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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 September 30, 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: 001-15957

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**CAPSTONE TURBINE CORPORATION**

(Exact name of Registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

95-4180883  
(I.R.S. Employer  
Identification No.)

21211 Nordhoff Street, Chatsworth, California 91311  
(Address of principal executive offices and zip code)

818-734-5300  
(Registrant's telephone number, including area code)

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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 Securities Exchange Act of 1934). Yes  No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Securities Exchange Act of 1934). Yes  No

The number of outstanding shares of the registrant's common stock as of September 30, 2005 was 85,392,413.

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CAPSTONE TURBINE CORPORATION

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**PART I — FINANCIAL INFORMATION****Item 1. Consolidated Financial Statements****CAPSTONE TURBINE CORPORATION  
CONSOLIDATED BALANCE SHEETS  
(Unaudited)**

	<u>September 30, 2005</u>	<u>March 31, 2005</u>
<b>Assets</b>		
Current Assets:		
Cash and cash equivalents	\$ 44,051,000	\$ 63,593,000
Accounts receivable, net of allowance for doubtful accounts and sales returns of \$702,000 at September 30, 2005 and \$536,000 at March 31, 2005	1,529,000	3,150,000
Inventory	15,933,000	11,273,000
Prepaid expenses and other current assets	1,617,000	912,000
Assets held for sale	<u>80,000</u>	<u>80,000</u>
Total current assets	<u>63,210,000</u>	<u>79,008,000</u>
Equipment and Leasehold Improvements:		
Machinery, equipment, and furniture	19,228,000	18,760,000
Leasehold improvements	8,609,000	8,563,000
Molds and tooling	<u>3,152,000</u>	<u>3,096,000</u>
	30,989,000	30,419,000
Less accumulated depreciation and amortization	<u>21,935,000</u>	<u>19,890,000</u>
Total equipment and leasehold improvements, net	<u>9,054,000</u>	<u>10,529,000</u>
Non-Current Portion of Inventory	2,643,000	3,990,000
Intangible Asset, net	1,293,000	1,427,000
Other Assets	<u>228,000</u>	<u>236,000</u>
Total	<u>\$ 76,428,000</u>	<u>\$ 95,190,000</u>
<b>Liabilities and Stockholders' Equity</b>		
Current Liabilities:		
Accounts payable	\$ 4,274,000	\$ 3,324,000
Accrued salaries and wages	1,487,000	1,442,000
Other accrued liabilities	3,396,000	2,472,000
Accrued warranty reserve	7,985,000	8,667,000
Deferred revenue	1,404,000	1,522,000
Current portion of notes payable and capital lease obligations	<u>19,000</u>	<u>19,000</u>
Total current liabilities	<u>18,565,000</u>	<u>17,446,000</u>
Long-Term Portion of Notes Payable and Capital Lease Obligations	56,000	64,000
Other Long-Term Liabilities	740,000	1,002,000
Commitments and Contingencies	—	—
Stockholders' Equity:		
Preferred stock, \$.001 par value; 10,000,000 shares authorized; none issued	—	—
Common stock, \$.001 par value; 415,000,000 shares authorized; 85,943,621 shares issued and 85,392,413 shares outstanding at September 30, 2005; 85,379,446 shares issued and 84,828,238 shares outstanding at March 31, 2005	86,000	85,000
Additional paid-in capital	532,309,000	530,391,000
Accumulated deficit	(474,533,000)	(453,469,000)
Less: Deferred stock compensation	(282,000)	(356,000)
Less: Treasury stock, at cost; 551,208 shares	<u>(513,000)</u>	<u>(513,000)</u>
Total stockholders' equity	<u>57,067,000</u>	<u>76,678,000</u>
Total	<u>\$ 76,428,000</u>	<u>\$ 95,190,000</u>

See accompanying notes to consolidated financial statements.

**CAPSTONE TURBINE CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(Unaudited)**

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Revenues	\$ 5,705,000	\$ 3,925,000	\$ 9,512,000	\$ 6,880,000
Cost of Goods Sold	6,768,000	6,039,000	13,992,000	11,470,000
Gross Loss	(1,063,000)	(2,114,000)	(4,480,000)	(4,590,000)
Operating Expenses:				
Research and development	2,728,000	2,919,000	4,833,000	6,333,000
Selling, general and administrative	6,788,000	4,779,000	12,525,000	9,646,000
Total operating expenses	9,516,000	7,698,000	17,358,000	15,979,000
Loss from Operations	(10,579,000)	(9,812,000)	(21,838,000)	(20,569,000)
Interest Income	377,000	315,000	773,000	559,000
Interest Expense	(19,000)	(15,000)	(21,000)	(35,000)
Other Income	22,000	365,000	24,000	366,000
Loss Before Income Taxes	(10,199,000)	(9,147,000)	(21,062,000)	(19,679,000)
Provision for Income Taxes	—	—	2,000	2,000
Net Loss	<u>\$(10,199,000)</u>	<u>\$(9,147,000)</u>	<u>\$(21,064,000)</u>	<u>\$(19,681,000)</u>
Weighted Average Common Shares Outstanding	<u>84,954,753</u>	<u>84,358,761</u>	<u>84,673,382</u>	<u>84,299,279</u>
Net Loss Per Share of Common Stock – Basic and Diluted	<u>\$ (0.12)</u>	<u>\$ (0.11)</u>	<u>\$ (0.25)</u>	<u>\$ (0.23)</u>

See accompanying notes to consolidated financial statements.

**CAPSTONE TURBINE CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

	Six Months Ended September 30,	
	2005	2004
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$(21,064,000)	\$(19,681,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,184,000	2,589,000
Provision for doubtful accounts and sales returns	166,000	81,000
Inventory write-down/(recovery)	716,000	(181,000)
Provision for warranty expenses	645,000	675,000
Loss on disposal of equipment	—	30,000
Non-employee stock compensation	425,000	53,000
Employee and director stock compensation	152,000	77,000
Changes in operating assets and liabilities:		
Accounts receivable	1,455,000	2,766,000
Inventory	(4,029,000)	(186,000)
Prepaid expenses and other assets	(697,000)	(16,000)
Accounts payable	941,000	729,000
Accrued salaries and wages, and other accrued and long-term liabilities	688,000	(633,000)
Accrued warranty reserve	(1,327,000)	(1,595,000)
Deferred revenue	(118,000)	144,000
Net cash used in operating activities	<u>(19,863,000)</u>	<u>(15,148,000)</u>
<b>Cash Flows from Investing Activities:</b>		
Acquisition of and deposits on fixed assets	(548,000)	(439,000)
Proceeds from disposal of fixed assets	1,000	1,000
Net cash used in investing activities	<u>(547,000)</u>	<u>(438,000)</u>
<b>Cash Flows from Financing Activities:</b>		
Repayment of notes payable and capital lease obligations	(8,000)	(589,000)
Exercise of stock options and employee stock purchases	876,000	228,000
Net cash provided by/(used in) financing activities	<u>868,000</u>	<u>(361,000)</u>
Net Decrease in Cash and Cash Equivalents	(19,542,000)	(15,947,000)
Cash and Cash Equivalents, Beginning of Period	63,593,000	102,380,000
Cash and Cash Equivalents, End of Period	<u>\$ 44,051,000</u>	<u>\$ 86,433,000</u>
<b>Supplemental Disclosures of Cash Flow Information:</b>		
Cash paid during the period for:		
Interest	\$ 21,000	\$ 35,000
Income taxes	\$ 2,000	\$ 2,000

**Supplemental Disclosures of Non-Cash Information:**

During the six months ended September 30, 2005 and 2004, the Company purchased on account \$28,000 and \$33,000 of fixed assets, respectively.

See accompanying notes to consolidated financial statements.

**CAPSTONE TURBINE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

### 1. Business and Organization

Capstone Turbine Corporation (the “Company”) develops, manufactures, markets and services microturbine technology solutions for use in stationary distributed power generation applications, including secure power, cogeneration (combined heat and power (“CHP”) and combined cooling, heat and power (“CCHP”)), and resource recovery (including “renewable” fuels). In addition, the Company’s microturbines can be used as generators for hybrid electric vehicle applications. The Company was organized in 1988 and has been commercially producing its microturbine generators since 1998.

The Company has incurred significant operating losses since its inception. Management anticipates incurring additional losses until the Company can produce sufficient revenues to cover costs and expenses. To date, the Company has funded its activities primarily through private and public equity offerings.

### 2. Basis of Presentation

The accompanying unaudited financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (“generally accepted accounting principles”) for interim financial information and with the instructions to Form 10-Q and Regulation S-X promulgated under the Securities Exchange Act of 1934. They do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. The balance sheet at March 31, 2005 was derived from audited financial statements included in the Company’s annual report on Form 10-K for the year ended March 31, 2005. In the opinion of management, the interim financial statements include all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial condition, results of operations and cash flows for such periods. Results of operations for any interim period are not necessarily indicative of results for any other interim period or for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto included in the Company’s annual report on Form 10-K for the year ended March 31, 2005. This quarterly report on Form 10-Q (this “Form 10-Q”) refers to the years ended March 31, 2004, March 31, 2005 and March 31, 2006 as “Fiscal 2004”, “Fiscal 2005” and “Fiscal 2006”, respectively.

Certain reclassifications have been made to some prior year balances to conform to the current year’s presentation.

### 3. Customer Concentrations and Accounts Receivable

Individually, four customers each accounted for 16%, 14%, 13% and 10% of revenues, respectively, for the second quarter of Fiscal 2006, totaling approximately 53% of revenues. For the same quarter a year ago, only one customer accounted for approximately 18% of revenues. United Technologies Corporation (“UTC”) accounted for 6% and 18% of revenues for the second quarter of Fiscal 2006 and Fiscal 2005, respectively. Individually, two customers each accounted for 21% and 10% of revenues, respectively, for the six months ended September 30, 2005, totaling approximately 31% of revenues. For the same period a year ago, one customer accounted for approximately 12% of revenues. UTC accounted for 21% and 12% of revenues for the six months ended September 30, 2005 and 2004, respectively. While the Company has individual customers who, in any period, may represent a significant portion of the Company’s business, overall, the Company is not dependent on any single customer or particular group of customers.

As of September 30, 2005 the Company had no individual customers or groups of customers who represented a significant portion of accounts receivable.

### 4. Inventory

Inventory is stated at the lower of standard cost (which approximates actual cost on the first-in, first-out method) or market and consists of the following:

	<u>September 30,</u> <u>2005</u>	<u>March 31,</u> <u>2005</u>
Raw materials	\$15,089,000	\$11,333,000
Work in process	1,404,000	2,580,000
Finished goods	<u>2,083,000</u>	<u>1,350,000</u>
Total	18,576,000	15,263,000

**CAPSTONE TURBINE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)**  
**(Unaudited)**

	September 30, 2005	March 31, 2005
Less non-current portion	2,643,000	3,990,000
Current portion	\$15,933,000	\$11,273,000

The non-current portion of inventory represents that portion of the inventory in excess of amounts expected to be sold or used in the next twelve months.

**5. Intangible Asset**

The Company's sole intangible asset is a manufacturing license as follows:

Gross carrying amount	\$ 3,663,000
Accumulated amortization and impairment loss	(2,236,000)
Balance, March 31, 2005	1,427,000
Amortization for the six months ended September 30, 2005	(134,000)
Net	\$ 1,293,000

This intangible asset, which was acquired in 2000, is being amortized over its estimated useful life of ten years. Related amortization expense for the three-month and six-month periods ended September 30, 2005 was \$67,000 and \$134,000, respectively. The related amortization expense for the same periods last year was \$67,000 and \$134,000, respectively. The manufacturing license is scheduled to be fully amortized by fiscal year 2011 with corresponding amortization estimated to be \$133,000 for the remainder of Fiscal 2006, \$267,000 for each of the fiscal years 2007, 2008, 2009 and 2010, and \$92,000 for fiscal year 2011. The agreement requires the Company to pay a per-unit royalty fee over a seventeen-year period for cores manufactured and sold by the Company using the technology. As of September 30, 2005, royalties of \$45,000 were earned under the terms of the agreement, of which \$15,000 was unpaid.

**6. Stock-Based Compensation**

The Company accounts for employee stock option plans under the intrinsic value method prescribed by Accounting Principles Board Opinion ("APB") No. 25, "Accounting for Stock Issued to Employees" and related interpretations. The Company accounts for equity instruments issued to non-employees using the fair value at the date of grant as prescribed by Statement of Financial Accounting Standards (SFAS) No. 123, "Accounting for Stock-Based Compensation" and Emerging Issues Task Force ("EITF") No. 96-18, "Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Service". The following table illustrates the effect on net loss and net loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to employee stock option grants, employee stock purchases, and stock awards:

	Three Months Ended September 30,		Six Months Ended September 30,	
In Thousands (except per share amounts)	2005	2004	2005	2004
Net loss, as reported	\$(10,199)	\$ (9,147)	\$(21,064)	\$(19,681)
Add: Stock-based employee and director compensation included in reported net loss	76	37	152	77
Deduct: Total stock-based employee and director compensation expense determined under fair value based method	(679)	(960)	(1,584)	(1,949)
Pro forma net loss	\$(10,802)	\$(10,070)	\$(22,496)	\$(21,553)
Net loss per share – Basic and Diluted:				
As reported	\$ (0.12)	\$ (0.11)	\$ (0.25)	\$ (0.23)
Pro forma	\$ (0.13)	\$ (0.12)	\$ (0.27)	\$ (0.26)

During the fiscal years ended December 31, 1999 and December 31, 2000, the Company granted options at less than the fair value of its common stock, which were fully amortized as of June 30, 2004. In addition, in Fiscal 2004, the Company issued shares of restricted common stock at less than the fair value of its common stock. Accordingly, the Company recorded employee and director stock-based compensation expense based on the vesting of these issuances as follows:



**CAPSTONE TURBINE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(Unaudited)**

	Three Months Ended September 30,		Six Months Ended September 30,	
	2005	2004	2005	2004
Cost of goods sold	\$ —	\$ —	\$ —	\$ —
Research and development	—	—	—	3,000
Selling, general and administrative	76,000	37,000	152,000	75,000
Total	<u>\$76,000</u>	<u>\$37,000</u>	<u>\$152,000</u>	<u>\$78,000</u>

In July 2005, the Company entered into a General Release and Separation Agreement and a Consulting Agreement with its then Chief Financial Officer. The agreement provides for, among other items, a continuation of the vesting period of her then unvested common stock options through April, 2006, and consulting fees for three months. The Company recognized stock-based compensation of \$236,000 in the three months ended September 2005 based upon the fair value of the unvested options in accordance with SFAS No. 123 and EITF 96-18.

As of September 30, 2005, the Company had \$282,000 in deferred stock compensation related to restricted stock, which will be amortized through the fiscal year ending March 31, 2008 (“Fiscal 2008”).

**7. Accrued Warranty Reserve**

The Company provides for the estimated costs of warranties at the time revenue is recognized. The specific terms and conditions of those warranties vary depending upon the product sold, geography of sale and the length of extended warranties sold. The Company’s product warranties generally start from the delivery date and continue for up to three years. Factors that affect the Company’s warranty obligation include product failure rates and costs of repair or replacement in correcting product failures. The Company also accrues the estimated costs to address reliability repairs on products no longer in warranty when, in the Company’s judgment, and in accordance with a specific plan developed by the Company, it is prudent to provide such repairs. The Company assesses the adequacy of recorded warranty liabilities and makes adjustments quarterly, if necessary.

Changes in accrued warranty reserve during the six months ended September 30, 2005 are as follows:

Balance, March 31, 2005	\$ 8,667,000
Warranty provision relating to products shipped during the period	927,000
Deduction for warranty payments	(1,327,000)
Changes for accruals related to preexisting warranties or reliability repairs programs	(282,000)
Balance, September 30, 2005	<u>\$ 7,985,000</u>

**8. Commitments and Contingencies**

As of September 30, 2005, the Company had firm commitments to purchase inventories of approximately \$7.6 million.

The Company leases offices and manufacturing facilities under various non-cancelable operating leases expiring at various times through the year ending March 31, 2011. All of the leases require the Company to pay maintenance, insurance and property taxes. The lease agreements provide for rent escalation over the lease term. Rent expense is recognized on a straight-line basis over the term of the lease. The difference between rent expense recorded and the amount paid is credited or charged to “deferred rent” which is included in Other Long-term Liabilities. Deferred rent amounted to \$651,000 and \$655,000 as of September 30, 2005 and March 31, 2005, respectively. Also included in Other Long-term liabilities was an accrual of \$81,000 and \$276,000 as of September 30, 2005 and March 31, 2005, respectively, for the expected loss on sub-lease of an office space previously occupied by the Company’s wholly owned subsidiary. The change in the accrual was a result of the lease payments and expected sublease income from the new sublease agreement. The sublessee vacated the premises during the third quarter of Fiscal 2005. During the second quarter ending September 30, 2005, we entered into a new sublease agreement. The sublessee payments will be offset against the deferred rent balance.

In December 2001, a purported shareholder class action lawsuit was filed against the Company, two of its then officers, and the underwriters of the Company’s initial public offering. The suit purports to be a class action filed on behalf of purchasers of the Company’s common stock during the period from June 28, 2000 to December 6, 2000. An amended complaint was filed on April 19,

**CAPSTONE TURBINE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(Unaudited)**

2002. Plaintiffs allege that the underwriter defendants agreed to allocate stock in the Company's June 28, 2000 initial public offering and November 16, 2000 secondary offering to certain investors in exchange for excessive and undisclosed commissions and agreements by those investors to make additional purchases of stock in the aftermarket at pre-determined prices. Plaintiffs allege that the prospectuses for these two public offerings were false and misleading in violation of the securities laws because they did not disclose these arrangements. A committee of the Company's Board of Directors conditionally approved a proposed partial settlement with the plaintiffs in this matter. The settlement would include, among other things, a release of the Company and of the individual defendants for the conduct alleged in the action to be wrongful in the amended complaint. The Company would agree to undertake other responsibilities under the partial settlement, including agreeing to assign away, not assert, or release certain potential claims the Company may have against its underwriters. Any direct financial impact of the proposed settlement is expected to be borne by the Company's insurers. The proposed settlement is pending final approval by parties to the action and the United States District Court for the Southern District of New York.

A demand for arbitration was filed by a party in March 2004 that conducts business with the Company, claiming damages for breach of contract in excess of \$10 million. The arbitration is currently scheduled for January 2006. The Company intends to vigorously defend against this action. As with any such action, the ultimate outcome is uncertain.

**9. Related Party Transactions**

Mr. Eliot Protsch is the Chairman of the Company's Board of Directors. Mr. Protsch is Senior Executive Vice-President and Chief Financial Officer of Alliant Energy Corporation. Alliant Energy Resources, Inc., a subsidiary of Alliant Energy Corporation, was a distributor for the Company. There were no sales to Alliant Energy Resources, Inc. during the three and six months ended September 30, 2005 and 2004.

In October 2002, the Company entered into a strategic alliance with UTC, a stockholder, through its UTC Power Division. In March 2005, Capstone and UTC replaced the strategic alliance agreement with an original equipment manufacturer ("OEM") agreement. The OEM agreement involves the integration, marketing, sales and service of CCHP solutions worldwide. Sales to UTC's affiliated companies were approximately \$327,000 and \$717,000 for the three months ended September 30, 2005 and 2004, respectively. Sales for the six months ended September 30, 2005 and 2004 were \$2,030,000 and \$854,000, respectively. Related accounts receivable were \$113,000 and \$1,496,000 at September 30, 2005 and March 31, 2005, respectively. In December 2003, the Company engaged United Technologies Research Center ("UTRC") to be a subcontractor of the Company in relation to one of the awards that the Company received from the Department of Energy. UTRC is the research and development branch of UTC. UTRC billed the Company \$8,000 under this subcontract for the three months ended September 30, 2005, and had an unpaid balance of \$14,000 at September 30, 2005. There were no billings under this contract for the three months ended September 30, 2004. For the six months ended September 30, 2005, there were approximately \$26,000 in billings compared to none for the same period a year ago.

On September 11, 2005, Capstone gave notice to UTC Power, LLC ("UTCP") pursuant to the OEM Agreement (the "Agreement") with UTCP, dated March 23, 2005, of certain breaches of the Agreement by UTCP and called upon UTCP to cure those breaches to avoid termination of the Agreement. UTCP filed suit in the United States District Court for the District of Connecticut on September 16, 2005, denying that it is in breach of the Agreement and seeking to enjoin Capstone from terminating or attempting to terminate the Agreement; monetary damages were not sought. The Agreement provides for arbitration of all disputes between the parties. Capstone has not withheld sales of products or parts to UTCP during the cure period. Capstone believes that the UTCP complaint is premature, failing to present a case or controversy for the courts. Meanwhile, Capstone has invited UTCP to cure its performance failures under the Agreement and to meet with Capstone to determine if the parties can resolve the matters in dispute.

**10. Net Loss Per Common Share**

Basic loss per share of common stock is computed using the weighted-average number of common shares outstanding for the period. For purposes of computing basic loss per share and diluted loss per share, shares of restricted common stock which are contingently returnable (i.e., subject to repurchase if the purchaser's status as an employee or consultant terminates) are not considered outstanding until they are vested. Diluted loss per share is also computed without consideration to potentially dilutive instruments because the Company incurred losses which would make them antidilutive. There were outstanding stock options at September 30, 2005 and 2004 to purchase 9,228,000 and 8,616,000 shares, respectively. As of September 30, 2005, 240,000 shares of restricted common stock are contingently returnable.

**CAPSTONE TURBINE CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS — (Continued)**  
**(Unaudited)**

Effective October 21, 2005, the Company completed a registered offering of the Company's common stock. Pursuant to the offering, the company issued a total of 17,000,000 shares of its common stock, resulting in gross proceeds of approximately \$41,400,000.

**12. Recent Accounting Pronouncements**

**New Accounting Pronouncements** — In May 2005, the Financial Accounting Standards Board ("FASB") issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS No. 154"). SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. In addition, it carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principles in most circumstances. The Company plans to prospectively adopt SFAS No. 154 at the beginning of the fiscal year ending March 31, 2007 ("Fiscal 2007").

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, "Accounting for Stock Issued to Employees". The Company will be required to adopt SFAS No. 123R at the beginning of Fiscal 2007. The Company believes that the adoption of SFAS No. 123R could have a material impact on the amount of earnings the Company reports in Fiscal 2007. The Company has not yet determined the specific impact that adoption of this standard will have on its financial position or results of operations.

## 11. Subsequent Event

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

The following discussion should be read in conjunction with the Consolidated Financial Statements and Notes included in this Quarterly Report and within the Company's Annual Report on Form 10-K for the year ended March 31, 2005. When used in this Quarterly Report, and in the following discussion, the words "believes", "anticipates", "intends", "expects" and similar expressions are intended to identify forward-looking statements. Such statements are subject to certain risks and uncertainties which could cause actual results to differ materially from those projected. These risks include those identified under "Business Risks" in Item 2 of Part I of this Quarterly Report. Readers are cautioned not to place undue reliance on forward-looking statements, which speak only as of the date hereof. All dollar amounts are approximate.

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

The preparation of the Company's financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Management believes the most complex and sensitive judgments, because of their significance to the consolidated financial statements, result primarily from the need to make estimates about the effects of matters that are inherently uncertain. Actual results could differ from management's estimates. We believe the critical accounting policies listed below affect our more significant accounting judgments and estimates used in the preparation of the consolidated financial statements. These policies are described in greater detail in our Annual Report on Form 10-K for Fiscal 2005 and continue to include the following areas:

- Impairment of long-lived assets, including intangible assets;
- Inventory write-downs and classification of inventory;
- Estimates of warranty obligations;
- Sales returns and allowances;
- Allowance for doubtful accounts;
- Deferred tax assets; and
- Loss contingencies.

**New Accounting Pronouncements** — In May 2005, the Financial Accounting Standards Board ("FASB") issued SFAS No. 154, "Accounting Changes and Error Corrections" ("SFAS No. 154"). SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. In addition, it carries forward without change the guidance contained in Opinion 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principles in most circumstances. The Company plans to prospectively adopt SFAS No. 154 at the beginning of Fiscal 2007.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123R"). SFAS No. 123R requires companies to recognize in the income statement the grant-date fair value of stock options and other equity-based compensation issued to employees. SFAS No. 123R eliminates the ability to account for share-based compensation transactions using APB Opinion No. 25, "Accounting for Stock Issued to Employees". The Company will be required to adopt SFAS No. 123R at the beginning of Fiscal 2007. The Company believes that the adoption of SFAS No. 123R could have a material impact on the amount of earnings the Company reports in Fiscal 2007. The Company has not yet determined the specific impact that adoption of this standard will have on its financial position or results of operations.

#### **Overview**

We develop, manufacture market and service microturbine technology solutions for use in stationary distributed power generation applications including secure power, cogeneration (combined heat and power ("CHP")) and combined cooling, heat and power ("CCHP"), and resource recovery ("renewable" fuels). In addition, our microturbines can be used as generators for hybrid electric vehicle applications. Microturbines allow customers to produce power on-site. There are several technologies which are used to provide "on-site power generation", also called "distributed generation" such as reciprocating engines, solar power, wind powered systems and fuel cells. For customers who do not have access to the electric utility grid, microturbines can provide clean, on-site power with lower scheduled maintenance intervals and greater fuel flexibility than competing technologies. For customers with access to the electric grid, microturbines can provide an additional source of continuous duty power, thereby providing additional reliability and in some instances, cost savings. With our stand-alone feature, customers can produce their own energy in the event of a power outage and can use the microturbines as their primary source of power for extended periods. Because our microturbines also produce

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clean, usable heat energy, they can provide economic advantages to customers who can benefit from the use of hot water, air conditioning and direct hot air. Our microturbines are sold primarily through our distributors. Our Authorized Service Companies (“ASCs”) provide installation and service. Successful implementation of the microturbine relies on the quality of the microturbine, the ability to sell into appropriate applications, and the quality of the installation and support of the ASCs.

We believe we were the first company to offer a commercially available power source using microturbine technology. Our Model C30 and Model C60 products are designed to produce electricity for commercial and small industrial users. A 30-kilowatt product can produce enough electricity to power a small convenience store. A 60-kilowatt product can produce enough heat to provide hot water to a 100-room hotel while also providing about one-third of its electrical requirements. Our microturbines combine patented air-bearing technology, advanced combustion technology and sophisticated power electronics to form efficient electricity and heat production systems. Because of our air-bearing technology, our microturbines do not require lubrication. This means they do not require routine maintenance to change oil or other lubrications, as do the most common competing products. The 30-kilowatt product can be fueled by various sources including natural gas, propane, sour gas, renewable fuels such as landfill or digester gas, kerosene and diesel. The 60-kilowatt product is available with an integrated heat exchanger, making it efficient to install in applications where hot water is used. Our products produce exceptionally clean power. In terms of nitrogen oxides (“NOx”) emissions, our microturbines have been shown to consistently produce less NOx than conventional reciprocating engines, including those designed for natural gas.

The market for our products is highly competitive and is changing rapidly. Our microturbines compete with existing technologies, such as the utility grid and reciprocating engines, and may also compete with emerging distributed generation technologies, including solar power, wind powered systems, fuel cells and other microturbines. Additionally, many of our distributed generation competitors are well-established firms that derive advantages from production economies of scale and have a worldwide presence and greater resources, which they can devote to product development or promotion.

We began commercial sales of our Model C30 products in 1998. In September 2000, we shipped the first commercial unit of our Model C60 microturbine. To date, we have sold more than 3,200 commercial units. At the end of Fiscal 2005, we revisited our strategic plan. With the first year of the strategic plan behind us, we reassessed our plans for Fiscal 2006, Fiscal 2007 and Fiscal 2008. While some aspects of the initial strategic plan were modified, the overall direction, targets and key initiatives remained in tact. An overview of our strategic plan progress and its current status follows:

1. *Focus on vertical markets* – Within the distributed generation markets that we serve, we focus on vertical markets that we identify as having the greatest near-term potential. In our primary products and applications (secure power, cogeneration (CHP, CCHP), and resource recovery), we identify specific targeted vertical market segments. Within each of these markets, we identify the critical factors to penetrating these markets and have built our plans around those factors.

During the second quarter of Fiscal 2006, we booked orders for 5.5 megawatts and shipped 5.1 megawatts of products, with 15.8 megawatts in backlog at the end of the second quarter. About 87% of our actual product shipments in the second quarter of Fiscal 2006 were to target markets: 54% for use in CHP applications, 25% for use in CCHP applications, and 8% for use in resource recovery applications.

2. *Sales and Distribution Channel* – Previously, we identified the need to refine our channels of distribution. While some distributors and representatives had business capabilities to support our growth plans in our targeted markets, others did not. Additionally, we identified the need to add new distributors and representatives who were experienced in our target markets. We made significant progress in tailoring our distribution channels to our needs in Fiscal 2005. In the Americas, we currently have eight distributors and four dealers. Internationally, we added distribution centers in a number of countries where we were previously under-represented. During 2006, we continue to refine the distribution channels to address our specific targeted markets.
3. *Geographic Focus* – The Americas have been, and will continue to be, our largest market. Within the United States, our focus will be on California and the Northeast. In Fiscal 2005, we opened a sales and service office in New York. We intend to use this presence to expand our penetration in the Northeastern market. During Fiscal 2006, we are investigating Boston as the next location for a direct Capstone presence in the Northeast. Based on our belief that Europe will offer significant opportunities, we opened a European headquarters office in Milan, Italy in Fiscal 2005. Since establishing that office, we have seen an improvement since last quarter of approximately 129% in our sales in Europe. During Fiscal 2006, we expect to continue to develop our distribution base and market presence in Europe. In Japan, we are focused on developing niche opportunities that we believe offer the potential for relatively significant sales

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volumes over the next three years. Additionally, we have established an office in Mexico to service our fourth largest market and we are in the process of establishing an office in China.

4. *Service* – During Fiscal 2005, we entered the direct service business. Previously, our service strategy was to serve all customers through our distributors and ASCs. Distributors were expected to sell the products, provide engineering solutions, and perform as ASCs by providing installation, commissioning and service. Several of our distributors did not provide the level of service desired and a number of end users requested to work directly with us. As a result, we are pursuing a strategy to serve customers directly, as well as through qualified distributors and ASCs, all of whom will perform their service work using technicians specifically trained by Capstone. In Fiscal 2005, we put the resources in place to initiate our direct service offering in North America. While service revenue is less than \$0.1 million for the second quarter of Fiscal 2006, we expect to leverage the investments we have made. In addition to one-time service contracts, we put nine multi-year service contracts in place during the first and second quarters of Fiscal 2006, continuing to demonstrate execution of our strategy. We also intend to establish a spare parts distribution center in strategic locations to ensure timely delivery of parts.

5. *Product Robustness and Life Cycle Maintenance Costs* – Customers expect high performance and competitive total cost of ownership. To address those needs, we must continually ensure a high level of performance. Performance is affected not only by the microturbine, but also by the proper application design and installation, and the quality of ongoing service. We established a team to enhance the robustness of both our Model C30 and Model C60 products. The objective of this team was to meet, and then exceed, an average of 8,000 hours mean-time-between-failures for our microturbines. Based on our expected performance of units being manufactured and shipped, the team met this goal early in Fiscal 2005. These product robustness enhancements are expected to lower our per unit warranty costs and other support costs.

To further provide us with the ability to evaluate microturbine performance in the field, we developed a “real-time” remote monitoring and diagnostic feature. This feature allows us to monitor installed units instantaneously and collect operating data on a continual basis. We intend to use this information to anticipate and quickly respond to field performance issues, evaluate component robustness and identify areas for continuous improvement. We expect this feature to be very important to allowing us to better serve our customers.

6. *New product development* – Our new product development is targeted specifically to meet the needs of our selected vertical markets. We expect that our existing product platforms, the Model C30 and Model C60, will be our foundational product lines throughout the strategic planning period. Our product development efforts are centered on enhancing the features of these base products. Our C200 product beta testing was successfully implemented during Fiscal 2005. Testing continues and we are in the process of implementing a market survey to establish launch customers for this new product.

7. *Cost and Core Competencies* – Improving overall product cost is an important element of the strategic plan. The planning process identified opportunities for improvement through focusing on core competencies. We believe that we can achieve overall cost improvements by outsourcing areas not consistent with our core competencies. We have identified design, assembly, test and installation support as areas where we have opportunities to save costs through outsourcing. In conjunction with these changes, we have launched a strategic supply chain initiative to begin developing suppliers in China and other parts of Asia. Although we are only in the early stages of the initiative, we are encouraged by the improved cost opportunities this effort may produce. While we are striving to reduce costs, commodity price increases in mid-to-late Fiscal 2005 increased our costs of goods sold. In response to this development, near year-end, we increased selling prices an average of 7%.

We believe that execution in each of these key areas of our strategic plan will be necessary to continue Capstone’s transition from an R&D focused company with a promising technology and early market leadership to achieving positive cash flow by the end of Fiscal 2007 with growing market presence and improving financial performance. We expect Fiscal 2006 to be an important year in our transformation.

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### Results of Operations

#### *Three Months Ended September 30, 2005 and 2004*

*Revenues.* Revenues for the second quarter of Fiscal 2006 increased \$1.8 million to \$5.7 million from \$3.9 million for the same period last year. Revenue from product shipments increased \$1.4 million to \$4.5 million during the current period from \$3.0 million in the prior year. Shipments during the current period were 5.1 megawatts compared with 4.1 megawatts in the prior period reflecting higher demand in the current period. Revenues from accessories, parts and service for the second quarter of Fiscal 2006 increased \$0.3 million to \$1.3 million from \$1.0 million for the same period last year.

Individually, four customers each accounted for 16%, 14%, 13% and 10% of revenues, respectively, for the second quarter of Fiscal 2006, totaling approximately 53% of revenues. For the same quarter a year ago, only one customer accounted for approximately 18% of revenues. UTC accounted for 6% and 18% of revenues for the second quarter of Fiscal 2006 and Fiscal 2005, respectively.

*Gross Loss.* Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. We had a gross loss of \$1.1 million for the second quarter of Fiscal 2006 compared with \$2.1 million for the same period last year. The \$1.0 million improvement in gross loss in the current period, compared with the same period last year is the result of an increase in production activity resulting in a higher absorption of overhead costs into inventory of approximately \$1.0 million. Additionally, a decrease in inventory charges of approximately \$0.1 million was offset by an increase in warranty expense of approximately \$0.1 million. The \$0.1 million decrease in inventory charges was primarily the result of \$0.3 million in physical inventory and obsolescence reserve adjustments, offset by a benefit of \$0.2 million from the use of previously fully written-down recuperator cores, for which future use was uncertain. The Company has since been able to use some of these cores in production. Warranty expense for unit shipments decreased approximately \$0.5 million as a result of improvements that have been made through engineering design changes, and the net benefit recorded for changes in estimated costs for reliability repair programs decreased \$0.6 million. In the second quarter of Fiscal 2005, a net benefit was recorded related to reliability repair programs resulting from the cancellation of a program of approximately \$0.8 million. In the current quarter, a net benefit of \$0.2 million was recorded. Warranty expense is a combination of a per-unit warranty accrual recorded at the time the product is shipped and changes in estimates of several reliability repair programs. These programs were established primarily in Fiscal 2004 based on a decision to provide some repairs voluntarily for products sold in prior periods. Changes in program estimates are recorded in the period that new information, such as design changes and product enhancements, becomes available.

We expect to continue to incur gross losses until we are able to increase our contribution margins through higher sales volumes, lower warranty and direct materials costs and reduced manufacturing costs through efforts such as outsourcing non-core functions, including design, assembly, test and installation support.

*Research and Development (“R&D”) Expenses.* R&D expenses include compensation, engineering department expenses, overhead allocations for administration and facilities and materials costs associated with development. R&D expenses for the second quarter of Fiscal 2006 decreased \$0.2 million to \$2.7 million from \$2.9 million for the same period last year. R&D expenses are reported net of benefits from cost sharing programs such as the Department of Energy (“DOE”) funding. There were approximately \$0.3 million of such benefits this quarter, compared with \$23,000 for the same period a year ago. The decrease in R&D expense is primarily the result of the benefit from the cost-sharing programs. Cost-Sharing programs vary from period-to-period depending on the phases of the programs. We expect R&D spending in Fiscal 2006 to be somewhat lower than in Fiscal 2005. This change is expected to occur as a result of higher spending being more than offset by cost-sharing programs. We expect to enter into at least one new cost-sharing program in Fiscal 2006. If we do not enter into cost-sharing programs as expected, we will not incur some of the planned costs and would expect our spending in Fiscal 2006 to be roughly equivalent to that incurred in Fiscal 2005.

*Selling, General, and Administrative (“SG&A”) Expenses.* SG&A expenses for the second quarter of Fiscal 2006 increased \$2.0 million to \$6.8 million from \$4.8 million for the same period last year. Approximately \$0.7 million of the increase in SG&A expenses relates to labor related costs, including salaries, consulting, recruitment and relocation expenses to support our continuous process improvement throughout the organization. Additionally, \$0.5 million of the increase is related to severance expense. Approximately \$0.5 million of the increase in SG&A expense results from legal and accounting fees and \$0.3 million results from an increase in the bad debt reserve and property tax accruals. We expect SG&A costs in Fiscal 2006 to be slightly higher than the prior year.

*Interest Income.* Interest income for the second quarter of Fiscal 2006 increased \$0.1 million to \$0.4 million from \$0.3 million for the same period last year. The increase was primarily attributable to higher interest rates. We expect interest income to increase in Fiscal 2006 as a result of the equity offering completed during the third quarter of Fiscal 2006 that resulted in gross proceeds of approximately \$41,400,000.

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*Other Income.* Other income for the second quarter of Fiscal 2006 was \$22,000 compared to \$0.4 million for the same period a year ago. The decrease resulted from a legal settlement in the prior year.

### *Six Months Ended September 30, 2005 and 2004*

*Revenues.* Revenues for the six months ended September 30, 2005 increased \$2.6 million to \$9.5 million from \$6.9 million for the same period last year, reflecting increased demand across products, parts, accessories and service in the current year. Shipments during the six-month period were 8.5 megawatts compared with 6.8 megawatts during the same period last year. Revenues from accessories, parts and service for the six months ended September 30, 2005 increased \$0.6 million to \$2.3 million from \$1.7 million for the same period last year. We expect sales in Fiscal 2006 to exceed sales for Fiscal 2005.

Individually, two customers each accounted for 21% and 10% of revenues, respectively, for the six months ended September 30, 2005, totaling approximately 31% of revenues. For the same period a year ago, one customer accounted for approximately 12% of revenues. UTC accounted for 21% and 12% of revenues for the six months ended September 30, 2006 and 2005, respectively.

*Gross Loss.* Cost of goods sold includes direct material costs, production overhead, inventory charges and provision for estimated product warranty expenses. We had a gross loss of \$4.5 million for the six months ended September 30, 2005 compared with \$4.6 million for the same period last year. The \$0.1 million improvement in gross loss in the current period, compared with the same period last year is the result of an increase in production activity resulting in a higher absorption of overhead costs into inventory of approximately \$0.6 million offset by an increase in inventory charges of approximately \$0.5 million. Of the \$0.5 million increase in inventory charges, \$0.3 million is a result of physical inventory and obsolescence reserve adjustments and the remainder is the result of a decrease in the benefit recognized for the use of previously fully written-down recuperator cores. Warranty expense for unit shipments decreased approximately \$0.5 million as a result of improvements that have been made through engineering design changes, and the net benefit recorded for changes in estimated costs for reliability repair programs decreased \$0.5 million. In the second quarter of Fiscal 2005, a net benefit was recorded related to reliability repair programs as a result of the cancellation of a program of approximately \$0.8 million. In the second quarter of Fiscal 2006, a net benefit of \$0.3 million was recorded. Warranty expense is a combination of a per-unit warranty accrual recorded at the time the product is shipped and changes in estimates of several reliability repair programs. These programs were established primarily in Fiscal 2004 based on a decision to provide some repairs voluntarily for products sold in prior periods. Changes in program estimates are recorded in the period that new information, such as design changes and product enhancements, becomes available.

*R&D Expenses.* R&D expenses for the six months ended September 30, 2005 decreased \$1.5 million to \$4.8 million from \$6.3 million for the same period last year. R&D expenses are reported net of benefits from cost-sharing programs. These benefits were \$1.1 million for the six months ended September 30, 2005, compared with \$0.1 million for the same period a year ago. The benefits from cost-sharing programs vary from period-to-period depending on the phases of the programs. The decrease in spending is primarily the result of the benefit from cost-sharing programs and a reduction in spending for supplies in conjunction with the C200 development program of approximately \$0.8 million, offset by higher costs for consulting and labor of approximately \$0.8 million associated with our product robustness and enhancement efforts.

*SG&A Expenses.* SG&A expenses for the six months ended September 30, 2005 increased \$2.9 million to \$12.5 million from \$9.6 million for the same period last year. Approximately \$2.0 million of the increase in SG&A expenses relates to labor related costs, including salaries, consulting, recruitment and relocation expenses to support our continuous process improvement throughout the organization. Additionally, \$0.5 million of the increase is related to severance expense. Approximately \$0.8 million of the increase is the result of legal and accounting fees and \$0.1 million of the increase is the result of property tax accruals. We expect SG&A costs in Fiscal 2006 to be slightly higher than prior year.

*Interest Income.* Interest income for the six months ended September 30, 2005 increased \$0.2 million to \$0.8 million from \$0.6 million for the same period last year. The increase was primarily attributable to higher average interest rates during the current period. We expect interest income to increase as a result of the equity offering completed during third quarter of Fiscal 2006.

*Other Income.* Other income was \$24,000 for the first six months of Fiscal 2006 compared to \$0.4 million for the same period a year ago. The decrease resulted from a legal settlement in the prior year.

### **Liquidity and Capital Resources**

Our cash requirements depend on many factors, including the execution of our strategic plan. We expect to continue to devote substantial capital resources to running our business and creating the strategic changes summarized herein. We believe that our current cash balance and the additional cash received from the sale of common stock in third quarter of Fiscal 2006 of approximately \$41,400,000 are sufficient to fund operating losses and our currently projected commitments for the next twelve months.



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We have invested our cash in an institutional fund that invests in high quality short-term money market instruments to provide liquidity for operations and for capital preservation.

*Operating Activities* - During the six months ended September 30, 2005 we used \$19.9 million in cash in our operating activities, which consisted of a net loss for the period of approximately \$21.0 million, offset by non-cash adjustments (primarily depreciation and impairment charges) of \$4.3 million and cash used for working capital of approximately \$3.1 million. This compared to operating cash usage of \$15.1 million during the six months ended September 30, 2004, which consisted of a net loss for the period of approximately \$19.7 million, offset by non-cash adjustments (primarily depreciation and warranty charges) of \$3.3 million and cash generated from working capital of approximately \$1.3 million. The working capital change between periods is largely attributable to a \$3.8 million increase in spending on inventory to support the expected sales in future periods, compared with the same period a year ago, as well as a \$1.3 million decrease in accounts receivable resulting primarily from collections of approximately \$1.8 million from the DOE in the prior period, offset by \$0.3 million less cash used for warranties as a result of improved product performance and a \$0.3 million increase in customer deposits.

*Investing Activities* - Net cash used in investing activities for acquisition of fixed assets was \$0.5 million and \$0.4 million for the six month periods ended September 30, 2005 and 2004, respectively. Our cash usage for investing activities has been relatively low. Our significant capital expenditures were made in previous periods.

*Financing Activities* - During the six month period ended September 30, 2005, we generated \$0.9 million from financing activities as compared with the prior year, in which we used \$0.4 million. The exercise of stock options, restricted stock awards and employee stock purchases yielded \$0.9 million in cash in the six months ended September 30, 2005 as compared with \$0.2 million in the prior year period. Repayments of capital lease obligations used \$8,000 during the six months ended September 30, 2005 as compared with \$0.6 million for the same period a year ago because the leases were substantially paid down during last year.

We anticipate that, as a result of our efforts to generate sales and margins while controlling costs, we will lower our cash usage. Our goal for Fiscal 2006 is to use less cash for operating and investing activities than in Fiscal 2005.

Except for scheduled payments made on operating and capital leases during the first half of Fiscal 2006, there have been no material changes in the Company's remaining commitments under non-cancelable operating leases and capital leases as disclosed in the Company's Annual Report on Form 10-K for Fiscal 2005.

Effective October 21, 2005, the Company completed a registered offering of the Company's common stock. Pursuant to the offering, the company issued a total of 17,000,000 shares of its common stock, resulting in gross proceeds of approximately \$41.4 million.

## **Business Risks**

This document contains certain forward-looking statements (as such term is defined in Section 27A of the Securities Act of 1933, as amended (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act") pertaining to, among other things, our future results of operations, R&D activities, sales and cash flow expectations, our ability to develop markets for our products, sources for parts, federal, state and local regulations, and general business, industry and economic conditions applicable to us. These statements are based largely on our current expectations, estimates and forecasts and are subject to a number of risks and uncertainties. Actual results could differ materially from these forward-looking statements. Factors that can cause actual results to differ materially include, but are not limited to, those discussed below. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof. The following factors should be considered in addition to the other information contained herein in evaluating Capstone and its business. We assume no obligation to update any of the forward-looking statements after the filing of this Form 10-Q to conform such statements to actual results or to changes in our expectations except as required by law.

Investors should carefully consider the risks described below before making an investment decision. In addition, these risks are not the only ones facing our Company. Additional risks of which we may not be aware or that we currently believe are not material may also impair our business operations or our stock price. Our business could be harmed by any of these risks. The trading price of our common stock has and could continue to vary as a result of any of these risks, and investors may lose all or part of their investment. These factors are described in greater detail in our Annual Report on Form 10-K for the year ended March 31, 2005 and our prospectus supplement filed pursuant to Rule 424(b)(5) of the Securities Act dated October 7, 2005.

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- Our operating history is characterized by net losses, and we anticipate further losses and may never become profitable;
- A sustainable market for microturbines may never develop or may take longer to develop than we anticipate, which would adversely affect our revenues and profitability;
- We operate in a highly competitive market among competitors who have significantly greater resources than we have, and we may not be able to compete effectively;
- If we do not effectively implement our sales, marketing and service plans, our sales will not grow and our profitability will suffer;
- We may not be able to retain or develop distributors in our targeted markets, in which case our sales would not increase as expected;
- Our largest customer's performance has been inadequate, and that customer has not and may not achieve its forecasted sales growth;
- We may not be able to develop sufficiently trained applications engineering, installation and service support to serve our targeted markets;
- Changes in our product components may require us to replace parts held at distributors and ASCs;
- We operate in a highly regulated business environment and changes in regulation could impose costs on us or make our products less economical, thereby affecting demand for our microturbines;
- Utility companies or governmental entities could place barriers to our entry into the marketplace and we may not be able to effectively sell our product;
- Product quality expectations may not be met, causing slower market acceptance or warranty cost exposure;
- We depend upon the development of new products and enhancements of existing products;
- Operational restructuring may result in asset impairment or other unanticipated charges;
- We may not achieve production cost reductions necessary to competitively price our product, which would impair our sales;
- Commodity market factors impact our costs and availability of materials;
- Our suppliers may not supply us with a sufficient amount of components or components of adequate quality, and we may not be able to produce our product;
- Our products involve a lengthy sales cycle and we may not anticipate sales levels appropriately, which could impair our potential profitability;
- Potential intellectual property, shareholder or other litigation may adversely impact our business;
- We may be unable to fund our future operating requirements, which could force us to curtail our operations;
- We may not be able to effectively manage our growth, expand our production capabilities or improve our operational, financial and management information systems, which would impair our sales and profitability;
- Our success depends in significant part upon the service of management and key employees;

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- We cannot be certain of the future effectiveness of our internal controls over financial reporting or the impact thereof on our operations or the market price of our common stock;
- Our operations are vulnerable to interruption by fire, earthquake and other events beyond our control;
- The market price of our common stock has been and may continue to be highly volatile and an investment in our common stock could suffer a decline in value; and
- Provisions in our certificate of incorporation, bylaws and our stockholder rights plan, as well as Delaware law, may discourage, delay or prevent a merger or acquisition at a premium price.

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

No material changes have occurred in the quantitative and qualitative market risk disclosure of the Company as presented in its Annual Report on Form 10-K for the year ended March 31, 2005.

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

#### *Evaluation of Disclosure Controls and Procedures*

The Company's management, with the participation of the Company's principal executive officer and the principal financial officer, evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Form 10-Q. The Company's principal executive officer and principal financial officer have concluded, based on their evaluation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report on Form 10-Q, that the Company's disclosure controls and procedures were not effective to ensure that the information required to be disclosed in reports that are filed or submitted under the Exchange Act is accumulated and communicated to management, including the principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure and that such information is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities Exchange Commission.

As a result of management's assessment of the effectiveness of the Company's internal control over financial reporting as of March 31, 2005 it was concluded that the Company's internal controls over financial reporting were ineffective. Three control deficiencies were identified in the Company's internal controls over financial reporting which constituted "material weaknesses" within the meaning of the Public Company Accounting Oversight Board Auditing Standard No. 2. A material weakness is defined as a significant deficiency or combination of significant deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

The first material weakness related to a deficiency in the design of controls for ensuring that the Company's financial accounting software was properly configured, during the Company's change in fiscal year, to correctly calculate depreciation and amortization expense of equipment and leasehold improvements. In the three month period ended March 31, 2004, the software was configured to change to fiscal from calendar years. Controls designed to detect errors in depreciation and amortization expense, principally the reconciliation and review of depreciation and amortization expense for reasonableness, did not operate effectively because they did not detect the error. These deficiencies in controls resulted in the Company recording an adjustment of \$609,000 to increase depreciation and amortization expense in the fourth quarter of Fiscal 2005. The impact of such adjustment on prior quarters was not significant. The second material weakness, a deficiency in the operation of controls for identifying and recording accounts payable and accrued liabilities, principally from the failure of the Company's controls to detect an understatement of accrued liabilities for legal expenses, resulted in recording adjustments aggregating \$277,000 to increase accounts payable and accrued liabilities and corresponding expenses as of and Fiscal 2005. The third material weakness relates to a deficiency in the operation of controls for compiling fiscal year-end physical inventory counts for work-in-process inventory, principally inadequate compiling of inventory count tags and the lack of review by supervisors sufficient to detect errors arising from manually input data.

Since March 31, 2005, we believe we have adequately addressed the first and second material weaknesses, however, we have continued to identify a material weakness related to the effectiveness of internal controls over inventory as it relates to custody, control and recording of assets. The deficiencies in this area of internal controls were concluded to be a material weakness based on the significance of the potential misstatement of the annual and interim financial statements and the significance of the controls over inventory to the preparation of reliable financial statements.

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### *Changes in Internal Control Over Financial Reporting*

The Company's management, with the participation of the Company's principal executive officer and principal financial officer, evaluated the changes in the Company's internal controls over financial reporting that occurred during the period covered by this Form 10-Q that have materially affected, or are reasonably likely to materially affect the Company's internal control over financial reporting. The Company has taken steps to remediate the control deficiencies identified in our annual report on Form 10-K for Fiscal 2005. The Company has and will continue to calculate and record depreciation and leasehold amortization expense manually until such time as its financial accounting software can be correctly configured. The Company has also developed analytical procedures to ensure amounts recorded are accurate. The Company has implemented additional controls over the accruals of legal fees to ensure amounts recorded are accurate. Specifically, the Company has provided training to appropriate personnel to ensure a better understanding of accounting concepts related to accruals and has developed a confirmation process in which monthly communication is made directly with any vendor providing legal services. The Company performed a limited scope physical inventory during the first and second quarter of Fiscal 2006. While progress was made with respect to compiling the quarter-end physical inventory counts, management is in the process of refining existing controls and considering implementation of new controls in an effort to remediate completely the material weakness related to inventory controls.

Management has discussed these issues and remediation efforts in detail with our Audit Committee. Our Chief Executive Officer and our Chief Financial Officer believe the aforementioned changes in the Company's internal controls over financial reporting have remediated the first and second material weaknesses and that management's planned activities with respect to inventory controls will remediate the third material weakness.

## PART II — OTHER INFORMATION

### **Item 1. Legal Proceedings**

On September 11, 2005, Capstone gave notice to UTC Power, LLC ("UTCP") pursuant to the OEM Agreement (the "Agreement") with UTCP, dated March 23, 2005, of certain breaches of the Agreement by UTCP and called upon UTCP to cure those breaches or the Agreement will terminate. UTCP filed suit in the United States District Court for the District of Connecticut on September 16, 2005, denying that it is in breach of the Agreement and seeking to enjoin Capstone from terminating or attempting to terminate the Agreement; monetary damages were not sought. The Agreement provides for arbitration of all disputes between the parties. Capstone has not withheld sales of products or parts to UTCP during the cure period. Capstone believes that the UTCP complaint is premature, failing to present a case or controversy for the courts. Meanwhile, Capstone has invited UTCP to cure its performance failures under the Agreement and to meet with Capstone to determine if the parties can resolve the matters in dispute.

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

- (a) The annual meeting of stockholders of the Company was held on September 16, 2005.
- (b) All directors stood for election and all nominees were elected.
- (c) The only matter voted upon at the meeting was the election of the directors. The votes cast with respect to such matter are as follows:

Election of Directors:	Votes Cast	
	For	Withheld
Director		
Eliot Protsch	63,849,760	8,880,908
Richard Donnelly	63,063,208	9,338,457
John Jagers	63,702,298	8,698,367
Noam Lotan	66,285,317	6,115,348
Dennis Schiffel	63,871,549	8,529,116
Gary Simon	66,348,540	6,052,125
John Tucker	63,869,038	8,531,627

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

The following exhibits are filed with, or incorporated by reference into, this Quarterly Report on Form 10-Q:

<b>Exhibit Number</b>	<b>Description</b>
3.1(3)	Second Amended and Restated Certificate of Incorporation of Capstone Turbine Corporation.
3.2(1)	Amended and Restated Bylaws of Capstone Turbine Corporation.
4.1(2)	Specimen stock certificate.
10.1(1)	Stock Option Agreement with Walter J. McBride.
10.2(1)	Form of Stock Option Agreement for Amended and Restated 2000 Equity Incentive Plan.
31.1(1)	CEO's Certification Pursuant to Rule 13a-14(a)/15d-14(a).
31.2(1)	CFO's Certification Pursuant to Rule 13a-14(a)/15d-14(a).
32.1(1)	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the CEO and CFO.

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(1) Filed herewith.

(2) Incorporated by reference to Capstone Turbine's Registration Statement on Form S-1/A, dated June 21, 2000 (File No. 333-33024).

(3) Incorporated by reference to Capstone Turbine's registration statement on Form S-1/A, dated May 8, 2000 (File No. 333-33024).



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### **Exhibit Index**

<u>Exhibit Number</u>	<u>Description of Document</u>
3.2	Amended and Restated Bylaws of Capstone Turbine Corporation.
10.1	Stock Option Agreement with Walter J. McBride.
10.2	Form of Stock Option Agreement for Amended and Restated 2000 Equity incentive Plan.
31.1	CEO's Certification Pursuant to Rule 13a-14(a)/15d-14(a).
31.2	CFO's Certification Pursuant to Rule 13a-14(a)/15d-14(a).
32.1	Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, of the CEO and CFO.





**AMENDED AND RESTATED BYLAWS OF  
CAPSTONE TURBINE CORPORATION**

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**AMENDED AND RESTATED BYLAWS**

**OF**

**CAPSTONE TURBINE CORPORATION**

**ARTICLE I**

**OFFICES**

Section 1. *Registered Office.* The registered office of Capstone Turbine Corporation (hereinafter, called the “corporation”) shall be in the City of Dover, County of Kent, State of Delaware.

Section 2. *Other Offices.* The corporation may also have offices at such other places both within and without the State of Delaware as the Board of Directors may from time to time determine or the business of the corporation may require.

**ARTICLE II**

**STOCKHOLDERS**

Section 1. *Place of Meetings.* Meetings of stockholders shall be held at any place within or outside the State of Delaware designated by the board of directors. In the absence of any such designation, stockholders’ meetings shall be held at the principal executive office of the corporation.

Section 2. *Annual Meetings of Stockholders.* The annual meeting of stockholders shall be held each year on a date and time designated by the board of directors. Any previously scheduled annual meeting of the stockholders may be postponed by resolution of the board of directors upon public notice given prior to the date previously scheduled for such annual meeting of the stockholders.

Section 3. *Special Meetings.* A special meeting of the stockholders may be called at any time by the chairman of the board of directors, or by a majority of the directors or by a committee of the board of directors which has been duly designated by the board of directors and whose powers and authority, as provided in a resolution of the board of directors, include the power to call such meetings, but such special meetings may not be called by any other person or persons. Any previously scheduled special meeting of the stockholders may be postponed by resolution of the board of directors upon public notice given prior to the date previously scheduled for such special meeting of the stockholders.

Section 4. *Notice of Stockholders’ Meetings.* All notices of meetings of stockholders shall be sent or otherwise given in accordance with Section 5 of this Article II not less than ten (10) nor more than sixty (60) days before the date of the meeting being noticed. The notice shall specify the place, date and hour of the meeting and in the case of a special meeting, the general nature of the business to be transacted.

Section 5. *Manner of Giving Notice; Affidavit of Notice.* Notice of any meeting of stockholders shall be deemed to have been given:

(A) when deposited in the mail, postage prepaid, directed to the stockholder at his address appearing on the books of the corporation or given by the stockholder to the corporation for the purpose of notice; or

(B) if electronically transmitted as provided in Article VIII, Section 1 of these bylaws.

An affidavit of the mailing, electronic transmission or other means of giving any notice of any stockholders' meeting shall be executed by the secretary, assistant secretary or any transfer agent of the corporation giving such notice, and shall be filed and maintained in the minute book of the corporation.

Section 6. *Quorum.* The presence in person or by proxy of the holders of a majority of the shares entitled to vote at any meeting of stockholders shall constitute a quorum for the transaction of business. The stockholders present at a duly called or held meeting at which a quorum is present may continue to do business until adjournment, notwithstanding the withdrawal of enough stockholders to leave less than a quorum, if any action taken (other than adjournment) is approved by at least a majority of the shares required to constitute a quorum.

Section 7. *Adjourned Meeting and Notice Thereof.* Any stockholders' meeting, annual or special, whether or not a quorum is present, may be adjourned from time to time by the chairman of the meeting, but in the absence of a quorum, no other business may be transacted at such meeting, except as provided in Section 6 of this Article II.

When any meeting of stockholders, either annual or special, is adjourned to another time or place, notice need not be given of the adjourned meeting if the time and place thereof are announced at a meeting at which the adjournment is taken, unless a new record date for the adjourned meeting is fixed, or unless the adjournment is for more than thirty (30) days from the date set for the original meeting. Notice of any such adjourned meeting, if required, shall be given to each stockholder of record entitled to vote at the adjourned meeting in accordance with the provisions of Sections 4 and 5 of this Article II. At any adjourned meeting the corporation may transact any business which might have been transacted at the original meeting.

Section 8. *Voting.* The stockholders entitled to vote at any meeting of stockholders shall be determined in accordance with the provisions of Section 11 of this Article II. Such vote may be by voice vote or by ballot, at the discretion of the chairman of the meeting. Any stockholder entitled to vote on any matter (other than the election of directors) may vote part of the shares in favor of the proposal and refrain from voting the remaining shares or vote them against the proposal; but, if the stockholder fails to specify the number of shares such stockholder is voting affirmatively, it will be conclusively presumed that the stockholder's approving vote is with respect to all shares such stockholder is entitled to vote. If a quorum is present, the affirmative vote of the majority of the shares represented at the meeting and entitled to vote on any matter shall be the act of the stockholders, unless the vote of a greater number or voting by classes is

required by the Delaware General Corporation Law (the “DGCL”) or the certificate of incorporation or the certificate of determination of preferences as to any preferred stock.

At a stockholders’ meeting involving the election of directors, no stockholder shall be entitled to cumulate (*i.e.*, cast for any one or more candidates a number of votes greater than the number of the stockholders shares). The candidates receiving the highest number of votes, up to the number of directors to be elected, shall be elected.

Section 9. *Waiver of Notice or Consent by Absent Stockholders.* The transactions of any meeting of stockholders, either annual or special, however called and noticed, and wherever held, shall be as valid as though had at a meeting duly held after regular call and notice, if a quorum be present either in person or by proxy, and if, either before or after the meeting, each person entitled to vote, not present in person or by proxy, delivers a written waiver signed by such person (or a waiver by electronic transmission by such person) of notice or a consent (manually signed or submitted by electronic transmission) to the holding of the meeting, or an approval of the minutes thereof. The waiver of notice or consent need not specify either the business to be transacted or the purpose of any annual or special meeting of stockholders. All such waivers, consents or approvals shall be filed with the corporate records or made part of the minutes of the meeting.

Attendance of a person at a meeting shall also constitute a waiver of notice of such meeting, except when the person objects, at the beginning of the meeting, to the transaction of any business because the meeting is not lawfully called or convened, and except that attendance at a meeting is not a waiver of any right to object to the consideration of matters not included in the notice of the meeting if such objection is expressly made at the meeting.

Section 10. *No Stockholder Action by Written Consent Without a Meeting.* Stockholders may take action only at a regular or special meeting of stockholders.

Section 11. *Record Date for Stockholder Notice and Voting.* For purposes of determining the holders entitled to notice of any meeting or to vote, the board of directors may fix, in advance, a record date, which shall not be more than sixty (60) days nor less than ten (10) days prior to the date of any such meeting, and in such case only stockholders of record on the date so fixed are entitled to notice and to vote, notwithstanding any transfer of any shares on the books of the corporation after the record date fixed as aforesaid, except as otherwise provided in the Delaware General Corporation Law.

If the board of directors does not so fix a record date, the record date for determining stockholders entitled to notice of or to vote at a meeting of stockholders shall be at the close of business on the business day next preceding the day on which notice is given or, if notice is waived, at the close of business on the business day next preceding the day on which the meeting is held.

Section 12. *Proxies.* Every person entitled to vote for directors or on any other matter shall have the right to do so either in person or by one or more agents authorized (a) by a written proxy signed by the person and filed with the secretary of the corporation or (b) by an electronic transmission permitted by law filed in accordance with the procedure established for the meeting.

A validly executed proxy which does not state that it is irrevocable shall continue in full force and effect unless (i) revoked by the person executing it, prior to the vote pursuant thereto, by a writing delivered to the corporation (whether manually signed or electronically transmitted) stating that the proxy is revoked or by a subsequent proxy executed or electronically transmitted by, or attendance at the meeting and voting in person by, the person executing or electronically transmitting the proxy, or (ii) written notice of the death or incapacity of the maker of such proxy is received by the corporation before the vote pursuant thereto is counted; provided, however, that no such proxy shall be valid after the expiration of one (1) year from the date of such proxy, unless otherwise provided in the proxy.

Section 13. *Inspectors of Election; Opening and Closing the Polls.* The board of directors by resolution shall appoint one or more inspectors, which inspector or inspectors may include individuals who serve the corporation in other capacities, including, without limitation, as officers, employees, agents or representatives, to act at the meetings of stockholders and make a written report thereof. One or more persons may be designated as alternate inspectors to replace any inspector who fails to act. If no inspector or alternate has been appointed to act or is able to act at a meeting of stockholders, the chairman of the meeting shall appoint one or more inspectors to act at the meeting. Each inspector, before discharging his or her duties, shall take and sign an oath faithfully to execute the duties of inspector with strict impartiality and according to the best of his or her ability. The inspectors shall have the duties prescribed by law.

The chairman of the meeting shall fix and announce at the meeting the date and time of the opening and the closing of the polls for each matter upon which the stockholders will vote at a meeting.

Section 14. *Nomination and Stockholder Business Bylaw.*

(A) *Annual Meetings of Stockholders.*

(1) Nominations of persons for election to the board of directors of the corporation and the proposal of business to be considered by the stockholders may be made at an annual meeting of stockholders (a) pursuant to the corporation's notice of meeting, (b) by or at the direction of the board of directors or (c) by any stockholder of the corporation who was a stockholder of record at the time of giving of notice provided for in this bylaw, who is entitled to vote at the meeting and who complies with the notice procedures set forth in this bylaw.

(2) For nominations or other business to be properly brought before an annual meeting by a stockholder pursuant to clause (c) of paragraph (A)(1) of this bylaw, the stockholder must have given timely notice thereof in writing to the secretary of the corporation and such other business must otherwise be a proper matter for stockholder action. To be timely, a stockholder's notice shall be delivered to the secretary at the principal executive offices of the corporation not less than the close of business on the 120th calendar day in advance of the first anniversary of the date the corporation's proxy statement was released to security holders in connection with the preceding year's annual meeting; provided, however, that if no annual meeting was held in the previous year or the date of the annual meeting has been changed by more than thirty (30) calendar days from the date contemplated at the time of the previous year's proxy statement, a proposal shall be received by the corporation no later than the close of business on the tenth day

following the day on which notice of the date of the meeting was mailed or public announcement of the date of the meeting was made, whichever comes first. In no event shall the public announcement of an adjournment of an annual meeting commence a new time period for the giving of a stockholder's notice as described above. Such stockholder's notice shall set forth (a) as to each person whom the stockholder proposes to nominate for election or reelection as a director all information relating to such person that is required to be disclosed in solicitations of proxies for election of directors in an election contest, or is otherwise required, in each case pursuant to applicable federal securities laws, including, without limitation, Regulation 14A under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and Rule 14a-11 thereunder (including such person's written consent to being named in the proxy statement as a nominee and to serving as a director if elected); (b) as to any other business that the stockholder proposes to bring before the meeting, a brief description of the business desired to be brought before the meeting, the reasons for conducting such business at the meeting and any material interest in such business of such stockholder and the beneficial owner, if any, on whose behalf the proposal is made; and (c) as to the stockholder giving the notice and the beneficial owner, if any, on whose behalf the nomination or proposal is made (i) the name and address of such stockholder, as they appear on the corporation's books, and of such beneficial owner and (ii) the class and number of shares of the corporation which are owned beneficially and of record by such stockholder and such beneficial owner.

(3) Notwithstanding anything in the second sentence of paragraph (A)(2) of this bylaw to the contrary, in the event that the number of directors to be elected to the board of directors of the corporation is increased and there is no public announcement by the corporation naming all of the nominees for director or specifying the size of the increased board of directors at least 70 days prior to the first anniversary of the date of the preceding year's annual meeting, a stockholders notice required by this bylaw shall also be considered timely, but only with respect to nominees for any new positions created by such increase, if it shall be delivered to the secretary at the principal executive offices of the corporation not later than the close of business on the 10th day following the day on which such public announcement is first made by the corporation.

(B) *Special Meetings of Stockholders.* Only such business shall be conducted at a special meeting of stockholders as shall be brought before the meeting pursuant to the corporation's notice of meeting. A stockholder's nomination of one or more persons for election to the board of directors shall only be permitted to be made at a special meeting of stockholders if: (i) the corporation's notice of such meeting specified that directors are to be elected at such special meeting; (ii) such stockholder was a stockholder of record entitled to vote at the meeting at the time of giving of notice provided for in this bylaw; and (iii) if such stockholder complies with the notice procedures set forth in this bylaw. In the event the corporation calls a special meeting of stockholders for the purpose of electing one or more directors to the board of directors, any such stockholder may nominate a person or persons (as the case may be), for election to such position(s) as specified in the corporation's notice of meeting, if the stockholder's notice required by paragraph (A)(2) of this bylaw shall be delivered to the secretary at the principal executive offices of the corporation not earlier than the close of business on the 90th day prior to such special meeting and not later than the close of business on the later of the 60th day prior to such special meeting or the 10th day following the day on which public announcement is first made of the date of the special meeting and of the nominees proposed by the board of directors



to be elected at such meeting. In no event shall the public announcement of an adjournment of a special meeting commence a new time period for the giving of a stockholder's notice as described above.

(C) *General.*

(1) Only such persons who are nominated in accordance with the procedures set forth in this bylaw shall be eligible to serve as directors. Except as otherwise provided by law, the certificate of incorporation or these bylaws, the chairman of the meeting shall have the power and authority to determine the procedures of a meeting of stockholders, including, without limitation, the authority to determine whether a nomination or any other business proposed to be brought before the meeting was made or proposed, as the case may be, in accordance with the procedures set forth in this bylaw and, if any proposed nomination or business is not in compliance with this bylaw, to declare that such defective proposal or nomination shall be disregarded.

(2) For purposes of this bylaw, "public announcement" shall mean disclosure in a press release reported by the Dow Jones News Service, Associated Press or comparable national news service or in a document publicly filed by the corporation with the Securities and Exchange Commission pursuant to Section 13, 14 or 15(d) of the Exchange Act.

(3) Notwithstanding the foregoing provisions of this bylaw, a stockholder shall also comply with all applicable requirements of the Exchange Act and the rules and regulations thereunder with respect to the matters set forth in this bylaw. Nothing in this bylaw shall be deemed to affect any rights (i) of stockholders to request inclusion of proposals in the corporation's proxy statement pursuant to Rule 14a-8 under the Exchange Act or (ii) of the holders of any series of preferred stock, if any, to elect directors under certain circumstances.

### **ARTICLE III**

#### **DIRECTORS**

Section 1. *Powers.* Subject to the provisions of the Delaware General Corporation Law and any limitations in the certificate of incorporation and these bylaws relating to action required to be approved by the stockholders or by the outstanding shares, the business and affairs of the corporation shall be managed and all corporate powers shall be exercised by or under the direction of the board of directors.

Section 2. *Number and Qualification of Directors.* Until otherwise determined by resolution by the Board of Directors, the number of directors of the corporation shall be seven (7).

Section 3. *Election and Term of Office of Directors.* Directors shall be elected at the annual meeting of the stockholders. Each director, including a director elected to fill a vacancy, shall serve for a term ending on the next annual meeting following the annual meeting at which such director was elected and until a successor has been elected and qualified or the earlier of his resignation or removal.

Section 4. *Vacancies.* Vacancies in the board of directors may be filled by a majority of the remaining directors, though less than a quorum, or by a sole remaining director. Each director

elected to fill a vacancy shall hold office for the remainder of the term of the person whom he succeeds, and until a successor has been elected and qualified.

A vacancy or vacancies in the board of directors shall be deemed to exist in the case of the death, retirement, resignation or removal of any director, or if the board of directors by resolution declares vacant the office of a director who has been declared of unsound mind by an order of court or convicted of a felony, or if the authorized number of directors be increased, or if the stockholders fail at any meeting of stockholders at which any director or directors are elected, to elect the full authorized number of directors to be voted for at that meeting.

Any director may resign or voluntarily retire upon giving notice in writing or by electronic transmission to the chairman of the board, the president, the secretary or the board of directors. Such retirement or resignation shall be effective upon the giving of the notice, unless the notice specifies a later time for its effectiveness. If such retirement or resignation is effective at a future time, the board of directors may elect a successor to take office when the retirement or resignation becomes effective.

No reduction of the authorized number of directors shall have the effect of removing any director prior to the expiration of his term of office.

*Section 5. Place of Meetings and Telephonic Meetings.* Regular meetings of the board of directors may be held at any place within or without the State of Delaware that has been designated from time to time by resolution of the board. In the absence of such designation, regular meetings shall be held at the principal executive office of the corporation. Special meetings of the board shall be held at any place within or without the State of Delaware that has been designated in the notice of the meeting or, if not stated in the notice or there is no notice, at the principal executive office of the corporation. Any meeting, regular or special, may be held by conference telephone or similar communication equipment, so long as all directors participating in such meeting can hear one another, and all such directors shall be deemed to be present in person at such meeting.

*Section 6. Annual Meetings.* Immediately following each annual meeting of stockholders, the board of directors shall hold a regular meeting for the purpose of organization, any desired election of officers and transaction of other business. Notice of this meeting shall not be required.

*Section 7. Other Regular Meetings.* Other regular meetings of the board of directors shall be held at such time as shall from time to time be determined by the board of directors. Such regular meetings may be held without notice provided that notice of any change in the determination of time of such meeting shall be sent to all of the directors. Notice of a change in the determination of the time shall be given to each director in the same manner as for special meetings of the board of directors.

*Section 8. Special Meetings.* Special meetings of the board of directors for any purpose or purposes may be called at any time by the chairman of the board or the president or any vice president or the secretary or any two directors.

Notice of the time and place of special meetings shall be delivered personally or by telephone to each director, sent by facsimile, first-class mail or telegram, charges prepaid, addressed to each director at his or her address as it is shown upon the records of the corporation, or sent by electronic mail addressed to each director at his or her electronic mail address as it is shown upon the records of the corporation. In case such notice is mailed, it shall be deposited in the United States mail at least four (4) days prior to the time of the holding of the meeting. In case such notice is delivered personally, by telephone, facsimile, telegram or electronic mail, it shall be delivered personally, or by telephone, by facsimile, to the telegraph company or by electronic mail at least twenty-four (24) hours prior to the time of the holding of the meeting. Any oral notice given personally or by telephone may be communicated to either the director or to a person at the office of the director who the person giving the notice has reason to believe will promptly communicate it to the director. The notice need not specify the purpose of the meeting nor the place if the meeting is to be held at the principal executive office of the corporation.

Section 9. *Quorum.* A majority of the authorized number of directors shall constitute a quorum for the transaction of business, except to adjourn as hereinafter provided. Every act or decision done or made by a majority of the directors present at a meeting duly held at which a quorum is present shall be regarded as the act of the board of directors. A meeting at which a quorum is initially present may continue to transact business notwithstanding the withdrawal of directors, if any action taken is approved by at least a majority of the required quorum for such meeting.

Section 10. *Waiver of Notice.* The transactions of any meeting of the board of directors, however called and noticed or wherever held, shall be as valid as though had at a meeting duly held after regular call and notice if a quorum be present and if, either before or after the meeting, each of the directors not present delivers a written waiver signed by such director (or a waiver by electronic transmission by such director) of notice or a consent (manually signed or submitted by electronic transmission) to the holding of the meeting, or an approval of the minutes thereof. The waiver of notice or consent need not specify the purpose of the meeting. All such waivers, consents and approvals shall be filed with the corporate records or made a part of the minutes of the meeting. Notice of a meeting shall also be deemed given to any director who attends the meeting without protesting, prior thereto or at its commencement, the lack of notice to such director.

Section 11. *Adjournment.* A majority of the directors present, whether or not constituting a quorum, may adjourn any meeting to another time and place.

Section 12. *Notice of Adjournment.* Notice of the time and place of an adjourned meeting need not be given, unless the meeting is adjourned for more than twenty-four (24) hours, in which case notice of such time and place shall be given prior to the time of the adjourned meeting, in the manner specified in Section 8 of this Article III, to the directors who were not present at the time of the adjournment.

Section 13. *Action Without Meeting.* Any action required or permitted to be taken by the board of directors may be taken without a meeting, if all members of the board shall individually or collectively consent in writing or by electronic transmission to such action. Such action by

written consent or electronic transmission shall have the same force and effect as a unanimous vote of the board of directors. Such written consent or consents or electronic transmission or transmissions shall be filed with the minutes of the proceedings of the board.

Section 14. *Fees and Compensation of Directors.* Directors and members of committees may receive such compensation, if any, for their services and such reimbursement of expenses, as may be fixed or determined by resolution of the board of directors. Nothing herein contained shall be construed to preclude any director from serving the corporation in any other capacity as an officer, agent, employee, or otherwise, and receiving compensation for such services.

#### **ARTICLE IV COMMITTEES**

Section 1. *Committees of Directors.* The board of directors may, by resolution adopted by a majority of the authorized number of directors, designate one or more committees, including an executive committee, each consisting of two or more directors, to serve at the pleasure of the board. The board may designate one or more directors as alternate members of any committee, who may replace any absent member at any meeting of the committee. Any such committee, to the extent provided in the resolution of the board, shall have all the authority of the board, except with respect to:

- (a) the approval of any action which, under the General Corporation Law of Delaware, also requires the approval of the full board of directors, or the stockholders of the outstanding shares;
- (b) the filling of vacancies on the board of directors or in any committee;
- (c) the fixing of compensation of the directors for serving on the board or on any committee;
- (d) the amendment or repeal of bylaws or the adoption of new bylaws;
- (e) the amendment or repeal of any resolution of the board of directors which by its express terms is not so amendable or repealable;
- (f) a distribution to the stockholders of the corporation, except at a rate or in a periodic amount or within a price range determined by the board of directors; or
- (g) the appointment of any other committees of the board of directors or the members thereof.

Section 2. *Meetings and Action of Committees.* Meetings and action of committees shall be governed by, and held and taken in accordance with, the provisions of Article III of these bylaws, Sections 5 (place of meetings), 7 (regular meetings), 8 (special meetings and notice), 9 (quorum), 10 (waiver of notice), 11 (adjournment), 12 (notice of adjournment) and 13 (action without meetings), with such changes in the context of those bylaws as are necessary to substitute the committee and its members for the board of directors and its members, except that the time of regular meetings of committees may be determined by resolution of the board of directors as well as the committee, special meetings of committees may also be called by

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

## **ARTICLE V**

### **OFFICERS**

Section 1. *Officers.* The officers of the corporation shall be chosen by the board of directors and shall include a chairman of the board or president, or both, a vice president, a secretary and a chief financial officer. The corporation may also have, at the discretion of the board of directors, a president, one or more additional vice presidents, one or more assistant secretaries, one or more assistant treasurers, and such other officers as may be held by the same person.

Section 2. *Election of Officers.* The officers of the corporation, except such officers as may be appointed in accordance with the provisions of Section 3 or Section 5 of this Article V, shall be chosen annually by the board of directors, and each shall hold his office until he shall resign or be removed or otherwise disqualified to serve or his successor shall be appointed in accordance with the provisions of Section 3 of this Article V. Any number of officers may be elected and qualified.

Section 3. *Subordinate Officers, etc.* The board of directors may appoint, and may empower the chairman of the board to appoint, such other officers as the business of the corporation may require, each of whom shall hold office for such period, have such authority and perform such duties as are provided in the bylaws or as the board of directors may from time to time determine.

Section 4. *Removal and Resignation of Officers.* Any officer may be removed, either with or without cause, by the board of directors, at any regular or special meeting thereof, or, except in case of an officer chosen by the board of directors, by any officer upon whom such power of removal may be conferred by the board of directors.

Any officer may resign at any time by giving written notice to the corporation. Any such resignation shall take effect at the date of the receipt of such notice or at any later time specified therein; and, unless otherwise specified therein, the acceptance of such resignation shall not be necessary to make it effective.

Section 5. *Vacancies in Office.* A vacancy in any office because of death, resignation, removal, disqualification, or any other cause shall be filled in the manner prescribed in these bylaws for regular appointments to such office.

Section 6. *Chairman of the Board.* The chairman of the board shall preside at all meetings of the stockholders and of the board of directors. The chairman of the Board shall be responsible for the general management of the affairs of the corporation and shall perform all duties incidental to his office which may be required by law and all such other duties as are properly required of him by the board of directors. Except where by law the signature of the president is required, the chairman of the board shall possess the same power as the president to sign all

certificates, contracts, and other instruments of the corporation which may be authorized by the board of directors. He shall make reports to the board of directors and the stockholders, and shall perform all such other duties as are properly required of him by the board of directors. He shall see that all orders and resolutions of the board of directors and of any committee thereof are carried into effect.

Section 7. *President.* The president shall act in a general executive capacity and shall assist the chairman of the board in the administration and operation of the corporation's business and general supervision of its policies and affairs. The president shall, in the absence of or because of the inability to act of the chairman of the board, perform all duties of the chairman of the board and preside at all meetings of stockholders and of the board of directors. The president may sign, alone or with the secretary, or an assistant secretary, or any other proper officer of the corporation authorized by the board of directors, certificates, contracts, and other instruments of the corporation as authorized by the board of directors.

Section 8. *Vice Presidents.* In the absence or disability of the president, a vice president designated by the board of directors shall perform all the duties of the president, and when so acting shall have all the powers of, and be subject to all the restrictions upon, the president. The vice presidents shall have such other powers and perform such other duties as from time to time may be prescribed for them respectively by the board of directors or the bylaws.

Section 9. *Secretary.* The secretary shall keep or cause to be kept, at the principal executive office or such other place as the board of directors may order, a book of minutes of all meetings and actions of directors, committees of directors and stockholders, with the time and place of holding, whether regular or special, and, if special, how authorized, the notice thereof given, the names of those present at directors' and committee meetings, the number of shares present or represented at stockholders' meetings, and the proceedings thereof.

The secretary shall keep, or cause to be kept, at the principal executive office or at the office of the corporation's transfer agent or registrar, as determined by resolution of the board of directors, a stock register, or a duplicate register, showing the names of all stockholders and their addresses, the number and classes of shares held by each, the number and date of certificates issued for the same, and the number and date of cancellation of every certificate surrendered for cancellation.

The secretary shall give, or cause to be given, notice of all meetings of the stockholders and of the board of directors required by the bylaws or by law to be given and shall have such other powers and perform such other duties as may be prescribed by the board of directors or by the bylaws.

Section 10. *Chief Financial Officer.* The chief financial officer shall keep and maintain, or cause to be kept and maintained, adequate and correct books and records of accounts of the properties and business transactions of the corporation, including accounts of its assets, liabilities, receipts, disbursements, gains, losses, capital, retained earnings and shares. The books of account shall be open at all reasonable times to inspection by any director.

The chief financial officer shall deposit all monies and other valuables in the name and to the credit of the corporation with such depositories as may be designated by the board of directors. The chief financial officer shall disburse the funds of the corporation as may be ordered by the board of directors, shall render to the chairman of the board and directors, whenever they request it, an account of all of his transactions as chief financial officer and of the financial condition of the corporation, and shall have other powers and perform such other duties as may be prescribed by the board of directors or the bylaws.

Section 11. *Assistant Secretaries and Assistant Treasurers.* Any assistant secretary may perform any act within the power of the secretary, and any assistant treasurer may perform any act within the power of the chief financial officer, subject to any limitations which may be imposed in these bylaws or in board resolutions.

**ARTICLE VI**  
**INDEMNIFICATION OF DIRECTORS, OFFICERS,**  
**EMPLOYEES AND OTHER AGENTS**

Section 1. *Indemnification.* The corporation shall indemnify, in the manner and to the full extent permitted by law, any person (or the estate of any person) who was or is a party to, or is threatened to be made a party to, any threatened, pending or completed action, suit or proceeding, whether or not by or in the right of the corporation, and whether civil, criminal, administrative, investigative or otherwise, by reason of the fact that such person is a director or officer of the corporation, and at the discretion of the board of directors may indemnify any person (or the estate of any person) who is such a party or threatened to be made such a party by reason of the fact that such person is or was an employee or agent of the corporation or is or was serving at the request of the corporation as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise. The corporation may, to the full extent permitted by law, purchase and maintain insurance on behalf of any such person against any liability which may be asserted against him and may enter into contracts providing for the indemnification of such person to the full extent permitted by law. To the full extent permitted by law, the indemnification provided herein shall include expenses (including attorneys' fees), judgments, fines and amounts paid in settlement, and, in the manner provided by law, any such expenses may be paid by the corporation in advance of the final disposition of such action, suit or proceeding. The indemnification provided herein shall not be deemed to limit the right of the corporation to indemnify any other person for any such expenses to the full extent permitted by law, nor shall it be deemed exclusive of any other rights to which any person seeking indemnification from the corporation may be entitled under any agreement, vote of stockholders or disinterested directors or otherwise, both as to action in his official capacity and as to action in another capacity while holding such office.

For the purposes of this Article VI, references to "the corporation" shall include, in addition to the resulting corporation, any constituent corporation (including any constituent of a constituent) absorbed in a consolidation or merger which, if its separate existence had continued, would have had power and authority to indemnify its directors or officers so that any person who is or was a director or officer of such constituent corporation, or is or was serving at the request of such constituent corporation as a director or officer of another corporation,

partnership, joint venture, trust or other enterprise, shall stand in the same position under the provisions of this Article VI with respect to the resulting or surviving corporation as he would have with respect to such constituent corporation if its separate existence had continued.

For purposes of this Article VI, references to "other enterprises" shall include employee benefit plans; references to "fines" shall include any excise taxes assessed on a person with respect to an employee benefit plan; and references to "serving at the request of the corporation" shall include service as a director or officer of the corporation which imposes duties on, or involves services by, such director or officer with respect to an employee benefit plan, its participants or beneficiaries; and a person who acted in good faith and in a manner he reasonably believed to be in the interest of the participants and beneficiaries of an employee benefit plan shall be deemed to have acted in a manner "not opposed to the best interests of the corporation" as referred to in this section.

## ARTICLE VII

### GENERAL CORPORATE MATTERS

Section 1. *Record Date for Purposes Other Than Notice and Voting.* For purposes of determining the stockholders entitled to receive payment of any dividend or other distribution or allotment of any rights or entitled to exercise any rights in respect of any other lawful action, the board of directors may fix, in advance, a record date, which date shall not precede the date upon which the resolution fixing the record date is adopted by the board of directors, and which shall not be more than sixty (60) nor less than ten (10) days prior to any such action, and in such case only stockholders of record on the date so fixed are entitled to receive the dividend, distribution or allotment of rights or to exercise the rights, as the case may be, notwithstanding any transfer of any shares on the books of the corporation after the record date fixed as aforesaid, except as otherwise provided in the Delaware General Corporation Law.

A determination of stockholders of record entitled to notice of or to vote at a meeting of stockholders shall apply to any adjournment of the meeting; provided, however, that the board of directors may fix a new record date for the adjourned meeting. In order that the corporation may determine the stockholders entitled to consent to corporate action in writing or by electronic transmission without a meeting, the board of directors may fix a record date which shall not be more than ten days after the date upon which the resolution fixing the record date is adopted by the board of directors.

Section 2. *Checks, Drafts, Evidences of Indebtedness.* All checks, drafts or other orders for payment of money, notes or other evidences of indebtedness, issued in the name of or payable to the corporation shall be signed or endorsed by such person or persons and in such manner as, from time to time, shall be determined by resolution of the board of directors.

Section 3. *Corporate Contracts and Instruments, How Executed.* The board of directors, except as otherwise provided in these bylaws, may authorize any officer or officers, agent or agents, to enter into any contract or execute any instrument in the name of and on behalf of the corporation, and such authority may be general or confined to specific instances; and, unless so authorized or ratified by the board of directors or within the agency power of an officer, no



officer, agent or employee shall have any power or authority to bind the corporation by any contract or engagement or to pledge its credit or to render it liable for any purpose or to any amount.

Section 4. *Stock Certificates*. A certificate or certificates for shares of the capital stock of the corporation shall be issued to each stockholder when any such shares are fully paid. All certificates shall be signed in the name of the corporation by the chairman of the board or the president or vice president and by the chief financial officer, the treasurer or an assistant treasurer or the secretary or any assistant secretary, certifying the number of shares and the class or series of shares owned by the stockholder. Any or all of the signatures on the certificate may be facsimile. In case any officer, transfer agent or registrar who has signed or whose facsimile signature has been placed upon a certificate shall have ceased to be such officer, transfer agent or registrar before such certificate is issued, it may be issued by the corporation with the same effect as if such person were an officer, transfer agent or registrar at the date of issue.

Section 5. *Lost Certificates*. Except as hereinafter in this Section 5 provided, no new stock certificate shall be issued in lieu of an old certificate unless the latter is surrendered to the corporation and canceled at the same time. The board of directors may in case any stock certificate or certificate for any other security is lost, stolen or destroyed, authorize the issuance of a new certificate in lieu thereof, upon such terms and conditions as the board of directors may require, including provision for indemnification of the corporation secured by a bond or other adequate security sufficient to protect the corporation against any claim that may be made against it, including any expense or liability, on account of the alleged loss, theft or destruction of such certificate or the issuance of such new certificate.

Section 6. *Representation of Stock of Other Corporations*. The chairman of the board, the president, or any vice president, or any other person authorized by resolution of the board of directors by any of the foregoing designated officers, is authorized to vote on behalf of the corporation any and all stock of any other corporation or corporations, foreign or domestic, standing in the name of the corporation. The authority herein granted to said officers to vote or represent on behalf of the corporation any and all stock by the corporation in any other corporation or corporations may be exercised by any such officer in person or by any person authorized to do so by proxy duly executed by said officer.

Section 7. *Construction and Definitions*. Unless the context requires otherwise, the general provisions, rules of construction, and definitions in the Delaware General Corporation Law shall govern the construction of the bylaws. Without limiting the generality of the foregoing, the singular number includes the plural, the plural number includes the singular, and the term "person" includes both a corporation and a natural person.

Section 8. *Fiscal Year*. The fiscal year of the corporation shall be fixed by resolution of the board of directors.

## ARTICLE VIII

### NOTICE BY ELECTRONIC TRANSMISSION

Section 1. *Notice by Electronic Transmission.* Without limiting the manner by which notice otherwise may be given effectively to stockholders pursuant to the DGCL, the certificate of incorporation or these bylaws, any notice to stockholders given by the Company under any provision of the DGCL, the certificate of incorporation or these bylaws shall be effective if given by a form of electronic transmission consented to by the stockholder to whom the notice is given. Any such consent shall be revocable by the stockholder by written notice to the Company. Any such consent shall be deemed revoked if:

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

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

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

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

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

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

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

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

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

Section 2. *Definition of Electronic Transmission.* An “electronic transmission” means any form of communication, not directly involving the physical transmission of paper, that creates a record that may be retained, retrieved, and reviewed by a recipient thereof, and that may be directly reproduced in paper form by such a recipient through an automated process.

Section 3. *Inapplicability.* Notice by a form of electronic transmission shall not apply to Sections 164, 296, 311, 312 or 324 of the DGCL.

**ARTICLE IX**  
**AMENDMENTS**

Section 1. *Amendment.* The bylaws, or any of them, may be rescinded, altered, amended or repealed, and new bylaws may be made (i) by the board of directors, by vote of a majority of the number of directors then in office as directors, acting at any meeting of the board of directors, or (ii) by the stockholders, by the vote of the holders of sixty-six and two-thirds percent (66-2/3%) of the outstanding voting stock of the corporation, at any annual or special meeting of stockholders, provided that notice of such proposed amendment, modification, repeal or adoption is given in the notice of the annual or special meeting; provided, however, that the bylaws can only be amended if such amendment would not conflict with the certificate of incorporation. Any bylaw made or altered by the requisite number of stockholders may be altered or repealed by the board of directors or may be altered or repealed by the requisite number of stockholders.

\* \* \* \*



## CAPSTONE TURBINE CORPORATION

## INDUCEMENT STOCK OPTION AGREEMENT

**THIS AGREEMENT** is entered into on this 5th day of August, 2005 by and between Capstone Turbine Corporation (the "Company") with **Walter J. McBride** (the "Optionee") to evidence the award of an option to purchase the common stock of the Company that was made on July 11, 2005.

**RECITALS:**

**WHEREAS**, the Company, through action of the compensation committee of its board of directors taken on July 1, 2005, made a conditional option award to Optionee to purchase the Company's Common Stock (the "Option") as an inducement to encourage Optionee to accept an offer of employment as the Company's chief financial officer;

**WHEREAS**, Optionee has accepted such employment and the parties desire to set forth the terms of such Option and to acknowledge that the shares of Common Stock that may be acquired hereunder shall be registered under the Securities Act of 1933, as amended ("Securities Act") on Form S-8; and

**WHEREAS**, the parties further acknowledge that this Option is granted separately from the Capstone Turbine Corporation 2000 Equity Incentive Plan (the "2000 Plan"), but desire that this Option be subject to the terms contained in the of the 2000 Plan, except as otherwise provided for herein;

**NOW, THEREFORE**, in consideration of these premises, and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties do hereby agree to the following terms and conditions regarding the Option covered hereby:

**I. NOTICE OF STOCK OPTION GRANT**

Notice is hereby given of the grant of the Option, subject to the following terms. References in this Agreement to certain terms of the Option shall be as defined in this Article I:

Date of Grant:	July 11, 2005
Exercise Price:	\$1.63 per Share
Total Number of Shares:	500,000
Total Exercise Price:	\$815,000
Type of Option:	Non-Qualified Stock Option
Term:	10 years commencing on Date of Grant

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### **Exercise and Vesting Schedule:**

This Option shall vest and become exercisable on the dates and as described in this paragraph, subject to the Optionee continuing to be either an Employee or a Consultant to the Company on such vesting dates. On **July 11, 2006**, Optionee shall be vested in and have the right to exercise the Option with respect to 125,000 Shares. Thereafter, Optionee shall become vested in and have the right to exercise this Option with respect to 1/48<sup>th</sup> of the number of Shares subject to the Option on the day of each month corresponding to the Date of Grant, so that the Option shall be fully vested and exercisable on the fourth anniversary of the Date of Grant. However, if Optionee is terminated by the Company other than for Cause prior to the one-year anniversary of the Date of Grant, Optionee shall become vested in and have the right to exercise this Option with respect to 1/48<sup>th</sup> of the number of Shares subject to the Option for each full month of employment following the Date of Grant, based on the day of the month corresponding to the Date of Grant, through the date of such termination.

### **Option Termination:**

The Option shall terminate on **July 11, 2015**; provided, however, that if Optionee ceases to be either an Employee or a Consultant prior thereto, then the Option shall terminate earlier pursuant to the terms of Sections 10(d), 10(e), and 10(f) of the Plan.

## **II. AGREEMENT**

1. Grant of Option. The Option to purchase the Shares of Common Stock is subject to the terms set forth in Article I of this Agreement. Except as expressly provided for herein, this Option is also subject to the terms, definitions and provisions of the 2000 Plan, which are incorporated herein by reference. All capitalized terms used in this Agreement shall have the meanings ascribed to such terms in the 2000 Plan, except as may be otherwise defined herein.

2. Exercise of Option. The Option shall be exercisable cumulatively according to the vesting schedule set forth in Article I of this Agreement, based on Optionee's continued status as an Employee or a Consultant, and subject to the procedures and methods for payment set forth in the 2000 Plan. Any portion of the exercisable portion of the Option may be exercised at any time by the Optionee until the Option has terminated.

3. Lock-Up Period. Optionee hereby agrees that if so requested by the Company or any representative of the underwriters (the "Managing Underwriter") in connection with any registration of the offering of any securities of the Company under the Securities Act or any applicable state laws, Optionee shall not sell or otherwise transfer any Shares or other securities of the Company during the 180-day period (or such longer period as may be requested in writing by the Managing Underwriter and agreed to in writing by the Company) (the "Market Standoff Period") following the effective date of a registration statement of the Company filed under the Securities Act. The Company may impose stop-transfer instructions with respect to securities subject to the foregoing restrictions until the end of such Market Standoff Period.

4. Non-Transferability of Option. The Option may not be transferred in any manner except by will or by the laws of descent or distribution. It may be exercised during the lifetime of

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Optionee only by Optionee. The terms of the Option shall be binding upon the executors, administrators, heirs, successors and assigns of the Optionee.

This Agreement may be executed in two or more counterparts, each of which shall be deemed an original and all of which shall constitute one document.

CAPSTONE TURBINE CORPORATION

By: /s/ JOHN R. TUCKER

Name: John R. Tucker

Title: Chief Executive Officer

OPTIONEE ACKNOWLEDGES AND AGREES THAT THE VESTING OF SHARES PURSUANT TO THE OPTION HEREOF IS EARNED ONLY BY CONTINUING EMPLOYMENT OR CONSULTANCY AT THE WILL OF THE COMPANY (NOT THROUGH THE ACT OF BEING HIRED, BEING GRANTED THE OPTION OR ACQUIRING SHARES HEREUNDER). OPTIONEE FURTHER ACKNOWLEDGES AND AGREES THAT NOTHING IN THIS STOCK OPTION AGREEMENT, NOR IN THE CAPSTONE TURBINE CORPORATION 2000 EQUITY INCENTIVE PLAN, WHICH IS INCORPORATED HEREIN BY REFERENCE, SHALL CONFER UPON OPTIONEE ANY RIGHT WITH RESPECT TO CONTINUATION OF EMPLOYMENT OR CONSULTANCY BY THE COMPANY, NOR SHALL IT INTERFERE IN ANY WAY WITH OPTIONEE'S RIGHT OR THE COMPANY'S RIGHT TO TERMINATE OPTIONEE'S EMPLOYMENT OR CONSULTANCY AT ANY TIME, WITH OR WITHOUT CAUSE.

Optionee hereby acknowledges receipt of the 2000 Plan and a current prospectus for the offering represented by the grant of this Option. Optionee represents that he is familiar with the terms and provisions of the 2000 Plan and this Agreement and does hereby accept the Option subject to all of its terms. Optionee has had an opportunity to obtain the advice of counsel prior to executing this Agreement and fully understands all provisions of this Agreement and the Option granted hereunder. Optionee hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Committee upon any questions arising under the 2000 Plan or this Agreement. Optionee further agrees to notify the Company upon any change in the residence address indicated below.

Dated: August 5, 2005

/s/ WALTER J. McBRIDE

Walter J. McBride, Optionee

Residence Address: \_\_\_\_\_

\_\_\_\_\_

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## EXHIBIT A

### CAPSTONE TURBINE CORPORATION

#### NOTICE OF EXERCISE

Capstone Turbine Corporation  
21211 Nordhoff Street  
Chatsworth, CA 91311

Attention: Corporate Secretary

1. Exercise of Option. Effective as of today, \_\_\_\_\_, 2\_\_\_\_, the undersigned ("Optionee") hereby elects to exercise the right to purchase \_\_\_\_\_ shares of the Common Stock (the "Shares") of Capstone Turbine Corporation (the "Company") under and pursuant to the terms of that certain option granted on **July 11, 2005**, as evidenced in an agreement dated August \_\_\_\_, 2005 (the "Agreement").

2. Representations of Optionee. Optionee acknowledges that he/she has received, read and understands the Agreement, the Capstone Turbine Corporation 2000 Equity Incentive Plan (the "2000 Plan") and all materials constituting the prospectus for the option described in the Agreement. Optionee has had opportunity to consult with legal and tax counsel prior to this exercise.

3. Rights as Stockholder. Optionee understands that (i) the Company shall promptly issue (or cause to be issued) Shares to be acquired upon the exercise signified in this notice, (ii) Optionee has no right to vote or receive dividends or any other rights as a stockholder with respect to Shares covered hereby until the Shares are issued, as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company, (iii) no adjustment will be made for a dividend or other right for which the record date is prior to the date the Shares are issued, except as provided in Section 15 of the 2000 Plan.

4. Tax Consultation. Optionee acknowledges that adverse tax consequences can result from the purchase or disposition of the Shares. Optionee represents that Optionee has consulted with any tax advisors that Optionee deems appropriate in connection with the purchase or disposition of the Shares and that Optionee is not relying on the Company for any tax advice.

5. Successors and Assigns. The Company may assign any of its rights under this notice to single or multiple assignees, and this notice shall inure to the benefit of the successors and assigns of the Company. This notice shall be binding upon Optionee and his heirs, executors, administrators, successors and assigns.

6. Interpretation. Any dispute regarding the interpretation of this notice shall be submitted by Optionee or by the Company forthwith to the Company's Board of Directors or the committee thereof that administers the 2000 Plan (the "Committee"), which shall review such dispute at its next regular meeting. The resolution of such a dispute by the Committee shall be final and binding on the Company and on Optionee.

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7. Governing Law; Severability. This notice shall be governed by and construed in accordance with the laws of the State of Delaware excluding that body of law pertaining to conflicts of law. Should any provision of this notice be determined by a court of law to be illegal or unenforceable, the other provisions shall nevertheless remain effective and shall remain enforceable.

8. Notices. Any notice required or permitted hereunder shall be given in writing and shall be deemed effectively given upon personal delivery or upon deposit in the United States mail by certified mail, with postage and fees prepaid, addressed to the other party at its address as shown below beneath its signature, or to such other address as such party may designate in writing from time to time to the other party.

9. Further Instruments. The parties agree to execute such further instruments and to take such further action as may be reasonably necessary to carry out the purposes and intent of this notice.

10. Delivery of Payment. Optionee herewith delivers to the Company the full Exercise Price for the Shares, as well as any applicable withholding tax.

11. Entire Agreement. The 2000 Plan and the Agreement are incorporated herein by reference. This notice, the 2000 Plan and the Agreement constitute the entire agreement of the parties and supersede in their entirety all prior undertakings and agreements of the Company and Optionee with respect to the subject matter hereof.

Submitted by:

Accepted by:

CAPSTONE TURBINE CORPORATION

\_\_\_\_\_  
OPTIONEE: Walter J. McBride

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

Name: \_\_\_\_\_

Title \_\_\_\_\_



## CAPSTONE TURBINE CORPORATION

## 2000 EQUITY INCENTIVE PLAN

## Stock Option Agreement

## NOTICE OF STOCK OPTION GRANT

## [Employee Name &amp; Address]

You (the "Optionee") have been granted a Stock Option (the "Option") to purchase Common Stock of the Company, subject to the terms and conditions of the Capstone Turbine Corporation 2000 Equity Incentive Plan (the "Plan") and this Stock Option Agreement. The terms of your grant are set forth below:

## I. NOTICE OF STOCK OPTION GRANT

Notice is hereby given of the grant of the Option, subject to the following terms. References in this Agreement to certain terms of the Option shall be as defined in this Article I:

Date of Grant: \_\_\_\_\_, 20\_\_\_\_

Exercise Price: \$ \_\_\_\_\_ per Share

Total Number of Shares:

Total Exercise Price: \$ \_\_\_\_\_

Type of Option: \_\_\_\_\_ Non-Qualified Stock Option  
 \_\_\_\_\_ Incentive Stock Option

Term: 10 years commencing on Date of Grant

**Exercise and Vesting Schedule:**

This Option shall vest and become exercisable on the dates and as described in this paragraph, subject to the Optionee continuing to be either an Employee or a Consultant to the Company on such vesting dates. On the first anniversary of the Date of Grant, Optionee shall be vested in and have the right to exercise the Option with respect to one-fourth of the Shares subject to this Option. Thereafter, Optionee shall become vested in and have the right to exercise this Option with respect to 1/48<sup>th</sup> of the number of Shares subject to the Option on the day of each month corresponding to the Date of Grant, so that the Option shall be fully vested and exercisable on the fourth anniversary of the Date of Grant.

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### **Option Termination:**

The Option shall terminate on the tenth anniversary of the Date of Grant; provided, however, that if Optionee ceases to be either an Employee or a Consultant prior thereto, the Option shall terminate earlier pursuant to the terms of Sections 10(d), 10(e), and 10(f) of the Plan.

## **II. AGREEMENT**

1. Grant of Option. The Option to purchase the Shares of Common Stock is subject to the terms set forth in Article I of this Agreement. Except as expressly provided for herein, this Option is also subject to the terms, definitions and provisions of the Plan, which are incorporated herein by reference. All capitalized terms used in this Agreement shall have the meanings ascribed to such terms in the Plan, except as may be otherwise defined herein.

If designated in the Notice of Stock Option Grant as an Incentive Stock Option, the Option is intended to qualify as an incentive stock option as defined in Section 422 of the Internal Revenue Code; provided, however, that to the extent that the aggregate Fair Market Value of stock with respect to which incentive stock options (within the meaning of Code Section 422, but without regard to Code Section 422(d)), including the Option, are exercisable for the first time by the Optionee during any calendar year (under the Plan and all other incentive stock option plans of the Company or any Subsidiary) exceeds \$100,000, such options shall be treated as not qualifying under Code Section 422, but rather shall be treated as Non-Qualified Stock Options to the extent required by Code Section 422. The rule set forth in the preceding sentence shall be applied by taking options into account in the order in which they were granted. For purposes of these rules, the Fair Market Value of stock shall be determined as of the time the Option with respect to such stock is granted.

2. Exercise of Option. The Option shall be exercisable cumulatively according to the vesting schedule set forth in Article I of this Agreement, based on Optionee's continued status as an Employee or a Consultant, and subject to the procedures and methods for payment set forth in the Plan. Any portion of the exercisable portion of the Option may be exercised at any time by the Optionee until the Option has terminated.

3. Lock-Up Period. Optionee hereby agrees that if so requested by the Company or any representative of the underwriters (the "Managing Underwriter") in connection with any registration of the offering of any securities of the Company under the Securities Act or any applicable state laws, Optionee shall not sell or otherwise transfer any Shares or other securities of the Company during the 180-day period (or such longer period as may be requested in writing by the Managing Underwriter and agreed to in writing by the Company) (the "Market Standoff Period") following the effective date of a registration statement of the Company filed under the Securities Act. The Company may impose stop-transfer instructions with respect to securities subject to the foregoing restrictions until the end of such Market Standoff Period.

4. Non-Transferability of Option. The Option may not be transferred in any manner except by will or by the laws of descent or distribution. It may be exercised during the lifetime of

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Optionee only by Optionee. The terms of the Option shall be binding upon the executors, administrators, heirs, successors and assigns of the Optionee.

This Agreement may be executed in two or more counterparts, each of which shall be deemed an original and all of which shall constitute one document.

CAPSTONE TURBINE CORPORATION

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

Name: Walter J. McBride

Title: Chief Financial Officer

OPTIONEE ACKNOWLEDGES AND AGREES THAT THE VESTING OF SHARES PURSUANT TO THE OPTION HEREOF IS EARNED ONLY BY CONTINUING EMPLOYMENT OR CONSULTANCY AT THE WILL OF THE COMPANY (NOT THROUGH THE ACT OF BEING HIRED, BEING GRANTED THE OPTION OR ACQUIRING SHARES HEREUNDER). OPTIONEE FURTHER ACKNOWLEDGES AND AGREES THAT NOTHING IN THIS STOCK OPTION AGREEMENT, NOR IN THE CAPSTONE TURBINE CORPORATION 2000 EQUITY INCENTIVE PLAN, WHICH IS INCORPORATED HEREIN BY REFERENCE, SHALL CONFER UPON OPTIONEE ANY RIGHT WITH RESPECT TO CONTINUATION OF EMPLOYMENT OR CONSULTANCY BY THE COMPANY, NOR SHALL IT INTERFERE IN ANY WAY WITH OPTIONEE'S RIGHT OR THE COMPANY'S RIGHT TO TERMINATE OPTIONEE'S EMPLOYMENT OR CONSULTANCY AT ANY TIME, WITH OR WITHOUT CAUSE.

Optionee hereby acknowledges receipt of the Plan and a current prospectus for the offering represented by the grant of this Option. Optionee represents that he is familiar with the terms and provisions of the Plan and this Agreement and does hereby accept the Option subject to all of its terms. Optionee has had an opportunity to obtain the advice of counsel prior to executing this Agreement and fully understands all provisions of this Agreement and the Option granted hereunder. Optionee hereby agrees to accept as binding, conclusive and final all decisions or interpretations of the Committee upon any questions arising under the Plan or this Agreement. Optionee further agrees to notify the Company upon any change in the residence address indicated below.

Dated: \_\_\_\_\_, 20\_\_\_\_

\_\_\_\_\_  
[name of optionee]

Residence Address: \_\_\_\_\_

\_\_\_\_\_

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## EXHIBIT A

### CAPSTONE TURBINE CORPORATION

#### NOTICE OF EXERCISE

Capstone Turbine Corporation  
21211 Nordhoff Street  
Chatsworth, CA 91311

Attention: Corporate Secretary

1. **Exercise of Option.** Effective as of today, \_\_\_\_\_, 20\_\_\_\_, the undersigned (“Optionee”) hereby elects to exercise the right to purchase \_\_\_\_\_ shares of the Common Stock (the “Shares”) of Capstone Turbine Corporation (the “Company”) under and pursuant to the terms of that certain option granted on [**grant date**], as evidenced in an agreement dated \_\_\_\_\_, 20\_\_\_\_ (the “Agreement”).

2. **Representations of Optionee.** Optionee acknowledges that he/she has received, read and understands the Agreement, the Capstone Turbine Corporation 2000 Equity Incentive Plan (the “Plan”) and all materials constituting the prospectus for the option described in the Agreement. Optionee has had opportunity to consult with legal and tax counsel prior to this exercise.

3. **Rights as Stockholder.** Optionee understands that (i) the Company shall promptly issue (or cause to be issued) Shares to be acquired upon the exercise signified in this notice, (ii) Optionee has no right to vote or receive dividends or any other rights as a stockholder with respect to Shares covered hereby until the Shares are issued, as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company, (iii) no adjustment will be made for a dividend or other right for which the record date is prior to the date the Shares are issued, except as provided in Section 15 of the Plan.

4. **Tax Consultation.** Optionee acknowledges that adverse tax consequences can result from the purchase or disposition of the Shares. Optionee represents that Optionee has consulted with any tax advisors that Optionee deems appropriate in connection with the purchase or disposition of the Shares and that Optionee is not relying on the Company for any tax advice.

5. **Successors and Assigns.** The Company may assign any of its rights under this notice to single or multiple assignees, and this notice shall inure to the benefit of the successors and assigns of the Company. This notice shall be binding upon Optionee and his heirs, executors, administrators, successors and assigns.

6. **Interpretation.** Any dispute regarding the interpretation of this notice shall be submitted by Optionee or by the Company forthwith to the Company’s Board of Directors or the committee thereof that administers the Plan (the “Committee”), which shall review such dispute at its next regular meeting. The resolution of such a dispute by the Committee shall be final and binding on the Company and on Optionee.

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7. Governing Law; Severability. This notice shall be governed by and construed in accordance with the laws of the State of Delaware excluding that body of law pertaining to conflicts of law. Should any provision of this notice be determined by a court of law to be illegal or unenforceable, the other provisions shall nevertheless remain effective and shall remain enforceable.

8. Notices. Any notice required or permitted hereunder shall be given in writing and shall be deemed effectively given upon personal delivery or upon deposit in the United States mail by certified mail, with postage and fees prepaid, addressed to the other party at its address as shown below beneath its signature, or to such other address as such party may designate in writing from time to time to the other party.

9. Further Instruments. The parties agree to execute such further instruments and to take such further action as may be reasonably necessary to carry out the purposes and intent of this notice.

10. Delivery of Payment. Optionee herewith delivers to the Company the full Exercise Price for the Shares, as well as any applicable withholding tax.

11. Entire Agreement. The Plan and the Agreement are incorporated herein by reference. This notice, the Plan and the Agreement constitute the entire agreement of the parties and supersede in their entirety all prior undertakings and agreements of the Company and Optionee with respect to the subject matter hereof.

Submitted by:

Accepted by:

CAPSTONE TURBINE CORPORATION

OPTIONEE:

By:

Name:

Title













CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER  
PURSUANT TO  
RULE 13a-14(b)/RULE 15d-14(b) OF THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED,  
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 of Capstone Turbine Corporation (the "Company") on Form 10-Q for the quarterly period ended September 30, 2005, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), John R. Tucker, Chief Executive Officer of the Company, and Walter J. McBride, Chief Financial Officer of the Company, certify, pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (Subsections (a) and (b) of Section 1350, Chapter 63 of Title 18, United States Code), that the Report complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ JOHN R. TUCKER  
John R. Tucker  
President and Chief Executive Officer

By: /s/ WALTER J. McBRIDE  
Walter J. McBride  
Chief Financial Officer

Date: November 9, 2005