

CONVERTED ORGANICS INC.

FORM 8-K/A

(Amended Current report filing)

Filed 08/17/10 for the Period Ending 08/13/10

Address	137A LEWIS WHARF BOSTON, MA 02110
Telephone	617 624 0111
CIK	0001366340
Symbol	COIN
SIC Code	2870 - Agricultural Chemicals
Industry	Chemical Manufacturing
Sector	Basic Materials
Fiscal Year	12/31

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

**FORM 8-K/A
(Amendment No. 3)**

**CURRENT REPORT
Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Date of Report (Date of Earliest Event Reported): August 13, 2010

CONVERTED ORGANICS INC.

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction
of incorporation)

001-33304

(Commission
File Number)

204075963

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

137A LEWIS WHARF, BOSTON,
MASSACHUSETTS

(Address of principal executive offices)

02110

(Zip Code)

Registrant's telephone number, including area code: 617-624-0111

Not Applicable

Former name or former address, if changed since last report

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

- Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)
 - Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)
 - Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))
 - Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
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Explanatory Note

On July 7, 2010, Converted Organics Inc., a Delaware corporation (“COIN”), filed a Current Report on Form 8-K to report that on July 6, 2010, a Membership Interest Purchase Agreement (the “Purchase Agreement”) was entered into by and among COIN, TerraSphere, Inc. a newly formed Delaware corporation and wholly-owned subsidiary of COIN, TerraSphere Systems, LLC, a Massachusetts limited liability company (“TerraSphere”) and the individuals owners of TerraSphere. On July 14, 2010, COIN filed Amendment No. 2 to the Form 8-K to include the historical financial statements of TerraSphere and the pro forma financial information relating to COIN’s potential acquisition of TerraSphere.

The purpose of this Amendment No. 3 to the Form 8-K is to update the previously provided financial statements of the business acquired and pro forma financial information to comply with the age of financial statements requirements under the Securities Act of 1933, as amended, and rules and regulations promulgated thereunder. Except as described herein, the information contained in the previous Form 8-K filing has not been updated or amended.

Item 9.01 Financial Statement and Exhibits.

(a) *Financial statements of businesses acquired.*

The unaudited consolidated financial statements of TerraSphere Systems LLC as of June 30, 2010 and for the three and six month periods ended June 30, 2010 and 2009, are filed in Exhibit 99.1 hereto.

(b) *Pro forma financial information.*

The unaudited pro forma consolidated financial information with respect to the transaction described is filed in Exhibit 99.1 hereto.

(c) Not applicable.

(d) Exhibits.

99.1 Unaudited pro forma consolidated combined consolidated financial information of Converted Organics Inc. and unaudited consolidated financial statements of TerraSphere Systems LLC as of June 30, 2010 and for the three and six month periods ended June 30, 2010 and 2009.

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 hereunto duly authorized.

CONVERTED ORGANICS INC.

August 17, 2010

By: /s/ Edward J. Gildea

Name: *Edward J. Gildea*

Title: *President and CEO*

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UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL STATEMENTS

Introduction

On July 6, 2010, Converted Organics Inc. (the “Company”) and its wholly-owned subsidiary TerraSphere Inc. entered into a membership interest purchase agreement (“Agreement”) with TerraSphere Systems LLC to acquire 100% of the membership interests in TerraSphere Systems LLC (“TerraSphere”) subject to, among other items, the Company’s shareholder approval. This acquisition enables the Company to license TerraSphere’s patented Growth System, which is a system of modules and processes for growing plants in a controlled environment. The system uses and controls precise combinations of light, water, nutrition, gravity, centrifugal forces, and gasses to produce growing conditions that can be controlled and manipulated to result in desired plant growth and maximum crop production.

Terms

The Agreement allows for an election by TerraSphere members to accept 1) a purchase price of \$21,000,000 of Company common stock upon closing of the transaction (with a 6 month holding period) (“Option One”) or 2) a purchase price of \$12,000,000 of Company common stock upon closing of the transaction with an option to earn an additional \$16,000,000 in contingent consideration based upon TerraSphere achieving certain milestones and agreeing to an 18 month holding period on stock distributed to them (“Option Two”). Based on 31% of TerraSphere members’ electing Option One and 69% electing Option Two, the maximum total purchase price is \$25,830,000 payable in the Company’s common stock valued at \$0.756 per share. Per the Agreement, TerraSphere members who elected Option One will receive \$6,510,000 upon closing and members electing Option Two will receive \$8,280,000 upon closing and up to an additional \$11,040,000 based on achieving the defined milestones (contingent consideration).

Milestone One Payment: \$3,450,000 of Company common stock, if, and only if, between the date of the Agreement and the 90th day following the closing date or the 180th day following the date of the Agreement, the following occurs (such shares to be payable within ten (10) business days of achievement of the following or the closing date, whichever is later): For a period of five (5) consecutive trading days, the Company’s market capitalization exceeds the sum of: (1) the Company’s initial market capitalization on the date of execution of the Agreement, plus (2) the closing price per share, or \$0.756, multiplied by the number of shares of Company common stock to be issued at closing pursuant to the Agreement, and, if such calculation is being made prior to the closing date, including this Milestone One. If between the date of the Agreement and the 90th day following the closing date or the 180th day following the date of the Agreement, the Company completes an equity financing, the cash received from the equity financing during such period shall be added to the market capitalization. If between the closing date and December 31, 2011, the Buyer sells equity of either the Company or any of the Company’s subsidiaries, any cash received from such equity sales during such period shall be added to the market capitalization;

Milestone Two Payment: \$1,380,000 of Company common stock, if, and only if, \$2,000,000 of TerraSphere’s accounts receivable as of the date of the Agreement are received prior to February 28, 2011;

Milestone Three Payment: \$3,450,000 of Company common stock, if, and only if, the Company generates gross margin of \$6,000,000 (gross margin target) from its operations during the period commencing as of the date of the Agreement and ending on December 31, 2011; provided that, if the Company generates gross margin of at least \$4,200,000 (gross margin

threshold) from its operations during such period, the Sellers shall be entitled to a *pro rata* portion of the Company common stock; and

Milestone Four Payment: \$2,760,000 of Company common stock, if, and only if, the Company generates gross margin of \$4,000,000 from its operations during any six-month period commencing on the Agreement date and ending on December 31, 2012; provided that, if the Company achieves the Milestone Three gross margin threshold, but does not achieve the Milestone Three gross margin target, 83.3% of the difference between the Milestone Three gross margin target and the actual gross margins achieved pursuant to the Agreement (the “Milestone Three Deficiency”) may be added by the Sellers to the Milestone Four Payment and the Milestone Four gross margin target. Notwithstanding anything to the contrary herein, the total amounts payable pursuant to the Milestone Three Payment and Milestone Four Payment shall be no more than \$6,210,000 of Company common stock.

The Company used the following assumptions to calculate fair value of the contingent consideration:

Milestone One: The acquisition of TerraSphere will diversify the Company's base while still sustaining business practices that protect and value the environment, current customers, colleagues, and shareholders. The likelihood of meeting this milestone is largely dependent on the state of the U.S. economy and future market conditions, both of which are uncertain and unpredictable. If the U.S. economy becomes stagnant or the market conditions are not favorable for investors, the Company may not achieve this milestone. Based on the uncertainty of the U.S. economy and the unpredictability of the market over the next 6-12 months, the Company has estimated that the likelihood of achieving this milestone is 75% and, as such, has determined that the fair value of this contingent payment is \$2,588,000.

Milestone Two: The Company has reviewed the customers' credit worthiness and ability to make the required installment payments. Based on this information, the Company has estimated that the likelihood of achieving this milestone is 95% and, as such, has determined that the fair value of this contingent payment is \$1,311,000.

Milestones Three and Four: The Company has evaluated milestones three and four together as they can be achieved over the same milestone period. The Company has reviewed TerraSphere's operating estimates and historical data and believes these milestones are achievable. TerraSphere's plans are based on the U.S. economy continuing to grow at a steady rate, investors investing in new technology and market acceptance of the Growth System technology. If the U.S. economy becomes stagnant or the market conditions are not favorable or the technology is not well received during the milestone periods, the Company may not achieve the milestones. Based on the uncertainty of the U.S. economy and the unpredictability of the market over the next 36 months, the Company has estimated that the likelihood of achieving milestones three and four is 50% and as such, has determined that the fair value of these contingent payments is \$3,105,000.

The estimated purchase price at fair value is as follows:

Election of Option One	\$ 6,510,000
Election of Option Two	8,280,000
Milestone one payment	2,588,000
Milestone two payment	1,311,000
Milestones three and four payments	3,105,000
	<u>\$21,794,000</u>

The following unaudited pro forma consolidated financial information gives effect to the Company acquiring 100% of the membership interest in TerraSphere Systems, LLC and should be read in conjunction with the Company's Form 8-K dated July 6, 2010 and filed on July 7, 2010, the historical financial statements and the related notes of Converted Organics Inc., which are included in our Annual Report on Form 10-K for the year ended December 31, 2009, the quarterly financial statements and the related notes of Converted Organics, Inc., which are included in our Form 10-Q as of June 30, 2010 and the TerraSphere Systems, LLC financial statements which are included herein.

The unaudited pro forma consolidated balance sheet as of June 30, 2010 gives effect to the acquisition of TerraSphere Systems, LLC transaction as if it had occurred on June 30, 2010, and the unaudited pro forma consolidated statements of operations and comprehensive income (loss) for the year ended December 31, 2009 and for the six month period ended June 30, 2010 give effect to the acquisition as if it had occurred on January 1, 2009.

The unaudited pro forma consolidated financial statements include all material pro forma adjustments necessary for their preparation, as required by Article 11 of Regulation S-X and, accordingly, do not assume any benefits from cost savings or synergies of operations.

The pro forma adjustments are based upon available information and certain assumptions that the Company believes are reasonable. The unaudited pro forma consolidated financial statements do not purport to represent what the Company's financial condition or results of operations would actually have been had these transactions in fact occurred as of the dates indicated above or to project the Company's results of operations for the period indicated or for any other period.

Changes in the fair value of contingent consideration that the Company recognizes after the acquisition date may be the result of additional information about facts and circumstances that existed at the acquisition date that the Company obtained after that date. Such changes are considered to be measurement period adjustments and would adjust the purchase price for changes within one year from the acquisition date. Contingent consideration classified as an asset or a liability that exceed a year from the acquisition date is remeasured at fair value and recognized in earnings.

CONVERTED ORGANICS INC.
UNAUDITED PRO FORMA CONSOLIDATED BALANCE SHEET
AS OF JUNE 30, 2010

	<u>Historical</u> Converted Organics Inc. and subsidiaries	<u>Pro Forma</u> <u>Adjustments</u>	<u>Reference</u>	<u>Pro Forma</u> <u>Consolidated</u>
ASSETS				
CURRENT ASSETS				
Cash and cash equivalents	\$ 2,053,028	\$ 30,054	(1)	\$ 2,083,082
Restricted cash	583,393	—		583,393
Accounts receivable, net	1,071,195	2,940,000	(1)	4,011,195
Inventories	213,519	—		213,519
Prepaid rent	692,928	—		692,928
Other prepaid expenses	669,809	234,138	(1)	903,947
Total current assets	<u>5,283,872</u>	<u>3,204,192</u>		<u>8,488,064</u>
Deposits	815,390	5,690	(1)	821,080
Restricted cash	29,769	—		29,769
Other assets	500,000	—		500,000
Property and equipment, net	18,068,637	185,062	(1)	18,253,699
Construction-in-progress	354,521	89,567	(1)	444,088
Capitalized bond costs, net	790,507	—		790,507
Intangible assets, net	1,851,615	10,000,000	(1)	11,851,615
Goodwill	—	9,860,000	(1)	9,860,000
Total assets	<u>\$ 27,694,311</u>	<u>\$23,344,511</u>		<u>\$ 51,038,822</u>
LIABILITIES AND OWNERS' EQUITY (DEFICIT)				
CURRENT LIABILITIES				
Term notes payable — current	\$ 1,777,468	\$ 112,351	(1)	\$ 1,889,819
Accounts payable	1,980,104	1,353,637	(1)	3,333,741
Accrued compensation, officers, directors and consultants	652,696	—		652,696
Accrued legal and other expenses	601,492	14,122	(1)	615,614
Accrued interest	598,588	—		598,588
Deferred revenue	—	70,401	(1)	70,401
Convertible notes payable, net of unamortized discount	198,447	—		198,447
Capital lease obligations — current	12,342	—		12,342
Total current liabilities	<u>5,821,137</u>	<u>1,550,511</u>		<u>7,371,648</u>
Capital lease obligation, net of current portion	22,464	—		22,464
Term notes payable, net of current portion	102,151	—		102,151
Derivative liabilities	2,096,109	—		2,096,109
Bonds payable	17,500,000	—		17,500,000
Total liabilities	<u>25,541,861</u>	<u>1,550,511</u>		<u>27,092,372</u>
COMMITMENTS AND CONTINGENCIES				
OWNERS' EQUITY (DEFICIT)				
Preferred stock, \$.0001 par value, authorized 10,000,000 shares; no shares issued and outstanding	—	—		—
Common stock, \$.0001 par value, authorized 250,000,000 shares	4,057	1,648	(1)	5,705
Additional paid-in capital	61,745,571	21,792,352	(1)	83,537,923
Accumulated deficit	(59,597,178)	—		(59,597,178)
Total owners' equity	<u>2,152,450</u>	<u>21,794,000</u>		<u>23,946,450</u>
Total liabilities and owners' equity	<u>\$ 27,694,311</u>	<u>\$23,344,511</u>		<u>\$ 51,038,822</u>

The accompanying notes are an integral part of these unaudited pro forma consolidated financial statements.



CONVERTED ORGANICS INC.
UNAUDITED PRO FORMA CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2010

	<u>Historical</u> <u>Converted Organics</u> <u>Inc. and subsidiaries</u>	<u>Pro Forma</u> <u>Adjustments</u>	<u>Reference</u>	<u>Pro Forma</u> <u>Consolidated</u>
Revenues	\$ 2,685,433	\$4,493,366	(2)	\$ 7,178,799
Cost of goods sold	<u>5,205,417</u>	<u>703,301</u>	(2)	<u>5,908,718</u>
Gross loss	(2,519,984)	3,790,065		1,270,081
Operating expenses				
General and administrative expenses	6,578,717	839,570	(2)	7,418,287
Research and development	143,859	—	(2)	143,859
Depreciation expense	5,730	—		5,730
Amortization of capitalized costs	150,741	356,014	(2),(3)	506,755
Amortization of license	<u>17,097</u>	<u>—</u>		<u>17,097</u>
Loss from operations	<u>(9,416,128)</u>	<u>2,594,481</u>		<u>(6,821,647)</u>
Other income/(expenses)				
Interest income	534	—		534
Derivative gain/(loss)	498,729	—		498,729
Other income	69	79,035	(2)	79,104
Interest expense	<u>(788,317)</u>	<u>(7,889)</u>	(2)	<u>(796,206)</u>
	<u>(288,985)</u>	<u>71,146</u>		<u>(217,839)</u>
Loss before provision for income taxes	(9,705,113)	2,665,627		(7,039,486)
Provision for income taxes	<u>—</u>	<u>—</u>	(4)	<u>—</u>
Net income (loss)	(9,705,113)	2,665,627		(7,039,486)
Net income (loss) attributable to noncontrolling interest	<u>—</u>	<u>(301,402)</u>	(2)	<u>(301,402)</u>
Net income (loss) attributable to Converted Organics Inc. before other comprehensive income (loss)	(9,705,113)	2,967,029		(6,738,084)
Other comprehensive income (loss):				
Foreign currency translation adjustment	<u>—</u>	<u>16,274</u>	(2)	<u>16,274</u>
Comprehensive income (loss)	(9,705,113)	2,983,303		(6,721,810)
Comprehensive income (loss) attributable to noncontrolling interest	<u>—</u>	<u>2,441</u>	(2)	<u>2,441</u>
Comprehensive income (loss) attributable to Converted Organics Inc.	<u>\$ (9,705,113)</u>	<u>\$2,980,862</u>		<u>\$ (6,724,251)</u>
Net loss per share, basic and diluted	<u>\$ (0.25)</u>		(5)	<u>\$ (0.13)</u>
Weighted average common shares outstanding	<u>38,902,816</u>		(5)	<u>52,633,018</u>

The accompanying notes are an integral part of these unaudited pro forma consolidated financial statements.

CONVERTED ORGANICS INC.
UNAUDITED PRO FORMA CONSOLIDATED STATEMENTS OF OPERATIONS
AND COMPREHENSIVE INCOME (LOSS)
FOR THE YEAR ENDED DECEMBER 31, 2009

	Historical Converted Organics Inc. and subsidiaries	Pro Forma Adjustments	Reference	Pro Forma Consolidated
Revenues	\$ 2,633,782	\$ 36,732	(2)	\$ 2,670,514
Cost of goods sold	<u>6,914,857</u>	<u>—</u>		<u>6,914,857</u>
Gross loss	(4,281,075)	36,732		(4,244,343)
Operating expenses				
General and administrative expenses	10,049,830	1,291,586	(2)	11,341,416
Research and development	637,142	613	(2)	637,755
Depreciation expense	723,846	—		723,846
Amortization of capitalized costs	357,718	673,050	(2),(3)	1,030,768
Amortization of license	<u>16,500</u>	<u>—</u>		<u>16,500</u>
Loss from operations	<u>(16,066,111)</u>	<u>(1,928,517)</u>		<u>(17,994,628)</u>
Other income/(expenses)				
Interest income	24,097	—		24,097
Loss on impairment of long-term assets	(3,928,129)	—		(3,928,129)
Derivative gain/(loss)	5,766,035	—		5,766,035
Other income	68,995	55,114	(2)	124,109
Interest expense	<u>(6,970,675)</u>	<u>(9,218)</u>	(2)	<u>(6,979,893)</u>
	<u>(5,039,677)</u>	<u>45,896</u>		<u>(4,993,781)</u>
Loss before provision for income taxes	(21,105,788)	(1,882,621)		(22,988,409)
Provision for income taxes	<u>—</u>	<u>—</u>	(4)	<u>—</u>
Net loss	(21,105,788)	(1,882,621)		(22,988,409)
Net income (loss) attributable to noncontrolling interest	<u>—</u>	<u>74,934</u>	(2)	<u>74,934</u>
Net income (loss) attributable to Converted Organics Inc. before other comprehensive income (loss)	(21,105,788)	(1,957,555)		(23,063,343)
Other comprehensive income (loss):				
Foreign currency translation adjustment	<u>—</u>	<u>(57,491)</u>	(2)	<u>(57,491)</u>
Comprehensive income (loss)	(21,105,788)	(2,015,046)		(23,120,834)
Comprehensive income (loss) attributable to noncontrolling interest	<u>—</u>	<u>(8,623)</u>	(2)	<u>(8,623)</u>
Comprehensive income (loss) attributable to Converted Organics Inc.	<u>\$ (21,105,788)</u>	<u>\$ (2,006,423)</u>		<u>\$ (23,112,211)</u>
Net loss per share, basic and diluted	<u>\$ (1.08)</u>		(5)	<u>\$ (0.61)</u>
Weighted average common shares outstanding	<u>19,569,853</u>		(5)	<u>38,114,781</u>

The accompanying notes are an integral part of these unaudited pro forma consolidated financial statements.

CONVERTED ORGANICS INC.
NOTES TO UNAUDITED PRO FORMA CONSOLIDATED FINANCIAL STATEMENTS

The following numbered notes are referenced on the Unaudited Pro Forma Consolidated Balance Sheet and Statements of Operations and Comprehensive Income (Loss).

- (1) The Company purchased 100% of the membership interests in TerraSphere Systems, LLC, for consideration and contingent consideration with an estimated fair value of \$21,794,000 all consideration is to be paid in the Company's common stock.

The estimated purchase price has been allocated to the assets and liabilities on a preliminary basis using estimated fair value information currently available. The allocation of the purchase price to the assets and liabilities will be finalized within a year as the Company obtains more information regarding asset valuations, liabilities assumed, contingent consideration and revisions of preliminary estimates of fair value made as the date of purchase. The preliminary purchase price allocation is as follows:

Cash and cash equivalents	\$ 30,054
Accounts receivable	2,940,000
Other assets	239,828
Leasehold improvements	185,062
Construction-in-process	89,567
Goodwill	9,860,000
Patents and patent related costs	10,000,000
Assumption of liabilities	<u>(1,550,511)</u>
Total allocation of purchase price (*)	<u>\$21,794,000</u>

The Company plans to amortize the leasehold improvements over their estimated service lives or the remaining terms of the related leases, whichever are shorter. Patents and patent related costs will be amortized over the 15 year remaining life of the patents.

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- (*) The purchase price of \$21,794,000 is an estimate based on the assumptions listed in the "Unaudited Pro Forma Condensed Combined Financial Statements" section of this document. Actual results could vary significantly from this estimate. Any adjustments within one year would adjust the purchase price. Adjustments after one year of the acquisition date are remeasured to fair value at each reporting date until the contingency is resolved and the changes in fair value are recognized in earnings in accordance with ASC 805 "Business Combinations".
- (2) The operations of TerraSphere Systems, LLC are consolidated with the operations of Converted Organics Inc. assuming that the transaction was completed on January 1, 2009.
- (3) Amortization expense related to the fair value assigned to the patent and patent related costs.
- (4) TerraSphere Systems, LLC provision for income taxes has been eliminated to give effect to the transaction occurring on January 1, 2009.
- (5) Earnings per share has been recalculated to reflect the number of common stock shares issued in acquiring TerraSphere.
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TERRASPHERE SYSTEMS LLC

CONSOLIDATED FINANCIAL STATEMENTS

**AS OF JUNE 30, 2010 (UNAUDITED)
AND DECEMBER 31, 2009 (AUDITED)
AND FOR THE THREE AND SIX MONTH PERIODS ENDED
JUNE 30, 2010 AND 2009 (UNAUDITED)**

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Balance Sheets as of June 30, 2010 (Unaudited) and December 31, 2009 (Audited)

Consolidated Statements of Operations and Comprehensive Income (Loss) for the three and six month periods ended June 30, 2010 and 2009 (Unaudited)

Consolidated Statement of Changes in Members' Equity (Deficit) for the six month period ended June 30, 2010 (Unaudited)

Consolidated Statements of Cash Flows for the six month periods ended June 30, 2010 and 2009 (Unaudited)

Notes to Consolidated Interim Financial Statements (Unaudited)

TERRASPERE SYSTEMS LLC
CONSOLIDATED BALANCE SHEETS

	June 30, 2010	December 31, 2009
	(Unaudited)	(Audited)
ASSETS		
Current assets:		
Cash	\$ 30,054	\$ 197,046
Accounts receivable	2,940,000	—
Other receivables	180,413	15,244
Inventories — work in process	—	34,565
Prepaid expenses	53,725	42,100
Total current assets	<u>3,204,192</u>	<u>288,955</u>
Leasehold improvements, net	185,062	161,948
Patent and patent related costs, net	148,945	134,932
Pre-construction costs	89,567	—
Other assets	5,690	5,692
Total assets	<u>\$ 3,633,456</u>	<u>\$ 591,527</u>
LIABILITIES AND MEMBERS' EQUITY (DEFICIT)		
Current liabilities:		
Note payable — member	\$ 20,000	\$ 20,000
Due to member	92,351	102,292
Accounts payable	1,355,608	732,866
Accrued expenses	14,122	6,862
Deferred tax liability	1,111,000	—
Deferred revenue	70,401	763,767
Total current liabilities	<u>2,663,482</u>	<u>1,625,787</u>
Members' equity (deficit):		
TerraSphere Systems LLC members' equity (deficit):		
Members' equity (deficit)	1,245,887	(1,043,475)
Accumulated other comprehensive loss	(28,421)	(42,254)
Total Terrasphere Systems LLC members' equity (deficit)	<u>1,217,466</u>	<u>(1,085,729)</u>
Noncontrolling interest	(247,492)	51,469
Total members' equity (deficit)	<u>969,974</u>	<u>(1,034,260)</u>
Total liabilities and members' equity (deficit)	<u>\$ 3,633,456</u>	<u>\$ 591,527</u>

The accompanying notes are an integral part of these consolidated interim financial statements.

TERRASPHERE SYSTEMS LLC
CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME (LOSS)
(UNAUDITED)

	<u>Three month periods ended</u>		<u>Six month periods ended</u>	
	<u>June 30, 2010</u>	<u>June 30, 2009</u>	<u>June 30, 2010</u>	<u>June 30, 2009</u>
Revenue:				
Sales	\$ —	\$ —	\$ 675,000	\$ —
Licensing and marketing fees	<u>2,809,183</u>	<u>9,183</u>	<u>3,818,366</u>	<u>18,366</u>
	2,809,183	9,183	4,493,366	18,366
Cost of goods sold	<u>—</u>	<u>—</u>	<u>703,301</u>	<u>—</u>
Gross profit	2,809,183	9,183	3,790,065	18,366
General and administrative expense	402,572	250,574	839,570	477,258
Amortization expense	<u>11,864</u>	<u>1,773</u>	<u>22,681</u>	<u>3,409</u>
Income (loss) from operations	<u>2,394,747</u>	<u>(243,164)</u>	<u>2,927,814</u>	<u>(462,301)</u>
Other income (expense)				
Other income	120,930	1	120,930	3,247
Foreign currency gain (loss)	(59,085)	19,685	(41,895)	11,131
Interest expense	<u>(3,984)</u>	<u>(930)</u>	<u>(7,889)</u>	<u>(1,404)</u>
Total other income (expense)	<u>57,861</u>	<u>18,756</u>	<u>71,146</u>	<u>12,974</u>
Net income (loss) before tax provision	2,452,608	(224,408)	2,998,960	(449,327)
Provision for income taxes	<u>723,000</u>	<u>—</u>	<u>1,111,000</u>	<u>—</u>
Net income (loss)	1,729,608	(224,408)	1,887,960	(449,327)
Net loss attributable to noncontrolling interest	<u>(183,895)</u>	<u>(13,991)</u>	<u>(301,402)</u>	<u>(30,923)</u>
Net income (loss) attributable to TerraSphere				
Systems LLC before other comprehensive income (loss)	1,913,503	(210,417)	2,189,362	(418,404)
Other comprehensive income (loss):				
Foreign currency translation adjustment	<u>58,040</u>	<u>(20,372)</u>	<u>16,274</u>	<u>(17,226)</u>
Comprehensive income (loss)	1,971,543	(230,789)	2,205,636	(435,630)
Comprehensive income (loss) attributable to noncontrolling interest	<u>8,705</u>	<u>(3,056)</u>	<u>2,441</u>	<u>(2,584)</u>
Comprehensive income (loss) attributable to TerraSphere Systems LLC	<u>\$ 1,962,838</u>	<u>\$ (227,733)</u>	<u>\$ 2,203,195</u>	<u>\$ (433,046)</u>

The accompanying notes are an integral part of these consolidated interim financial statements.

TERRASPHERE SYSTEMS LLC
CONSOLIDATED STATEMENT OF CHANGES IN MEMBERS' EQUITY (DEFICIT)
FOR THE SIX MONTH PERIOD ENDED JUNE 30, 2010
(UNAUDITED)

	TerraSphere Systems LLC				Members' Equity (Deficit) Total
	Members' Equity (Deficit)	Accumulated Other Comprehensive Loss	Total	Noncontrolling Interest	
Balance, December 31, 2009	\$ (1,043,475)	\$ (42,254)	\$(1,085,729)	\$ 51,469	\$ (1,034,260)
Contributions	100,000	—	100,000	—	100,000
Foreign currency translation adjustment	—	13,833	13,833	2,441	16,274
Net income (loss)	2,189,362	—	2,189,362	(301,402)	1,887,960
Balance, June 30, 2010	<u>\$ 1,245,887</u>	<u>\$ (28,421)</u>	<u>\$ 1,217,466</u>	<u>\$ (247,492)</u>	<u>\$ 969,974</u>

The accompanying notes are an integral part of these consolidated interim financial statements.

TERRASPHERE SYSTEMS LLC
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six month periods ended	
	June 30, 2010	June 30, 2009
Net income (loss)	\$ 1,887,960	\$ (449,327)
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Amortization of patents and patent related costs	4,271	3,409
Amortization of leasehold improvements	18,117	—
Deferred income taxes	1,111,000	—
Changes in operating assets and liabilities:		
(Increase) decrease in:		
Accounts receivable	(2,940,000)	400,000
Other receivables	(167,846)	11,914
Inventories	34,565	—
Prepaid expenses	(11,625)	(24,000)
Other assets	—	3,766
Increase (decrease) in:		
Accounts payable	626,759	43,660
Accrued expenses	7,260	(4,774)
Deferred revenue	(693,366)	6,634
Net cash used in operating activities	(122,905)	(8,718)
Cash flows from investing activities:		
Patent and patent related costs	(18,284)	(42,781)
Expenditures for leasehold improvements	(41,654)	—
Pre-construction costs	(89,567)	—
Net cash used in investing activities	(149,505)	(42,781)
Cash flows from financing activities:		
Member contributions	100,000	100,000
Advances from (repayments to) member	(9,941)	63,173
Net cash provided by financing activities	90,059	163,173
Effect of exchange rate changes on cash	15,359	(27,951)
(Decrease) increase in cash	(166,992)	83,723
Cash, beginning of period	197,046	8,083
Cash, end of period	\$ 30,054	\$ 91,806

The accompanying notes are an integral part of these consolidated interim financial statements.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 1 — NATURE OF OPERATIONS

TerraSphere Systems LLC (“TerraSphere”), located in Boston, Massachusetts designs and builds highly efficient systems for growing organic fruits and vegetables in a controlled, indoor environment. The Company partners with private businesses and public institutions to create solutions for food production challenges. The Company derives its revenues from licensing fees and royalties, as well as the sale of equipment and expects future revenue from operating facilities using the TerraSphere System. The TerraSphere System uses technology to operate automated, software driven plant growth systems that can be used to grow a variety of crops, from lettuce to tree seedlings to rare medicinal herbs. The Company is also pursuing a possible acquisition by another entity to further its mission of creating solutions to food production challenges.

PharmaSphere, LLC (“PharmaSphere”), located in Boston, Massachusetts, is a wholly-owned subsidiary of TerraSphere. PharmaSphere’s business plan is to utilize the TerraSphere System for the production of high value biocompounds sourced from plants and used as active pharmaceutical ingredients and for the production of transgenic plants (genetically engineered plants) for the biotechnology market. PharmaSphere has a wholly-owned subsidiary PharmaSphere Worcester, LLC, which was formed to build a facility in Worcester, Massachusetts utilizing PharmaSphere’s business plan. The building of the facility has not commenced. PharmaSphere has no revenue to date.

TerraSphere Systems Canada, Inc. (“TerraSphere Canada”), located in Vancouver, British Columbia, operates the research and manufacturing facility for TerraSphere and is eighty-five percent owned by TerraSphere.

NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

CONSOLIDATION

The accompanying consolidated financial statements include the transactions and balances of TerraSphere System LLC and its wholly-owned subsidiary, PharmaSphere, LLC. The assets, liabilities and results of operations of TerraSphere Systems Canada, Inc. are included in the consolidated financial statements with appropriate recognition of noncontrolling interest. All intercompany transactions and balances have been eliminated in consolidation.

CODIFICATION

Effective July 1, 2009, the Financial Accounting Standard Board’s (“FASB”) Accounting Standards Codification (“ASC”) became the single official source of authoritative, non-governmental U.S. generally accepted accounting principles (“GAAP”). The historical GAAP hierarchy was eliminated and the ASC became the only level of authoritative GAAP. The Company’s accounting policies were not affected by the conversion to ASC.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (*Continued*)

FOREIGN OPERATIONS

The accounting records of TerraSphere Canada are maintained in Canadian dollars, its functional currency. Revenue and expense transactions are translated to U.S. dollars using the average exchange rate of the month in which the transaction took place. Assets and liabilities are translated to U.S. dollars using the exchange rate in effect as of the balance sheet date. Equity transactions are translated to U.S. dollars using the exchange rate in effect as of the date of the equity transaction. Translation gains and losses are reported as a component of accumulated other comprehensive income or loss. Gains and losses resulting from transactions which are denominated in other than the functional currencies are reported as foreign currency exchange gain or loss in the statements of operations and comprehensive income (loss) in the period the gain or loss occurred.

USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect reported amounts and disclosures in the consolidated financial statements. Actual results could differ from those estimates.

ACCOUNTS RECEIVABLE

Accounts receivable represent balances due from customers, net of applicable reserves for doubtful accounts. In determining the need for an allowance, objective evidence that a single receivable is uncollectible, as well as historical collection patterns for accounts receivable are considered at each balance sheet date. At June 30, 2010 and December 31, 2009, the Company has determined that an allowance for doubtful accounts is not deemed necessary.

INVENTORIES

Inventories are valued at the lower of cost or market, with cost determined by the first in, first out method. Inventories consisted of the work-in-process related to twelve TerraSphere System units at December 31, 2009. There were no inventory reserves at June 30, 2010 or December 31, 2009.

LEASEHOLD IMPROVEMENTS

Leasehold improvements are carried at cost and are amortized over their estimated service life or the remaining term of the related lease, whichever is shorter. Amortization expense incurred for the six month periods ended June 30, 2010 and 2009 was \$18,117 and \$-0-, respectively.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

PATENT AND PATENT RELATED COSTS

The Company accounts for its patent and patent related costs in accordance with ASC 350, which requires that intangible assets with finite lives, such as the Company's specifically identifiable costs for patent and patent applications, be capitalized and amortized over their respective estimated lives and reviewed for impairment whenever events or other changes in circumstances indicate that the carrying amount may not be recoverable.

PRE-CONSTRUCTION COSTS

Pre-construction costs include architectural and engineering services related to the building of the PharmaSphere facility.

REVENUE RECOGNITION

Revenue is recognized when all of the following criteria are met:

- Persuasive evidence of a sales arrangement exists;
- Delivery of the product has occurred;
- The sales price is fixed or determinable; and
- Collectability is reasonably assured.

In those cases where all four criteria are not met, the Company defers recognition of revenue until the period these criteria are satisfied. Revenue is generally recognized upon shipment or upon completed performance on exclusive technology licenses where the term is equal to the life of the associated intellectual property.

The Company recognizes deferred revenue when payment has been received for product sales but the revenue recognition criteria have not been met. In addition, the Company defers revenue when payment has been received for future services to be provided.

INCOME TAXES

No provision for income taxes is recognized for the period from January 1, 2010 through February 21, 2010 because the Company is a limited liability company. In lieu of federal and state income taxes, all income, losses, deductions and credits pass through to the members for them to report on their personal returns.

The Company elected to be treated as a taxable association effective February 22, 2010 for United States federal and state tax purposes. The Company accounts for income taxes following the asset and liability method in accordance with ASC 740. Under such method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years that the asset is expected to be recovered or the liability settled.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES *(Continued)*

INCOME TAXES *(Continued)*

Management has performed an evaluation of the Company's tax positions, ensuring that these tax return positions meet the "more likely than not" recognition threshold and can be measured with sufficient precision. These evaluations provide management with a comprehensive model for how the Company should recognize, measure, present and disclose in its financial statements certain tax positions that the Company has taken or expects to take on income tax returns. Based upon these evaluations, management has concluded that the Company has no uncertain tax positions that qualify for either recognition or disclosure in the financial statements as of June 30, 2010. See Note 9 for additional information.

RESEARCH AND DEVELOPMENT

Research and development costs are charged to operations as incurred. There were no research and development costs incurred for the six month periods ended June 30, 2010 and 2009.

FAIR VALUE MEASUREMENTS

The Company applies FASB ASC 820, which defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. FASB ASC 820 applies to reported balances that are required or permitted to be measured at fair value under existing accounting pronouncements; accordingly, the standard does not require any new fair value measurements of reported balances.

FASB ASC 820 emphasizes that fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement should be determined based on the assumptions that market participants would use in pricing the asset or liability. As a basis for considering market participant assumptions in fair value measurements, FASB ASC 820 establishes a fair value hierarchy that distinguishes between market participant assumptions based on market data obtained from sources independent of the reporting entity (observable inputs that are classified within Levels 1 and 2 of the hierarchy) and the reporting entity's own assumptions about market participant assumptions (unobservable inputs classified within Level 3 of the hierarchy).

Level 1 inputs utilize quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access. Level 2 inputs are inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. Level 2 inputs may include quoted prices for similar assets and liabilities in active markets, as well as inputs that are observable for the asset or liability (other than quoted prices), such as interest rates, foreign exchange rates and yield curves that are observable at commonly quoted intervals. Level 3 inputs are unobservable inputs for the asset or liability, which are typically based on an entity's own assumptions, as there is little, if any, related market activity. In instances where the determination of the fair value measurement is based on inputs from different levels of the fair value hierarchy, the level in the fair value hierarchy within which the entire fair value measurement falls is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment and considers factors specific to the asset or liability.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 3 — CONCENTRATION OF CREDIT RISK

The Company's financial instruments that are exposed to a concentration of credit risk are cash and accounts receivable.

Cash - The Company places its cash deposits with credit worthy banking institutions in the United States and Canada which are continually reviewed by management. From time to time, the bank balances of the Company's cash may exceed current United States and Canadian insured limits. The Company, however, has not experienced any losses in this area and management believes its cash deposits are not subject to significant credit risk. At June 30, 2010 and December 31, 2009, the Company's did not have cash balances on deposit that exceeded United States and Canadian federal depository insurance limits.

Accounts receivable - Four customers accounted for 100% of the Company's accounts receivable at June 30, 2010. Five customers accounted for 100% of revenue for the six month period ended June 30, 2010.

NOTE 4 — PATENT AND PATENT RELATED COSTS

The following reflects the Company's patent and patent related costs at:

	June 30, 2010	December 31, 2009
Carousel with spheres patent	\$ 32,407	\$ 32,407
Carousel with arcuate ribs patent	9,666	9,666
Rotatable carousel with arcuate ribs patent	13,582	13,582
Carousel with spheres application (Canadian)	10,259	7,199
Carousel with spheres application (Canadian)	6,711	5,836
Carousel with spheres application (European)	21,024	19,001
Carousel with spheres application (Chinese)	11,210	10,391
Carousel with spheres application (Hong Kong)	1,461	1,461
Carousel with spheres application (Japanese)	14,901	14,901
Rotatable carousel with arcuate ribs application	8,514	8,514
Rotatable carousel with drum-like members (Canadian)	5,900	4,760
Rotatable carousel with drum-like members application	5,901	5,267
Carousel with spheres application	10,040	10,040
Tray apparatus costs	5,780	5,780
Collapsible stack costs	6,140	6,140
Marchildon costs	2,338	2,338
Apparatus for growing plants costs	9,733	—
Total	<u>175,567</u>	<u>157,283</u>
Accumulated amortization	<u>26,622</u>	<u>22,351</u>
Total, net amortization	<u>\$ 148,945</u>	<u>\$ 134,932</u>

Amortization expense for the six month periods ended June 30, 2010 and 2009 was \$4,271 and \$3,190, respectively.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 4 — PATENT AND PATENT RELATED COSTS (Continued)

Aggregate expected amortization expense is expected to be as follows in the years ending December 31:

2010 (July 1, 2010 through December 31, 2010)	\$ 3,814
2011	7,628
2012	7,628
2013	7,628
2014	7,628
Thereafter	114,619
Total	<u>\$148,945</u>

NOTE 5 — NOTES PAYABLE

On May 29, 2009, the Company issued an unsecured note payable to a member in the amount of \$20,000, with a fixed interest rate of 10% per annum, maturing July 29, 2009. The Company is in default of the note and the member has not called the note as of June 30, 2010. The principal due as of June 30, 2010 is \$20,000. The Company has accrued interest totaling \$2,180 and \$1,189 as of June 30, 2010 and December 31, 2010, respectively and incurred \$992 in interest expense for the six months ended June 30, 2010 and incurred \$181 in interest expense for the six months ended June 30, 2009.

NOTE 6 — DUE TO MEMBER

During the year ended December 31, 2009, a member provided an advance to the Company for working capital with an interest rate of 10% per annum. The amount due to the member at June 30, 2010 and December 31, 2009 is \$92,351 and \$102,292, respectively. The Company has accrued interest totaling \$11,942 and \$5,673 as of June 30, 2010 and December 31, 2009, respectively and incurred \$6,268 and \$474 in interest for the six month periods ended June 30, 2010 and 2009, respectively.

NOTE 7 — DEFERRED REVENUE

The Company has recognized deferred revenue of \$70,401 and \$763,767 at June 30, 2010 and December 31, 2009, respectively.

On May 18, 2007, TerraSphere Canada entered into a marketing agreement with the Squamish Nation (“Squamish”) to promote the TerraSphere System to other First Nations bands in Canada for \$200,000 Canadian dollars (\$183,772 U.S.). The Company is recognizing the marketing fee over the term of the agreement (*See Note 10*). At June 30, 2010 and December 31, 2009, deferred revenue associated with this agreement is approximately \$70,000 and \$89,000, respectively.

The Company deferred a \$675,000 payment from the Squamish received in December 2009 relating to twelve TerraSphere System units which were delivered during the six month period ended June 30, 2010. Accordingly, the associated revenue was recognized during the same period.

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 8 — LICENSING FEES

The Company has developed a system of modules and processes for growing plants in a controlled environment. The system uses and controls precise combinations of light, water, nutrition, gravity, centrifugal forces, and gasses to produce growing conditions that can be controlled and manipulated to result in desired plant growth and maximum crop production (the “Growth System”). The Company has granted exclusive licenses to use the Growth System for the remaining term of the associated patents in accordance to the license agreement. Revenue recognized in connection with these license agreements was \$3,800,000 for the six months ended June 30, 2010 as the Company has determined the revenue recognition criteria have been met.

NOTE 9 — INCOME TAXES

The Company elected to be treated as a taxable association effective February 22, 2010 (Note 2).

Income taxes for United States federal and state tax purposes for the six month period ended June 30, 2010 consisted of the following:

Current	\$ —
Deferred	1,111,000
	<u>\$1,111,000</u>

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts used for income tax purposes on the cash basis of accounting and amounts of assets and liabilities for financial reporting purposes. The principal sources of these differences include the carrying value of accounts receivable, accounts payable and deferred revenue for financial statement purposes which are not recognized for income tax purposes.

Principal components of the Company’s net deferred tax liability at June 30, 2010 are as follows:

Accounts receivable	\$1,117,000
Accounts payable	(146,000)
Deferred revenue	27,000
Other	113,000
	<u>\$1,111,000</u>

The effective tax rate based on the federal and state statutory rates is reconciled to the actual tax rate for the six month period ended June 30, 2010 as follows:

Federal and state statutory income tax rates	34%
Increase (decrease) resulting from:	
Exclusion of net loss incurred in period prior to corporate tax election	2%
Exclusion of net loss in foreign subsidiary	1%
Effective tax rate	<u>37%</u>

TERRASPHERE SYSTEMS LLC
NOTES TO CONSOLIDATED INTERIM FINANCIAL STATEMENTS
(UNAUDITED)

NOTE 10 — COMMITMENTS AND CONTINGENCIES

LEASE

On September 30, 2009, the Company entered into an operating lease agreement to begin November 1, 2009 for warehouse space in Vancouver, British Columbia for TerraSphere Canada. The term is five years and the Company has a right to extend for an additional five years. Future minimum payments under this lease are as follows:

2010 (July 1, 2010 through December 31, 2010)	\$ 45,000
2011	89,990
2012	89,990
2013	89,990
2014	74,990
Total	<u>\$389,960</u>

Rent expense incurred in connection with this lease was approximately \$45,000 for the six months ended June 30, 2010.

MARKETING AGREEMENT

On May 18, 2007, TerraSphere Canada entered into a marketing agreement with the Squamish Nation to promote the TerraSphere System to other First Nations bands in Canada. The Squamish paid TerraSphere \$200,000 Canadian dollars (\$183,772 U.S.) to secure the rights to work with the First Nations bands across Canada through May 2012. This fee is being recognized as revenue over the term of the agreement (*Note 7*). Revenue recognized in connection with this agreement was \$18,366 for the six months ended June 30, 2010 and 2009.

In addition, the agreement stipulates that Squamish will receive a fee of 10% of any license fee agreement executed between TerraSphere and a First Nations band. Squamish also has the right of first refusal to participate in an ownership interest of any venture formed pursuant to the First Nation band license agreement. These rights must be executed no later than May 2012.

NOTE 11 — SUBSEQUENT EVENTS

In connection with the preparation of the consolidated financial statements, management evaluated subsequent events after the balance sheet date of June 30, 2010 through August 13, 2010.

On July 6, 2010, the members of TerraSphere entered into a membership acquisition agreement with Converted Organics, Inc (“Converted”), a publicly traded company, whereby Converted agreed to acquire 100% of the membership interest of TerraSphere solely in exchange for shares of Converted’s common stock estimated at a maximum purchase price of \$25.8 million, subject to certain adjustments. Completion of the membership acquisition is contingent upon receipt of approval from Converted’s shareholders. Converted’s Chairman and Chief Executive Officer, has an 8.75% membership interest in TerraSphere, and his family members hold significant membership units of TerraSphere and serve as officers of TerraSphere.