles;
- difficulties in managing and staffing foreign operations;
- foreign currency exchange rate fluctuations and the associated effects on product demand and timing of payment;
- political and economic stability, particularly in the Middle East and Northern Africa;
- greater difficulty in the contracting and shipping process and in accounts receivable collection and longer collection periods;
- greater difficulty in hiring qualified technical sales and application engineers; and
- difficulties with financial reporting in foreign countries.

To date, the majority of our sales to international customers and purchases of components from international suppliers have been denominated in U.S. dollars. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive for our international customers to purchase, thus rendering our products less competitive. As we increases sales in foreign markets, we are making more sales that are denominated in other currencies, primarily euros. Those sales in currencies other than U.S. dollars can result in translation gains and losses. Currently we do not engage in hedging activities for our international operations. However, we may engage in hedging activities in the future.

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We may expand or modify our operations internationally. Despite our efforts, we may not be able to expand or modify our operations internationally in a timely or cost-effective manner. Such an outcome may limit or eliminate any sales growth internationally, which in turn, could materially adversely affect our business, operating results and financial condition. Even if we successfully expand or modify our international operations, we may be unable to maintain or increase international market demand for our products.

### **We are subject to risks relating to product concentration and lack of revenue diversification.**

We derive a substantial portion of our revenues from a limited number of products, and we expect these products to continue to account for a large percentage of our revenues in the near term. Continued market acceptance of these products, is therefore, critical to our future success. Our future success will also depend on our ability to reduce our dependence on these few products by developing and introducing to the market new products and product enhancements in a timely manner. Specifically, our ability to capture significant market share depends on our ability to develop and market extensions to our existing UPS product line at higher and lower power range offerings, and on our ability to develop and market our extended runtime products, such as the CleanSource XR. Even if we are able to develop and commercially introduce new products and enhancements, they may not achieve market acceptance, which would substantially impair our revenue, profitability and overall financial prospects. Successful product development and market acceptance of our existing and future products depend on a number of factors including:

- changing requirements of customers;
- accurate prediction of market and technical requirements;
- timely completion and introduction of new designs;
- quality, price and performance of our products;
- availability, quality, price and performance of competing products and technologies;
- our customer service and support capabilities and responsiveness;
- successful development of our relationships with existing and potential customers; and
- changes in technology, industry standards or end-user preferences

### **We have underutilized manufacturing capacity and have no experience manufacturing our products in large quantities.**

In 2001, we completed a 127,000 square foot facility used for manufacturing and testing of our three-phase product line, including our DC and UPS products. To be financially successful, and to fully utilize the capacity of this facility and allocate its associated overhead, we must achieve significantly higher sales volumes. We must accomplish this while also preserving the quality levels we achieved when manufacturing these products in more limited quantities. To date, we have not been successful at increasing our sales volume to a level that fully utilizes the capacity of the facility and we may never increase our sales volume to necessary levels. We do intend to manufacture and test our CleanSource XR product in this facility, which will help increase the utilization of our facility. If we do not reach these necessary sales volume levels, or if we cannot sell our products at our suggested prices, our ability to reach profitability will be materially limited.

Achieving the necessary production levels presents a number of technological and engineering challenges for us. We have not previously manufactured our products in high volume. We do not know whether or when we will be able to develop efficient, low-cost manufacturing capability and processes that will enable us to meet the quality, price, engineering, design and product standards or production

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volumes required to successfully manufacture large quantities of our products. Even if we are successful in developing our manufacturing capability and processes, we do not know whether we will do so in time to meet our product commercialization schedule or to satisfy the requirements of our customers.

### **We depend on sole and limited source suppliers, and outsource component manufacturing.**

We purchase several component parts from sole source and limited source suppliers. As a result of our current volumes, we lack significant leverage with these suppliers. If our suppliers receive excess demand for their products, we may receive a low priority for order fulfillment as large volume customers will receive priority that may result in delays in our acquiring components. If we are delayed in acquiring components for our products, the manufacture and shipment of our products also will be delayed. We are, however, continuing to enter into long-term agreements with our sole suppliers and other key suppliers, when available, using a rolling sales volume forecast to stabilize component availability. Lead times for ordering materials and components vary significantly and depend on factors such as specific supplier requirements, contract terms, the extensive production time required and current market demand for such components. Some of these delays may be substantial. As a result, we purchase several components in large quantities to protect our ability to deliver finished products. If we overestimate our component requirements, we may have excess inventory, which will increase our costs. If we underestimate our component requirements, we will have inadequate inventory, which will delay our manufacturing and render us unable to deliver products to customers on scheduled delivery dates. If we are unable to obtain a component from a supplier or if the price of a component has increased substantially, we may be required to manufacture the component internally, which will also result in delays or be required to absorb price increases. Manufacturing delays could negatively impact our ability to sell our products and could damage our customer relationships.

To assure the availability of our products to our customers, we outsource the manufacturing of selected components prior to the receipt of purchase orders from customers based on their forecasts of their product needs and internal product sales revenue forecasts. However, these forecasts do not represent binding purchase commitments and we do not recognize revenue for such products until the product is shipped to the customer. As a result, we incur inventory and manufacturing costs in advance of anticipated revenue. As demand for our products may not materialize, this product delivery method subjects us to increased risks of high inventory carrying costs, obsolescence and excess, and may increase our operating costs. In addition, we may from time to time make design changes to our products, which could lead to obsolescence of inventory.

### **We must build quality products to ensure acceptance of our products.**

The markets' perception of our products and related acceptance of the products is highly dependent upon the quality and reliability of the products that we build. Any quality problems attributable to the CleanSource DC, CleanSource UPS or CleanSource XR product lines may substantially impair our revenue prospects. Moreover, quality problems for our product lines could cause us to delay or cease shipments of products or have to recall products, this adversely affecting our ability to meet revenue or cost targets. In addition, while we seek to limit our liability as a result of product failure or defects through warranty and other limitations, if one of our products fails, a customer could suffer a significant loss and seek to hold us responsible for that loss.

### **Failure to expand our distribution channels and manage our existing and new product distribution relationships could impede our future growth.**

The future growth of our business will depend in part on our ability to expand our existing relationships with distributors, to identify and develop additional channels for the distribution and sale of our products and to manage these relationships. As part of our growth strategy, we may expand our

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relationships with distributors and develop relationships with new distributors. We will also look to identify and develop new relationships with additional parties that could serve as an outlet for our products, including CleanSource XR. For example, we recently broadened our sales and distribution channel by offering our products through manufacturer's representatives throughout North America and internationally. We also recently entered into a long term supply agreement with GE Zenith Controls to source UPS systems from them that we intend to sell along side our CleanSource XR product. Our inability to successfully execute this strategy, and to integrate and manage our existing OEM channel partners, Caterpillar and Eaton Power Quality, and our new manufacturer's representatives could impede our future growth.

### **We must continue to hire and retain skilled personnel.**

We believe our future success will depend in large part upon our ability to attract, motivate and retain highly skilled managerial, engineering and sales and marketing personnel. There is a limited supply of skilled employees in the power quality marketplace. A decline in our stock price has resulted in a substantial number of "underwater" stock options, whereby the exercise price of the option is greater than the current market value of our common stock. As a result, the financial attractiveness of the stock options is substantially diminished, which may cause certain of our employees to seek employment elsewhere as a result of this decreased financial incentive, or impair our ability to recruit new employees. Our efforts to attract and retain highly skilled employees could be harmed by our past or any future workforce reductions. Our failure to attract and retain the highly trained technical personnel who are essential to our product development, marketing, sales, service and support teams may limit the rate at which we can develop new products or generate revenues. If we are unable to retain the personnel we currently employ, or if we are unable to quickly replace departing employees, our operations and new product development may suffer.

### **We face significant competition from other companies.**

The markets for power quality and power reliability are intensely competitive. There are many companies engaged in all areas of traditional and alternative UPS and backup systems in the United States and abroad, including, among others, major electric and specialized electronics firms, as well as universities, research institutions and foreign government-sponsored companies. There are many companies that are developing flywheel-based energy storage systems and flywheel-based power quality systems. We also compete indirectly with companies that are developing other types of power technologies, such as high-speed composite flywheels, ultra capacitors and superconducting magnetic energy storage.

Many of our current and potential competitors have longer operating histories, significantly greater financial, technical, marketing and other resources, broader name recognition and a larger installed base of customers. As a result, these competitors may have greater credibility with our existing and potential customers. They also may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can to ours, which would allow them to respond more quickly than us to new or emerging technologies or changes in customer requirements. In addition, some of our current and potential competitors have established supplier or joint development relationships with our current or potential customers. These competitors may be able to leverage their existing relationships to discourage these customers from purchasing products from us or to persuade them to replace our products with their products. Increased competition could decrease our prices, reduce our sales, lower our margins, or decrease our market share. These and other competitive pressures could prevent us from competing successfully against current or future competitors and could materially harm our business.

### **We may be unable to protect our intellectual property and proprietary rights.**

Our success depends to a significant degree upon our ability to protect our proprietary technology, and we expect that future technological advancements made by us will be critical to sustain market

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acceptance of our products. We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. We also enter into confidentiality or license agreements with our employees, consultants and business partners and control access to and distribution of our software, documentation and other proprietary information. Despite these efforts, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where applicable laws may not protect our proprietary rights as fully as in the United States. In addition, the measures we undertake may not be sufficient to adequately protect our proprietary technology and may not preclude competitors from independently developing products with functionality or features similar to those of our products.

In recent years, there has been significant litigation in the United States involving patents, trademarks and other intellectual property rights. We may become involved in litigation in the future to protect our intellectual property or defend allegations of infringement asserted by others. Legal proceedings could subject us to significant liability for damages or invalidate our intellectual property rights. Any litigation, regardless of its merits or its outcome, would likely be time consuming and expensive to resolve and would divert management's time and attention. Any potential intellectual property litigation also could force us to take specific actions, including:

- cease selling our products that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology or trademark, which license may not be available on reasonable terms, or at all; or
- redesign those products that use infringing intellectual property or cease to use an infringing trademark.

### **We may require substantial additional funds in the future to finance our product development and commercialization plans.**

Our product development and commercialization schedule could be delayed if we are unable to fund our research and development activities or the development of our manufacturing capabilities with our revenue and our cash on hand. We expect that our current cash, including the proceeds of our February 2005 private placement of shares of our common stock, and investments, together with our other available sources of working capital, will be sufficient to fund development activities for at least 24 months. However, unforeseen delays or difficulties in these activities could increase costs and exhaust our resources prior to the full commercialization of our products under development. We do not know whether we will be able to secure additional funding, or funding on terms acceptable to us, to continue our operations as planned. If financing is not available, we may be required to reduce, delay or eliminate certain activities or to license or sell to others some of our proprietary technology.

### **We have anti-takeover provisions that could discourage, delay or prevent our acquisition.**

Provisions of our certificate of incorporation and bylaws could have the effect of discouraging, delaying or preventing a merger or acquisition that a stockholder may consider favorable. Additionally, in December of 2001 our board of directors approved a stockholder rights plan, which would require a potential acquiror to negotiate directly with our board of directors regarding any planned acquisition. We also are subject to the anti-takeover laws of the State of Delaware, which may further discourage, delay or prevent someone from acquiring or merging with us. In addition, our agreement with Caterpillar for the distribution of CleanSource UPS provides that Caterpillar may terminate the agreement in the event we are acquired or undergo a change in control. The possible loss of our most significant customer could be a significant deterrent to possible acquirers and may substantially limit the number of possible acquirers. All of these factors may decrease the likelihood that we would be acquired, which may depress the market price of our common stock.

**If we do not timely register shares of common stock we sold in February 2005 we may incur significant financial penalties.**

In February 2005 we sold unregistered shares of our common stock to several private investors. As a condition to that sale, we agreed to register for resale under the Securities Act of 1933 all of the shares issued in this offering. We filed a registration statement on Form S-3 with the Securities and Exchange Commission on March 24, 2005. If this registration statement is not declared effective before June 4, 2005, we may be obligated to pay each investor an amount in cash equal to one percent of the aggregate purchase price paid by each investor as partial liquidated damages. This obligation recurs on each of the next two monthly anniversaries if the registration statement is still not effective, and thereafter shall increase to two percent of the aggregate purchase price per month. In the event that we are unable to have the registration statement declared effective in a timely manner, or fail to act as required in the Registration Rights Agreement, we would incur significant financial penalties.

**Failure to achieve and maintain effective internal control over financial reporting in accordance with rules of the Securities and Exchange Commission promulgated under Section 404 of the Sarbanes-Oxley Act could harm our business and operating results and/or result in a loss of investor confidence in our financial reports, which could in turn have a material adverse effect on our business and stock price.**

Under rules of the Securities and Exchange Commission promulgated under Section 404 of the Sarbanes-Oxley Act of 2002, beginning with our Annual Report on Form 10-K for the fiscal year ended December 31, 2004, we were required to furnish a report by our management on our internal control over financial reporting. In the course of our assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004, which assessment was conducted during the fourth quarter of 2004 and the first quarter of 2005 in connection with the preparation of 2004 audited financial statements and our annual report on Form 10-K for 2004, we identified a material weakness in our internal control over financial reporting resulting from the combination of a limited accounting staff and the transitional status of our chief financial officer. This material weakness in our internal control over financial reporting, as described in Item 9A, Controls and Procedures, of our Annual Report on Form 10-K for the year ended December 31, 2004, as well as any other weaknesses or deficiencies that may exist or hereafter arise or be identified, could harm our business and operating results, and could result in adverse publicity and a loss in investor confidence in the accuracy and completeness of our financial reports, which in turn could have a material adverse effect on our stock price, and, if such weaknesses are not properly remediated, could adversely affect our ability to report our financial results on a timely and accurate basis.

We determined in the first quarter of 2005 that a material weakness in our internal control over financial reporting as of December 31, 2004 existed. As a part of our assessment of the effectiveness of our internal control over financial reporting as of December 31, 2004, we had considered both the composition and the limited size of our accounting department and their effect on the design of the controls established over our financial reporting process. Also, in December 2004 our chief financial officer announced his resignation to pursue another opportunity, but continued to serve as our chief financial officer on a transitional basis through the completion of certain financial reporting events, including the filing of our Annual Report on Form 10-K. We determined that the combination of a limited staff and the transitional status of our chief financial officer resulted in ineffective oversight and monitoring controls over our year-end financial reporting process. This material weakness was identified primarily because a number of deficiencies in controls and errors were detected by both an external accounting firm we had engaged to assist in assessing and testing our internal controls, and by our independent registered public accounting firm. These errors were detected during the performance and completion of the Section 404 testing during the fourth quarter 2004 and during the course of the annual audit (from January 2005 through early March 2005). While it was determined that, individually and collectively, these errors were not material, and in all cases the Company's financial statements were corrected during the completion of our 2004 audit in February and early March 2005, such that our independent registered public accounting firm expressed an unqualified opinion on our December 31, 2004 financial statements, we concluded that in light of these ineffective controls as of December 31, 2004, there was more than a remote likelihood that a material misstatement of our annual or interim financial statements would not be prevented or detected, and that, therefore, there was a "material weakness" in our internal control over financial reporting as of December 31, 2004.

Since December 31, 2004, we have hired a new chief financial officer, who assumed his office the first quarter of 2005, following the filing of our Annual Report on Form 10-K. During the first quarter of 2005, we also have hired additional accounting personnel. We believe that these steps, when taken together, will provide additional supervision, approval and review of accounting transactions and also provide our chief financial officer with the necessary time to perform oversight and supervisory functions.



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Although we believe that we have remediated this material weakness, as described in Item 4, Controls and Procedures, of this report, we cannot assure you that this remediation has been successful or that additional deficiencies or weaknesses in our controls and procedures will not be identified. In addition, we cannot assure you that our independent registered public accounting firm will agree with our assessment that our material weakness has been remediated. Moreover, while we have added accounting personnel, we continue to operate at a relatively small staffing level. Our control procedures have been designed with this staffing level in mind; however, they are highly dependent on each individual's performance of controls in the required manner. The loss of accounting personnel, particularly our chief financial officer, would adversely impact the effectiveness of our control environment and our internal controls, including our internal controls over financial reporting.

### **The price of our stock has been volatile and could result in claims against us.**

Our common stock is traded in the NASDAQ National Market. Historically the market price of our common stock has fluctuated significantly. In 2004 the sales price of our common stock ranged from \$2.53 to \$4.95 and in the first quarter of 2005 the sales price ranged from \$2.39 to \$4.61. The market price of our common stock can be expected to fluctuate significantly in response to numerous factors, some of which are beyond our control, in addition to our financial performance. Furthermore, stock prices for many companies, including our own, fluctuate widely for reasons that may be unrelated to operating results. Some of the factors that may cause the market price of our stock to fluctuate including the following:

- actual or anticipated fluctuations in our operating results;
- changes in financial estimates by securities analysts or our failure to perform in line with such estimates;
- changes in market valuations of other technology companies, particularly those that sell products used in power quality systems;
- announcements by us or our competitors of significant technical innovations, acquisitions, strategic partnerships, joint ventures or capital commitments;
- introduction of technologies or product enhancements that reduce the need for flywheel energy storage systems;
- the loss of one or more key OEM customers;
- inability to expand our distribution channels;
- departures of key personnel; and
- changing external capital market conditions.

### **Item 3. Quantitative and Qualitative Disclosures about Market Risk**

We invest our cash in a variety of financial instruments, including bank time deposits, and taxable variable rate and fixed rate obligations of corporations, municipalities, and local, state and national government entities and agencies. These investments are denominated in U.S. dollars.

Our interest income is sensitive to changes in the general level of U.S. interest rates, particularly since the majority of our investments are in short-term instruments. We believe that our investment policy is conservative, both in terms of the average maturity of investments that we allow and in terms of the credit quality of the investments we hold. We estimate that a 1% decrease in market interest rates would decrease our annual interest income by \$500,000.

Our international sales are made primarily in U.S. dollars. Those sales in currencies other than U.S. dollars can result in translation gains and losses. Currently, we do not engage in hedging activities for our international operations. However, we may engage in hedging activities in the future.

Our international business is subject to the typical risks of any international business, including, but not limited to, the risks described in Item 2 – “Business – Risk Factors that May Affect Future Results” above. Accordingly, our future results could be materially harmed by the actual occurrence of any of these or other risks.

### **Item 4. Controls and Procedures**

- (a) Evaluation of disclosure controls and procedures. We performed an evaluation under the supervision and with the participation of our management, including our Chief Executive Officer (CEO) and Chief Financial Officer (“CFO”), of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934. Based on their evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of March 31, 2005 (a date within 90 days of the filing of this Quarterly Report on Form 10-Q) to ensure that information required to be disclosed by us in the reports filed or submitted by us under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms.
- (b) Changes in internal control over financial reporting. During the three months ended March 31, 2005 we hired a new CFO and have also added additional staffing resources to our accounting department. We believe that these changes will provide additional supervision, approval and review of accounting transactions and will also provide the CFO with the ability to perform appropriate oversight and supervisory functions. We believe that these actions have corrected the material weakness with respect to our disclosure controls and procedures and internal control over financial reporting that we disclosed at December 31, 2004.

Other than the aforementioned, there was no change in our internal control over financial reporting that occurred during the three months ended March 31, 2005 that has materially affected, or that we believe is reasonably likely to materially affect, our internal control over financial reporting.

ACTIVE POWER, INC.

**PART II – OTHER INFORMATION**

**Item 1. Legal Proceedings**

*Active Power, Inc., et al. v. Greenwich Insurance Company*

Between March 2002 and October 2004, Active Power and Joseph Pinkerton, our Chairman and Chief Executive Officer, were parties to a lawsuit with Magnex Corporation and other plaintiffs alleging breach of a joint venture agreement, misappropriation of trade secrets and other torts. As disclosed in our 2004 Annual Report on form 10-K, this litigation was settled in October 2004 with the Company paying \$5.08 million in settlement expense in 2004. The plaintiffs dismissed their claims and provided a covenant not to sue the defendants in the future. The plaintiffs further agreed to transfer, assign and otherwise release to the defendants all rights to certain technology involved in the lawsuit.

On July 16, 2004 we filed a lawsuit against Greenwich Insurance Company seeking coverage under an insurance policy providing for management liability and company reimbursement coverage for certain of our and our CEO, Joe Pinkerton's, expenses and damages related to the Magnex litigation described above.

This case seeks a declaratory judgment that we are entitled to coverage under our policy with Greenwich Insurance Company and also alleges breach of contract for Greenwich's failure to fulfill its contractual obligations under the policy. This case was filed in the Travis County District Court, in Texas state court. An amended petition was filed on September 14, 2004. Discovery in this case is underway.

In the event of any recovery in this action, we will retain an amount equal to our legal expenses related to this Greenwich Insurance litigation. Any additional recovery up to \$1.22 million shall next be paid to Mr. Pinkerton as reimbursement for his settlement expense and other costs related to the Magnex lawsuit. Any recovery beyond this amount shall be retained by us.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

On February 4, 2005, we sold 5,454,510 shares of our common stock at a price of \$3.64 per share for an aggregate offering price of approximately \$19.8 million, to several institutional investors. We also issued Additional Investment Rights to purchase an additional 1,636,353 shares of our common stock to the purchasers with an exercise price per share of \$3.64. The Additional Investment Rights are exercisable until the earliest to occur of (1) the date that is three months following the effective date of our registration statement registering the resale of the shares of common stock sold to the purchasers and the shares of common stock issuable upon exercise of the Additional Investment Rights, (2) immediately prior to a merger or acquisition pursuant to which the we are not the surviving entity, or (3) February 4, 2007. The transaction was exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended and Regulation D promulgated thereunder, as a transaction not involving a public offering, and in reliance on similar exemptions under applicable state laws. We believe that each of the purchasers qualifies as an "accredited investor" (as defined by Rule 501(a) under the Securities Act).

The Securities and Exchange Commission on August 7, 2000 declared effective our registration statement on Form S-1 (File No. 333-36946) relating to the initial public offering of our common stock. As of March 31, 2005, we have used all of the net offering proceeds for the purchase of temporary investments, consisting of cash, cash equivalents, and short-term investments used for working capital and general corporate purposes, including financing accounts receivable and capital expenditures made in the ordinary course of business. We also may apply a portion of the proceeds of the offering to acquire

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businesses, products and technologies, or enter into joint venture arrangements, that are complementary to our business and product offerings; however, at this time we have not identified a specific acquisition or joint venture or allocated a specific amount for this purpose. We also may apply a portion of the proceeds to the payment of cash dividends or for additional stock repurchases or other similar transactions.

We did not repurchase any of our equity securities during the first fiscal quarter of 2005.

### **Item 3. Defaults Upon Senior Securities.**

Not applicable.

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

Not applicable.

### **Item 5. Other Information.**

Not applicable.

### **Item 6. Exhibits.**

#### (a) Exhibits

The following documents are filed as exhibits to this report:

- 10.1 Form of Additional Investment Right (filed as Exhibit 99.1 to Registrant's Current Report on Form 8-K dated February 4, 2005 and incorporated herein by reference)
- 10.2 Securities Purchase Agreement dated as of February 3, 2005 by and among Registrant and the Purchasers set forth on Schedule I thereto
- 10.3 Registration Rights Agreement dated as of February 3, 2005 by and among Registrant and the Purchasers set forth on Schedule I to the Securities Purchase Agreement
- 10.4 Letter agreement dated January 26, 2005 between Registrant and David S. Gino
- 10.5\* Long Term Supply Agreement Between Active Power, Inc. and GE Zenith Controls, Inc. dated March 16, 2005 (filed as Exhibit 10.1 to Registrant's Current Report on Form 8-K dated March 16, 2005 and incorporated herein by this reference)
- 31.1 Rule 13a-15(e)/15d-15(e) Certification of Principal Executive Officer
- 31.2 Rule 13a-15(e)/15d-15(e) Certification of Principal Financial Officer
- 32.1 Section 1350 Certification of Principal Executive Officer
- 32.2 Section 1350 Certification of Principal Financial Officer

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\* Portions of this exhibit have been omitted pursuant to a confidential treatment previously granted.

**SIGNATURES\***

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

**ACTIVE POWER, INC.**  
(Registrant)

April 27, 2005  
(Date)

/s/ Joseph F. Pinkerton, III

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Joseph F. Pinkerton, III  
Chairman of the Board, President and  
Chief Executive Officer  
(Principal Executive Officer)

April 27, 2005  
(Date)

/s/ John K. Penver

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John K. Penver  
Vice President of Finance, Chief Financial Officer and Secretary  
(Principal Accounting Officer)

## SECURITIES PURCHASE AGREEMENT

This Securities Purchase Agreement (this "Agreement") is dated as of February 3, 2005, among Active Power, Inc., a Delaware corporation (the "Company"), and each purchaser identified on the signature pages and Schedule A hereto (each, including its successors and assigns, a "Purchaser" and collectively the "Purchasers"); and

WHEREAS, subject to the terms and conditions set forth in this Agreement and pursuant to Section 4(2) of the Securities Act (as defined below), and Rule 506 promulgated thereunder, the Company desires to issue and sell to each Purchaser, and each Purchaser, severally and not jointly, desires to purchase from the Company in the aggregate, up to \$20,000,000 of shares of Common Stock and certain Additional Investment Rights on the Closing Date.

NOW, THEREFORE, IN CONSIDERATION of the mutual covenants contained in this Agreement, and for other good and valuable consideration the receipt and adequacy of which are hereby acknowledged, the Company and each Purchaser agree as follows:

ARTICLE I  
DEFINITIONS

1.1 Definitions. In addition to the terms defined elsewhere in this Agreement, for all purposes of this Agreement, the following terms have the meanings indicated in this Section 1.1:

"Action" shall have the meaning ascribed to such term in Section 3.1(j).

"Additional Investment Right" means the Additional Investment Rights as described in Section 2.2(a)(iii).

"Additional Investment Right Exercise Price" shall have the meaning ascribed to such term in Section 2.2(a)(iii).

"Additional Investment Right Shares" means the shares of Common Stock issuable upon exercise of the Additional Investment Rights.

"Affiliate" means any Person that, directly or indirectly through one or more intermediaries, controls or is controlled by or is under common control with a Person as such terms are used in and construed under Rule 144. With respect to a Purchaser, any investment fund or managed account that is managed on a discretionary basis by the same investment manager as such Purchaser will be deemed to be an Affiliate of such Purchaser.

"Closing" means the closing of the purchase and sale of the Common Stock and the Additional Investment Rights pursuant to Section 2.1.

"Closing Date" means the Trading Day when all of the Transaction Documents have been executed and delivered by the applicable parties thereto, and all conditions precedent to (i) the Purchasers' obligations to pay the Subscription Amount and (ii) the Company's obligations to deliver the Securities have been satisfied or waived.

“Commission” means the Securities and Exchange Commission.

“Common Stock” means the common stock of the Company, par value \$0.001 per share, together with the associated Rights, and any securities into which such common stock may hereafter be reclassified.

“Common Stock Equivalents” means any securities of the Company or the Subsidiaries which would entitle the holder thereof to acquire at any time Common Stock, including without limitation, any debt, preferred stock, rights, options, warrants or other instrument that is at any time convertible into or exchangeable for, or otherwise entitles the holder thereof to receive, Common Stock.

“Company Counsel” means Andrews Kurth LLP.

“Disclosure Schedules” means the Disclosure Schedules of the Company delivered concurrently herewith.

“Effective Date” means the date that the Registration Statement is first declared effective by the Commission.

“Evaluation Date” shall have the meaning ascribed to such term in Section 3.1(r).

“Exchange Act” means the Securities Exchange Act of 1934, as amended.

“Exempt Issuance” means the issuance of (a) shares of Common Stock or options to employees, officers, directors of the Company or others providing services to the Company pursuant to the Company’s 2000 Stock Incentive Plan, as amended, or any stock or option plan or agreement duly adopted by a majority of the non-employee members of the Board of Directors of the Company, a majority of the members of a committee of non-employee directors or a duly authorized committee of the Board of Directors of the Company established for such purpose, (b) shares of Common Stock issuable pursuant to the Company’s Employee Stock Purchase Plan, as amended and restated, (c) securities upon the exercise of or conversion of any Securities issued hereunder, and any convertible securities, options or warrants issued and outstanding on the date of this Agreement, provided that such securities have not been amended since the date of this Agreement to increase the number of such securities or to decrease the exercise or conversion price of any such securities, and (d) securities issued pursuant to acquisitions or strategic transactions, provided any such issuance shall only be to a Person which is, itself or through its subsidiaries, and in good faith judgment of the Board, an operating company, in which the Company receives benefits in addition to the investment of funds, but shall not include a transaction in which the Company is issuing securities primarily for the purpose of raising capital or to an entity whose primary business is investing in securities.

“FW” means Feldman Weinstein LLP with offices located at 420 Lexington Avenue, Suite 2620, New York, New York 10170-0002.

“GAAP” shall have the meaning ascribed to such term in Section 3.1(h).

“Intellectual Property Rights” shall have the meaning ascribed to such term in Section 3.1(o).

“Legend Removal Date” shall have the meaning ascribed to such term in Section 4.1(c).

“Liens” means a lien, charge, security interest, encumbrance, right of first refusal, preemptive right or other restriction.

“Material Adverse Effect” shall have the meaning ascribed to such term in Section 3.1(b).

“Material Permits” shall have the meaning ascribed to such term in Section 3.1(m).

“Participation Maximum” shall have the meaning ascribed to such term in Section 4.13.

“Per Share Purchase Price” equals **\$3.64**, subject to adjustment for reverse and forward stock splits, stock dividends, stock combinations and other similar transactions of the Common Stock that occur after the date of this Agreement.

“Person” means an individual or corporation, partnership, trust, incorporated or unincorporated association, joint venture, limited liability company, joint stock company, government (or an agency or subdivision thereof) or other entity of any kind.

“Pre-Notice” shall have the meaning ascribed to such term in Section 4.13.

“Proceeding” means an action, claim, suit, investigation or proceeding (including, without limitation, an investigation or partial proceeding, such as a deposition), whether commenced or threatened.

“Purchaser Party” shall have the meaning ascribed to such term in Section 4.9.

“Registration Rights Agreement” means the Registration Rights Agreement, dated as of the date of this Agreement, among the Company and each Purchaser, in the form of Exhibit A hereto.

“Registration Statement” means a registration statement meeting the requirements set forth in the Registration Rights Agreement and covering the resale by the Purchasers of the Shares and the Additional Investment Right Shares.



“Required Approvals” shall have the meaning ascribed to such term in Section 3.1(e).

“Rights” shall mean the Company’s preferred share purchase rights pursuant to that certain Rights Agreement dated December 13, 2001, as amended or restated from time to time.

“Rule 144” means Rule 144 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar rule or regulation hereafter adopted by the Commission having substantially the same effect as such Rule.

“SEC Reports” shall have the meaning ascribed to such term in Section 3.1(h).

“Securities” means the Shares, the Additional Investment Rights and the Additional Investment Right Shares.

“Securities Act” means the Securities Act of 1933, as amended.

“Shares” means the shares of Common Stock issued or issuable to each Purchaser pursuant to this Agreement.

“Short Sales” shall include, without limitation, all “short sales” as defined in Rule 3b-3 of the Exchange Act.

“Subscription Amount” means, as to each Purchaser, the amounts set forth below such Purchaser’s signature block on the signature page hereto, in United States dollars and in immediately available funds.

“Subsidiary” shall mean the subsidiaries of the Company, if any, set forth on Schedule 3.1(a).

“Trading Day” means a day on which the Common Stock is traded on a Trading Market.

“Trading Market” means the following markets or exchanges on which the Common Stock is listed or quoted for trading on the date in question: the Nasdaq SmallCap Market, the American Stock Exchange, the New York Stock Exchange or the Nasdaq National Market.

“Transaction Documents” means this Agreement, the Additional Investment Rights and the Registration Rights Agreement and any other documents or agreements executed in connection with the transactions contemplated hereunder.

“VWAP” shall mean, for any period of time in question, the price determined by the first of the following clauses that applies: (a) if the Common Stock is then listed or quoted on a Trading Market, the volume weighted average price of the Common Stock for such period on the primary Trading Market on which the Common Stock is then listed

or quoted as reported by Bloomberg Financial L.P. (based on a trading day from 9:30 a.m. ET to 4:02 p.m. Eastern Time); (b) if the Common Stock is not then listed or quoted on a Trading Market and if prices for the Common Stock are then quoted in the "Pink Sheets" published by the Pink Sheets LLC (or a similar organization or agency succeeding to its functions of reporting prices), the most recent closing price per share of the Common Stock so reported; or (c) in all other cases, the fair market value of a share of Common Stock as determined by an independent appraiser selected in good faith by the Purchaser.

ARTICLE II.  
PURCHASE AND SALE

2.1 Closing. On the Closing Date, each Purchaser shall purchase from the Company, severally and not jointly with the other Purchasers, and the Company shall issue and sell to each Purchaser, (a) a number of Shares equal to such Purchaser's Subscription Amount divided by the Per Share Purchase Price and (b) the Additional Investment Rights as determined pursuant to Section 2.2(a)(iii). The aggregate Subscription Amounts for Shares sold hereunder shall be up to \$20,000,000. Upon satisfaction of the conditions set forth in Sections 2.2 and 2.3, the Closing shall occur at the offices of FW or such other location as the parties shall mutually agree.

2.2 Deliveries.

(a) On the Closing Date, the Company shall deliver or cause to be delivered to each Purchaser the following:

(i) this Agreement duly executed by the Company;

(ii) a copy of the irrevocable instructions to the Company's transfer agent instructing the transfer agent to deliver, on an expedited basis, a certificate evidencing a number of Shares equal to such Purchaser's Subscription Amount divided by the Per Share Purchase Price, registered in the name of such Purchaser;

(iii) a copy of an Additional Investment Right, registered in the name of such Purchaser, pursuant to which such Purchaser shall have the right to purchase up to the number of shares of Common Stock equal to 30% of the Shares to be issued to such Purchaser and which shall be exercisable immediately upon issuance until the earlier of (a) the three (3) month anniversary of the Effective Date and (b) the 24 month anniversary of the Closing Date, at an exercise price equal to **\$3.64**, subject to adjustment therein (the "Additional Investment Right Exercise Price"), which Additional Investment Right shall otherwise be in the form of Exhibit B attached hereto;

(iv) the Registration Rights Agreement duly executed by the Company; and

(v) a legal opinion of Company Counsel, covering the matters addressed in the form of Exhibit C attached hereto.

- (b) On the Closing Date, each Purchaser shall deliver or cause to be delivered to the Company the following:
  - (i) this Agreement duly executed by such Purchaser;
  - (ii) such Purchaser's Subscription Amount by wire transfer to the account as specified in writing by the Company; and
  - (iii) the Registration Rights Agreement duly executed by such Purchaser.

### 2.3 Closing Conditions.

- (a) The obligations of the Company hereunder in connection with the Closing are subject to the following conditions being met:
  - (i) the accuracy when made and on the Closing Date of the representations and warranties of the Purchasers contained herein;
  - (ii) all obligations, covenants and agreements of the Purchasers required to be performed at or prior to the Closing Date shall have been performed; and
  - (iii) the delivery by the Purchasers of the items set forth in Section 2.2(b) of this Agreement.
- (b) The respective obligations of the Purchasers hereunder in connection with the Closing are subject to the following conditions being met:
  - (i) the accuracy in all material respects on the Closing Date of the representations and warranties of the Company contained herein;
  - (ii) all obligations, covenants and agreements of the Company required to be performed at or prior to the Closing Date shall have been performed;
  - (iii) the delivery by the Company of the items set forth in Section 2.2(a) of this Agreement;
  - (iv) there shall have been no Material Adverse Effect with respect to the Company since the date hereof; and
  - (v) From the date hereof to the Closing Date, trading in the Common Stock shall not have been suspended by the Commission (except for any suspension of trading of limited duration agreed to by the Company, which suspension shall be terminated prior to the Closing), and, at any time prior to the Closing Date, trading in securities generally as reported by Bloomberg Financial Markets shall not have been suspended or limited, or minimum prices shall not have been established on securities whose trades are reported by such service, or

on any Trading Market on which the Common Stock is listed or included for quotation, nor shall a banking moratorium have been declared either by the United States or New York State authorities nor shall there have occurred any material outbreak or escalation of hostilities or other national or international calamity of such magnitude in its effect on, or any material adverse change in, any financial market which, in each case, in the reasonable judgment of each Purchaser, makes it impracticable or inadvisable to purchase the Shares at the Closing.

ARTICLE III.  
REPRESENTATIONS AND WARRANTIES

3.1 Representations and Warranties of the Company. Except as set forth under the corresponding section of the Disclosure Schedules, which Disclosure Schedules shall be deemed a part hereof, the Company hereby makes the representations and warranties set forth below to each Purchaser:

(a) Subsidiaries. All of the direct and indirect subsidiaries of the Company are set forth on Schedule 3.1(a). The Company owns, directly or indirectly, all of the capital stock or other equity interests of each Subsidiary free and clear of any Liens, and all the issued and outstanding shares of capital stock of each Subsidiary are validly issued and are fully paid, non-assessable and free of preemptive and similar rights to subscribe for or purchase securities. If the Company has no subsidiaries, then references in the Transaction Documents to the Subsidiaries will be disregarded.

(b) Organization and Qualification. The Company and each of the Subsidiaries is an entity duly incorporated or otherwise organized, validly existing and in good standing under the laws of the jurisdiction of its incorporation or organization (as applicable), with the requisite power and authority to own and use its properties and assets and to carry on its business as currently conducted. Neither the Company nor any Subsidiary is in violation or default of any of the provisions of its respective certificate or articles of incorporation, bylaws or other organizational or charter documents. Each of the Company and the Subsidiaries is duly qualified to conduct business and is in good standing as a foreign corporation or other entity in each jurisdiction in which the nature of the business conducted or property owned by it makes such qualification necessary, except where the failure to be so qualified or in good standing, as the case may be, could not have or reasonably be expected to result in (i) a material adverse effect on the legality, validity or enforceability of any Transaction Document, (ii) a material adverse effect on the results of operations, assets, business or financial condition of the Company and the Subsidiaries, taken as a whole, or (iii) a material adverse effect on the Company's ability to perform in any material respect on a timely basis its obligations under any Transaction Document (any of (i), (ii) or (iii), a "Material Adverse Effect") and no Proceeding has been instituted in any such jurisdiction revoking, limiting or curtailing or seeking to revoke, limit or curtail such power and authority or qualification.

(c) Authorization; Enforcement. The Company has the requisite corporate power and authority to enter into and to consummate the transactions contemplated by each of

the Transaction Documents and otherwise to carry out its obligations thereunder. The execution and delivery of each of the Transaction Documents by the Company and the consummation by it of the transactions contemplated thereby have been duly authorized by all necessary action on the part of the Company and no further action is required by the Company in connection therewith other than in connection with the Required Approvals. Each Transaction Documents has been (or upon delivery will have been) duly executed by the Company and, when delivered in accordance with the terms hereof, will constitute the valid and binding obligation of the Company enforceable against the Company in accordance with its terms except (i) as limited by applicable bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting enforcement of creditors' rights generally and (ii) as limited by laws relating to the availability of specific performance, injunctive relief or other equitable remedies.

(d) No Conflicts. The execution, delivery and performance of the Transaction Documents by the Company, the issuance and sale of the Shares and the consummation by the Company of the other transactions contemplated thereby do not and will not (i) conflict with or violate any provision of the Company's or any Subsidiary's certificate or articles of incorporation, bylaws or other organizational or charter documents, or (ii) conflict with, or constitute a default (or an event that with notice or lapse of time or both would become a default) under, result in the creation of any Lien upon any of the properties or assets of the Company or any Subsidiary, or give to others any rights of termination, amendment, acceleration or cancellation (with or without notice, lapse of time or both) of, any agreement, credit facility, debt or other instrument (evidencing a Company or Subsidiary debt or otherwise) or other understanding to which the Company or any Subsidiary is a party or by which any property or asset of the Company or any Subsidiary is bound or affected, or (iii) subject to the Required Approvals, conflict with or result in a violation of any law, rule, regulation, order, judgment, injunction, decree or other restriction of any court or governmental authority to which the Company or a Subsidiary is subject (including federal and state securities laws and regulations), or by which any property or asset of the Company or a Subsidiary is bound or affected; except in the case of each of clauses (ii) and (iii), such as could not have or reasonably be expected to result in a Material Adverse Effect.

(e) Filings, Consents and Approvals. The Company is not required to obtain any consent, waiver, authorization or order of, give any notice to, or make any filing or registration with, any court or other federal, state, local or other governmental authority or other Person in connection with the execution, delivery and performance by the Company of the Transaction Documents, other than (i) filings required pursuant to Section 4.4 of this Agreement, (ii) the filing with the Commission of the Registration Statement, (iii) application(s) to each applicable Trading Market for the listing of the Shares and the Additional Investment Right Shares for trading thereon in the time and manner required thereby, and (iv) the filing of Form D with the Commission and such filings as are required to be made under applicable state securities laws (collectively, the "Required Approvals").

(f) Issuance of the Securities. The Shares and Additional Investment Rights are duly authorized and, when issued and paid for in accordance with the Transaction

Documents, will be duly and validly issued, fully paid and nonassessable, free and clear of all Liens imposed by the Company, other than restrictions on transfer provided for in the Transaction Documents. The Additional Investment Right Shares, when issued in accordance with the terms of the Transaction Documents, will be validly issued, fully paid and nonassessable, and free and clear of all Liens imposed by the Company, other than transfer restrictions imposed by the Transaction Documents. The Company has reserved from its duly authorized capital stock the maximum number of shares of Common Stock issuable pursuant to this Agreement and the Additional Investment Rights.

(g) Capitalization. The capitalization of the Company as of February 1, 2005 is as set forth on Schedule 3.1(g) of the Disclosure Schedules. The Company has not issued any capital stock since October 27, 2004, the date the Company filed its Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2004, other than pursuant to the exercise of employee stock options under the Company's stock option plans, the issuance of shares of Common Stock to employees pursuant to the Company's employee stock purchase plan and pursuant to the conversion or exercise of outstanding Common Stock Equivalents. No Person has any right of first refusal, preemptive right, right of participation, or any similar right to participate in the transactions contemplated by the Transaction Documents. Except as a result of the purchase and sale of the Securities, there are no outstanding options, warrants, script rights to subscribe to, calls or commitments of any character whatsoever relating to, or securities, rights or obligations convertible into or exchangeable for, or giving any Person any right to subscribe for or acquire, any shares of Common Stock, or contracts, commitments, understandings or arrangements by which the Company or any Subsidiary is or may become bound to issue additional shares of Common Stock or Common Stock Equivalents. The issue and sale of the Securities will not obligate the Company to issue shares of Common Stock or other securities to any Person (other than the Purchasers) and will not result in a right of any holder of Company securities to adjust the exercise, conversion, exchange or reset price under such securities. All of the outstanding shares of capital stock of the Company are validly issued, fully paid and nonassessable, have been issued in compliance with all federal and state securities laws, and none of such outstanding shares was issued in violation of any preemptive rights or similar rights to subscribe for or purchase securities. No further approval or authorization of any stockholder, the Board of Directors of the Company or others is required for the issuance and sale of the Shares. There are no stockholders agreements, voting agreements or other similar agreements with respect to the Company's capital stock to which the Company is a party or, to the knowledge of the Company, between or among any of the Company's stockholders.

(h) SEC Reports; Financial Statements. The Company has filed all reports, schedules, forms, statements and other documents required to be filed by it under the Securities Act and the Exchange Act, including pursuant to Section 13(a) or 15(d) thereof, for the two years preceding the date hereof (or such shorter period as the Company was required by law to file such material) (the foregoing materials, including the exhibits thereto and documents incorporated by reference therein, being collectively referred to herein as the "SEC Reports") on a timely basis or has received a valid extension of such time of filing and has filed any such SEC Reports prior to the

expiration of any such extension. As of their respective dates, the SEC Reports complied in all material respects with the requirements of the Securities Act and the Exchange Act and the rules and regulations of the Commission promulgated thereunder, and none of the SEC Reports, when filed, contained any untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary in order to make the statements therein, in light of the circumstances under which they were made, not misleading. The financial statements of the Company included in the SEC Reports comply in all material respects with applicable accounting requirements and the rules and regulations of the Commission with respect thereto as in effect at the time of filing. Such financial statements have been prepared in accordance with United States generally accepted accounting principles applied on a consistent basis during the periods involved ("GAAP"), except as may be otherwise specified in such financial statements or the notes thereto and except that unaudited financial statements may not contain all footnotes required by GAAP, and fairly present in all material respects the financial position of the Company and its consolidated subsidiaries as of and for the dates thereof and the results of operations and cash flows for the periods then ended, subject, in the case of unaudited statements, to normal, immaterial, year-end audit adjustments.

(i) Material Changes. Since September 30, 2004 (the date of the latest unaudited financial statements included within the SEC Reports) except as specifically disclosed in the SEC Reports, (i) there has been no event, occurrence or development that has had or that could reasonably be expected to result in a Material Adverse Effect, (ii) the Company has not incurred any liabilities (contingent or otherwise) other than (A) trade payables and accrued expenses incurred in the ordinary course of business consistent with past practice and (B) liabilities not required to be reflected in the Company's financial statements pursuant to GAAP or required to be disclosed in filings made with the Commission, (iii) the Company has not altered its method of accounting, (iv) the Company has not declared or made any dividend or distribution of cash or other property to its stockholders or purchased, redeemed or made any agreements to purchase or redeem any shares of its capital stock and (v) the Company has not issued any equity securities to any officer, director or Affiliate, except pursuant to existing Company stock option plan or agreement or employee stock purchase plan. The Company does not have pending before the Commission any request for confidential treatment of information.

(j) Litigation. There is no action, suit, inquiry, notice of violation, proceeding or investigation pending or, to the knowledge of the Company, threatened against or affecting the Company, any Subsidiary or any of their respective properties before or by any court, arbitrator, governmental or administrative agency or regulatory authority (federal, state, county, local or foreign) (collectively, an "Action") which (i) adversely affects or challenges the legality, validity or enforceability of any of the Transaction Documents or the Securities or (ii) could, if there were an unfavorable decision, have or reasonably be expected to result in a Material Adverse Effect. Neither the Company nor any Subsidiary, nor any director or officer thereof, is or has been the subject of any Action involving a claim of violation of or liability under federal or state securities laws or a claim of breach of fiduciary duty. There has not been, and to the knowledge of the Company, there is not pending or contemplated, any investigation by the Commission involving the Company or any current or former director or officer of the Company. The

Commission has not issued any stop order or other order suspending the effectiveness of any registration statement filed by the Company or any Subsidiary under the Exchange Act or the Securities Act.

(k) Labor Relations. No material labor dispute exists or, to the knowledge of the Company, is imminent with respect to any of the employees of the Company which could reasonably be expected to result in a Material Adverse Effect.

(l) Compliance. Neither the Company nor any Subsidiary (i) is in default under or in violation of (and no event has occurred that has not been waived that, with notice or lapse of time or both, would result in a default by the Company or any Subsidiary under), nor has the Company or any Subsidiary received notice of a claim that it is in default under or that it is in violation of, any indenture, loan or credit agreement or any other agreement or instrument to which it is a party or by which it or any of its properties is bound (whether or not such default or violation has been waived), (ii) is in violation of any order of any court, arbitrator or governmental body, or (iii) is or has been in violation of any statute, rule or regulation of any governmental authority, including without limitation all foreign, federal, state and local laws applicable to its business except in each case as would not have a Material Adverse Effect.

(m) Regulatory Permits. The Company and the Subsidiaries possess all certificates, authorizations and permits issued by the appropriate federal, state, local or foreign regulatory authorities necessary to conduct their respective businesses as described in the SEC Reports, except where the failure to possess such permits could not have or reasonably be expected to result in a Material Adverse Effect ("Material Permits"), and neither the Company nor any Subsidiary has received any notice of proceedings relating to the revocation or modification of any Material Permit.

(n) Title to Assets. The Company and the Subsidiaries have good and marketable title in fee simple to all real property owned by them that is material to the business of the Company and the Subsidiaries and good and marketable title in all personal property owned by them that is material to the business of the Company and the Subsidiaries, in each case free and clear of all Liens, except for Liens as do not materially affect the value of such property and do not materially interfere with the use made and proposed to be made of such property by the Company and the Subsidiaries and Liens for the payment of federal, state or other taxes, the payment of which is neither delinquent nor subject to penalties. Any real property and facilities held under lease by the Company and the Subsidiaries are held by them under valid, subsisting and enforceable leases of which the Company and the Subsidiaries are in compliance.

(o) Patents and Trademarks. The Company and the Subsidiaries have, or have rights to use, all patents, patent applications, trademarks, trademark applications, service marks, trade names, copyrights, licenses and other similar rights necessary or material for use in connection with their respective businesses as described in the SEC Reports and which the failure to so have could have a Material Adverse Effect (collectively, the "Intellectual Property Rights"). Neither the Company nor any Subsidiary has received a written notice that the Intellectual Property Rights used by the Company or any



Subsidiary violates or infringes upon the rights of any Person. To the knowledge of the Company, all such Intellectual Property Rights are enforceable and there is no existing infringement by another Person of any of the Intellectual Property Rights of others.

(p) Insurance. The Company and the Subsidiaries are insured by insurers of recognized financial responsibility against such losses and risks and in such amounts as are prudent and customary in the businesses in which the Company and the Subsidiaries are engaged, including, but not limited to, directors and officers insurance coverage. To the Company's knowledge, such insurance contracts and policies are accurate and complete. Neither the Company nor any Subsidiary has any reason to believe that it will not be able to renew its existing insurance coverage as and when such coverage expires or to obtain similar coverage from similar insurers as may be necessary to continue its business without a significant increase in cost.

(q) Transactions With Affiliates and Employees. Except as set forth in the SEC Reports, none of the officers or directors of the Company and, to the knowledge of the Company, none of the employees of the Company is presently a party to any transaction with the Company or any Subsidiary (other than for services as employees, officers and directors), including any contract, agreement or other arrangement providing for the furnishing of services to or by, providing for rental of real or personal property to or from, or otherwise requiring payments to or from any officer, director or such employee or, to the knowledge of the Company, any entity in which any officer, director, or any such employee has a substantial interest or is an officer, director, trustee or partner, in each case in excess of \$60,000 other than (i) for payment of salary or consulting fees for services rendered, (ii) reimbursement for expenses incurred on behalf of the Company and (iii) for other employee benefits, including stock option agreements under any stock option plan of the Company or the issuance of Common Stock under the Company's employee stock purchase plan.

(r) Sarbanes-Oxley; Internal Accounting Controls. The Company is in material compliance with all provisions of the Sarbanes-Oxley Act of 2002 which are applicable to it as of the Closing Date. The Company and the Subsidiaries maintain a system of internal accounting controls sufficient to provide reasonable assurance that (i) transactions are executed in accordance with management's general or specific authorizations, (ii) transactions are recorded as necessary to permit preparation of financial statements in conformity with GAAP and to maintain asset accountability, (iii) access to assets is permitted only in accordance with management's general or specific authorization, and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences. The Company has established disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Company and designed such disclosure controls and procedures to ensure that material information relating to the Company, including its Subsidiaries, is made known to the certifying officers by others within those entities, particularly during the period in which the Company's most recently filed periodic report under the Exchange Act, as the case may be, was prepared. The Company's certifying officers have evaluated the effectiveness of the Company's controls and procedures as of the date prior to the filing date of the most recently filed

periodic report under the Exchange Act (such date, the "Evaluation Date"). The Company presented in its most recently filed periodic report under the Exchange Act the conclusions of the certifying officers about the effectiveness of the disclosure controls and procedures based on their evaluations as of the Evaluation Date. Since the Evaluation Date, there have been no significant changes in the Company's internal controls (as such term is defined in Item 307(b) of Regulation S-K under the Exchange Act) or, to the Company's knowledge, in other factors that could significantly affect the Company's internal controls.

(s) Certain Fees. No brokerage or finder's fees or commissions are or will be payable by the Company to any broker, financial advisor or consultant, finder, placement agent, investment banker, bank or other Person with respect to the transactions contemplated by this Agreement. The Purchasers shall have no obligation with respect to any fees or with respect to any claims made by or on behalf of other Persons for fees of a type contemplated in this Section that may be due in connection with the transactions contemplated by this Agreement.

(t) Private Placement. Assuming the accuracy of the Purchasers representations and warranties set forth in Section 3.2, no registration under the Securities Act is required for the offer and sale of the Securities by the Company to the Purchasers as contemplated hereby. The issuance and sale of the Securities hereunder does not contravene the rules and regulations of the Trading Market.

(u) Investment Company. The Company is not, and is not an Affiliate of, and immediately after receipt of payment for the Shares, will not be or be an Affiliate of, an "investment company" within the meaning of the Investment Company Act of 1940, as amended. The Company shall conduct its business in a manner so that it will not become subject to the Investment Company Act.

(v) Registration Rights. Other than each of the Purchasers, no Person has any right to cause the Company to effect the registration under the Securities Act of any securities of the Company.

(w) Listing and Maintenance Requirements. The Company's Common Stock is registered pursuant to Section 12(g) of the Exchange Act, and the Company has taken no action designed to, or which to its knowledge is likely to have the effect of, terminating the registration of the Common Stock under the Exchange Act nor has the Company received any notification that the Commission is contemplating terminating such registration. The Company has not, in the 12 months preceding the date hereof, received notice from any Trading Market on which the Common Stock is or has been listed or quoted to the effect that the Company is not in compliance with the listing or maintenance requirements of such Trading Market. The Company is, and has no reason to believe that it will not in the foreseeable future continue to be, in compliance with all such listing and maintenance requirements.

(x) Application of Takeover Protections. The Company and its Board of Directors have taken all necessary action, if any, in order to render inapplicable any

control share acquisition, business combination, poison pill (including any distribution under a rights agreement) or other similar anti-takeover provision under the Company's Certificate of Incorporation (or similar charter documents) or the laws of its state of incorporation that is or could become applicable to the Purchasers as a result of the Purchasers and the Company fulfilling their obligations or exercising their rights under the Transaction Documents, including without limitation the Company's issuance of the Securities and the Purchasers' ownership of the Securities.

(y) Disclosure. The Company confirms that, neither the Company nor, to the Company's knowledge, any other Person acting on its behalf has provided any of the Purchasers or their agents or counsel with any information that constitutes or would reasonably be expected to constitute material, non-public information. The Company understands and confirms that the Purchasers will rely on the foregoing representations and covenants in effecting transactions in securities of the Company. All disclosure provided to the Purchasers regarding the Company, its business and the transactions contemplated hereby, including the Disclosure Schedules to this Agreement, furnished by or on behalf of the Company with respect to the representations and warranties made herein are true and correct with respect to such representations and warranties and do not contain any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made therein, in light of the circumstances under which they were made, not misleading. The Company acknowledges and agrees that no Purchaser makes or has made any representations or warranties with respect to the transactions contemplated hereby other than those specifically set forth in Section 3.2 hereof.

(z) No Integrated Offering. Assuming the accuracy of the Purchasers' representations and warranties set forth in Section 3.2, neither the Company, nor any of its affiliates, nor any Person acting on its or their behalf has, directly or indirectly, made any offers or sales of any security or solicited any offers to buy any security, under circumstances that would cause this offering of the Securities to be integrated with prior offerings by the Company for purposes of the Securities Act or any applicable shareholder approval provisions, including, without limitation, under the rules and regulations of any Trading Market on which any of the securities of the Company are listed or designated.

(aa) Solvency. Based on the financial condition of the Company as of the Closing Date after giving effect to the receipt by the Company of the proceeds from the sale of the Securities hereunder, (i) the Company's fair saleable value of its assets exceeds the amount that will be required to be paid on or in respect of the Company's existing debts and other liabilities (including known contingent liabilities) as they mature; (ii) the Company's assets do not constitute unreasonably small capital to carry on its business for the current fiscal year as now conducted and as proposed to be conducted including its capital needs taking into account the particular capital requirements of the business conducted by the Company, and projected capital requirements and capital availability thereof; and (iii) the current cash flow of the Company, together with the proceeds the Company would receive, were it to liquidate all of its assets, after taking into account all anticipated uses of the cash, would be sufficient to pay all amounts on or

in respect of its debt when such amounts are required to be paid. The Company does not intend to incur debts beyond its ability to pay such debts as they mature (taking into account the timing and amounts of cash to be payable on or in respect of its debt). The Company has no knowledge of any facts or circumstances which lead it to believe that it will file for reorganization or liquidation under the bankruptcy or reorganization laws of any jurisdiction within one year from the Closing Date. The SEC Reports set forth as of the dates thereof all outstanding secured and unsecured Indebtedness of the Company or any Subsidiary, or for which the Company or any Subsidiary has commitments. For the purposes of this Agreement, “Indebtedness” shall mean (a) any liabilities for borrowed money or amounts owed in excess of \$50,000 (other than trade accounts payable incurred in the ordinary course of business), (b) all guaranties, endorsements and other contingent obligations in respect of Indebtedness of others, whether or not the same are or should be reflected in the Company’s balance sheet (or the notes thereto), except guaranties by endorsement of negotiable instruments for deposit or collection or similar transactions in the ordinary course of business; and (c) the present value of any lease payments in excess of \$50,000 due under leases required to be capitalized in accordance with GAAP. Neither the Company nor any Subsidiary is in default with respect to any Indebtedness.

(bb) Form S-3 Eligibility. The Company is eligible to register the resale of its Common Stock by the Purchasers under Form S-3 promulgated under the Securities Act and the Company hereby covenants and agrees to use its reasonable best efforts to maintain its eligibility to use Form S-3 until the Registration Statement covering the resale of the Shares shall have been filed with, and declared effective by, the Commission.

(cc) Taxes. Except for matters that would not, individually or in the aggregate, have or reasonably be expected to result in a Material Adverse Effect, the Company and each Subsidiary has filed all necessary federal, state and foreign income and franchise tax returns and has paid or accrued all taxes shown as due thereon, and the Company has no knowledge of a tax deficiency which has been asserted or threatened against the Company or any Subsidiary.

(dd) General Solicitation. Neither the Company nor, to the Company’s knowledge, any Person acting on behalf of the Company has offered or sold any of the Shares by any form of general solicitation or general advertising. The Company has offered the Shares for sale only to the Purchasers and certain other “accredited investors” within the meaning of Rule 501 under the Securities Act.

(ee) Foreign Corrupt Practices. Neither the Company, nor to the knowledge of the Company, any agent or other person acting on behalf of the Company, has (i) directly or indirectly, used any funds for unlawful contributions, gifts, entertainment or other unlawful expenses related to foreign or domestic political activity, (ii) made any unlawful payment to foreign or domestic government officials or employees or to any foreign or domestic political parties or campaigns from corporate funds, (iii) failed to disclose fully any contribution made by the Company (or made by any person acting on its behalf of which the Company is aware) which is in violation of law, or (iv) violated in any material respect any provision of the Foreign Corrupt Practices Act of 1977, as amended.

(ff) Accountants. The Company's accountants are set forth on Schedule 3.1(ff) of the Disclosure Schedule. To the Company's knowledge, such accountants, who the Company expects will express their opinion with respect to the financial statements to be included in the Company's Annual Report on Form 10-K for the year ending December 31, 2004 are a registered public accounting firm as required by the Securities Act.

(gg) Acknowledgment Regarding Purchasers' Purchase of Shares. The Company acknowledges and agrees that each of the Purchasers is acting solely in the capacity of an arm's length purchaser with respect to the Transaction Documents and the transactions contemplated hereby. The Company further acknowledges that no Purchaser is acting as a financial advisor or fiduciary of the Company (or in any similar capacity) with respect to this Agreement and the transactions contemplated hereby and any advice given by any Purchaser or any of their respective representatives or agents in connection with this Agreement and the transactions contemplated hereby is merely incidental to the Purchasers' purchase of the Shares. The Company further represents to each Purchaser that the Company's decision to enter into this Agreement has been based solely on the independent evaluation of the transactions contemplated hereby by the Company and its representatives.

(hh) Acknowledgement Regarding Purchasers' Trading Activity. Anything in this Agreement or elsewhere herein to the contrary notwithstanding (except for Section 4.15 hereof), it is understood and agreed by the Company (i) that none of the Purchasers have been asked to agree, nor has any Purchaser agreed, to desist from purchasing or selling, long and/or short, securities of the Company, or "derivative" securities based on securities issued by the Company or to hold the Securities for any specified term; (ii) that past or future open market or other transactions by any Purchaser, including Short Sales, and specifically including, without limitation, Short Sales or "derivative" transactions, before or after the closing of this or future private placement transactions, may negatively impact the market price of the Company's publicly-traded securities; (iii) that any Purchaser, and counter parties in "derivative" transactions to which any such Purchaser is a party, directly or indirectly, presently may have a "short" position in the Common Stock, and (iv) that each Purchaser shall not be deemed to have any affiliation with or control over any arm's length counter-party in any "derivative" transaction.

3.2 Representations and Warranties of the Purchasers. Each Purchaser hereby, for itself and for no other Purchaser, represents and warrants as of the date hereof and as of the Closing Date to the Company as follows:

(a) Organization; Authority. Such Purchaser is an entity duly organized, validly existing and in good standing under the laws of the jurisdiction of its organization with full right, corporate or partnership power and authority to enter into and to consummate the transactions contemplated by the Transaction Documents and otherwise to carry out its obligations thereunder. The execution, delivery and performance by such Purchaser of the transactions contemplated by this Agreement have been duly authorized by all necessary corporate or similar action on the part of such Purchaser. Each Transaction Documents to which it is a party has been duly executed by such Purchaser, and when delivered by such Purchaser in accordance with the terms hereof, will constitute the valid

and legally binding obligation of such Purchaser, enforceable against it in accordance with its terms, except (i) as limited by general equitable principles and applicable bankruptcy, insolvency, reorganization, moratorium and other laws of general application affecting enforcement of creditors' rights generally, (ii) as limited by laws relating to the availability of specific performance, injunctive relief or other equitable remedies and (iii) insofar as indemnification and contribution provisions may be limited by applicable law.

(b) Own Account. Such Purchaser understands that the Securities are "restricted securities" and have not been registered under the Securities Act or any applicable state securities law and is acquiring the Securities as principal for its own account and not with a view to or for distributing or reselling such Securities or any part thereof, has no present intention of distributing any of such Securities and has no arrangement or understanding with any other persons regarding the distribution of such Securities (this representation and warranty not limiting such Purchaser's right to sell the Securities pursuant to the Registration Statement or otherwise in compliance with applicable federal and state securities laws). Such Purchaser is acquiring the Securities hereunder in the ordinary course of its business. Such Purchaser does not have any agreement or understanding, directly or indirectly, with any Person to distribute any of the Securities.

(c) Purchaser Status. At the time such Purchaser was offered the Securities, it was, and at the date hereof it is, and on each date on which it exercises any Additional Investment Rights, it will be either: (i) an "accredited investor" as defined in Rule 501(a)(1), (a)(2), (a)(3), (a)(7) or (a)(8) under the Securities Act or (ii) a "qualified institutional buyer" as defined in Rule 144A(a) under the Securities Act. Such Purchaser is not required to be registered as a broker-dealer under Section 15 of the Exchange Act.

(d) Experience of Such Purchaser. Such Purchaser, either alone or together with its representatives, has such knowledge, sophistication and experience in business and financial matters so as to be capable of evaluating the merits and risks of the prospective investment in the Securities, and has so evaluated the merits and risks of such investment. Such Purchaser is able to bear the economic risk of an investment in the Securities and, at the present time, is able to afford a complete loss of such investment.

(e) General Solicitation. Such Purchaser is not purchasing the Securities as a result of any advertisement, article, notice or other communication regarding the Securities published in any newspaper, magazine or similar media or broadcast over television or radio or presented at any seminar or any other general solicitation or general advertisement.

(f) Short Sales. Such Purchaser has not directly or indirectly, nor has any Person acting on behalf of or pursuant to any understanding with such Purchaser, executed any Short Sales in the securities of the Company (including, without limitations, any Short Sales involving the Company's securities) since 9 P.M. (New York Time) on January 28, 2005 which was the time that such Purchaser was first contacted regarding an investment in the Company ("Discussion Time") through the date hereof.

The Company acknowledges and agrees that each Purchaser does not make or has not made any representations or warranties with respect to the transactions contemplated hereby other than those specifically set forth in this Section 3.2.

ARTICLE IV.  
OTHER AGREEMENTS OF THE PARTIES

4.1 Transfer Restrictions.

(a) The Securities may only be disposed of in compliance with state and federal securities laws. In connection with any transfer of Securities other than pursuant to an effective registration statement or Rule 144, to the Company or to an affiliate of a Purchaser or in connection with a pledge as contemplated in Section 4.1(b), the Company may require the transferor thereof to provide to the Company an opinion of counsel selected by the transferor and reasonably acceptable to the Company, the form and substance of which opinion shall be reasonably satisfactory to the Company, to the effect that such transfer does not require registration of such transferred Securities under the Securities Act. As a condition of transfer, any such transferee shall agree in writing to be bound by the terms of this Agreement and shall have the rights of a Purchaser under this Agreement and the Registration Rights Agreement.

(b) The Purchasers agree to the imprinting, so long as is required by this Section 4.1(b), of a legend on any of the Securities in the following form:  
THESE SECURITIES HAVE NOT BEEN REGISTERED WITH THE SECURITIES AND EXCHANGE COMMISSION OR THE SECURITIES COMMISSION OF ANY STATE IN RELIANCE UPON AN EXEMPTION FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE "SECURITIES ACT"), AND, ACCORDINGLY, MAY NOT BE OFFERED OR SOLD EXCEPT PURSUANT TO AN EFFECTIVE REGISTRATION STATEMENT UNDER THE SECURITIES ACT OR PURSUANT TO AN AVAILABLE EXEMPTION FROM, OR IN A TRANSACTION NOT SUBJECT TO, THE REGISTRATION REQUIREMENTS OF THE SECURITIES ACT AND IN ACCORDANCE WITH APPLICABLE STATE SECURITIES LAWS AS EVIDENCED BY A LEGAL OPINION OF COUNSEL TO THE TRANSFEROR TO SUCH EFFECT, THE SUBSTANCE OF WHICH SHALL BE REASONABLY ACCEPTABLE TO THE COMPANY. THESE SECURITIES MAY BE PLEDGED IN CONNECTION WITH A BONA FIDE MARGIN ACCOUNT WITH A REGISTERED BROKER-DEALER OR OTHER LOAN WITH A FINANCIAL INSTITUTION THAT IS AN "ACCREDITED INVESTOR" AS DEFINED IN RULE 501(a) UNDER THE SECURITIES ACT.

The Company acknowledges and agrees that a Purchaser may from time to time pledge pursuant to a bona fide margin agreement with a registered broker-dealer or grant a security interest in some or all of the Securities to a financial institution that is an "accredited investor" as defined in Rule 501(a) under the Securities Act and who agrees

to be bound by the provisions of this Agreement and the Registration Rights Agreement and, if required under the terms of such arrangement, such Purchaser may transfer pledged or secured Securities to the pledgees or secured parties. Such a pledge or transfer would not be subject to approval of the Company and no legal opinion of legal counsel of the pledgee, secured party or pledgor shall be required in connection therewith. Further, no notice shall be required of such pledge. At the appropriate Purchaser's expense, the Company will execute and deliver such reasonable documentation as a pledgee or secured party of Securities may reasonably request in connection with a pledge or transfer of the Securities, including, if the Securities are subject to registration pursuant to the Registration Rights Agreement, the preparation and filing of any required prospectus supplement under Rule 424(b)(3) under the Securities Act or other applicable provision of the Securities Act to appropriately amend the list of Selling Stockholders thereunder.

(c) Certificates evidencing the Shares and Additional Investment Right Shares shall not contain any legend (including the legend set forth in Section 4.1(b)), (i) while a registration statement (including the Registration Statement) covering the resale of such security is effective under the Securities Act, or (ii) following any sale of such Shares or Additional Investment Right Shares pursuant to Rule 144, or (iii) if such Shares or Additional Investment Right Shares are eligible for sale under Rule 144(k), or (iv) if such legend is not required under applicable requirements of the Securities Act (including judicial interpretations and pronouncements issued by the Staff of the Commission). The Company shall cause its counsel to issue a legal opinion to the Company's transfer agent promptly after the Effective Date if required by the Company's transfer agent to effect the removal of the legend hereunder. If all or any portion of an Additional Investment Right is exercised at a time when there is an effective registration statement to cover the resale of the Warrant Shares or Additional Investment Right Shares, such Additional Investment Right Shares, as the case may be, shall be issued free of all legends. The Company agrees that following the Effective Date or at such time as such legend is no longer required under this Section 4.1(c), it will, no later than three Trading Days following the delivery by a Purchaser to the Company or the Company's transfer agent of a certificate representing Shares or Additional Investment Right Shares, as the case may be, issued with a restrictive legend (such date, the "Legend Removal Date"), deliver or cause to be delivered to such Purchaser a certificate representing such Securities that is free from all restrictive and other legends. The Company may not make any notation on its records or give instructions to any transfer agent of the Company that enlarge the restrictions on transfer set forth in this Section. Certificates for Securities subject to legend removal hereunder shall be transmitted by the transfer agent of the Company to the Purchasers by crediting the account of the Purchaser's prime broker with the Depository Trust Company System.

(d) In addition to such Purchaser's other available remedies, the Company shall pay to a Purchaser, in cash, as partial liquidated damages and not as a penalty, for each \$1,000 of Shares or Additional Investment Right Shares (based on the VWAP of the Common Stock on the date such Securities are submitted to the Company's transfer agent) subject to Section 4.1(c), \$10 per Trading Day (increasing to \$20 per Trading Day five (5) Trading Days after such damages have begun to accrue) for each Trading Day



after the Legend Removal Date until such certificate is delivered. Nothing herein shall limit such Purchaser's right to pursue actual damages for the Company's failure to deliver certificates representing any Securities as required by the Transaction Documents, and such Purchaser shall have the right to pursue all remedies available to it at law or in equity including, without limitation, a decree of specific performance and/or injunctive relief.

(e) Each Purchaser, severally and not jointly with the other Purchasers, agrees that the removal of the restrictive legend from certificates representing Securities as set forth in this Section 4.1 is predicated upon the Company's reliance that the Purchaser will sell any Securities pursuant to either the registration requirements of the Securities Act, including any applicable prospectus delivery requirements, or an exemption therefrom.

4.2 Furnishing of Information. As long as any Purchaser owns Securities, the Company covenants to timely file (or obtain extensions in respect thereof and file within the applicable grace period) all reports required to be filed by the Company after the date hereof pursuant to the Exchange Act. As long as any Purchaser owns Securities, if the Company is not required to file reports pursuant to the Exchange Act, it will prepare and furnish to the Purchasers and make publicly available in accordance with Rule 144(c) such information as is required for the Purchasers to sell the Securities under Rule 144. The Company further covenants that it will take such further action as any holder of Securities may reasonably request, all to the extent required from time to time to enable such Person to sell such Securities without registration under the Securities Act within the limitation of the exemptions provided by Rule 144.

4.3 Integration. The Company shall not sell, offer for sale or solicit offers to buy or otherwise negotiate in respect of any security (as defined in Section 2 of the Securities Act) that would be integrated with the offer or sale of the Securities in a manner that would require the registration under the Securities Act of the sale of the Securities to the Purchasers or that would be integrated with the offer or sale of the Securities for purposes of the rules and regulations of any Trading Market such that it would require shareholder approval prior to the closing of such other transaction unless shareholder approval is obtained before the closing of such subsequent transaction.

4.4 Securities Laws Disclosure; Publicity. The Company shall, by 8:30 a.m. Eastern time on the Trading Day following the date hereof, issue a press release in form reasonably acceptable to each Purchaser disclosing the material terms of the transactions contemplated hereby. Within four (4) business days following the date hereof, the Company shall issue a Current Report on Form 8-K disclosing the material terms of the transactions contemplated hereby, and shall attach each Transaction Document required to be filed as an exhibit thereto. The Company and each Purchaser shall consult with each other in issuing any other press releases with respect to the transactions contemplated hereby, and neither the Company nor any Purchaser shall issue any such press release or otherwise make any such public statement without the prior consent of the Company, with respect to any press release of any Purchaser, or without the prior consent of each Purchaser, with respect to any press release of the Company, which consent shall not unreasonably be withheld in either case, except if such disclosure is required by law, in which case the disclosing party shall promptly provide the other party with prior notice of such public statement or communication. Notwithstanding the foregoing, the Company shall not publicly

disclose the name of any Purchaser, or include the name of any Purchaser in any filing with the Commission or any regulatory agency or Trading Market, without the prior written consent of such Purchaser, except (i) to the extent the name of each Purchaser and each Purchaser's Subscription Amount is contained in the Transaction Documents which are filed as exhibits to the reports, forms or other documents the Company is required to file under the Securities Act and the Exchange Act, (ii) as required by federal securities law in connection with the registration statement contemplated by the Registration Rights Agreement and (iii) to the extent such disclosure is required by law or Trading Market regulations, in which case the Company shall provide the Purchasers with prior notice of such disclosure permitted under subclause (i), (ii) or (iii).

4.5 Shareholder Rights Plan. No claim will be made or enforced by the Company or, to the knowledge of the Company, any other Person that any Purchaser is an "Acquiring Person" under any shareholder rights plan or similar plan or arrangement in effect or hereafter adopted by the Company, or that any Purchaser could be deemed to trigger the provisions of any such plan or arrangement, by virtue of receiving Securities under the Transaction Documents. The Company shall conduct its business in a manner so that it will not become subject to the Investment Company Act.

4.6 Non-Public Information. The Company covenants and agrees that neither it nor any other Person acting on its behalf will provide any Purchaser or its agents or counsel with any information that the Company believes constitutes material non-public information, unless prior thereto such Purchaser shall have executed a written agreement regarding the confidentiality and use of such information. The Company understands and confirms that each Purchaser shall be relying on the foregoing representations in effecting transactions in securities of the Company.

4.7 Use of Proceeds. Except as set forth on Schedule 4.7 attached hereto, the Company shall use the net proceeds from the sale of the Securities hereunder for working capital purposes. The Company has no present intention to use the net proceeds from the sale of the Securities hereunder for the satisfaction of any portion of the Company's debt (other than payment of trade payables in the ordinary course of the Company's business and prior practices), to redeem any Common Stock or Common Stock Equivalents or to settle any outstanding litigation.

4.8 Reimbursement. If any Purchaser becomes involved in any capacity in any Proceeding by or against any Person who is a stockholder of the Company (except as a result of sales, pledges, margin sales and similar transactions by such Purchaser to or with any current stockholder), solely as a result of such Purchaser's acquisition of the Securities under this Agreement, the Company will reimburse such Purchaser for its actual and reasonable legal and other out-of-pocket expenses (including the cost of any investigation preparation and travel in connection therewith) incurred in connection therewith, as such expenses are incurred. The reimbursement obligations of the Company under this paragraph shall be in addition to any liability which the Company may otherwise have, shall extend upon the same terms and conditions to any Affiliates of the Purchasers who are actually named in such action, proceeding or investigation, and partners, directors, agents, employees and controlling persons (if any), as the case may be, of the Purchasers and any such Affiliate, and shall be binding upon and inure to the benefit of any successors, assigns, heirs and personal representatives of the Company, the

Purchasers and any such Affiliate and any such Person. The Company also agrees that neither the Purchasers nor any such Affiliates, partners, directors, agents, employees or controlling persons shall have any liability to the Company or any Person asserting claims on behalf of or in right of the Company solely as a result of acquiring the Securities under this Agreement.

4.9 Indemnification of Purchasers. Subject to the provisions of this Section 4.9, the Company will indemnify and hold the Purchasers and their directors, officers, shareholders, partners, employees and agents (each, a “Purchaser Party”) harmless from any and all losses, liabilities, obligations, claims, contingencies, damages, costs and expenses, including all judgments, amounts paid in settlements, court costs and reasonable attorneys’ fees and costs of investigation that any such Purchaser Party may suffer or incur as a result of or relating to (a) any breach of any of the representations, warranties, covenants or agreements made by the Company in this Agreement or in the other Transaction Documents or (b) any action instituted against a Purchaser, or any of them or their respective Affiliates, by any stockholder of the Company who is not an Affiliate of such Purchaser, with respect to any of the transactions contemplated by the Transaction Documents (unless such action is based upon a breach of such Purchaser’s representations, warranties or covenants under the Transaction Documents or any agreements or understandings such Purchaser may have with any such stockholder or any violations or alleged violation by the Purchaser of state or federal securities laws or any conduct by such Purchaser which constitutes fraud, gross negligence, willful misconduct or malfeasance). If any action shall be brought against any Purchaser Party in respect of which indemnity may be sought pursuant to this Agreement, such Purchaser Party shall promptly notify the Company in writing, and the Company shall have the right to assume the defense thereof with counsel of its own choosing. Any Purchaser Party shall have the right to employ separate counsel in any such action and participate in the defense thereof, but the fees and expenses of such counsel shall be at the expense of such Purchaser Party except to the extent that (i) the employment thereof and the Company’s payment of such fees and expenses has been specifically authorized by the Company in writing, (ii) the Company has failed after a reasonable period of time to assume such defense and to employ counsel or (iii) in such action there is, in the reasonable opinion of such separate counsel, a material conflict on any material issue between the position of the Company and the position of such Purchaser Party. The Company will not be liable to any Purchaser Party under this Agreement (i) for any settlement by a Purchaser Party effected without the Company’s prior written consent, which shall not be unreasonably withheld or delayed; or (ii) to the extent, but only to the extent that a loss, claim, damage or liability is attributable to any Purchaser Party’s breach of any of the representations, warranties, covenants or agreements made by the Purchasers in this Agreement or in the other Transaction Documents.

4.10 Reservation of Common Stock. As of the date hereof, the Company has reserved and the Company shall continue to reserve and keep available at all times, free of preemptive rights, a sufficient number of shares of Common Stock for the purpose of enabling the Company to issue Shares pursuant to this Agreement and the Additional Investment Right Shares pursuant to any exercise of the Additional Investment Rights.

4.11 Listing of Common Stock. The Company hereby agrees to use best efforts to maintain the listing of the Common Stock on a Trading Market, and as soon as reasonably practicable following the Closing (but not later than the earlier of the

Effective Date and the first anniversary of the Closing Date) to list (or qualify for inclusion for quotation) all of the Shares and Additional Investment Right Shares on such Trading Market. The Company further agrees, if the Company applies to have the Common Stock traded on any other Trading Market, it will include in such application all of the Shares and Additional Investment Right Shares and will take such other action as is necessary to cause all of the Shares and Additional Investment Right Shares to be listed on such other Trading Market as promptly as possible. The Company will take all action reasonably necessary to continue the listing and trading of its Common Stock on a Trading Market and will comply in all respects with the Company's reporting, filing and other obligations under the bylaws or rules of the Trading Market.

4.12 Equal Treatment of Purchasers. No consideration shall be offered or paid to any person to amend or consent to a waiver or modification of any provision of any of the Transaction Documents unless the same consideration is also offered to all of the parties to the Transaction Documents. For clarification purposes, this provision constitutes a separate right granted to each Purchaser by the Company and negotiated separately by each Purchaser, and is intended to treat for the Company the Purchasers as a class and shall not in any way be construed as the Purchasers acting in concert or as a group with respect to the purchase, disposition or voting of Securities or otherwise.

4.13 Participation in Future Financing.

(a) From the date hereof until twelve (12) months after the Effective Date, upon any financing by the Company of its Common Stock or Common Stock Equivalents (a "Subsequent Financing"), each Purchaser shall have the right to participate in up to 30% of such Subsequent Financing (the "Participation Maximum").

(b) At least 5 Trading Days prior to the closing of the Subsequent Financing, the Company shall deliver to each Purchaser a written notice of its intention to effect a Subsequent Financing ("Pre-Notice"), which Pre-Notice shall ask such Purchaser if it wants to review the details of such financing (such additional notice, a "Subsequent Financing Notice"). Upon the request of a Purchaser, and only upon a request by such Purchaser, for a Subsequent Financing Notice, the Company shall promptly, but no later than 1 Trading Day after such request, deliver a Subsequent Financing Notice to such Purchaser. The Subsequent Financing Notice shall describe in reasonable detail the proposed terms of such Subsequent Financing, the amount of proceeds intended to be raised thereunder, the Person or Persons (if then known) with whom such Subsequent Financing is proposed to be effected, and attached to which shall be a term sheet or similar document relating thereto if the same shall exist for such proposed financing, otherwise a summary of the proposed material terms of the Subsequent Financing.

(c) Any Purchaser desiring to participate in such Subsequent Financing must provide written notice to the Company by not later than 5:30 p.m. (New York City time) on the 5<sup>th</sup> Trading Day after the Purchaser has received the Pre-Notice that the Purchaser is willing to participate in the Subsequent Financing, the amount of the Purchaser's participation, and that the Purchaser has such funds ready, willing, and available for investment on the terms set forth in the Subsequent Financing Notice. If the Company receives no notice from a Purchaser as of such fifth Trading Day, such Purchaser shall be deemed to have notified the Company that it does not elect to participate.

(d) If by 5:30 p.m. (New York City time) on the fifth Trading Day after all of the Purchasers have received the Pre-Notice, notifications by the Purchasers of their willingness to participate in the Subsequent Financing (or to cause their designees to participate) is, in the aggregate, less than the Participation Maximum of the Subsequent Financing, then the Company may effect the remaining portion of such Subsequent Financing on the terms and to the Persons set forth in the Subsequent Financing Notice.

(e) The Company must provide the Purchasers with a second Subsequent Financing Notice, and the Purchasers will again have the right of participation set forth above in this Section 4.13, if the Subsequent Financing subject to the initial Subsequent Financing Notice is not consummated for any reason on the terms set forth in such Subsequent Financing Notice within 60 Trading Days after the date of the initial Subsequent Financing Notice. In the event the Company receives responses to Subsequent Financing Notices from Purchasers seeking to purchase more than the aggregate amount of the Subsequent Financing, each such Purchaser shall have the right to purchase their Pro Rata Portion (as defined below) of the Participation Maximum. "Pro Rata Portion" is the ratio of (x) the Subscription Amount of Securities purchased by a participating Purchaser and (y) the sum of the aggregate Subscription Amount of all participating Purchasers.

(f) Notwithstanding the foregoing, this Section 4.13 shall not apply in respect of an Exempt Issuance.

#### 4.14 Subsequent Equity Sales.

(a) From the date hereof until 90 days after the Effective Date, neither the Company nor any Subsidiary shall issue shares of Common Stock or Common Stock Equivalents; provided, however, the 90 day period set forth in this Section 4.14 shall be extended for the number of Trading Days during such period in which (y) trading in the Common Stock is suspended by any Trading Market, or (z) following the Effective Date, the Registration Statement is not effective or the prospectus included in the Registration Statement may not be used by the Purchasers for the resale of the Shares and Additional Investment Right Shares.

(b) From the date hereof until the earlier of (i) two (2) years after the Effective Date or (ii) such time as the Purchasers collectively hold less than 10% of the Securities issued pursuant to this Agreement (including unexercised but unexpired Additional Investment Rights), the Company shall be prohibited from effecting or entering into an agreement to effect any Subsequent Financing involving a "Variable Rate Transaction" or an "MFN Transaction" (each as defined below). The term "Variable Rate Transaction" shall mean a transaction in which the Company issues or sells (i) any debt or equity securities that are convertible into, exchangeable or exercisable for, or include the right to receive additional shares of Common Stock either (A) at a conversion, exercise or exchange rate or other price that is based upon and/or varies with the trading prices of or quotations for the shares of Common Stock at any time after the initial

issuance of such debt or equity securities, or (B) with a conversion, exercise or exchange price that is subject to being reset at some future date after the initial issuance of such debt or equity security or upon the occurrence of specified or contingent events directly or indirectly related to the business of the Company or the market for the Common Stock or (ii) enters into any agreement, including, but not limited to, an equity line of credit, whereby the Company may sell securities at a future determined price. The term "MFN Transaction" shall mean a transaction in which the Company issues or sells any securities in a capital raising transaction or series of related transactions which grants to an investor the right to receive additional shares based upon future transactions of the Company on terms more favorable than those granted to such investor in such offering. Any Purchaser shall be entitled to obtain injunctive relief against the Company to preclude any such issuance, which remedy shall be in addition to any right to collect damages.

(c) Notwithstanding the foregoing, this Section 4.14 shall not apply in respect of an Exempt Issuance, except that no Variable Rate Transaction or MFN Transaction shall be an Exempt Issuance.

4.15 Short Sales. Each Purchaser covenants that neither it nor any affiliates acting on its behalf or pursuant to any understanding with it have executed or will execute any Short Sales during the period from the Discussion Time until prior to the time that the transactions contemplated by this Agreement are first publicly announced as described in Section 4.4. Notwithstanding the foregoing, no Purchaser makes any representation, warranty or covenant hereby that it will not engage in Short Sales in the securities of the Company after the time that the transactions contemplated by this Agreement are first publicly announced as described in Section 4.4.

4.16 Delivery of Securities After Closing. The Company shall deliver, or cause to be delivered, the respective Shares and Additional Investment Right purchased by each Purchaser to such Purchaser within 3 Trading Days of the Closing Date.

#### ARTICLE V. MISCELLANEOUS

5.1 Termination. This Agreement may be terminated by any Purchaser, by written notice to the other parties, if the Closing has not been consummated on or before February 14, 2005; provided that no such termination will affect the right of any party to sue for any breach by the other party (or parties).

5.2 Fees and Expenses. Except as otherwise set forth in this Agreement, each party shall pay the fees and expenses of its advisers, counsel, accountants and other experts, if any, and all other expenses incurred by such party incident to the negotiation, preparation, execution, delivery and performance of this Agreement. The Company shall pay all stamp and other taxes and duties levied in connection with the delivery of the Securities.

5.3 Entire Agreement. The Transaction Documents, together with the exhibits and schedules thereto, contain the entire understanding of the parties with respect to the subject matter hereof and supersede all prior agreements and understandings, oral or written, with respect to such matters, which the parties acknowledge have been merged into such documents, exhibits and schedules.

5.4 Notices. Any and all notices or other communications or deliveries required or permitted to be provided hereunder shall be in writing and shall be deemed given and effective on the earliest of (a) the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number set forth on the signature pages attached hereto prior to 5:30 p.m. (New York City time) on a Trading Day, (b) the next Trading Day after the date of transmission, if such notice or communication is delivered via facsimile at the facsimile number set forth on the signature pages attached hereto on a day that is not a Trading Day or later than 5:30 p.m. (New York City time) on any Trading Day, (c) the second Trading Day following the date of mailing, if sent by U.S. nationally recognized overnight courier service, or (d) upon actual receipt by the party to whom such notice is required to be given. The address for such notices and communications shall be as set forth on the signature pages attached hereto.

5.5 Amendments; Waivers. No provision of this Agreement may be waived or amended except in a written instrument signed, in the case of an amendment, by the Company and each Purchaser or, in the case of a waiver, by the party against whom enforcement of any such waiver is sought. No waiver of any default with respect to any provision, condition or requirement of this Agreement shall be deemed to be a continuing waiver in the future or a waiver of any subsequent default or a waiver of any other provision, condition or requirement hereof, nor shall any delay or omission of either party to exercise any right hereunder in any manner impair the exercise of any such right.

5.6 Headings. The headings herein are for convenience only, do not constitute a part of this Agreement and shall not be deemed to limit or affect any of the provisions hereof. The language used in this Agreement will be deemed to be the language chosen by the parties to express their mutual intent, and no rules of strict construction will be applied against any party.

5.7 Successors and Assigns. This Agreement shall be binding upon and inure to the benefit of the parties and their successors and permitted assigns. The Company may not assign this Agreement or any rights or obligations hereunder without the prior written consent of each Purchaser. Any Purchaser may assign any or all of its rights under this Agreement to any Person to whom such Purchaser assigns or transfers any Securities, provided such transferee agrees in writing to be bound, with respect to the transferred Securities, by the provisions hereof that apply to the "Purchasers".

5.8 No Third-Party Beneficiaries. This Agreement is intended for the benefit of the parties hereto and their respective successors and permitted assigns and is not for the benefit of, nor may any provision hereof be enforced by, any other Person, except as otherwise set forth in Section 4.9.

5.9 Governing Law. All questions concerning the construction, validity, enforcement and interpretation of the Transaction Documents shall be governed by and construed and enforced in accordance with the internal laws of the State of New York, without regard to the principles of conflicts of law thereof. Each party agrees that all legal proceedings concerning the interpretations, enforcement and defense of the transactions contemplated by this Agreement and

any other Transaction Documents (whether brought against a party hereto or its respective affiliates, directors, officers, shareholders, employees or agents) shall be commenced exclusively in the state and federal courts sitting in the City of New York. Each party hereby irrevocably submits to the exclusive jurisdiction of the state and federal courts sitting in the City of New York, borough of Manhattan for the adjudication of any dispute hereunder or in connection herewith or with any transaction contemplated hereby or discussed herein (including with respect to the enforcement of any of the Transaction Documents), and hereby irrevocably waives, and agrees not to assert in any suit, action or proceeding, any claim that it is not personally subject to the jurisdiction of any such court, that such suit, action or proceeding is improper or inconvenient venue for such proceeding. Each party hereby irrevocably waives personal service of process and consents to process being served in any such suit, action or proceeding by mailing a copy thereof via registered or certified mail or overnight delivery (with evidence of delivery) to such party at the address in effect for notices to it under this Agreement and agrees that such service shall constitute good and sufficient service of process and notice thereof. Nothing contained herein shall be deemed to limit in any way any right to serve process in any manner permitted by law. The parties hereby waive all rights to a trial by jury. If either party shall commence an action or proceeding to enforce any provisions of the Transaction Documents, then the prevailing party in such action or proceeding shall be reimbursed by the other party for its attorneys' fees and other costs and expenses incurred with the investigation, preparation and prosecution of such action or proceeding.

5.10 Survival. The representations and warranties herein shall survive the Closing and delivery of the Shares and Additional Investment Right Shares for the duration of the statute of limitations applicable to such matter.

5.11 Execution. This Agreement may be executed in two or more counterparts, all of which when taken together shall be considered one and the same agreement and shall become effective when counterparts have been signed by each party and delivered to the other party, it being understood that both parties need not sign the same counterpart. In the event that any signature is delivered by facsimile transmission, such signature shall create a valid and binding obligation of the party executing (or on whose behalf such signature is executed) with the same force and effect as if such facsimile signature page were an original thereof.

5.12 Severability. If any provision of this Agreement is held to be invalid or unenforceable in any respect, the validity and enforceability of the remaining terms and provisions of this Agreement shall not in any way be affected or impaired thereby and the parties will attempt to agree upon a valid and enforceable provision that is a reasonable substitute therefor, and upon so agreeing, shall incorporate such substitute provision in this Agreement.

5.13 Rescission and Withdrawal Right. Notwithstanding anything to the contrary contained in (and without limiting any similar provisions of) the Transaction Documents, whenever any Purchaser exercises a right, election, demand or option under a Transaction Documents and the Company does not timely perform its related obligations within the periods therein provided, then such Purchaser may rescind or withdraw, in its sole discretion from time to time upon written notice to the Company, any relevant notice, demand or election in whole or in part without prejudice to its future actions and rights.



5.14 Replacement of Securities. If any certificate or instrument evidencing any Securities is mutilated, lost, stolen or destroyed, the Company shall issue or cause to be issued in exchange and substitution for and upon cancellation thereof, or in lieu of and substitution therefor, a new certificate or instrument, but only upon receipt of evidence reasonably satisfactory to the Company of such loss, theft or destruction and customary and reasonable indemnity, if requested. The applicants for a new certificate or instrument under such circumstances shall also pay any reasonable third-party costs associated with the issuance of such replacement Securities.

5.15 Remedies. In addition to being entitled to exercise all rights provided herein or granted by law, including recovery of damages, each of the Purchasers and the Company will be entitled to specific performance under the Transaction Documents. The parties agree that monetary damages may not be adequate compensation for any loss incurred by reason of any breach of obligations described in the foregoing sentence and hereby agrees to waive in any action for specific performance of any such obligation the defense that a remedy at law would be adequate.

5.16 Payment Set Aside. To the extent that the Company makes a payment or payments to any Purchaser pursuant to any Transaction Document or a Purchaser enforces or exercises its rights thereunder, and such payment or payments or the proceeds of such enforcement or exercise or any part thereof are subsequently invalidated, declared to be fraudulent or preferential, set aside, recovered from, disgorged by or are required to be refunded, repaid or otherwise restored to the Company, a trustee, receiver or any other person under any law (including, without limitation, any bankruptcy law, state or federal law, common law or equitable cause of action), then to the extent of any such restoration the obligation or part thereof originally intended to be satisfied shall be revived and continued in full force and effect as if such payment had not been made or such enforcement or setoff had not occurred.

5.17 Independent Nature of Purchasers' Obligations and Rights. The obligations of each Purchaser under any Transaction Document are several and not joint with the obligations of any other Purchaser, and no Purchaser shall be responsible in any way for the performance of the obligations of any other Purchaser under any Transaction Document. Nothing contained herein or in any Transaction Document, and no action taken by any Purchaser pursuant thereto, shall be deemed to constitute the Purchasers as a partnership, an association, a joint venture or any other kind of entity, or create a presumption that the Purchasers are in any way acting in concert or as a group with respect to such obligations or the transactions contemplated by the Transaction Documents and the Company acknowledges that, to its knowledge, the Purchasers are not acting in concert or as a group with respect to such obligations or the transactions contemplated by the Transaction Documents. Each Purchaser shall be entitled to independently protect and enforce its rights, including without limitation, the rights arising out of this Agreement or out of the other Transaction Documents, and it shall not be necessary for any other Purchaser to be joined as an additional party in any proceeding for such purpose. Each Purchaser has been represented by its own separate legal counsel in their review and negotiation of the Transaction Documents. For reasons of administrative convenience only, Purchasers and their respective counsel have chosen to communicate with the Company through FW. FW does not represent the Purchasers but only RBC Capital Markets, who has acted as placement agent to the transaction. The Company has elected to provide all Purchasers with the same terms and Transaction Documents for the convenience of the Company and not because it was required or requested to do so by the Purchasers.

5.18 Liquidated Damages. The Company's obligations to pay any partial liquidated damages or other amounts owing under the Transaction Documents is a continuing obligation of the Company and shall not terminate until all unpaid partial liquidated damages and other amounts have been paid notwithstanding the fact that the instrument or security pursuant to which such partial liquidated damages or other amounts are due and payable shall have been canceled.

5.19 Construction. The parties agree that each of them and/or their respective counsel has reviewed and had an opportunity to revise the Transaction Documents and, therefore, the normal rule of construction to the effect that any ambiguities are to be resolved against the drafting party shall not be employed in the interpretation of the Transaction Documents or any amendments hereto.

*(Signature Page Follows)*

IN WITNESS WHEREOF, the parties hereto have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Active Power, Inc.

Address for Notice:

By: /s/ Joseph F. Pinkerton, III

Active Power, Inc.

2128 W. Braker Lane, BK 12

Name: Joseph F. Pinkerton, III

Austin, Texas 78758

Title: Chairman of the Board, President and  
Chief Executive Officer

Fax: 512.836

Email: [jpinkerton@activepower.com](mailto:jpinkerton@activepower.com)

Attn: Chief Executive Officer

With a copy to (which shall not constitute notice):

Andrews Kurth LLP

111 Congress Avenue, Suite 1700

Austin, Texas 78701

Fax: 512.320.9292

Attn: J. Matthew Lyons

With a copy to (which shall not constitute notice):

Active Power, Inc.

2128 W. Braker Lane, BK 12

Austin, Texas 78758

Fax: 512.836.4511

Email: [mchibib@activepower.com](mailto:mchibib@activepower.com)

Attn: General Counsel

[REMAINDER OF PAGE INTENTIONALLY LEFT BLANK  
SIGNATURE PAGES FOR PURCHASERS FOLLOW]

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Capital Ventures International

*Signature of Authorized Signatory of Purchaser:* /s/ Martin Kobinger

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Name of Authorized Signatory: Heights Capital Management, Inc. Authorized Signatory

Title of Authorized Signatory: Investment Manager

Address for Notice of Purchaser:

Heights Capital Management, Inc.

101 California Street, Suite 3250

San Francisco, CA 94111

Attn: Martin Kobinger

Address for Delivery of Securities for Purchaser (if not same as above):

401 City Line Avenue, Suite 220

Bala Cynwyd, PA 19004

Attn: Accounts Receivable

Subscription Amount: \$2,500,024.80

Shares: 686,820

Additional Investment Right Shares: 206,046

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Smithfield Fiduciary LLC

Signature of Authorized Signatory of Purchaser: /s/ Adam J. Chill

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Name of Authorized Signatory: Adam J. Chill

Title of Authorized Signatory: Authorized Signatory

Address for Notice of Purchaser:

c/o Highbridge Capital Management, LLC

9 West 57<sup>th</sup> Street, 27<sup>th</sup> Floor

New York, NY 10019

Attention: Ari J. Storch/Adam J. Chill

Tel: 2120287-4720

Fax: 212-751-0755

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$3,640,000

Shares: 1,000,000

Additional Investment Right Shares: 300,000

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: D.B. Zwirn Special Opportunities Fund, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ Daniel B. Zwirn

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Name of Authorized Signatory: Daniel B. Zwirn

Title of Authorized Signatory: Managing Partner

Address for Notice of Purchaser:

745 Fifth Avenue

18th Floor

New York, NY 10151

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$1,800,009.12

Shares: 494,508

Additional Investment Right Shares: 148,352

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: D.B. Zwirn Special Opportunities Fund, Ltd.

*Signature of Authorized Signatory of Purchaser:* /s/ Daniel B. Zwirn

---

Name of Authorized Signatory: Daniel B. Zwirn

Title of Authorized Signatory: Managing Partner

Address for Notice of Purchaser:

745 Fifth Avenue

18th Floor

New York, NY 10151

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$2,700,013.68

Shares: 741,762

Additional Investment Right Shares: 222,529

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Southport Millennium Fund, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/James M. Thorburn

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Name of Authorized Signatory: Southport Millennium Management, LLC (GP), James M. Thorburn

Title of Authorized Signatory: Managing Member of GP

Address for Notice of Purchaser:

c/o Dawson-Herman Capital Management, Inc.

354 Pequot Avenue

Southport, CT 06890

Attention: James M. Thorburn

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$117,208

Shares: 32,200

Additional Investment Right Shares: 9,660

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**



IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Southport Millennium Fund II, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: Southport Millennium II Management, LLC (GP), James M. Thorburn

Title of Authorized Signatory: Managing Member of GP

Address for Notice of Purchaser:

c/o Dawson-Herman Capital Management, Inc.

354 Pequot Avenue

Southport, CT 06890

Attention: James M. Thorburn

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$195,468

Shares: 53,700

Additional Investment Right Shares: 16,110

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Southport Millennium Micro Cap Fund, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: Southport Micro Cap Management, LLC (GP), James M. Thorburn

Title of Authorized Signatory: Managing Member of GP

Address for Notice of Purchaser:

c/o Dawson-Herman Capital Management, Inc.

354 Pequot Avenue

Southport, CT 06890

Attention: James M. Thorburn

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$47,684

Shares: 13,100

Additional Investment Right Shares: 3,930

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Southport Millennium Offshore Fund, Inc.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: James M. Thorburn

Title of Authorized Signatory: Director

Address for Notice of Purchaser:

c/o Dawson-Herman Capital Management, Inc.

354 Pequot Avenue

Southport, CT 06890

Attention: James M. Thorburn

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$549,640

Shares: 151,000

Additional Investment Right Shares: 45,300

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Southport Energy Plus Partners L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ Anthony Grammalva

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Name of Authorized Signatory: Anthony Grammalva

Title of Authorized Signatory: CEO-Sound Energy Partners, Inc. its Investment Manager

Address for Notice of Purchaser:

354 Pequot Avenue  
Southport, CT 06890  
Attention: Slavko Negulic

Address for Delivery of Securities for Purchaser (if not same as above):

Mike Farrell  
Seward & Kissel LLP  
One Battery Park Plaza  
New York, NY 10004

Subscription Amount: \$1,350,804

Shares: 371,100

Additional Investment Right Shares: 111,330

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Southport Energy Plus Offshore Fund, Inc.

*Signature of Authorized Signatory of Purchaser:* /s/ Anthony Grammalva

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Name of Authorized Signatory: Anthony Grammalva

Title of Authorized Signatory: CEO-Sound Energy Partners, Inc. its Investment Advisor

Address for Notice of Purchaser:

354 Pequot Avenue  
Southport, CT 06890  
Attention: Slavko Negulic

Address for Delivery of Securities for Purchaser (if not same as above):

Mike Farrell  
Seward & Kissel LLP  
One Battery Park Plaza  
New York, NY 10004

Subscription Amount: \$341,068

Shares: 93,700

Additional Investment Right Shares: 28,110

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Sound Energy Capital Offshore Fund, Ltd.

*Signature of Authorized Signatory of Purchaser:* /s/ Anthony Grammalva

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Name of Authorized Signatory: Anthony Grammalva

Title of Authorized Signatory: GP-Sound Energy Capital Management, L.P. its Investment Advisor

Address for Notice of Purchaser:

354 Pequot Avenue  
Southport, CT 06890  
Attention: Slavko Negulic

Address for Delivery of Securities for Purchaser (if not same as above):

Mike Farrell  
Seward & Kissel LLP  
One Battery Park Plaza  
New York, NY 10004

Subscription Amount: \$128,128

Shares: 35,200

Additional Investment Right Shares: 10,560

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: SF Capital Partners Ltd.

Signature of Authorized Signatory of Purchaser: /s/ Robert J. Barnard

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Name of Authorized Signatory: Robert J. Barnard

Title of Authorized Signatory: Authorized Signatory

Address for Notice of Purchaser:

c/o Stark Offshore Management, LLC

3600 South Lake Drive

St. Francis, WI 53235

Address for Delivery of Securities for Purchaser (if not same as above):

Subscription Amount: \$1,820,000.00

Shares: 500,000

Additional Investment Right Shares: 150,000

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: Portside Growth and Opportunity Fund

*Signature of Authorized Signatory of Purchaser:* /s/ Jeffrey Smith

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Name of Authorized Signatory: Jeffrey Smith

Title of Authorized Signatory: Authorized Signatory

Address for Notice of Purchaser:

C/o Ramius Capital Group, LLC

666 Third Avenue, 26<sup>th</sup> Floor

New York, NY 10017

Address for Delivery of Securities for Purchaser (if not same as above):

Christina Pesci

Citigroup

390 Greenwich St. 5<sup>th</sup> Floor

New York, NY 10013

Telephone: 212-723-5811

Subscription Amount: \$3,245,351.20

Shares: 891,580

Additional Investment Right Shares: 267,474

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**



IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: ALM Brand Bank

Signature of Authorized Signatory of Purchaser: /s/ Lars Hackenberg

Name of Authorized Signatory: Lars Hackenberg

Title of Authorized Signatory: Senior Portfolio Manager

Address for Notice of Purchaser:

Midtermolen 7

DK – 2100 Copenhagen

Address for Delivery of Securities for Purchaser (if not same as above):

DTC 0997 State Street Bank

Acc. 26Q2 Alm Brand Bank (ALMBDKKK)

State Street Bank

2 International Place

Boston, MA 02110

PO Box 5048

Boston MA 02107

Subscription Amount: \$546,000

Shares: 150,000

Additional Investment Right Shares: 45,000

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: IMPAX Environmental Market (Ireland) Fund  
*Signature of Authorized Signatory of Purchaser: /s/ Adrian Cornwell*

Name of Authorized Signatory: Adrian Cornwell  
Title of Authorized Signatory: Marketing Manager

Address for Notice of Purchaser:

Bruce Jenkyn-Jones  
IMPAX Asset Management  
Broughton House, 6-8 Jackville Street  
London, W1S 3PG, UK  
Tel +44 (0) 20 7 434 1122  
Fax: +44 (0) 20 7 437 1245

Address for Delivery of Securities for Purchaser (if not same as above):

Brown Brothers Harriman & Co.  
Investor Services, 140 Broadway  
New York, NY 10005-1101, USA

Subscription Amount: \$54,600

Shares: 15,000

Additional Investment Right Shares: 4,500

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: IMPAX Environmental Market PLC

*Signature of Authorized Signatory of Purchaser:* /s/ Bruce Jenkyn-Jones

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Name of Authorized Signatory: Bruce Jenkyn-Jones

Title of Authorized Signatory: Investment Manager

Address for Notice of Purchaser:

Bruce Jenkyn-Jones

IMPAX Asset Management

Broughton House, 6-8 Jackville Street

London, WIS 3PG, UK

Tel +44 (0) 20 7 434 1122

Fax: +44 (0) 20 7 437 1245

Address for Delivery of Securities for Purchaser (if not same as above):

Booth A Co

50 South Lasalle Street

Chicago, IL 60875, USA

Subscription Amount: \$218,400

Shares: 60,000

Additional Investment Right Shares: 18,000

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

IN WITNESS WHEREOF, the undersigned have caused this Securities Purchase Agreement to be duly executed by their respective authorized signatories as of the date first indicated above.

Name of Purchaser: PNE Invest Ltd.

Signature of Authorized Signatory of Purchaser: /s/ \_\_\_\_\_

Name of Authorized Signatory:

Title of Authorized Signatory:

Email Address of Purchaser:

Address for Notice of Purchaser:

Helvetia Court, South Esplanade  
P.O. Box 474, St. Pedro Port GYL 4EE, Guernsey  
Attn: Jane Davis  
Ph: +44 1 481 725 440

Address for Delivery of Securities for Purchaser (if not same as above):

George Fuger  
Credit Suisse Asset Management  
Qieess \_\_\_\_\_, 30  
PO Box 800  
CH – 8070 Zurid\_\_\_\_\_

Subscription Amount: \$600,017.60

Shares: 164,840

Additional Investment Right Shares: 43,452

EIN Number: **[PROVIDE THIS UNDER SEPARATE COVER]**

## REGISTRATION RIGHTS AGREEMENT

This Registration Rights Agreement (this "Agreement") is made and entered into as of February 3, 2005, by and among Active Power, Inc., a Delaware corporation (the "Company"), and the purchasers signatory hereto (each such purchaser, a "Purchaser" and collectively, the "Purchasers").

This Agreement is made pursuant to the Securities Purchase Agreement, dated as of the date hereof among the Company and the Purchasers (the "Purchase Agreement").

The Company and the Purchasers hereby agree as follows:

1. Definitions. Capitalized terms used and not otherwise defined herein that are defined in the Purchase Agreement shall have the meanings given such terms in the Purchase Agreement. As used in this Agreement, the following terms shall have the following meanings:

"Advice" shall have the meaning set forth in Section 6(d).

"Effectiveness Date" means, with respect to the Registration Statement required to be filed hereunder, the earlier of (a) the 90<sup>th</sup> calendar day following the date of the Purchase Agreement (120<sup>th</sup> calendar day if the Registration Statement is reviewed by the Commission) and (b) the fifth Trading Day following the date on which the Company is notified by the Commission that the Registration Statement will not be reviewed or is no longer subject to further review and comments.

"Effectiveness Period" shall have the meaning set forth in Section 2(a).

"Event" shall have the meaning set forth in Section 2(b).

"Event Date" shall have the meaning set forth in Section 2(b).

"Filing Date" means, with respect to the Registration Statement required to be filed hereunder, the 10<sup>th</sup> calendar day following the date on which the Company files its Form 10-K for the fiscal year ending December 31, 2004, but in no event later than April 10, 2005.

"Holder" or "Holders" means the holder or holders, as the case may be, from time to time of Registrable Securities.

"Indemnified Party" shall have the meaning set forth in Section 5(c).

"Indemnifying Party" shall have the meaning set forth in Section 5(c).

"Losses" shall have the meaning set forth in Section 5(a).

“Plan of Distribution” shall have the meaning set forth in Section 2(a).

“Proceeding” means an action, claim, suit, investigation or proceeding (including, without limitation, an investigation or partial proceeding, such as a deposition), whether commenced or threatened.

“Prospectus” means the prospectus included in the Registration Statement (including, without limitation, a prospectus that includes any information previously omitted from a prospectus filed as part of an effective registration statement in reliance upon Rule 430A promulgated under the Securities Act), as amended or supplemented by any prospectus supplement, with respect to the terms of the offering of any portion of the Registrable Securities covered by the Registration Statement, and all other amendments and supplements to the Prospectus, including post-effective amendments, and all material incorporated by reference or deemed to be incorporated by reference in such Prospectus.

“Registrable Securities” means all of the Shares and the Additional Investment Right Shares issuable, together with any shares of Common Stock issued or issuable upon any stock split, dividend or other distribution, recapitalization or similar event with respect to the foregoing.

“Registration Statement” means the registration statements required to be filed hereunder, including (in each case) the Prospectus, amendments and supplements to the registration statement or Prospectus, including pre- and post-effective amendments, all exhibits thereto, and all material incorporated by reference or deemed to be incorporated by reference in the registration statement.

“Rule 415” means Rule 415 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar rule or regulation hereafter adopted by the Commission having substantially the same purpose and effect as such Rule.

“Rule 424” means Rule 424 promulgated by the Commission pursuant to the Securities Act, as such Rule may be amended from time to time, or any similar rule or regulation hereafter adopted by the Commission having substantially the same purpose and effect as such Rule.

“Selling Shareholder Questionnaire” shall have the meaning set forth in Section 3(a).

## 2. Registration.

(a) On or prior to the Filing Date, the Company shall prepare and file with the Commission the Registration Statement covering the resale of all of the Registrable Securities for an offering to be made on a continuous basis pursuant to Rule 415. The Registration Statement required hereunder shall be on Form S-3 (except if the Company is not then eligible to register for resale the Registrable Securities on Form S-3, in which case the Registration shall be on another appropriate form in accordance herewith). The Registration Statement required hereunder shall contain (except if otherwise directed by

the Holders) substantially the “Plan of Distribution” attached hereto as Annex A. Subject to the terms of this Agreement, the Company shall use its best efforts to cause the Registration Statement to be declared effective under the Securities Act as promptly as possible after the filing thereof, but in any event not later than the Effectiveness Date, and shall use its best efforts to keep the Registration Statement continuously effective under the Securities Act until the earlier of (i) the date that is three years following the Effectiveness Date or (ii) the date when all Registrable Securities covered by the Registration Statement have been sold or may be sold without volume restrictions pursuant to Rule 144(k) as determined by the counsel to the Company pursuant to a written opinion letter to such effect, addressed and acceptable to the Company’s transfer agent and the affected Holders (the “Effectiveness Period”). The Company shall as promptly as reasonably possible notify the Holders via facsimile or e-mail of the effectiveness of the Registration Statement on the same day that the Company receives notification of the effectiveness from the Commission. Failure to so notify the Holder within 1 Trading Day after the Trading Day on which such notification is received shall be deemed an Event under Section 2(b).

(b) If: (i) a Registration Statement is not filed on or prior to the Filing Date (if the Company files a Registration Statement without affording the Holder the opportunity to review and comment on the same as required by Section 3(a), the Company shall not be deemed to have satisfied this clause (i)), or (ii) the Company fails to file with the Commission a request for acceleration in accordance with Rule 461 promulgated under the Securities Act, within five Trading Days of the date that the Company is notified (orally or in writing, whichever is earlier) by the Commission that a Registration Statement will not be “reviewed,” or is not subject to further review, or (iii) prior to the date when such Registration Statement is first declared effective by the Commission, the Company fails to file a pre-effective amendment and otherwise respond in writing to comments made by the Commission in respect of such Registration Statement within 10 Trading Days after the receipt of comments by or notice from the Commission that such amendment is required in order for a Registration Statement to be declared effective, or (iv) a Registration Statement filed or required to be filed hereunder is not declared effective by the Commission on or before the Effectiveness Date, or (v) after a Registration Statement is first declared effective by the Commission, it ceases for any reason to remain continuously effective as to all Registrable Securities for which it is required to be effective, or the Holders are not permitted to utilize the Prospectus therein to resell such Registrable Securities, for in any such case 10 consecutive Trading Days but no more than an aggregate of 20 Trading Days during any 12 month period (which need not be consecutive Trading Days) (any such failure or breach being referred to as an “Event,” and for purposes of clause (i) or (iv) the date on which such Event occurs, or for purposes of clause (ii) the date on which such five Trading Day period is exceeded, or for purposes of clause (iii) the date which such 10 Trading Day period is exceeded, or for purposes of clause (v) the date on which such 10 or 20 Trading Day period, as applicable, is exceeded being referred to as “Event Date”), then in addition to any other rights the Holders may have hereunder or under applicable law, on each such Event Date and, on each of the next two monthly anniversaries of each such Event Date (if the applicable Event shall not have been cured by such date) until the applicable Event is cured, the Company shall pay to each Holder an amount in cash, as partial liquidated damages and

not as a penalty, equal to 1% of the aggregate purchase price paid by such Holder pursuant to the Purchase Agreement for any Registrable Securities then held by such Holder; and after the second monthly anniversary of any Event Date, equal to 2% of the aggregate purchase price paid by such Holder pursuant to the Purchase Agreement for any Registrable Securities then held by such Holder. If the Company fails to pay any partial liquidated damages pursuant to this Section in full within seven days after the date payable, the Company will pay interest thereon at a rate of 18% per annum (or such lesser maximum amount that is permitted to be paid by applicable law) to the Holder, accruing daily from the date such partial liquidated damages are due until such amounts, plus all such interest thereon, are paid in full. The partial liquidated damages pursuant to the terms hereof shall apply on a daily pro-rata basis for any portion of a month prior to the cure of an Event.

### 3. Registration Procedures

In connection with the Company's registration obligations hereunder, the Company shall:

(a) Not less than five Trading Days prior to the filing of the Registration Statement or any related Prospectus or any amendment or supplement thereto, the Company shall, (i) furnish to the Holders copies of all such documents proposed to be filed (including documents incorporated or deemed incorporated by reference to the extent requested in writing by such Person) which documents will be subject to the review of such Holders, and (ii) cause its officers and directors, counsel and independent certified public accountants to respond to such inquiries as shall be necessary, in the reasonable opinion of respective counsel to conduct a reasonable investigation within the meaning of the Securities Act. The Company shall not file the Registration Statement or any such Prospectus or any amendments or supplements thereto to which the Holders of a majority of the Registrable Securities shall reasonably object in good faith, provided that the Company is notified of such objection in writing no later than 5 Trading Days after the Holders have been so furnished copies of such documents. Each Holder agrees to furnish to the Company a completed Questionnaire in the form attached to this Agreement as Annex B (a "Selling Shareholder Questionnaire") not less than two Trading Days prior to the Filing Date or by the end of the fourth Trading Day following the date on which such Holder receives draft materials in accordance with this Section.

(b) (i) Prepare and file with the Commission such amendments, including post-effective amendments, to the Registration Statement and the Prospectus used in connection therewith as may be necessary to keep the Registration Statement continuously effective as to the applicable Registrable Securities for the Effectiveness Period and prepare and file with the Commission such additional Registration Statements in order to register for resale under the Securities Act all of the Registrable Securities; (ii) cause the related Prospectus to be amended or supplemented by any required Prospectus supplement, and as so supplemented or amended to be filed pursuant to Rule 424; (iii) respond as promptly as reasonably possible to any comments received from the Commission with respect to the Registration Statement or any amendment thereto and, as promptly as reasonably possible, upon request, provide the Holders true and complete



copies of all correspondence from and to the Commission relating to the Registration Statement; and (iv) comply in all material respects with the provisions of the Securities Act and the Exchange Act with respect to the disposition of all Registrable Securities covered by the Registration Statement during the applicable period in accordance with the intended methods of disposition by the Holders thereof set forth in the Registration Statement as so amended or in such Prospectus as so supplemented.

(c) Notify the Holders of Registrable Securities to be sold as promptly as reasonably possible and (if requested by any such Person) confirm such notice in writing promptly following the day (i)(A) when a Prospectus or any Prospectus supplement or post-effective amendment to the Registration Statement is proposed to be filed; (B) when the Commission notifies the Company whether there will be a "review" of the Registration Statement and whenever the Commission comments in writing on the Registration Statement (the Company shall upon request provide true and complete copies thereof and all written responses thereto to each of the Holders); and (C) with respect to the Registration Statement or any post-effective amendment, when the same has become effective; (ii) of any request by the Commission or any other Federal or state governmental authority during the period of effectiveness of the Registration Statement for amendments or supplements to the Registration Statement or Prospectus or for additional information; (iii) of the issuance by the Commission or any other federal or state governmental authority of any stop order suspending the effectiveness of the Registration Statement covering any or all of the Registrable Securities or the initiation of any Proceedings for that purpose; (iv) of the receipt by the Company of any notification with respect to the suspension of the qualification or exemption from qualification of any of the Registrable Securities for sale in any jurisdiction, or the initiation or threatening of any Proceeding for such purpose; and (v) of the occurrence of any event or passage of time that makes the financial statements included in the Registration Statement ineligible for inclusion therein or any statement made in the Registration Statement or Prospectus or any document incorporated or deemed to be incorporated therein by reference untrue in any material respect or that requires any revisions to the Registration Statement, Prospectus or other documents so that, in the case of the Registration Statement or the Prospectus, as the case may be, it will not contain any untrue statement of a material fact or omit to state any material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

(d) Use its reasonable best efforts to avoid the issuance of, or, if issued, obtain the withdrawal of (i) any order suspending the effectiveness of the Registration Statement, or (ii) any suspension of the qualification (or exemption from qualification) of any of the Registrable Securities for sale in any jurisdiction, at the earliest practicable moment.

(e) Furnish to each Holder, without charge, at least one conformed copy of the Registration Statement and each amendment thereto, including financial statements and schedules, all documents incorporated or deemed to be incorporated therein by reference to the extent requested by such Person, and all exhibits to the extent requested by such Person (including those previously furnished or incorporated by reference) promptly after the filing of such documents with the Commission.

(f) Promptly deliver to each Holder, without charge, as many copies of the Prospectus or Prospectuses (including each form of prospectus) and each amendment or supplement thereto as such Persons may reasonably request in connection with resales by the Holder of Registrable Securities. Subject to the terms of this Agreement, the Company hereby consents to the use of such Prospectus and each amendment or supplement thereto by each of the selling Holders in connection with the offering and sale of the Registrable Securities covered by such Prospectus and any amendment or supplement thereto, except after the giving on any notice pursuant to Section 3(c).

(g) Prior to any resale of Registrable Securities by a Holder, use its commercially reasonable efforts to register or qualify or cooperate with the selling Holders in connection with the registration or qualification (or exemption from the Registration or qualification) of such Registrable Securities for the resale by the Holder under the securities or Blue Sky laws of such jurisdictions within the United States as any Holder reasonably requests in writing, to keep the Registration or qualification (or exemption therefrom) effective during the Effectiveness Period and to do any and all other acts or things reasonably necessary to enable the disposition in such jurisdictions of the Registrable Securities covered by the Registration Statement; provided, that the Company shall not be required to qualify generally to do business in any jurisdiction where it is not then so qualified, subject the Company to any material tax in any such jurisdiction where it is not then so subject or file a general consent to service of process in any such jurisdiction.

(h) If NASD Rule 2710 requires any broker-dealer to make a filing prior to executing a sale by a Holder, make an Issuer Filing with the NASD Regulation, Inc. ("NASDR") Corporate Financing Department pursuant to NASD Rule 2710(b)(10)(A)(i) and respond within five Trading Days to any comments received from NASDR in connection therewith, and pay the filing fee required in connection therewith.

(i) If requested by the Holders, cooperate with the Holders to facilitate the timely preparation and delivery of certificates representing Registrable Securities to be delivered to a transferee pursuant to the Registration Statement, which certificates shall be free, to the extent permitted by the Purchase Agreement, of all restrictive legends, and to enable such Registrable Securities to be in such denominations and registered in such names as any such Holders may request.

(j) Upon the occurrence of any event contemplated by Section 3(c)(v), as promptly as reasonably possible, prepare a supplement or amendment, including a post-effective amendment, to the Registration Statement or a supplement to the related Prospectus or any document incorporated or deemed to be incorporated therein by reference, and file any other required document so that, as thereafter delivered, neither the Registration Statement nor such Prospectus will contain an untrue statement of a material fact or omit to state a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made,

not misleading. If the Company notifies the Holders in accordance with clauses (ii) through (v) of Section 3(c) above to suspend the use of any Prospectus until the requisite changes to such Prospectus have been made, then the Holders shall suspend use of such Prospectus. The Company will use its best efforts to ensure that the use of the Prospectus may be resumed as promptly as is practicable. The Company shall be entitled to exercise its right under this Section 3(i) to suspend the availability of a Registration Statement and Prospectus, subject to the payment of partial liquidated damages pursuant to Section 2(b), for a period not to exceed 60 days (which need not be consecutive days) in any 12 month period.

(k) Comply with all applicable rules and regulations of the Commission.

(l) The Company may require each selling Holder to furnish to the Company a certified statement as to the number of shares of Common Stock beneficially owned by such Holder and, if required by the Commission, the person thereof that has voting and dispositive control over the Shares. During any periods that the Company is unable to meet its obligations hereunder with respect to the registration of the Registrable Securities solely because any Holder fails to furnish such information within three Trading Days of the Company's request, any liquidated damages that are accruing at such time as to such Holder only shall be tolled and any Event that may otherwise occur solely because of such delay shall be suspended as to such Holder only, until such information is delivered to the Company.

4. Registration Expenses. All fees and expenses incident to the performance of or compliance with this Agreement by the Company shall be borne by the Company whether or not any Registrable Securities are sold pursuant to the Registration Statement. The fees and expenses referred to in the foregoing sentence shall include, without limitation, (i) all registration and filing fees (including, without limitation, fees and expenses (A) with respect to filings required to be made with the Trading Market on which the Common Stock is then listed for trading, (B) in compliance with applicable state securities or Blue Sky laws reasonably agreed to by the Company in writing (including, without limitation, fees and disbursements of counsel for the Company in connection with Blue Sky qualifications or exemptions of the Registrable Securities and determination of the eligibility of the Registrable Securities for investment under the laws of such jurisdictions as requested by the Holders) and (C) if not previously paid by the Company in connection with an Issuer Filing, with respect to any filing that may be required to be made by any broker through which a Holder intends to make sales of Registrable Securities with NASDR pursuant to the NASD Rule 2710, so long as the broker is receiving no more than a customary brokerage commission in connection with such sale, (ii) printing expenses (including, without limitation, expenses of printing certificates for Registrable Securities and of printing prospectuses if the printing of prospectuses is reasonably requested by the holders of a majority of the Registrable Securities included in the Registration Statement), (iii) messenger, telephone and delivery expenses, (iv) fees and disbursements of counsel for the Company, (v) Securities Act liability insurance, if the Company so desires such insurance, and (vi) fees and expenses of all other Persons retained by the Company in connection with the consummation of the transactions contemplated by this Agreement. In addition, the Company shall be responsible for all of its internal expenses incurred in connection with the consummation of the transactions contemplated by this Agreement (including, without limitation, all salaries and expenses of its

officers and employees performing legal or accounting duties), the expense of any annual audit and the fees and expenses incurred in connection with the listing of the Registrable Securities on any securities exchange as required hereunder. In no event shall the Company be responsible for any broker or similar commissions or, except to the extent provided for in the Transaction Documents, any legal fees or other costs of the Holders.

#### 5. Indemnification

(a) Indemnification by the Company. The Company shall, notwithstanding any termination of this Agreement, indemnify and hold harmless each Holder, the officers, directors, agents, brokers (including brokers who offer and sell Registrable Securities as principal as a result of a pledge or any failure to perform under a margin call of Common Stock), investment advisors and employees of each of them, each Person who controls any such Holder (within the meaning of Section 15 of the Securities Act or Section 20 of the Exchange Act) and the officers, directors, agents and employees of each such controlling Person, to the fullest extent permitted by applicable law, from and against any and all losses, claims, damages, liabilities, costs (including, without limitation, reasonable attorneys' fees) and expenses (collectively, "Losses"), as incurred, arising out of or relating to any untrue or alleged untrue statement of a material fact contained in the Registration Statement, any Prospectus or any form of prospectus or in any amendment or supplement thereto or in any preliminary prospectus, or arising out of or relating to any omission or alleged omission of a material fact required to be stated therein or necessary to make the statements therein (in the case of any Prospectus or form of prospectus or supplement thereto, in light of the circumstances under which they were made) not misleading, except to the extent, but only to the extent, that (i) such untrue statements or omissions are based solely upon information regarding such Holder furnished in writing to the Company by such Holder expressly for use therein, or to the extent that such information relates to such Holder or such Holder's proposed method of distribution of Registrable Securities and was reviewed and expressly approved in writing by such Holder expressly for use in the Registration Statement, such Prospectus or such form of Prospectus or in any amendment or supplement thereto (it being understood that the Holder has approved Annex A hereto for this purpose) or (ii) in the case of an occurrence of an event of the type specified in Section 3(c)(ii)-(v), the use by such Holder of an outdated or defective Prospectus after the Company has notified such Holder in writing that the Prospectus is outdated or defective and prior to the receipt by such Holder of the Advice contemplated in Section 6(d). The Company shall notify the Holders promptly of the institution, threat or assertion of any Proceeding of which the Company is aware in connection with the transactions contemplated by this Agreement.

(b) Indemnification by Holders. Each Holder shall, severally and not jointly, indemnify and hold harmless the Company, its directors, officers, agents and employees, each Person who controls the Company (within the meaning of Section 15 of the Securities Act and Section 20 of the Exchange Act), and the directors, officers, agents or employees of such controlling Persons, to the fullest extent permitted by applicable law, from and against all Losses, as incurred, to the extent arising out of or based solely upon: (x) such Holder's failure to comply with the prospectus delivery requirements of the Securities Act or (y) any untrue or alleged untrue statement of a material fact contained in

any Registration Statement, any Prospectus, or any form of prospectus, or in any amendment or supplement thereto or in any preliminary prospectus, or arising out of or relating to any omission or alleged omission of a material fact required to be stated therein or necessary to make the statements therein not misleading (i) to the extent, but only to the extent, that such untrue statement or omission is contained in any information so furnished in writing by such Holder to the Company specifically for inclusion in the Registration Statement or such Prospectus or (ii) to the extent that (1) such untrue statements or omissions are based solely upon information regarding such Holder furnished in writing to the Company by such Holder expressly for use therein, or to the extent that such information relates to such Holder or such Holder's proposed method of distribution of Registrable Securities and was reviewed and expressly approved in writing by such Holder expressly for use in the Registration Statement (it being understood that the Holder has approved Annex A hereto for this purpose), such Prospectus or such form of Prospectus or in any amendment or supplement thereto or (2) in the case of an occurrence of an event of the type specified in Section 3(c)(ii)-(v), the use by such Holder of an outdated or defective Prospectus after the Company has notified such Holder in writing that the Prospectus is outdated or defective and prior to the receipt by such Holder of the Advice contemplated in Section 6(d). In no event shall the liability of any selling Holder hereunder be greater in amount than the dollar amount of the net proceeds received by such Holder upon the sale of the Registrable Securities giving rise to such indemnification obligation.

(c) Conduct of Indemnification Proceedings. If any Proceeding shall be brought or asserted against any Person entitled to indemnity hereunder (an "Indemnified Party"), such Indemnified Party shall promptly notify the Person from whom indemnity is sought (the "Indemnifying Party") in writing, and the Indemnifying Party shall have the right to assume the defense thereof, including the employment of counsel reasonably satisfactory to the Indemnified Party and the payment of all fees and expenses incurred in connection with defense thereof; provided, that the failure of any Indemnified Party to give such notice shall not relieve the Indemnifying Party of its obligations or liabilities pursuant to this Agreement, except (and only) to the extent that it shall be finally determined by a court of competent jurisdiction (which determination is not subject to appeal or further review) that such failure shall have prejudiced the Indemnifying Party.

An Indemnified Party shall have the right to employ separate counsel in any such Proceeding and to participate in the defense thereof, but the fees and expenses of such counsel shall be at the expense of such Indemnified Party or Parties unless: (1) the Indemnifying Party has agreed in writing to pay such fees and expenses; (2) the Indemnifying Party shall have failed promptly to assume the defense of such Proceeding and to employ counsel reasonably satisfactory to such Indemnified Party in any such Proceeding; or (3) the named parties to any such Proceeding (including any impleaded parties) include both such Indemnified Party and the Indemnifying Party, and such Indemnified Party shall reasonably believe that a material conflict of interest is likely to exist if the same counsel were to represent such Indemnified Party and the Indemnifying Party (in which case, if such Indemnified Party notifies the Indemnifying Party in writing that it elects to employ separate counsel at the expense of the Indemnifying Party, the Indemnifying Party shall not have the right to assume the defense thereof and the

reasonable fees and expenses of one separate counsel shall be at the expense of the Indemnifying Party). The Indemnifying Party shall not be liable for any settlement of any such Proceeding effected without its written consent, which consent shall not be unreasonably withheld. No Indemnifying Party shall, without the prior written consent of the Indemnified Party, effect any settlement of any pending Proceeding in respect of which any Indemnified Party is a party, unless such settlement includes an unconditional release of such Indemnified Party from all liability on claims that are the subject matter of such Proceeding.

Subject to the terms of this Agreement, all reasonable fees and expenses of the Indemnified Party (including reasonable fees and expenses to the extent incurred in connection with investigating or preparing to defend such Proceeding in a manner not inconsistent with this Section) shall be paid to the Indemnified Party, as incurred, within ten Trading Days of written notice thereof to the Indemnifying Party; provided, that the Indemnified Party shall promptly reimburse the Indemnifying Party for that portion of such fees and expenses applicable to such actions for which such Indemnified Party is not entitled to indemnification hereunder, determined based upon the relative faults of the parties.

(d) Contribution. If the indemnification under Section 5(a) or 5(b) is unavailable to an Indemnified Party or insufficient to hold an Indemnified Party harmless for any Losses, then each Indemnifying Party shall contribute to the amount paid or payable by such Indemnified Party, in such proportion as is appropriate to reflect the relative fault of the Indemnifying Party and Indemnified Party in connection with the actions, statements or omissions that resulted in such Losses as well as any other relevant equitable considerations. The relative fault of such Indemnifying Party and Indemnified Party shall be determined by reference to, among other things, whether any action in question, including any untrue or alleged untrue statement of a material fact or omission or alleged omission of a material fact, has been taken or made by, or relates to information supplied by, such Indemnifying Party or Indemnified Party, and the parties' relative intent, knowledge, access to information and opportunity to correct or prevent such action, statement or omission. The amount paid or payable by a party as a result of any Losses shall be deemed to include, subject to the limitations set forth in this Agreement, any reasonable attorneys' or other reasonable fees or expenses incurred by such party in connection with any Proceeding to the extent such party would have been indemnified for such fees or expenses if the indemnification provided for in this Section was available to such party in accordance with its terms.

The parties hereto agree that it would not be just and equitable if contribution pursuant to this Section 5(d) were determined by pro rata allocation or by any other method of allocation that does not take into account the equitable considerations referred to in the immediately preceding paragraph. Notwithstanding the provisions of this Section 5(d), no Holder shall be required to contribute, in the aggregate, any amount in excess of the amount by which the proceeds actually received by such Holder from the sale of the Registrable Securities subject to the Proceeding exceeds the amount of any damages that such Holder has otherwise been required to pay by reason of such untrue or alleged untrue statement or omission or alleged omission, except in the case of fraud by such Holder.

The indemnity and contribution agreements contained in this Section are in addition to any liability that the Indemnifying Parties may have to the Indemnified Parties.

#### 6. Miscellaneous

(a) Remedies. In the event of a breach by the Company or by a Holder, of any of their obligations under this Agreement, each Holder or the Company, as the case may be, in addition to being entitled to exercise all rights granted by law and under this Agreement, including recovery of damages, will be entitled to specific performance of its rights under this Agreement. The Company and each Holder agree that monetary damages would not provide adequate compensation for any losses incurred by reason of a breach by it of any of the provisions of this Agreement and hereby further agrees that, in the event of any action for specific performance in respect of such breach, it shall waive the defense that a remedy at law would be adequate.

(b) No Piggyback on Registrations. Except as set forth on Schedule 6(b) attached hereto, neither the Company nor any of its security holders (other than the Holders in such capacity pursuant hereto) may include securities of the Company in a Registration Statement other than the Registrable Securities. No Person has any right to cause the Company to effect the registration under the Securities Act of any securities of the Company. The Company shall not file any other registration statements until the Registration Statement required hereunder is declared effective by the Commission, provided that this Section 6(b) shall not prohibit the Company from filing amendments to registration statements already filed.

(c) Compliance. Each Holder covenants and agrees that it will comply with the prospectus delivery requirements of the Securities Act as applicable to it in connection with sales of Registrable Securities pursuant to the Registration Statement.

(d) Discontinued Disposition. Each Holder agrees by its acquisition of such Registrable Securities that, upon receipt of a notice from the Company of the occurrence of any event of the kind described in Section 3(c), such Holder will forthwith discontinue disposition of such Registrable Securities under the Registration Statement until such Holder's receipt of the copies of the supplemented Prospectus and/or amended Registration Statement or until it is advised in writing (the "Advice") by the Company that the use of the applicable Prospectus may be resumed, and, in either case, has received copies of any additional or supplemental filings that are incorporated or deemed to be incorporated by reference in such Prospectus or Registration Statement. The Company will use its best efforts to ensure that the use of the Prospectus may be resumed as promptly as it practicable. The Company agrees and acknowledges that any periods during which the Holder is required to discontinue the disposition of the Registrable Securities hereunder shall be subject to the provisions of Section 2(b).

(e) Piggy-Back Registrations. If at any time during the Effectiveness Period there is not an effective Registration Statement covering all of the Registrable Securities and the Company shall determine to prepare and file with the Commission a registration statement relating to an offering for its own account or the account of others under the Securities Act of any of its equity securities, other than on Form S-4 or Form S-8 (each as promulgated under the Securities Act) or their then equivalents relating to equity securities to be issued solely in connection with any acquisition of any entity or business or equity securities issuable in connection with the stock option or other employee benefit plans, then the Company shall send to each Holder a written notice of such determination and, if within fifteen days after the date of such notice, any such Holder shall so request in writing, the Company shall include in such registration statement all or any part of such Registrable Securities such Holder requests to be registered, subject to customary underwriter cutbacks applicable to all holders of registration rights.

(f) Amendments and Waivers. The provisions of this Agreement, including the provisions of this sentence, may not be amended, modified or supplemented, and waivers or consents to departures from the provisions hereof may not be given, unless the same shall be in writing and signed by the Company and each Holder of the then outstanding Registrable Securities. Notwithstanding the foregoing, a waiver or consent to depart from the provisions hereof with respect to a matter that relates exclusively to the rights of Holders and that does not directly or indirectly affect the rights of other Holders may be given by Holders of all of the Registrable Securities to which such waiver or consent relates; provided, however, that the provisions of this sentence may not be amended, modified, or supplemented except in accordance with the provisions of the immediately preceding sentence.

(g) Notices. Any and all notices or other communications or deliveries required or permitted to be provided hereunder shall be delivered as set forth in the Purchase Agreement.

(h) Successors and Assigns. This Agreement shall inure to the benefit of and be binding upon the successors and permitted assigns of each of the parties and shall inure to the benefit of each Holder. The Company may not assign its rights or obligations hereunder without the prior written consent of all of the Holders of the then-outstanding Registrable Securities. Each Holder may assign their respective rights hereunder in the manner and to the Persons as permitted under the Purchase Agreement.

(i) No Inconsistent Agreements. Neither the Company nor any of its subsidiaries has entered, as of the date hereof, nor shall the Company or any of its subsidiaries, on or after the date of this Agreement, enter into any agreement with respect to its securities, that would have the effect of impairing the rights granted to the Holders in this Agreement or otherwise conflicts with the provisions hereof. Except as set forth on Schedule 6(i), neither the Company nor any of its subsidiaries has previously entered into any agreement granting any registration rights with respect to any of its securities to any Person that have not been satisfied in full.



(j) Execution and Counterparts. This Agreement may be executed in any number of counterparts, each of which when so executed shall be deemed to be an original and, all of which taken together shall constitute one and the same Agreement. In the event that any signature is delivered by facsimile transmission, such signature shall create a valid binding obligation of the party executing (or on whose behalf such signature is executed) the same with the same force and effect as if such facsimile signature were the original thereof.

(k) Governing Law. All questions concerning the construction, validity, enforcement and interpretation of this Agreement shall be determined with the provisions of the Purchase Agreement.

(l) Cumulative Remedies. The remedies provided herein are cumulative and not exclusive of any remedies provided by law.

(m) Severability. If any term, provision, covenant or restriction of this Agreement is held by a court of competent jurisdiction to be invalid, illegal, void or unenforceable, the remainder of the terms, provisions, covenants and restrictions set forth herein shall remain in full force and effect and shall in no way be affected, impaired or invalidated, and the parties hereto shall use their commercially reasonable efforts to find and employ an alternative means to achieve the same or substantially the same result as that contemplated by such term, provision, covenant or restriction. It is hereby stipulated and declared to be the intention of the parties that they would have executed the remaining terms, provisions, covenants and restrictions without including any of such that may be hereafter declared invalid, illegal, void or unenforceable.

(n) Headings. The headings in this Agreement are for convenience of reference only and shall not limit or otherwise affect the meaning hereof.

(o) Independent Nature of Holders' Obligations and Rights. The obligations of each Holder hereunder are several and not joint with the obligations of any other Holder hereunder, and no Holder shall be responsible in any way for the performance of the obligations of any other Holder hereunder. Nothing contained herein or in any other agreement or document delivered at any closing, and no action taken by any Holder pursuant hereto or thereto, shall be deemed to constitute the Holders as a partnership, an association, a joint venture or any other kind of entity, or create a presumption that the Holders are in any way acting in concert with respect to such obligations or the transactions contemplated by this Agreement and the Company acknowledges that, to its knowledge, the Holders are not acting in concert or as a group with respect to such obligations or the transactions contemplated by this Agreement or any other Transaction Document. Each Holder shall be entitled to protect and enforce its rights, including without limitation the rights arising out of this Agreement, and it shall not be necessary for any other Holder to be joined as an additional party in any proceeding for such purpose.

\*\*\*\*\*

IN WITNESS WHEREOF, the parties have executed this Registration Rights Agreement as of the date first written above.

Active Power, Inc.

By: /s/ Joseph F. Pinkerton, III

\_\_\_\_\_  
Name: Joseph F. Pinkerton, III

Title: Chairman of the Board, President and Chief  
Executive Officer

[SIGNATURE PAGE OF HOLDERS FOLLOWS]

## ANNEX A

### Plan of Distribution

The Selling Stockholders (the “Selling Stockholders”) of the common stock (“Common Stock”) of the Company and any of their pledgees, assignees and successors-in-interest may, from time to time, sell any or all of their shares of Common Stock on any stock exchange, market or trading facility on which the shares are traded or in private transactions. These sales may be at fixed or negotiated prices. The Selling Stockholders may use any one or more of the following methods when selling shares:

- ordinary brokerage transactions and transactions in which the broker-dealer solicits purchasers;
- block trades in which the broker-dealer will attempt to sell the shares as agent but may position and resell a portion of the block as principal to facilitate the transaction;
- purchases by a broker-dealer as principal and resale by the broker-dealer for its account;
- an exchange distribution in accordance with the rules of the applicable exchange;
- privately negotiated transactions;
- settlement of short sales entered into after the date of this prospectus;
- broker-dealers may agree with the Selling Stockholders to sell a specified number of such shares at a stipulated price per share;
- a combination of any such methods of sale;
- through the writing or settlement of options or other hedging transactions, whether through an options exchange or otherwise; or
- any other method permitted pursuant to applicable law.

The Selling Stockholders may also sell shares under Rule 144 under the Securities Act of 1933, as amended (the “Securities Act”), if available, rather than under this prospectus.

Broker-dealers engaged by the Selling Stockholders may arrange for other brokers-dealers to participate in sales. Broker-dealers may receive commissions or discounts from the Selling Stockholders (or, if any broker-dealer acts as agent for the purchaser of shares, from the purchaser) in amounts to be negotiated, but, except as set forth in a supplement to this Prospectus, in the case of an agency transaction not in excess of a customary brokerage commission in compliance with NASD Rule 2440; and in the case of a principal transaction a markup or markdown in compliance with NASD IM-2440.

In connection with the sale of the Common Stock or interests therein, the Selling Stockholders may enter into hedging transactions with broker-dealers or other financial institutions, which may in turn engage in short sales of the Common Stock in the course of hedging the positions they assume. The Selling Stockholders may also sell shares of the Common Stock short and deliver these securities to close out their short positions, or loan or pledge the Common Stock to broker-dealers that in turn may sell these securities. The Selling Stockholders may also enter into option or other transactions with broker-dealers or other financial institutions or the creation of one or more derivative securities which require the delivery to such broker-dealer or other financial institution of shares offered by this prospectus, which shares such broker-dealer or other financial institution may resell pursuant to this prospectus (as supplemented or amended to reflect such transaction).

The Selling Stockholders and any broker-dealers or agents that are involved in selling the shares may be deemed to be “underwriters” within the meaning of the Securities Act in connection with such sales. In such event, any commissions received by such broker-dealers or agents and any profit on the resale of the shares purchased by them may be deemed to be underwriting commissions or discounts under the Securities Act. Each Selling Stockholder has informed the Company that it does not have any written or oral agreement or understanding, directly or indirectly, with any person to distribute the Common Stock. In no event shall any broker-dealer receive fees, commissions and markups which, in the aggregate, would exceed eight percent (8%).

The Company is required to pay certain fees and expenses incurred by the Company incident to the registration of the shares. The Company has agreed to indemnify the Selling Stockholders against certain losses, claims, damages and liabilities, including liabilities under the Securities Act.

Because Selling Stockholders may be deemed to be “underwriters” within the meaning of the Securities Act, they will be subject to the prospectus delivery requirements of the Securities Act. In addition, any securities covered by this prospectus which qualify for sale pursuant to Rule 144 under the Securities Act may be sold under Rule 144 rather than under this prospectus. Each Selling Stockholder has advised us that they have not entered into any written or oral agreements, understandings or arrangements with any underwriter or broker-dealer regarding the sale of the resale shares. There is no underwriter or coordinating broker acting in connection with the proposed sale of the resale shares by the Selling Stockholders.

We agreed to keep this prospectus effective until the earlier of (i) the date on which the shares may be resold by the Selling Stockholders without registration and without regard to any volume limitations by reason of Rule 144(e) under the Securities Act or any other rule of similar effect or (ii) all of the shares have been sold pursuant to the prospectus or Rule 144 under the Securities Act or any other rule of similar effect. The resale shares will be sold only through registered or licensed brokers or dealers if required under applicable state securities laws. In addition, in certain states, the resale shares may not be sold unless they have been registered or qualified for sale in the applicable state or an exemption from the registration or qualification requirement is available and is complied with.

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Under applicable rules and regulations under the Exchange Act, any person engaged in the distribution of the resale shares may not simultaneously engage in market making activities with respect to the Common Stock for a period of two business days prior to the commencement of the distribution. In addition, the Selling Stockholders will be subject to applicable provisions of the Exchange Act and the rules and regulations thereunder, including Regulation M, which may limit the timing of purchases and sales of shares of the Common Stock by the Selling Stockholders or any other person. We will make copies of this prospectus available to the Selling Stockholders and have informed them of the need to deliver a copy of this prospectus to each purchaser at or prior to the time of the sale.

## ACTIVE POWER, INC.

## Selling Securityholder Notice and Questionnaire

The undersigned beneficial owner of common stock, par value \$0.001 per share (the "Common Stock"), of Active Power, Inc., a Delaware corporation (the "Company"), (the "Registrable Securities") understands that the Company has filed or intends to file with the Securities and Exchange Commission (the "Commission") a registration statement on Form S-3 (the "Registration Statement") for the registration and resale under Rule 415 of the Securities Act of 1933, as amended (the "Securities Act"), of the Registrable Securities, in accordance with the terms of the Registration Rights Agreement, dated as of February 3, 2005 (the "Registration Rights Agreement"), among the Company and the Purchasers named therein. A copy of the Registration Rights Agreement is available from the Company upon request at the address set forth below. All capitalized terms not otherwise defined herein shall have the meanings ascribed thereto in the Registration Rights Agreement.

Certain legal consequences arise from being named as a selling securityholder in the Registration Statement and the related prospectus. Accordingly, holders and beneficial owners of Registrable Securities are advised to consult their own securities law counsel regarding the consequences of being named or not being named as a selling securityholder in the Registration Statement and the related prospectus.

## NOTICE

The undersigned beneficial owner (the "Selling Securityholder") of Registrable Securities hereby elects to include the Registrable Securities owned by it and listed below in Item 3 (unless otherwise specified under such Item 3) in the Registration Statement.

The undersigned hereby provides the following information to the Company and represents and warrants that such information is accurate:

**QUESTIONNAIRE**

**1. Name.**

(a) Full Legal Name of Selling Securityholder

\_\_\_\_\_

(b) Full Legal Name of Registered Holder (if not the same as (a) above) through which Registrable Securities Listed in Item 3 below are held:

\_\_\_\_\_

(c) Full Legal Name of Natural Control Person (which means a natural person who directly or indirectly alone or with others has power to vote or dispose of the securities covered by the questionnaire):

\_\_\_\_\_

**2. Address for Notices to Selling Securityholder:**

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Telephone: \_\_\_\_\_

Fax: \_\_\_\_\_

Contact Person: \_\_\_\_\_

**3. Beneficial Ownership of Registrable Securities:**

(a) Type and Number of Registrable Securities beneficially owned:

\_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

**4. Broker-Dealer Status:**

(a) Are you a broker-dealer?  
Yes  No

Note: If yes, the Commission's staff has indicated that you should be identified as an underwriter in the Registration Statement.

(b) Are you an affiliate of a broker-dealer?  
Yes  No

(c) If you are an affiliate of a broker-dealer, do you certify that you bought the Registrable Securities in the ordinary course of business, and at the time of the purchase of the Registrable Securities to be resold, you had no agreements or understandings, directly or indirectly, with any person to distribute the Registrable Securities?  
Yes  No

Note: If no, the Commission's staff has indicated that you should be identified as an underwriter in the Registration Statement.

**5. Beneficial Ownership of Other Securities of the Company Owned by the Selling Securityholder.**

*Except as set forth below in this Item 5, the undersigned is not the beneficial or registered owner of any securities of the Company other than the Registrable Securities listed above in Item 3.*

(a) Type and Amount of Other Securities beneficially owned by the Selling Securityholder:

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**6. Relationships with the Company:**

*Except as set forth below, neither the undersigned nor any of its affiliates, officers, directors or principal equity holders (owners of 5% or more of the equity securities of the undersigned) has held any position or office or has had any other material relationship with the Company (or its predecessors or affiliates) during the past three years.*

State any exceptions here:

\_\_\_\_\_

\_\_\_\_\_

The undersigned agrees to promptly notify the Company of any inaccuracies or changes in the information provided herein that may occur subsequent to the date hereof at any time while the Registration Statement remains effective.

By signing below, the undersigned consents to the disclosure of the information contained herein in its answers to Items 1 through 6 and the inclusion of such information in the Registration Statement and the related prospectus and any amendments or supplements thereto. The undersigned understands that such information will be relied upon by the Company in connection with the preparation or amendment of the Registration Statement and the related prospectus.

IN WITNESS WHEREOF the undersigned, by authority duly given, has caused this Notice and Questionnaire to be executed and delivered either in person or by its duly authorized agent.

Dated: \_\_\_\_\_

Beneficial Owner: \_\_\_\_\_

By: \_\_\_\_\_

Name:

Title:

**PLEASE FAX A COPY OF THE COMPLETED AND EXECUTED NOTICE AND QUESTIONNAIRE, AND RETURN THE ORIGINAL BY OVERNIGHT MAIL, TO:**

Name of Purchaser: Capital Ventures International

*Signature of Authorized Signatory of Purchaser:* /s/ Martin Kobinger

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Name of Authorized Signatory: Heights Capital Management, Inc. Authorized Signatory

Title of Authorized Signatory: Investment Manager

Name of Purchaser: Smithfield Fiduciary LLC

*Signature of Authorized Signatory of Purchaser:* /s/ Adam J. Chill

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Name of Authorized Signatory: Adam J. Chill

Title of Authorized Signatory: Authorized Signatory

Name of Purchaser: D.B. Zwirn Special Opportunities Fund, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ Daniel B. Zwirn

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Name of Authorized Signatory: Daniel B. Zwirn

Title of Authorized Signatory: Managing Partner

Name of Purchaser: D.B. Zwirn Special Opportunities Fund, Ltd.

*Signature of Authorized Signatory of Purchaser:* /s/ Daniel B. Zwirn

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Name of Authorized Signatory: Daniel B. Zwirn

Title of Authorized Signatory: Managing Partner

Name of Purchaser: Southport Millennium Fund, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: Southport Millennium Management, LLC (GP), James M. Thorburn

Title of Authorized Signatory: Managing Member of GP

Name of Purchaser: Southport Millennium Fund II, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: Southport Millennium II Management, LLC (GP), James M. Thorburn

Title of Authorized Signatory: Managing Member of GP

Name of Purchaser: Southport Millennium Micro Cap Fund, L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: Southport Micro Cap Management, LLC (GP), James M. Thorburn

Title of Authorized Signatory: Managing Member of GP



Name of Purchaser: Southport Millennium Offshore Fund, Inc.

*Signature of Authorized Signatory of Purchaser:* /s/ James M. Thorburn

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Name of Authorized Signatory: James M. Thorburn

Title of Authorized Signatory: Director

Name of Purchaser: Southport Energy Plus Partners L.P.

*Signature of Authorized Signatory of Purchaser:* /s/ Anthony Grammalva

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Name of Authorized Signatory: Anthony Grammalva

Title of Authorized Signatory: CEO-Sound Energy Partners, Inc. its Investment Manager

Name of Purchaser: Southport Energy Plus Offshore Fund, Inc.

*Signature of Authorized Signatory of Purchaser:* /s/ Anthony Grammalva

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Name of Authorized Signatory: Anthony Grammalva

Title of Authorized Signatory: CEO-Sound Energy Partners, Inc. its Investment Advisor

Name of Purchaser: Sound Energy Capital Offshore Fund, Ltd.

*Signature of Authorized Signatory of Purchaser:* /s/ Anthony Grammalva

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Name of Authorized Signatory: Anthony Grammalva

Title of Authorized Signatory: GP-Sound Energy Capital Management, L.P. its Investment Advisor

Name of Purchaser: SF Capital Partners Ltd.

*Signature of Authorized Signatory of Purchaser:* /s/ Robert J. Barnard

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Name of Authorized Signatory: Robert J. Barnard

Title of Authorized Signatory: Authorized Signatory

Name of Purchaser: Portside Growth and Opportunity Fund

*Signature of Authorized Signatory of Purchaser:* /s/ Jeffrey Smith

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Name of Authorized Signatory: Jeffrey Smith

Title of Authorized Signatory: Authorized Signatory

Name of Purchaser: ALM Brand Bank

*Signature of Authorized Signatory of Purchaser:* /s/ Lars Hackenberg

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Name of Authorized Signatory: Lars Hackenberg

Title of Authorized Signatory: Senior Portfolio Manager

Name of Purchaser: IMPAX Environmental Market (Ireland) Fund  
*Signature of Authorized Signatory of Purchaser:* /s/ Adrian Cornwell

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Name of Authorized Signatory: Adrian Cornwell  
Title of Authorized Signatory: Marketing Manager



Name of Purchaser: IMPAX Environmental Market PLC

*Signature of Authorized Signatory of Purchaser:* /s/ Bruce Jenkyn-Jones

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Name of Authorized Signatory: Bruce Jenkyn-Jones

Title of Authorized Signatory: Investment Manager

Name of Purchaser: PNE Invest Ltd.

*Signature of Authorized Signatory of Purchaser: /s/*

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Name of Authorized Signatory:

Title of Authorized Signatory:

Email Address of Purchaser:

WRITER'S DIRECT DIAL NUMBER IS (512) 744-9555

January 26, 2005

**VIA HAND DELIVERY**

David S. Gino  
Active Power, Inc.  
2128 W. Braker Lane  
Austin, TX 78758

**Re: Letter Agreement**

Dear David:

As a result of your voluntary resignation, which has been accepted by the Company, your employment as Vice President, Chief Operating Officer and Chief Financial Officer of Active Power, Inc. (the "Company") will end upon the completion of certain financial year-end closing and SEC reporting duties estimated to be February 28, 2005 ("Employment End Date").

Please note, from today through the Employment End Date (the "Transition Period") you will remain an employee of the Company and receive salary and benefits. You will also continue to vest in your options. In exchange for your assistance during the Transition Period, the Company has agreed to set the period in which you can exercise the vested options noted below until January 30, 2006. As noted above, you will cease vesting in any of your options on the Employment End Date.

I. Options grants that can be exercised through January 30, 2006:

<u>Grant Date</u>	<u>Option Exercise Price</u>	<u>Number of Option Shares Granted</u>	<u>Number of Vested Option Shares Remaining as of Employment End Date</u>	<u>Number of Unvested Option Shares Remaining</u>	<u>ISO/NQO</u>
Jan. 25, 2001	\$ 20.00	40,500	40,500	0	20 - ISO 40,480 - NQO
Feb. 21, 2002	\$ 3.58	125,000	93,750 (as of 2/21/05)	31,250	11,237 - ISO 113,763 - NQO
Feb. 12, 2003	\$ 1.22	85,000	42,500 (as of 2/12/05)	42,500	81,967 - ISO 3,033 - NQO
Feb. 13, 2004	\$ 3.24	85,000	21,250 (as of 2/12/05)	63,750	30,864 - ISO 54,136 - NQO

II. Miscellaneous

This Letter Agreement shall, in all respects, be interpreted, enforced and governed under the laws of the State of Texas applicable to contracts executed and performed in Texas without giving effect to conflicts of law principles. You agree that any disputes or litigation that may arise with respect to this Letter Agreement shall be brought and prosecuted in Travis County, Texas, and you agree to waive any objections to the location of such disputes or litigation, including, but not limited to objections based on forum non conveniens.

You agree that if any provision or portion of any provision of this Letter Agreement is held to be invalid or unenforceable or to be contrary to public policy or any law, for any reason, the remainder of the Letter Agreement shall not be affected thereby.

You and the Company each agree to take whatever additional actions and execute whatever additional documents that may be necessary or advisable in order to carry out or effect one or more of the obligations provided for in this Letter Agreement.

This Letter Agreement may be executed in separate counterparts and by facsimile and each such counterpart shall be deemed an original with the same effect as if the Company and you signed the same document.

We wish you the best of luck in your future endeavors and appreciate the service you have provided to the Company.

Very truly yours,

**ACTIVE POWER, INC.**

By: /s/ Joseph F. Pinkerton, III

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Name: Joseph F. Pinkerton, III  
Title: Chairman of the Board, Chief Executive  
Officer and President

By executing this Letter Agreement, I hereby agree to the provisions hereof.

**ACCEPTED AND ACKNOWLEDGED:**

/s/ David S. Gino

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David S. Gino

## CERTIFICATIONS

I, Joseph F. Pinkerton, III, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, 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(s) 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) 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
  - (d) 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(s) 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: April 27, 2005

/s/ Joseph F. Pinkerton, III

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Joseph F. Pinkerton, III  
Chairman of the Board, President and Chief Executive Officer  
(Principal Executive Officer)

## CERTIFICATIONS

I, John K. Penver, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Active Power, 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(s) 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)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) 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) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) 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
  - (d) 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(s) 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: April 27, 2005

/s/ John K. Penver

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John K. Penver  
Vice President of Finance and Chief Financial Officer  
(Principal Financial and Accounting Officer)

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

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending March 31, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Joseph F. Pinkerton, III, Chief Executive Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13a or 15d, as applicable, of the Securities Exchange Act of 1934, as amended; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Joseph F. Pinkerton, III

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Joseph F. Pinkerton, III  
Chairman of the Board, President  
and Chief Executive Officer  
April 27, 2005



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

In connection with the Quarterly Report on Form 10-Q of Active Power, Inc. (the "Company") for the period ending March 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, John K. Penver, Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to my knowledge:

- (1) The Report fully complies with the requirements of Section 13a or 15d, as applicable, of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ John K. Penver

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John K. Penver  
Vice President of Finance and Chief Financial Officer  
April 27, 2005