

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

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended July 3, 2010

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 001-33170



**NETLIST, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**

State or other jurisdiction of incorporation or organization

**95-4812784**

(I.R.S. Employer Identification No.)

**51 Discovery, Suite 150**

**Irvine, CA 92618**

(Address of principal executive offices) (Zip Code)

**(949) 435-0025**

(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The number of shares outstanding of each of the registrant's classes of common stock as of the latest practicable date:

Common Stock, par value \$0.001 per share  
25,266,327 shares outstanding at July 30, 2010

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**NETLIST, INC. AND SUBSIDIARIES  
QUARTERLY REPORT ON FORM 10-Q  
FOR THE THREE AND SIX MONTHS ENDED JULY 3, 2010**

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

**NETLIST, INC. AND SUBSIDIARIES**  
**Condensed Consolidated Balance Sheets**  
(in thousands, except par value)

	(unaudited) July 3, 2010	(audited) January 2, 2010
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 16,993	\$ 9,942
Investments in marketable securities	5,211	3,949
Accounts receivable, net	7,119	4,273
Inventories	4,259	2,232
Prepaid expenses and other current assets	687	854
Total current assets	<u>34,269</u>	<u>21,250</u>
Property and equipment, net	4,085	4,779
Long-term investments in marketable securities	902	941
Other assets	242	221
Total assets	<u>\$ 39,498</u>	<u>\$ 27,191</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 6,179	\$ 4,057
Accrued payroll and related liabilities	1,839	2,332
Accrued expenses and other current liabilities	507	605
Accrued engineering charges	1,431	661
Current portion of long-term debt	92	108
Deferred gain on sale and leaseback transaction	49	108
Total current liabilities	<u>10,097</u>	<u>7,871</u>
Long-term debt, net of current portion	10	51
Total liabilities	<u>10,107</u>	<u>7,922</u>
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value - 90,000 shares authorized; 25,266 (2010) and 20,111 (2009) shares issued and outstanding	25	20
Additional paid-in capital	88,435	71,332
Accumulated deficit	(58,965)	(52,026)
Accumulated other comprehensive loss	(104)	(57)
Total stockholders' equity	<u>29,391</u>	<u>19,269</u>
Total liabilities and stockholders' equity	<u>\$ 39,498</u>	<u>\$ 27,191</u>

See accompanying notes.

**NETLIST, INC. AND SUBSIDIARIES**  
**Unaudited Condensed Consolidated Statements of Operations**  
(in thousands, except per share amounts)

	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Net sales	\$ 9,304	\$ 3,173	\$ 17,194	\$ 5,335
Cost of sales(1)	7,486	2,929	13,558	5,628
Gross profit (loss)	1,818	244	3,636	(293)
Operating expenses:				
Research and development(1)	3,190	2,030	6,198	3,644
Selling, general and administrative(1)	2,607	2,120	5,177	4,055
Total operating expenses	5,797	4,150	11,375	7,699
Operating loss	(3,979)	(3,906)	(7,739)	(7,992)
Other income (expense):				
Interest income, net	3	18	4	100
Other income (expense), net	4	(45)	71	130
Total other income (expense), net	7	(27)	75	230
Loss before provision (benefit) for income taxes	(3,972)	(3,933)	(7,664)	(7,762)
Provision (benefit) for income taxes	2	31	(725)	49
Net loss	<u>\$ (3,974)</u>	<u>\$ (3,964)</u>	<u>\$ (6,939)</u>	<u>\$ (7,811)</u>
Net loss per common share:				
Basic and diluted	\$ (0.16)	\$ (0.20)	\$ (0.31)	\$ (0.39)
Weighted-average common shares outstanding:				
Basic and diluted	24,780	19,855	22,734	19,855

(1) Amounts include stock-based compensation expense as follows:

Cost of sales	\$ 12	\$ 38	\$ 22	\$ 67
Research and development	117	48	163	106
Selling, general and administrative	297	204	623	424

See accompanying notes.

**NETLIST, INC. AND SUBSIDIARIES**  
**Unaudited Condensed Consolidated Statements of Cash Flows**  
(in thousands)

	Six Months Ended	
	July 3, 2010	July 4, 2009
Cash flows from operating activities:		
Net loss	\$ (6,939)	\$ (7,811)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,130	1,150
Amortization of deferred gain on sale and leaseback transaction	(59)	(59)
Gain on disposal of assets	—	(118)
Stock-based compensation	808	597
Changes in operating assets and liabilities:		
Accounts receivable	(2,846)	394
Inventories	(2,027)	(125)
Income taxes receivable	—	1,229
Prepaid expenses and other current assets	167	2
Other assets	(21)	13
Accounts payable	2,078	669
Accrued payroll and related expenses	(493)	35
Accrued expenses and other current liabilities	(98)	84
Accrued engineering charges	770	511
Net cash used in operating activities	<u>(7,530)</u>	<u>(3,429)</u>
Cash flows from investing activities:		
Acquisition of property and equipment	(392)	(56)
Proceeds from sales of equipment	—	342
Purchase of investments in marketable securities	(2,380)	(10,203)
Proceeds from maturities and sales of investments in marketable securities	1,110	6,325
Net cash used in investing activities	<u>(1,662)</u>	<u>(3,592)</u>
Cash flows from financing activities:		
Borrowings on line of credit	2,000	10,325
Payments on line of credit	(2,000)	(8,172)
Proceeds from public offering, net	16,210	—
Proceeds from exercise of stock options and warrants	90	—
Payments on debt	(57)	(240)
Net cash provided by financing activities	<u>16,243</u>	<u>1,913</u>
Increase (decrease) in cash and cash equivalents	7,051	(5,108)
Cash and cash equivalents at beginning of period	9,942	15,214
Cash and cash equivalents at end of period	<u>\$ 16,993</u>	<u>\$ 10,106</u>
Supplemental disclosure of non-cash investing activities:		
Unrealized losses (gains) from investments in marketable securities	<u>\$ 47</u>	<u>\$ (38)</u>
Increase in purchases of property and equipment accrued in accounts payable	<u>\$ 44</u>	<u>\$ —</u>

See accompanying notes.

**NETLIST, INC. AND SUBSIDIARIES**  
**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**July 3, 2010**

**Note 1—Description of Business**

Netlist, Inc. (the “Company” or “Netlist”) designs, manufactures and sells high-performance, logic-based memory subsystems for the server, storage and communications equipment markets. The Company’s memory subsystems consist of combinations of dynamic random access memory integrated circuits, NAND flash memory, application-specific integrated circuits (“ASICs”) and other components assembled on printed circuit boards. The Company primarily markets and sells its products to leading original equipment manufacturer (“OEM”) customers. Netlist’s solutions are targeted at applications where memory plays a key role in meeting system performance requirements.

**Note 2—Summary of Significant Accounting Policies**

*Basis of Presentation*

The interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (the “U.S.”) for interim financial information and with the instructions to Securities and Exchange Commission (“SEC”) Form 10-Q and Article 8 of SEC Regulation S-X. These financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the U.S. for complete financial statements. Therefore, these unaudited condensed consolidated financial statements should be read in conjunction with the Company’s audited consolidated financial statements and notes thereto for the year ended January 2, 2010, included in the Company’s Annual Report on Form 10-K filed with the SEC on February 19, 2010.

The condensed consolidated financial statements included herein as of July 3, 2010 are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of the Company’s management, are necessary to present fairly the condensed consolidated financial position of the Company and its wholly owned subsidiaries as of July 3, 2010, the condensed consolidated results of its operations for the three and six months ended July 3, 2010 and July 4, 2009, and the condensed consolidated cash flows for the six months ended July 3, 2010 and July 4, 2009. The results of operations for the three and six months ended July 3, 2010 are not necessarily indicative of the results to be expected for the full year or any future interim periods.

*Reclassifications*

Certain amounts in the 2009 financial statements have been reclassified to conform with the current year presentation.

*Principles of Consolidation*

The condensed consolidated financial statements include the accounts of Netlist, Inc. and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

*Fiscal Year*

The Company operates under a 52/53-week fiscal year ending on the Saturday closest to December 31. For fiscal 2010, the Company’s fiscal year is scheduled to end on January 1, 2011 and will consist of 52 weeks. Each of the Company’s first three quarters in a fiscal year is comprised of 13 weeks.

*Use of Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the condensed consolidated financial statements, and the reported amounts of net sales and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. Significant estimates made by management include, among others, provisions for uncollectible receivables and sales returns, warranty liabilities, valuation of inventories, fair value of financial instruments, impairment of long-lived assets, stock-based compensation expense and realization of deferred tax assets. The Company bases its estimates on historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. The Company reviews its estimates on an on-going basis. The actual results experienced by the Company may differ materially and adversely from its estimates. To the extent there are material differences between the estimates and the actual results, future results of operations will be affected.

*Revenue Recognition*

The Company's revenues primarily consist of product sales of high-performance memory subsystems to OEMs. Revenues also include sales of excess component inventories to distributors and other users of memory integrated circuits ("ICs"). Such sales amounted to less than \$0.1 million for each of the three and six months ended July 3, 2010, and totaled approximately \$0.1 million for each of the three and six months ended July 4, 2009.

The Company recognizes revenues in accordance with the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 605. Accordingly, the Company recognizes revenues when there is persuasive evidence of an arrangement, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

The Company generally uses customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with FOB Shipping Point terms and upon receipt for customers with FOB Destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. The Company assesses whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund. Customers are generally allowed limited rights of return for up to 30 days, except for sales of excess component inventories, which contain no right-of-return privileges. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. The Company offers a standard product warranty to its customers and has no other post-shipment obligations. The Company assesses collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer's payment history.

All amounts billed to customers related to shipping and handling are classified as revenues, while all costs incurred by the Company for shipping and handling are classified as cost of sales.

*Cash and Cash Equivalents*

Cash and cash equivalents consist of cash and short-term investments with original maturities of three months or less, other than short-term investments in securities that lack an active market.

*Investments in Marketable Securities*

The Company accounts for its investments in marketable securities in accordance with ASC Topic 320. The Company determines the appropriate classification of its investments at the time of purchase and reevaluates such designation at each balance sheet date. The Company's investments in marketable securities have been classified and accounted for as available-for-sale based on management's investment intentions relating to these securities. Available-for-sale securities are stated at market value, generally based on market quotes, to the extent they are available. Unrealized gains and losses, net of applicable deferred taxes, are recorded as a component of other comprehensive income (loss). Realized gains and losses and declines in value judged to be other than temporary are determined based on the specific identification method and are reported in other income, net in the unaudited condensed consolidated statements of operations.

The Company generally invests its excess cash in domestic bank-issued certificates of deposit which carry federal deposit insurance, money market funds and in highly liquid debt instruments of U.S. municipalities, corporations and the U.S. government and its agencies. All highly liquid investments with stated maturities of three months or less from the date of purchase are classified as cash equivalents; all investments with stated maturities of greater than three months are classified as investments in marketable securities.

*Fair Value of Financial Instruments*

The Company's financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities (see Note 4) commercial paper and short-term corporate bonds, the fair value of the Company's cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. Because of their short-term nature, commercial paper and short-term corporate bonds are not frequently traded. Although there are observable quotes for these securities, the markets are not considered active. Accordingly, the fair values of these investments are based on Level 2 inputs. The Company recognizes transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. The Company believes that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

*Allowance for Doubtful Accounts*

The Company evaluates the collectibility of accounts receivable based on a combination of factors. In cases where the Company is aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, the Company will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount the Company reasonably believes will be collected. For all other customers, the Company records allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and its historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted.

*Concentration of Credit Risk*

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash and cash equivalents, investments in marketable securities, and accounts receivable.

The Company invests its cash equivalents primarily in money market funds. Cash equivalents are maintained with high quality institutions, the composition and maturities of which are regularly monitored by management. The Company had \$0.5 million of Federal Deposit Insurance Corporation insured cash and cash equivalents at July 3, 2010. Investments in marketable securities are generally in high-credit quality debt instruments with an active resale market. Such investments are made only in instruments issued or enhanced by high-quality institutions. The Company has not incurred any credit risk losses related to these investments.

The Company's trade accounts receivable are primarily derived from sales to OEMs in the computer industry. The Company performs credit evaluations of its customers' financial condition and limits the amount of credit extended when deemed necessary, but generally requires no collateral. The Company believes that the concentration of credit risk in its trade receivables is moderated by its credit evaluation process, relatively short collection terms, the high level of credit worthiness of its customers (see Note 3), and foreign credit insurance. Reserves are maintained for potential credit losses, and such losses historically have not been significant and have been within management's expectations.

*Inventories*

Inventories are valued at the lower of actual cost to purchase or manufacture the inventory or net realizable value of the inventory. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. At each balance sheet date, the Company evaluates its ending inventory quantities on hand and on order and records a provision for excess quantities and obsolescence. Among other factors, the Company considers historical demand and forecasted demand in relation to the inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value of raw material inventory. Provisions are made to reduce excess or obsolete inventories to their estimated net realizable values. Once established, write-downs are considered permanent adjustments to the cost basis of the excess or obsolete inventories.

*Property and Equipment*

Property and equipment are recorded at cost and depreciated on a straight-line basis over their estimated useful lives, which generally range from three to seven years. Leasehold improvements are recorded at cost and amortized on a straight-line basis over the shorter of their estimated useful lives or the remaining lease term.

*Impairment of Long-Lived Assets*

The Company evaluates the recoverability of the carrying value of long-lived assets held and used in its operations for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their net book value may not be recoverable. When such factors and circumstances exist, the Company compares the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. These projected future cash flows may vary significantly over time as a result of increased competition, changes in technology, fluctuations in demand, consolidation of our customers and reductions in average selling prices. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows.

*Warranties*

The Company offers warranties generally ranging from one to three years, depending on the product and negotiated terms of the purchase agreements with customers. Such warranties require the Company to repair or replace defective product returned to the Company during the warranty period at no cost to the customer. Warranties are not offered on sales of excess component inventory. The Company records an estimate for warranty-related costs at the time of sale based on its historical and estimated product return rates and expected repair or replacement costs (see Note 3). Such costs have historically been consistent between periods and within management's expectations and the provisions established.

*Stock-Based Compensation*

The Company accounts for equity issuances to non-employees in accordance with ASC Topic 505. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date used to determine the fair value of the equity instrument issued is the earlier of the date on which the third-party performance is complete or the date on which it is probable that performance will occur.

In accordance with ASC Topic 718, employee and director stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Given that stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. ASC Topic 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. The Company's estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The fair value of common stock option awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, which affect the estimated fair values of the Company's common stock option awards. The expected term of options granted is calculated as the average of the weighted vesting period and the contractual expiration date of the option. This calculation is based on the safe harbor method permitted by the SEC in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. Prior to fiscal 2009, the expected volatility was based on the historical volatilities of the common stock of comparable publicly traded companies based on management's belief that the Company had limited historical data regarding the volatility of its stock price on which to base a meaningful estimate of expected volatility. Beginning in fiscal 2009, the expected volatility is based on the historical volatility of the Company's common stock. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividend assumption is based on the Company's history and management's expectation regarding dividend payouts. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award.

The Company recognizes the fair value of restricted stock awards issued to employees and outside directors as stock-based compensation expense on a straight-line basis over the vesting period for the last separately vesting portion of the awards. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock award, if any, reduced by expected forfeitures.

*Income Taxes*

Under ASC Topic 270, the Company is required to adjust its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. The Company is also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.

Deferred tax assets and liabilities are recognized to reflect the estimated future tax effects, calculated at currently effective tax rates, of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the condensed consolidated financial statements. A valuation allowance related to a net deferred tax asset is recorded when it is more likely than not that some portion of the deferred tax asset will not be realized.

ASC Topic 740 prescribes a recognition threshold and measurement requirement for the financial statement recognition of a tax position that has been taken or is expected to be taken on a tax return and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under ASC Topic 740 the Company may only recognize or continue to recognize tax positions that meet a “more likely than not” threshold.

#### *Research and Development Expenses*

Research and development expenditures are expensed in the period incurred.

#### *Collaborative Arrangement*

The Company has entered into a collaborative arrangement with a partner in order to develop products using certain of the Company’s proprietary technology. Under the arrangement, the development partner was granted a non-exclusive license to specified intellectual property for exclusive use in the development and production of ASIC chipsets for the Company. Both the Company and the development partner provided and continue to provide engineering project management resources at their own expense. The development partner is entitled to non-recurring engineering fees based upon the achievement of development milestones, and to a minimum portion of the Company’s purchasing allocations for the component. Expenses incurred and paid to the development partner are included in research and development expense in the accompanying condensed consolidated statements of operations.

#### *Comprehensive Loss*

ASC Topic 220 establishes standards for reporting and displaying comprehensive income and its components in the condensed consolidated financial statements. Accumulated other comprehensive loss includes unrealized gains or losses on investments.

#### *Risks and Uncertainties*

The Company’s operations in the PRC are subject to various political, geographical and economic risks and uncertainties inherent to conducting business in China. These include, but are not limited to, (i) potential changes in economic conditions in the region, (ii) managing a local workforce that may subject the Company to uncertainties or certain regulatory policies, (iii) changes in other policies of the Chinese governmental and regulatory agencies, and (iv) changes in the laws and policies of the U.S. government regarding the conduct of business in foreign countries, generally, or in China, in particular. Additionally, the Chinese government controls the procedures by which its local currency, the Chinese Renminbi (“RMB”), is converted into other currencies and by which dividends may be declared or capital distributed for the purpose of repatriation of earnings and investments. If restrictions in the conversion of RMB or in the repatriation of earnings and investments through dividend and capital distribution restrictions are instituted, the Company’s operations and operating results may be negatively impacted. Restricted net assets of our subsidiary in the PRC totaled \$2.7 million at both July 3, 2010 and January 2, 2010.

#### *Foreign Currency Re-measurement*

The functional currency of the Company’s foreign subsidiary is the U.S. dollar. Local currency financial statements are re-measured into U.S. dollars at the exchange rate in effect as of the balance sheet date for monetary assets and liabilities and the historical exchange rate for nonmonetary assets and liabilities. Expenses are re-measured using the average exchange rate for the period, except items related to nonmonetary assets and liabilities, which are re-measured using historical exchange rates. All re-measurement gains and losses are included in determining net loss.

#### *Net Loss Per Share*

Basic net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period, excluding unvested shares issued pursuant to restricted share awards under our share-based compensation plans. Diluted net loss per share is calculated by dividing the net loss by the weighted-average shares and dilutive potential common shares outstanding during the period. Dilutive potential shares consist of dilutive shares issuable upon the exercise or vesting of outstanding stock options and restricted stock awards, respectively, and the exercise of warrants, computed using the treasury stock method. In periods of losses, basic and diluted loss per share are the same, as the effect of stock options, unvested restricted share awards and warrants on loss per share is anti-dilutive.

*New Accounting Pronouncements*

In September 2009, the FASB issued Accounting Standards Update (“ASU”) 2009-13, *Multiple-Deliverable Revenue Arrangements* (“ASU 2009-13”), which amends the revenue guidance under ASC Topic 605, which describes the accounting for multiple element arrangements. ASU 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how arrangement consideration shall be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-13 is effective on a prospective basis for the Company’s fiscal year 2011, with earlier adoption permitted. The Company is currently evaluating the adoption of ASU 2009-13 and the impact that ASU 2009-13 will have on its condensed consolidated financial statements.

In September 2009, the FASB issued ASU 2009-14, *Certain Revenue Arrangements That Include Software Elements* (“ASU 2009-14”), which excludes tangible products containing software components and non-software components that function together to deliver the product’s essential functionality from the scope of ASC Topic 985, which describes the accounting for software revenue recognition. ASU 2009-14 is effective on a prospective basis for the Company’s fiscal year 2011, with earlier adoption permitted. The Company is currently evaluating the impact that ASU 2009-14 will have on its condensed consolidated financial statements.

**Note 3—Supplemental Financial Information***Inventories*

Inventories consist of the following (in thousands):

	<u>July 3, 2010</u>	<u>January 2, 2010</u>
Raw materials	\$ 2,334	\$ 997
Work in process	656	342
Finished goods	1,269	893
	<u>\$ 4,259</u>	<u>\$ 2,232</u>

*Warranty Liability*

The following table summarizes the activity related to the warranty liability (in thousands):

	<u>Six Months Ended</u>	
	<u>July 3, 2010</u>	<u>July 4, 2009</u>
Beginning balance	\$ 240	\$ 277
Charged to costs and expenses	81	92
Usage	(111)	(108)
Ending balance	<u>\$ 210</u>	<u>\$ 261</u>

The warranty liability is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets.

*Facility Relocation Costs*

The following table summarizes the activity related to the Company's accrual for facility relocation costs during the six months ended July 3, 2010 and July 4, 2009 (in thousands):

	<u>Six Months Ended</u>	
	<u>July 3, 2010</u>	<u>July 4, 2009</u>
Beginning balance	\$ 84	\$ 80
(Reduction) increase in expected costs	(28)	61
Net payments	(6)	(17)
Ending balance	<u>\$ 50</u>	<u>\$ 124</u>

In May 2009, the Company entered into an agreement to sublease a portion of its new domestic headquarters facility to another tenant at a discount from the rent required under its lease commitment. As a result, the Company recorded an additional charge of approximately \$61,000. In February 2010, the sublessor vacated the space that it had subleased. The Company determined that the space could be used in its operations. As a result, the Company reversed \$28,000 of its accrual for facility relocation costs. The resulting expense increase and reduction are included as a component of selling, general and administrative expenses in the accompanying condensed consolidated statement of operations for the six months ended July 3, 2010 and July 4, 2009.

The liability for facility relocation costs is included as a component of accrued expenses and other current liabilities in the accompanying condensed consolidated balance sheets.

*Comprehensive Loss*

The components of comprehensive loss, net of taxes, consist of the following (in thousands):

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 3, 2010</u>	<u>July 4, 2009</u>	<u>July 3, 2010</u>	<u>July 4, 2009</u>
Net loss	\$ (3,974)	\$ (3,964)	\$ (6,939)	\$ (7,811)
Other comprehensive loss:				
Change in net unrealized gain (loss) on investments, net of tax	(12)	6	(47)	38
Total comprehensive loss	<u>\$ (3,986)</u>	<u>\$ (3,958)</u>	<u>\$ (6,986)</u>	<u>\$ (7,773)</u>

Accumulated other comprehensive loss reflected on the condensed consolidated balance sheets at July 3, 2010 and January 2, 2010, represents accumulated net unrealized losses on investments in marketable securities.

*Computation of Net Loss Per Share*

Basic and diluted net loss per share is calculated by dividing net loss by the weighted-average common shares outstanding during the period. The following table sets forth the computation of net loss per share (in thousands, except per share data):

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 3, 2010</u>	<u>July 4, 2009</u>	<u>July 3, 2010</u>	<u>July 4, 2009</u>
Numerator: Net loss	\$ (3,974)	\$ (3,964)	\$ (6,939)	\$ (7,811)
Denominator: Weighted-average common shares outstanding, basic and diluted	24,780	19,855	22,734	19,855
Net loss per share, basic and diluted	<u>\$ (0.16)</u>	<u>\$ (0.20)</u>	<u>\$ (0.31)</u>	<u>\$ (0.39)</u>

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The following table sets forth potentially dilutive common share equivalents, consisting of shares issuable upon the exercise or vesting of outstanding stock options and restricted stock awards, respectively, and the exercise of warrants, computed using the treasury stock method. These potential common shares have been excluded from the diluted net loss per share calculations above as their effect would be anti-dilutive for the periods then ended (in thousands):

	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Common share equivalents	1,798	388	2,070	277

The above common share equivalents would have been included in the calculation of diluted earnings per share had the Company reported net income for the periods then ended.

### Major Customers

Net sales to some of the Company's OEM customers include memory modules that are qualified by the Company directly with the OEM customer and sold to electronic manufacturing services providers ("EMSs"), for incorporation into products manufactured exclusively for the OEM customer or in some instances, to facilitate credit and logistics. These net sales to EMSs have historically fluctuated period to period as a portion of the total net sales to the OEM customers. Net sales to Hon Hai Precision Industry Co. Ltd., an EMS operating under the trade name Foxconn that purchases memory modules from the Company for incorporation into products manufactured exclusively for Dell, Inc. ("Dell"), represented approximately 92% and 58% of net sales to Dell for the six months ended July 3, 2010 and July 4, 2009, respectively. Arrow Electronics Inc. ("Arrow") is an EMS for DRS Electronics, Inc. ("DRS Electronics"). Substantially all of the Company's products sold to Arrow are incorporated into components manufactured for DRS Electronics. Similarly, Flextronics International Ltd. ("Flextronics") distributes substantially all of the products purchased from the Company to F5 Networks, Inc. ("F5 Networks"). The following table sets forth sales to customers comprising 10% or more of the Company's net sales for the periods presented:

Customer:	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Dell (including Foxconn)	49%	60%	44%	49%
Flextronics (F5 Networks)	32%	*%	32%	*%
Arrow Electronics (DRS Electronics)	*%	15%	*%	17%

\* less than 10% of net sales

The Company's accounts receivable are concentrated with two customers at July 3, 2010 representing approximately 48% and 40%, and two customers at January 2, 2010, representing approximately 68% and 10%, of aggregate gross receivables. A significant reduction in sales to, or the inability to collect receivables from, a significant customer could have a material adverse impact on the Company. The Company mitigates risk associated with foreign receivables by purchasing comprehensive foreign credit insurance.

### Cash Flow Information

The following table sets forth cash received (paid) for income taxes and interest for the periods presented (in thousands):

	Six Months Ended	
	July 3, 2010	July 4, 2009
Income taxes	\$ 725	\$ (12)
Interest	\$ (36)	\$ (29)

**Note 4—Fair Value Measurements**

The following tables detail the fair value measurements within the fair value hierarchy of the Company's investments in marketable securities (in thousands):

	Fair Value at July 3, 2010	Fair Value Measurements at July 3, 2010 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale debt securities:				
Obligations of the U.S. government	\$ 1,000	\$ 1,000	\$ —	\$ —
Federal agency notes and bonds	500	500	—	—
Commercial paper	1,049	—	1,049	—
Corporate notes and bonds	2,662	—	2,662	—
Auction and variable floating rate notes	902	—	—	902
<b>Total</b>	<b>\$ 6,113</b>	<b>\$ 1,500</b>	<b>\$ 3,711</b>	<b>\$ 902</b>

	Fair Value at January 2, 2010	Fair Value Measurements at January 2, 2010 Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Available for sale debt securities:				
Obligations of the U.S. government	\$ 997	\$ 997	\$ —	\$ —
Federal agency notes and bonds	61	61	—	—
Commercial paper	1,048	1,048	—	—
Corporate notes and bonds	1,843	1,843	—	—
Auction and variable floating rate notes	941	—	—	941
<b>Total</b>	<b>\$ 4,890</b>	<b>\$ 3,949</b>	<b>\$ —</b>	<b>\$ 941</b>

As of January 3, 2010, the Company reclassified its investments in commercial paper and corporate notes and bonds, with a fair value of \$2,891,000, from assets measured at fair value using Level 1 inputs to assets measured at fair value using Level 2 inputs. The transfer resulted solely from management's reassessment of the level of activity in the secondary market for these investments, which historically has been low due to the short-term nature of the instruments. Management does not believe that the reassessment in any way reflects a change in the actual liquidity or credit quality of these investments. The reassessment was precipitated by a change in custodial institutions in connection with the Company's new revolving credit agreement (see Note 6).

Fair value measurements using Level 3 inputs in the table above relate to the Company's investments in auction rate securities. Level 3 inputs are unobservable inputs used to estimate the fair value of assets or liabilities and are utilized to the extent that observable inputs are not available.

The following table provides a reconciliation of the beginning and ending balances for the Company's assets measured at fair value using Level 3 inputs (in thousands):

	Six Months Ended	
	July 3, 2010	July 4, 2009
Beginning balance	\$ 941	\$ 960
Unrealized loss included in accumulated other comprehensive loss	(39)	19
<b>Ending balance</b>	<b>\$ 902</b>	<b>\$ 979</b>

**Note 5—Investments in Marketable Securities**

Investments in marketable securities consist of the following (in thousands):

	<b>July 3, 2010</b>		
	<b>Amortized Cost</b>	<b>Net Unrealized Gain (Loss)</b>	<b>Fair Value</b>
Obligations of the U.S. government	\$ 999	\$ 1	\$ 1,000
Federal agency notes and bonds	500	—	500
Commercial paper	1,049	—	1,049
Corporate notes and bonds	2,665	(3)	2,662
Auction and variable floating rate notes	1,003	(101)	902
	<u>\$ 6,216</u>	<u>\$ (103)</u>	<u>\$ 6,113</u>
	<b>January 2, 2010</b>		
	<b>Amortized Cost</b>	<b>Net Unrealized Gain (Loss)</b>	<b>Fair Value</b>
Obligations of the U.S. government	\$ 997	\$ —	\$ 997
Federal agency notes and bonds	61	—	61
Commercial paper	1,048	—	1,048
Corporate notes and bonds	1,839	4	1,843
Auction and variable floating rate notes	1,002	(61)	941
	<u>\$ 4,947</u>	<u>\$ (57)</u>	<u>\$ 4,890</u>

Realized gains and losses on the sale of investments in marketable securities are determined using the specific identification method. Net realized gains and losses recorded were not significant in any of the periods reported upon.

The following table provides the breakdown of investments in marketable securities with unrealized losses (in thousands):

	<b>July 3, 2010</b>			
	<b>Continuous Unrealized Loss</b>			
	<b>Less than 12 months</b>		<b>12 months or greater</b>	
	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
Corporate notes and bonds	1,922	(3)	—	—
Auction and variable floating rate notes	—	—	902	(101)
	<u>\$ 1,922</u>	<u>\$ (3)</u>	<u>\$ 902</u>	<u>\$ (101)</u>
	<b>January 2, 2010</b>			
	<b>Continuous Unrealized Loss</b>			
	<b>Less than 12 months</b>		<b>12 months or greater</b>	
	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
Corporate notes and bonds	\$ 366	\$ (1)	—	—
Auction and variable floating rate notes	—	—	941	(61)
	<u>\$ 366</u>	<u>\$ (1)</u>	<u>\$ 941</u>	<u>\$ (61)</u>

As of July 3, 2010 and January 2, 2010, the Company held seven and four investments, respectively, that were in an unrealized loss position.

#### *Auction Rate Securities*

Disruptions in the credit market continue to adversely affect the liquidity and overall market for auction rate securities. As of July 3, 2010 and January 2, 2010, the Company held two investments in auction rate securities with a total purchase cost of \$1.0 million. These two investments represent (i) a Baa1 rated, fully insured debt obligation of a municipality and (ii) an A3 rated debt obligation backed by pools of student loans guaranteed by the U.S. Department of Education. Given the insufficient observable market inputs and related information available, the Company has classified its investments in auction rate securities within Level 3 of the fair value hierarchy (see Note 4).

The Company does not believe that the current illiquidity of its investments in auction rate securities will materially impact its ability to fund its working capital needs, capital expenditures or other business requirements. The Company, however, remains uncertain as to when liquidity will return to the auction rate markets, whether other secondary markets will become available or when the underlying securities may be called by the issuer. Given these and other uncertainties, the Company's investments in auction rate securities have been classified as long-term investments in marketable securities in the accompanying unaudited consolidated balance sheet as of July 3, 2010. The Company has concluded that the estimated gross unrealized losses on these investments, which totaled approximately \$101,000 at July 3, 2010, are temporary because (i) the Company believes that the absence of liquidity that has occurred is due to general market conditions, (ii) the auction rate securities continue to be of a relatively high credit quality and interest is paid as due and (iii) the Company has the intent and ability to hold these investments until a recovery in the market occurs.

#### *Other Investments in Marketable Securities*

Excluding its auction rate securities, the gross unrealized losses on the Company's other investments in marketable securities totaled approximately \$3,000 and \$1,000 as of July 3, 2010 and January 2, 2010, respectively, and are generally due to the ongoing uncertainties in the credit and financial markets, as well as changes in interest rates. The fair value of these investments was determined based on Level 1 and Level 2 inputs, consisting of quoted prices from actual market transactions for identical investments. The Company has determined that the unrealized losses on these investments as of July 3, 2010 are temporary in nature. Factors considered in determining whether impairments are other than temporary include (i) the length of time and extent to which fair value has been less than the amortized cost basis, (ii) the financial condition and near-term prospects of the investee and (iii) the Company's intent and ability to hold an investment for a period of time sufficient to allow for any anticipated recovery in market value.

The Company maintains an investment portfolio of various holdings, types and maturities. The Company invests in instruments that meet high quality credit standards, as specified in its investment policy guidelines. These guidelines generally limit the amount of credit exposure to any one issue, issuer or type of instrument. The fair value of the Company's investments in marketable securities could change significantly in the future and the Company may be required to record other-than-temporary impairment charges or additional unrealized losses in future periods.

The following table presents the amortized cost and fair value of the Company's investments in marketable securities classified as available-for-sale at July 3, 2010 by contractual maturity (in thousands):

Maturity	July 3, 2010	
	Amortized Cost	Fair Value
Less than one year	\$ 5,213	\$ 5,211
One to two years	—	—
Greater than two years*	1,003	902
	<u>\$ 6,216</u>	<u>\$ 6,113</u>

\* Comprised of auction rate securities which generally have reset dates of 90 days or less but final contractual maturity dates in excess of 15 years.

#### Note 6—Credit Agreement

On October 31, 2009, the Company entered into a revolving credit agreement with Silicon Valley Bank. Under the original terms of the credit agreement, the Company could borrow up to the lesser of (i) 80% of eligible accounts receivable, minus \$1.0 million, or (ii) \$5.0 million. The revolving credit agreement was amended on March 24, 2010 to allow for increased accounts receivable eligibility and to remove the \$1.0 million reduction from the calculated accounts receivable borrowing base and further amended on June 30, 2010 to modify certain financial covenants. The credit agreement contains an overall sublimit of \$2.5 million to collateralize the Company's contingent obligations under letters of credit, foreign exchange contracts and cash management services. Amounts outstanding under the overall sublimit reduce the amount available pursuant to the credit agreement. At July 3, 2010, letters of credit in the amount of \$1.8 million were outstanding. The letters of credit expire on September 30, 2010.

Interest is payable monthly at either (i) prime plus 1.25%, as long as the Company maintains \$8.5 million in revolving credit availability plus unrestricted cash on deposit with the financial institution, or (ii) prime plus 2.25%. The minimum monthly interest due is \$3,750 minus the aggregate amount of any interest earned by the bank. The credit agreement matures on October 30, 2010, at which time all advances and interest are due and payable.

The Company's previous credit facility, which consisted of a revolving line of credit and a non-revolving equipment line, expired on August 31, 2009 and all borrowings were repaid to the bank. Interest on the credit facility was payable monthly at the greatest of (i) the sum of the prime rate plus 3%, (ii) the sum of LIBOR plus 6% or (iii) 8%.

The following table presents details of interest expense related to borrowings on revolving credit lines, along with certain other applicable information (in thousands):

	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Interest expense	<u>\$ 13</u>	<u>\$ 9</u>	<u>\$ 24</u>	<u>\$ 12</u>
Outstanding borrowings on the revolving line of credit			<u>July 3, 2010</u>	<u>January 2, 2010</u>
Borrowing availability under the revolving line of credit			<u>\$ —</u>	<u>\$ —</u>
			<u>\$ 3,200</u>	<u>\$ —</u>

Obligations under this revolving credit agreement are secured by a first priority lien on the Company's tangible and intangible assets. In connection with the revolving credit agreement, the Company entered into an Intercompany Subordination Agreement, which provided that one of the Company's subsidiaries, Netlist Technology Texas, LP, is an additional obligor on the revolving credit agreement.

The revolving credit agreement subjects the Company to certain affirmative and negative covenants, including financial covenants with respect to the Company's liquidity and profitability and restrictions on the payment of dividends. As of July 3, 2010, the Company was in compliance with its financial covenants.

**Note 7—Long-Term Debt**

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

	July 3, 2010	January 2, 2010
Obligations under capital leases	\$ 102	\$ 159
Less current portion	(92)	(108)
	<u>\$ 10</u>	<u>\$ 51</u>

Interest expense related to long-term debt is presented in the following table (in thousands):

	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Interest expense	\$ 2	\$ 8	\$ 5	\$ 19

**Note 8—Income Taxes**

The following table sets forth the Company's provision (benefit) for income taxes, along with the corresponding effective tax rates (in thousands, except percentages):

	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Provision (benefit) for income taxes	\$ 2	\$ 31	\$ (725)	\$ 49
Effective tax rate	(0.1)%	(0.8)%	9.5%	(0.6)%

The Company is required to adjust its effective tax rate each quarter to be consistent with the estimated annual effective tax rate. The Company is also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.

During the six months ended July 3, 2010, the Company carried back approximately \$1.7 million of gross net operating losses under the Worker, Homeownership, and Business Act and received a federal income tax refund of approximately \$0.7 million.

The Company evaluates whether a valuation allowance should be established against its deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. Due to uncertainty of future utilization, the Company has provided a full valuation allowance as of July 3, 2010 and January 2, 2010. Accordingly, no benefit has been recognized for net deferred tax assets, including net operating losses that cannot be realized currently via carryback to periods of taxable income.

The Company had unrecognized tax benefits at July 3, 2010 and January 2, 2010 of approximately \$0.1 million that, if recognized, would affect the Company’s annual effective tax rate.

## **Note 9—Commitments and Contingencies**

### *Litigation*

#### *Federal Securities Class Action*

Beginning in May 2007, the Company, certain of its officers and directors, and the Company’s underwriters were named as defendants in four purported class action shareholder complaints, two of which were filed in the U.S. District Court for the Southern District of New York, and two of which were filed in the U.S. District Court for the Central District of California. These purported class action lawsuits were filed on behalf of persons and entities who purchased or otherwise acquired the Company’s common stock pursuant or traceable to the Company’s November 30, 2006 initial public offering (the “IPO”). The lawsuits were consolidated into a single action—*Belodoff v. Netlist, Inc.*, Lead Case No. SACV07-677 DOC (MLGx)—which is currently pending in the Central District of California. Lead Plaintiff filed the Consolidated Complaint in November 2007. Defendants filed their motions to dismiss the Consolidated Complaint in January 2008. The motions to dismiss were taken under submission in April 2008 and on May 30, 2008, the court granted the defendants’ motions. However, plaintiffs were granted the right to amend their complaint and subsequently filed their First Amended Consolidated Class Action Complaint (“Amended Complaint”) in July 2008. The defendants filed motions to dismiss the Amended Complaint in January 2009, and on April 17, 2009, the court granted defendants’ motions to dismiss. However, plaintiffs were again granted the right to amend their complaint. Plaintiffs’ filed their Second Amended Consolidated Class Action Complaint (“Second Amended Complaint”) in May 2009. Generally, the Second Amended Complaint, like the preceding complaints, alleged that the Registration Statement filed by the Company in connection with the IPO contained untrue statements of material fact or omissions of material fact in violation of Sections 11 and 15 of Securities Act of 1933. Defendants filed motions to dismiss the Second Amended Complaint in June 2009. The motions to dismiss were taken under submission in August 2009 and on September 1, 2009, the Court granted the defendants’ motions. However, plaintiffs again were granted the right to amend their complaint.

In December 2008, the parties reached a tentative agreement in principle to settle the class action. In February 2010, the parties executed a Stipulation and Agreement of Settlement documenting the essential terms of the proposed settlement, informed the court of their proposed settlement, and drafted a joint motion to submit to the court for preliminary approval of the proposed settlement. Under the settlement agreement presented to the court for approval, plaintiffs and the class will dismiss all claims, with prejudice, in exchange for a cash payment of \$2.6 million. The Company’s directors’ and officers’ liability insurers will pay the settlement amount in accordance with the Company’s insurance policies.

On April 19, 2010, the court issued an order preliminarily approving the settlement. A final settlement approval hearing is scheduled to be held on September 30, 2010. Despite the proposed agreement to settle this action, the Company believes that the allegations lack merit and, if necessary, intends to vigorously defend all claims asserted. The Company makes no assurances at this time that the court will grant approval of the proposed settlement terms or that the matter ultimately will be settled.

#### *Patent Claims*

In May 2008, the Company initiated discussions with Google, Inc. regarding the Company’s claims that Google has infringed on a US patent assigned to the Company relating generally to “rank multiplication” in memory modules. On August 29, 2008, Google filed a declaratory judgment lawsuit against the Company in United States District Court for the Northern District of California, seeking a declaration that Google did not infringe on the Company’s patent, and that the Company’s patent is invalid. Google is not seeking any monetary damages. On November 18, 2008, the Company filed a counterclaim for infringement of the patent by Google. Claim construction proceedings were held on November 14, 2009, and the Company prevailed on every disputed claim construction issue. On June 1, 2010, the Company filed a motion for summary judgment of patent infringement and a motion for summary judgment dismissing Google’s affirmative defenses based on Netlist’s activities with the JEDEC standard-setting body. Trial is currently set for November 1, 2010.

On December 4, 2009, the Company filed a patent infringement suit against Google in the United States District Court for the Northern District of California, seeking damages and injunctive relief based on Google's infringement of a recently issued patent related to the Company's patent-in-suit in the August 29, 2008 declaratory judgment action filed by Google. On February 3, 2010 the court ordered a settlement conference in both cases by May 4, 2010. On February 11, 2010, Google answered the Company's complaint and has asserted counterclaims against the Company seeking a declaration that the patent is invalid and not infringed, and claiming that the Company committed fraud, negligent misrepresentation and contractual breaches in connection with the setting of standards covered by the patent. The counterclaim seeks unspecified compensatory damages. Claim construction proceedings are currently scheduled for September 9, 2010. The Company intends to vigorously pursue its infringement claims against Google and to vigorously defend against Google's claims.

On September 22, 2009, the Company filed a patent infringement lawsuit against Inphi Corporation in the United States District Court for the Central District of California. The suit alleges that Inphi is contributorily infringing and actively inducing the infringement of a US patent assigned to the Company which is directed to memory modules with load isolation and memory domain translation capabilities. The Company is seeking damages and injunctive relief based on Inphi's use of its patented technology. On December 22, 2009, Netlist filed an Amended Complaint asserting claims of patent infringement based on two additional patents concerning load isolation and memory domain translation technologies. Inphi has denied infringement and has asserted that the patents-in-suit are invalid. On April 20, 2010, Inphi filed a request for reexamination of all three patents in suit with the United States Patent and Trademark Office and concurrently, filed a motion to stay the case until the Patent Office completes reexamination. The stay was granted on May 18, 2010; however, the Company intends to continue to vigorously pursue its infringement claims and to vigorously defend against Inphi's claims of invalidity in the Patent Office as well as the Court.

On November 30, 2009, Inphi Corporation filed a patent infringement lawsuit against the Company in the United States District Court for the Central District of California alleging infringement of two patents related to memory module output buffers. Discovery is currently underway, and the Company intends to vigorously defend against Inphi's claims of infringement.

On March 24, 2010, Ring Technologies Enterprises filed a patent infringement lawsuit in the United States District Court for the Eastern District of Texas against Dell Computer and its suppliers. The suit alleges that the Company and forty-two (42) other defendants infringed on its patent no. 6,879,526. The Company is preparing an answer to Ring Technologies' complaint and intends to vigorously defend against Ring Technologies' claims of infringement.

#### *Trade Secret Claim*

On November 18, 2008, the Company filed a claim for trade secret misappropriation against Texas Instruments ("TI") in Santa Clara County Superior Court, based on TI's disclosure of confidential Company materials to the JEDEC standard-setting body. Pursuant to a confidential settlement agreement between the parties, the case was dismissed with prejudice on May 10, 2010.

#### *Other Contingent Obligations*

During its normal course of business, the Company has made certain indemnities, commitments and guarantees under which it may be required to make payments in relation to certain transactions. These include (i) intellectual property indemnities to the Company's customers and licensees in connection with the use, sales and/or license of Company products; (ii) indemnities to vendors and service providers pertaining to claims based on the Company's negligence or willful misconduct; (iii) indemnities involving the accuracy of representations and warranties in certain contracts; (iv) indemnities to directors and officers of the Company to the maximum extent permitted under the laws of the State of Delaware; and (v) certain real estate leases, under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company's use of the applicable premises. The duration of these indemnities, commitments and guarantees varies and, in certain cases, may be indefinite. The majority of these indemnities, commitments and guarantees do not provide for any limitation of the maximum potential for future payments the Company could be obligated to make. Historically, the Company has not been obligated to make significant payments for these obligations, and no liabilities have been recorded for these indemnities, commitments and guarantees in the accompanying condensed consolidated balance sheets.

**Note 10—Stockholders’ Equity**

*Common Stock*

On March 24, 2010, the Company sold 4,594,250 shares of common stock in a registered public offering. The shares were sold to the public at a price of \$3.85 per share. The Company received net proceeds of \$16.2 million, after underwriting discounts and commissions, and estimated expenses payable by the Company.

*Stock-Based Compensation*

The Company has stock-based compensation awards outstanding pursuant to the 2000 Equity Incentive Plan (the “2000 Plan”) and the 2006 Equity Incentive Plan (the “2006 Plan”). Effective as of the IPO, no further grants may be made under the 2000 Plan. In addition to awards made pursuant to the 2006 Plan, the Company periodically issues inducement grants outside the 2006 Plan to certain new hires. In the six months ended July 3, 2010, the Company issued 305,000 stock options pursuant to inducement grants.

On June 2, 2010, the Company’s shareholders approved an amendment to the 2006 Plan to provide that the number of shares of common stock that may be issued shall be increased annually by a number of shares equal to the lesser of 5.0% of the issued and outstanding shares as of January 1 of each year or 1,200,000 shares. Prior to June 2, 2010, the annual increase in shares available under the 2006 Plan was capped at 500,000. The amendment is effective for fiscal 2010. An additional 505,566 shares are available for issuance as a result of the amendment to the 2006 Plan. At July 3, 2010, the Company had 607,281 shares available for grant pursuant to option, stock appreciation right, performance unit, restricted stock, restricted stock unit or stock grant awards under the 2006 Plan.

A summary of the Company’s common stock option activity as of and for the six months ended July 3, 2010 is presented below (shares in thousands):

	<u>Options Outstanding</u>	
	<u>Number of Shares</u>	<u>Weighted-Average Exercise Price</u>
Options outstanding at January 2, 2010	4,298	\$ 2.41
Options granted	360	3.58
Options exercised	(56)	1.19
Options cancelled	(142)	0.93
Options outstanding at July 3, 2010	<u>4,460</u>	<u>\$ 2.57</u>

A summary of the Company’s restricted stock awards as of and for the six months ended July 3, 2010 is presented below (shares in thousands):

	<u>Restricted Stock Outstanding</u>	
	<u>Number of Shares</u>	<u>Weighted-Average Grant-Date Fair Value per Share</u>
Balance outstanding at January 2, 2010	—	\$ —
Restricted stock granted	486	3.48
Balance outstanding at July 3, 2010	<u>486</u>	<u>\$ 3.48</u>

Restricted stock awards vest in eight equal increments at intervals of approximately six months from the date of grant.

The following table presents details of the assumptions used to calculate the weighted-average grant date fair value of common stock options granted by the Company:

	Six Months Ended	
	July 3, 2010	July 4, 2009
Expected term (in years)	5.5	5.4
Expected volatility	146%	111%
Risk-free interest rate	2.43%	2.96%
Expected dividends	—	—
Weighted-average grant date fair value per share	\$ 3.30	\$ 0.27

The weighted-average fair value per share of the restricted stock granted in the six months ended July 3, 2010 was \$3.48, calculated based on the fair market value of the Company's common stock on the respective grant dates.

At July 3, 2010, the amount of unearned stock-based compensation currently estimated to be expensed from fiscal 2010 through fiscal 2014 related to unvested common stock options and restricted stock awards is approximately \$3.2 million, net of estimated forfeitures. The weighted-average period over which the unearned stock-based compensation is expected to be recognized is approximately 3.1 years. If there are any modifications or cancellations of the underlying unvested awards, the Company may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense.

*Warrants*

A summary of activity with respect to outstanding warrants to purchase shares of the Company's common stock for the six months ended July 3, 2010 is presented below (shares in thousands):

	Number of Shares	Weighted- Average Exercise Price
Warrants outstanding at January 2, 2010	18	\$ 1.25
Warrants exercised	(18)	1.25
Warrants outstanding and exercisable at July 3, 2010	—	\$ —

**Note 11—Segment and Geographic Information**

The Company operates in one reportable segment: the design and manufacture of high-performance memory subsystems for the server, high-performance computing and communications markets. The Company evaluates financial performance on a Company-wide basis.

At July 3, 2010 and January 2, 2010, approximately \$2.6 million and \$3.0 million, respectively, of the Company's net long-lived assets were located in the PRC.

**Note 12—Subsequent Events**

In July 2010, the Company purchased approximately \$0.4 million of equipment under two 36-month capital lease agreements. The interest rates on the leases are approximately 6%. Annual repayment commitments under the leases are approximately \$0.1 million.

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

**Cautionary Statement**

*The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our Unaudited Condensed Consolidated Financial Statements and the related notes thereto contained in Part I, Item 1 of this Report. The information contained in this Quarterly Report on Form 10-Q is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Report and in our other reports filed with the Securities and Exchange Commission, or SEC, including our Annual Report on Form 10-K for the fiscal year ended January 2, 2010 and subsequent reports on Form 8-K, which discuss our business in greater detail.*

*The section entitled “Risk Factors” set forth in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended January 2, 2010 filed with the SEC on February 19, 2010, and similar discussions in our other SEC filings, describe some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this Report and in our other filings with the SEC, before deciding to purchase, hold or sell our common stock.*

*This Report contains forward-looking statements that involve risks, uncertainties, estimates and assumptions. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those expected or projected. These risks and uncertainties include, but are not limited to, continuing development, qualification and volume production of NetVault™ NV and HyperCloud™; the rapidly-changing nature of technology; risks associated with intellectual property, including the costs and unpredictability of litigation over infringement of our intellectual property; volatility in the pricing of DRAM ICs and NAND; changes in and uncertainty of customer acceptance of, and demand for, our existing products and products under development, including uncertainty of and/or delays in product orders and product qualifications; delays in our and our customers’ product releases and development; introductions of new products by competitors; changes in end-user demand for technology solutions; our ability to attract and retain skilled personnel; our reliance on suppliers of critical components; fluctuations in the market price of critical components; evolving industry standards; and the political and regulatory environment in the People’s Republic of China. Other risks and uncertainties are described under the heading “Risk Factors” in our Annual Report on Form 10-K for the year ended January 2, 2010. Except as required by law, we undertake no obligation to revise or update publicly any forward-looking statements for any reason.*

## Overview

We design, manufacture and sell high-performance, logic-based memory subsystems for the server, storage and communications equipment markets. Our memory subsystems consist of combinations of dynamic random access memory integrated circuits (“DRAM ICs” or “DRAM”), NAND flash memory (“NAND”), application-specific integrated circuits (“ASICs”) and other components assembled on printed circuit boards (“PCBs”). We primarily market and sell our products to leading original equipment manufacturer (“OEM”) customers. Our solutions are targeted at applications where memory plays a key role in meeting system performance requirements.

In November 2009, we introduced HyperCloud™ DDR3 memory technology. HyperCloud™ utilizes an ASIC chipset that incorporates Netlist patented rank multiplication technology that increases memory capacity and load reduction functionality that increases memory bandwidth. We expect that this achievement will make possible improved levels of performance for memory intensive datacenter applications and workloads, including search engines, social networks/communications, media internet portals, virtualization, and high performance scientific and defense-related computing. HyperCloud™ memory is being evaluated by several of our OEM customers for use in their server products. HyperCloud™ is interoperable with Joint Electronics Devices Engineering Council (“JEDEC”) standard DDR3 memory modules. Our HyperCloud™ products are designed to allow for installation in servers without the need for a bios change. As such, their anticipated sales launch is not dependent on the design plans or product cycle of our OEM customers. As of July 3, 2010, we have not shipped any production quantities of HyperCloud™.

In February 2010, we announced general availability of NetVault™ NV, a non-volatile cache memory subsystem targeting Redundant Array of Independent Disks, (“RAID”) storage applications. NetVault™ NV provides server and storage OEMs a solution for enhanced datacenter fault recovery. Unlike our traditional battery-powered fault tolerant cache product which relied solely on batteries to power the cache, NetVault™ NV utilizes a combination of DRAM for high throughput performance and flash for extended data retention. The introduction of NetVault™ NV, as well as the launch of the Dell, Inc. (“Dell”) PERC 7 line of servers in December 2009, has resulted in RAID controller subsystem revenues of \$7.0 million, or 41% of total revenues for the six months ended July 3, 2010, compared with \$1.5 million, or 29% of total revenues for the six months ended July 4, 2009. Although revenues through July 3, 2010 have been exclusively for shipments to Dell, we intend to qualify NetVault™ NV with several OEMs and to pursue end-user opportunities. Although we can make no assurances, we anticipate that NetVault™ products will continue to contribute significantly to our revenues as the product ramps through the second half of 2010.

The remainder of our revenues arise primarily from OEM sales of custom memory modules, the majority of which are utilized in data center and industrial applications. When developing custom modules for an equipment product launch, we engage with our OEM customers from the earliest stages of new product definition, providing us unique insight into their full range of system architecture and performance requirements. This close collaboration has also allowed us to develop a significant level of systems expertise. We leverage a portfolio of proprietary technologies and design techniques, including efficient planar design, alternative packaging techniques and custom semiconductor logic, to deliver memory

subsystems with high speed, capacity and signal integrity, small form factor, attractive thermal characteristics and low cost per bit. Revenues from custom modules have improved as a result of OEM product placements on new platforms and improved economic conditions compared with 2009. The continuation of this trend, which cannot be assured, is dependent on our ability to qualify our memory modules on new platforms as current platforms reach the end of their life cycles, and on the state of the global economy.

Consistent with the concentrated nature of the OEM customer base in our target markets, a small number of large customers have historically accounted for a significant portion of our net sales. Dell and Flextronics International Ltd. (“Flextronics”) represented approximately 44% and 32%, respectively, of our net sales for the six months ended July 3, 2010. Dell and Arrow Electronics, Inc. (“Arrow”) represented approximately 49% and 17%, respectively, of our net sales for the six months ended July 4, 2009. Net sales to some of our OEM customers include memory modules that are qualified by us directly with the OEM customer and sold to electronic manufacturing services providers (“EMSs”), for incorporation into products manufactured exclusively for the OEM customer or in some instances, to facilitate credit and logistics. These net sales to EMSs have historically fluctuated period to period as a portion of the total net sales to the OEM customers. Net sales to Hon Hai Precision Industry Co. Ltd., an EMS operating under the trade name Foxconn that purchases memory modules from us for incorporation into products manufactured exclusively for Dell, represented approximately 92% and 58% of net sales to Dell for the six months ended July 3, 2010 and July 4, 2009, respectively. Arrow is an EMS for DRS Electronics, Inc. (“DRS Electronics”). Substantially all of our products sold to Arrow are incorporated into components manufactured for DRS Electronics. Similarly, Flextronics distributes substantially all of the products purchased from us to F5 Networks, Inc.

### Key Business Metrics

The following describes certain line items in our condensed consolidated statements of operations that are important to management’s assessment of our financial performance:

*Net Sales.* Net sales consist primarily of sales of our high performance memory subsystems, net of a provision for estimated returns under our right of return policies, which generally range up to 30 days. We generally do not have long-term sales agreements with our customers. Although OEM customers typically provide us with non-binding forecasts of future product demand over specific periods of time, they generally place orders with us approximately two weeks in advance of scheduled delivery. Selling prices are typically negotiated monthly, based on competitive market conditions and the current price of DRAM ICs and NAND. Purchase orders generally have no cancellation or rescheduling penalty provisions. We often ship our products to our customers’ international manufacturing sites. All of our sales to date, however, are denominated in United States (“U.S.”) dollars. We also sell excess component inventory of DRAM ICs and NAND to distributors and other users of memory ICs. As compared to previous years, component inventory sales remain a relatively small percentage of net sales as a result of our efforts to diversify both our customer and product line bases. This diversification effort has also allowed us to use components in a wider range of memory subsystems. We expect that component inventory sales will continue to represent a minimal portion of our net sales in future periods.

*Cost of Sales.* Our cost of sales includes the cost of materials, manufacturing costs, depreciation and amortization of equipment, inventory valuation provisions, stock-based compensation and occupancy costs and other allocated fixed costs. The DRAM ICs and NAND incorporated into our products constitute a significant portion of our cost of sales, and thus our cost of sales will fluctuate based on the current price of DRAM ICs and NAND. We attempt to pass through such DRAM IC and NAND flash memory cost fluctuations to our customers by renegotiating pricing prior to the placement of their purchase orders. However, the sales prices of our memory subsystems can also fluctuate due to competitive situations unrelated to the pricing of DRAM ICs and NAND, which affects gross margins. The gross margin on our sales of excess component DRAM IC and NAND inventory is much lower than the gross margin on our sales of our memory subsystems. We assess the valuation of our inventories on a monthly basis and record a provision to cost of sales as necessary to reduce inventories to the lower of cost or net realizable value.

*Research and Development.* Research and development expense consists primarily of employee and independent contractor compensation and related costs, non-recurring engineering fees, patent filing and protection legal fees, computer-aided design software licenses, reference design development costs, depreciation or rental of evaluation equipment, stock-based compensation, and occupancy and other allocated overhead costs. Also included in research and development expense are the costs of material and overhead related to the production of engineering samples of new products under development or products used solely in the research and development process, reduced by estimated salvage value. Our customers typically do not separately compensate us for design and engineering work involved in developing application-specific products for incorporation into their products. All research and development costs are expensed as incurred. We anticipate that research and development expenditures will increase in future periods as we seek to expand new product opportunities, increase our activities related to new and emerging markets and continue to develop additional proprietary technologies.

*Selling, General and Administrative.* Selling, general and administrative expenses consist primarily of employee salaries and related costs, stock-based compensation, independent sales representative commissions, professional services, promotional and other selling and marketing expenses, sample expense and occupancy and other allocated overhead costs. A significant portion of our selling effort is directed at building relationships with OEMs and other customers and working through the product approval and qualification process with them. Therefore, the cost of material and overhead related to products manufactured for qualification is included in selling expenses. As we continue to service existing and establish new customers, we anticipate that our sales and marketing expenses will increase.

*Provision (Benefit) for Income Taxes.* We are required to adjust our effective tax rate each quarter to be consistent with the estimated annual effective tax rate. We are also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.

We evaluate whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. As of July 3, 2010 and January 2, 2010, we have provided a full valuation allowance and no benefit has been recognized for net operating losses and other deferred tax assets due to uncertainty of future utilization.

### **Critical Accounting Policies**

The preparation of our condensed consolidated financial statements in conformity with accounting principles generally accepted in the U.S. requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the condensed consolidated financial statements and the reported amounts of net sales and expenses during the reporting period. By their nature, these estimates and assumptions are subject to an inherent degree of uncertainty. We base our estimates on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. We review our estimates on an on-going basis. Actual results may differ from these estimates, which may result in material adverse effects on our operating results and financial position. We believe the following critical accounting policies involve our more significant assumptions and estimates used in the preparation of our condensed consolidated financial statements:

*Revenue Recognition.* We recognize revenues in accordance with the Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 605. Accordingly, we recognize revenues when there is persuasive evidence that an arrangement, product delivery and acceptance have occurred, the sales price is fixed or determinable, and collectibility of the resulting receivable is reasonably assured.

We generally use customer purchase orders and/or contracts as evidence of an arrangement. Delivery occurs when goods are shipped for customers with FOB Shipping Point terms and upon receipt for customers with FOB Destination terms, at which time title and risk of loss transfer to the customer. Shipping documents are used to verify delivery and customer acceptance. We assess whether the sales price is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund. Customers are generally allowed limited rights of return for up to 30 days, except for sales of excess component inventories, which contain no right-of-return privileges. Estimated returns are provided for at the time of sale based on historical experience or specific identification of an event necessitating a reserve. We offer a standard product warranty to our customers and have no other post-shipment obligations. While these sales returns have historically been within our expectations and the provisions established, we cannot guarantee that we will continue to experience similar sales return rates in the future. Any significant increase in product return rates could have a material adverse effect on our operating results for the period or periods in which such returns materialize. We assess collectibility based on the creditworthiness of the customer as determined by credit checks and evaluations, as well as the customer’s payment history.

All amounts billed to customers related to shipping and handling are classified as net sales, while all costs incurred by us for shipping and handling are classified as cost of sales.

*Fair Value of Financial Instruments.* Our financial instruments consist principally of cash and cash equivalents, investments in marketable securities, accounts receivable, accounts payable, accrued expenses and debt instruments. Other than for certain investments in auction rate securities, commercial paper and short-term corporate bonds, the fair value of our cash equivalents and investments in marketable securities is determined based on quoted prices in active markets for identical assets or Level 1 inputs. Because of their short-term nature, commercial paper and short-term corporate bonds are not frequently traded. Although there are observable quotes for these securities, the markets are not considered active. Accordingly, the fair values of these investments are based on Level 2 inputs. We recognize transfers between Levels 1 through 3 of the fair value hierarchy at the beginning of the reporting period. We believe that the carrying values of all other financial instruments approximate their current fair values due to their nature and respective durations.

*Allowance for Doubtful Accounts.* We perform credit evaluations of our customers' financial condition and limit the amount of credit extended to our customers as deemed necessary, but generally require no collateral. We evaluate the collectibility of accounts receivable based on a combination of factors. In cases where we are aware of circumstances that may impair a specific customer's ability to meet its financial obligations subsequent to the original sale, we will record an allowance against amounts due, and thereby reduce the net recognized receivable to the amount that we reasonably believe will be collected. For all other customers, we record allowances for doubtful accounts based primarily on the length of time the receivables are past due based on the terms of the originating transaction, the current business environment and our historical experience. Uncollectible accounts are charged against the allowance for doubtful accounts when all cost effective commercial means of collection have been exhausted. Generally, our credit losses have been within our expectations and the provisions established. However, we cannot guarantee that we will continue to experience credit loss rates similar to those we have experienced in the past.

Our accounts receivable are highly concentrated among a small number of customers, and a significant change in the liquidity or financial position of one of these customers could have a material adverse effect on the collectability of our accounts receivable, our liquidity and our future operating results.

*Inventories.* We value our inventories at the lower of the actual cost to purchase or manufacture the inventory or the net realizable value of the inventory. Cost is determined on an average cost basis which approximates actual cost on a first-in, first-out basis and includes raw materials, labor and manufacturing overhead. At each balance sheet date, we evaluate ending inventory quantities on hand and record a provision for excess quantities and obsolescence. Among other factors, we consider historical demand and forecasted demand in relation to the inventory on hand, competitiveness of product offerings, market conditions and product life cycles when determining obsolescence and net realizable value. In addition, we consider changes in the market value of DRAM ICs and NAND in determining the net realizable value of our raw material inventory. Once established, any write downs are considered permanent adjustments to the cost basis of our excess or obsolete inventories.

A significant decrease in demand for our products could result in an increase in the amount of excess inventory quantities on hand. In addition, our estimates of future product demand may prove to be inaccurate, in which case we may have understated or overstated the provision required for excess and obsolete inventory. In the future, if our inventories are determined to be overvalued, we would be required to recognize additional expense in our cost of sales at the time of such determination. Likewise, if our inventories are determined to be undervalued, we may have over-reported our costs of sales in previous periods and would be required to recognize additional gross profit at the time such inventories are sold. In addition, should the market value of DRAM ICs or NAND decrease significantly, we may be required to lower our selling prices to reflect the lower current cost of our raw materials. If such price decreases reduce the net realizable value of our inventories to less than our cost, we would be required to recognize additional expense in our cost of sales in the same period. Although we make every reasonable effort to ensure the accuracy of our forecasts of future product demand, any significant unanticipated changes in demand, technological developments or the market value of DRAM ICs or NAND could have a material effect on the value of our inventories and our reported operating results.

*Impairment of Long-Lived Assets.* We evaluate the recoverability of the carrying value of long-lived assets held and used in our operations for impairment on at least an annual basis or whenever events or changes in circumstances indicate that their net book value may not be recoverable. When such factors and circumstances exist, we compare the projected undiscounted future net cash flows associated with the related asset or group of assets over their estimated useful lives against their respective carrying amount. These projected future cash flows may vary significantly over time as a result of increased competition, changes in technology, fluctuations in demand, consolidation of our customers and reductions in average selling prices. If the carrying value is determined not to be recoverable from future operating cash flows, the asset is deemed impaired and an impairment loss is recognized to the extent the carrying value exceeds the estimated fair value of the asset. The fair value of the asset or asset group is based on market value when available, or when unavailable, on discounted expected cash flows.

*Warranty Reserve.* We offer product warranties generally ranging from one to three years, depending on the product and negotiated terms of purchase agreements with our customers. Such warranties require us to repair or replace defective product returned to us during the warranty period at no cost to the customer. Warranties are not offered on sales of excess component inventory. Our estimates for warranty-related costs are recorded at the time of sale based on historical and estimated future product return rates and expected repair or replacement costs. While such costs have historically been consistent between periods and within our expectations and the provisions established, unexpected changes in failure rates could have a material adverse impact on us, requiring additional warranty reserves, and adversely affecting our gross profit and gross margins.

*Stock-Based Compensation.* We account for equity issuances to non-employees in accordance with ASC Topic 505. All transactions in which goods or services are the consideration received for the issuance of equity instruments are accounted for based on the fair value of the consideration received or the fair value of the equity instrument issued, whichever is more reliably measurable. The measurement date used to determine the fair value of the equity instrument issued is the earlier of the date on which the third-party performance is complete or the date on which it is probable that performance will occur.

In accordance with ASC Topic 718, employee and director stock-based compensation expense recognized during the period is based on the value of the portion of stock-based payment awards that is ultimately expected to vest during the period. Given that stock-based compensation expense recognized in the condensed consolidated statements of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. ASC Topic 718 requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Our estimated average forfeiture rates are based on historical forfeiture experience and estimated future forfeitures.

The fair value of common stock option awards to employees and directors is calculated using the Black-Scholes option pricing model. The Black-Scholes model requires subjective assumptions regarding future stock price volatility and expected time to exercise, along with assumptions about the risk-free interest rate and expected dividends, all of which affect the estimated fair values of our common stock option awards. The expected term of options granted is calculated as the average of the weighted vesting period and the contractual expiration date of the option. This calculation is based on the safe harbor method permitted by the SEC in instances where the vesting and exercise terms of options granted meet certain conditions and where limited historical exercise data is available. Prior to fiscal 2009, the expected volatility was based on the historical volatilities of the common stock of comparable publicly traded companies based on our belief that we had limited historical data regarding the volatility of our stock price on which to base a meaningful estimate of expected volatility. Beginning in fiscal 2009, the expected volatility is based on the historical volatility of our common stock. The risk-free rate selected to value any particular grant is based on the U.S. Treasury rate that corresponds to the expected term of the grant effective as of the date of the grant. The expected dividends assumption is based on our history and our expectations regarding dividend payouts. We evaluate the assumptions used to value our common stock option awards on a quarterly basis. If factors change and we employ different assumptions, stock-based compensation expense may differ significantly from what we have recorded in prior periods. Compensation expense for common stock option awards with graded vesting schedules is recognized on a straight-line basis over the requisite service period for the last separately vesting portion of the award.

We recognize the fair value of restricted stock awards issued to employees and outside directors as stock-based compensation expense on a straight-line basis over the vesting period for the last separately vesting portion of the awards. Fair value is determined as the difference between the closing price of our common stock on the grant date and the purchase price of the restricted stock award, if any, reduced by expected forfeitures.

If there are any modifications or cancellations of the underlying vested or unvested stock-based awards, we may be required to accelerate, increase or cancel any remaining unearned stock-based compensation expense, or record additional expense for vested stock-based awards. Future stock-based compensation expense and unearned stock-based compensation may increase to the extent that we grant additional common stock options or other stock-based awards.

*Income Taxes.* Under ASC Topic 270, we are required to adjust our effective tax rate each quarter to be consistent with the estimated annual effective tax rate. We are also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.

Deferred tax assets and liabilities are recognized to reflect the estimated future tax effects, calculated at currently effective tax rates, of future deductible or taxable amounts attributable to events that have been recognized on a cumulative basis in the condensed consolidated financial statements. A valuation allowance related to a net deferred tax asset is recorded when it is more likely than not that some portion of the deferred tax asset will not be realized.

ASC Topic 740 prescribes a recognition threshold and measurement requirement for the financial statement recognition of a tax position that has been taken or is expected to be taken on a tax return and also provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. Under ASC Topic 740 we may only recognize or continue to recognize tax positions that meet a “more likely than not” threshold.

The application of tax laws and regulations is subject to legal and factual interpretation, judgment and uncertainty. Tax laws and regulations themselves are subject to change as a result of changes in fiscal policy, changes in legislation, the evolution of regulations and court rulings. Therefore, the actual liability for U.S. or foreign taxes may be materially different from our estimates, which could result in the need to record additional tax liabilities or potentially reverse previously recorded tax liabilities.

## Results of Operations

The following table sets forth certain condensed consolidated statements of operations data as a percentage of net sales for the periods indicated:

	Three Months Ended		Six Months Ended	
	July 3, 2010	July 4, 2009	July 3, 2010	July 4, 2009
Net sales	100%	100%	100%	100%
Cost of sales	80	92	79	105
Gross profit (loss)	20	8	21	(5)
Operating expenses:				
Research and development	34	64	36	68
Selling, general and administrative	28	67	30	76
Total operating expenses	62	131	66	144
Operating loss	(43)	(123)	(45)	(149)
Other income (expense):				
Interest income, net	—	1	—	2
Other income (expense), net	—	(2)	1	2
Total other income (expense), net	—	(1)	1	4
Loss before provision (benefit) for income taxes	(43)	(124)	(44)	(145)
Provision (benefit) for income taxes	—	1	(4)	1
Net loss	(43)%	(125)%	(40)%	(146)%

**Three and Six Months Ended July 3, 2010 Compared to Three and Six Months Ended July 4, 2009****Net Sales, Cost of Sales and Gross Profit**

The following table presents net sales, cost of sales and gross profit for the three and six months ended July 3, 2010 and July 4, 2009 (in thousands, except percentages):

	<u>Three Months Ended</u>		<u>Change</u>	<u>% Change</u>
	<u>July 3, 2010</u>	<u>July 4, 2009</u>		
Net sales	\$ 9,304	\$ 3,173	\$ 6,131	193%
Cost of sales	7,486	2,929	4,557	156%
Gross profit	<u>\$ 1,818</u>	<u>\$ 244</u>	<u>\$ 1,574</u>	645%
Gross margin	<u>20%</u>	<u>8%</u>	<u>12%</u>	
	<u>Six Months Ended</u>			
	<u>July 3, 2010</u>	<u>July 4, 2009</u>	<u>Change</u>	<u>% Change</u>
Net sales	\$ 17,194	\$ 5,335	\$ 11,859	222%
Cost of sales	13,558	5,628	7,930	141%
Gross profit (loss)	<u>\$ 3,636</u>	<u>\$ (293)</u>	<u>\$ 3,929</u>	1,341%
Gross margin	<u>21%</u>	<u>(5)%</u>	<u>27%</u>	

**Net Sales.** Overall, net sales of our RAID, data center optimization and industrial applications increased as a result of the selection of our memory modules for inclusion in new product platforms. Net sales in all product categories have benefited from resurgence in technology investment, as general economic conditions have improved. Should economic conditions erode positive sales trends may not continue.

The increase in net sales for the three months ended July 3, 2010 as compared with the three months ended July 4, 2009 resulted primarily from increases of approximately (i) \$3.3 million in sales of NetVault™ non-volatile cache systems used in RAID controller subsystems, including \$2.4 million from the launch of NetVault™ NV, the flash-based cache system that became generally available in 2010, and (ii) \$2.3 million in sales of memory modules utilized in data center targeted server applications.

The increase in net sales for the six months ended July 3, 2010 as compared with the six months ended July 4, 2009 resulted from increases of approximately (i) \$5.5 million in sales of NetVault™ products, including \$2.6 million from NetVault™ NV, (ii) \$4.2 million in sales of memory modules utilized in data center targeted server applications, and (iii) \$1.2 million in sales of memory modules designed for industrial applications.

**Gross Profit (Loss) and Gross Margin.** The overall improvements in gross profit (loss) are due to increased sales and manufacturing volume.

Gross profit for the three months ended July 3, 2010 as compared to the three months ended July 4, 2009 increased due to the 193% increase in net sales between the two periods, resulting in profits earned on each unit sold, as well as an improved ability to absorb fixed manufacturing costs. These volume based improvements are partially offset by increased DRAM prices, which affected margins in some product categories. Gross profits for the six months ended July 3, 2010 as compared to the six months ended July 4, 2009 were impacted by the same trends, including a 222% increase in net sales between the two periods.

**Research and Development .**

The following table presents research and development expenses for the three and six months ended July 3, 2010 and July 4, 2009 (in thousands, except percentages):

	Three Months Ended		Change	%
	July 3, 2010	July 4, 2009		
Research and development	\$ 3,190	\$ 2,030	\$ 1,160	57%

	Six Months Ended		Change	%
	July 3, 2010	July 4, 2009		
Research and development	\$ 6,198	\$ 3,644	\$ 2,554	70%

The increase in research and development expense in the three months ended July 3, 2010 as compared to the three months ended July 4, 2009 resulted primarily from increases of (i) \$0.3 million in engineering expenses as a result of an increase in non-recurring engineering charges and both internal engineering headcount and outside contractors engaged in new product development activities in the first quarter of 2010, (ii) \$0.4 million in legal and professional fees as we continue to increase patent filing and protection activities related to new and emerging markets and (iii) \$0.4 million in material expenses related to product builds and testing, primarily related to our HyperCloud™ products.

The increase in research and development expense in the six months ended July 3, 2010 as compared to the six months ended July 4, 2009 resulted primarily from increases of (i) \$1.0 million in non-recurring engineering charges, headcount, and outside consultants, (ii) \$1.0 million in patent related legal expense, and (iii) \$0.5 million in product qualification builds and testing.

**Selling, General and Administrative .**

The following table presents selling, general and administrative expenses for the three and six months ended July 3, 2010 and July 4, 2009 (in thousands, except percentages):

	Three Months Ended		Change	%
	July 3, 2010	July 4, 2009		
Selling, general and administrative	\$ 2,607	\$ 2,120	\$ 487	23%

	Six Months Ended		Change	%
	July 3, 2010	July 4, 2009		
Selling, general and administrative	\$ 5,177	\$ 4,055	\$ 1,122	28%

The increase in selling, general and administrative expense in the three months ended July 3, 2010 as compared to the three months ended July 4, 2009 resulted primarily from increases of approximately (i) \$0.2 million in commission expenses due to an increase in sales revenue, (ii) \$0.1 million in personnel-related expenses primarily attributable to hiring personnel to support the development of markets for HyperCloud™ and NetVault™ NV, and (iii) \$0.1 million in product samples and travel costs as a result of activities related to the OEM qualification process for HyperCloud™ and NetVault™ NV.

The increase in selling, general and administrative expense in the six months ended July 3, 2010 as compared to the six months ended July 4, 2009 resulted primarily from increases of approximately (i) \$0.4 million in commission expenses, (ii) \$0.4 million in personnel-related expenses, and (iii) \$0.3 million in product samples and travel costs as a result of activities related to the OEM qualification process for HyperCloud™ and NetVault™ NV.

**Other Income (Expense).**

The following table presents other income for the three and six months ended July 3, 2010 and July 4, 2009 (in thousands, except percentages):

	<b>Three Months Ended</b>		<b>Change</b>	<b>% Change</b>
	<b>July 3, 2010</b>	<b>July 4, 2009</b>		
Interest income, net	\$ 3	\$ 18	\$ (15)	(83)%
Other income (expense), net	4	(45)	49	109%
Total other income (expense), net	<u>\$ 7</u>	<u>\$ (27)</u>	<u>\$ 34</u>	<u>126%</u>

  

	<b>Six Months Ended</b>		<b>Change</b>	<b>% Change</b>
	<b>July 3, 2010</b>	<b>July 4, 2009</b>		
Interest income, net	\$ 4	\$ 100	\$ (96)	(96)%
Other income (expense), net	71	130	(59)	(45)%
Total other income (expense), net	<u>\$ 75</u>	<u>\$ 230</u>	<u>\$ (155)</u>	<u>(67)%</u>

Net interest income for the three and six months ended July 3, 2010 was comprised of nominal interest income, offset by nominal interest expense. Net interest income for the three and six months ended July 4, 2009 was comprised of interest income of approximately \$0.2 million and \$0.5 million, respectively, partially offset by interest expense of approximately \$0.1 million and \$0.02 million, respectively. The decrease in interest income in the three and six months ended July 3, 2010 as compared to the three and six months ended July 4, 2009 was due to a combination of our lower average cash and investment balances and the decrease in the yield earned on those balances due to lower interest rates. The decrease in interest expense during 2010 as compared to 2009 resulted primarily from our lower average outstanding balances on our line of credit and debt balances during the current year.

Other income, net, for the six months ended July 3, 2010 was primarily comprised of cash proceeds from the early termination of a sublease of our headquarters facility. Other income, net, for the six months ended July 4, 2009 was primarily comprised of gains from the sale of equipment held for sale during the first quarter.

**(Benefit) Provision for Income Taxes .**

The following table presents the (benefit) provision for income taxes for the three and six months ended July 3, 2010 and July 4, 2009 (in thousands, except percentages):

	<b>Three Months Ended</b>		<b>Change</b>	<b>% Change</b>
	<b>July 3, 2010</b>	<b>July 4, 2009</b>		
Provision (benefit) for income taxes	\$ 2	\$ 31	\$ (29)	(94)%

  

	<b>Six Months Ended</b>		<b>Change</b>	<b>% Change</b>
	<b>July 3, 2010</b>	<b>July 4, 2009</b>		
Provision (benefit) for income taxes	\$ (725)	\$ 49	\$ 774	1,580%

On an interim basis, we estimate what our effective tax rate will be in each jurisdiction for the full fiscal year and record a quarterly income tax (benefit) provision in accordance with the anticipated blended annual rate. We are also required to record the tax impact of certain discrete items, unusual or infrequently occurring, including changes in judgment about valuation allowances and effects of changes in tax laws or rates, in the interim period in which they occur. During the six

months ended July 3, 2010, we carried back approximately \$1.7 million of gross net operating losses under the Worker, Homeownership, and Business Act and recorded a tax benefit and income tax receivable of approximately \$0.7 million, which was received in April 2010. In addition, jurisdictions with a projected loss for the year or a year-to-date loss where no tax benefit can be recognized are excluded from the estimated annual effective tax rate. The impact of such an exclusion could result in a higher or lower effective tax rate during a particular quarter, based upon the mix and timing of actual earnings versus annual projections.

We evaluate whether a valuation allowance should be established against our deferred tax assets based on the consideration of all available evidence using a “more likely than not” standard. Due to uncertainty of future utilization, we have provided a full valuation allowance as of July 3, 2010 and January 2, 2010. Accordingly, no benefit has been recognized for net deferred tax assets, including net operating losses that cannot be realized currently via carryback to periods of taxable income.

Our income tax benefit of \$0.7 million for the six months ended July 3, 2010 was the result of a special carryback of operating losses that was made available through legislative changes. We recorded a provision for income taxes for the quarters ended July 3, 2010 and July 4, 2009 and for the six months ended July 4, 2009 due to state minimum taxes.

## Liquidity and Capital Resources

Since our inception, we have financed our operations primarily through issuances of equity and debt securities and cash generated from operations. We have also funded our operations with a revolving line of credit under our bank credit facility, from capitalized lease obligations and from the sale and leaseback of our domestic manufacturing facility.

### Working Capital and Cash and Marketable Securities

The following table presents working capital, cash and cash equivalents and investments in marketable securities (in thousands):

	July 3, 2010	January 2, 2010
Working Capital	\$ 24,172	\$ 13,379
Cash and cash equivalents(1)	\$ 16,993	\$ 9,942
Short-term marketable securities(1)	5,211	3,949
Long-term marketable securities	902	941
	<u>\$ 23,106</u>	<u>\$ 14,832</u>

(1) Included in working capital

Our working capital increased in the six months ended July 3, 2010 primarily as a result of our increase in cash, cash equivalents and short-term marketable securities resulting from our public offering of our shares of common stock. Additionally, we experienced increases in certain operating assets, offset by increases in certain operating liabilities resulting from our increase in sales of our legacy products and production ramp up for HyperCloud™ and NetVault™ NV.

### Cash Provided and Used in the Six Months Ended July 3, 2010 and July 4, 2009

The following table summarizes our cash flows for the periods indicated (in thousands):

	Six Months Ended	
	July 3, 2010	July 4, 2009
<b>Net cash provided by (used in):</b>		
Operating activities	\$ (7,530)	\$ (3,429)
Investing activities	(1,662)	(3,592)
Financing activities	16,243	1,913
Net increase (decrease) in cash and cash equivalents	<u>\$ 7,051</u>	<u>\$ (5,108)</u>

*Operating Activities.* Net cash used in operating activities for the six months ended July 3, 2010 was primarily a result of (i) net loss of approximately \$6.9 million and (ii) cash used by changes in operating assets and liabilities of approximately \$2.5 million, partially offset by approximately \$1.9 million in net non-cash operating expenses, primarily consisting of depreciation and amortization and stock-based compensation expense. Net cash used in operating activities for the six months ended July 4, 2009 was primarily a result of a net loss of approximately \$7.8 million, partially offset by (i) approximately \$2.8 million in net cash provided by changes in operating assets and liabilities, and (ii) approximately \$1.6 million in net non-cash operating expenses, primarily comprising depreciation and amortization and stock-based compensation.

Accounts receivable increased approximately \$2.8 million during the six months ended July 3, 2010 primarily as a result of the increase in our net sales during the period. During the same period, we were successful in collecting cash from sales to our customers substantially in accordance with our standard payment terms with those customers. Inventories increased approximately \$2.0 million during the six months ended July 3, 2010 as we prepare for production of our HyperCloud™ products and initiated production of our NetVault™ NV products. During the six months ended July 3, 2010, we were able to partially fund the growth in our accounts receivable and inventory through an increase in accounts payable of \$2.1 million, primarily from component vendors.

*Investing Activities.* Net cash used in investing activities for the six months ended July 3, 2010 was primarily the result of purchases of \$2.4 million of investments in marketable securities, offset by sales of \$1.1 million. Additionally, we acquired \$0.4 million in property and equipment. Net cash used in investing activities for the six months ended July 4, 2009 was primarily a result of purchases of additional investments in marketable securities of approximately \$10.2 million, partially offset by (i) proceeds received from maturities and sales of certain investments in marketable securities of approximately \$6.3 million and (ii) proceeds from the sale of equipment of \$0.3 million.

*Financing Activities.* Net cash provided by financing activities for the six months ended July 3, 2010 was a result of the net proceeds of \$16.2 million from the sale of 4,594,250 shares of our common stock in a registered public offering, which closed on March 24, 2010. Net cash provided by financing activities for the six months ended July 4, 2009 was a result of net borrowing on our credit facility of approximately \$2.2 million, partially offset by repayment of approximately \$0.2 million on our long-term debt.

**Capital Resources**

On October 31, 2009, we entered into a revolving credit agreement with Silicon Valley Bank. Under the original terms of the credit agreement, we could borrow up to the lesser of (i) 80% of eligible accounts receivable, minus \$1.0 million, or (ii) \$5.0 million. The revolving credit agreement was amended on March 24, 2010 to allow for increased accounts receivable eligibility and to remove the \$1.0 million reduction from the calculated accounts receivable borrowing base and further amended on June 30, 2010 to modify certain financial covenants. The credit agreement contains an overall sublimit of \$2.5 million to collateralize our contingent obligations under letters of credit, foreign exchange contracts and cash management services. Amounts outstanding under the overall sublimit reduce the amount available pursuant to the credit agreement. Interest is payable monthly at either (i) prime plus 1.25%, as long as we maintain \$8.5 million in revolving credit availability plus unrestricted cash on deposit with the financial institution, or (ii) prime plus 2.25%. The credit agreement matures on October 30, 2010, at which time all advances and interest are due and payable. At July 3, 2010, letters of credit in the amount of \$1.8 million were outstanding.

The following table presents details of outstanding borrowings and availability under our line of credit (in thousands):

	July 3, 2010	January 2, 2010
Outstanding borrowings on the revolving line of credit	\$ —	\$ —
Borrowing availability under the revolving line of credit	\$ 3,200	\$ —

Obligations under our revolving credit agreement are secured by a first priority lien on our tangible and intangible assets. In connection with the revolving credit agreement, we entered into an Intercompany Subordination Agreement, which provided that Netlist Technology Texas, LP, one of our subsidiaries, is an additional obligor on the revolving credit agreement.

The only restriction on the use of these funds is that we must be in compliance with the covenants of the revolving credit agreement. The credit agreement includes affirmative and negative covenants, including financial covenants with respect to our liquidity and profitability. As of July 3, 2010, we were in compliance with all financial covenants and expect to maintain compliance for the foreseeable future. However, we have in the past been in violation of one or more covenants of other credit agreements, and we could violate one or more covenants in the future. If we were to be in violation of covenants under our credit agreement, our lender could choose to accelerate payment on all outstanding loan balances. If that were to occur, we may be unable to quickly obtain equivalent or suitable replacement financing. If we were not able to secure alternative sources of funding, such acceleration would have a material adverse impact on our financial condition.

We have in the past utilized equipment leasing arrangements to finance certain capital expenditures. Equipment leases continue to be a financing alternative that we expect to pursue in the future.

We believe our existing cash balances, borrowing availability under our bank credit facility, and the cash expected to be generated from operations, will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors, including our levels of net sales, the timing and extent of expenditures to support research and development activities, the expansion of manufacturing capacity both domestically and internationally and the continued market acceptance of our products. We could be required, or may choose, to seek additional funding through public or private equity or debt financings. In addition, in connection with any future acquisitions, we may require additional funding which may be provided in the form of additional debt or equity financing or a combination thereof. These additional funds may not be available on terms acceptable to us, or at all.

### ***New Accounting Pronouncements***

In September 2009, the FASB issued Accounting Standards Update (“ASU”) 2009-13, *Multiple-Deliverable Revenue Arrangements* (“ASU 2009-13”), which amends the revenue guidance under ASC Topic 605, which describes the accounting for multiple element arrangements. ASU 2009-13 addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting and how arrangement consideration shall be measured and allocated to the separate units of accounting in the arrangement. ASU 2009-13 is effective on a prospective basis for the Company’s fiscal year 2011, with earlier adoption permitted. We are currently evaluating the adoption of ASU 2009-13 and the impact that ASU 2009-13 will have on our condensed consolidated financial statements.

In September 2009, the FASB issued ASU 2009-14, *Certain Revenue Arrangements That Include Software Elements* (“ASU 2009-14”), which excludes tangible products containing software components and non-software components that function together to deliver the product’s essential functionality from the scope of ASC Topic 985, which describes the accounting for software revenue recognition. ASU 2009-14 is effective on a prospective basis for our fiscal year 2011, with earlier adoption permitted. We are currently evaluating the impact that ASU 2009-14 will have on its condensed consolidated financial statements.

### ***Off-Balance Sheet Arrangements***

We do not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes. In addition, we do not have any undisclosed borrowings or debt, and we have not entered into any synthetic leases. We are, therefore, not materially exposed to any financing, liquidity, market or credit risk that could arise if we had engaged in such relationships.

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

(a) *Evaluation of Disclosure Controls and Procedures.* We carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, (“Exchange Act”)) as of the end of our fiscal quarter ended July 3, 2010. Based upon that evaluation, our principal executive officer and principal financial officer concluded that our disclosure controls and procedures are effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms and (ii) is accumulated and communicated to our management, including our principal executive officer and principal financial officer as appropriate to allow timely decisions regarding required disclosure.

(b) *Change in internal controls over financial reporting.* During the fiscal quarter that ended July 3, 2010, there were no changes in our internal controls over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

***Inherent Limitations on Internal Control***

A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple errors. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls is also based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

The information set forth in the sections entitled Federal Securities Class Action, Patent Claims and Trade Secret Claim under Note 9 of Notes to Unaudited Condensed Consolidated Financial Statements, included in Part I, Item I of this Report, is incorporated herein by reference.

**Item 6. Exhibits**

Exhibit Number	Description of Document
3.1(1)	Restated Certificate of Incorporation of Netlist, Inc.
3.2(1)	Amended and Restated Bylaws of Netlist, Inc.
10.1(2)#	Amended and Restated 2006 Equity Incentive Plan
10.2(2)	Amendment to Loan Documents entered into as of June 30, 2010, by and between Silicon Valley Bank and Netlist, Inc., a Delaware Corporation.
31.1(2)	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as Amended.
31.2(2)	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as Amended.
32(3)	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and furnished herewith pursuant to SEC Release No. 33-8238.

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- (1) Incorporated by reference to the corresponding exhibit number of the registration statement on Form S-1 of the registrant (No. 333-136735) filed with the Securities and Exchange Commission on October 23, 2006.
  - (2) Filed herewith.
  - (3) The information in Exhibit 32 shall not be deemed “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, (the “Exchange Act”), or otherwise subject to the liabilities of that section, nor shall they be deemed incorporated by reference in any filing under the Securities Act of 1933, as amended, or the Exchange Act (including this Report), unless the registrant specifically incorporates the foregoing information into those documents by reference.

# Management contract or compensatory plan or arrangement

**SIGNATURES**

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

Date: August 12, 2010

NETLIST, INC.  
a Delaware corporation  
(Registrant)

By: \_\_\_\_\_ /s/ Chun K. Hong  
**Chun K. Hong**  
**President, Chief Executive Officer and**  
**Chairman of the Board**  
**(Principal Executive Officer)**

By: \_\_\_\_\_ /s/ Gail M. Sasaki  
**Gail M. Sasaki**  
**Vice President and Chief Financial**  
**Officer**  
**(Principal Financial Officer)**

**EXHIBIT INDEX**

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# Management contract or compensatory arrangement

## NETLIST, INC.,

## AMENDED AND RESTATED 2006 EQUITY INCENTIVE PLAN

Amended by the Stockholders on June 2, 2010

**1. Purpose**

This Plan is intended to encourage ownership of Stock by employees, consultants, advisors and directors of the Company and its Affiliates and to provide additional incentive for them to promote the success of the Company's business through the grant of Awards of, or pertaining to, shares of the Company's Stock. This Plan is intended to be an incentive stock option plan within the meaning of Section 422 of the Code, but not all Awards are required to be Incentive Options. This Plan shall not become effective until the Effective Date.

**2. Definitions**

As used in this Plan, the following terms shall have the following meanings:

2.1 *Accelerate*, *Accelerated*, and *Acceleration*, means: (a) when used with respect to an Option or Stock Appreciation Right, that as of the time of reference the Option or Stock Appreciation Right will become exercisable with respect to some or all of the shares of Stock for which it was not then otherwise exercisable by its terms; (b) when used with respect to Restricted Stock or Restricted Stock Units, that the Risk of Forfeiture otherwise applicable to the Stock or Units shall expire with respect to some or all of the shares of Restricted Stock or Units then still otherwise subject to the Risk of Forfeiture; and (c) when used with respect to Performance Units, that the applicable Performance Goals shall be deemed to have been met as to some or all of the Units.

2.2 *Acquisition* means (i) a merger or consolidation of the Company with or into another person, (ii) the sale, transfer, or other disposition of all or substantially all of the Company's assets to one or more other persons in a single transaction or series of related transactions, or (iii) the acquisition of beneficial ownership (determined pursuant to Securities and Exchange Commission Rule 13d-3 promulgated under the Securities Exchange Act of 1934, as amended and in effect from time to time) by any person of more than 50% of the Company's outstanding common stock pursuant to a tender or exchange offer made directly to the Company's stockholders, other than an underwriter temporarily holding common stock pursuant to an offering of such common stock. Notwithstanding the foregoing, a transaction shall not constitute an "Acquisition" if its sole purpose is to change the state of the Company's incorporation or to create a holding company that will be owned in substantially the same proportions by the persons who held the Company's securities immediately prior to such transaction.

2.3 *Affiliate* means any corporation, partnership, limited liability company, business trust, or other entity controlling, controlled by or under common control with the Company.

2.4 *Award* means any grant or sale pursuant to the Plan of Options, Stock Appreciation Rights, Performance Units, Restricted Stock, Restricted Stock Units or Stock Grants.

2.5 *Award Agreement* means an agreement between the Company and the recipient of an Award, setting forth the terms and conditions of the Award.

2.6 *Board* means the Company's Board of Directors.

2.7 *Code* means the Internal Revenue Code of 1986, as amended from time to time, or any successor statute thereto, and any regulations issued from time to time thereunder.

2.8 *Committee* means the Compensation Committee of the Board, which in general is responsible for the administration of the Plan, as provided in Section 5 of the Plan. For any period during which no such committee is in existence "Committee" shall mean the Board and all authority and responsibility assigned to the Committee under the Plan shall be exercised, if at all, by the Board.

2.9 *Company* means Netlist, Inc., a corporation organized under the laws of the State of Delaware.

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2.10 *Covered Employee* means an employee who is a “covered employee” within the meaning of Section 162(m) of the Code.

2.11 *Effective Date* means the date on which the Company’s registration statement on Form S-1, initially filed with the Securities and Exchange Commission on August 18, 2006 in connection with the initial public offering of its common stock in a firm commitment underwriting, as amended, is declared effective by the Securities and Exchange Commission.

2.12 *Grant Date* means the date as of which an Option is granted, as determined under Section 7.1(a).

2.13 *Incentive Option* means an Option which by its terms is to be treated as an “incentive stock option” within the meaning of Section 422 of the Code.

2.14 *Market Value* means the value of a share of Stock on a particular date determined by such methods or procedures as may be established by the Committee. Unless otherwise determined by the Committee, the Market Value of Stock as of any date is the closing price for the Stock as quoted on the NGM (or on any other national securities exchange on which the Stock is then listed) for that date or, if no closing price is reported for that date, the closing price on the next preceding date for which a closing price was reported. For purposes of Awards effective as of the effective date of the Company’s initial public offering, Market Value of Stock shall be the price at which the Company’s Stock is offered to the public in its initial public offering.

2.15 *NGM* means the NASDAQ Global Market.

2.16 *Nonstatutory Option* means any Option that is not an Incentive Option.

2.17 *Option* means an option to purchase shares of Stock.

2.18 *Optionee* means a Participant to whom an Option shall have been granted under the Plan.

2.19 *Participant* means any holder of an outstanding Award under the Plan.

2.20 *Performance Criteria* means the criteria that the Committee selects for purposes of establishing the Performance Goal or Performance Goals for a Participant for a Performance Period. The Performance Criteria used to establish Performance Goals are limited to: (i) cash flow (before or after dividends), (ii) earnings per share (including, without limitation, earnings before interest, taxes, depreciation and amortization), (iii) stock price, (iv) return on equity, (v) stockholder return or total stockholder return, (vi) return on capital (including, without limitation, return on total capital or return on invested capital), (vii) return on investment, (viii) return on assets or net assets, (ix) market capitalization, (x) economic value added, (xi) debt leverage (debt to capital), (xii) revenue, (xiii) sales or net sales, (xiv) backlog, (xv) income, pre-tax income or net income, (xvi) operating income or pre-tax profit, (xvii) operating profit, net operating profit or economic profit, (xviii) gross margin, operating margin or profit margin, (xix) return on operating revenue or return on operating assets, (xx) cash from operations, (xxi) operating ratio, (xxii) operating revenue, (xxiii) market share improvement, (xxiv) general and administrative expenses or (xxv) customer service.

2.21 *Performance Goals* means, for a Performance Period, the written goal or goals established by the Committee for the Performance Period based upon the Performance Criteria. The Performance Goals may be expressed in terms of overall Company performance or the performance of a division, business unit, subsidiary, or an individual, either individually, alternatively or in any combination, applied to either the Company as a whole or to a business unit or Affiliate, either individually, alternatively or in any combination, and measured either quarterly, annually or cumulatively over a period of years, on an absolute basis or relative to a pre-established target, to previous years’ results or to a designated comparison group, in each case as specified by the Committee. The Committee will, in the manner and within the time prescribed by Section 162(m) of the Code in the case of Qualified Performance-Based Awards, objectively define the manner of calculating the Performance Goal or Goals it selects to use for such Performance Period for such Participant. To the extent consistent with Section 162(m) of the Code, the Committee may appropriately adjust any evaluation of performance against a Performance Goal to exclude any of the following events that occurs during a performance period: (i) asset write-downs, (ii) litigation,

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claims, judgments or settlements, (iii) the effect of changes in tax law, accounting principles or other such laws or provisions affecting reported results, (iv) accruals for reorganization and restructuring programs and (v) any extraordinary, unusual, non-recurring or non-comparable items (A) as described in Accounting Principles Board Opinion No. 30, (B) as described in management's discussion and analysis of financial condition and results of operations appearing in the Company's Annual Report to stockholders for the applicable year, or (C) publicly announced by the Company in a press release or conference call relating to the Company's results of operations or financial condition for a completed quarterly or annual fiscal period.

2.22 *Performance Period* means the one or more periods of time, which may be of varying and overlapping durations, selected by the Committee, over which the attainment of one or more Performance Goals will be measured for purposes of determining a Participant's right to, and the payment of, a Performance Unit.

2.23 *Performance Unit* means a right granted to a Participant under Section 7.5, to receive cash, Stock or other Awards, the payment of which is contingent on achieving Performance Goals established by the Committee.

2.24 *Plan* means this 2006 Equity Incentive Plan of the Company, as amended from time to time, and including any attachments or addenda hereto.

2.25 *Qualified Performance-Based Awards* means Awards intended to qualify as "performance-based compensation" under Section 162(m) of the Code.

2.26 *Restricted Stock* means a grant or sale of shares of Stock to a Participant subject to a Risk of Forfeiture.

2.27 *Restriction Period* means the period of time, established by the Committee in connection with an Award of Restricted Stock or Restricted Stock Units, during which the shares of Restricted Stock or Restricted Stock Units are subject to a Risk of Forfeiture described in the applicable Award Agreement.

2.28 *Risk of Forfeiture* means a limitation on the right of the Participant to retain Restricted Stock or Restricted Stock Units, including a right in the Company to reacquire shares of Restricted Stock at less than their then Market Value, arising because of the occurrence or non-occurrence of specified events or conditions.

2.29 *Restricted Stock Units* means rights to receive shares of Stock at the close of a Restriction Period, subject to a Risk of Forfeiture.

2.30 *Stock* means common stock, par value \$0.001 per share, of the Company, and such other securities as may be substituted for Stock pursuant to Section 8.

2.31 *Stock Appreciation Right* means a right to receive any excess in the Market Value of shares of Stock (except as otherwise provided in Section 7.2(c)) over a specified exercise price.

2.32 *Stock Grant* means the grant of shares of Stock not subject to restrictions or other forfeiture conditions.

2.33 *Ten Percent Owner* means a person who owns, or is deemed within the meaning of Section 422(b)(6) of the Code to own, stock possessing more than 10% of the total combined voting power of all classes of stock of the Company (or any parent or subsidiary corporations of the Company, as defined in Sections 424(e) and (f), respectively, of the Code). Whether a person is a Ten Percent Owner shall be determined with respect to an Option based on the facts existing immediately prior to the Grant Date of the Option.

### **3. Term of the Plan**

Unless the Plan shall have been earlier terminated by the Board, Awards may be granted under this Plan at any time in the period commencing on the date of approval of the Plan by the Board and ending immediately prior to the tenth anniversary of the earlier of the adoption of the Plan by the Board or approval of the Plan by the

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Company's stockholders. Awards granted pursuant to the Plan within that period shall not expire solely by reason of the termination of the Plan. Awards of Incentive Options granted prior to stockholder approval of the Plan are expressly conditioned upon such approval, but in the event of the failure of the stockholders to approve the Plan shall thereafter and for all purposes be deemed to constitute Nonstatutory Options.

#### **4. Stock Subject to the Plan**

At no time shall the number of shares of Stock issued pursuant to or subject to outstanding Awards granted under the Plan (including, without limitation, pursuant to Incentive Options), nor the number of shares of Common Stock issued pursuant to Incentive Options, exceed the sum of (a) 500,000 shares of Stock plus (b) an annual increase to be added on the first day of each calendar year beginning on or after January 1, 2007 equal to the lesser of (i) 500,000 shares of Stock, and (ii) such lesser number as the Board may approve for the fiscal year, provided, however, that beginning on January 1, 2010, the annual increase to the number of shares of Stock that may be issued pursuant to the Plan shall be equal to the lesser of (x) 5.0% of the number of shares of Stock that are issued and outstanding as of the first day of the calendar year, and (y) 1,200,000 shares of Stock; *subject, however*, to the provisions of Section 8 of the Plan. For purposes of applying the foregoing limitation, (a) if any Option or Stock Appreciation Right expires, terminates, or is cancelled for any reason without having been exercised in full, or if any other Award is forfeited by the recipient or repurchased at less than its Market Value, the shares not purchased by the Optionee or which are forfeited by the recipient or repurchased shall again be available for Awards to be granted under the Plan and (b) if any Option is exercised by delivering previously-owned shares in payment of the exercise price therefor, only the net number of shares, that is, the number of shares issued minus the number received by the Company in payment of the exercise price, shall be considered to have been issued pursuant to an Award granted under the Plan. In addition, settlement of any Award shall not count against the foregoing limitations except to the extent settled in the form of Stock. Shares of Stock issued pursuant to the Plan may be either authorized but unissued shares or shares held by the Company in its treasury.

#### **5. Administration**

The Plan shall be administered by the Committee; *provided, however*, that at any time and on any one or more occasions the Board may itself exercise any of the powers and responsibilities assigned the Committee under the Plan and when so acting shall have the benefit of all of the provisions of the Plan pertaining to the Committee's exercise of its authorities hereunder; and *provided further, however*, that the Committee may delegate to an executive officer or officers the authority to grant Awards hereunder to employees who are not officers, and to consultants and advisors, in accordance with such guidelines as the Committee shall set forth at any time or from time to time. Subject to the provisions of the Plan, the Committee shall have complete authority, in its discretion, to make or to select the manner of making all determinations with respect to each Award to be granted by the Company under the Plan including the employee, consultant, advisor or director to receive the Award and the form of Award. In making such determinations, the Committee may take into account the nature of the services rendered by the respective employees, consultants, advisors and directors, their present and potential contributions to the success of the Company and its Affiliates, and such other factors as the Committee in its discretion shall deem relevant. Subject to the provisions of the Plan, the Committee shall also have complete authority to interpret the Plan, to prescribe, amend and rescind rules and regulations relating to it, to determine the terms and provisions of the respective Award Agreements (which need not be identical), and to make all other determinations necessary or advisable for the administration of the Plan, including, but not limited to, the cancellation, amendment, repricing, reclassification or exchange of outstanding Options and other Awards, subject to the provisions of Section 14. The Committee's determinations made in good faith on matters referred to in the Plan shall be final, binding and conclusive on all persons having or claiming any interest under the Plan or an Award made pursuant hereto.

#### **6. Authorization of Grants**

6.1 *Eligibility.* The Committee may grant from time to time and at any time prior to the termination of the Plan one or more Awards, either alone or in combination with any other Awards, to any employee of, or consultant or advisor to, one or more of the Company and its Affiliates or to any non-employee member of the Board or of any board of directors (or similar governing authority) of any Affiliate. However, only employees of the Company, and of any parent or subsidiary corporations of the Company, as defined in Sections 424(e) and (f), respectively, of the Code, shall be eligible for the grant of an Incentive Option. Further, in no event shall the number of shares of Stock covered by Options or other Awards granted to any one person in any one calendar year exceed 25% of the aggregate number of shares of Stock subject to the Plan.

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6.2 *General Terms of Awards.* Each grant of an Award shall be subject to all applicable terms and conditions of the Plan (including but not limited to any specific terms and conditions applicable to that type of Award set out in the following Section), and such other terms and conditions, not inconsistent with the terms of the Plan, as the Committee may prescribe. No prospective Participant shall have any rights with respect to an Award, unless and until such Participant shall have complied with the applicable terms and conditions of such Award (including, if applicable, delivering a fully-executed copy of any agreement evidencing an Award to the Company).

6.3 *Effect of Termination of Employment, Etc.* Unless the Committee shall provide otherwise with respect to any Award, if the Participant's employment or other association with the Company and its Affiliates ends for any reason, including because of the Participant's employer ceasing to be an Affiliate, (a) any outstanding Option or Stock Appreciation Right of the Participant shall cease to be exercisable in any respect not later than 90 days following that event and, for the period it remains exercisable following that event, shall be exercisable only to the extent exercisable at the date of that event, and (b) any other outstanding Award of the Participant shall be forfeited or otherwise subject to return to, or repurchase by, the Company on the terms specified in the applicable Award Agreement. Military or sick leave or other bona fide leave shall not be deemed a termination of employment or other association, *provided* that it does not exceed the longer of 90 days or the period during which the absent Participant's reemployment rights, if any, are guaranteed by statute or by contract.

6.4 *Transferability of Awards.* Except as otherwise provided in this Section 6.4, Awards shall not be transferable, and no Award or interest therein may be sold, transferred, pledged, assigned, or otherwise alienated or hypothecated, other than by will or by the laws of descent and distribution. The foregoing sentence shall not limit the transferability of Stock Grants or of Restricted Stock that is no longer subject to a Risk of Forfeiture. All of a Participant's rights in any Award may be exercised during the life of the Participant only by the Participant or the Participant's legal representative. However, the Committee may, at or after the grant of an Award of a Nonstatutory Option, or shares of Restricted Stock, provide that such Award may be transferred by the recipient to a family member; *provided, however*, that any such transfer is without payment of any consideration whatsoever and that no transfer shall be valid unless first approved by the Committee, acting in its sole discretion. For this purpose, "family member" means any child, stepchild, grandchild, parent, stepparent, spouse, former spouse, sibling, niece, nephew, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships, any person sharing the employee's household (other than a tenant or employee), a trust in which the foregoing persons have more than 50% of the beneficial interests, a foundation in which the foregoing persons (or the Participant) control the management of assets, and any other entity in which these persons (or the Participant) own more than 50% of the voting interests.

## 7. **Specific Terms of Awards**

### 7.1 *Options.*

(a) *Date of Grant.* The granting of an Option shall take place at the time specified in the Award Agreement. Only if expressly so provided in the applicable Award Agreement shall the Grant Date be the date on which the Award Agreement shall have been duly executed and delivered by the Company and the Optionee.

(b) *Exercise Price.* The price at which shares of Stock may be acquired under each Incentive Option shall be not less than 100% of the Market Value of Stock on the Grant Date, or not less than 110% of the Market Value of Stock on the Grant Date if the Optionee is a Ten Percent Owner. The price at which shares may be acquired under each Nonstatutory Option shall not be so limited solely by reason of this Section.

(c) *Option Period.* No Incentive Option may be exercised on or after the tenth anniversary of the Grant Date, or on or after the fifth anniversary of the Grant Date if the Optionee is a Ten Percent Owner. The Option period under each Nonstatutory Option shall not be so limited solely by reason of this Section.

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(d) *Exercisability.* An Option may be immediately exercisable or become exercisable in such installments, cumulative or non-cumulative, as the Committee may determine. In the case of an Option not otherwise immediately exercisable in full, the Committee may Accelerate such Option in whole or in part at any time; *provided, however,* that in the case of an Incentive Option, any such Acceleration of the Option would not cause the Option to fail to comply with the provisions of Section 422 of the Code or the Optionee consents to the Acceleration.

(e) *Method of Exercise.* An Option may be exercised by the Optionee giving written notice, in the manner provided in Section 16, specifying the number of shares with respect to which the Option is then being exercised. The notice shall be accompanied by payment in the form of cash or check payable to the order of the Company in an amount equal to the exercise price of the shares to be purchased or, subject in each instance to the Committee's approval, acting in its sole discretion, and to such conditions, if any, as the Committee may deem necessary to avoid adverse accounting effects to the Company) by delivery to the Company of

- (i) shares of Stock having a Market Value equal to the exercise price of the shares to be purchased, or
- (ii) unless prohibited by applicable law, the Optionee's executed promissory note in the principal amount equal to the exercise price of the shares to be purchased and otherwise in such form as the Committee shall have approved.

If the Stock is traded on an established market, payment of any exercise price may also be made through and under the terms and conditions of any formal cashless exercise program authorized by the Company entailing the sale of the Stock subject to an Option in a brokered transaction (other than to the Company). Receipt by the Company of such notice and payment in any authorized, or combination of authorized, means shall constitute the exercise of the Option. Within thirty (30) days thereafter but subject to the remaining provisions of the Plan, the Company shall deliver, or cause to be delivered, to the Optionee or his agent a certificate or certificates for the number of shares then being purchased. Such shares shall be fully paid and nonassessable.

(f) *Limit on Incentive Option Characterization.* An Incentive Option shall be considered to be an Incentive Option only to the extent that the number of shares of Stock for which the Option first becomes exercisable in a calendar year do not have an aggregate Market Value (as of the date of the grant of the Option) in excess of the "current limit". The current limit for any Optionee for any calendar year shall be \$100,000 *minus* the aggregate Market Value at the date of grant of the number of shares of Stock available for purchase for the first time in the same year under each other Incentive Option previously granted to the Optionee under the Plan, and under each other incentive stock option previously granted to the Optionee under any other incentive stock option plan of the Company and its Affiliates, after December 31, 1986. Any shares of Stock which would cause the foregoing limit to be violated shall be deemed to have been granted under a separate Nonstatutory Option, otherwise identical in its terms to those of the Incentive Option.

(g) *Notification of Disposition.* Each person exercising any Incentive Option granted under the Plan shall be deemed to have covenanted with the Company to report to the Company any disposition of such shares prior to the expiration of the holding periods specified by Section 422(a)(1) of the Code (currently the later of two years from the Grant Date and one year from the date of exercise of the Incentive Option) and, if and to the extent that the realization of income in such a disposition imposes upon the Company federal, state, local or other withholding tax requirements, or any such withholding is required to secure for the Company an otherwise available tax deduction, to remit to the Company an amount in cash sufficient to satisfy those requirements.

## 7.2 *Stock Appreciation Rights.*

(a) *Tandem or Stand-Alone.* Stock Appreciation Rights may be granted in tandem with an Option (at or, in the case of a Nonstatutory Option, after the award of the Option), or alone and unrelated to an Option. Stock Appreciation Rights in tandem with an Option shall terminate to the extent that the related Option is exercised, and the related Option shall terminate to the extent that the tandem Stock Appreciation Rights are exercised.

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(b) *Exercise Price.* Stock Appreciation Rights shall have such exercise price as the Committee may determine, except that in the case of Stock Appreciation Rights in tandem with Options, the exercise price of the Stock Appreciation Rights shall equal the exercise price of the related Option.

(c) *Other Terms.* Except as the Committee may deem inappropriate or inapplicable in the circumstances, Stock Appreciation Rights shall be subject to terms and conditions substantially similar to those applicable to a Nonstatutory Option. In addition, a Stock Appreciation Right related to an Option which can only be exercised during limited periods following a Change in Control may entitle the Participant to receive an amount based upon the highest price paid or offered for Stock in any transaction relating to the Change in Control or paid during the thirty (30) day period immediately preceding the occurrence of the Change in Control in any transaction reported in the stock market in which the Stock is normally traded.

### 7.3 *Restricted Stock.*

(a) *Purchase Price.* Shares of Restricted Stock shall be issued under the Plan for such consideration, in cash, other property or services, or any combination thereof, as is determined by the Committee.

(b) *Issuance of Certificates.* Each Participant receiving a Restricted Stock Award, subject to subsection (c) below, shall be issued a stock certificate in respect of such shares of Restricted Stock. Such certificate shall be registered in the name of such Participant, and, if applicable, shall bear an appropriate legend referring to the terms, conditions, and restrictions applicable to such Award substantially in the following form:

The transferability of this certificate and the shares represented by this certificate are subject to the terms and conditions of the Netlist, Inc. 2006 Equity Incentive Plan and an Award Agreement entered into by the registered owner and Netlist, Inc. Copies of such Plan and Agreement are on file in the offices of Netlist, Inc.

(c) *Escrow of Shares.* The Committee may require that the stock certificates evidencing shares of Restricted Stock be held in custody by a designated escrow agent (which may but need not be the Company) until the restrictions thereon shall have lapsed, and that the Participant deliver a stock power, endorsed in blank, relating to the Stock covered by such Award.

(d) *Restrictions and Restriction Period.* During the Restriction Period applicable to shares of Restricted Stock, such shares shall be subject to limitations on transferability and a Risk of Forfeiture arising on the basis of such conditions related to the performance of services, Company or Affiliate performance or otherwise as the Committee may determine and provide for in the applicable Award Agreement. Any such Risk of Forfeiture may be waived or terminated, or the Restriction Period shortened, at any time by the Committee on such basis as it deems appropriate.

(e) *Rights Pending Lapse of Risk of Forfeiture or Forfeiture of Award.* Except as otherwise provided in the Plan or the applicable Award Agreement, at all times prior to lapse of any Risk of Forfeiture applicable to, or forfeiture of, an Award of Restricted Stock, the Participant shall have all of the rights of a stockholder of the Company, including the right to vote, and the right to receive any dividends with respect to, the shares of Restricted Stock. The Committee, as determined at the time of Award, may permit or require the payment of cash dividends to be deferred and, if the Committee so determines, reinvested in additional Restricted Stock to the extent shares are available under Section 4.

(f) *Lapse of Restrictions.* If and when the Restriction Period expires without a prior forfeiture of the Restricted Stock, the certificates for such shares shall be delivered to the Participant promptly if not previously delivered.

### 7.4 *Restricted Stock Units.*

(a) *Character.* Each Restricted Stock Unit shall entitle the recipient to a share of Stock at a close of such Restriction Period as the Committee may establish and be subject to a Risk of Forfeiture arising on the basis of such conditions relating to the performance of services, Company or Affiliate performance or otherwise as the Committee may determine and provide for in the applicable Award Agreement. Any such Risk of Forfeiture may be waived or terminated, or the Restriction Period shortened, at any time by the Committee on such basis as it deems appropriate.

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(b) *Form and Timing of Payment.* Payment of earned Restricted Stock Units shall be made in a single lump sum following the close of the applicable Restriction Period. At the discretion of the Committee, Participants may be entitled to receive payments equivalent to any dividends declared with respect to Stock referenced in grants of Restricted Stock Units but only following the close of the applicable Restriction Period and then only if the underlying Stock shall have been earned. Unless the Committee shall provide otherwise, any such dividend equivalents shall be paid, if at all, without interest or other earnings.

#### 7.5 *Performance Units.*

(a) *Character.* Each Performance Unit shall entitle the recipient to the value of a specified number of shares of Stock, over the initial value for such number of shares, if any, established by the Committee at the time of grant, at the close of a specified Performance Period to the extent specified Performance Goals shall have been achieved.

(b) *Earning of Performance Units.* The Committee shall set Performance Goals in its discretion which, depending on the extent to which they are met within the applicable Performance Period, will determine the number and value of Performance Units that will be paid out to the Participant. After the applicable Performance Period has ended, the holder of Performance Units shall be entitled to receive payout on the number and value of Performance Units earned by the Participant over the Performance Period, to be determined as a function of the extent to which the corresponding Performance Goals have been achieved.

(c) *Form and Timing of Payment.* Payment of earned Performance Units shall be made in a single lump sum following the close of the applicable Performance Period. At the discretion of the Committee, Participants may be entitled to receive any dividends declared with respect to Stock which have been earned in connection with grants of Performance Units which have been earned, but not yet distributed to Participants. The Committee may permit or, if it so provides at grant, require a Participant to defer such Participant's receipt of the payment of cash or the delivery of Stock that would otherwise be due to such Participant by virtue of the satisfaction of any requirements or goals with respect to Performance Units. If any such deferral election is permitted or required, the Committee shall establish rules and procedures for such payment deferrals.

7.6 *Stock Grants.* Stock Grants shall be awarded solely in recognition of significant contributions to the success of the Company or its Affiliates, in lieu of compensation otherwise already due and in such other limited circumstances as the Committee deems appropriate. Stock Grants shall be made without forfeiture conditions of any kind.

#### 7.7 *Qualified Performance-Based Awards.*

(a) *Purpose.* The purpose of this Section 7.7 is to provide the Committee the ability to qualify Awards as "performance-based compensation" under Section 162(m) of the Code. If the Committee, in its discretion, decides to grant an Award as a Qualified Performance-Based Award, the provisions of this Section 7.7 will control over any contrary provision contained in the Plan. In the course of granting any Award, the Committee may specifically designate the Award as intended to qualify as a Qualified Performance-Based Award. However, no Award shall be considered to have failed to qualify as a Qualified Performance-Based Award solely because the Award is not expressly designated as a Qualified Performance-Based Award if the Award otherwise satisfies the provisions of this Section 7.7 and the requirements of Section 162(m) of the Code and the regulations thereunder applicable to "performance-based compensation."

(b) *Authority.* All grants of Awards intended to qualify as Qualified Performance-Based Awards and determination of terms applicable thereto shall be made by the Committee or, if not all of the members thereof qualify as "outside directors" within the meaning of applicable IRS regulations under Section 162 of the Code, a subcommittee of the Committee consisting of such of the members of the Committee as do so qualify. Any action by such a subcommittee shall be considered the action of the Committee for purposes of the Plan.

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(c) *Applicability.* This Section 7.7 will apply only to those Covered Employees, or to those persons who the Committee determines are reasonably likely to become Covered Employees in the period covered by an Award, selected by the Committee to receive Qualified Performance-Based Awards. The Committee may, in its discretion, grant Awards to Covered Employees that do not satisfy the requirements of this Section 7.7.

(d) *Discretion of Committee with Respect to Qualified Performance-Based Awards.* Options may be granted as Qualified Performance-Based Awards in accordance with Section 7.1, except that the exercise price of any Option intended to qualify as a Qualified Performance-Based Award shall in no event be less than the Market Value of the Stock on the date of grant. With regard to other Awards intended to qualify as Qualified Performance-Based Awards, such as Restricted Stock, Restricted Stock Units, or Performance Units, the Committee will have full discretion to select the length of any applicable Restriction Period or Performance Period, the kind and/or level of the applicable Performance Goal, and whether the Performance Goal is to apply to the Company, a Subsidiary or any division or business unit or to the individual. Any Performance Goal or Goals applicable to Qualified Performance-Based Awards shall be objective, shall be established not later than ninety (90) days after the beginning of any applicable Performance Period (or at such other date as may be required or permitted for “performance-based compensation” under Section 162(m) of the Code) and shall otherwise meet the requirements of Section 162(m) of the Code, including the requirement that the outcome of the Performance Goal or Goals be substantially uncertain (as defined in the regulations under Section 162(m) of the Code) at the time established.

(e) *Payment of Qualified Performance-Based Awards.* A Participant will be eligible to receive payment under a Qualified Performance-Based Award which is subject to achievement of a Performance Goal or Goals only if the applicable Performance Goal or Goals period are achieved within the applicable Performance Period, as determined by the Committee. In determining the actual size of an individual Qualified Performance-Based Award, the Committee may reduce or eliminate the amount of the Qualified Performance-Based Award earned for the Performance Period, if in its sole and absolute discretion, such reduction or elimination is appropriate.

(f) *Maximum Award Payable.* The maximum Qualified Performance-Based Award payment to any one Participant under the Plan for a Performance Period is 25% of the number of shares of Stock set forth in Section 4 above, or if the Qualified Performance-Based Award is paid in cash, that number of shares multiplied by the Market Value of the Stock as of the date the Qualified Performance-Based Award is granted.

(g) *Limitation on Adjustments for Certain Events.* No adjustment of any Qualified Performance-Based Award pursuant to Section 8 shall be made except on such basis, if any, as will not cause such Award to provide other than “performance-based compensation” within the meaning of Section 162(m) of the Code.

7.8 *Awards to Participants Outside the United States.* The Committee may modify the terms of any Award under the Plan granted to a Participant who is, at the time of grant or during the term of the Award, resident or primarily employed outside of the United States in any manner deemed by the Committee to be necessary or appropriate to conform that Award to laws, regulations, and customs of the country in which the Participant is then resident or primarily employed, or so that the value and other benefits of the Award to the Participant, as affected by foreign tax laws and other restrictions applicable as a result of the Participant’s residence or employment abroad, shall be comparable to the value of such an Award to a Participant who is resident or primarily employed in the United States. The Committee may establish supplements to, or amendments, restatements, or alternative versions of, the Plan for the purpose of granting and administering any such modified Award. No such modification, supplement, amendment, restatement or alternative version may increase the share limit of Section 4.

## **8. Adjustment Provisions**

8.1 *Adjustment for Corporate Actions.* All of the share numbers set forth in the Plan reflect the capital structure of the Company as of the Effective Date. Subject to Section 8.2, if subsequent to that date the outstanding shares of Stock (or any other securities covered by the Plan by reason of the prior application of this Section) are increased, decreased, or exchanged for a different number or kind of shares or other securities, or if additional shares or new or different shares or other securities are distributed with respect to shares of Stock, through a merger, consolidation, sale of all or substantially all the property of the Company, reorganization, recapitalization, reclassification, stock dividend, stock split, reverse stock split, or other similar distribution with respect to such shares of Stock, an appropriate and proportionate adjustment will be made in (i) the maximum numbers and kinds of shares provided in Section 4, (ii) the numbers and kinds of shares or other securities subject to the then outstanding Awards, (iii) the exercise price for each share or other unit of any other securities subject to then outstanding Options and Stock Appreciation Rights (without change in the aggregate purchase price as to which such Options or Rights remain exercisable), and (iv) the repurchase price of each share of Restricted Stock then subject to a Risk of Forfeiture in the form of a Company repurchase right.

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## 8.2 *Treatment in Certain Acquisitions.*

(a) Subject to any provisions of then outstanding Awards granting greater rights to the holders thereof, in the event of an Acquisition, the Committee may, either in advance of the Acquisition or at the time thereof and upon such terms as it may deem appropriate, provide for the Acceleration of any then outstanding Awards in full if, and only if, such Awards are not assumed or replaced by comparable Awards referencing shares of the capital stock of the successor or acquiring entity or parent thereof, and after a reasonable period following such Acceleration, as determined by the Committee, such Accelerated Awards and all other then outstanding Awards not assumed or replaced by comparable Awards shall terminate. As to any one or more outstanding Awards which are not otherwise Accelerated in full by reason of such Acquisition, the Committee may also, either in advance of an Acquisition or at the time thereof and upon such terms as it may deem appropriate, provide for the Acceleration of such outstanding Awards in the event that the employment of the Participants should subsequently terminate following the Acquisition. Each outstanding Award that is assumed in connection with an Acquisition, or is otherwise to continue in effect subsequent to the Acquisition, will be appropriately adjusted, immediately after the Acquisition, as to the number and class of securities and other relevant terms in accordance with Section 8.1.

(b) For the purposes of this Section 8.2, an Award shall be considered assumed or replaced by a comparable Award if, following the Acquisition, the Award confers the right to purchase, for each share of Stock subject to the Award immediately prior to the Acquisition, the consideration (whether stock, cash or other securities or property) received in the Acquisition by holders of Stock on the effective date of the Acquisition (and if holders were offered a choice of consideration, the type of consideration chosen by the holders of a majority of the outstanding shares of Stock); *provided, however*, that if such consideration received in the Acquisition was not solely common stock of the successor corporation or its parent or subsidiary, the Committee may, with the consent of the successor corporation, provide for the consideration to be received upon the exercise of the Award for each share of Stock subject to the Award to be solely common stock of the successor corporation or its parent or subsidiary equal in fair market value to the per share consideration received by holders of Stock in the Acquisition, or any combination of cash and common stock, (including the payment of cash equal to the net of Market Value over the exercise price of the shares of Stock subject to the Award) so approved by the Committee with the consent of the successor corporation; and provided further that such Award may continue to be subject to the same vesting requirements or Risks of Forfeiture after the Acquisition.

8.3 *Dissolution or Liquidation.* Upon the dissolution or liquidation of the Company, other than as part of an Acquisition or similar transaction, each outstanding Option and Stock Appreciation Right shall terminate, but the Optionee or Stock Appreciation Right holder shall have the right, immediately prior to the dissolution or liquidation, to exercise the Option or Stock Appreciation Right to the extent exercisable on the date of the dissolution or liquidation.

8.4 *Adjustment of Awards Upon the Occurrence of Certain Unusual or Nonrecurring Events.* In the event of any corporate action not specifically covered by the preceding Sections, including but not limited to an extraordinary cash distribution on Stock, a corporate separation or other reorganization or liquidation, the Committee may make such adjustment of outstanding Awards and their terms, if any, as it, in its sole discretion, may deem equitable and appropriate in the circumstances. The Committee may make adjustments in the terms and conditions of, and the criteria included in, Awards in recognition of unusual or nonrecurring events (including, without limitation, the events described in this Section) affecting the Company or the financial statements of the Company or of changes in applicable laws, regulations, or accounting principles, whenever the Committee determines that such adjustments are appropriate in order to prevent the dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan.

8.5 *Related Matters.* Any adjustment in Awards made pursuant to this Section 8 shall be determined and made, if at all, by the Committee and shall include any correlative modification of terms, including of Option exercise prices, rates of vesting or exercisability, Risks of Forfeiture, applicable repurchase prices for Restricted Stock, and Performance Goals and other financial objectives which the Committee may deem necessary or

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appropriate so as to ensure the rights of the Participants in their respective Awards are not substantially diminished nor enlarged as a result of the adjustment and corporate action other than as expressly contemplated in this Section 8. No fraction of a share shall be purchasable or deliverable upon exercise, but in the event any adjustment hereunder of the number of shares covered by an Award shall cause such number to include a fraction of a share, such number of shares shall be adjusted to the nearest smaller whole number of shares. No adjustment of an Option exercise price per share pursuant to this Section 8 shall result in an exercise price which is less than the par value of the Stock.

## **9. Settlement of Awards**

9.1 *In General.* Options and Restricted Stock shall be settled in accordance with their terms. All other Awards may be settled in cash, Stock, or other Awards, or a combination thereof, as determined by the Committee at or after grant and subject to any contrary Award Agreement. The Committee may not require settlement of any Award in Stock pursuant to the immediately preceding sentence to the extent issuance of such Stock would be prohibited or unreasonably delayed by reason of any other provision of the Plan.

9.2 *Violation of Law.* Notwithstanding any other provision of the Plan or the relevant Award Agreement, if, at any time, in the reasonable opinion of the Company, the issuance of shares of Stock covered by an Award may constitute a violation of law, then the Company may delay such issuance and the delivery of a certificate for such shares until (i) approval shall have been obtained from such governmental agencies, other than the Securities and Exchange Commission, as may be required under any applicable law, rule, or regulation and (ii) in the case where such issuance would constitute a violation of a law administered by, or a regulation of, the Securities and Exchange Commission, one of the following conditions shall have been satisfied:

(a) the shares are at the time of the issue of such shares effectively registered under the Securities Act of 1933, as amended; or

(b) the Company shall have determined, on such basis as it deems appropriate (including an opinion of counsel in form and substance satisfactory to the Company) that the sale, transfer, assignment, pledge, encumbrance or other disposition of such shares or such beneficial interest, as the case may be, does not require registration under the Securities Act of 1933, as amended, or any applicable State securities laws.

The Company shall make all reasonable efforts to bring about the occurrence of said events.

9.3 *Corporate Restrictions on Rights in Stock.* Any Stock to be issued pursuant to Awards granted under the Plan shall be subject to all restrictions upon the transfer thereof which may be now or hereafter imposed by the certificate of incorporation and by-laws (or similar charter documents) of the Company.

9.4 *Investment Representations.* The Company shall be under no obligation to issue any shares covered by any Award unless the shares to be issued pursuant to Awards granted under the Plan have been effectively registered under the Securities Act of 1933, as amended, or the Participant shall have made such written representations to the Company (upon which the Company believes it may reasonably rely) as the Company may deem necessary or appropriate for purposes of confirming that the issuance of such shares will be exempt from the registration requirements of that Act and any applicable state securities laws and otherwise in compliance with all applicable laws, rules and regulations, including but not limited to that the Participant is acquiring the shares for his or her own account for the purpose of investment and not with a view to, or for sale in connection with, the distribution of any such shares.

9.5 *Registration.* If the Company shall deem it necessary or desirable to register under the Securities Act of 1933, as amended or other applicable statutes any shares of Stock issued or to be issued pursuant to Awards granted under the Plan, or to qualify any such shares of Stock for exemption from the Securities Act of 1933, as amended, or other applicable statutes, then the Company shall take such action at its own expense. The Company may require from each recipient of an Award, or each holder of shares of Stock acquired pursuant to the Plan, such information in writing for use in any registration statement, prospectus, preliminary prospectus or offering circular as is reasonably necessary for that purpose and may require reasonable indemnity to the Company and its officers and directors from that holder against all losses, claims, damage and liabilities arising from use of the information so furnished and caused by any untrue statement of any material fact therein or caused by the omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading in the light of

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the circumstances under which they were made. In addition, the Company may require of any such person that he or she agree that, without the prior written consent of the Company or the managing underwriter in any public offering of shares of Stock, he or she will not sell, make any short sale of, loan, grant any option for the purchase of, pledge or otherwise encumber, or otherwise dispose of, any shares of Stock during the 180 day period commencing on the effective date of the registration statement relating to the underwritten public offering of securities. Without limiting the generality of the foregoing provisions of this Section 9.5, if in connection with any underwritten public offering of securities of the Company the managing underwriter of such offering requires that the Company's directors and officers enter into a lock-up agreement containing provisions that are more restrictive than the provisions set forth in the preceding sentence, then (a) each holder of shares of Stock acquired pursuant to the Plan (regardless of whether such person has complied or complies with the provisions of clause (b) below) shall be bound by, and shall be deemed to have agreed to, the same lock-up terms as those to which the Company's directors and officers are required to adhere; and (b) at the request of the Company or such managing underwriter, each such person shall execute and deliver a lock-up agreement in form and substance equivalent to that which is required to be executed by the Company's directors and officers.

9.6 *Placement of Legends; Stop Orders; etc.* Each share of Stock to be issued pursuant to Awards granted under the Plan may bear a reference to the investment representation made in accordance with Section 9.4 in addition to any other applicable restriction under the Plan, the terms of the Award and if applicable under the Stockholders' Agreement and to the fact that no registration statement has been filed with the Securities and Exchange Commission in respect to such shares of Stock. All certificates for shares of Stock or other securities delivered under the Plan shall be subject to such stock transfer orders and other restrictions as the Committee may deem advisable under the rules, regulations, and other requirements of any stock exchange upon which the Stock is then listed, and any applicable federal or state securities law, and the Committee may cause a legend or legends to be put on any such certificates to make appropriate reference to such restrictions.

9.7 *Tax Withholding.* Whenever shares of Stock are issued or to be issued pursuant to Awards granted under the Plan, the Company shall have the right to require the recipient to remit to the Company an amount sufficient to satisfy federal, state, local or other withholding tax requirements if, when, and to the extent required by law (whether so required to secure for the Company an otherwise available tax deduction or otherwise) prior to the delivery of any certificate or certificates for such shares. The obligations of the Company under the Plan shall be conditional on satisfaction of all such withholding obligations and the Company shall, to the extent permitted by law, have the right to deduct any such taxes from any payment of any kind otherwise due to the recipient of an Award. However, in such cases Participants may elect, subject to the approval of the Committee, to satisfy an applicable withholding requirement, in whole or in part, by having the Company withhold shares to satisfy their tax obligations. Participants may only elect to have Shares withheld having a Market Value on the date the tax is to be determined equal to the minimum statutory total tax which could be imposed on the transaction. All elections shall be irrevocable, made in writing, signed by the Participant, and shall be subject to any restrictions or limitations that the Committee deems appropriate.

## **10. Reservation of Stock**

The Company shall at all times during the term of the Plan and any outstanding Awards granted hereunder reserve or otherwise keep available such number of shares of Stock as will be sufficient to satisfy the requirements of the Plan (if then in effect) and the Awards and shall pay all fees and expenses necessarily incurred by the Company in connection therewith.

## **11. Limitation of Rights in Stock; No Special Service Rights**

A Participant shall not be deemed for any purpose to be a stockholder of the Company with respect to any of the shares of Stock subject to an Award, unless and until a certificate shall have been issued therefor and delivered to the Participant or his agent. Nothing contained in the Plan or in any Award Agreement shall confer upon any recipient of an Award any right with respect to the continuation of his or her employment or other association with the Company (or any Affiliate), or interfere in any way with the right of the Company (or any Affiliate), subject to the terms of any separate employment or consulting agreement or provision of law or corporate articles, by-laws or similar charter documents to the contrary, at any time to terminate such employment or consulting agreement or to increase or decrease, or otherwise adjust, the other terms and conditions of the recipient's employment or other association with the Company and its Affiliates.

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## **12. Unfunded Status of Plan**

The Plan is intended to constitute an “unfunded” plan for incentive compensation, and the Plan is not intended to constitute a plan subject to the provisions of the Employee Retirement Income Security Act of 1974, as amended. With respect to any payments not yet made to a Participant by the Company, nothing contained herein shall give any such Participant any rights that are greater than those of a general creditor of the Company. In its sole discretion, the Committee may authorize the creation of trusts or other arrangements to meet the obligations created under the Plan to deliver Stock or payments with respect to Options, Stock Appreciation Rights and other Awards hereunder, *provided, however*, that the existence of such trusts or other arrangements is consistent with the unfunded status of the Plan.

## **13. Nonexclusivity of the Plan**

Neither the adoption of the Plan by the Board nor the submission of the Plan to the stockholders of the Company shall be construed as creating any limitations on the power of the Board to adopt such other incentive arrangements as it may deem desirable, including without limitation, the granting of stock options and restricted stock other than under the Plan, and such arrangements may be either applicable generally or only in specific cases.

## **14. Termination and Amendment of the Plan**

The Board may at any time terminate the Plan or make such modifications of the Plan as it shall deem advisable. Unless the Board otherwise expressly provides, no amendment of the Plan shall affect the terms of any Award outstanding on the date of such amendment.

The Committee may amend the terms of any Award theretofore granted, prospectively or retroactively, provided that the Award as amended is consistent with the terms of the Plan. Also within the limitations of the Plan, the Committee may modify, extend or assume outstanding Awards or may accept the cancellation of outstanding Awards or of outstanding stock options or other equity-based compensation awards granted by another issuer in return for the grant of new Awards for the same or a different number of shares and on the same or different terms and conditions (including but not limited to the exercise price of any Option). Furthermore, the Committee may at any time (a) offer to buy out for a payment in cash or cash equivalents an Award previously granted or (b) authorize the recipient of an Award to elect to cash out an Award previously granted, in either case at such time and based upon such terms and conditions as the Committee shall establish.

No amendment or modification of the Plan by the Board, or of an outstanding Award by the Committee, shall impair the rights of the recipient of any Award outstanding on the date of such amendment or modification or such Award, as the case may be, without the Participant’s consent; *provided, however*, that no such consent shall be required if (i) the Board or Committee, as the case may be, determines in its sole discretion and prior to the date of any Acquisition that such amendment or alteration either is required or advisable in order for the Company, the Plan or the Award to satisfy any law or regulation, including without limitation the provisions of Section 409A of the Code or to meet the requirements of or avoid adverse financial accounting consequences under any accounting standard, or (ii) the Board or Committee, as the case may be, determines in its sole discretion that such amendment or alteration is not reasonably likely to significantly diminish the benefits provided under the Award, or that any such diminution has been adequately compensated.

## **15. Notices and Other Communications**

Any notice, demand, request or other communication hereunder to any party shall be deemed to be sufficient if contained in a written instrument delivered in person or duly sent by first class registered, certified or overnight mail, postage prepaid, or telecopied with a confirmation copy by regular, certified or overnight mail, addressed or telecopied, as the case may be, (i) if to the recipient of an Award, at his or her residence address last filed with the Company and (ii) if to the Company, at its principal place of business, addressed to the attention of its

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Treasurer, or to such other address or telecopier number, as the case may be, as the addressee may have designated by notice to the addressor. All such notices, requests, demands and other communications shall be deemed to have been received: (i) in the case of personal delivery, on the date of such delivery; (ii) in the case of mailing, when received by the addressee; and (iii) in the case of facsimile transmission, when confirmed by facsimile machine report.

**16. Governing Law**

The Plan and all Award Agreements and actions taken thereunder shall be governed, interpreted and enforced in accordance with the laws of the State of Delaware, without regard to the conflict of laws principles thereof.

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AMENDMENT TO LOAN DOCUMENTS

THIS AMENDMENT TO LOAN DOCUMENTS (this "Amendment") is entered into as of June 30, 2010, by and between SILICON VALLEY BANK ("Bank" or "Silicon") and NETLIST, INC., a Delaware corporation ("Borrower"). Borrower's chief executive office is located at 51 Discovery, Suite 150, Irvine, CA 92618.

RECITALS

- A. Bank and Borrower are parties to that certain Loan and Security Agreement with an Effective Date of October 31, 2009 (as amended, modified, supplemented or restated, the "Loan Agreement") in effect between Bank and Borrower.
- B. Bank has extended credit to Borrower for the purposes permitted in the Loan Agreement.
- C. Borrower has requested that Bank amend the Loan Agreement to modify the Profitability Financial Covenant as more fully set forth herein.
- D. Bank has agreed to so amend the Loan Agreement, but only to the extent, in accordance with the terms, subject to the conditions and in reliance upon the representations and warranties set forth below.

AGREEMENT

NOW, THEREFORE, in consideration of the foregoing recitals and other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, and intending to be legally bound, the parties hereto agree as follows:

1. **Definitions.** Capitalized terms used but not defined in this Amendment shall have the meanings given to them in the Loan Agreement.

2. **Amendments to Loan Documents.**

2.1 **Modified Profitability Financial Covenant.** Section 6.9(b) of the Loan Agreement is hereby amended in its entirety to read as follows:

(b) Profitability. Measured as of the end of each of the following fiscal quarters, minimum Gross Profit of not less than the following [note — amounts within pointed brackets ( < \$ > ) are negative amounts]:

<u>Fiscal Quarter ending ...</u>	<u>Minimum Gross Profit</u>
September 30, 2009	\$ <415,000.00>
December 31, 2009	\$ 43,000.00
March 31, 2010	\$ 1,429,000.00
June 30, 2010	\$ 1,500,000.00
September 30, 2010	\$ 2,000,000.00

**3. Limitation of Amendments.**

**3.1** The amendments set forth in **Section 2**, above, are effective for the purposes set forth herein and shall be limited precisely as written and shall not be deemed to (a) be a consent to any amendment, waiver or modification of any other term or condition of any Loan Document, or (b) otherwise prejudice any right or remedy which Bank may now have or may have in the future under or in connection with any Loan Document.

**3.2** This Amendment shall be construed in connection with and as part of the Loan Documents and all terms, conditions, representations, warranties, covenants and agreements set forth in the Loan Documents (as amended by this Amendment, as applicable) are hereby ratified and confirmed and shall remain in full force and effect.

**4. Representations and Warranties.** To induce Bank to enter into this Amendment, Borrower hereby represents and warrants to Bank as follows:

**4.1** Immediately after giving effect to this Amendment, (a) the representations and warranties contained in the Loan Documents are true, accurate and complete in all material respects as of the date hereof (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date, or except as otherwise previously disclosed in writing by Borrower to Bank), and (b) no Event of Default has occurred and is continuing;

**4.2** Borrower has the power and authority to execute and deliver this Amendment and to perform its obligations under the Loan Documents, as amended by this Amendment;

**4.3** The organizational documents of Borrower delivered to Bank on the Effective Date remain true, accurate and complete and have not been otherwise amended, supplemented or restated and are and continue to be in full force and effect;

**4.4** The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Documents, as amended by this Amendment, have been duly authorized;

**4.5** The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Documents, as amended by this Amendment, do not and will not contravene (a) any law or regulation binding on or affecting Borrower, (b) any contractual restriction with a Person binding on Borrower, (c) any order, judgment or decree of any court or other governmental or public body or authority, or subdivision thereof, binding on Borrower, or (d) the organizational documents of Borrower;

**4.6** The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Documents, as amended by this Amendment, do not require any order, consent, approval, license, authorization or validation of, or filing, recording or registration with, or exemption by any governmental or public body or authority, or subdivision thereof, binding on either Borrower, except as already has been obtained or made; and

**4.7** This Amendment has been duly executed and delivered by Borrower and is the binding obligation of Borrower, enforceable against Borrower in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, liquidation, moratorium or other similar laws of general application and equitable principles relating to or affecting creditors' rights.

**5. Release by Borrower and Guarantor** . Each of Borrower and Guarantor (individually and collectively, "Obligor") hereby agree as follows:

**5.1 FOR GOOD AND VALUABLE CONSIDERATION** , Obligor hereby forever relieves, releases, and discharges Bank and its present or former employees, officers, directors, agents, representatives, attorneys, and each of them, from any and all claims, debts, liabilities, demands, obligations, promises, acts, agreements, costs and expenses, actions and causes of action, of every type, kind, nature, description or character whatsoever, whether known or unknown, suspected or unsuspected, absolute or contingent, arising out of or in any manner whatsoever connected with or related to facts, circumstances, issues, controversies or claims existing or arising from the beginning of time through and including the date of execution of this Amendment (collectively "**Released Claims** "). Without limiting the foregoing, the Released Claims shall include any and all liabilities or claims arising out of or in any manner whatsoever connected with or related to the Loan Documents, the Recitals hereto, any instruments, agreements or documents executed in connection with any of the foregoing or the origination, negotiation, administration, servicing and/or enforcement of any of the foregoing.

**5.2** In furtherance of this release, Obligor expressly acknowledges and waives any and all rights under Section 1542 of the California Civil Code, which provides as follows:

**"A GENERAL RELEASE DOES NOT EXTEND TO CLAIMS WHICH THE CREDITOR DOES NOT KNOW OR EXPECT TO EXIST IN HIS OR HER FAVOR AT THE TIME OF EXECUTING THE RELEASE, WHICH IF KNOWN BY HIM OR HER MUST HAVE MATERIALLY AFFECTED HIS OR HER SETTLEMENT WITH THE DEBTOR."** (Emphasis added.)

**5.3** By entering into this release, Obligor recognizes that no facts or representations are ever absolutely certain and it may hereafter discover facts in addition to or different from those which it presently knows or believes to be true, but that it is the intention of Obligor hereby to fully, finally and forever settle and release all matters, disputes and differences, known or unknown, suspected or unsuspected; accordingly, if Obligor should subsequently discover that any fact that it relied upon in entering into this release was untrue, or that any understanding of the facts was incorrect, Obligor shall not be entitled to set aside this release by reason thereof, regardless of any claim of mistake of fact or law or any other circumstances whatsoever. Obligor acknowledges that it is not relying upon and has not relied upon any representation or statement made by Bank with respect to the facts underlying this release or with regard to any of such party's rights or asserted rights.

**5.4** This release may be pleaded as a full and complete defense and/or as a cross-complaint or counterclaim against any action, suit, or other proceeding that may be instituted, prosecuted or attempted in breach of this release. Obligor acknowledges that the release contained herein constitutes a material inducement to Bank to enter into this Amendment, and that Bank would not have done so but for Bank's expectation that such release is valid and enforceable in all events.

**5.5** Obligor hereby represents and warrants to Bank, and Bank is relying thereon, as follows:

(a) Except as expressly stated in this Amendment, neither Bank nor any agent, employee or representative of Bank has made any statement or representation to Obligor regarding any fact relied upon by Obligor in entering into this Amendment.

(b) Obligor has made such investigation of the facts pertaining to this Amendment and all of the matters appertaining thereto, as it deems necessary.

(c) The terms of this Amendment are contractual and not a mere recital.

(d) This Amendment has been carefully read by Obligor, the contents hereof are known and understood by Obligor, and this Amendment is signed freely, and without duress, by Obligor.

(e) Obligor represents and warrants that it is the sole and lawful owner of all right, title and interest in and to every claim and every other matter which it releases herein, and that it has not heretofore assigned or transferred, or purported to assign or transfer, to any person, firm or entity any claims or other matters herein released. Obligor shall indemnify Bank, defend and hold it harmless from and against all claims based upon or arising in connection with prior assignments or purported assignments or transfers of any claims or matters released herein.

6. **Fee.** In consideration for Bank entering into this Amendment, Borrower shall pay Bank a fee in the mutually agreed amount of **\$2,500.00** , which fee shall be earned in full and payable concurrently with the execution and delivery of this Amendment. Such fee shall be non-refundable and in addition to all interest and other fees payable to Bank under the Loan Documents. Bank is authorized to charge such fee to Borrower's loan account.

7. **Bank Expenses.** Borrower shall pay to Bank, when due, all Bank Expenses (including reasonable attorneys' fees and expenses), when due, incurred in connection with or pursuant to this Amendment.

8. **Counterparts.** This Amendment may be executed in any number of counterparts and all of such counterparts taken together shall be deemed to constitute one and the same instrument.

9. **Effectiveness .** This Amendment shall be deemed effective upon the due execution and delivery to Bank of this Amendment by each party hereto.

[Remainder of page intentionally left blank; signature page immediately follows.]

**IN WITNESS WHEREOF**, the parties hereto have caused this Amendment to be duly executed and delivered as of the date first written above.

**BANK**

Silicon Valley Bank

By: /s/ Kurt Miklinski

Name: Kurt Miklinski

Title: Vice President

**BORROWER**

NETLIST, INC.

By: /s/ Gail Sasaki

Name: Gail Sasaki

Title: Chief Financial Officer

**CONSENT**

The undersigned hereby expressly agrees to Section 5 of the foregoing Amendment and acknowledges that its consent to the rest of the foregoing Amendment is not required, but the undersigned nevertheless does hereby agree and consent to the entire foregoing Amendment and to the documents and agreements referred to therein and to all future modifications and amendments thereto, and any termination thereof, and to any and all other present and future documents and agreements between or among the foregoing parties. Nothing herein shall in any way limit any of the terms or provisions of the Guaranty, the Guarantor Security Agreement, or any other Loan Documents, executed by the undersigned, all of which are hereby ratified and affirmed.

**GUARANTOR:**

NETLIST TECHNOLOGY TEXAS LP, a Texas limited partnership

By: NETLIST, INC., its general partner

By: /s/ Gail Sasaki

Name: Gail Sasaki

Title: Chief Financial Officer

Signature Page

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**CERTIFICATION PURSUANT TO RULE 13A-14(A) AND RULE 15D-14(A) OF THE SECURITIES EXCHANGE  
ACT AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Chun K. Hong, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Netlist, Inc., a Delaware corporation (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

August 12, 2010

/s/ Chun K. Hong

Chun K. Hong  
President, Chief Executive Officer and Chairman of the Board  
(Principal Executive Officer)

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**CERTIFICATION PURSUANT TO RULE 13A-14(A) AND RULE 15D-14(A) OF THE SECURITIES EXCHANGE  
ACT AS ADOPTED PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Gail M. Sasaki, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Netlist, Inc., a Delaware corporation (the "Registrant");
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f) for the Registrant and we have:
  - a) designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
  - a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

August 12, 2010

/s/ Gail M. Sasaki  
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Gail M. Sasaki  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

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

In connection with the Quarterly Report on Form 10-Q of Netlist, Inc., a Delaware corporation (“Netlist”) for the quarter ended July 3, 2010 (the “Report”), Chun K. Hong, president, chief executive officer and chairman of the board of Netlist, and Gail M. Sasaki, vice president and chief financial officer of Netlist, each hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that, to his or her knowledge:

- (1) the Report fully complies with the requirements of Section 13(a) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of Netlist, Inc.

August 12, 2010

/s/ Chun K. Hong  
\_\_\_\_\_  
Chun K. Hong  
President, Chief Executive Officer and Chairman of the Board  
(Principal Executive Officer)

August 12, 2010

/s/ Gail M. Sasaki  
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Gail M. Sasaki  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

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