

# NETFLIX INC

## FORM 10-Q (Quarterly Report)

Filed 8/9/2006 For Period Ending 6/30/2006

Address	100 WINCHESTER CIRCLE . LOS GATOS, California 95032
Telephone	408-540-3700
CIK	0001065280
Industry	Recreational Activities
Sector	Services
Fiscal Year	12/31

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-Q

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(Mark One)

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

For the quarterly period ended June 30, 2006

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: 000-49802

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### Netflix, Inc.

(Exact name of Registrant as specified in its charter)

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

**77-0467272**  
(I.R.S. Employer  
Identification Number)

**100 Winchester Circle, Los Gatos, California 95032**  
(Address and zip code of principal executive offices)

**(408) 540-3700**  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

As of August 3, 2006, there were 68,068,332 shares of the registrant's common stock, par value \$0.001, outstanding.

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**PART I. FINANCIAL INFORMATION**

***Item 1. Financial Statements***

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**Netflix, Inc.**  
**Condensed Consolidated Statements of Operations**  
**(unaudited)**  
**(in thousands, except per share data)**

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Revenues	\$164,027	\$239,351	\$316,473	\$463,477
Cost of revenues:				
Subscription	99,957	128,605	193,943	254,825
Fulfillment expenses*	17,892	21,974	35,027	44,019
Total cost of revenues	117,849	150,579	228,970	298,844
Gross profit	46,178	88,772	87,503	164,633
Operating expenses:				
Technology and development*	8,648	12,043	17,214	23,249
Marketing*	26,959	47,031	63,508	99,999
General and administrative*	6,233	6,773	12,921	15,065
Gain on disposal of DVDs	(116)	(964)	(811)	(2,351)
Total operating expenses	41,724	64,883	92,832	135,962
Operating income (loss)	4,454	23,889	(5,329)	28,671
Other income (expense):				
Interest and other income	1,246	3,701	2,297	6,153
Interest and other expense	(3)	—	(41)	—
Income (loss) before income taxes	5,697	27,590	(3,073)	34,824
Provision for income taxes	13	10,553	57	13,383
Net income (loss)	\$ 5,684	\$ 17,037	\$ (3,130)	\$ 21,441
Net income (loss) per share:				
Basic	\$ .11	\$ .29	\$ (.06)	\$ .38
Diluted	\$ .09	\$ .25	\$ (.06)	\$ .32
Weighted average common shares outstanding:				
Basic	53,190	58,383	53,005	56,808
Diluted	64,592	69,175	53,005	67,813
* Amortization of stock-based compensation included in expense line items:				
Fulfillment	\$ 332	\$ 223	\$ 773	\$ 483
Technology and development	1,135	867	2,546	1,832
Marketing	621	529	1,367	1,083
General and administrative	1,335	1,468	3,016	2,999
	\$ 3,423	\$ 3,087	\$ 7,702	\$ 6,397

See accompanying notes to condensed consolidated financial statements.

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**Netflix, Inc.**  
**Condensed Consolidated Balance Sheets**  
**(unaudited)**  
**(in thousands, except share and par value data)**

	As of	
	December 31, 2005	June 30, 2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 212,256	\$341,702
Prepaid expenses	7,848	5,956
Prepaid revenue sharing expenses	5,252	6,055
Deferred tax assets	13,666	6,832
Other current assets	4,669	9,545
	<u>243,691</u>	<u>370,090</u>
Total current assets	243,691	370,090
DVD library, net	57,032	79,030
Intangible assets, net	457	1,019
Property and equipment, net	40,213	41,607
Deposits	1,249	1,136
Deferred tax assets	21,239	18,700
Other assets	800	1,130
	<u>364,681</u>	<u>\$512,712</u>
Total assets	\$ 364,681	\$512,712
<b>Liabilities and Stockholders' Equity</b>		
Current liabilities:		
Accounts payable	\$ 63,491	\$ 70,785
Accrued expenses	25,563	25,513
Deferred revenue	48,533	49,029
	<u>137,587</u>	<u>145,327</u>
Total current liabilities	137,587	145,327
Deferred rent	842	1,031
	<u>138,429</u>	<u>146,358</u>
Total liabilities	138,429	146,358
Commitments and contingencies		
Stockholders' equity:		
Common stock, \$0.001 par value; 160,000,000 shares authorized at December 31, 2005 and June 30, 2006; 54,755,731 and 67,936,774 issued and outstanding at December 31, 2005 and June 30, 2006, respectively	55	68
Additional paid-in capital	315,868	434,516
Accumulated deficit	(89,671)	(68,230)
	<u>226,252</u>	<u>366,354</u>
Total stockholders' equity	226,252	366,354
	<u>\$ 364,681</u>	<u>\$512,712</u>
Total liabilities and stockholders' equity	\$ 364,681	\$512,712

See accompanying notes to condensed consolidated financial statements.

**Netflix, Inc.**  
**Condensed Consolidated Statements of Cash Flows**  
**(unaudited)**  
**(in thousands)**

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
<b>Cash flows from operating activities:</b>				
Net income (loss)	\$ 5,684	\$ 17,037	\$ (3,130)	\$ 21,441
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation of property and equipment	2,156	3,854	4,094	7,463
Amortization of DVD library	25,552	31,910	47,558	59,191
Amortization of intangible assets	380	11	834	23
Stock-based compensation expense	3,423	3,087	7,702	6,397
Excess tax benefits from stock-based compensation	—	(2,952)	—	(3,642)
Loss on disposal of property and equipment	—	—	—	(23)
Gain on disposal of DVDs	(208)	(2,029)	(1,337)	(4,078)
Noncash interest expense	—	—	11	—
Deferred taxes	—	7,315	—	9,373
Changes in operating assets and liabilities:				
Prepaid expenses and other current assets	(3,219)	(6,091)	1,452	(3,787)
Accounts payable	3,579	(7,211)	6,436	7,294
Accrued expenses	(1,979)	153	571	3,592
Deferred revenue	1,034	1,104	1,561	496
Deferred rent	92	119	185	189
Net cash provided by operating activities	<u>36,494</u>	<u>46,307</u>	<u>65,937</u>	<u>103,929</u>
<b>Cash flows from investing activities:</b>				
Purchases of property and equipment	(5,931)	(5,373)	(12,776)	(8,857)
Acquisition of intangible asset	—	(585)	—	(585)
Acquisitions of DVD library	(29,218)	(37,669)	(62,258)	(82,345)
Proceeds from sale of DVDs	470	2,753	2,164	5,234
Proceeds from disposal of property and equipment	—	—	—	23
Deposits and other assets	22	74	(155)	(217)
Net cash used in investing activities	<u>(34,657)</u>	<u>(40,800)</u>	<u>(73,025)</u>	<u>(86,747)</u>
<b>Cash flows from financing activities:</b>				
Proceeds from issuance of common stock	3,313	105,478	3,678	108,622
Excess tax benefits from stock-based compensation	—	2,952	(79)	3,642
Net cash provided by financing activities	<u>3,313</u>	<u>108,430</u>	<u>3,599</u>	<u>112,264</u>
Net increase (decrease) in cash and cash equivalents	5,150	113,937	(3,489)	129,446
Cash and cash equivalents, beginning of period	165,822	227,765	174,461	212,256
Cash and cash equivalents, end of period	<u>\$170,972</u>	<u>\$341,702</u>	<u>\$170,972</u>	<u>\$341,702</u>

See accompanying notes to condensed consolidated financial statements.

**Netflix, Inc.**

**Notes to Condensed Consolidated Financial Statements  
(in thousands, except shares, per share data and percentages)**

***1. Basis of Presentation and Summary of Significant Accounting Policies***

The accompanying condensed consolidated interim financial statements of Netflix, Inc. and its wholly owned subsidiary (the “Company”) have been prepared in conformity with accounting principles generally accepted in the United States and are consistent in all material respects with those applied in the Company’s annual report on Form 10-K for the year ended December 31, 2005. The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. Examples include the estimate of useful lives and residual value of its DVD library; the valuation of stock-based compensation; and the recognition and measurement of income tax assets and liabilities. The actual results experienced by the Company may differ from management’s estimates.

The interim financial information is unaudited, but reflects all normal recurring adjustments that are, in the opinion of management, necessary to fairly present the information set forth therein. The interim financial statements should be read in conjunction with the audited financial statements and related notes included in the Company’s 2005 annual report on Form 10-K filed with the Securities and Exchange Commission on March 16, 2006. Interim results are not necessarily indicative of the results for a full year.

***Reclassifications***

Certain amounts in the Company’s prior years’ Condensed Consolidated Statements of Operations were reclassified to conform with the current period presentation. Proceeds from sales of previously viewed DVDs and the related cost of DVDs sold were reported as Sales revenues and Cost of sales revenues, respectively, in the Condensed Consolidated Statements of Operations in previous years. In light of discussions with the SEC and consistent with the guidance in Statement of Financial Accounting Standards (“SFAS”) 95, *Statement of Cash Flows*, and SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, in the fourth quarter of 2005 the Company began to report the net gain on sales of DVDs as a separate line item within Operating expenses. Accordingly, Sales revenues and Cost of sales revenues contained in the Condensed Consolidated Statements of Operations for the three months and six months ended June 30, 2005 have been reclassified to conform to the current presentation. Cash flows associated with the acquisition of its DVD Library and proceeds from sale of DVDs continue to be classified as cash flows from investing activities in the Condensed Consolidated Statements of Cash Flows.

Additionally, in light of discussions with the SEC, the Company reclassified fulfillment expenses in its Condensed Consolidated Statements of Operations as a component of Cost of revenues in the fourth quarter of 2005. In prior periods the Company had reported Fulfillment expenses as a component of Operating expenses. Accordingly, Cost of revenues, Gross profit and Operating expenses in the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2005 have been reclassified to conform to the current presentation.

In accordance with the SEC Staff Accounting Bulletin No. 107 (“SAB 107”), stock-based compensation is no longer presented as a separate line item on our Condensed Consolidated Statements of Operations. Stock-based compensation is now presented in the same lines as cash compensation paid to the same individuals. Stock-based compensation recognized in prior periods has been reclassified to conform with the presentation in the current period.

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### Netflix, Inc.

#### Notes to Condensed Consolidated Financial Statements (continued) (in thousands, except shares, per share data and percentages)

The reclassifications did not impact operating income (loss) or net income (loss), working capital or net cash provided by operating activities as previously reported. The following amounts were reclassified for the three and six months ended June 30, 2005:

Condensed Consolidated Statements of Operations	Three Months Ended June 30, 2005			Six Months Ended June 30, 2005		
	As previously reported	Reclassifications	As Reclassified	As previously reported	Reclassifications	As Reclassified
<b>Revenues:</b>						
Subscription	\$ 164,027	\$ —	\$ 164,027	\$ 316,473	\$ —	\$ 316,473
Sales	470	(470)	—	2,164	(2,164)	—
<b>Total revenues</b>	<b>164,497</b>	<b>(470)</b>	<b>164,027</b>	<b>318,637</b>	<b>(2,164)</b>	<b>316,473</b>
<b>Cost of revenues:</b>						
Subscription	99,957	—	99,957	193,943	—	193,943
Sales	354	(354)	—	1,353	(1,353)	—
Fulfillment expenses	—	17,892	17,892	35,027	35,027	35,027
<b>Total cost of revenues</b>	<b>100,311</b>	<b>17,538</b>	<b>117,849</b>	<b>195,296</b>	<b>33,674</b>	<b>228,970</b>
<b>Gross profit</b>	<b>64,186</b>	<b>(18,008)</b>	<b>46,178</b>	<b>123,341</b>	<b>(35,838)</b>	<b>87,503</b>
<b>Operating expenses:</b>						
Fulfillment	17,560	(17,560)	—	34,254	(34,254)	—
Technology and development	7,513	1,135	8,648	14,668	2,546	17,214
Marketing	26,338	621	26,959	62,141	1,367	63,508
General and administrative	4,898	1,335	6,233	9,905	3,016	12,921
Stock-based compensation	3,423	(3,423)	—	7,702	(7,702)	—
Gain on disposal of DVDs	—	(116)	(116)	—	(811)	(811)
<b>Total operating expenses</b>	<b>59,732</b>	<b>(18,008)</b>	<b>41,724</b>	<b>128,670</b>	<b>(35,838)</b>	<b>92,832</b>
<b>Operating income (loss)</b>	<b>4,454</b>	<b>—</b>	<b>4,454</b>	<b>(5,329)</b>	<b>—</b>	<b>(5,329)</b>
<b>Other income (expense):</b>						
Interest and other income	1,246	—	1,246	2,297	—	2,297
Interest and other expense	(3)	—	(3)	(41)	—	(41)
<b>Income (loss) before income taxes</b>	<b>5,697</b>	<b>—</b>	<b>5,697</b>	<b>(3,073)</b>	<b>—</b>	<b>(3,073)</b>
Provision for income taxes	13	—	13	57	—	57
<b>Net income (loss)</b>	<b>\$ 5,684</b>	<b>\$ —</b>	<b>\$ 5,684</b>	<b>\$ (3,130)</b>	<b>\$ —</b>	<b>\$ (3,130)</b>

#### Fair Value of Financial Instruments

The fair value of the Company's cash, short-term investments, accounts payable and accrued expenses approximates their carrying value due to their short maturity.

#### Restricted Cash

As of June 30, 2006, Other assets included restricted cash of \$750 related to a workers' compensation insurance deposit. In addition, Other current assets included \$2,548 set aside for plaintiffs' attorneys' fees and expenses in the *Chavez vs. Netflix, Inc.* lawsuit.

**Netflix, Inc.**

**Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)**

***Revenue Recognition***

Subscription revenues are recognized ratably over each subscriber's monthly subscription period. Refunds to subscribers are recorded as a reduction of revenues.

***Cost of Revenues***

*Subscription.* Cost of subscription consists of revenue sharing expenses, amortization of the DVD library, amortization of intangible assets related to equity instruments issued to studios, and postage and packaging expenses related to DVDs provided to paying subscribers. Revenue sharing expenses are recorded as DVDs subject to revenue sharing agreements are shipped to subscribers.

The terms of some revenue sharing agreements with studios obligate the Company to make minimum revenue sharing payments for certain titles. The Company amortizes minimum revenue sharing prepayments (or accretes an amount payable to studios if the payment is due in arrears) as revenue sharing obligations are incurred. A provision for estimated shortfall, if any, on minimum revenue sharing payments is made in the period in which the shortfall becomes probable and can be reasonably estimated. Additionally, the terms of some revenue-sharing agreements with studios provide for rebates based on achieving specified performance levels. The Company accrues for these rebates as earned based on historical title performance and estimates of demand for the titles over the remainder of the title term. Actual rebates may vary which could result in an increase or reduction in the estimated amounts previously accrued.

*Fulfillment expenses.* Fulfillment expenses represent those costs incurred in operating and staffing the Company's fulfillment and customer service centers, including costs attributable to receiving, inspecting and warehousing the Company's DVD library. Fulfillment expenses also include credit card fees.

***Technology and Development***

Technology and development expenses consist of payroll and related costs incurred in testing, maintaining and modifying the Company's Web Site, its recommendation service, developing solutions for downloading movies to subscribers, telecommunications systems and infrastructure and other internal-use software systems. Technology and development expenses also include depreciation on computer hardware and capitalized software.

***Marketing***

Marketing expenses consist of compensation and related expenses and advertising expenses. Advertising expenses include marketing program expenditures and other promotional activities, including revenue sharing expenses, postage and packaging expenses and library amortization related to free trial periods. Advertising costs are expensed as incurred except for advertising production costs, which are expensed the first time the advertising is run.

In November of 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 02-16, *Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor*, which addresses the accounting for cash consideration given to a reseller of a vendor's products from the vendor. The Company and its vendors participate in a variety of cooperative advertising programs and other promotional programs in which the vendors provide the Company with cash consideration in exchange for marketing and advertising of the vendor's products. If the consideration received represents reimbursement of specific incremental and identifiable costs incurred to promote the vendor's product, it is recorded as an offset to the

**Netflix, Inc.**

**Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)**

associated marketing expense incurred. Any reimbursement greater than the specific incremental and identifiable costs incurred is recognized as a reduction of cost of revenues when recognized in the Company's statements of operations.

***Gain on disposal of DVDs***

Gain on disposal of DVDs represents the difference between proceeds from sales of previously viewed DVDs and associated cost of DVD sales. Cost of DVD sales includes the net book value of the DVDs sold, shipping charges and, where applicable, a contractually specified percentage of the sales value for the DVDs that are subject to revenue sharing agreements.

***Stock-based compensation***

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* ("SFAS 123R"), using the modified prospective method. The Company had previously adopted the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an Amendment of FASB Statement No. 123* in 2003, and restated prior periods at that time. Because the fair value recognition provisions of SFAS 123 and SFAS 123R were materially consistent under its equity plans, the adoption of SFAS 123R did not have a significant impact on the Company's financial position or results of operations. Upon the adoption of SFAS 123R, the Company classified tax benefits resulting from tax deductions in excess of the compensation cost recognized for those options as financing cash flows.

In March 2005, the Securities and Exchange Commission (the "SEC") issued Staff Accounting Bulletin No. 107 ("SAB 107") regarding the SEC's interpretation of SFAS 123R and the valuation of share-based payments for public companies. The Company has applied the provisions of SAB 107 in its adoption of SFAS 123R. See Note 6 to the Condensed Consolidated Financial Statements for a further discussion on stock-based compensation.

***2. Recent Accounting Pronouncements***

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes." The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with Statement of Financial Accounting Standards No. 109, "Accounting for Income Taxes." Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations.

In February 2006, the FASB issued SFAS 155, *Accounting for Certain Hybrid Instruments* which amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. This statement is effective for all

Netflix, Inc.

Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)

financial instruments acquired or issued in fiscal years beginning after September 15, 2006. The Company does not expect the adoption of this standard to have a material effect on its financial position or results of operations.

3. DVD Library

The Company acquires DVDs from studios and distributors through either direct purchases or revenue sharing agreements. The Company acquires DVDs for the purpose of renting them to its subscribers and earning subscription rental revenues and as such, the Company considers its DVD library to be a productive asset. Accordingly, the Company classifies its DVD Library as a non-current asset on its Condensed Consolidated Balance Sheet. Additionally, in accordance with SFAS 95, *Statement of Cash Flows*, cash outflows for the acquisition of the DVD Library, including any upfront non-refundable payments required under revenue sharing agreements, are classified as cash flows from investing activities on the Company's Condensed Consolidated Statements of Cash Flows.

The Company amortizes its DVD library, less estimated salvage value, on a "sum-of-the-months" accelerated basis over its estimated useful life. The useful life of the new-release DVDs and back-catalogue DVDs is estimated to be 1 year and 3 years, respectively. In estimating the useful life of the DVD library, the Company takes into account library utilization as well as an estimate for lost or damaged DVDs. Volume purchase discounts received from studios on the purchase of titles are recorded as a reduction of DVD library inventory when earned.

The Company provides a salvage value of \$3.00 per DVD for those direct purchase DVDs that the Company estimates it will sell at the end of their useful lives. For those DVDs that the Company does not expect to sell, no salvage value is provided.

The Company capitalizes film costs in accordance with Statement of Position 00-2 ("SOP 00-2") *Accounting by Producers or Distributors of Films*. Net capitalized film costs are recorded within DVD Library as such amounts are currently not material to the condensed consolidated financial statements. Capitalized film costs include costs to develop and produce movies, which primarily consist of concept development, pre-production and production. Capitalized film costs are stated at the lower of unamortized cost or estimated fair value on an individual film basis. Once a film is released, capitalized film production costs are amortized in the proportion that the revenue during the period for each film bears to the estimated total revenue to be received from all sources for the film ("Ultimate Revenue") under the individual-film-forecast method as defined in SOP 00-2. In the event a film is not set for production within three years from the time of the first capitalized transaction, all such costs will be expensed. The Company makes certain estimates and judgments of Ultimate Revenue for each film based on performance of comparable titles and our knowledge of the industry. Estimates of Ultimate Revenue are reviewed periodically and are revised if necessary. Unamortized film production costs are evaluated for impairment each quarter on a film-by-film basis in accordance with the requirements of SOP 00-2. If forecasts of Ultimate Revenue are not sufficient to recover the unamortized film costs for that film, the unamortized film costs will be written down to fair value.

DVD library and accumulated amortization are as follows:

	As of	
	December 31, 2005	June 30, 2006
DVD library, gross	\$ 304,490	\$ 382,703
Less accumulated amortization	(247,458)	(303,673)
DVD library, net	\$ 57,032	\$ 79,030

**Netflix, Inc.**  
**Notes to Condensed Consolidated Financial Statements (continued)**  
**(in thousands, except shares, per share data and percentages)**

**4. Intangible Assets**

Intangible assets and accumulated amortization consists of the following:

	As of	
	December 31, 2005	June 30, 2006
Patents, gross	\$ 480	\$1,066
Less accumulated amortization	(23)	(47)
Patents, net	\$ 457	\$1,019

In the second quarter of 2006, the Company capitalized \$585 related to certain technology patents acquired. The capitalized patents are being amortized to 'Technology and Development' in the Condensed Consolidated Statements of Operations over the remaining life of the patents, the last of which expires in August 2020.

**5. Stockholders' Equity**

On May 3, 2006, the Company issued 3.5 million shares of common stock upon the closing of a public offering for net proceeds of \$101.1 million.

**6. Employee Stock benefit Plans**

*Employee Stock Purchase Plan*

In February 2002, the Company adopted the 2002 Employee Stock Purchase Plan, which reserved a total of 1,166,666 shares of common stock for issuance. The 2002 Employee Stock Purchase Plan also provides for annual increases in the number of shares available for issuance on the first day of each year, beginning with 2003, equal to the lesser of:

- 2 percent of the outstanding shares of the common stock on the first day of the applicable year;
- 666,666 shares; and
- such other amount as the Company's Board of Directors may determine.

Under the 2002 Employee Stock Purchase Plan, shares of the Company's common stock may be purchased over an offering period with a duration of 24 months at 85 percent of the lower of the fair market value on the first day of the applicable offering period or on the last day of the six-month purchase period. In May 2006, the Company amended its 2002 Employee Stock Purchase Plan so that offering periods under the plan going forward have a duration of 6 months instead of 24 months. Employees may invest up to 15 percent of their gross compensation through payroll deductions. In no event shall an employee be permitted to purchase more than 8,334 shares of common stock during any six-month purchase period. As of June 30, 2006, 2,344,940 shares were available for future issuance under the 2002 Employee Stock Purchase Plan.

*Stock Option Plans*

In December 1997, the Company adopted the 1997 Stock Plan, which was amended and restated in October 2001. The 1997 Stock Plan provides for the issuance of stock purchase rights, incentive stock options or non-statutory stock options.

Netflix, Inc.

Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)

In February 2002, the Company adopted the 2002 Stock Plan. The 2002 Stock Plan provides for the grant of incentive stock options to employees and for the grant of non-statutory stock options and stock purchase rights to employees, directors and consultants. The Company initially reserved a total of 1,333,334 shares of common stock for issuance under the 2002 Stock Plan. In addition, 643,884 remaining shares reserved but not yet issued under the 1997 Stock Plan as of the effective date of the Company's initial public offering were added to the total reserved shares of 1,333,334 under the 2002 Stock Plan and deducted from the total reserved shares under the 1997 Stock Plan. Prior to its amendment and restatement, the Company's 2002 Stock Plan further provided for annual increases in the number of shares available for issuance on the first day of each year, beginning with 2003, equal to the lesser of:

- 5 percent of the outstanding shares of common stock on the first day of the applicable year;
- 2,000,000 shares; and
- such other amount as the Company's Board of Directors may determine.

Options granted under the 2002 Stock Plan generally expire in 10 years, however, they may be limited to five years if the optionee owns stock representing more than 10 percent of the Company. Generally, the Company's Board of Directors grants options at an exercise price of not less than the fair value of the Company's common stock at the date of grant. Prior to the third quarter of 2003, the vesting periods generally provided for options to vest over three to four years. During the third quarter of 2003, the Company began granting fully vested options on a monthly basis. The Company issues new shares to satisfy stock option exercises.

In May 2006, the 2002 Stock Plan was amended and restated to, among other things, eliminate the ability to reprice options without stockholder approval, to remove the provisions that provide for automatic annual increases in the number of shares available, permit the Company to deduct certain performance-based equity awards for tax purposes and to increase the limitation on the number of options that can be granted annually to any individual from 1,000,000 to 1,500,000 or in connection with initial service from 333,333 to 500,000.

A summary of option activity during the three and six months ended June 30, 2006 is as follows:

	Shares Available for Grant	Options Outstanding		Weighted-Average Remaining contractual term (in years)	Aggregate Intrinsic value (in thousands)
		Number of Shares	Weighted-Average Exercise Price		
Balances as of December 31, 2005	4,582,833	5,854,816	\$ 10.43		
Authorized	2,000,000	—	—		
Granted	(240,517)	240,517	\$ 26.67		
Exercised	—	(497,043)	\$ 6.31		
Canceled	13,786	(13,786)	\$ 24.25		
Balances as of March 31, 2006	6,356,102	5,584,504	\$ 11.46	7.21	\$ 100,255
Granted	(231,375)	231,375	\$ 28.74		
Exercised	—	(444,753)	\$ 6.07		
Canceled	9,865	(9,865)	\$ 32.31		
Balances as of June 30, 2006	6,134,592	5,361,261	\$ 12.61	7.15	\$ 81,742
Exercisable as of June 30, 2006		5,329,468	\$ 12.64	7.16	\$ 81,133
Vested and expected to vest at June 30, 2006		5,361,261	\$ 12.61	7.15	\$ 81,742

Netflix, Inc.

Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)

The aggregate intrinsic value in the table above represents the total pretax intrinsic value (the difference between the Company's closing stock price on the last trading day of the second quarter of 2006 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on June 30, 2006. This amount changes based on the fair market value of the Company's common stock. Total intrinsic value of options exercised for the three months ended June 30, 2005 and 2006 was \$2.1 million and \$10.5 million, respectively.

Cash received from option exercises and purchases under the ESPP for the three and six months ended June 30, 2006 was \$4.6 million and \$7.8 million, respectively.

*Stock-Based Compensation*

The Company adopted the provisions of SFAS 123R on January 1, 2006. See Note 1 for a description of the Company's adoption of SFAS 123R. The fair value of employee stock options granted as well as the fair value of shares issued under the employee stock purchase plan is estimated using the Black-Scholes option pricing model.

The following table summarizes the assumptions used to value option grants:

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Dividend yield	0%	0%	0%	0%
Expected volatility	45%	44-46%	45%-85%	44%-53%
Risk-free interest rate	3.81%-3.91%	4.87%	2.85%-3.91%	4.45%-4.87%
Expected life (in years)	3.0-4.0	3.0-4.5	1.0-4.0	3.0-4.5

The following table summarizes the assumptions used to value shares issued under the employee stock purchase plan:

	Three Months Ended	
	June 30, 2005	June 30, 2006
Dividend yield	0%	0%
Expected volatility	37%-45%	39%
Risk-free interest rate	3.14%-3.64%	5.01%
Expected life (in years)	0.5-2.0	0.5

Since the second quarter of 2003, the Company began granting stock options on a monthly basis. Such stock options are designated as non-qualified stock options and vest immediately. As a result of immediate vesting, stock-based compensation expense determined under SFAS No. 123R is fully recognized upon the stock option grants and no estimate is required for pre-vesting option forfeitures. For those stock options granted prior to the third quarter of 2003 with three to four-year vesting periods, the Company continues to amortize the deferred compensation related to the stock options over the remaining vesting periods using the accelerated multiple-option approach.

In light of the guidance in SAB 107, the Company re-evaluated the assumptions used to estimate the value of stock options beginning in the second quarter of 2005.

The Company estimates expected volatility based on a blend of historical volatility of the Company's common stock and implied volatility of tradable forward call options to purchase shares of its common stock.

**Netflix, Inc.**

**Notes to Condensed Consolidated Financial Statements (continued)**  
**(in thousands, except shares, per share data and percentages)**

The decision to use implied volatility was based on the Company's assessment that implied volatility of publicly traded options in its common stock is expected to be more reflective of market conditions and, therefore, can reasonably be expected to be a better indicator of expected volatility than historical volatility of its common stock.

The Company bifurcates its option grants into two employee groupings (executive and non-executive) based on exercise behavior and considers several factors in determining the estimate of expected life for each group, including the historical option exercise behavior, the terms and vesting periods of the options granted. In the second quarter of 2006, the Company used an estimate of expected life of 4.5 years for one group and 3 years for the other group. Prior to the second quarter of 2006, the Company used an estimate of expected life of 4 years for one group and 3 years for the other group.

The Company bases the risk-free interest rate on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term on the options. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model.

The weighted-average fair value of employee stock options granted during the three months ended June 30, 2005 and 2006 was \$4.55 and \$11.89 per share, respectively. As of June 30, 2006, total unrecognized compensation cost related to unvested stock options is \$0.04 million which is expected to be recognized over the next nine months.

The following table summarizes stock-based compensation expense, net of tax, related to stock option plans and employee stock purchases under SFAS 123R for the three and six months ended June 30, 2006 which was allocated as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>	<b>June 30,</b>
	<b>2005</b>	<b>2006</b>	<b>2005</b>	<b>2006</b>
Fulfillment	\$ 332	\$ 223	\$ 773	\$ 483
Technology and development	1,135	867	2,546	1,832
Marketing	621	529	1,367	1,083
General and administrative	1,335	1,468	3,016	2,999
Stock-based compensation expense before income taxes	3,423	3,087	7,702	6,397
Income tax benefit	—	(1,179)	—	(2,473)
<b>Total stock-based compensation after income-taxes</b>	<b>\$ 3,423</b>	<b>\$ 1,908</b>	<b>\$ 7,702</b>	<b>\$ 3,924</b>

**7. Income Taxes**

The Company accounts for income taxes using the asset and liability method. Deferred income taxes are recognized by applying enacted statutory tax rates applicable to future years to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. The measurement of deferred tax assets is reduced, if necessary, by a valuation allowance for any tax benefits for which future realization is uncertain.

Netflix, Inc.

Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)

8. Net Income (loss) Per Share

Basic net income (loss) per share is computed using the weighted-average number of outstanding shares of common stock during the period. Diluted net income per share is computed using the weighted-average number of outstanding shares of common stock and, when dilutive, potential common shares outstanding during the period. Potential common shares consist primarily of incremental shares issuable upon the assumed exercise of stock options, warrants to purchase common stock and shares currently purchasable pursuant to our employee stock purchase plan using the treasury stock method. The shares used in the computation of net income per share are as follows (rounded to the nearest thousand):

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Weighted-average shares – basic	53,190,000	58,383,000	53,005,000	56,809,000
Effect of dilutive potential common shares:				
Warrants	8,112,000	8,177,000	—	8,286,000
Employee stock options	3,290,000	2,615,000	—	2,718,000
Weighted-average shares – diluted	64,592,000	69,175,000	53,005,000	67,813,000

For the three months ended June 30, 2005 and 2006 and the six months ended June 30, 2006, employee stock options with exercise prices greater than the average market price of the common stock were excluded from the diluted calculation as their inclusion would have been anti-dilutive. No outstanding warrants were excluded from the diluted calculation as their exercise prices were lower than the average market price of the common stock. For the six months ended June 30, 2005, potential common shares from the assumed exercise of warrants and employee stock options were excluded from the diluted calculation as their inclusion would have been anti-dilutive as the Company was in a net loss position.

The following table summarizes the outstanding potential common shares excluded from the diluted calculation (rounded to the nearest thousand):

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Warrants	—	—	7,991,000	—
Employee stock options	1,291,000	512,000	3,126,000	618,000

9. Legal Proceedings

From time to time, in the normal course of its operations, the Company is a party to litigation matters and claims, including claims relating to employee relations and business practices. Litigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. The Company expenses legal fees as incurred. Listed below are material legal proceedings to which the Company is a party. An unfavorable outcome of any of these matters could have a material adverse effect on the Company's financial position, liquidity or results of operations.

On September 23, 2004, Frank Chavez, individually and on behalf of others similarly situated, filed a class action lawsuit against the Company in California Superior Court, City and County of San Francisco. The complaint asserts claims of, among other things, false advertising, unfair and deceptive trade practices, breach of

Netflix, Inc.

Notes to Condensed Consolidated Financial Statements (continued)  
(in thousands, except shares, per share data and percentages)

contract as well as claims relating to the Company's statements regarding DVD delivery times. The Company previously reported a tentative settlement. On March 8, 2006, the Company entered into an amended settlement which received court approval on April 28, 2006. Under the terms of the amended settlement, Netflix subscribers who were enrolled in a paid membership before January 15, 2005 and were a member on October 19, 2005 are eligible to receive a free one-month upgrade in service level and Netflix subscribers who were enrolled in a paid membership before January 15, 2005 and were not a member on October 19, 2005 are eligible to receive a free one-month Netflix membership of either the 1, 2 or 3 DVDs at-a-time unlimited program. Under the settlement agreement, the Company had also agreed to pay the plaintiffs' attorneys' fees and expenses in an amount not to exceed \$2,528. The registration period for the settlement closed on June 26, 2006. The Court issued final judgment on the settlement on July 28, 2006, awarding plaintiffs' attorneys' fees and expenses of \$2,127. The final judgment remains subject to appeal until September 29, 2006. The Company initially estimated the total cost of the settlement to be approximately \$8,953 with the actual cost dependent upon many unknown factors such as the number of former Netflix subscribers who will claim the settlement benefit. In accordance with SFAS No. 5, *Accounting for Contingencies*, in 2005, the Company estimated and recorded a charge against earnings in General and administrative expenses of \$8,953 associated with the legal fees and the free one month membership to former subscribers in 2005. At the conclusion of the registration period, in the second quarter of 2006, the Company revised its estimate of the total cost of settlement to be \$7,442. The charge for the free one month upgrade to the next level program for existing subscribers will be recorded when the subscribers utilize the upgrade. The Company also recorded an insurance receivable of \$1,000, representing the portion of legal fees to be reimbursed by the Company's insurer. The Company denies any wrongdoing.

On March 10, 2006, the Company filed a complaint for declaratory judgment of patent invalidity and non-infringement against NCR Corporation in the United States District Court for the Northern District of California. The suit was brought in response to letters and other communications by NCR, accusing the Company of infringing certain NCR patents. The complaint sought a judgment from the court that the Company's activities did not infringe, induce infringement or contributorily infringe any of NCR's patents and that the NCR patents were invalid. On April 5, 2006, NCR filed its Answer and Counterclaim. The counterclaim alleged that the Company had infringed and continues to infringe one or more claims of specified NCR patents. The parties reached a settlement on June 23, 2006, in which the Company received a nonexclusive license to the NCR patents. On that same date, the Company's and NCR's lawsuits were dismissed.

On April 4, 2006, the Company filed a complaint for patent infringement against Blockbuster, Inc. in the United States District Court for the Northern District of California. The complaint alleges that Blockbuster willfully infringed two of our patents—U.S. Patent No. 7,024,381 entitled "Approach for Renting Items to Customers" and U.S. Patent No. 6,584,450 entitled "Method and Apparatus for Renting Items." The complaint seeks a judgment that Blockbuster has willfully infringed the specified patents and seeks a preliminary and/or permanent injunction enjoining Blockbuster from any further infringement, unspecified compensatory enhanced damages, attorneys' fees, expenses and costs. On June 13, 2006, Blockbuster responded and filed a counterclaim alleging that Netflix had violated Section 2 of the Sherman Antitrust Act. The counterclaim also seeks a declaratory judgment that Blockbuster had not infringed Netflix's asserted patents and that both patents were invalid. In addition to the declaratory judgment, Blockbuster is also seeking compensatory damages, attorneys' fees and expenses, costs of the suit, pre-and post-judgment damage on all amounts awarded and general relief.

**10. Intellectual Property Indemnification Obligations**

In the ordinary course of business, the Company has entered into contractual arrangements under which it has agreed to provide indemnification of varying scope and terms to business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of the Company's breach of such

**Netflix, Inc.**

**Notes to Condensed Consolidated Financial Statements (continued)**  
**(in thousands, except shares, per share data and percentages)**

agreements and out of intellectual property infringement claims made by third parties. Payment by the Company may be conditional on the other party making a claim pursuant to the procedures specified in the particular contract, which procedures typically allow the Company to challenge the other party's claims. Further, the Company's obligations under these agreements may be limited in terms of time or amount, and in some instances, the Company may have recourse against third parties for certain payments made by it under these agreements. In addition, the Company has entered into indemnification agreements with its directors and certain of its officers that will require it, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers. The terms of such obligations vary.

It is not possible to make a reasonable estimate of the maximum potential amount of future payments under these or similar agreements due to the conditional nature of the Company's obligations and the unique facts and circumstances involved in each particular agreement. No amount has been accrued in the accompanying financial statements with respect to these indemnification obligations.

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

#### **Forward-Looking Statements**

This quarterly report on Form 10-Q contains certain forward-looking statements within the meaning of the federal securities laws. These forward-looking statements include, but are not limited to, statements regarding our business growth, operating expenses, churn, gross margin and liquidity. These forward-looking statements are subject to risks and uncertainties that could cause actual results and events to differ. Factors that might cause or contribute to such differences include, but are not limited to, those discussed in the section titled "Risk Factors" in Part II, Item 1A of this report and in the Annual Report on Form 10-K for fiscal 2005 filed with the Securities and Exchange Commission on March 16, 2006, in the Quarterly Report on Form 10-Q filed with the Securities and Exchange Commission on May 9, 2006 and the other Quarterly Reports on Form 10-Q to be filed by us in 2006.

We undertake no obligation to revise or publicly release the results of any revision to any forward-looking statements contained in this Quarterly Report on Form 10-Q or to explain why actual results differ.

#### **Overview**

##### ***Our Business***

Netflix (Nasdaq: NFLX) is the world's largest online movie rental service, providing more than five million subscribers access to over 60,000 DVD titles. The Company offers a variety of subscription plans, starting at \$5.99 a month. There are no due dates, no late fees and no shipping fees. DVDs are delivered by the United States Postal Service ("USPS") from regional shipping centers located throughout the United States. Netflix can reach more than 90 percent of its subscribers with generally one business-day delivery. Netflix offers personalized movie recommendations to its members and has more than one billion movie ratings. Netflix also allows members to share and recommend movies to one another through its Friends<sup>SM</sup> feature. The terms and conditions by which subscribers utilize our service and a more detailed description of how our service works can be found at [www.netflix.com/TermsOfUse](http://www.netflix.com/TermsOfUse).

Our business has grown rapidly since inception, resulting in substantially increased revenues. Our growth has been fueled by the rapid adoption of DVDs as a medium for home entertainment as well as increased awareness of online DVD rentals. We expect that our business will continue to grow as the market for online DVD rentals continues to grow, a reflection of both the convenience and value of the subscription rental model.

We continued to see strong growth and financial results in the second quarter of 2006, with revenues growing 46% from a year ago. This growth is attributed to our expanding subscriber base. We added approximately 0.3 million net new subscribers in the second quarter of 2006, growing from 4.9 million to 5.2 million subscribers at June 30, 2006.

##### ***Key Business Metrics***

Management periodically reviews certain key business metrics, within the context of our articulated performance goals, in order to evaluate the effectiveness of our operational strategies, allocate resources and maximize the financial performance of our business. The key business metrics include the following:

- **Churn:** Churn is a monthly measure defined as customer cancellations in the quarter divided by the sum of beginning subscribers and gross subscriber additions, then divided by three months. Management reviews this metric to evaluate whether we are retaining our existing subscribers in accordance with our business plans.

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- *Subscriber Acquisition Cost*: Subscriber acquisition cost is defined as total marketing expense divided by total gross subscriber additions. Management reviews this metric to evaluate how effective our marketing programs are in acquiring new subscribers on an economical basis in the context of estimated subscriber lifetime value.
- *Gross Margin*: Management reviews gross margin to monitor variable costs and operating efficiency.

Management believes it is useful to monitor these metrics together and not individually as it does not make business decisions based upon any single metric. Please see “Results of Operations” below for further discussion on these key business metrics.

### Critical Accounting Policies and Estimates

Other than the adoption of Statement of Financial Accounting Standards (“SFAS”) 123R *Share-Based Payment*, to account for stock-based compensation, there have been no significant changes during the six months ended June 30, 2006 to the items that we disclosed as our critical accounting policies and estimates in Management’s Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the year ended December 31, 2005.

#### *Stock-Based Compensation*

We adopted the provisions of SFAS 123R on January 1, 2006. Under the fair value recognition provisions of this statement, stock-based compensation cost is estimated at the grant date based on the fair value of the awards expected to vest and is recognized as expense ratably over the requisite service period, which is the vesting period. We adopted the fair value recognition provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation – Transition and Disclosure, an Amendment of FASB Statement No. 123* in the second quarter of 2003, and restated prior periods at that time. Because the fair value recognition provisions of SFAS 123 and SFAS 123R were materially consistent under our equity plans, the adoption of SFAS 123R did not have a significant impact on our financial position or results of operations.

We use the Black-Scholes option pricing model to determine the fair value of stock options and employee stock purchase plan shares. The Black-Scholes option-pricing model requires the input of highly subjective assumptions, including the option’s expected life and the price volatility of the underlying stock. Changes in the subjective input assumptions can materially affect the estimate of fair value of options granted and our results of operations could be materially impacted. In light of the guidance in Staff Accounting Bulletin No. 107 (“SAB 107”), we re-evaluated the assumptions used to estimate the value of stock options beginning in the second quarter of 2005.

- *Expected Volatility*: Our computation of expected volatility is based on a blend of historical volatility of our common stock and implied volatility of tradable forward call options to purchase shares of our common stock. Our decision to use implied volatility was based on our assessment that implied volatility of publicly traded options in our common stock is expected to be more reflective of market conditions and, therefore, can reasonably be expected to be a better indicator of expected volatility than historical volatility of our common stock.
- *Expected life*: We bifurcate our option grants into two employee groupings (executive and non-executive) based on exercise behavior and consider several factors in determining the estimate of expected life for each group, including the historical option exercise behavior and the terms and vesting periods of the options granted. In the second quarter of 2006, we used an estimate of expected life of 4.5 years for one group and 3 years for the other group. Prior to the second quarter of 2006, we used an estimate of expected life of 4 years for one group and 3 years for the other group.

We grant stock options to our employees on a monthly basis. Such stock options are designated as non-qualified stock options and vest immediately. As a result of immediate vesting, stock-based compensation

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expense determined under SFAS 123R is fully recognized upon the stock option grants and no estimate is required for pre-vesting option forfeitures.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period and could materially affect the fair value estimate of stock-based payments, our operating income, net income and net income per share.

See Note 6 for further information regarding the SFAS 123R disclosures.

### Results of Operations

The following table sets forth, for the periods presented, the line items in our Statements of Operations as a percentage of total revenues. The information contained in the table below should be read in conjunction with the Financial Statements, Notes to Financial Statements, and Management's Discussion and Analysis of Financial Condition and Results of Operations included in this Quarterly Report on Form 10-Q.

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Revenues	100.0%	100.0%	100.0%	100.0%
Cost of revenues:				
Subscription	60.9%	53.7%	61.3%	55.0%
Fulfillment expenses*	10.9%	9.2%	11.1%	9.5%
Total cost of revenues	71.8%	62.9%	72.4%	64.5%
Gross profit	28.2%	37.1%	27.6%	35.5%
Operating expenses:				
Technology and development*	5.3%	5.0%	5.4%	5.0%
Marketing*	16.4%	19.6%	20.1%	21.6%
General and administrative*	3.8%	2.8%	4.1%	3.3%
Gain on disposal of DVDs	(0.1)%	(0.3)%	(0.3)%	(0.6)%
Total operating expenses	25.4%	27.1%	29.3%	29.3%
Operating income (loss)	2.8%	10.0%	(1.7)%	6.2%
Other income (expense):				
Interest and other income	0.7%	1.5%	0.7%	1.3%
Interest and other expense	—	—	—	—
Income (loss) before income taxes	3.5%	11.5%	(1.0)%	7.5%
Provision for income taxes	—	4.4%	—	2.9%
Net income (loss)	3.5%	7.1%	(1.0)%	4.6%
<b>* Amortization of stock-based compensation included in expense line items above:</b>				
Fulfillment	0.2%	0.1%	0.2%	0.1%
Technology and development	0.7%	0.4%	0.8%	0.4%
Marketing	0.4%	0.2%	0.4%	0.2%
General and administrative	0.8%	0.6%	1.0%	0.7%
Total stock-based compensation	2.1%	1.3%	2.4%	1.4%

\* Stock-based compensation recognized in the three and six months ended June 30, 2005 has been reclassified to this expense line to conform with the current period presentation.

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### Three and Six Months Ended June 30, 2006 Compared to Three and Six Months Ended June 30, 2005

#### Revenues

	Three Months Ended			Six Months Ended		
	June 30, 2005	June 30, 2006	Percent Change	June 30, 2005	June 30, 2006	Percent Change
	(in thousands except percentages and average monthly revenue per paying subscriber)					
Revenues	\$164,027	\$239,351	45.9%	\$316,473	\$463,477	46.5%
Average number of paying subscribers	2,998	4,876	62.6%	2,843	4,628	62.8%
Average monthly revenue per paying subscriber	\$ 18.24	\$ 16.36	(10.3)%	\$ 18.55	\$ 16.69	(10.0)%

We currently generate all of our revenues in the United States. We derive substantially all of our revenues from monthly subscription fees and recognize subscription revenues ratably over each subscriber's monthly subscription period. In addition, for the three and six months ended June 30, 2006, we generated a small portion of our revenues from the sale of advertising.

The increase in our revenues in the second quarter of 2006 as compared to 2005 was primarily attributable to substantial growth in the average number of paying subscribers as summarized in the table above, offset in part by a decline in average monthly revenue per paying subscriber. We believe the increase in the number of paying subscribers was driven primarily by increased consumer awareness of the benefits of online DVD rentals and continuing improvements in our service. The decline in the average monthly revenue per paying subscriber was a result of the increased promotion of our lower cost subscription plans. We introduced new lower priced subscription plans in the second quarter of 2005. We expect the average revenue per paying subscriber to continue to decline due to the introduction of and increased consumer awareness of our lower priced subscription plans.

Subscriber churn was 4.3 percent in the second quarter of 2006, down slightly from 4.7 percent in the second quarter of 2005. We believe the decline was primarily due to the following factors:

- Aging subscriber base. As we grow, the ratio of new subscribers to total subscribers declines, leading to an increase in the average duration, or age, of the subscriber base. New subscribers are actually more likely to cancel their subscriptions than older subscribers, and therefore, an increase in subscriber age helps overall reductions in churn.
- The continued popularity of our lower cost subscription plans and the price parity of our subscription plans with those offered by Blockbuster. In the first part of 2005, we saw aggressive pricing and heavy marketing spending by Blockbuster which was not matched in the current 2006 period.
- Service improvements. We continued to make improvements in a number of key areas, including increasing the selection of titles as we expanded our DVD library and enhancing our Web site and recommendation service. We believe these improvements to our service increased subscriber satisfaction, which resulted in lower churn.

If we are unable to compete effectively against Blockbuster and our other existing competitors as well as against potential new entrants into the online movie rental subscription business, in both retaining our existing subscribers and attracting new subscribers, our churn will likely increase and our business will be adversely affected.

The following table presents our ending subscriber information:

	As of	
	June 30, 2005	June 30, 2006
	(in thousands, except percentages)	
Free subscribers	87	152
As a percentage of total subscribers	2.7%	2.9%
Paid subscribers	3,109	5,017
As a percentage of total subscribers	97.3%	97.1%
Total subscribers	3,196	5,169

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### Cost of Revenues

	Three Months Ended			Six Months Ended		
	June 30, 2005	June 30, 2006	Percent	June 30, 2005	June 30, 2006	Percent
			Change			Change
(in thousands, except percentages)						
Cost of revenues:						
Subscription	\$ 99,957	\$ 128,605	28.7%	\$ 193,943	\$ 254,825	31.4%
Fulfillment expenses	17,892	21,974	22.8%	35,027	44,019	25.7%
<b>Total cost of revenues</b>	<b>\$ 117,849</b>	<b>\$ 150,579</b>	<b>27.8%</b>	<b>\$ 228,970</b>	<b>\$ 298,844</b>	<b>30.5%</b>

Cost of subscription revenues consists of revenue sharing expenses, amortization of our DVD library, and postage and packaging expenses related to shipping titles to paying subscribers. Costs related to free-trial subscribers are allocated to marketing expenses. Fulfillment expenses represent those expenses incurred in operating and staffing our shipping and customer service centers, including costs attributable to receiving, inspecting and warehousing our library. Fulfillment expenses also include credit card fees.

#### Subscription

The increase in cost of subscription revenues in absolute dollars for the three and six months ended June 30, 2006 in comparison with the same prior-year periods corresponds with the increase in the number of average paying subscribers offset in part by a decline in monthly movie rentals per average paying subscriber. The increase in average paying subscribers drove increases in number of DVDs mailed to paying subscribers and related postage and packaging expenses and revenue-sharing expenses. Additionally, DVD amortization increased due to increased acquisitions for our DVD library.

Our cost of subscription fluctuates based on several factors, including the level of acquisitions for our DVD library; the percentage of DVDs subject to revenue sharing agreements mailed to paying subscribers; revenue sharing costs per paid shipment and postage rates. In the first and second quarters of 2006, cost of subscription was impacted by the increase in the postage rates by 2 cents effective January 8, 2006.

#### Fulfillment expenses

The increase in fulfillment expenses in absolute dollars for the three and six months ended June 30, 2006 in comparison with the same prior-year periods was primarily attributable to the following factors:

- an increase in credit card fees as a result of the increase in subscriptions,
- an increase in personnel-related costs resulting from the higher volume of activities in our customer service and shipping centers and,
- an increase in facility-related costs resulting from expansion of certain of our shipping centers and the addition of new ones.

### Gross Margin

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
(in thousands, except percentages)				
Gross profit	\$46,178	\$88,772	\$87,503	\$164,633
Gross margin	28.2%	37.1%	27.6%	35.5%

In the fourth quarter of 2005, in light of discussions with the Securities and Exchange Commission ("SEC"), we reclassified fulfillment expenses in our Consolidated Statements of Income as a component of Cost of

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revenues. In prior periods we had reported fulfillment expenses as a component of Operating expenses. Accordingly, Cost of revenues, Gross profit and Operating expenses in the Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2005 have been reclassified to conform to this presentation. ( See Note 1 of Notes to Condensed Consolidated Financial Statements ).

The increase in gross margin in the three and six months ended June 30, 2006 in comparison with the same prior-year period was primarily due to a decrease in revenue share cost per paid shipment as well as an increase in revenue per paid shipment as a result of a decline in overall usage and the continued popularity of our lower-priced plans. The increase in postage rates by 2 cents effective January 8, 2006 negatively impacted gross margin for the quarter, however, this impact was offset by a decline in fulfillment costs as a result of increased operational efficiencies.

If movie rentals per average paying subscriber increases or if we see more shipments of DVDs subject to revenue share and the revenue share cost per shipment does not decline, erosion in our gross margin could occur. Additionally, in May 2006, the USPS proposed an increase in the rate of first class postage by 3 cents to \$0.42. If approved, the increase would likely be effective in May 2007. The anticipated increase in postage rates may adversely affect our gross margin.

### Technology and Development

	Three Months Ended			Six Months Ended		
	June 30, 2005	June 30, 2006	Percent Change	June 30, 2005	June 30, 2006	Percent Change
	(in thousands, except percentages)					
Technology and development	\$ 8,648	\$ 12,043	39.3%	\$17,214	\$23,249	35.1%
As a percentage of revenues	5.3%	5.0%		5.4%	5.0%	

The increase in technology and development expenses in absolute dollars for the three and six months ended June 30, 2006 in comparison with the same prior-year period was primarily the result of an increase in personnel and facility-related costs. As a percentage of revenues, technology and development expenses decreased slightly in the three and six months ended June 30, 2006 in comparison with the same prior-year period primarily due to a greater increase in revenues than technology and development expenses.

We continuously research and test a variety of potential improvements to our internal hardware and software systems in an effort to improve our productivity and enhance our subscribers' experience. Additionally, we are developing solutions for downloading movies to subscribers. As a result, we expect our technology and development expenses will continue to increase in absolute dollars for the remainder of 2006.

### Marketing

	Three Months Ended			Six Months Ended		
	June 30, 2005	June 30, 2006	Percent Change	June 30, 2005	June 30, 2006	Percent Change
	(in thousands, except percentages and subscriber acquisition cost)					
Marketing	\$26,959	\$47,031	74.5%	\$63,508	\$99,999	57.5%
As a percentage of revenues	16.4%	19.6%		20.1%	21.6%	
Other data:						
Gross subscriber additions	707	1,070	51.3%	1,652	2,447	48.1%
Subscriber acquisition cost	\$ 38.13	\$ 43.95	15.3%	\$ 38.44	\$ 40.87	6.3%

The increase in marketing expenses in absolute dollars for the three and six months ended June 30, 2006 in comparison with the same prior-year periods was primarily attributable to an increase in marketing program costs, primarily direct mail, online advertising and television advertising to attract new subscribers.

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Subscriber acquisition cost increased for the three and six months ended June 30, 2006 in comparison with the same prior-year period primarily due to an increase in marketing program spending consisting of primarily direct mail and online advertising, offset in part by a decrease in cost of providing free trials associated with our lower priced plans. As a percentage of revenues, marketing expenses increased for the three and six months ended June 30, 2006 as compared to the same prior-year period primarily due to a greater increase in marketing expenses than revenues.

The competitive landscape, including the increased promotion by Blockbuster of its online service and the potential entry of others into the online subscription rental business, could adversely impact our marketing expenditures as we seek to maintain and increase our market leadership. We anticipate that our marketing expense will increase in absolute dollars for the remainder of 2006 as we grow our business.

### General and Administrative

	Three Months Ended			Six Months Ended		
	June 30, 2005	June 30, 2006	Percent Change	June 30, 2005	June 30, 2006	Percent Change
	(in thousands, except percentages)					
General and administrative	\$ 6,233	\$ 6,773	8.7%	\$12,921	\$15,065	16.6%
As a percentage of revenues	3.8%	2.8%		4.1%	3.3%	

The increase in general and administrative expenses in absolute dollars for the three and six months ended June 30, 2006 in comparison with the same prior-year periods was primarily attributable to an increase in personnel costs and professional fees to support our growing operations. This increase was offset in part by a reduction of \$1.5 million in estimated settlement costs of the *Chavez vs. Netflix, Inc.* lawsuit (See Note 9) as well as a reduction in costs related to ongoing legal proceedings.

As a percentage of revenues, the decrease in general and administrative expenses was primarily due to a greater increase in revenues than general and administrative expenses.

We expect our general and administrative expenses will continue to increase in absolute dollars for the remainder of 2006 in order to support our growing operations.

### Interest and Other Income

	Three Months Ended			Six Months Ended		
	June 30, 2005	June 30, 2006	Percent Change	June 30, 2005	June 30, 2006	Percent Change
	(in thousands, except percentages)					
Interest and other income	\$ 1,246	\$ 3,701	197.0%	\$2,297	\$6,153	167.9%
As a percentage of revenues	0.7%	1.5%		0.7%	1.3%	

The increase in interest and other income for the three and six months ended June 30, 2006 in comparison with the same prior-year periods was primarily due to higher interest income earned on our cash and cash equivalents due to increased interest rates as well as higher average cash balances resulting from net proceeds of \$101.1 million from the public offering of our common stock in May 2006.

### Provision for Income Taxes

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
	(in thousands, except percentages)			
Provision for income taxes	\$ 13	\$ 10,553	\$ 57	\$ 13,383
Effective tax rate	—	38.2%	—	38.4%

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In the second quarter of 2006 we recorded an income tax expense of \$10.6 million (38.2% effective tax rate), compared to tax expense of \$13 thousand for the second quarter of 2005. Our tax expense is higher in 2006 because we no longer have a valuation allowance against deferred tax assets, the realization of which served to minimize tax expense in prior years. Prior to the fourth quarter of 2005 we only recorded income tax expense related to currently payable alternative minimum tax liabilities. In the fourth quarter of 2005 we recorded an income tax benefit due to a reduction in our valuation allowance of \$34.9 million. We continuously monitor the circumstances impacting the expected realization of our deferred tax assets. In the fourth quarter of 2005, based on our then updated forecast of future projected income and as a result of current developments in the competitive landscape, we reduced the valuation allowance after determining that substantially all deferred tax assets were more likely than not to be realized due to expected future income.

### Liquidity and Capital Resources

Since inception, we have financed our activities primarily through a series of private placements of convertible preferred stock, subordinated promissory notes, our public offerings and net cash generated from operating activities. As of June 30, 2006, we had cash and cash equivalents of \$341.7 million. On May 3, 2006, we issued 3.5 million shares of common stock upon the closing of a public offering for net proceeds of \$101.1 million. We intend to use the net proceeds from the sale of the common stock for general corporate purposes, including working capital.

We have generated net cash from operations during each quarter since the second quarter of 2001. Many factors will impact our ability to continue to generate and grow cash from our operations including, but not limited to, the number of subscribers who sign up for our service, the growth or reduction in our subscriber base, and our ability to develop new revenue sources. In addition, we may have to, or otherwise choose to, lower our prices and increase our marketing expenses in order to grow faster or respond to competition. Although we currently anticipate that cash flows from operations, together with our available funds, will be sufficient to meet our cash needs for the foreseeable future, we may require or choose to obtain additional financing. Our ability to obtain financing will depend on, among other things, our development efforts, business plans, operating performance and the condition of the capital markets at the time we seek financing. If we raise additional funds through the issuance of equity, equity-linked or debt securities, those securities may have rights, preferences or privileges senior to the rights of our common stock, and our stockholders may experience dilution.

The following table summarizes our cash flow activities:

	Three Months Ended		Six Months Ended	
	June 30, 2005	June 30, 2006	June 30, 2005	June 30, 2006
Net cash provided by operating activities	\$ 36,494	\$ 46,307	\$ 65,937	\$103,929
Net cash used in investing activities	(34,657)	(40,800)	(73,025)	(86,747)
Net cash provided by financing activities	3,313	108,430	3,599	112,264

We generated cash from operating activities in amounts greater than net income in the three months ended June 30, 2006 mainly due to non-cash charges to net income, offset in part by the impact of changes to working capital assets and liabilities. Non-cash adjustments to net income included the amortization of our DVD library, depreciation of property and equipment and stock-based compensation expense related to employee stock options. The primary working capital use of cash was an increase in prepaid expenses and other current assets and a decrease in accounts payable as a result of timing of acquisitions of titles for our DVD library.

We generated cash from operating activities in amounts greater than net income in the six months ended June 30, 2006 mainly due to non-cash charges to net income and the impact of changes in working capital assets and liabilities. The primary working capital source of cash was an increase in accounts payable and accrued expenses as a result of timing of acquisitions of titles for our DVD library and marketing program spending.

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SFAS 123R requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits represent tax benefits related to exercised options in excess of the associated deferred tax asset for such options. As a result of adopting FAS 123R, \$2.9 million and \$3.6 million of excess tax benefits for the three and six months ended June 30, 2006 have been classified as an operating cash outflow and a financing cash inflow.

Net cash used in investing activities for the three months ended June 30, 2006 increased by \$6.1 million in comparison with the same prior-year period primarily due to an increase in acquisition of titles for our DVD library to support our larger subscriber base. The increase was offset in part by an increase in proceeds from the sale of previously viewed DVDs. Net cash used in investing activities for the six months ended June 30, 2006 increased by \$13.7 million in comparison with the same prior-year period primarily due to an increase in acquisition of titles for our DVD library to support our larger subscriber base. The increase was offset in part by lower outflows related to the acquisition of property and equipment and an increase in proceeds from the sale of previously viewed DVDs. Net cash provided by financing activities increased by \$105.1 million and \$108.6 million in the three and six months ended June 30, 2006 in comparison with the same prior-year periods primarily due to the proceeds of \$101.1 million from the public offering of our common stock in May 2006.

### *Operating Leases*

We have entered into various other non-cancelable operating lease agreements for our offices and our distribution centers throughout the U.S. with original lease periods expiring through 2012. We recognize rent expense on our operating leases on a straight-line basis at the commencement of the lease. Certain of these leases have free or escalating rent payment provisions. We recognize rent expense under such leases on a straight-line basis over the term of the lease.

In March 2006, we exercised our option to lease a building adjacent to our headquarters in Los Gatos, California. The building will comprise approximately 80,000 square feet of office space and have an initial term of 5 years. Under the terms of the lease agreement, we are obligated to make payments of \$6 million toward the construction costs of the building in six monthly installments of \$1 million each beginning October 2006. The building is expected to be completed in the first quarter of 2008.

### *Off-Balance Sheet Arrangements*

As part of our ongoing business, we do not engage in transactions that generate relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities. Accordingly, our operating results, financial condition and cash flows are not subject to off-balance sheet risks.

### *Indemnification Arrangements*

In the ordinary course of business, we enter into contractual arrangements under which we agree to provide indemnification of varying scope and terms to business partners and other parties with respect to certain matters, including, but not limited to, losses arising out of our breach of such agreements and out of intellectual property infringement claims made by third parties. In addition, we have entered into indemnification agreements with our directors and certain of our officers that will require us, among other things, to indemnify them against certain liabilities that may arise by reason of their status or service as directors or officers.

The terms of such obligations vary. Generally, a maximum obligation is not explicitly stated, so the overall maximum amount of the obligations cannot be reasonably estimated. To date, we have not incurred material costs as a result of such obligations and have not accrued any liabilities related to such indemnification obligations in our financial statements.

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### Recent Accounting Pronouncements

In June 2006, the FASB issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes.” The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company’s financial statements in accordance with Statement of Financial Accounting Standards No. 109, “Accounting for Income Taxes.” Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The interpretation is effective for fiscal years beginning after December 15, 2006. We do not expect the adoption of this standard to have a material effect on our financial position or results of operations.

In February 2006 the Financial Accounting Standards Board (“FASB”) issued SFAS 155, *Accounting for Certain Hybrid Instruments* which amends SFAS 133, *Accounting for Derivative Instruments and Hedging Activities* and SFAS 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. SFAS 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. This statement is effective for all financial instruments acquired or issued in fiscal years beginning after September 15, 2006. We do not expect the adoption of this standard to have a material effect on our financial position or results of operations.

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

For financial market risks related to changes in interest rates, reference is made to Item 7A “Quantitative and Qualitative Disclosures About Market Risk” contained in Part II of our Annual Report on Form 10-K for the year ended December 31, 2005. Our exposure to market risk has not changed materially since December 31, 2005.

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

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

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report on Form 10-Q. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q were effective in providing reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is (i) recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms and (ii) accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate to allow timely decisions regarding required disclosure.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. 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 design of a control system must reflect the fact that there are resource constraints, and 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, within Netflix have been detected.

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

There were no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2006 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

**Item 1. Legal proceedings**

The information set forth above under Note 9 contained in the Notes to Condensed Consolidated Financial Statements is incorporated herein by reference.

**Item 1A. Risk Factors**

There have been no material changes from risk factors as previously disclosed under the heading “Risk Factors” in the Company’s Annual Report Form 10-K for the year ended December 31, 2005 and the Quarterly Report Form 10Q for the quarter ended March 31, 2006.

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

(d) Use of Proceeds:

We continue to maintain approximately \$72.0 million of the net proceeds from our initial public offering in May 2002 in cash and cash equivalents.

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

Our Annual Meeting of Stockholders was held on May 17, 2006. The following three proposals were adopted:

*Proposal One:*

Election of a Class I Director:

Nominees	Number of Shares	
	For	Withheld
Richard Barton	52,962,465	134,836

In addition, the following individuals continued to be directors following the Annual Meeting of Stockholders: A. George Battle, Reed Hastings, Timothy Haley, Michael Schuh, Jay Hoag and Greg Stanger.

*Proposal Two:*

Ratification of the appointment of KPMG LLP as independent auditors for the year ending December 31, 2006:

Number of Shares			
For	Against	Abstain	Non-Votes
52,958,082	79,242	59,977	0

*Proposal Three:*

To approve the Company’s Amended and Restated 2002 Stock Plan:

Number of Shares			
For	Against	Abstain	Non-Votes
37,451,611	2,649,325	97,149	12,899,216

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### Item 6 . Exhibits

(a) Exhibits:

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
3.1	Amended and Restated Certificate of Incorporation	10-Q	000-49802	3.1	August 2, 2004	
3.2	Amended and Restated Bylaws	S-1/A	333-83878	3.4	April 16, 2002	
3.3	Certificate of Amendment to the Amended and Restated Certificate of Incorporation	10-Q	000-49802	3.2	August 2, 2004	
4.1	Form of Common Stock Certificate	S-1/A	333-83878	4.1	April 16, 2002	
10.1**	Form of Indemnification Agreement entered into by the registrant with each of its executive officers and directors	S-1/A	333-83878	10.1	March 20, 2002	
10.2**	2002 Employee Stock Purchase Plan					X
10.3**	Amended and Restated 1997 Stock Plan	S-1/A	333-83878	10.3	May 16, 2002	
10.4**	Amended and Restated 2002 Stock Plan	Def 14A	000-49802	A	March 31, 2006	
10.5	Amended and Restated Stockholders' Rights Agreement	S-1	333-83878	10.5	March 6, 2002	
10.6	Office Lease between the registrant and BR3 Partners	S-1	333-83878	10.7	March 6, 2002	
10.14	Lease between Sobrato Land Holdings and Netflix, Inc.	10-Q	000-49802	10.15	August 2, 2004	
10.15	Lease between Sobrato Interests II and Netflix, Inc.	10-Q	000-49802	10.16	August 2, 2004	
10.16	Lease between Sobrato Land Holdings and Netflix, Inc. dated June 26, 2006					X
10.17	Description of Director Equity Compensation Plan	8-K	000-49802	10.1	July 5, 2005	
10.18	Executive Severance and Retention Incentive Plan	8-K	000-49802	10.2	July 5, 2005	
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002					X
32.1*	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002					X

\*\* Indicates a management contract or compensatory plan.

\* These certifications are not deemed filed by the SEC and are not to be incorporated by reference in any filing we make under the Securities Act of 1933 or the Securities Exchange Act of 1934, irrespective of any general incorporation language in any filings.



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**NETFLIX, INC.**  
**2002 EMPLOYEE STOCK PURCHASE PLAN**  
**Adopted February 27, 2002**  
**Amended Effective May 1, 2006**

The following constitutes the provisions of the 2002 Employee Stock Purchase Plan of Netflix, Inc.

1. *Purpose* . The purpose of the Plan is to provide Employees with an opportunity to purchase Common Stock through accumulated payroll deductions. It is the intention of the Company to have the Plan qualify as an “Employee Stock Purchase Plan” under Section 423 of the Code. The provisions of the Plan, accordingly, shall be construed so as to extend and limit Plan participation in a manner that is consistent with the requirements of that section of the Code.

2. *Definitions* .

- (a) “ *Administrator* ” means the Board or any committee thereof designated by the Board in accordance with Section 14.
- (b) “ *Board* ” means the Board of Directors of the Company.
- (c) “ *Change of Control* ” means the occurrence of any of the following events:
  - (i) Any “person” (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) becomes the “beneficial owner” (as defined in Rule 13d-3 of the Exchange Act), directly or indirectly, of securities of the Company representing fifty percent (50%) or more of the total voting power represented by the Company’s then outstanding voting securities; or
  - (ii) The consummation of the sale or disposition by the Company of all or substantially all of the Company’s assets; or
  - (iii) The consummation of a merger or consolidation of the Company, with any other corporation, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity or its parent) at least fifty percent (50%) of the total voting power represented by the voting securities of the Company, or such surviving entity or its parent outstanding immediately after such merger or consolidation.
  - (iv) A change in the composition of the Board, as a result of which fewer than a majority of the Directors are Incumbent Directors. “Incumbent Directors” means Directors who either (A) are Directors as of the effective date of the Plan (pursuant to Section 23), or (B) are elected, or nominated for election, to the Board with the affirmative votes of at least a majority of those Directors whose election or nomination was not in connection with any transaction described in subsections (i), (ii) or (iii) or in connection with an actual or threatened proxy contest relating to the election of Directors.
- (d) “ *Code* ” means the Internal Revenue Code of 1986, as amended. Any reference to a section of the Code herein shall be a reference to any successor or amended section of the Code.
- (e) “ *Common Stock* ” means the common stock of the Company.
- (f) “ *Company* ” means Netflix, Inc., a Delaware corporation.
- (g) “ *Compensation* ” shall mean all salary, wages (including amounts elected to be deferred by the employee, that would otherwise have been paid, under a cash or deferred arrangement established by the Company), overtime pay, commissions, bonuses and any other remuneration paid directly to the employee,

but excluding profit sharing, the cost of employee benefits paid for by the Company, education or tuition reimbursements, imputed income arising under any Company group insurance or benefit program, traveling expenses, business and moving expense reimbursements, income recognized in connection with stock options, contributions made by the Company under any employee benefit plan, and similar items of compensation.

(h) “*Designated Subsidiary*” means any Subsidiary that has been designated by the Administrator from time to time in its sole discretion as eligible to participate in the Plan.

(i) “*Director*” means a member of the Board.

(j) “*Employee*” means any individual who is a common law employee of an Employer and is customarily employed for at least twenty (20) hours per week and more than five (5) months in any calendar year by the Employer. For purposes of the Plan, the employment relationship shall be treated as continuing intact while the individual is on sick leave or other leave of absence approved by the Employer. Where the period of leave exceeds ninety (90) days and the individual’s right to reemployment is not guaranteed either by statute or by contract, the employment relationship shall be deemed to have terminated on the 91st day of such leave.

(k) “*Employer*” means any one or all of the Company and its Designated Subsidiaries.

(l) “*Enrollment Date*” means the first Trading Day of each Offering Period.

(m) “*Exchange Act*” means the Securities Exchange Act of 1934, as amended, including the rules and regulations promulgated thereunder.

(n) “*Exercise Date*” means the first Trading Day on or after May 1<sup>st</sup> and November 1<sup>st</sup> of each year. The first Exercise Date under the Plan shall be November 1, 2002.

(o) “*Fair Market Value*” means, as of any date, the value of Common Stock determined as follows:

(i) If the Common Stock is listed on any established stock exchange or a national market system, including without limitation the Nasdaq National Market or The Nasdaq SmallCap Market of The Nasdaq Stock Market, its Fair Market Value shall be the closing sales price for the Common Stock (or the closing bid, if no sales were reported) as quoted on such exchange or system on the date of determination, as reported in *The Wall Street Journal* or such other source as the Administrator deems reliable, or;

(ii) If the Common Stock is regularly quoted by a recognized securities dealer but selling prices are not reported, its Fair Market Value shall be the mean of the closing bid and asked prices for the Common Stock on the date of determination, as reported in *The Wall Street Journal* or such other source as the Administrator deems reliable, or;

(iii) In the absence of an established market for the Common Stock, its Fair Market Value shall be determined in good faith by the Administrator, or;

(iv) For purposes of the Enrollment Date of the first Offering Period under the Plan, the Fair Market Value shall be the initial price to the public as set forth in the final prospectus deemed to be included within the registration statement on Form S-1 filed with the Securities and Exchange Commission for the initial public offering of the Common Stock (the “Registration Statement”).

(p) “*Offering Periods*” through November 1, 2005 means the periods of approximately twenty-four (24) months during which an option granted pursuant to the Plan may be exercised, commencing on the first Trading Day on or after May 1<sup>st</sup> and November 1<sup>st</sup> of each year and terminating on the first Trading Day on or after the May 1<sup>st</sup> and November 1<sup>st</sup> Offering Period commencement date approximately twenty-four (24) months later; provided, however, that the first Offering Period under the Plan shall commence with the first Trading Day on or after the date on which the Securities and Exchange Commission declares the Company’s Registration Statement effective and ending on the first Trading Day on or after the earlier of (i) May 1, 2004 or (ii) twenty-seven (27) months from the beginning of the first Offering Period; and provided, further, that the second Offering Period under the Plan shall commence on November 1, 2002.

Effective May 1, 2006, Offering Periods means the periods of approximately six (6) months during which an option granted pursuant to the Plan may be exercised, commencing on the first Trading Day on or after May 1<sup>st</sup> and November 1<sup>st</sup> of each year and terminating on the first Trading Day on or after the next November 1<sup>st</sup> and May 1<sup>st</sup>, respectively. The duration and timing of Offering Periods may be changed pursuant to Section 4 of this Plan.

(q) “*Parent*” means a “parent corporation,” whether now or hereafter existing, as defined in Section 424(e) of the Code.

(r) “*Plan*” means this 2002 Employee Stock Purchase Plan.

(s) “*Purchase Period*” means the approximately six (6) month period commencing on one Exercise Date and ending with the next Exercise Date, except that the first Purchase Period of any Offering Period shall commence on the Enrollment Date and end with the next Exercise Date.

(t) “*Purchase Price*” means an amount equal to eighty-five percent (85%) of the Fair Market Value of a share of Common Stock on the Enrollment Date or on the Exercise Date, whichever is lower; provided however, that the Purchase Price may be adjusted by the Administrator pursuant to Section 20.

(u) “*Subsidiary*” means a “subsidiary corporation,” whether now or hereafter existing, as defined in Section 424(f) of the Code.

(v) “*Trading Day*” means a day on which the U.S. national stock exchanges and the Nasdaq System are open for trading.

### 3. Eligibility .

(a) *First Offering Period*. Any individual who is an Employee immediately prior to the first Offering Period under the Plan shall be automatically enrolled in the first Offering Period.

(b) *Subsequent Offering Periods* . Any individual who is an Employee as of the Enrollment Date of any future Offering Period shall be eligible to participate in such Offering Period, subject to the requirements of Section 5.

(c) *Limitations* . Any provisions of the Plan to the contrary notwithstanding, no Employee shall be granted an option under the Plan (i) to the extent that, immediately after the grant, such Employee (or any other person whose stock would be attributed to such Employee pursuant to Section 424(d) of the Code) would own capital stock of the Company or any Parent or Subsidiary of the Company and/or hold outstanding options to purchase such stock possessing five percent (5%) or more of the total combined voting power or value of all classes of the capital stock of the Company or of any Parent or Subsidiary of the Company, or (ii) to the extent that his or her rights to purchase stock under all employee stock purchase plans (as defined in Section 423 of the Code) of the Company or any Parent or Subsidiary of the Company accrues at a rate which exceeds twenty-five thousand dollars (\$25,000) worth of stock (determined at the Fair Market Value of the stock at the time such option is granted) for each calendar year in which such option is outstanding at any time.

4. *Offering Periods* . Through November 1, 2005, the Plan shall be implemented by consecutive, overlapping Offering Periods with a new Offering Period commencing on the first Trading Day on or after May 1<sup>st</sup> and November 1<sup>st</sup> of each year, or on such other date as the Administrator shall determine, and continuing thereafter until terminated in accordance with Section 20; provided, however, that the first Offering Period under the Plan shall commence with the first Trading Day on or after the date on which the Securities and Exchange Commission declares the Company’s Registration Statement effective and ending on the first Trading Day on or after the earlier of (i) May 1, 2004 or (ii) twenty-seven (27) months from the beginning of the first Offering Period; and provided, further, that the second Offering Period under the Plan shall commence on November 1, 2002.

Effective May 1, 2006, the Plan shall be implemented by consecutive, concurrent Offering and Purchase Periods with a new Period commencing on the first Trading Day on or after May 1<sup>st</sup> and November 1<sup>st</sup> of each

year, or on such other date as the Administrator shall determine, and continuing thereafter until terminated in accordance with Section 20.

The Administrator shall have the power to change the duration of Offering Periods (including the commencement dates thereof) with respect to future offerings and create new Offering Periods without stockholder approval.

#### 5. *Participation* .

(a) *First Offering Period*. An Employee who has become a participant in the first Offering Period under the Plan pursuant to Section 3(a) shall be entitled to continue his or her participation in such Offering Period only if he or she submits to the Company's payroll office (or its designee) a properly completed subscription agreement authorizing payroll deductions in the form provided by the Administrator for such purpose (i) no earlier than the effective date of the filing of the Company's Registration Statement on Form S-8 with respect to the shares of Common Stock issuable under the Plan (the "Effective Date") and (ii) no later than five (5) business days from the Effective Date (the "Enrollment Window"). A participant's failure to submit the subscription agreement during the Enrollment Window pursuant to this Section 5(a) shall result in the automatic termination of his or her participation in the first Offering Period under the Plan.

(b) *Subsequent Offering Periods* . An Employee who is eligible to participate in the Plan pursuant to Section 3(b) may become a participant by (i) submitting to the Company's payroll office (or its designee), on or before a date prescribed by the Administrator prior to an applicable Enrollment Date, a properly completed subscription agreement authorizing payroll deductions in the form provided by the Administrator for such purpose, or (ii) following an electronic or other enrollment procedure prescribed by the Administrator.

#### 6. *Payroll Deductions* .

(a) At the time a participant enrolls in the Plan pursuant to Section 5, he or she shall elect to have payroll deductions made on each payday during the Offering Period in an amount not exceeding 15% of the Compensation which he or she receives on each such payday.

(b) Payroll deductions authorized by a participant shall commence on the first payday following the Enrollment Date and shall end on the last payday in the Offering Period to which such authorization is applicable, unless sooner terminated by the participant as provided in Section 10; provided, however, that for the first Offering Period under the Plan, payroll deductions shall commence on the first payday on or following the end of the Enrollment Window.

(c) All payroll deductions made for a participant shall be credited to his or her account under the Plan and shall be withheld in whole percentages only. A participant may not make any additional payments into such account.

(d) A participant may discontinue his or her participation in the Plan as provided in Section 10, or may change the rate of his or her payroll deductions during the Offering Period by (i) properly completing and submitting to the Company's payroll office (or its designee), on or before a date prescribed by the Administrator prior to an applicable Exercise Date, a new subscription agreement authorizing the change in payroll deduction rate in the form provided by the Administrator for such purpose, or (ii) following an electronic or other procedure prescribed by the Administrator; provided, however, that a participant may only make two payroll deduction changes during each Purchase Period. If a participant has not followed such procedures to change the rate of payroll deductions, the rate of his or her payroll deductions shall continue at the last properly elected rate throughout the Offering Period and future Offering Periods (unless terminated as provided in Section 10). The Administrator may, in its sole discretion, limit the nature and/or number of payroll deduction rate changes that may be made by participants during any Offering Period. Any change in payroll deduction rate made pursuant to this Section 6(d) shall be effective as of the first full

payroll period following five (5) business days after the date on which the change is made by the participant (unless the Company, in its sole discretion, elects to process a given change in payroll deduction rate more quickly).

(e) Notwithstanding the foregoing, to the extent necessary to comply with Section 423(b)(8) of the Code and Section 3(c), a participant's payroll deductions may be decreased to zero percent (0%) at any time during a Purchase Period. Payroll deductions shall recommence at the rate originally elected by the participant effective as of the beginning of the first Purchase Period which is scheduled to end in the following calendar year, unless terminated by the participant as provided in Section 10.

(f) At the time the option is exercised, in whole or in part, or at the time some or all of the Company's Common Stock issued under the Plan is disposed of, the participant must make adequate provision for the Company's federal, state, or other tax withholding obligations, if any, which arise upon the exercise of the option or the disposition of the Common Stock. At any time, the Company may, but shall not be obligated to, withhold from the participant's compensation the amount necessary for the Company to meet applicable withholding obligations, including any withholding required to make available to the Company any tax deductions or benefits attributable to the sale or early disposition of Common Stock by the Employee.

*7. Grant of Option .* On the Enrollment Date of each Offering Period, each Employee participating in such Offering Period shall be granted an option to purchase on each Exercise Date during such Offering Period (at the applicable Purchase Price) up to a number of shares of Common Stock determined by dividing such participant's payroll deductions accumulated prior to such Exercise Date and retained in the participant's account as of the Exercise Date by the applicable Purchase Price; provided that in no event shall a participant be permitted to purchase during each Purchase Period more than 8,334 shares of Common Stock (subject to any adjustment pursuant to Section 19), and provided further that such purchase shall be subject to the limitations set forth in Sections 3(c) and 13. The Employee may accept the grant of such option by submitting a properly completed subscription agreement in accordance with the requirements of Section 5. The Administrator may, for future Offering Periods, increase or decrease, in its absolute discretion, the maximum number of shares of Common Stock that a participant may purchase during each Purchase Period of such Offering Period. Exercise of the option shall occur as provided in Section 8, unless the participant has withdrawn pursuant to Section 10. The option shall expire on the last day of the Offering Period.

#### *8. Exercise of Option .*

(a) Unless a participant withdraws from the Plan as provided in Section 10, his or her option for the purchase of shares of Common Stock shall be exercised automatically on the Exercise Date, and the maximum number of full shares subject to option shall be purchased for such participant at the applicable Purchase Price with the accumulated payroll deductions in his or her account. No fractional shares of Common Stock shall be purchased; any payroll deductions accumulated in a participant's account which are not sufficient to purchase a full share shall be retained in the participant's account for the subsequent Purchase Period or Offering Period, subject to earlier withdrawal by the participant as provided in Section 10. Any other monies left over in a participant's account after the Exercise Date shall be returned to the participant. During a participant's lifetime, a participant's option to purchase shares hereunder is exercisable only by him or her.

(b) Notwithstanding any contrary Plan provision, if the Administrator determines that, on a given Exercise Date, the number of shares of Common Stock with respect to which options are to be exercised may exceed (i) the number of shares of Common Stock that were available for sale under the Plan on the Enrollment Date of the applicable Offering Period, or (ii) the number of shares of Common Stock available for sale under the Plan on such Exercise Date, the Administrator may in its sole discretion (x) provide that the Company shall make a pro rata allocation of the shares of Common Stock available for purchase on such Enrollment Date or Exercise Date, as applicable, in as uniform a manner as shall be practicable and as it shall determine in its sole discretion to be equitable among all participants exercising options to purchase Common Stock on such Exercise Date, and continue all Offering Periods then in effect, or (y) provide that

the Company shall make a pro rata allocation of the shares of Common Stock available for purchase on such Enrollment Date or Exercise Date, as applicable, in as uniform a manner as shall be practicable and as it shall determine in its sole discretion to be equitable among all participants exercising options to purchase Common Stock on such Exercise Date, and terminate any or all Offering Periods then in effect pursuant to Section 20. The Company may make pro rata allocation of the shares of Common Stock available on the Enrollment Date of any applicable Offering Period pursuant to the preceding sentence, notwithstanding any authorization of additional shares of Common Stock for issuance under the Plan by the Company's shareholders subsequent to such Enrollment Date.

9. *Delivery* . As soon as administratively practicable after each Exercise Date on which a purchase of shares of Common Stock occurs, the Company shall arrange the delivery to each participant, as appropriate, the shares purchased upon exercise of his or her option in a form determined by the Administrator (in its sole discretion). No participant shall have any voting, dividend, or other shareholder rights with respect to shares of Common Stock subject to any option granted under the Plan until such shares have been purchased and delivered to the participant as provided in this Section 9.

10. *Withdrawal* .

(a) Under procedures established by the Administrator, a participant may withdraw all but not less than all the payroll deductions credited to his or her account and not yet used to exercise his or her option under the Plan at any time by (i) submitting to the Company's payroll office (or its designee) a written notice of withdrawal in the form prescribed by the Administrator for such purpose, or (ii) following an electronic or other withdrawal procedure prescribed by the Administrator. All of the participant's payroll deductions credited to his or her account shall be paid to such participant as promptly as practicable after the effective date of his or her withdrawal and such participant's option for the Offering Period shall be automatically terminated, and no further payroll deductions for the purchase of shares shall be made for such Offering Period. If a participant withdraws from an Offering Period, payroll deductions shall not resume at the beginning of the succeeding Offering Period unless the participant re-enrolls in the Plan in accordance with the provisions of Section 5.

(b) A participant's withdrawal from an Offering Period shall not have any effect upon his or her eligibility to participate in any similar plan which may hereafter be adopted by the Company or in succeeding Offering Periods which commence after the termination of the Offering Period from which the participant withdraws.

11. *Termination of Employment* . Upon a participant's ceasing to be an Employee, for any reason, he or she shall be deemed to have elected to withdraw from the Plan and the payroll deductions credited to such participant's account during the Offering Period but not yet used to purchase shares of Common Stock under the Plan shall be returned to such participant or, in the case of his or her death, to the person or persons entitled thereto under Section 15, and such participant's option shall be automatically terminated. The preceding sentence notwithstanding, a participant who receives payment in lieu of notice of termination of employment shall be treated as continuing to be an Employee for the participant's customary number of hours per week of employment during the period in which the participant is subject to such payment in lieu of notice.

12. *Interest* . No interest shall accrue on the payroll deductions of a participant in the Plan.

13. *Stock* .

(a) Subject to adjustment upon changes in capitalization of the Company as provided in Section 19, the maximum number of shares of Common Stock which shall be made available for sale under the Plan shall be 1,166,666 shares plus an annual increase to be added on the first day of the Company's fiscal year beginning in fiscal year 2003, equal to the lesser of (i) 666,666 shares, (ii) two percent (2%) of the outstanding shares on such date or (iii) an amount determined by the Board.

(b) Shares of Common Stock to be delivered to a participant under the Plan shall be registered in the name of the participant or in the name of the participant and his or her spouse.

14. *Administration* . The Board or a committee of members of the Board who shall be appointed from time to time by, and shall serve at the pleasure of, the Board, shall administer the Plan. The Administrator shall have full and exclusive discretionary authority to construe, interpret and apply the terms of the Plan, to determine eligibility and to adjudicate all disputed claims filed under the Plan. The Administrator, in its sole discretion and on such terms and conditions as it may provide, may delegate to one or more individuals all or any part of its authority and powers under the Plan. Every finding, decision and determination made by the Administrator (or its designee) shall, to the full extent permitted by law, be final and binding upon all parties.

15. *Designation of Beneficiary* .

(a) A participant may designate a beneficiary who is to receive any shares of Common Stock and cash, if any, from the participant's account under the Plan in the event of such participant's death subsequent to an Exercise Date on which the option is exercised but prior to delivery to such participant of such shares and cash. In addition, a participant may designate a beneficiary who is to receive any cash from the participant's account under the Plan in the event of such participant's death prior to exercise of the option. If a participant is married and the designated beneficiary is not the spouse, spousal consent shall be required for such designation to be effective.

(b) Such designation of beneficiary may be changed by the participant at any time. In the event of the death of a participant and in the absence of a beneficiary validly designated under the Plan who is living at the time of such participant's death, the Company shall deliver such shares and/or cash to the executor or administrator of the estate of the participant, or if no such executor or administrator has been appointed (to the knowledge of the Company), the Company, in its discretion, may deliver such shares and/or cash to the spouse or to any one or more dependents or relatives of the participant, or if no spouse, dependent or relative is known to the Company, then to such other person as the Company may designate.

(c) All beneficiary designations under this Section 15 shall be made in such form and manner as the Administrator may prescribe from time to time.

16. *Transferability* . Neither payroll deductions credited to a participant's account nor any rights with regard to the exercise of an option or to receive shares of Common Stock under the Plan may be assigned, transferred, pledged or otherwise disposed of in any way (other than by will, the laws of descent and distribution or as provided in Section 15) by the participant. Any such attempt at assignment, transfer, pledge or other disposition shall be without effect, except that the Company may treat such act as an election to withdraw from an Offering Period in accordance with Section 10.

17. *Use of Funds* . All payroll deductions received or held by the Company under the Plan may be used by the Company for any corporate purpose, and the Company shall not be obligated to segregate such payroll deductions. Until shares of Common Stock are issued under the Plan (as evidenced by the appropriate entry on the books of the Company or of a duly authorized transfer agent of the Company), a participant shall only have the rights of an unsecured creditor with respect to such shares.

18. *Reports* . Individual accounts shall be maintained for each participant in the Plan. Statements of account shall be given to participating Employees at least annually, which statements shall set forth the amounts of payroll deductions, the Purchase Price, the number of shares of Common Stock purchased and the remaining cash balance, if any.

19. *Adjustments, Dissolution, Liquidation or Change of Control* .

(a) *Adjustments* . In the event that any dividend or other distribution (whether in the form of cash, Common Stock, other securities, or other property), recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase, or exchange of Common Stock or other securities of the Company, or other change in the corporate structure of the Company affecting the Common Stock such that an adjustment is determined by the Administrator (in its sole discretion) to be appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan, then the Administrator shall, in such manner as it may deem equitable, adjust the number and class of Common Stock which may be delivered under the Plan, the Purchase Price per share and the number of shares of Common Stock covered by each option under the Plan which has not yet been exercised, and the numerical limits of Sections 7 and 13.

(b) *Dissolution or Liquidation* . In the event of the proposed dissolution or liquidation of the Company, the Offering Period then in progress shall be shortened by setting a new Exercise Date (the “New Exercise Date”), and shall terminate immediately prior to the consummation of such proposed dissolution or liquidation, unless provided otherwise by the Board. The New Exercise Date shall be before the date of the Company’s proposed dissolution or liquidation. The Board shall notify each participant in writing, at least ten (10) business days prior to the New Exercise Date, that the Exercise Date for the participant’s option has been changed to the New Exercise Date and that the participant’s option shall be exercised automatically on the New Exercise Date, unless prior to such date the participant has withdrawn from the Offering Period as provided in Section 10.

(c) *Change of Control* . In the event of a Change of Control, each outstanding option shall be assumed or an equivalent option substituted by the successor corporation or a Parent or Subsidiary of the successor corporation. In the event that the successor corporation refuses to assume or substitute for the option, any Purchase Periods then in progress shall be shortened by setting a new Exercise Date (the “New Exercise Date”) and any Offering Periods then in progress shall end on the New Exercise Date. The New Exercise Date shall be before the date of the Company’s proposed Change of Control. The Administrator shall notify each participant in writing, at least ten (10) business days prior to the New Exercise Date, that the Exercise Date for the participant’s option has been changed to the New Exercise Date and that the participant’s option shall be exercised automatically on the New Exercise Date, unless prior to such date the participant has withdrawn from the Offering Period as provided in Section 10.

20. *Amendment or Termination* .

(a) The Administrator may at any time and for any reason terminate or amend the Plan. Except as provided in Section 19, no such termination can affect options previously granted under the Plan, provided that an Offering Period may be terminated by the Administrator on any Exercise Date if the Administrator determines that the termination of the Plan is in the best interests of the Company and its stockholders. Except as provided in Section 19 and this Section 20, no amendment may make any change in any option theretofore granted which adversely affects the rights of any participant. To the extent necessary to comply with Section 423 of the Code (or any successor rule or provision or any other applicable law, regulation or stock exchange rule), the Company shall obtain stockholder approval in such a manner and to such a degree as required.

(b) Without stockholder consent and without regard to whether any participant rights may be considered to have been “adversely affected,” the Administrator shall be entitled to change the Offering Periods, limit the frequency and/or number of changes in the amount withheld during an Offering Period, establish the exchange ratio applicable to amounts withheld in a currency other than U.S. dollars, permit payroll withholding in excess of the amount designated by a participant in order to adjust for delays or mistakes in the Company’s processing of properly completed withholding elections, establish reasonable waiting and adjustment periods and/or accounting and crediting procedures to ensure that amounts applied toward the purchase of Common Stock for each participant properly correspond with amounts withheld

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from the participant's Compensation, and establish such other limitations or procedures as the Administrator determines in its sole discretion advisable which are consistent with the Plan.

(c) In the event the Administrator determines that the ongoing operation of the Plan may result in unfavorable financial accounting consequences, the Board may, in its discretion and, to the extent necessary or desirable, modify or amend the Plan to reduce or eliminate such accounting consequence including, but not limited to:

- (i) altering the Purchase Price for any Offering Period including an Offering Period underway at the time of the change in Purchase Price;
- (ii) shortening any Offering Period so that Offering Period ends on a new Exercise Date, including an Offering Period underway at the time of the Board action; and
- (iii) allocating shares.

Such modifications or amendments shall not require stockholder approval or the consent of any Plan participants.

21. *Notices* . All notices or other communications by a participant to the Company under or in connection with the Plan shall be deemed to have been duly given when received in the form specified by the Company at the location, or by the person, designated by the Company for the receipt thereof.

22. *Conditions Upon Issuance of Shares* . Shares of Common Stock shall not be issued with respect to an option under the Plan unless the exercise of such option and the issuance and delivery of such shares pursuant thereto shall comply with all applicable provisions of law, domestic or foreign, including, without limitation, the Securities Act of 1933, as amended, including the rules and regulations promulgated thereunder, the Exchange Act and the requirements of any stock exchange upon which the shares may then be listed, and shall be further subject to the approval of counsel for the Company with respect to such compliance.

As a condition to the exercise of an option, the Company may require the person exercising such option to represent and warrant at the time of any such exercise that the shares are being purchased only for investment and without any present intention to sell or distribute such shares if, in the opinion of counsel for the Company, such a representation is required by any of the aforementioned applicable provisions of law.

23. *Term of Plan* . The Plan shall become effective upon the earlier to occur of its adoption by the Board or its approval by the stockholders of the Company. It shall continue in effect until terminated under Section 20.

24. *Automatic Transfer to Low Price Offering Period* . To the extent permitted by any applicable laws, regulations, or stock exchange rules if the Fair Market Value of the Common Stock on any Exercise Date in an Offering Period is lower than the Fair Market Value of the Common Stock on the Enrollment Date of such Offering Period, then all participants in such Offering Period shall be automatically withdrawn from such Offering Period immediately after the exercise of their option on such Exercise Date and automatically re-enrolled in the immediately following Offering Period.

**Lease between  
Sobrato Land Holdings and Netflix, Inc.**

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**1. PARTIES: THIS LEASE**, is entered into on this 26th day of June, 2006, (“Effective Date”) between SOBRATO LAND HOLDINGS, a California Limited Partnership, whose address is 10600 North De Anza Boulevard, Suite 200, Cupertino, CA 95014 and NETFLIX, INC., a Delaware Corporation, whose address is 100 Winchester Circle, Los Gatos, CA 95032, hereinafter called respectively Landlord and Tenant. Landlord and Tenant are collectively referred to in this Lease as the “Parties”.

**2. PREMISES:** Landlord hereby leases to Tenant, and Tenant hires from Landlord that certain building (referred to herein as “Building” or “Premises”) to be constructed on Lot 2 as shown on *Exhibit “A”* attached hereto situated in the Town of Los Gatos, County of Santa Clara, State of California. The Building is situated within a project site which at completion will be shared with (i) an existing building (“Building 1”) constructed on Lot 1 and leased by Tenant pursuant to that certain lease between the parties for Building 1 dated June 28, 2004 (“Building 1 Lease”), (ii) a subterranean parking structure (“Parking Structure”) and surface parking and common areas constructed on Lot A and (iii) a residential condominium development to be constructed on Lot B, all as shown in *Exhibit “A”* (“Project”). The parties acknowledge that Lot 1 and Lot 2 are separate parcels from Lot A, however, for all purposes hereunder when referring to Lot 2, it shall include all appurtenant rights of an owner to the use, enjoyment, management and control of Lot A. For purposes of this Lease the Building is to contain approximately 80,000 rentable square feet. Until the Building is completed and the Parking Structure is expanded as provided below, all parking spaces to be located in the Parking Structure and on the surface of Lot A (which are not shown on Exhibit A as shared parking (“Shared Parking”)) shall be for the exclusive use of Tenant pursuant to the Building 1 Lease (the “Commercial Parking”). Concurrently with the completion of the Building, the Commercial Parking will be increased by expanding the Parking Structure on Lot A and the Building and Building 1 will share (i) the Commercial Parking, (ii) the Shared Parking (iii) landscaped common areas, sidewalks, service areas and other site facilities detailed on the plans and specifications. The Commercial Parking provided to the Building and Building 1 shall not be allocated between Tenant and any other tenant of either the Building or Building 1, (if Tenant no longer leases the entirety of both Buildings), unless any tenant notifies Landlord that there are not consistently 3.5 spaces per 1,000 square feet available to Tenant,. In such event Landlord agrees to designate by striping the parking or other signage based on square footage to Tenant and the other tenants of the Buildings. In such event, Landlord shall undertake such action to effectuate such request and thereafter Tenant shall be able to enforce its right to utilize such parking through towing or other reasonable measures. Upon substantial completion of the Building, Landlord shall deliver to Tenant a certified statement of the final determination of the Building rentable square footage, which determination shall be made by measuring from the exterior outside wall to exterior of the opposite outside wall without deduction plus the area of the covered balconies and shall serve as the rentable square footage used under this Lease. Rentable square footage shall exclude any uncovered balconies, common area arcades or parking structure. Upon determination of the final Building rentable square footage, the initial Base Monthly Rent payable pursuant to Section 4.A shall be adjusted to the product of (i) the Building rentable square footage and (ii) Two and 55/100 Dollars (\$2.55) per rentable square foot. Tenant shall also have access between 8:30 a.m. and 5 p.m. Monday through Friday, normal business holidays excluded, to the fitness center and swimming pool constructed on Lot B. Unless expressly provided otherwise, the term Premises as used herein shall include the Tenant Improvements (defined in Section 5.B) constructed by Tenant pursuant to Section 5.B. Tenant acknowledges Landlord’s right to and hereby consents to construction of additional building(s) within the Project or on adjacent land owned by Landlord, provided however, such construction will not result in increased obligations of Tenant hereunder.

**3. USE:**

**A. Permitted Uses:** Tenant shall use the Premises as permitted under applicable zoning laws only for the following purposes and shall not use the Premises for any other purpose without the prior written consent of Landlord, which shall not be unreasonably withheld: Office, research and development, marketing, light manufacturing, ancillary storage and other incidental uses thereto. Tenant shall use only the number of parking spaces allocated to Tenant under this Lease. Tenant shall have the right to park up to four (4) delivery vehicles

overnight in the parking lot. All commercial trucks and delivery vehicles shall be (i) parked away from the adjacent residential development, (ii) loaded and unloaded in a manner which does not interfere with the businesses of other occupants of the Project, and (iii) permitted to remain within the Project only so long as is reasonably necessary to complete the loading and unloading. Landlord represents and warrants that the use specified herein is permitted pursuant to any current Laws or Restrictions.

**B. Uses Prohibited:** Tenant shall not commit or suffer to be committed on the Premises any waste, nuisance, or other act or thing which may disturb the quiet enjoyment of any other tenant in or around the Premises, nor allow any sale by auction or any other use of the Premises for an unlawful purpose. Tenant shall not (i) damage or overload the electrical, mechanical or plumbing systems of the Premises, (ii) attach, hang or suspend anything from the ceiling, walls or columns of the Building in excess of the load limits for which such ceiling, walls or columns are designed, or set any load on the floor in excess of the load limits for which such floors are designed, or (iii) generate dust, fumes or waste products which create a fire or health hazard or damage the Premises or any portion of the Project, including without limitation the soils or ground water in or around the Project. No materials, supplies, equipment, finished products or semi-finished products, raw materials or articles of any nature, or any waste materials, refuse, scrap or debris, shall be stored upon or permitted to remain on any portion of the Premises outside of the Building without Landlord's prior approval, which approval may be withheld in its sole discretion.

**C. Advertisements and Signs:** Tenant will not place or permit to be placed, in, upon or about the Premises any signs not approved by the town and other governing authority having jurisdiction. Tenant will not place or permit to be placed upon the Premises any signs, advertisements or notices without the written consent of Landlord as to type, size, design, lettering, coloring and location, which consent will not be unreasonably withheld. Any sign placed on the Premises shall be removed by Tenant, at its sole cost, prior to the Expiration Date or promptly following the earlier termination of the Lease, and Tenant shall repair, at its sole cost, any damage or injury to the Premises caused thereby, and if not so removed, then Landlord may have same so removed at Tenant's expense. Notwithstanding anything herein to the contrary, Tenant shall be permitted to affix signage to or around the Building as permitted by the Town of Los Gatos.

**D. Covenants, Conditions and Restrictions:** Subject to Section 20.T, this Lease is subject to the effect of (i) any covenants, conditions, restrictions, easements, mortgages or deeds of trust, ground leases, rights of way of record and any other matters or documents of record; and (ii) any zoning laws of the town, county and state where the Building is situated (collectively referred to herein as "Restrictions") and Tenant will conform to and will not violate the terms of any such Restrictions. This Lease is specifically subject to that certain agreement entitled Declaration Of Reciprocal Easements And Operating Agreement For Shared Roadway Common Services And Operations which governs among other things the use and allocation of the costs associated with the shared roadway of the Project attached hereto as *Exhibit "B"* ("Declaration"). Landlord shall not make any modifications to the Declaration or any Restrictions that may increase Tenant's obligations or decrease its rights or otherwise interfere with Tenant's use, access or parking. Notwithstanding anything in the Declaration to the contrary, Tenant shall have reasonable approval rights over any budget produced under the Declaration or any other expenditures.

#### **4. TERM AND RENTAL:**

**A. Base Monthly Rent:** The term ("Lease Term") shall be for sixty (60) months, commencing on substantial completion of Building Shell and Tenant Improvements as determined pursuant to Section 5 (the "Commencement Date") estimated to occur on **February 15, 2008** ("Target Commencement Date") and ending sixty (60) months thereafter ("Expiration Date"). Notwithstanding the Parties' agreement that the Lease Term begins on the Commencement Date, this Lease and all of the obligations of Landlord and Tenant shall be binding and in full force and effect from and after the Effective Date. In addition to all other sums payable by Tenant under this Lease, Tenant shall pay as base monthly rent ("Base Monthly Rent") for the Premises the amount of Two Dollars and Fifty-Five Cents (\$2.55) per rentable square foot. (such amount to be Two Hundred Four Thousand and No/100 Dollars (\$204,000.00) for an 80,000 rentable square foot building). Base Monthly Rent shall be due in advance

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on or before the first day of each calendar month during the Lease Term. All sums payable by Tenant under this Lease shall be paid to Landlord in lawful money of the United States of America, without offset or deduction and without prior notice or demand, at the address specified in Section 1 of this Lease or at such place or places as may be designated in writing by Landlord during the Lease Term. Base Monthly Rent for any period less than a calendar month shall be a pro rata portion of the monthly installment.

**B. Rental Adjustment:** Beginning twelve (12) months after the Commencement Date, and every twelve (12) months thereafter (an "Adjustment Date"), the then-payable Base Monthly Rent shall be subject to adjustment based on the increase, if any, in the Consumer Price Index that has occurred during the twelve (12) months preceding the then-applicable Adjustment Date, but in no event shall the increase on any Adjustment Date be less than two percent (2%) or more than six percent (6%). The basis for computing the adjustment shall be the U.S. Department of Labor, Bureau of Labor Statistic's Consumer Price Index for All Urban Consumers, All Items, 1982-84=100, for the San Francisco-Oakland-San Jose area ("Index"). The Index most recently published preceding the Commencement Date shall be considered the "Base Index" for the first adjustment. Thereafter, the index most recently published preceding the previous Adjustment Date shall be considered the "Base Index." If the Index most recently published preceding the Adjustment Date ("Comparison Index") is greater than the Base Index, the then-payable Base Monthly Rent shall be increased by multiplying the then-payable Base Monthly Rent by a fraction, the numerator of which is the Comparison Index and the denominator of which is the Base Index. On adjustment of the Base Monthly Rent, which shall be completed within 3 months of each Adjustment Date, Landlord shall notify Tenant by letter stating the new Base Monthly Rent and providing reasonable detail to support the Landlord's calculation. Landlord's calculation of the Base Monthly Rent escalation shall be conclusive and binding unless Tenant objects to said calculation within thirty (30) days of Tenant's receipt from Landlord of such calculation. Landlord's failure to adjust Base Monthly Rent on an Adjustment Date shall not prevent Landlord from retroactively adjusting Base Monthly Rent at any subsequent time during the Lease Term provided however, Landlord shall use all commercially reasonable efforts to give Tenant notice of any adjustment promptly. If the Index base year is changed so that it differs from 1982-84=100, the Index shall be converted in accordance with the conversion factor published by the United States Department of Labor, Bureau of Labor Statistics. If the Index is changed, revised or discontinued for any reason, there shall be substituted in lieu thereof and the term "Consumer Price Index" shall thereafter refer to the most nearly comparable official price index of the United States Government in order to obtain substantially the same result as would have been obtained had the original Consumer Price Index not been discontinued, revised or changed, which alternative index shall be selected by Landlord and shall be subject to Tenant's written reasonable approval.

**C. Late Charges:** Tenant hereby acknowledges that late payment by Tenant to Landlord of Base Monthly Rent and other sums due hereunder will cause Landlord to incur costs not contemplated by this Lease, the exact amount of which is extremely difficult to ascertain. Such costs include but are not limited to: administrative, processing, accounting, and late charges which may be imposed on Landlord by the terms of any contract, revolving credit, mortgage, or trust deed covering the Premises. Accordingly, if any installment of Base Monthly Rent or other sum due from Tenant shall not be received by Landlord or its designee within five (5) business days after notice that such payment is past due (provided however no such notice is required if Landlord has given such notice more than twice in any given calendar year). Tenant shall pay to Landlord a late charge equal to five (5%) percent of such overdue amount, which late charge shall be due and payable on the same date that the overdue amount was due. The parties agree that such late charge represents a fair and reasonable estimate of the costs Landlord will incur by reason of late payment by Tenant, excluding interest and attorneys' fees and costs. If any rent or other sum due from Tenant remains delinquent for a period in excess of thirty (30) days then, in addition to such late charge, Tenant shall pay to Landlord interest on any rent that is not paid when due at the Agreed Interest Rate specified in Section 20.J following the date such amount became due until paid. Acceptance by Landlord of such late charge shall not constitute a waiver of Tenant's default with respect to such overdue amount nor prevent Landlord from

exercising any of the other rights and remedies granted hereunder. In the event that a late charge is payable hereunder, whether or not collected, for three (3) consecutive installments of Base Monthly Rent, then the Base Monthly Rent shall automatically become due and payable quarterly in advance, rather than monthly, notwithstanding any provision of this Lease to the contrary.

**C. Security Deposit:** Intentionally deleted.

## **5. CONSTRUCTION:**

**A. Building Shell Construction:** At Landlord's sole cost and expense, Landlord shall cause the shell of the Building ("Building Shell" or "Shell") to be constructed by Sobrato Construction ("General Contractor"), in the location and configuration shown on *Exhibit "A"* and in accordance with all applicable Laws and Governmental Regulations and the Building Shell plans and guideline specifications prepared by Form4, Inc. ("Landlord's Architect") which shall be attached as *Exhibit "C"* ("Shell Plans and Specifications"). The Shell Plans and Specifications and building design shall be generally consistent with those prepared for Building 1, and include an underground parking structure (the "Garage"). Landlord has delivered and Tenant has approved the Schematic Design Shell Plans and Specifications dated **May 30, 2006**. On or before **July 26, 2006** Landlord shall cause Landlord's Architect to prepare and deliver to Tenant that portion of the Shell Plans and Specifications relating to the Garage (the "Garage Plans and Specifications"), including fully-engineered working drawings for the Garage and structural steel for the Shell. Within ten (10) business days following receipt of the proposed Garage Plans and Specifications, Tenant shall either approve the proposed Garage Plans and Specifications or deliver to Landlord its proposal for the changes that are necessary in Tenant's opinion to conform such proposed Garage Plans and Specifications to the approved Schematic Design Shell Plans and Specifications. If Tenant fails to approve or disapprove the proposed Garage Plans and Specifications within the allowed time period, the draft Garage Plans and Specifications proposed by Landlord shall be deemed to be the approved Garage Plans and Specifications for purposes of this Agreement. If Tenant disapproves the proposed Garage Plans and Specifications in any respect, the parties shall confer and negotiate in good faith to reach agreement on the final Garage Plans and Specifications. On or before **September 29, 2006** Landlord shall cause Landlord's Architect to prepare and deliver to Tenant the remaining proposed Shell Plans and Specifications, including fully-engineered working drawings for the Shell including the previously approved Garage Plans and Specifications. Within ten (10) business days following receipt of the proposed Shell Plans and Specifications, Tenant shall either approve the proposed Shell Plans and Specifications or deliver to Landlord its proposal for the changes that are necessary in Tenant's opinion to conform such proposed Shell Plans and Specifications to Schematic Design Shell Plans and Specifications. If Tenant fails to approve or disapprove the proposed Garage Plans and Specifications within the allowed time period, the draft Garage Plans and Specifications proposed by Landlord shall be deemed to be the approved Garage Plans and Specifications for purposes of this Agreement. If Tenant disapproves the proposed Garage Plans and Specifications in any respect, the parties shall confer and negotiate in good faith to reach agreement on the final Garage Plans and Specifications. The Building Shell shall include the Parking Structure, the foundation system and slab, walls, structural and finished roof, exterior glazing (including soundproofing), entry doors, and all improvements necessary for the Shell to comply with the Americans with Disabilities Act ("ADA"); all parking areas (including striping and ADA-required signage), driveways, curbs, sidewalks, utility installations to the Shell, exterior lighting, irrigation systems, landscaping, and other outside area improvements specified in the Shell Plans and Specifications; and all other on-site and off-site improvements required by any governmental authority as a condition of its issuance of any approval for construction of the Shell or the Tenant Improvements (including road widening, resurfacing and striping, signalization, sidewalks, curbs, lighting and other improvements; and shall include those items set forth in the attached *Exhibit "D"* ("Building Shell Definition").

As soon as Landlord and Tenant approve the Shell Plans and Specifications, Landlord shall submit the approved Shell Plans and Specifications to all appropriate governmental agencies for their approval and issuance of all required permits. Landlord shall use its reasonable best efforts to obtain all governmental approvals and permits necessary for

construction of the Shell, including a building permit from the Town of Los Gatos, as soon as possible and thereafter cause the General Contractor to Substantially Complete the Building Shell. The Building Shell shall be deemed substantially complete ("Substantially Complete" or "Substantial Completion") when: (i) the Building Shell has been substantially completed in accordance with the Shell Plans and Specifications, as evidenced by a final inspection or its equivalent by the appropriate governmental authority, including a temporary certificate of occupancy for the Shell, if applicable, or any final "sign-off" by all required governmental authorities, (ii) the Landlord's Architect has certified that the Building Shell has been completed in accordance with the Shell Plans and Specifications, (iii) all utilities have been installed in accordance with the Shell Plans and Specifications, and (iv) all incomplete or defective construction which could interfere with or impede construction and installation of the Tenant Improvements has been remedied and repaired.

**B. Tenant Improvement Construction:** Landlord shall cause the improvements to the interior of the Premises ("Tenant Improvements") to be constructed by General Contractor or by Devcon Construction at the election of Tenant to be made on or before June 1, 2006 (the "Tenant GC"), in accordance with plans and outline specifications to be attached as Exhibit "E" ("Tenant Improvement Plans and Specifications"). For purposes of this Lease, the "Building Core" means elevators, finished restrooms, down heads of the fire sprinklers, HVAC and electrical systems distributed to each floor, exiting stair finishes, and a finished building lobby. The Tenant Improvements Plans and Specifications shall be prepared, at Tenant's expense by Form4, Inc. ("Tenant's Architect"). On or before **July 7, 2006**, Tenant shall notify Landlord of its elevator design and specifications to be incorporated into the Shell. On or before **August 14, 2006**, Tenant shall cause Tenant's Architect to prepare and deliver to Landlord a space plan for the Tenant Improvements for Landlord's approval, which approval shall not be unreasonably withheld or delayed. If Landlord fails to approve or disapprove the proposed space plan within ten (10) business days following delivery of the proposed space plan to Landlord, the space plan proposed by Tenant shall be deemed to be the approved preliminary plans for the Tenant Improvements (the "Preliminary TI Plans"). The Preliminary TI Plans shall contain sufficient detail in the building core and floor penetrations as to allow Tenant GC to price and order any equipment which lead time requires a early commitment to purchase in order to meet the Target Commencement Date ("Long Lead Items"). If Landlord disapproves the proposed space plan, Landlord shall deliver to Tenant Landlord's written proposal for required changes, and the parties shall negotiate in good faith to reach agreement on the Preliminary TI Plans. On or before **September 18, 2006**, Tenant shall submit its design build specifications for the mechanical, electrical, plumbing, and fire designs. On or before **January 8, 2007**, Tenant shall cause Tenant's Architect to prepare and deliver to Landlord proposed final Tenant Improvement Plans and Specifications with all detail reasonably necessary for submittal to the Town for issuance of building permits and for construction and shall include any information required by the relevant agencies regarding Tenant's use of Hazardous Materials if applicable. Within ten business (10) days thereafter, Landlord shall either approve or disapprove the proposed final Tenant Improvement Plans and Specifications, Landlord shall not unreasonably withhold or delay its approval and may not in any event disapprove proposed Tenant Improvement Plans and Specifications so long as they are consistent with the approved Preliminary TI Plans. If Landlord disapproves the proposed Tenant Improvement Plans and Specifications in any respect, Landlord shall specify in reasonable detail the changes that are required, in Landlord's reasonable opinion, to conform the proposed Tenant Improvement Plans and Specifications to the Preliminary TI Plans. If Landlord fails to approve or disapprove the proposed Tenant Improvement Plans and Specifications within the allowed time period, the final Tenant Improvement Plans and Specifications proposed by Tenant shall be deemed to be the approved Tenant Improvement Plans and Specifications for purposes of this Agreement.

The Tenant Improvement Plans and Specifications shall provide for a minimum build-out in all areas of the Premises consisting of: (i) the Building Core, (ii) floor coverings, (iii) t-bar suspended ceiling (iv) distribution of the HVAC system, and (v) 2' x 4' drop-in fluorescent lighting. Tenant shall not have the right to delay the completion of the foregoing minimum Tenant Improvement build-out beyond a reasonable time,

subject to Section 5.G (Force Majeure) below. The Tenant Improvement Plans and Specifications shall be prepared in sufficient detail to allow the Tenant GC to construct the Tenant Improvements. The Tenant Improvements shall not be removed or altered by Tenant without the prior written consent of Landlord as provided in Section 7. Tenant shall have the right to depreciate and claim and collect any investment tax credits for the Tenant Improvements during the Lease Term and Landlord shall have the right to depreciate and claim any investment tax credits for the Building Shell and Parking Structure. Upon expiration of the Lease Term or any earlier termination of the Lease, the Tenant Improvements shall become the property of Landlord and shall remain upon and be surrendered with the Premises, and title thereto shall automatically vest in Landlord without any payment therefore.

As soon as Landlord and Tenant approve the Tenant Improvement Plans and Specifications, Landlord shall submit the approved Tenant Improvements Plans and Specifications to all appropriate governmental authorities for their approval and issuance of all required permits. Landlord shall use its reasonable best efforts to obtain all governmental approvals and permits necessary for construction and installation of the Tenant Improvements in accordance with the approved Tenant Improvement Plans and Specifications as soon as possible, including a building permit from the Town of Los Gatos for the Tenant Improvements. As soon as such governmental approvals and permits have been obtained, Landlord shall cause the Tenant GC to commence and diligently prosecute completion of the construction and installation of the Tenant Improvements so that the Tenant Improvements will be substantially complete by the Target Commencement Date. Landlord shall cause the Shell and the Tenant Improvements to be constructed in a good and workmanlike manner, in accordance with the approved Shell Plans and Specifications and Tenant Improvement Plans and Specifications, in compliance with all applicable Laws and Governmental Regulations, and using only new materials of good quality. The Tenant Improvements shall be deemed substantially complete when (i) the Tenant Improvements have been substantially completed in accordance with the Tenant Improvement Plans and Specifications, as evidenced by the issuance of a certificate of occupancy or its equivalent by the appropriate governmental authority, (ii) Tenant's Architect has certified that the Tenant Improvements has been completed in accordance with the Tenant Improvement Plans and Specifications and all applicable Laws and Governmental Regulations, (iii) all utilities are hooked up and available for use, (iv) all incomplete or defective construction which interferes with Tenant's use of the Premises has been remedied and repaired, (v) Landlord has delivered possession of the Premises to Tenant, and (vi) Tenant has had forty-five (45) days within which to install its trade fixtures, furniture and equipment, including, without limitation, Tenant's telephone, telecommunications, data cabling and security systems, signage, and other operating systems for the Premises. Installation of Tenant's data and phone cabling, or Tenant's furniture, shall not, however, be required in order to deem the Tenant Improvements Substantially Complete. When the Premises are substantially complete, including all Tenant Improvements, Landlord shall deliver possession of the completed Premises to Tenant. Tenant shall not, however, have any obligation to accept possession of the Premises or commence payment of rent until the date that the Premises (including all Tenant Improvements), are substantially complete.

Landlord acknowledges that its failure to deliver the Premises to Tenant substantially complete on or before **June 15, 2008** (subject to extension for Force Majeure or Tenant Delay) will cause Tenant to incur costs not contemplated by this Lease, the exact amount of which will be extremely difficult to ascertain. Accordingly, if Landlord fails to deliver to Tenant the Premises (including all Tenant Improvements) substantially complete on or before said date, Landlord shall pay to Tenant, as reimbursement for such costs, an amount equal to Ten Thousand Dollars (\$10,000) as liquidated damages for each day delivery of the Premises is delayed beyond such date as its sole and exclusive remedy for Landlord's failure to achieve substantial completion. The parties agree that such amount represents a fair and reasonable estimate of the cost Tenant will incur by reason of the late delivery of the Premises. At Tenant's election, Tenant may offset any sum due Tenant under this paragraph against rental and other payments otherwise due Landlord (including, without limitation, under paragraph 5.E below).

**C. Preliminary Pricing:** Within fourteen (14) days after completion of the Preliminary TI

Plans Landlord shall prepare a conceptual budget ("Conceptual Budget") in sufficient detail to allow Tenant to approve the cost of the Long Lead Items. Should Tenant disapprove the Conceptual Budget within ten (10) days from receipt of same, the Tenant's Architect shall have ten (10) days following disapproval to make modifications to the design and resubmit revised Preliminary TI Plans to the Tenant GC for pricing. The Tenant GC shall thereafter have five business (5) days to price the changes and resubmit revised pricing to Tenant for approval.

**D. Final Pricing:** With fourteen (14) days following completion of the Tenant Improvements Plans and Specifications, Landlord shall cause the Tenant GC to submit to Tenant competitive bids, solicited from at least three (3) subcontractors approved by Tenant for each aspect of the work in excess of Fifty Thousand and No/100 Dollars (\$50,000.00) related to the Tenant Improvements or such other amount as requested by Tenant. All such bidding shall be on an "open book" basis so that Tenant may be present at the opening of each bid and Tenant shall in any event receive copies of all bid solicitations and responses to and from prospective bidders. Notwithstanding Tenant's right to approve the subcontractors, each subcontractor shall be a contractor only of the Tenant GC and/or Landlord, and Tenant shall have no liability to any subcontractor under any subcontract or otherwise with respect to the Premises. Landlord shall cause the Tenant GC to utilize the low bid in each case unless Tenant approves Tenant GC's use of another subcontractor. Landlord shall promptly prepare and deliver to Tenant, for Tenant's approval, a detailed, comprehensive, budget (the "Tenant Improvement Budget") which shall identify all costs to be incurred in connection with the construction and installation of the Tenant Improvements, including a five percent (5%) contingency to protect the Tenant GC against cost overruns and the general contractor fee specified in Section 5.I below, which amount may be spent only with approval of Tenant, not to be unreasonably withheld. Upon Tenant's written approval of the Tenant Improvement Budget, which approval shall not be unreasonably withheld or delayed, Landlord and Tenant shall be deemed to have given their respective approvals of the final Tenant Improvement Plans and Specifications on which the Tenant Improvement Budget was made, and Landlord shall cause the Tenant GC to proceed with the construction of the Tenant Improvements in accordance with the terms of Section 5.B above. If Tenant does not specifically approve or disapprove the Tenant Improvement Budget within ten (10) business days of submission, Tenant shall be deemed to have approved the bids. Should Tenant disapprove the Tenant Improvement Budget within ten (10) days from receipt of same, the Tenant's Architect shall have ten (10) business days following disapproval to make modifications to the design and resubmit revised Tenant Improvement Plans to the Tenant GC for pricing. The Tenant GC shall thereafter have five business (5) days to price the changes with the low bidder from each trade and resubmit revised pricing to Tenant for approval.

**E. Change Orders:** Subject to the reasonable approval by Landlord, Tenant shall have the right to order changes in the Tenant Improvements. Upon request and prior to Tenant's submitting any binding change order, Landlord shall cause the Tenant GC to promptly provide Tenant with written statements of the actual, direct construction cost to implement and any time delay or increased construction costs associated with any proposed change order, which statements shall be binding on Tenant GC. If no time delay or increased construction cost amount is noted on the written statement, the parties agree that there shall be no adjustment to the construction cost or the Commencement Date associated with such change order. If ordered by Tenant, Landlord shall cause the Tenant GC to implement such change order and the cost of constructing the Tenant Improvements shall be increased or decreased in accordance with the cost statement previously delivered by Tenant GC to Tenant for any such change order. All such costs of construction to implement any such change shall be calculated in accordance with Section 5.G below.

**F. Building Shell Costs:** Tenant shall initially pay for the cost of the Parking Structure not to exceed the sum of Six Million and No/100 Dollars (\$6,000,000.00). Tenant may elect to pay the foregoing amount in either of the following ways (i) within two weeks after notice from Landlord that all necessary permits have been obtained and construction on the Parking Structure has commenced (such notice to be given no earlier than **October 1, 2006**), make a payment of \$1,000,000 and thereafter make payments of \$1,000,000 no later than the 5<sup>th</sup> day of each calendar month for the 5 calendar months following delivery of the Landlord's notice or (ii) make progress payments as set forth

below. If electing (ii) above, then during the course of construction of Parking Structure, Landlord shall cause the Tenant GC to deliver to Tenant not more than once each calendar month a written request for payment ("Progress Invoice") which shall include and be accompanied by (i) Tenant GC's certified statements setting forth the amount requested, certifying the percentage of completion of each item for which reimbursement is requested and that the construction of the Parking Structure is "on budget", (ii) copies of paid invoices of suppliers and subcontractors performing work on the Parking Structure in the aggregate amount of the Progress Invoice, and (iii) Landlord Architect's certified statement that all of the work for which payment is to be made pursuant to such Progress Invoice has been performed in compliance with the Shell Plans and Specifications and this Lease. Tenant shall pay Landlord the amount due pursuant to the Progress Invoice, within ten (10) business days after Tenant's receipt and approval of the above items. Landlord shall pay the balance of all costs associated with the Building Shell, including all other costs associated with the Parking Structure.

**G. Tenant Improvement Costs:** Tenant shall also pay the Tenant Improvement Costs described below, however Tenant shall have the right to offset and credit against all Tenant Improvement Costs all amounts paid by Tenant for the Parking Structure pursuant to Section 5.F above. The "Tenant Improvement Costs" shall consist of only the following to the extent actually incurred by Tenant GC in connection with the construction of Tenant Improvements: construction costs for labor and materials, amounts paid to governmental authorities for inspections and issuance of building permits and approvals for the Tenant Improvements (but not that portion of such amounts applicable to, or based on the value of, the Shell), and the Tenant GC overhead and profit as described in Section 5.I below. In no event, however, shall Tenant Improvement Costs include (i) charges and expenses for changes to the Tenant Improvement Plans and Specifications which have not been approved by Tenant, (ii) wages, labor and overhead for overtime and premium time, (iii) additional costs and expenses incurred by Landlord on account of any contractor's or subcontractor's default or construction defects, (iv) principal, interest and fees for construction and permanent financing, (v) offsite management or other general overhead costs incurred by Landlord, (vi) bond premiums, (vii) costs for which Landlord has a right of reimbursement from others (including, without limitation, insurers and warrantors), (viii) restoration costs in excess of insurance proceeds as a consequence of casualties, (ix) penalties and late charges attributable to Landlord's failure to pay Tenant Improvement Costs, (x) attorneys', experts' and other fees and costs in connection with contracts and disputes, and (xi) costs in excess of the approved Tenant Improvement Budget, as modified by change orders approved by Tenant; all of which shall be the sole obligation of Landlord.

Following Substantial Completion of the Tenant Improvements, Landlord shall deliver to Tenant a written request for payment which shall include and be accompanied by Tenant GC's certified statements setting forth the amount expended for Tenant Improvement Costs less the aggregate amount previously paid by Tenant for the Parking Structure, together with all other items required to be submitted for each Progress Invoice under Section 5.F above, except that all such items shall relate to the construction and installation of the Tenant Improvements and not the Parking Structure. In addition, when the Premises are substantially complete, Landlord shall submit to Tenant a final and detailed accounting of all Tenant Improvement Costs paid by Landlord, certified to be true and correct by Landlord's financial officers. Tenant may audit the books, records and supporting documents of Landlord and Tenant GC to the extent necessary to determine the accuracy of such accounting. Tenant shall bear the cost of such audit unless such audit discloses that Landlord has overstated the Tenant Improvement Costs by more than two percent (2%), in which event Landlord shall pay the costs of Tenant's audit. Landlord shall promptly refund any overpayments to Tenant. Provided that the Tenant Improvements have in fact been substantially completed and Tenant has received from Tenant's Architect a written statement certifying such substantial completion of the Tenant Improvements in accordance with the approved Tenant Improvements Plans and Specifications, Tenant shall pay to Landlord the amount due pursuant to the invoice, within thirty (30) days after Tenant's receipt and approval of the above items. If the aggregate amount paid by Tenant for the Parking Structure under Section 5.F exceeds the aggregate amount of the Tenant Improvement Costs, then Landlord shall

promptly refund such excess to Tenant. Tenant shall have the further right to offset and credit any amounts not so refunded by Landlord against any rental or other amounts payable by Tenant under this Lease.

**H. Force Majeure:** Any prevention, delay or stoppage due to strikes, lockouts, labor disputes (excluding disputes between Landlord and the General Contractor, Tenant GC or between or among the General Contractor and the Tenant GC or any subcontractors), governmental restrictions, regulations, controls, civil commotion, fire or other act of God, and other similar causes beyond the reasonable control of Landlord (except financial inability) shall extend the dates contained in this Section 5 by a period equal to the period of any said prevention, delay or stoppage; provided, however, that Landlord shall use its reasonable best efforts to minimize all such delays. If Landlord fails to obtain all building permits necessary to construct the Parking Structure and Building Shell and fails to commence construction by **October 1, 2006**, Tenant shall have the right to terminate this Lease by providing Landlord with written notice of termination and thereafter this Lease shall be deemed terminated provided Tenant shall be entitled to a refund of any monies advanced hereunder.

**I. Tenant GC Overhead & Profit:** As compensation to the Tenant GC for its services related to construction of the Building Shell and Tenant Improvements, Tenant GC shall receive a fee of 6% of the Tenant Improvement Costs or as may otherwise be mutually agreed to by Tenant and Tenant GC, which fee shall cover all of the following: insurance, construction supervision and administration, temporary on-site facilities, home office administration, supervision, and coordination and construction profit. Except as provided therein, neither Landlord nor Tenant GC shall receive any other fee or payment from Tenant in connection with the development, construction and installation of the Premises.

**J. Tenant Delays:** A "Tenant Delay" shall mean any delay in substantial completion of the Building to the extent actually caused by the following: (i) Tenant's failure to complete or approve the Tenant Improvement Plans by the dates set forth in Section 5.B, (ii) Tenant's failure to approve the bids for construction by the dates set forth in Section 5.C, (iii) changes to the plans requested by Tenant which delay the progress of the work, not to exceed any delay approved by Tenant under the applicable change order, (iv) Tenant's failure to make a progress payment for the Parking Structure costs as provided in Section 5.F, and (v) any errors or omissions in the Tenant Improvement Plans provided by Tenant's architect. Tenant Delay shall exclude, however, any delay in substantial completion of the Building to the extent caused by the following: (i) Landlord's failure timely to perform its obligations under this Lease, its agreement with the Tenant GC, or any permits or licenses with governmental authorities (including, without limitation, payment of costs to construct and install the Shell and the Tenant Improvements as provided herein); (ii) Tenant GC's failure to perform its obligations under this Lease and/or its agreement with Landlord; (iii) Landlord's failure to approve the Tenant Improvements Plans and Specifications by the date set forth in Section 5.B; and (iv) any errors or omissions in the Shell Plans and Specifications. Notwithstanding anything to the contrary set forth in this Lease, and regardless of the actual date the Premises are substantially complete, the Commencement Date shall be deemed to be the date the Commencement Date would have occurred if no Tenant Delay had occurred. Notwithstanding anything herein to the contrary, Tenant shall have the ability to stagger or otherwise delay completion of the Tenant Improvements not included in the Building Core, provided however, such delay shall not delay the commencement under the Lease and provided further that Tenant provides Landlord with reasonable security (in the form of a letter of credit or other similar instrument) to cover the cost of completion of the Tenant Improvements.

**K. Insurance:** Risk of loss of the Premises prior to the Commencement Date shall be borne by Landlord. Landlord shall cause the General Contractor and/or Tenant GC to procure (as part of Contractor's Fee) a "Broad Form" liability insurance policy in the amount of Three Million Dollars (\$3,000,000.00). Landlord shall also procure (as a cost of the Building Shell) builder's risk insurance for the full replacement cost of the Building Shell and Tenant Improvements while the Building and Tenant Improvements are under construction, up until the date that the casualty insurance policy described in Section 9 is in full force and effect. Landlord's insurance policy (i) shall be in a form

reasonably satisfactory to Tenant and name Tenant as a named insured, (ii) shall be carried with a company reasonably acceptable to Tenant, (iii) shall provide that such policy shall not be subject to cancellation or change except after at least ten (10) days prior written notice to Tenant, and (iv) shall contain a "cross liability" provision insuring Landlord and Tenant against any loss incurred by the negligence of the other party. Tenant shall be designated as a named insured on such insurance policy and the "deductible" thereunder shall not exceed Fifty Thousand Dollars (\$50,000).

If the Premises are damaged or destroyed prior to the Commencement Date of this Lease, Tenant shall have the right to terminate this Lease if the Premises (including the Tenant Improvements), in the reasonable opinion of Landlord's Architect, cannot be substantially completed prior to **January 1, 2009**. If this Lease is so terminated, Tenant shall be entitled to that amount of the insurance proceeds equal to the amount paid by Tenant for the Parking Structure and the Tenant Improvements prior to the termination date. If the Premises are damaged or destroyed and this Lease is not terminated, Landlord shall promptly and diligently complete construction of the Premises (including the Tenant Improvements) in accordance with this Lease, and all insurance proceeds with respect to the loss shall be paid to an independent depository, reasonably acceptable to Landlord and Tenant, for disbursement to the contractors completing the Premises as the work progresses in accordance with customary institutional lending practices.

**L. Punch List & Warranty:** Within thirty (30) days after the Building Shell and Tenant Improvements are substantially complete, Landlord shall cause the General Contractor and/or Tenant GC to immediately correct any construction defect or other "punch list" item which Tenant brings to General Contractor's and or Tenant GC's attention. All such work shall be performed so as to reasonably minimize the interruption to Tenant and its activities on the Premises. The preparation of such a "punch list" shall not, however, be deemed an acceptance by Tenant of the Premises as free from defects and shall not in any way affect Landlord's or General Contractor's warranty obligations.

General Contractor and Tenant GC shall provide a standard contractor's warranty with respect to the Building Shell and the Tenant Improvements for one (1) year from the Commencement Date. Such warranty shall exclude routine maintenance, damage caused by Tenant's negligence or misuse, damages arising from any deficiency in the Tenant Improvement plans and specifications provided by Tenant's architect, and acts of God. In addition, effective upon delivery of the Premises to Tenant, Landlord warrants that (i) the Shell and the Tenant Improvements were constructed in accordance with all Laws and Governmental Regulations, (ii) the Shell and the Tenant Improvements were constructed in accordance with the Shell Plans and Specifications and the Tenant Improvements Plans and Specifications, respectively, and in a good and workmanlike manner, (iii) all material and equipment installed in the Premises was new and otherwise of good quality and was installed in accordance with all manufacturer's specifications, instructions and requirements, and (iv) all material and equipment installed in the Premises has been paid for and is free of liens and security interests. All construction, product and equipment warranties and guaranties obtained by Landlord shall, to the extent obtainable, provide that such warranties and guaranties shall also run to the benefit of Tenant and its successors and assigns. Landlord shall cooperate with Tenant in enforcing such warranties and guaranties. Notwithstanding anything to the contrary in this Lease, Tenant's acceptance of the Premises shall not be deemed a waiver of the foregoing warranty, and Landlord shall promptly repair all violations of the warranty set forth in this paragraph at its sole cost and expense.

**M. Other Work by Tenant:** All work not described in the Shell Plans and Specifications or Tenant Improvement Plans and Specifications, such as furniture, telephone equipment, telephone wiring and office equipment work, shall be furnished and installed by Tenant at Tenant's cost. Landlord shall assure that all utilities are installed and available to the Premises. Prior to substantial completion, Tenant shall be obligated to (i) provide active phone lines to any elevators, and (ii) contract with a firm to monitor the fire system. Forty Five (45) days prior to the estimated date of Substantial Completion, Landlord shall notify Tenant and shall permit Tenant and its authorized representatives and contractors access to the Premises before the Commencement Date for the purpose of installing Tenant's trade fixtures and equipment. Any such installation work by Tenant or

its authorized representatives and contractor shall be undertaken upon the following conditions: (i) the entry into the Premises by Tenant or its representatives or contractors shall not interfere with or delay General Contractor's/Tenant GC work, (ii) any contractor used by Tenant in connection with such entry and installation shall use union labor, and (iii) Tenant shall maintain the liability insurance required pursuant to this Lease.

## **6. ACCEPTANCE OF POSSESSION AND COVENANTS TO SURRENDER:**

**A. Delivery and Acceptance:** On the Commencement Date, Landlord shall deliver and Tenant shall accept possession of the Premises and enter into occupancy of the Premises on the Commencement Date. By accepting possession, Tenant acknowledges that it has had an opportunity to conduct, and has conducted, such inspections of the Premises as it deems necessary to evaluate its condition. Except as otherwise specifically provided herein, Tenant agrees to accept possession of the Premises in its then existing condition, subject to all Restrictions and without representation or warranty or further obligation by Landlord except as provided in this Lease. Tenant's taking possession of any part of the Premises shall be deemed to be an acceptance of any work of improvement done by Landlord in such part as complete and in accordance with the terms of this Lease except for (i) "Punch List" type items of which Tenant has given Landlord written notice prior to the time Tenant takes possession and (ii) Landlord's warranties provided in Section 5 above or elsewhere in this Lease. Within sixty (60) days after the Commencement Date, Tenant agrees to be in occupancy of at least twenty percent (20%) of the rentable square footage of the Premises.

**B. Condition Upon Surrender:** Tenant further agrees on the Expiration Date or on the sooner termination of this Lease, to surrender the Premises to Landlord in good condition and repair, normal wear and tear excepted. In this regard, "normal wear and tear" shall be construed to mean wear and tear caused to the Premises by the natural aging process which occurs in spite of prudent application of the commercially reasonable standards for maintenance, repair replacement, and janitorial practices, and does not include items of neglected or deferred maintenance. In any event, Tenant shall cause the following to be done prior to the Expiration Date or sooner termination of this Lease: (i) all interior walls shall be patched and spot painted, (ii) all tiled floors shall be cleaned and waxed, (iii) all carpets shall be cleaned and shampooed, (iv) all broken, marred, stained or nonconforming acoustical ceiling tiles shall be replaced, (v) all cabling placed above the ceiling by Tenant or Tenant's contractors shall be removed, (vi) all windows shall be washed; (vii) the HVAC system shall be serviced by a reputable and licensed service firm and left in "good operating condition and repair" as so certified by such firm, (viii) the plumbing and electrical systems and lighting shall be placed in good order and repair (including replacement of any burned out, discolored or broken light bulbs, ballasts, or lenses. Notwithstanding the foregoing, in no event shall the total cost of the work to complete items i, ii, iii, iv, v, vi and viii above (absent Tenant's negligence or misconduct and excluding any repairs or maintenance required for the HVAC system) exceed Forty Thousand and No/100 Dollars (\$40,000.00). On or before the Expiration Date or sooner termination of this Lease, Tenant shall remove all its personal property and trade fixtures from the Premises. All property and fixtures not so removed shall be deemed as abandoned by Tenant. If Landlord has so indicated pursuant to Section 7 below Tenant shall, at Tenant's sole cost and expense, remove such Alterations as Landlord has required and shall repair and restore such to condition at time of commencement, normal wear and tear excluded. Such repair and restoration shall include causing the Premises to be brought into compliance with all applicable building codes and laws in effect at the time of the removal but only to the extent such compliance is necessitated by and relates solely to the repair and restoration work of the Tenant Improvements. In no event, however, shall Tenant be required to remove any portion of the initial Tenant Improvements installed in accordance with the terms of this Lease.

**C. Failure to Surrender:** If the Premises are not surrendered at the Expiration Date or sooner termination of this Lease in the condition required by this Section 6, Tenant shall be deemed in a holdover tenancy pursuant to this Section 6.C. If Tenant remains in possession of the Premises after the Expiration Date or sooner termination of this Lease without Landlord's consent, Tenant's continued possession shall be on the basis of a tenancy at sufferance and Tenant shall pay as rent during the holdover period an amount equal to one hundred

twenty-five percent (125%) of the Base Monthly Rent due in the month preceding the earlier termination or Expiration Date, as applicable, plus all other amounts payable by Tenant under this Lease. Any holding over shall otherwise be on the terms and conditions herein specified, except those provisions relating to the Lease Term and any options to extend or renew, which provisions shall be of no further force and effect. This provision shall survive the termination or expiration of the Lease.

## **7. ALTERATIONS AND ADDITIONS:**

**A. Tenant's Alterations:** Tenant shall not make, or suffer to be made, any alteration or addition to the Premises ("Alterations"), or any part thereof, without obtaining Landlord's prior written consent and delivering to Landlord the proposed architectural and structural plans for all such Alterations at least fifteen (15) days prior to the start of construction. Notwithstanding the foregoing, Tenant shall be entitled without obtaining Landlord's consent, to make any Alterations which (i) do not affect the structure of the Building, and (ii) cost does not exceed Fifty Thousand Dollars (\$50,000.00) per alteration nor an aggregate of One Hundred Thousand Dollars (\$100,000.00) in any twelve (12) month period (such amounts to increase annually by any increase in the CPI). If such Alterations affect the structure of the Building, Tenant additionally agrees to reimburse Landlord its reasonable out-of-pocket costs incurred in reviewing Tenant's plans not to exceed \$1,000 per alteration. Upon the request of Tenant, Landlord shall, within the 15-day period, advise Tenant in writing as to whether Landlord shall require removal of an Alteration in question upon the expiration or earlier termination of the Lease Term. After obtaining Landlord's consent, Tenant shall not proceed to make such Alterations until Tenant has obtained all required governmental approvals and permits, and in the event the total estimated cost of the Alteration exceeds \$300,000 (such amount to increase annually by any increase in the CPI) provides Landlord reasonable security, in form reasonably approved by Landlord, to protect Landlord against mechanics' lien claims. Tenant agrees to provide Landlord (i) written notice of the anticipated and actual start-date of the work, (ii) a complete set of half-size (15" X 21") vellum as-built drawings, and (iii) a certificate of occupancy for the work upon completion of the Alterations, if applicable. All Alterations shall be constructed by a licensed general contractor in compliance with all applicable building codes and laws including, without limitation, the Americans with Disabilities Act of 1990 as amended from time to time. Upon the Expiration Date, all Alterations, except movable furniture, equipment and trade fixtures, shall become a part of the realty and belong to Landlord but shall nevertheless be subject to removal by Tenant as provided in Section 6 above. Alterations that are not deemed as trade fixtures include heating, lighting, electrical systems, air conditioning, walls, carpeting, or any other installation that has become an integral part of the Premises. All Alterations shall be maintained, replaced or repaired by Tenant at its sole cost and expense.

**B. Free From Liens:** Tenant shall keep the Premises free from all liens arising out of work performed, materials furnished, or obligations incurred by Tenant or claimed to have been performed for Tenant. In the event Tenant fails to discharge any such lien within ten (10) days after receiving notice of the filing, Landlord shall immediately be entitled to discharge the lien at Tenant's expense and all reasonable resulting costs incurred by Landlord, including attorney's fees shall be due immediately from Tenant as additional rent.

**C. Compliance With Governmental Regulations:** The term Laws or Governmental Regulations shall include all federal, state, county, town or governmental agency laws, statutes, ordinances, standards, rules, requirements, or orders now in force or hereafter enacted, promulgated, or issued. The term also includes government measures regulating or enforcing public access, traffic mitigation, occupational, health, or safety standards for employers, employees, landlords, or tenants. Tenant, at Tenant's sole expense will comply with all such Governmental Regulations applicable to the premises or the Tenant's use of the Premises and shall make all repairs, replacements, alterations, or improvements necessary to comply with said Governmental Regulations. Such expense shall be borne solely by Tenant if the Governmental Regulations relate to or are required by any Law because of (i) Tenant's particular use or change of use of the Premises, (ii) Tenant's application for any permit or governmental approval, or (iii) Tenant's construction or installation of any Alterations or Trade Fixtures. To the extent repairs, replacements,

alterations or improvements are required by Governmental Regulations and are not related to or required by Tenant pursuant to the preceding sentence, then the expense shall be split between Landlord and Tenant based on the following: Landlord and Tenant shall establish the useful life of the item in question based upon generally accepted accounting principles. Tenant shall pay a portion of the cost equal to the actual compliance-related expense times a fraction, the numerator of which is the number of months remaining in the initial Lease Term, and the denominator of which is the useful life of the required work in months. Landlord shall make such portion of its payment to Tenant within fifteen (15) days after written demand. Tenant shall thereafter submit payment and deliver proof of payment by Tenant to Landlord. The judgment of any court of competent jurisdiction or the admission of Tenant in any action or proceeding against Tenant (whether Landlord be a party thereto or not) that Tenant has violated any such law, regulation or other requirement in its use of the Premises shall be conclusive of that fact as between Landlord and Tenant.

## **8. MAINTENANCE OF PREMISES:**

**A. Landlord's Obligations:** Landlord at its sole cost and expense, shall maintain in good condition, order, and repair, and replace as and when necessary, the foundation, all exterior walls, structural support systems, and roof structure of the Building Shell. Landlord further agrees to perform the maintenance, repair and restoration obligations and payments thereunder of "Commercial Owner" under the Declaration and to enforce obligations of other owners under the Declaration.

**B. Tenant's Obligations:** Subject to 8.A above, Tenant shall clean, maintain, repair and replace when necessary the Premises and every part thereof through regular inspections and servicing, including but not limited to: (i) all plumbing and sewage facilities, (ii) all heating ventilating and air conditioning facilities and equipment, (iii) all fixtures, interior walls floors, carpets and ceilings, (iv) all windows, door entrances, plate glass and glazing systems including caulking, and skylights, (v) all electrical facilities and equipment, (vi) all automatic fire extinguisher equipment, (vii) the parking lot and all underground utility facilities servicing the Premises, (viii) all elevator equipment, (ix) the roof membrane system. All wall surfaces and floor tile are to be maintained in an as good a condition as when Tenant took possession free of holes, gouges, or defacements. With respect to items (ii), (viii) and (ix) above, Tenant shall provide Landlord a copy of a service contract between Tenant and a licensed service contractor providing for periodic maintenance of all such systems or equipment in conformance with the manufacturer's recommendations. Tenant shall provide Landlord a copy of such preventive maintenance contracts and paid invoices for the recommended work if requested by Landlord.

**C. Landlord and Tenant's Obligations Regarding Reimbursable Operating Costs:** In addition to the direct payment by Tenant of expenses as provided in Sections 8.B, 9, 10 and 11 of this Lease, Tenant agrees to reimburse Landlord for Tenant's Allocable Share (as defined in Section 8.E below) of Reimbursable Operating Costs (as defined in Section 8.D below) which are not otherwise paid by Tenant directly. Tenant agrees to pay its Allocable Share of the Reimbursable Operating Costs as additional rental within thirty (30) days of written invoice from Landlord.

**D. Reimbursable Operating Costs:** For purposes of calculating Tenant's Allocable Share of Building and Project Costs, the term "Reimbursable Operating Costs" is defined as all reasonable costs and expenses hereinafter described which are actually incurred by Landlord in connection with operation of the Building or the Project in which Premises are located. All such costs and expenses shall be determined in accordance with generally accepted accounting principles which shall be consistently applied, including but not limited to the following: (i) common area utilities, including water, power, telephone, heating, lighting, air conditioning, ventilating, and Building utilities to the extent not separately metered; (ii) common area maintenance and service agreements for the Building and/or Project and the equipment therein, including without limitation, common area janitorial services, alarm and security services, exterior window cleaning, and maintenance of the sidewalks, landscaping, waterscape, roof membrane, parking areas, driveways, service areas, mechanical rooms, elevators, and the building exterior; (iii) insurance premiums and costs, including without limitation, the premiums and cost of fire, casualty terrorism and

liability coverage and rental abatement and, if elected by Landlord, earthquake insurance applicable to the Building or Project, all as limited by Section 9; (iv) repairs, replacements and general maintenance (excluding repairs and general maintenance paid by proceeds of insurance or by Tenant or other third parties, and repairs or alterations attributable solely to tenants of the Building or Project other than Tenant); and (v) all real estate taxes and assessment installments or other impositions or charges which may be levied on the Building or Project, upon the occupancy of the Building or Project and including any substitute or additional charges which may be imposed during, or applicable to the Lease Term including real estate tax increases (as permitted under Section 10) due to a sale, transfer or other change of ownership of the Building or Project, as such taxes are levied or appear on the Town and County tax bills and assessment rolls. Landlord shall have no obligation to provide guard services or other security measures for the benefit of the Project. Tenant assumes all responsibility for the protection of Tenant and Tenant's Agents from acts of third parties; provided, however, that nothing contained herein shall prevent Landlord, at its sole option, from providing security measures for the Project. This is a "Net" Lease, meaning that Base Monthly Rent is paid to Landlord absolutely net of all costs and expenses, except as provided otherwise herein. The provision for payment of Reimbursable Operating Costs by means of periodic payment of Tenant's Allocable Share of Building and/or Project Costs is intended to pass on to Tenant and reimburse Landlord for all costs of operating and managing the Building and/or Project. The provisions of the Section 8 notwithstanding, if the any capital improvements or repairs, including without limitation, roof membrane or the HVAC system requires replacement during the Lease Term, then Tenant shall make such replacement and the cost of such replacement shall be allocated as follows: Landlord and Tenant shall establish the useful life of the replacement or repair based upon the useful life of the replacement or repair in months. Landlord shall within ten (10) days reimburse Tenant for the cost of the replacement less the product of such total cost multiplied by a fraction, the numerator of which is the number of years remaining in the Lease Term, the denominator of which is the useful life (in years) of the replacement. Notwithstanding anything in this lease to the contrary, Reimbursable Operating Cost shall not include (i) costs incurred in connection with the original construction of the Building; (ii) costs of correcting defects in or inadequacy of the initial design or construction of the Building; (iii) fines, penalties, ground-lease rental or interest; (iv) expenses resulting from the negligence of Landlord, its agents, servants or employees or from another tenant of the Project; (v) bad debt loss, rent loss or reserves of any kind; (vi) costs associated with the operation of the business of the partnership which constitutes Landlord (as distinguished from costs of operation of the Building), including without limitation, partnership accounting and legal matters, cost of defending lawsuits, or cost of financing; (vii) fees (including legal) or commissions incurred in connection with leasing the Project; (viii) cost for which Landlord is reimbursed by another tenant or occupant of the Project; (ix) wages and benefits of any employee who does not devote substantially all of his or her time to the Building; (x) costs paid to Landlord or to affiliates of Landlord for services in the building to the extent the same exceed or would exceed the costs for such services if rendered by unaffiliated third parties on a competitive basis; (xi) net income, inheritance, gift or estate tax; (xii) Landlord's general corporate overhead and general administrative expenses; (xiii) any management fees; (xiv) any Project Costs associated with the development, improvement, construction, repair, maintenance, ownership or operation of Lot 1 or Lot B, except as specifically provided in the Declaration as to be shared between the Commercial Owner and the Residential Owner, as defined in the Declaration.

Tenant shall have the right, at Tenant's expense and not more than once every 12 months, upon not less than twenty (20) days prior written notice to Landlord, to review, at reasonable times in Landlord's office or at another reasonable location designated by Landlord, Landlord's books and records applicable to this Lease and for the prior year's Reimbursable Operating Costs, for purposes of reviewing Landlord's expenditures and Landlord's calculation of such Reimbursable Operating Costs. In the event that Tenant disputes any amount charged to Tenant, Tenant shall further have the right to have Landlord's books and records with respect to such costs for such fiscal year to be audited by a certified public accountant selected by Tenant. Tenant's Allocable Share of such Reimbursable Operating Cost shall be appropriately adjusted on the basis of such audit. If such audit discloses a liability for a

refund in excess of five (5%) percent of Tenant's Allocable Share of Reimbursable Operating Costs previously paid, the reasonable cost of such audit shall be borne by Landlord; otherwise, the cost of such audit shall be paid by Tenant.

**E. Tenant's Allocable Share:** For purposes of prorating Reimbursable Operating Costs which Tenant shall pay, Tenant's Allocable Share of Reimbursable Operating Costs shall be computed by multiplying the Reimbursable Operating Costs by a fraction, the numerator of which is the rentable square footage of the Premises and the denominator of which is either the total rentable square footage of the Building if the service or cost is allocable only to the Building, or the total rentable square footage of the Project if the service or cost is allocable to the entire Project. Tenant's obligation to share in Reimbursable Operating Costs shall be adjusted to reflect the Lease Commencement and Expiration dates and subject to recalculation in the event of expansion of the Building or Project.

**F. Waiver of Liability:** Failure by Landlord to perform any defined services, or any cessation thereof, when such failure is caused by accident, breakage, repairs, strikes, lockout or other labor disturbances or labor disputes of any character or by any other cause, similar or dissimilar, shall not render Landlord liable to Tenant in any respect, including damages to either person or property, nor be construed as an eviction of Tenant, nor cause an abatement of rent, nor relieve Tenant from fulfillment of any covenant or agreement hereof. Should any equipment or machinery utilized in supplying the services listed herein break down or for any cause cease to function properly, upon receipt of written notice from Tenant of any deficiency or failure of any services, Landlord shall use reasonable diligence to repair the same promptly, but Tenant shall have no right to terminate this Lease and shall have no claim for rebate of rent or damages on account of any interruptions in service occasioned thereby or resulting therefrom. Tenant waives the provisions of California Civil Code Sections 1941 and 1942 concerning the Landlord's obligation of tenantability and Tenant's right to make repairs and deduct the cost of such repairs from the rent. Landlord shall not be liable for a loss of or injury to person or property, however occurring, through or in connection with or incidental to furnishing, or its failure to furnish, any of the foregoing.

## **9. HAZARD INSURANCE:**

**A. Tenant's Use:** Tenant shall not use or permit the Premises, or any part thereof, to be used for any purpose other than that for which the Premises are hereby leased; and no use of the Premises shall be made or permitted, nor acts done, which will cause an increase in premiums or a cancellation of any insurance policy covering the Premises or any part thereof, nor shall Tenant sell or permit to be sold, kept, or used in or about the Premises, any article prohibited by the standard form of fire insurance policies. Tenant shall, at its sole cost, comply with all reasonable requirements pertaining to the Premises of any insurance company or organization necessary for the maintenance of reasonable fire and public liability insurance covering the Premises and appurtenances.

**B. Landlord's Insurance:** Landlord agrees to purchase and keep in force All Risk and fire insurance in an amount equal to the full replacement cost of the Building (including any Tenant Improvements (without depreciation) or Alterations paid for by Tenant). Tenant shall provide Landlord annually an estimate of the cost to replace its Tenant Improvements and Alterations. At Tenant's request, Landlord shall deliver certificates of insurance to Landlord evidencing such Insurance. The insurance shall provide for thirty (30) days' prior written notice to Tenant of any cancellation, or termination in coverage. The cost of such insurance shall constitute a Reimbursable Operating Cost. Landlord's insurance on the Tenant Improvements and Alterations shall name Tenant as an additional insured. At Landlord's election, such all risk and fire insurance may be endorsed to cover loss caused by such additional perils against which Landlord may elect to insure, including earthquake, flood or terrorist acts, and shall contain reasonable deductibles. If Landlord elects to obtain insurance against any such additional perils Tenant's obligation to reimburse Landlord for the cost of the additional coverage shall be limited to an annual amount of Eighty Five Thousand and No/100 Dollars (\$85,000) increased each year during the Lease term by three percent (3%) compounded. Additionally Landlord may maintain a policy of (i) commercial general liability insurance insuring Landlord (and such others designated by Landlord) against liability for personal injury, bodily injury, death and damage to property occurring or resulting from an occurrence in, on or about the Premises in an

amount as Landlord determines is reasonably necessary for its protection, and (ii) rental loss insurance covering a twelve (12) month period. Tenant agrees to pay Landlord as additional rent, on demand, the full reasonable cost of said insurance as evidenced by insurance billings to Landlord, and in the event of damage covered by said insurance, the amount of any deductible under such policy not to exceed Fifty Thousand and no/100 Dollars (\$50,00.00). Payment shall be due to Landlord within thirty (30) days after written invoice to Tenant. It is understood and agreed that Tenant's obligation under this Section will be prorated to reflect the Lease Commencement and Expiration Dates.

**C. Tenant's Insurance :** Tenant agrees, at its sole cost, to insure its personal property, against damage for their full replacement value. Said insurance shall provide All Risk and fire coverage equal to the replacement cost of said property. The property insurance provided by Tenant as required by this paragraph and shall name Landlord and Landlord's lender, as loss payee with respect to Tenant Improvements and Alterations only. Tenant shall deliver certificates of insurance to Landlord evidencing such Insurance. Tenant agrees, at its sole cost, and to obtain worker's compensation and Commercial General Liability insurance for occurrences within the Premises. Worker's Compensation limits shall be per state law. General Liability Insurance shall contain a combined single limit of not less than Five Million Dollars (\$5,000,000.00) (coverage may be provided by any combination of primary and excess insurance). Tenant's liability insurance shall be primary insurance containing a cross-liability clause, and shall provide coverage on an "occurrence" rather than on a "claims made" basis. All such insurance shall provide for severability of interests; shall provide that an act or omission of one of the named (additional) insureds shall not reduce or avoid coverage to the other named (additional insureds). Tenant shall name Landlord, Sobrato Development Companies and Landlord's lender as an additional insured (except with respect to damages arising out of its sole negligence or with respect to structural alteration, new construction or demolition operations performed by or on behalf of and shall deliver a certificates of insurance to Landlord. All insurance policies required under this section shall provide for thirty (30) days' prior written notice to Landlord of any cancellation or termination in coverage. Notwithstanding the above, Landlord retains the right to have Tenant provide other forms of insurance which may be reasonably required to cover future risks, provided such as available at commercially reasonable rates but in no event exceeding an annual amount payable by Tenant of \$25,000.

**D. Waiver:** Notwithstanding anything in this Lease to the contrary, Landlord and Tenant hereby waive rights each may have against the other on account of property damage sustained by Landlord or Tenant, as the case may be to the Premises or its contents, which may arise from any risk covered by their respective property insurance policies (or which would have been covered had such insurance policies been maintained in accordance with this Lease) as set forth above. The Parties shall each obtain from their respective insurance companies a waiver of any right of subrogation which said insurance company may have against Landlord or Tenant, as the case may be.

**10. TAXES:** Tenant shall be liable for and shall pay as additional rental, prior to delinquency, the following: (i) all taxes and assessments levied against Tenant's personal property and trade or business fixtures; (ii) all real estate taxes and assessment installments or other impositions or charges which may be levied on the Premises or upon the occupancy of the Premises, including any substitute or additional charges which may be imposed applicable to the Lease Term; and (iii) real estate tax increases due to an increase in assessed value resulting from a sale, transfer or other change of ownership of the Premises as it appears on the City and County tax bills during the Lease Term. All real estate taxes shall be prorated to reflect the Lease Commencement and Expiration Dates. If, at any time during the Lease Term a tax, excise on rents, business license tax or any other tax, however described, is levied or assessed against Landlord as a substitute or addition, in whole or in part, for taxes assessed or imposed on land or Buildings, Tenant shall pay and discharge its pro rata share of such tax or excise on rents or other tax before it becomes delinquent; except that this provision is not intended to cover net income taxes, inheritance, gift or estate tax imposed upon Landlord. Any tax assessments shall be payable over the longest term allowed. In the event that a tax is placed, levied, or assessed against Landlord and the taxing authority takes the position that Tenant cannot pay and discharge its pro rata share of such tax on behalf of Landlord, then at Landlord's sole election,

Landlord may increase the Base Monthly Rent by the exact amount of such tax and Tenant shall pay such increase. If by virtue of any application or proceeding brought by Landlord, there results a reduction in the assessed value of the Premises during the Lease Term, Tenant agrees to pay Landlord a fee consistent with the fees charged by a third party appeal firm for such services but in no event more than the amount of tax savings. Notwithstanding the foregoing, if property taxes increase during the Lease Term as a result of a reassessment due to a voluntary change of ownership, Tenant's shall be responsible for payment of the resulting property tax increase as follows: during the first twelve months, Tenant shall be responsible for payment of thirty three percent (33%) of the tax increase; during the second twelve months, Tenant shall be responsible for payment of sixty seven percent (67%) of the tax increase, thereafter Tenant shall be responsible for payment of the entire tax increase.

**11. UTILITIES:** Tenant shall pay directly to the providing utility all water, gas, electric, telephone, and other utilities supplied to the Premises. Landlord shall not be liable for loss of or injury to person or property, however occurring, through or in connection with or incidental to furnishing or the utility company's failure to furnish utilities to the Premises, and in such event Tenant shall not be entitled to abatement or reduction of any portion of Base Monthly Rent or any other amount payable under this Lease.

**12. TOXIC WASTE AND ENVIRONMENTAL DAMAGE:**

**A. Use of Hazardous Material:** Without the prior written consent of Landlord, Tenant or Tenant's agents, employees, contractors, subtenants or invitees ("Tenant's Agents") shall not cause or permit any Hazardous Material, as defined below, to be generated, brought onto, used, stored, created, released or disposed of in or about the Premises, except in strict compliance with all Environmental Laws, as defined below. As used herein, the term "Hazardous Material" shall mean any substance, material or waste (whether liquid, solid or gaseous), which is a pollutant or contaminant, or which is hazardous, toxic, ignitable, reactive, corrosive, dangerous, harmful or injurious, or which presents a risk to public health or the environment, and which is or becomes regulated by or under the authority of any Environmental Laws, as defined below, including, without limitation, asbestos or asbestos containing materials, petroleum products, pesticides, polychlorinated biphenyls, flammable explosives, radioactive materials and urea formaldehyde. As used herein, the term "Environmental Laws" shall mean any present or future federal, state or local law, whether common law, statute, rule, regulation or ordinance, judgment, order, or other governmental restriction, guideline, listing or requirement, relating to the environment or any Hazardous Material, including without limitation, the Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. §9601 et seq., the Resource Conservation and Recovery Act of 1976, 42 U.S.C. §6901 et seq., and applicable provisions of the California Health and Safety Code and the California Water Code, all as heretofore or hereafter may be amended from time to time. In order to obtain consent, Tenant shall deliver to Landlord its written proposal describing the Hazardous Material to be brought onto the Premises, measures to be taken for storage and disposal thereof, and safety measures to be employed to prevent pollution or contamination of the air, soil, surface and ground water. Landlord's approval may be withheld in its reasonable judgment. In the event Landlord consents to Tenant's use of Hazardous Materials on the Premises or such consent is not required, Tenant represents and warrants that it shall comply with all Governmental Regulations applicable to Hazardous Material including doing the following: (i) adhere to all reporting and inspection requirements imposed by Federal, State, County or Municipal laws, ordinances or regulations and provide Landlord a copy of any such reports or agency inspections; (ii) obtain and provide Landlord copies of all necessary permits required for the use and handling of Hazardous Material on the Premises; (iii) enforce Hazardous Material handling and disposal practices consistent with industry standards; (iv) surrender the Premises free from any Hazardous Materials to the extent required by Environmental Laws and arising from Tenant's generating, bringing, using, storing, creating, releasing, or disposing of Hazardous Material; and (v) properly close the facility with regard to Hazardous Material including the removal or decontamination of any process piping, mechanical ducting, storage tanks, containers, or trenches which have come into contact with Hazardous Material and obtaining a closure certificate from the local administering agency prior to the Expiration Date.

**B. Tenant's Indemnity Regarding Hazardous Material:** Landlord represents and warrants, to the best of its knowledge, that as of the Effective Date there does not exist any Hazardous Materials on the Premises or the property of which the Premises are a part. Tenant shall, at its sole cost and expense and with counsel reasonably acceptable to Landlord, indemnify, defend and hold harmless Landlord and Landlord's trustees, shareholders, directors, officers, employees, partners, affiliates, agents, successors and assigns from, and against any and all claims, liabilities, obligations, penalties, fines, actions, costs or expenses incurred or suffered arising from generating, bringing, using, storing, creating, releasing or disposing of Hazardous Material by Tenant or Tenant's Agents in or about the Premises, or the violation of any Governmental Regulation or Environmental Laws by Tenant or Tenant's Agents. This indemnification applies whether or not the concentrations of any such Hazardous Material exceed applicable maximum contaminant or action levels or any governmental agency has issued a cleanup order. Tenant's indemnification, defense, and hold harmless obligations include, without limitation, the following: (i) claims, liabilities, costs or expenses resulting from or based upon administrative, judicial (civil or criminal) or other action, legal or equitable, brought by any private or public person under present or future laws, including Environmental Laws; (ii) claims, liabilities, costs or expenses pertaining to the assessment and identification, monitoring, cleanup, containment, or removal of Hazardous Material from soils, riverbeds or aquifers including the provision of an alternative public drinking water source; (iii) losses attributable to diminution in the value of the Premises or the Building (iv) loss or restriction of use of rentable space in the Building; and (v) all other liabilities, obligations, penalties, fines, claims, actions (including remedial or enforcement actions of any kind and administrative or judicial proceedings, orders or judgments), damages (including consequential and punitive damages), and costs (including attorney, consultant, and expert fees and expenses) directly resulting from the release or violation. This Section 12.B shall survive the expiration or termination of this Lease.

**C. Notice of Release or Violation:** Tenant agrees to notify Landlord of any lawsuits or orders of which Tenant has been notified in writing which relate to the remedying of or actual release of Hazardous Materials on or into the soils or ground water at or under the Premises. Tenant shall also provide Landlord all notices required by Section 25359.7(B) of the Health and Safety Code and all other notices required by law to be given to Landlord in connection with Hazardous Materials. Without limiting the foregoing, Tenant shall also deliver to Landlord, within twenty (20) days after receipt thereof, any written notices from any governmental agency alleging a material violation of, or material failure to comply with, any federal, state or local laws, regulations, ordinances or orders, the violation of which of failure to comply with poses a foreseeable and material risk of contamination of the ground water or injury to humans (other than injury solely to Tenant, Tenant's Agents and employees within the Building).

In the event of any release on or into the Premises or into the soil or ground water under the Premises, the Building or the Project of any Hazardous Materials used, treated, stored or disposed of by Tenant or Tenant's Agents, Tenant agrees to comply, at its sole cost, with all laws, regulations, ordinances and orders of any federal, state or local agency relating to the monitoring or remediation of such Hazardous Materials. In the event of any such release of Hazardous Materials Tenant shall immediately give verbal and follow-up written notice of the release to Landlord, and Tenant agrees to meet and confer with Landlord and its Lender to attempt to eliminate and mitigate any financial exposure to such Lender and resultant exposure to Landlord under California Code of Civil Procedure Section 736(b) as a result of such release, and promptly to take reasonable monitoring, cleanup and remedial steps given, inter alia, the historical uses to which the Property has and continues to be used, the risks to public health posed by the release, the then available technology and the costs of remediation, cleanup and monitoring, consistent with acceptable customary practices for the type and severity of such contamination and all applicable laws. Nothing in the preceding sentence shall eliminate, modify or reduce the obligation of Tenant under 12.B of this Lease to indemnify, defend and hold Landlord harmless from any claims liabilities, costs or expenses incurred or suffered by Landlord. Tenant shall provide Landlord prompt written notice of Tenant's monitoring, cleanup and remedial steps.

In the absence of an order of any federal, state or local governmental or quasi-governmental agency

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relating to the cleanup, remediation or other response action required by applicable law, any dispute arising between Landlord and Tenant concerning Tenant's obligation to Landlord under this Section 12.C concerning the level, method, and manner of cleanup, remediation or response action required in connection with such a release of Hazardous Materials shall be resolved by mediation and/or arbitration pursuant to this Lease.

**D. Remediation Obligations:** In the event of any release on, under or about the Premises of any Hazardous Material generated, brought onto, used, stored, created or disposed of by Tenant or Tenant's Agents, Tenant shall, at its sole cost, promptly take all necessary and appropriate actions, in compliance with applicable Environmental Laws, to remove or remediate such Hazardous Material, whether or not any governmental agency has issued a cleanup order, so as to return the Premises to substantially the condition that existed before the introduction of such Hazardous Material or as may otherwise be required by law. Tenant shall obtain Landlord's written consent prior to implementing any proposed removal or remedial action, provided, however, that Tenant shall be entitled to respond immediately to an emergency without first obtaining Landlord's written consent. Nothing in the preceding sentence shall in any way eliminate, modify or reduce the obligation of Tenant under 12.B of this Lease to indemnify, defend and hold Landlord harmless from any claims, liabilities, costs or expenses incurred or suffered by Landlord.

**E. Environmental Monitoring:** Landlord and its agents shall have the right to inspect, investigate, sample and monitor the Premises, including any air, soil, water, ground water, or to conduct any other sampling or testing, digging, drilling or analysis, to determine whether Tenant is complying with the terms of this Section 12. If Landlord discovers that Tenant is not in compliance with the terms of this Section 12, any costs incurred by Landlord in determining Tenant's non-compliance, including attorneys', consultants' and experts' fees, shall be due and payable by Tenant to Landlord within thirty (30) following Landlord's written demand therefor.

**13. TENANT'S DEFAULT:** The occurrence of any of the following shall constitute a material default and breach of this Lease by Tenant: (i) Tenant's failure to pay the Base Monthly Rent including additional rent or any other payment due under this Lease, where such failure to pay continues for five (5) days after written notice thereof by Landlord to Tenant, (ii) the abandonment of the Premises by Tenant; (iii) Tenant's failure to observe and perform any other required provision of this Lease, where such failure continues for thirty (30) days after written notice from Landlord provided, however, that if the nature of the default is such that it cannot reasonably be cured within the 30-day period, Tenant shall not be deemed in default if it commences within such period to cure, and thereafter diligently prosecutes the same to completion; (iv) Tenant's making of any general assignment for the benefit of creditors; (v) the filing by or against Tenant of a petition to have Tenant adjudged a bankrupt or of a petition for reorganization or arrangement under any law relating to bankruptcy (unless, in the case of a petition filed against Tenant, the same is dismissed after the filing); (vi) the appointment of a trustee or receiver to take possession of substantially all of Tenant's assets located at the Premises or of Tenant's interest in this Lease, where possession is not restored to Tenant within thirty (30) days; (vii) the attachment, execution or other judicial seizure of substantially all of Tenant's assets located at the Premises or of Tenant's interest in this Lease, where such seizure is not discharged within thirty (30) days, or (viii) any default by Tenant under the Building 1 Lease.

**A. Remedies:** In the event of any such default by Tenant, then in addition to other remedies available to Landlord at law or in equity, Landlord shall have the immediate option to terminate this Lease and all rights of Tenant hereunder by giving written notice of such intention to terminate. In the event Landlord elects to so terminate this Lease, Landlord may recover from Tenant all the following: (i) the worth at time of award of any unpaid rent which had been earned at the time of such termination; (ii) the worth at time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss for the same period that Tenant proves could have been reasonably avoided; (iii) the worth at time of award of the amount by which the unpaid rent for the balance of the Lease Term after the time of award exceeds the amount of such rental loss that Tenant proves could be reasonably avoided; (iv) any other amount necessary to compensate Landlord for all

detriment proximately caused by Tenant's failure to perform its obligations under this Lease, or which in the ordinary course of things would be likely to result therefrom; including the following: (x) expenses for repairing, altering or remodeling the Premises for purposes of reletting, (y) unamortized broker's fees, advertising costs or other expenses of reletting the Premises, and (z) costs of carrying the Premises such as taxes, insurance premiums, utilities and security precautions; and (v) at Landlord's election, such other amounts in addition to or in lieu of the foregoing as may be permitted by applicable California law. The term "rent", as used herein, is defined as the minimum monthly installments of Base Monthly Rent and all other sums required to be paid by Tenant pursuant to this Lease, all such other sums being deemed as additional rent due hereunder. As used in (i) and (ii) above, "worth at the time of award" shall be computed by allowing interest at a rate equal to the discount rate of the Federal Reserve Bank of San Francisco plus five (5%) percent per annum. As used in (iii) above, "worth at the time of award" shall be computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one (1%) percent.

**B. Right to Re-enter:** In the event of any such default by Tenant, Landlord shall have the right, after terminating this Lease, to re-enter the Premises and remove all persons and property. Such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of Tenant, and disposed of by Landlord in any manner permitted by law.

**C. Continuation of Lease:** If Landlord does not elect to terminate this Lease as provided in Section 13.A or 13.B above, then the provisions of California Civil Code Section 1951.4, (Landlord may continue the lease in effect after Tenant's breach and abandonment and recover rent as it becomes due if Tenant has a right to sublet and assign, subject only to reasonable limitations) as amended from time to time, shall apply and Landlord may from time to time, without terminating this Lease, either recover all rental as it becomes due or relet the Premises or any part thereof for such term or terms and at such rental or rentals and upon such other terms and conditions as Landlord in its sole but reasonable discretion may deem advisable, with the right to make alterations and repairs to the Premises. In the event that Landlord elects to so relet, rentals received by Landlord from such reletting shall be applied in the following order to: (i) the payment of any indebtedness other than Base Monthly Rent due hereunder from Tenant to Landlord; (ii) the payment of any cost of such reletting; (iii) the payment of the cost of any alterations and repairs to the Premises; and (iv) the payment of Base Monthly Rent and other sums due and unpaid hereunder. The residual rentals, if any, shall be held by Landlord and applied in payment of future Base Monthly Rent as the same may become due and payable hereunder. Landlord shall have the obligation to market the space but shall have no obligation to relet the Premises following a default if Landlord has other comparable available space within the Building or Project. In the event the portion of rentals received from such reletting which is applied to the payment of rent hereunder during any month be less than the rent payable during that month by Tenant hereunder, then Tenant shall pay such deficiency to Landlord immediately upon demand. Such deficiency shall be calculated and paid monthly. Tenant shall also pay to Landlord, as soon as ascertained, any reasonable costs and expenses incurred by Landlord in such reletting or in making such alterations and repairs not covered by the rentals received from such reletting.

**D. No Termination:** Landlord's re-entry or taking possession of the Premises pursuant to 13.B or 13.C shall not be construed as an election to terminate this Lease unless written notice of such intention is given to Tenant or unless the termination is decreed by a court of competent jurisdiction. Notwithstanding any reletting without termination by Landlord because of any default by Tenant, Landlord may at any time after such reletting elect to terminate this Lease for any such default.

**E. Non-Waiver:** Landlord may accept Tenant's payments without waiving any rights under this Lease, including rights under a previously served notice of default. No payment by Tenant or receipt by Landlord of a lesser amount than any installment of rent due shall be deemed as other than payment on account of the amount due. If Landlord accepts payments after serving a notice of default, Landlord may nevertheless commence and pursue an action to enforce rights and remedies under the previously served notice of default without giving Tenant any further notice or demand. Furthermore, the Landlord's acceptance of rent from the Tenant when

the Tenant is holding over without express written consent does not convert Tenant's Tenancy from a tenancy at sufferance to a month to month tenancy. No waiver of any provision of this Lease shall be implied by any failure of Landlord to enforce any remedy for the violation of that provision, even if that violation continues or is repeated. Any waiver by Landlord of any provision of this Lease must be in writing. Such waiver shall affect only the provision specified and only for the time and in the manner stated in the writing. No delay or omission in the exercise of any right or remedy by Landlord shall impair such right or remedy or be construed as a waiver thereof by Landlord. No act or conduct of Landlord, including, without limitation, the acceptance of keys to the Premises, shall constitute acceptance of the surrender of the Premises by Tenant before the Expiration Date. Only written notice from Landlord to Tenant of acceptance shall constitute such acceptance of surrender of the Premises. Landlord's consent to or approval of any act by Tenant which requires Landlord's consent or approvals shall not be deemed to waive or render unnecessary Landlord's consent to or approval of any subsequent act by Tenant.

**F. Performance by Landlord:** If Tenant fails to perform any obligation required under this Lease or by law or governmental regulation, and such failure continues after any applicable notice and cure period, Landlord in its sole discretion may, without further notice, without waiving any rights or remedies and without releasing Tenant from its obligations hereunder, perform such obligation, in which event Tenant shall pay Landlord as additional rent all sums paid by Landlord in connection with such substitute performance, including interest at the Agreed Interest Rate (as defined in Section 20.J) within thirty (30) days of Landlord's written notice for such payment.

#### **14. LANDLORD'S LIABILITY:**

**A. Limitation on Landlord's Liability:** In the event of Landlord's failure to perform any of its covenants or agreements under this Lease, Tenant shall give Landlord written notice of such failure and shall give Landlord thirty (30) days to cure or commence to cure such failure prior to any claim for breach or resultant damages, provided, however, that if the nature of the default is such that it cannot reasonably be cured within the 30-day period, Landlord shall not be deemed in default if it commences within such period to cure, and thereafter diligently prosecutes the same to completion. In addition, upon any such failure by Landlord, Tenant shall give notice by registered or certified mail or by nationally recognized overnight delivery service to any person or entity with a security interest in the Premises ("Mortgagee") that has provided Tenant with written notice of its interest in the Premises, and shall provide Mortgagee a reasonable opportunity to cure such failure, including such time as is reasonably necessary to obtain an appointment of a receiver, if such should prove necessary to effectuate a cure. Tenant agrees that each of the Mortgagees to whom this Lease has been assigned is an expressed third-party beneficiary hereof. Tenant waives any right under California Civil Code Section 1950.7 or any other present or future law to the collection of any payment or deposit from Mortgagee or any purchaser at a foreclosure sale of Mortgagee's interest unless Mortgagee or such purchaser shall have actually received and not refunded the applicable payment or deposit. Tenant further waives any right to terminate this Lease and to vacate the Premises on Landlord's default under this Lease. Tenant's sole remedy on Landlord's default is an action for damages or injunctive or declaratory relief; provided, however, Landlord and its partners, trustees, beneficiaries and employees shall not be liable to Tenant for any consequential damages suffered or incurred by Tenant on account of Landlord's default including, without limitation, on account of lost profits or the interruption of Tenant's business. Tenant hereby agrees that Landlord shall, except to the extent of any gross negligence or misconduct of Landlord, not be liable for injury to Tenant's business or any loss of income therefrom or for damage to the goods, wares, merchandise, or other property of Tenant, Tenant's employees, invitees, customers, or any other person in or about the Premises or the Project, nor shall Landlord be liable for injury to the person of Tenant, Tenant's employees, agents, or contractors, whether such damage or injury is caused by or results from fire, steam, electricity, gas, water, or rain, or from the breakage, leakage, obstruction, or other defects of pipes, sprinklers, wires, appliances, plumbing, air conditioning, or lighting fixtures, or from any other cause, whether said damage or injury results from conditions arising upon the Premises or upon other portions of the Project or from other sources or places and regardless of whether the cause of such

damage or injury or the means of repairing the same is inaccessible to Tenant. Landlord shall not be liable for any damages arising from any act or neglect or any other tenant, occupant, or user of the Project, nor from the failure of Landlord to enforce the provisions of any other lease of the Project.

**B. Limitation on Tenant's Recourse:** If Landlord is a corporation, trust, partnership, joint venture, unincorporated association or other form of business entity, then (i) the obligations of Landlord shall not constitute personal obligations of the officers, directors, trustees, partners, joint venturers, members, owners, stockholders, or other principals or representatives except to the extent of their property interest in Lot 2 and all appurtenances thereto. Tenant shall have recourse only to the interest of Landlord in Lot 2 and all appurtenances thereto for the satisfaction of the obligations of Landlord and shall not have recourse to any other assets of Landlord for the satisfaction of such obligations. The provisions of this Section 14.B shall be effective only following substantial completion of the Building. During the effectiveness of this Lease, Landlord shall maintain a net equity as to its property interest in Lot 2 of no less than Five Million and No/100 Dollars (\$5,000,000.00). The limitation of this Section 14.B shall not apply at anytime that there is a breach of the foregoing net equity covenant. As used herein, "net equity" shall mean the then fair market value of Lot 2 and all appurtenances thereto less debt, liens or other obligations against the property interest in the Lot 2.

**C. Indemnification of Landlord:** Except to the extent due to the negligence or willful misconduct of Landlord, as a material part of the consideration rendered to Landlord, Tenant hereby waives all claims against Landlord for damages to goods, wares and merchandise, and all other personal property in, upon or about said Premises and for injuries to persons in or about said Premises, from any cause arising at any time to the fullest extent permitted by law, and Tenant shall indemnify, defend with counsel reasonably acceptable to Landlord (it being agreed that a counsel preferred by Tenant's insurance company is acceptable) and hold Landlord, and their shareholders, directors, officers, trustees, employees, partners, affiliates and agents from any claims, liabilities, costs or expenses incurred or suffered arising from the use or occupancy of the Premises or any part of the Project by Tenant or Tenant's Agents, the acts or omissions of Tenant or Tenant's Agents, Tenant's breach of this Lease, or any damage or injury to person or property from any such cause, including but not limited to the use or occupancy of the Premises or any part of the project by Tenant or Tenant's Agents, the acts or omissions of Tenant or Tenant's Agents, Tenant's breach of this Lease or from the failure of Tenant to keep the Premises in good condition and repair as herein provided. Further, in the event Landlord is made party to any litigation due to the acts or omission of Tenant or Tenant's Agents, Tenant will indemnify, defend (with counsel reasonably acceptable to Landlord) and hold Landlord harmless from any such claim or liability including Landlord's costs and expenses and reasonable attorney's fees incurred in defending such claims.

## **15. DESTRUCTION OF PREMISES:**

**A. Landlord's Obligation to Restore:** In the event of a destruction of the Premises during the Lease Term Landlord and Tenant, to the extent of its alterations and Tenant Improvements, shall repair the same to a similar condition to that which existed prior to such destruction. Such destruction shall not annul or void this Lease; however, Tenant shall be entitled to a proportionate reduction of Base Monthly Rent and Additional Rent while repairs are being made, such proportionate reduction to be based upon the extent to which the repairs interfere with Tenant's business in the Premises, as reasonably determined by Landlord. In no event shall Landlord be required to replace or restore Alterations, Tenant Improvements paid for by Tenant from sources other than the Work Allowance or Tenant's fixtures, equipment or personal property. Tenant shall be obligated to replace and restore all alterations and Tenant Improvements paid for by Tenant but not exceeding \$6,000,000 (increased by the CPI each year of the Lease Term) or, at Tenant's option, to assign to Landlord tenant's proceeds of insurance covering the replacement (not exceeding \$6,000,000 (as increased by the CPI each year of the Lease Term) of such alterations and Tenant Improvements in which event Landlord shall restore.

**B. Limitations on Landlord's Restoration Obligation:** Notwithstanding the provisions of Section 15.A, Landlord shall have no obligation to repair, or restore the Premises if any of the following occur: (i) if the repairs cannot be made in two hundred and seventy (270) days from the date of

destruction as reasonably determined by Landlord (ii) the damage or destruction is not fully covered (or would not have been covered) by the insurance that Landlord is required to have maintained under this Lease and exceeds ten percent (10%) of the replacement cost of the Premises, (iii) the damage or destruction occurs in the last twelve (12) months of the Lease Term and would reasonably take greater than 120 days to restore (provided that if Tenant exercises an option to extend there shall be no termination right hereunder), or (iv) Tenant is in default, beyond any applicable notice and cure period, pursuant to the provisions of Section 13, or (v) Tenant has abandoned the Premises for more than ninety (90) days. In any such event Landlord may elect either to (i) complete the repair or restoration, or (ii) terminate this Lease by providing Tenant written notice of its election within sixty (60) days following the damage or destruction. If Landlord elects to repair or restore, this Lease shall continue in full force and effect. Tenant hereby waives the benefits and rights provided to Tenant by the provisions of Civil Code Sections 1932 and 1933.

Notwithstanding anything in this Lease to the contrary, Tenant shall have the right to terminate the Lease in the event of a destruction of the Premises or of Building 1 that either: (i) occurs during the last year of the Lease Term and cannot be repaired within one hundred twenty (120) days of the date of such destruction; or (ii) cannot be repaired within two hundred seventy (270) days from the date of destruction, as reasonably determined by Landlord. If Tenant elects to terminate the Lease pursuant to the above, it shall do so by providing written notice to Landlord no later than fifteen (15) days following notification by Landlord of the time period necessary to repair the destruction.

**16. C ONDEMNATION :** If any part of the Premises shall be taken for any public or quasi-public use, under any statute or by right of eminent domain or private purchase in lieu thereof, and only a part thereof remains which is susceptible of occupation hereunder, this Lease shall, as to the part so taken, terminate as of the day before title vests in the condemnor or purchaser (“Vesting Date”) and Base Monthly Rent payable hereunder shall be adjusted so that Tenant is required to pay for the remainder of the Lease Term only such portion of Base Monthly Rent as the value of the part remaining after such taking bears to the value of the entire Premises prior to such taking. If all of the Premises or Building 1 or such part thereof be taken so that there does not remain a portion reasonably susceptible for occupation by Tenant for its intended use, this Lease shall terminate on the Vesting Date. If part or all of the Premises be taken, all compensation awarded upon such taking shall go to Landlord, and Tenant shall have no claim thereto; except Landlord shall cooperate with Tenant, without cost to Landlord, to recover compensation for damage to or taking of any Alterations, Tenant Improvements paid for by Tenant from sources other than the Work Allowance, or for Tenant’s moving costs. Tenant hereby waives the provisions of California Code of Civil Procedures Section 1265.130 and any other similarly enacted statute, and the provisions of this Section 16 shall govern in the case of a taking.

#### **17. ASSIGNMENT OR SUBLEASE:**

**A. Consent by Landlord:** Except as specifically provided in Section 17.E, Tenant may not voluntarily, involuntarily or by operation of law, assign, sell or otherwise transfer all or any part of Tenant’s interest in this Lease or in the Premises, cause or permit any part of the Premises to be sublet, occupied or used by anyone other than Tenant, or permit any person to succeed to any interest in this Lease or the Premises (all of the foregoing being a “Transfer”) without the express written consent of Landlord. In the event Tenant desires to effectuate a Transfer, Tenant shall deliver to Landlord (i) executed counterparts of any agreement and of all ancillary agreements with the proposed transferee, (ii) current financial statements of the transferee covering the preceding three years, (iii) the nature of the proposed transferee’s business to be carried on in the Premises, (iv) a statement outlining all consideration to be given on account of the Transfer, and (v) a current financial statement of Tenant. Landlord may condition its approval of any Transfer on receipt of a certification from both Tenant and the proposed transferee of all consideration to be paid to Tenant in connection with such Transfer. At Landlord’s request, Tenant shall also provide additional information reasonably required by Landlord to determine whether it will consent to the proposed Transfer. Landlord shall have a ten (10) day period following receipt of all the foregoing within which to notify Tenant in writing that Landlord elects to: (i) permit Tenant to Transfer such space to the named transferee on the terms and conditions set

forth in the notice; or (ii) refuse consent and the basis therefore. If Landlord should fail to notify Tenant in writing of such election within the 10-day period, Landlord shall be deemed to have elected option (i) above. Landlord's consent to the proposed Transfer shall not be unreasonably withheld, provided and upon the condition that: (i) the proposed transferee is engaged in a business that is limited to the use expressly permitted under this Lease; (ii) the proposed transferee is a company with sufficient financial worth and management ability to undertake the financial obligation of this Lease and Landlord has been furnished with reasonable proof thereof; (iii) the proposed transfer agreement, if it is a sublease, conforms to the requirements of subsection 17.I (Sublease Requirements) or if it is an assignment, is in a form reasonably satisfactory to Landlord; and (iv) Tenant reimburses Landlord within 30 days following for any reasonable costs (not exceeding \$5,000) that may be incurred by Landlord in connection with said Transfer, including the costs of making investigations as to the acceptability of the proposed transferee and legal costs incurred in connection with the granting or denial of any requested consent. In the event all or any one of the foregoing conditions are not satisfied (without limiting other factors that may be considered or conditions that may be imposed by Landlord in connection with a requested Transfer), Landlord shall be considered to have acted reasonably if it withholds its consent. Tenant shall not hypothecate, mortgage, pledge or otherwise encumber Tenant's interest in this Lease or the Premises or otherwise use the Lease as a security device in any manner without the consent of Landlord, (all of the foregoing being an "Hypothecation") which consent Landlord may withhold in its sole discretion. Tenant shall reimburse Landlord within 30 days following demand for any reasonable costs that may be incurred by Landlord in connection with an Hypothecation, including legal costs incurred in connection with the granting or denial of any requested consent. Landlord's consent to one or more Transfers or Hypothecations shall not operate to waive Tenant's obligation to obtain Landlord's consent to other Transfers or Hypothecations nor constitute consent to an assignment or other Transfer following foreclosure of any permitted lien, mortgage or other encumbrance. If Tenant is a corporation, limited liability company, unincorporated association, partnership or other legal entity, the sale, assignment, transfer or hypothecation of any stock, membership or other ownership interest in such entity (whether occurring at one time or over a period of time) in the aggregate of more than fifty percent (50%) (determined cumulatively) shall be deemed an assignment of this Lease; in the case of a partnership, any withdrawal or substitution (whether occurring at one time or over a period of time) of any partners owning fifty percent (50%) or more (cumulatively) of the partnership, or the dissolution of the partnership shall be deemed an assignment of this Lease; provided that, subject to Section 17.D below, the foregoing provisions of this sentence shall not apply to a transfer of stock in a corporation whose stock is publicly traded on a public stock exchange. If Tenant is a corporation whose stock is not publicly traded on a public stock exchange, any dissolution, merger, consolidation or reorganization of Tenant shall be deemed a Transfer.

**B. Assignment or Subletting Consideration:** Landlord and Tenant hereby agree that that during any renewal terms, fifty percent (50%), of any rent or other economic consideration (including without limitation, payments for trade fixtures and personal property in excess of the fair market value thereof, stock, warrants, and options) in excess of the Base Monthly Rent (or if a gross sublease, inclusive of a credit for Additional Rent) payable hereunder (i) realized by Tenant in connection with any Transfer by Tenant, and/or (ii) realized by a subtenant or any other person or entity (other than Tenant) (any such subtenant, person or entity being a "Subsequent Transferor") in connection with a sublease, assignment or other Transfer by such Subsequent Transferor, shall be paid by Tenant to Landlord promptly after such amounts are paid to Tenant or a Subsequent Transferor As used in this Section 17.B, "Reasonable Transfer Costs" shall mean unamortized (based on reasonable useful life) cost of Tenant Improvements or Alterations paid for by Tenant and all costs to the extent reasonably incurred in connection with the Transfer in question, including without limitation: (i) advertising costs, legal fees and brokerage commissions payable to unaffiliated third parties, and (ii) tenant improvement costs incurred solely in connection with such Transfer. All Reasonable Transfer Costs shall be recovered by Tenant prior to payment of any excess Base Rent to Landlord. Tenant's obligation to pay over Landlord's portion of the consideration constitutes an obligation for additional rent hereunder. The above provisions relating to relating

to the allocation of excess rent are independently negotiated terms of the Lease which constitute a material inducement for the Landlord to enter into the Lease, and are agreed by the Parties to be commercially reasonable. No Transfer by Tenant shall relieve it of any obligation under this Lease. Any Transfer which conflicts with the provisions of this Lease shall be void.

**C. No Release:** Any Transfer shall be made only if and shall not be effective until the transferee shall execute, acknowledge, and deliver to Landlord an agreement, in form and substance satisfactory to Landlord, whereby the transferee, in the case of an assignment, shall assume all the obligations of this Lease on the part of Tenant to be performed or observed to the extent of the interest being transferred and shall be subject to all the covenants, agreements, terms, provisions and conditions in this Lease to the extent applicable to the interest being transferred. Notwithstanding any Transfer and the acceptance of rent or other sums by Landlord from any transferee, Tenant shall remain fully liable for the payment of Base Monthly Rent and additional rent due, and to become due hereunder, for the performance of all the covenants, agreements, terms, provisions and conditions contained in this Lease on the part of Tenant to be performed and for all acts and omissions of any transferee or any other person claiming under or through any transferee that shall be in violation of any of the terms and conditions of this Lease, and any such violation shall be deemed a violation by Tenant. Tenant shall indemnify, defend and hold Landlord harmless from and against all losses, liabilities, damages, costs and expenses (including reasonable attorney fees) resulting from any claims that may be made against Landlord by the proposed transferee arising out of this Lease or by any real estate brokers or other persons claiming compensation in connection with the proposed Transfer.

**D. Reorganization of Tenant:** The provisions of this Section 17.D shall apply if Tenant is a publicly-held corporation and: (i) there is a dissolution, merger, consolidation, or other reorganization of or affecting Tenant, where Tenant is not the surviving corporation, or (ii) there is a sale or transfer of stock possessing more than fifty percent (50%) of the total combined voting power of all classes of Tenant's capital stock issued, outstanding and entitled to vote for the election of directors to one person or entity (or to any group of related persons or entities) (the "Acquiring Entity"), and after such sale or transfer of stock Tenant's stock is no longer publicly traded. In a transaction under clause (i), the surviving corporation shall promptly execute and deliver to Landlord an agreement in form reasonably satisfactory to Landlord under which such surviving corporation assumes the obligations of Tenant hereunder. In a transaction under clause (ii), the Acquiring Entity shall promptly execute and deliver to Landlord an agreement in form reasonably satisfactory to Landlord under which such Acquiring Entity assumes the obligations of Tenant to the extent accruing after such transferee's acquisition of Tenant's stock possessing more than 50% of the total combined voting of all classes of Tenant's capital stock issued, outstanding and entitled to vote for the election of directors. The foregoing notwithstanding, in the event the Acquiring Entity is itself not a publicly-traded corporation, but is instead the subsidiary of a publicly-traded corporation (or a subsidiary of a subsidiary of a publicly-traded corporation, or a subsidiary in a chain of entities in which a parent corporation is publicly traded), then the publicly-traded parent corporation shall be required to execute and deliver to Landlord the Lease Guaranty. It is the intent of the parties that after such an acquisition of the stock of Tenant, Landlord shall be entitled to rely on the creditworthiness of a publicly-traded corporation and to receive audited financial information from a publicly-traded corporation.

**E. Permitted Transfers:** Notwithstanding anything contained in this Section 17, (but subject to Section 17.D), Tenant may enter into any of the following Transfers (a "Permitted Transfer") without Landlord's prior consent, and Landlord shall not be entitled to terminate the Lease or to receive any part of any consideration resulting therefrom that would otherwise be due pursuant to Sections 17.A and 17.B: Tenant may sublease all or part of the Premises or assign its interest in this Lease to (i) any corporation which controls, is controlled by, or is under common control with Tenant to this Lease by means of an ownership interest of more than fifty percent (50%); (ii) a corporation which results from a merger, consolidation or other reorganization, so long as the surviving corporation has a net worth at the time of such assignment that is equal to or greater than the net worth of Tenant as of the Effective Date of this Lease; and (iii) a corporation which purchases or

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otherwise acquires all or substantially all of the assets or stock of Tenant so long as such acquiring corporation has a net worth at the time of such assignment that is equal to or greater than the net worth of Tenant as of the Effective Date of this Lease.

**F. Effect of Default:** In the event of Tenant's default after notice and opportunity to cure, Tenant hereby assigns all amounts due to Tenant from any Transfer as security for performance of Tenant's obligations under this Lease, and Landlord may collect such amounts as Tenant's Attorney-in-Fact, except that Tenant may collect such amounts unless a default exists as described in Section 13 above. A termination of the Lease due to Tenant's default shall not automatically terminate a Transfer then in existence; rather at Landlord's election (1) such Transfer shall survive the Lease termination, (2) the transferee shall attorn to Landlord, and (3) Landlord shall undertake the obligations of Tenant under the transfer agreement; except that Landlord shall not be liable for prepaid rent, security deposits not received by Landlord or other defaults of Tenant to the transferee, or for any acts or omissions of Tenant and Tenant's Agents.

**G. Conveyance by Landlord:** In the event of any transfer of Landlord's interest in this Lease, the Landlord herein named (and in case of any subsequent transfer, the then transferor) shall be automatically freed and relieved from and after the date of such transfer of all liability for the performance of any covenants or obligations on the part of Landlord contained in this Lease thereafter to be performed; provided, however, that any funds in the hands of Landlord or the then transferor at the time of such transfer, in which Tenant has an interest shall be turned over to the transferee and any amount then due and payable to Tenant by Landlord or the then transferor under any provision of this Lease shall be paid to Tenant; and provided, further, that upon any such transfer, the transferee shall be deemed to have assumed, subject to the limitations of this Section 17, all of the agreements, covenants and conditions in this Lease to be performed on the part of Landlord, it being intended hereby that the covenants and obligations contained in this Lease to be performed on the part of Landlord shall, subject as aforesaid, be binding on each Landlord, its successors and assigns, only during its period of ownership. Notwithstanding anything in this Lease to the contrary, the original Landlord shall not transfer its interest in (A) Lot 2 to an entity not controlled by the immediate Sobrato family until substantial completion of the Building. In the event of any such transfer, the original Sobrato entity shall not be relieved of its obligations. Landlord acknowledges that Tenant has relied upon original Landlord (in particular, Landlord's affiliation with the Sobrato Development Companies) and such has served as a material inducement for Tenant to enter into this Lease.

**H. Successors and Assigns:** Subject to the provisions of this Section 17, the covenants and conditions of this Lease shall apply to and bind the heirs, successors, executors, administrators and assigns of all Parties hereto; and all parties hereto comprising Tenant and Landlord shall be jointly and severally liable hereunder.

**I. Sublease Requirements:** If Landlord consents to any sublet of the premises by Tenant to an approved Subtenant ("Subtenant"), every sublet transaction shall be evidenced by a written sublease between Tenant and Subtenant (the "Sublease"). The Sublease shall comply with the following requirements: (i) The form of the Sublease and the terms and conditions thereof shall be subject to Landlord's approval which shall not be withheld unreasonably; (ii) The Sublease shall provide that it is subject to all of the terms and conditions of this Lease, except those terms and conditions relating to Rent, Additional Rent, and any other amount due under this Lease; (iii) The Sublease shall provide that the Subtenant shall have no right to exercise any option or other right granted to Tenant in this Lease; (iv) The Sublease shall contain a waiver of subrogation against Landlord and shall require Subtenant's insurance policies to acknowledge such waiver of subrogation; (v) The Sublease shall provide that all requirements of the Lease applicable to subleases shall be applicable to sub-subleases; (vi) The Sublease shall require Subtenant, acting through Tenant, to obtain Landlord's prior written approval, to any alteration to the Premises to the same extent Tenant is required by this Lease to obtain such consent; (vii) The Sublease shall require Subtenant to send Landlord copies of any and all default notices concerning the Premises that Subtenant is obligated to provide to Tenant and Tenant to send Landlord copies of any and all default notices concerning the Premises that Tenant is

obligated to provide to Subtenant; and (viii) The Sublease shall provide that, at Landlord's option, the Sublease shall not terminate in the event that this Lease terminates and shall require Subtenant to execute an attornment agreement if Landlord, in its sole and absolute discretion, shall elect to have the Sublease continue beyond the date of termination of this Lease as provided in Section 17.F.

#### **18. OPTION TO EXTEND THE LEASE TERM:**

**A. Grant and Exercise of Option:** Landlord grants to Tenant, subject to the terms and conditions set forth in this Section 18.A, four (4) options (the "Options") to extend the Lease Term for an additional term (the "Option Term"). The first two (2) Option Terms shall be for a period of thirty six (36) months each and the second two (2) Option Terms shall be for sixty (60) months each. All Option Terms shall be exercised, if at all, by written notice to Landlord no earlier than eighteen (18) months prior to the date the Lease Term would expire but for such exercise but no later than twelve (12) months prior to the date the Lease Term would expire but for such exercise, time being of the essence for the giving of such notice. If Tenant exercises the Option, all of the terms, covenants and conditions of this Lease shall apply except for the grant of additional Options pursuant to this Section (all remaining options will, however, continue to be in effect), provided that Base Monthly Rent for the Premises payable by Tenant during the Option Term shall be the greater of (i) the Base Monthly Rent applicable to the period immediately prior to the commencement of the Option Term, and (ii) ninety percent (90%) of the Fair Market Rental as hereinafter defined. Notwithstanding anything herein to the contrary, if Tenant is in monetary or material non-monetary default (beyond any applicable notice or cure period) under any of the terms, covenants or conditions of this Lease at the time Tenant exercises the Option, then Landlord shall have, in addition to all of Landlord's other rights and remedies provided in this Lease, the right to terminate the Option upon notice to Tenant, in which event the Lease Term shall not be extended pursuant to this Section 18.A. As used herein, the term "Fair Market Rental" is defined as the rental and all other monetary payments, including any escalations and adjustments thereto (including without limitation Consumer Price Indexing) that Landlord could obtain during the Option Term from a third party desiring to lease the Premises, based upon the (i) current use and other potential uses of the Premises, as determined by the rents then obtainable for new leases of space comparable in age and quality to the Premises in the same real estate submarket as the Building and on substantially the same terms and conditions as this Lease (e.g., triple net operating expenses). The appraisers shall be instructed that the foregoing ten percent (10.0%) discount is intended to offset comparable rents that include the following costs which Landlord will not incur in the event Tenant exercises its option (i) brokerage commissions, (ii) tenant improvement or relocation allowances, and (iii) vacancy costs.

**B. Determination of Fair Market Rental:** If Tenant exercises the Option, Landlord shall send Tenant a notice setting forth the Fair Market Rental for the Option Term within thirty (30) days following the Exercise Date. If Tenant disputes Landlord's determination of Fair Market Rental for the Option Term, Tenant shall, within thirty (30) days after the date of Landlord's notice setting forth Fair Market Rental for the Option Term, send to Landlord a notice stating that Tenant either elects to terminate its exercise of the Option, in which event the Option shall lapse and this Lease shall terminate on the Expiration Date, or that Tenant disagrees with Landlord's determination of Fair Market Rental for the Option Term and elects to resolve the disagreement as provided in Section 18.C below. If Tenant does not send Landlord a notice as provided in the previous sentence, Landlord's determination of Fair Market Rental shall be the Base Monthly Rent payable by Tenant during the Option Term. If Tenant elects to resolve the disagreement as provided in Section 18.C and such procedures are not concluded prior to the commencement date of the Option Term, Tenant shall pay to Landlord as Base Monthly Rent the Fair Market Rental as determined by Landlord in the manner provided above. If the Fair Market Rental as finally determined pursuant to Section 18.C is greater than Landlord's determination, Tenant shall pay Landlord the difference between the amount paid by Tenant and the Fair Market Rental as so determined in Section 18.C within thirty (30) days after such determination. If the Fair Market Rental as finally determined in Section 18.C is less than Landlord's determination, the difference between the amount paid by Tenant and the Fair Market Rental as so determined in Section 18.C shall be credited against the next installments of Base Monthly Rent and Additional Rent due from Tenant to Landlord hereunder.

**C. Resolution of a Disagreement over the Fair Market Rental:** Any disagreement regarding Fair Market Rental shall be resolved as follows:

1. Within thirty (30) days after Tenant's response to Landlord's notice setting forth the Fair Market Rental, Landlord and Tenant shall meet at a mutually agreeable time and place, in an attempt to resolve the disagreement.

2. If within the 30-day period referred to above, Landlord and Tenant cannot reach agreement as to Fair Market Rental, each party shall select one appraiser to determine Fair Market Rental. Each such appraiser shall arrive at a determination of Fair Market Rental and submit their conclusions to Landlord and Tenant within thirty (30) days after the expiration of the 30-day consultation period described above.

3. If only one appraisal is submitted within the requisite time period, it shall be deemed as Fair Market Rental. If both appraisals are submitted within such time period and the two appraisals so submitted differ by less than ten percent (10%), the average of the two shall be deemed as Fair Market Rental. If the two appraisals differ by more than 10%, the appraisers shall immediately select a third appraiser who shall, within thirty (30) days after his selection, make and submit to Landlord and Tenant a determination of Fair Market Rental. This third appraisal will then be averaged with the closer of the two previous appraisals and the result shall be Fair Market Rental.

4. All appraisers specified pursuant to this Section shall be members of the American Institute of Real Estate Appraisers with not less than ten (10) years experience appraising office and industrial properties in the Santa Clara Valley. Each party shall pay the cost of the appraiser selected by such party and one-half of the cost of the third appraiser.

**D. Personal to Tenant:** All Options provided to Tenant in this Lease are personal and granted to Netflix, Inc., Acquiring Entity, or any successor by Permitted Transfer and are not exercisable by any third party should Tenant otherwise assign or sublet all or a portion of its rights under this Lease, unless Landlord consents to permit exercise of any option by any assignee or subtenant, in Landlord's sole and absolute discretion. In the event Tenant has multiple options to extend this Lease, a later option to extend the Lease cannot be exercised unless the prior option has been properly exercised.

#### **19. RIGHT OF FIRST OFFERING TO PURCHASE:**

**A. Grant:** Landlord hereby grants Tenant a right of first offer to purchase Landlord's interest in Lot 2 and all appurtenances thereto, including the Building, or Landlord's interest in Lot 1 and all appurtenances thereto, including Building 1 (if the Landlord's interest in the Building and Building 1 are offered separately) or Lot 1 and Lot 2 and all appurtenances thereto, including the Building and Building 1 (if the Landlord's interest in Building and Building 1 are offered together). Prior to Landlord offering to sell its interest in either Lot 1 or Lot 2 to a third party, Landlord shall give Tenant written notice of such desire and the terms and other information under which Landlord intends to sell Lot 1 and/or Lot 2 (and all appurtenances thereto), including without limitation, (i) sales price, (ii) seller financing, (iii) assumable 3rd party financing (iv) state of title; (v) date for close of escrow; (vi) allocation of closing costs; (vii) legal description; and (v) any other material terms. Provided at the time of exercise, Tenant is not in default beyond the expiration of any applicable cure period, Tenant shall have the option, which must be exercised, if at all, by written notice to Landlord within thirty (30) days after Tenant's receipt of Landlord's notice, to purchase Landlord's interest in Lot 1 and/or Lot 2, as applicable, at the sales price and terms of sale specified in the notice. In the event Tenant timely exercises such option to purchase Landlord's interest, Landlord shall sell Landlord's interest to Tenant, and Tenant shall purchase Landlord's interest from Landlord in accordance with the price and terms specified in Landlord's notice. Landlord and Tenant shall, in good faith, attempt to reach agreement on the terms of a mutually acceptable reasonable purchase agreement consistent with the terms set forth in Landlord's notice within thirty (30) days of Landlord's notice. In the event (i) Landlord and Tenant, in good faith, are unable to reach agreement on a mutually acceptable reasonable purchase agreement within such thirty (30) day period or (ii) Tenant fails to exercise Tenant's option within said thirty (30) day period, Landlord shall have one hundred eighty (180) days thereafter to sell such Landlord's interest at no less than ninety five percent

(95%) of the sales price and upon the same or substantially the same other terms of sale as specified in the notice to Tenant. In the event Landlord fails to close escrow on the sale of Landlord's interest within said one hundred eighty (180) day period or in the event Seller proposes to sell Landlord's interest at less than ninety five percent (95%) of the sales price or on other material terms which are more favorable to the prospective buyer than that proposed to Tenant, Landlord shall be required to resubmit such offer to Tenant in accordance with this Right of First Offering except that Tenant shall be required to respond to any resubmission within a ten (10) day period. For purposes of clarification, any sale, transfer or other hypothecation of any interest in the entity comprising Landlord shall be subject to the provisions of this Section 20. Notwithstanding anything herein to the contrary, Lot 1 and Lot 2 referred to herein shall include all appurtenant rights of an owner to the use, enjoyment, management and control of Lot A.

**B. Exclusions :** This Right of First Offering shall automatically terminate, upon the expiration or sooner termination of the Lease. In addition, this Right of First Offering shall not be triggered by an event of a foreclosure or other involuntary transfer of Landlord's interest in the Premises, provided the Right of First Offering shall survive any such foreclosure or involuntary transfer. Notwithstanding the forgoing, this Right of First Offering shall not apply to (but shall survive and remain in effect after) transfers of all or a portion of the Building to (i) John A. Sobrato and/or John M. Sobrato (individually and collectively "Sobrato"), and (ii) any immediate family member of Sobrato, and (iii) any trust established, in whole or in part, for the benefit of Sobrato and/or any immediate family member of Sobrato, (iv) any partnership in which Sobrato or any immediate family member, either directly or indirectly (e.g., through a partnership or corporate entity or a trust) retains a general partner interest, and/or (v) any corporation under the control, either directly or indirectly, by Sobrato or any immediate family member of Sobrato.

## **20. GENERAL PROVISIONS:**

**A. Attorney's Fees :** In the event a suit or alternative form of dispute resolution is brought for the possession of the Premises, for the recovery of any sum due hereunder, to interpret the Lease, or because of the breach of any other covenant herein; then the losing party shall pay to the prevailing party reasonable attorney's fees including the expense of expert witnesses, depositions and court testimony as part of its costs which shall be deemed to have accrued on the commencement of such action. The prevailing party shall also be entitled to recover all costs and expenses including reasonable attorney's fees incurred in enforcing any judgment or award against the other party. The foregoing provision relating to post-judgment costs is severable from all other provisions of this Lease.

**B. Authority of Parties:** Tenant and Landlord each hereby represents and warrants that it is duly formed and in good standing, and is duly authorized to execute and deliver this Lease on behalf of said party, in accordance with a duly adopted resolution of the Board of Directors of said corporation or in accordance with the by-laws of said corporation, and that this Lease is binding upon said corporation in accordance with its terms. At Landlord's request, Tenant shall provide Landlord with corporate resolutions or other proof in a form acceptable to Landlord, authorizing the execution of the Lease.

**C. Brokers:** Tenant represents it has not utilized or contacted a real estate broker or finder with respect to this Lease other than Colliers International and Tenant agrees to indemnify, defend and hold Landlord harmless against any claim, cost, liability or cause of action asserted by any other broker or finder claiming through Tenant. Landlord shall be responsible for commissions payable to Colliers International in accordance with a separate agreement between Landlord and Colliers International

**D. Choice of Law:** This Lease shall be governed by and construed in accordance with California law. Except as provided in Section 20.E, venue shall be Santa Clara County.

**E. Dispute Resolution :** Landlord and Tenant and any other party that may become a party to this Lease or be deemed a party to this Lease including any subtenants agree that, except for any claim by Landlord for unlawful detainer, or any claim within the jurisdiction of the small claims court (which small claims court shall be the sole court of competent jurisdiction), any controversy, dispute, or claim of whatever nature arising out of, in connection with or in relation to the interpretation, performance

or breach of this Lease, including any claim based on contract, tort, or statute, shall be resolved at the request of any party to this agreement through a two-step dispute resolution process administered by J.A.M.S. or another judicial mediation service mutually acceptable to the parties located in Santa Clara County, California. The dispute resolution process shall involve first, mediation, followed, if necessary, by final and binding arbitration administered by and in accordance with the then existing rules and practices of J.A.M.S. or other judicial mediation service selected. In the event of any dispute subject to this provision, either party may initiate a request for mediation and the parties shall use reasonable efforts to promptly select a J.A.M.S. mediator and commence the mediation. In the event the parties are not able to agree on a mediator within thirty (30) days, J. A. M. S. or another judicial mediation service mutually acceptable to the parties shall appoint a mediator. The mediation shall be confidential and in accordance with California Evidence Code § 1119 et. seq. The mediation shall be held in Santa Clara County, California and in accordance with the existing rules and practice of J. A. M. S. (or other judicial and mediation service selected). The parties shall use reasonable efforts to conclude the mediation within sixty (60) days of the date of either party's request for mediation. The mediation shall be held prior to any arbitration or court action (other than a claim by Landlord for unlawful detainer or any claim within the jurisdiction of the small claims court which are not subject to this mediation/arbitration provision and may be filed directly with a court of competent jurisdiction). In order for the prevailing party to be entitled to the payment of attorney's fees, the prevailing party must have followed the provisions of this section and have attempted to mediate any dispute prior to invoking arbitration.

IF A MEDIATION IS CONDUCTED BUT IS UNSUCCESSFUL, IT SHALL BE FOLLOWED BY FINAL AND BINDING ARBITRATION ADMINISTERED BY AND IN ACCORDANCE WITH THE THEN EXISTING RULES AND PRACTICES OF J.A.M.S. OR THE OTHER JUDICIAL AND MEDIATION SERVICE SELECTED, AND JUDGMENT UPON ANY AWARD RENDERED BY THE ARBITRATOR(S) MAY BE ENTERED BY ANY STATE OR FEDERAL COURT HAVING JURISDICTION THEREOF AS PROVIDED BY CALIFORNIA CODE OF CIVIL PROCEDURE SECTION 1280 ET. SEQ, AS SAID STATUTES THEN APPEAR, INCLUDING ANY AMENDMENTS TO SAID STATUTES OR SUCCESSORS TO SAID STATUTES OR AMENDED STATUTES, EXCEPT THAT IN NO EVENT SHALL THE PARTIES BE ENTITLED TO PROPOUND INTERROGATORIES OR REQUEST FOR ADMISSIONS DURING THE ARBITRATION PROCESS. THE ARBITRATOR SHALL BE A RETIRED JUDGE OR A LICENSED CALIFORNIA ATTORNEY. THE VENUE FOR ANY SUCH ARBITRATION OR MEDIATION SHALL BE IN SANTA CLARA COUNTY, CALIFORNIA.

NOTICE: BY INITIALING IN THE SPACE BELOW YOU ARE AGREEING TO HAVE ANY DISPUTE ARISING OUT OF THE MATTERS INCLUDED IN THE "MEDIATION AND ARBITRATION OF DISPUTES" PROVISION DECIDED BY NEUTRAL ARBITRATION AS PROVIDED BY CALIFORNIA LAW AND YOU ARE GIVING UP ANY RIGHTS YOU MIGHT POSSESS TO HAVE THE DISPUTE LITIGATED IN A COURT OR JURY TRIAL. BY INITIALING IN THE SPACE BELOW YOU ARE GIVING UP YOUR JUDICIAL RIGHTS TO DISCOVERY AND APPEAL, UNLESS THOSE RIGHTS ARE SPECIFICALLY INCLUDED IN THE "MEDIATION AND ARBITRATION OF DISPUTES" PROVISION. IF YOU REFUSE TO SUBMIT TO ARBITRATION AFTER AGREEING TO THIS PROVISION, YOU MAY BE COMPELLED TO ARBITRATE UNDER THE AUTHORITY OF THE CALIFORNIA CODE OF CIVIL PROCEDURE. YOUR AGREEMENT TO THIS ARBITRATION PROVISION IS VOLUNTARY.

WE HAVE READ AND UNDERSTAND THE FOREGOING AND AGREE TO SUBMIT DISPUTES ARISING OUT OF THE MATTERS INCLUDED IN THE "MEDIATION AND ARBITRATION OF DISPUTES" PROVISION TO NEUTRAL ARBITRATION.

LANDLORD:           TENANT:

**F. Entire Agreement:** This Lease and the exhibits attached hereto contain all of the agreements and conditions made between the Parties hereto and may not be modified orally or in any other manner

other than by written agreement signed by all parties hereto or their respective successors in interest. This Lease supersedes and revokes all previous negotiations, letters of intent, lease proposals, brochures, agreements, representations, promises, warranties, and understandings, whether oral or in writing, between the parties or their respective representatives or any other person purporting to represent Landlord or Tenant.

**G. Entry by Landlord:** Upon prior notice to Tenant and subject to Tenant's reasonable security regulations, Tenant shall permit Landlord and his agents to enter into and upon the Premises at all reasonable times, and without any rent abatement or reduction or any liability to Tenant for any loss of occupation or quiet enjoyment of the Premises thereby occasioned, for the following purposes: (i) inspecting and maintaining the Premises; (ii) making repairs, alterations or additions to the Premises; (iii) erecting additional building(s) and improvements on the land where the Premises are situated or on adjacent land owned by Landlord; (iv) performing any obligations of Landlord under the Lease including remediation of Hazardous Materials if determined to be the responsibility of Landlord, (v) posting and keeping posted thereon notices of non-responsibility for any construction, alteration or repair thereof, as required or permitted by any law, and (vi) showing the Premises to Landlord's or the Master Landlord's existing or potential successors, purchaser, tenants and lenders. Tenant shall permit Landlord and his agents, at any time within twelve (12) months prior to the Expiration Date (or at any time during the Lease if Tenant is in default hereunder), to place upon the Premises "For Lease" signs and exhibit the Premises to real estate brokers and prospective tenants at reasonable hours. Notwithstanding anything in this Lease to the contrary, any entry by Landlord in the Premises or upon Lot A shall be designed to minimize interruption to Tenant's ongoing operations.

**H. Estoppel Certificates:** At any time during the Lease Term, Tenant or Landlord, as applicable shall, within ten (10) days following written notice from the other, execute and deliver to the requesting party a written statement certifying, if true, the following: (i) that this Lease is unmodified and in full force and effect (or, if modified, stating the nature of such modification); (ii) the date to which rent and other charges are paid in advance, if any; (iii) acknowledging that there are not, to the certifying party's knowledge, any uncured defaults on Landlord's or Tenant's part, as applicable, hereunder (or specifying such defaults if they are claimed); and (iv) such other information as Landlord or Tenant, as applicable, may reasonably request. Any such statement may be conclusively relied upon by any prospective purchaser or encumbrancer of Landlord's interest in the Premises. Tenant's failure to deliver such statement within such time shall be conclusive upon the Tenant that this Lease is in full force and effect without modification, except as may be represented by Landlord, and that there are no uncured defaults in Landlord's performance. To extent Tenant is not a publicly traded company. Tenant agrees to provide, within five (5) days of Landlord's request, Tenant's most recent three (3) years of audited financial statements for Landlord's use in financing or sale of the Premises or Landlord's interest therein.

**I. Exhibits:** All exhibits referred to are attached to this Lease and incorporated by reference.

**J. Interest:** All rent due hereunder, if not paid when due, shall bear interest at the rate of the Reference Rate published by Bank of America, San Francisco Branch, plus two percent (2%) per annum from that date until paid in full ("Agreed Interest Rate"). This provision shall survive the expiration or sooner termination of the Lease. Despite any other provision of this Lease, the total liability for interest payments shall not exceed the limits, if any, imposed by the usury laws of the State of California. Any interest paid in excess of those limits shall be refunded to Tenant by application of the amount of excess interest paid against any sums outstanding in any order that Landlord requires. If the amount of excess interest paid exceeds the sums outstanding, the portion exceeding those sums shall be refunded in cash to Tenant by Landlord. To ascertain whether any interest payable exceeds the limits imposed, any non-principal payment (including late charges) shall be considered to the extent permitted by law to be an expense or a fee, premium, or penalty rather than interest.

**K. Modifications Required by Lender:** If any lender of Landlord or ground lessor of the Premises requires a modification of this Lease that will not increase Tenant's cost or expense or materially or

adversely change Tenant's rights and obligations, Tenant agrees to execute whatever reasonable documentation is required to effectuate and modification and deliver them to Landlord within ten (10) days after the request.

**L. No Presumption Against Drafter:** Landlord and Tenant understand, agree and acknowledge that this Lease has been freely negotiated by both Parties; and that in any controversy, dispute, or contest over the meaning, interpretation, validity, or enforceability of this Lease or any of its terms or conditions, there shall be no inference, presumption, or conclusion drawn whatsoever against either party by virtue of that party having drafted this Lease or any portion thereof.

**M. Notices:** All notices, demands, requests, or consents required to be given under this Lease shall be sent in writing by U.S. certified mail, return receipt requested, nationally recognized overnight courier service or by personal delivery addressed to the party to be notified at the address for such party specified in Section 1 of this Lease, or to such other place as the party to be notified may from time to time designate by at least fifteen (15) days prior notice to the notifying party.

**N. Property Management:** In the event Tenant is not the tenant of Building 1, then upon occupancy of another tenant of Building 1 (excluding, however any tenancy by or through Tenant), Tenant agrees to pay Landlord along with the expenses to be reimbursed by Tenant a monthly fee for management services rendered by either Landlord or a third party manager engaged by Landlord (which may be a party affiliated with Landlord), in the amount of two percent (2.0%) of the Base Monthly Rent. Except as provided herein, no management fee shall be due by Tenant to Landlord.

**O. Rent:** All monetary sums due from Tenant to Landlord under this Lease, including, without limitation those referred to as "additional rent", shall be deemed as rent.

**P. Representations:** Except for the provisions of this Lease, Tenant acknowledges that neither Landlord nor any of its employees or agents have made any agreements, representations, warranties or promises with respect to the Premises or with respect to present or future rents, expenses, operations, tenancies or any other matter. Except as herein expressly set forth herein, Tenant relied on no statement of Landlord or its employees or agents for that purpose.

**Q. Rights and Remedies:** Subject to Section 14 above, All rights and remedies hereunder are cumulative and not alternative to the extent permitted by law, and are in addition to all other rights and remedies in law and in equity.

**R. Severability:** If any term or provision of this Lease is held unenforceable or invalid by a court of competent jurisdiction, the remainder of the Lease shall not be invalidated thereby but shall be enforceable in accordance with its terms, omitting the invalid or unenforceable term.

**S. Submission of Lease:** Submission of this document for examination or signature by the parties does not constitute an option or offer to lease the Premises on the terms in this document or a reservation of the Premises in favor of Tenant. This document is not effective as a lease or otherwise until executed and delivered by both Landlord and Tenant.

**T. Subordination:** Landlord represents to Tenant that the Premises will be unencumbered by a real estate loan as of the Effective Date. Landlord shall cause any future lender to furnish to Tenant, within sixty (60) days of the date of both parties' execution of this Lease, or placement of a lien by lender on the property, as applicable, with a written agreement providing for (i) recognition by the lender of all of the terms and conditions of this Lease; and (ii) continuation of this Lease upon foreclosure of existing lender's security interest in the Premises. Subject to the above, this Lease is subject and subordinate to ground and underlying leases, mortgages and deeds of trust (collectively "Encumbrances") which may now affect the Premises, to any covenants, conditions or restrictions of record, and to all renewals, modifications, consolidations, replacements and extensions thereof; provided, however, if the holder or holders of any such Encumbrance ("Holder") require that this Lease be prior and superior thereto, within seven (7) days after written request of Landlord to Tenant, Tenant shall execute, have acknowledged and deliver all documents or instruments, in the reasonable form presented to Tenant, which Landlord or Holder reasonably deems necessary or desirable for such

purposes. Landlord shall have the right to cause this Lease to be and become and remain subject and subordinate to any and all Encumbrances which are now or may hereafter be executed covering the Premises or any renewals, modifications, consolidations, replacements or extensions thereof, for the full amount of all advances made or to be made thereunder and without regard to the time or character of such advances, together with interest thereon and subject to all the terms and provisions thereof; provided only, that in the event of termination of any such lease or upon the foreclosure of any such mortgage or deed of trust, Holder agrees to recognize and not disturb Tenant's rights under this Lease as long as Tenant is not then in default (beyond applicable cure periods) and continues to pay Base Monthly Rent and additional rent and observes and performs all required provisions of this Lease. Within ten (10) days after Landlord's written request, Tenant shall execute any reasonable documents required by Landlord or the Holder to make this Lease subordinate to any lien of the Encumbrance so long as such documents provide for (i) recognition by the Holder of all of the terms and conditions of this Lease; and (ii) continuation of this Lease upon foreclosure on the Encumbrance. If Tenant fails to do so, then in addition to such failure constituting a default by Tenant, it shall be deemed that this Lease is so subordinated to such Encumbrance. Notwithstanding anything to the contrary in this Section, subject to agreement not to disturb, Tenant hereby attorns and agrees to attorn to any entity purchasing or otherwise acquiring the Premises at any sale or other proceeding or pursuant to the exercise of any other rights, powers or remedies under such encumbrance.

**U. Survival of Indemnities:** All indemnification, defense, and hold harmless obligations of Landlord and Tenant under this Lease shall survive the expiration or sooner termination of the Lease.

**V. Time:** Time is of the essence hereunder.

**W. Transportation Demand Management Programs :** Tenant agrees that the cost of TDM (Transportation Demand Management) programs required on the Premises shall be paid by Tenant and that the cost of any TDM that is available for use by Lot B (or another tenant of Building 1, if any) shall be shared on a proportionate of use basis. Further, any ongoing costs or expenses associated with a TDM program which are required for the Project and not provided by Tenant, such as an on-site TDM coordinator, shall be provided by Landlord with such costs being included as additional rent and Tenant's proportionate share shall be reimbursed to Landlord by Tenant within thirty (30) days after demand in accordance with Section 8 above. As of the date of this Lease, the TDM programs which have been imposed are: (i) provision EcoPasses to any full time employee who requests one, (ii) provision of a wireless network connection for employees in the courtyard, and (iii) the agreement to allow the police department to install a small antenna on the roof of the Building.

**X. Waiver of Right to Jury Trial:** Landlord and Tenant waive their respective rights to trial by jury of any contract or tort claim, counterclaim, cross-complaint, or cause of action in any action, proceeding, or hearing brought by either party against the other on any matter arising out of or in any way connected with this Lease, the relationship of Landlord and Tenant, or Tenant's use or occupancy of the Premises, including any claim of injury or damage or the enforcement of any remedy under any current or future law, statute, regulation, code, or ordinance.

**Y. Memorandum of Lease** Tenant agrees not to record this Lease, but may record the memorandum of lease attached hereto as Exhibit F on both Lots 1 and Lots 2.

**Z. Approvals and Expenses .** Whenever the Lease requires an approval, consent or other action by either Landlord or Tenant, such approval, consent or action shall not be unreasonably withheld, conditioned or delayed. Any reimbursable expenditure shall be limited to the actual and reasonable amount of such expenditure.

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**IN WITNESS WHEREOF** , Landlord and Tenant have executed this Lease on the day and year first above written.

**Landlord:** SOBRATO LAND HOLDINGS  
a California Limited Partnership

**Tenant:** NETFLIX, INC.  
a Delaware Corporation

By: /s/ John M. Sobrato  
\_\_\_\_\_

Its: General Partner

By: /s/ David Hyman  
\_\_\_\_\_

Its: General Counsel

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**EXHIBIT "A" – Premises & Building**

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**EXHIBIT “B” – Declaration**

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**EXHIBIT “C” – Building Shell Plans and Specifications**

*to be attached following lease execution*

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## **EXHIBIT “D” – Building Shell Definition**

### **1. Site and Shell:**

All permits and fees required for approval, permits, use, and governmental sign-off. All landscape, site work, lighting, paving, and signage, utilities stubbed into the Building Shell to appropriate areas as agreed by the Parties. Common Area site landscape irrigation and site electrical will be separately metered by common house site and water meters. Work includes all vaults, fees, backflow and monitoring devices. Landlord to provide 2 – 4” phone conduits and 2 – 4” private fiber conduits to a designated spot in the building (MPOE).

### **2. Garage:**

All work related to the construction of the garage including compliance to all codes including ADA and Title 24 but shall not include elevators nor elevator lobbies and finishes which work shall be part of the Tenant Improvements. Landlord to provide garage drainage system, domestic water hose bibs, convenience electrical, including car chargers if required by the Town. Garage electrical including transformers and panels for lighting, convenience power and ventilation, will be stubbed into electrical room for final connection by Tenant. All finishes, perimeter painting, signage, garage floor sealer concrete finished access and egress stairs, doors with electronically locking hardware (system by Tenant), automatic CO2 system and mechanical venting, all lighting to code levels. Separate fire riser and fully monitored fire sprinkler system (monitoring system by Tenant). Landlord to provide rollup/tilt up gates, with time clocks and loop detection, and cable rails with safety devices at ramp edge. Except as specifically provided herein, all work required for a garage final inspection.

### **3. Shell:**

All work required to obtain a shell permit final inspection (not a TCO for occupancy). All work shall conform to local building codes, ADA and Title 24 for the shell. Exterior doors to have electronic hardware (system provided by Tenant). Stairs for access and egress with one set to the roof. Interior walls to be furred out above and below windows. Fire riser and complete shell system, including “up heads” with capped tees for Tenant improvements at all floors and roof, monitors and PIV (monitoring system by Tenant). Provided shaft locations and HVAC equipment are determined prior to steel fabrication, steel framework shall be designed to accommodate shaft and elevator openings and mechanical support and leveling pads at no cost to Tenant. Complete sewer “gut line” under podium slab connecting restroom cores to site utility.

### **4. Electrical:**

All primary and secondary electrical service from the street to a location in building or garage, transformer pad, and house meter section. All wiring of Common Area devices including meter, feeders, transformer, and distribution, such as: lighting, site amenities and landscape irrigation. Communication and monitoring conduits as described above.

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**EXHIBIT “E” – Tenant Improvement Plans and Specifications**

*To be attached when completed*

**EXHIBIT F – Memorandum of Lease**

**RECORDING REQUESTED BY AND WHEN RECORDED RETURN TO:**

Wilson Sonsini Goodrich & Rosati  
650 Page Mill Road  
Palo Alto, California 94304-1050  
ATTENTION: Real Estate Department/DKK

**MEMORANDUM OF LEASE AND OPTIONS**

THIS MEMORANDUM is made as of the \_\_\_\_\_ day of \_\_\_\_\_, 2006, by and between SOBRATO LAND HOLDINGS, a California limited partnership (“Landlord”), and NETFLIX, INC., a Delaware corporation (“Tenant”), with reference to the following facts and objectives:

A. Landlord and Tenant entered that certain unrecorded Lease (the “Lease”) dated \_\_\_\_\_, 2006, regarding the real estate located on Winchester Boulevard in Los Gatos, Santa Clara County, California, more particularly described on *Exhibit “A”* attached hereto and made a part hereof (the “Land”).

B. Landlord and Tenant mutually desire to give public notice of the existence of the Lease and the rights and options of Tenant thereunder.

NOW, THEREFORE, in consideration of the premises and mutual covenants contained in the Lease and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Landlord and Tenant hereby agree as follows:

1. Landlord hereby leases to Tenant, and Tenant hereby leases from Landlord, on the terms and conditions of the Lease the “Building” described in the Lease to be constructed by Landlord on the portion of the Land described on *Exhibit “B”* attached hereto, together with all rights, privileges, easements and appurtenances thereunto appertaining.

2. Landlord and Tenant acknowledge that the term of the Lease will be for a term of sixty (60) months commencing upon substantial completion of the Building Shell and Tenant Improvements (as described in the Lease). Landlord hereby grants Tenant four (4) options to extend the Lease Term for additional terms. The first two (2) option terms shall be for a period of thirty six (36) months each and the second two (2) Option Terms shall be for sixty (60) months each.

3. Landlord hereby grants Tenant the first right, option and opportunity to purchase the Premises on the terms and conditions provided in the Lease.

4. All capitalized terms used herein shall have the meanings ascribed to them in the Lease. The purpose of this Memorandum is to give public notice of the existence of the Lease and the rights and options of Tenant thereunder. In the event, however, of any inconsistency between this Memorandum and the terms and conditions of the Lease, the Lease shall prevail.

IN WITNESS WHEREOF, Landlord and Tenant have executed this Memorandum of Lease and Options, by their duly-authorized representatives, as of the day and year first above written.

*LANDLORD:*

SOBRATO LAND HOLDINGS,  
a California limited partnership

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

John Michael Sobrato  
Managing General Partner

*TENANT:*

NETFLIX, INC.,  
a Delaware corporation

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

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

Title: \_\_\_\_\_

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State of California )

) ss.

County of )

On \_\_\_\_\_, 2004, before me, \_\_\_\_\_, personally appeared JOHN MICHAEL SOBRATO, personally known to me or proved to me on the basis of satisfactory evidence, to be the person whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his authorized capacity and that by his signature on the instrument the person, or the entity upon behalf of which the person acted, executed the instrument.

WITNESS my hand and official seal.

\_\_\_\_\_  
Notary Public

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State of California )

) ss.

County of )

On \_\_\_\_\_, 2004, before me, \_\_\_\_\_, personally appeared \_\_\_\_\_, personally known to me or proved to me on the basis of satisfactory evidence, to be the person whose name is subscribed to the within instrument and acknowledged to me that he executed the same in his authorized capacity and that by his signature on the instrument the person, or the entity upon behalf of which the person acted, executed the instrument.

WITNESS my hand and official seal.

\_\_\_\_\_  
Notary Public

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Reed Hastings, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Netflix, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) 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 registrant's board of directors (or persons performing the equivalent function):
  - 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.

Dated: August 8, 2006

By: \_\_\_\_\_ / s / R E E D H A S T I N G S

**Reed Hastings  
Chief Executive Officer**



