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**COPY**

**EXCELSIOR ENERGY INC. \$8,000,000**  
**CONVERTIBLE DEBENTURE AGREEMENT**

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**STATE OF MINNESOTA  
OFFICE OF THE COMMISSIONER OF  
IRON RANGE RESOURCES AND REHABILITATION**

**EXCELSIOR ENERGY INC.  
\$8,000,000 CONVERTIBLE DEBENTURE  
AGREEMENT**

*THIS AGREEMENT* is made by and between the State of Minnesota acting by and through its **Office of the Commissioner of Iron Range Resources and Rehabilitation**, with offices at 4261 Highway 53 South, P.O. Box 441, Eveleth, Minnesota 55734-0441 (Telephone Number: (218) 744-7400; FAX Number: (218) 744-7402) ("**State**") and **Excelsior Energy Inc.**, a Minnesota business corporation ("**Company**"), with its principal offices at 11100 Wayzata Boulevard, Suite 305, Minnetonka, Minnesota 55305 (Telephone Number: (952) 847-2360; FAX Number: (952) 847-2373; and shall become effective upon the date on which this Agreement is executed by the last State official whose signature is required below.

**RECITALS**

*WHEREAS*, the State is empowered to use the monies appropriated to the Commissioner of Iron Range Resources and Rehabilitation of the State of Minnesota ("**Commissioner**") under Minnesota Statutes Section 298.22 to participate with private sources in providing financing for various projects within or for the benefit of the Taconite Assistance Area (the "**TAA**") defined in Minnesota Statutes Section 273.1341, and

*WHEREAS*, Company has made Application to the State for a Loan of \$8,000,000 for the purpose of providing a portion of the funds necessary to develop and license an integrated gasification combined cycle ("**IGCC**") electrical power generation plant and transmission facilities in the TAA as more fully described herein; and

*WHEREAS*, the principal of the Loan is convertible by the State into shares of Common Stock of Company at a conversion price equal to 80% of the Average Price paid for Common Stock from the Closing Date through the Project Closing Date; and

*WHEREAS*, the use of the proceeds from the Loan will be as set forth herein and will not be used for lobbying expenses; and



*WHEREAS*, the Company has requested such debt funding to be in the form of a Convertible Debenture, as hereinafter defined, and the Commissioner has determined that it would be in the best interests of the State to provide such funding; and

*WHEREAS*, the Commissioner, the Board at its June 30, 2004, meeting, and the Governor by his approval of the Project have each determined, in accordance with Minnesota Statutes Sections 298.28, subd. 7 and 298.223, subd. 2, that the proposed funding of the Project is authorized under the said statute and have approved the said Company's Application for public monies conditioned upon the receipt of certain documents and the fulfillment of certain conditions as more fully described below; and

*WHEREAS*, the parties hereto desire to more fully describe and specify the terms and conditions under which the said Loan will be made and thereafter administered and the terms and conditions with respect to the conversion of the principal of the Loan into Common Stock (Conversion Stock) and the rights of the holders of record of said Conversion Stock upon issuance.

*NOW, THEREFORE*, IT IS AGREED BY AND BETWEEN THE PARTIES HERETO AS FOLLOWS:

## **1 DEFINITIONS**

1.1. **Defined Terms.** As used in this Agreement, the following terms shall have the following respective meanings (and such meanings shall be equally applicable to both the singular and the plural forms of the terms defined, as the context may require):

1.1.1. "Agreement" means this \$8,000,000 Convertible Debenture Agreement as it may be amended, restated, supplemented or otherwise modified from time to time.

1.1.2. "Anniversary Date" means that month and day in each year after the Closing Date during the term of this Agreement that is the same month and day as the month and day on which the Closing Date occurred.

1.1.3. "Application" means all of the documented materials submitted by Company to the State requesting and in support of its request for all or any part of the Loan which is the subject of this Agreement.

1.1.4. "Articles" means the Articles of Incorporation of the Company as of closing attached hereto as Exhibit A.

1.1.5. "Average Price" means the price determined by dividing the total number of shares sold by the total dollars received for the shares, adjusted for stock splits or reverse

splits.

- 1.1.6. "Business Days" means any day excluding Saturday, Sunday and any day which is a legal holiday under the laws of the State of Minnesota.
- 1.1.7. "Capital Stock" means Common Stock, Preferred Stock, and any other class of stock now or hereafter authorized by the Company.
- 1.1.8. "Closing" is defined as the closing of the purchase and sale of the Debenture hereunder.
- 1.1.9. "Closing Date" means that date on which the Debenture is executed or this Agreement becomes effective, whichever such date shall occur last.
- 1.1.10. "Code" means the Internal Revenue Code of 1986, as amended, and the Treasury Regulations thereunder.
- 1.1.11. "Commission" means the Securities and Exchange Commission.
- 1.1.12. "Commissioner" means the Commissioner of Iron Range Resources and Rehabilitation of the State of Minnesota.
- 1.1.13. "Common Stock" means the shares of common stock authorized by the Articles, any additional shares of common stock which may be authorized in the future by the Company, and any stock into which such Common Stock may hereafter be changed, and shall also include Capital Stock of any other class of the Company which is not preferred as to dividends or assets over any other class of stock of the Company.
- 1.1.14. "Company" means Excelsior Energy Inc., a Minnesota business corporation, and its successors and assigns.
- 1.1.15. "Conversion Price" means that price that is equal to 80% of the Average Price of Common Stock from the Closing Date through the date of conversion.
- 1.1.16. "Conversion Stock" means Common Stock issued pursuant to the conversion of the Debenture.
- 1.1.17. "Current Directors" means Thomas Micheletti and Julie Jorgensen.



- 1.1.18. "Debenture" means that certain convertible debenture issued by the Company to the State evidencing the Company's Obligation to repay the Loan, the principal of such loan being convertible, on or after the Project Closing Date, at the option of the State in whole or in part into shares of Common Stock of the Project Company, including any amendments, restatements, substitutions, supplements or modifications from time to time thereof.
- 1.1.19. "Default" means a condition, act or event that, after notice or lapse of time or both, would constitute an Event of Default if that condition or event were not cured or removed within any applicable grace or cure period.
- 1.1.20. "Disclosure Schedule" is defined in Article 5 hereof and in Exhibit B to this Agreement.
- 1.1.21. "Due Date" means the earlier of: the fifteenth (15<sup>th</sup>) annual anniversary of the Closing Date; such other Due Date as may be specified in the Debenture; or such accelerated date upon which the entire outstanding balance of principal and accrued interest then due under the Debenture may become due and payable as a result of the occurrence of an Event of Default.
- 1.1.22. "Immediately Available Funds" means lawful money of the United States of America which are funds with good value on the day and in the city in which payment is received.
- 1.1.23. "Know", "Knowledge" or "Knowing of" means to be aware of the truth or factually of the matter to which it refers and includes matters of which a normally prudent businessperson would be aware. When used with respect to the Company it includes the Current Directors.
- 1.1.24. "Liabilities" shall have the meaning given that term in accordance with GAAP.
- 1.1.25. "Lien" means any lien, mortgage, pledge, security interest, charge or encumbrance of any kind, whether voluntary or involuntary, (including any conditional sale or other title retention agreement, any lease in the nature thereof, and any agreement to give any security interest).
- 1.1.26. "Loan" means that loan made by the State to Company pursuant to this Agreement in the original principal amount of Eight Million Dollars (\$8,000,000) as more fully described in Article 3, the obligation for repayment of which is evidenced by the Debenture.
- 1.1.27. "Loan Documents" means this Agreement, the Debenture and those instruments, documents and agreements executed by or on behalf of Company and delivered

concurrently herewith or at any time hereafter to or for the benefit of the State in connection with the Project, including subsequent amendments, restatements, supplements or modifications thereof from time to time.

- 1.1.28. "Loan Proceeds" means the proceeds of the Loan as disbursed to the Company by the State.
- 1.1.29. "Obligation" means all obligations, Liabilities and indebtedness of any kind of Company from time to time owed to State under this Agreement including the principal amount of all debts, claims and indebtedness, accrued and unpaid interest and all fees, costs and expenses, whether primary, secondary, direct, contingent, fixed or otherwise, heretofore, now and/or from time to time hereafter owing, due or payable including, without limitation, all interest, fees, cost and expenses accrued or incurred after the filing of any petition under any bankruptcy or insolvency law.
- 1.1.30. "Person" means and includes natural persons, corporations, limited partnerships, general partnerships, limited liability companies, joint stock companies, joint ventures, associations, companies, trusts, banks, trust companies, land trusts, business trusts or other organizations, whether or not legal entities, and governments and agencies and political subdivisions thereof.
- 1.1.31. "Project" means the use of loan proceeds to develop and license an integrated gasification combined cycle (IGCC) electrical power generation plant and electric transmission facilities in the TAA, to include: evaluating potential sites, environmental analysis, environmental impact statement preparation, licensing, project engineering, transmission development and analysis, and certain project development, consultant, legal, regulatory, personnel and office expenses directly related to locating and developing the power plant in the TAA.
- 1.1.32. "Project Closing Date" shall mean the date on which the Project Company has entered into agreements to fund, in debt and equity, at least 30 percent of the total costs of the Project and all conditions to such funding have been satisfied.
- 1.1.33. "Project Company" shall mean the Company or, if applicable, the entity formed for purposes of owning the Project.
- 1.1.34. "Project Costs" means all those costs reasonably and necessarily related to the Project, provided that the salaries of the two principal shareholders of Company shall not be paid or reimbursed from funding under this Agreement and must be funded from the proceeds of Third Party Cash Funding. Funds disbursed under this Agreement may not be used for



lobbying but can be used in connection with any costs associated with the Project, including, but not limited to, Project development and engineering, regulatory and administrative activities in connection with power plant and transmission line siting and licensing, environmental impact statement filings and proceedings, power purchase agreements, public utility commission proceedings, federal activities, and all other regulatory or environmental approvals associated with the Project. The Project Cost Budget as of the Closing Date is attached as Exhibit I. The Company may update the Project Cost Budget from time to time to take into account the needs of the Project upon notice to the State and delivery of an updated Project Cost Budget.

1.1.35. "Securities" means the Debenture and Conversion Stock.

1.1.36. "Securities Act" means the Securities Act of 1933, as amended from time to time.

1.1.37. "State" means the State of Minnesota acting by and through its Office of the Commissioner of Iron Range Resources and Rehabilitation or its assigns, or any successor agency of the State of Minnesota to which its powers in regard the Loan, the Debenture and the Conversion Shares or the statutory funding source for the Loan may subsequently be delegated by statute.

1.1.38. "Third Party Cash Funding" means all cash funding provided to Company by third parties, including equity investments, cash grants, loans, or other forms of cash funding. Federal funding, including \$36 million of funding under the Department of Energy's Clean Coal Power Initiative, will qualify as Third Party Cash Funding, and will be deemed received by the Company as of October 26, 2004, the date the Department of Energy announced its selection of the Company as a recipient of an award under the Clean Coal Power Initiative.

1.2. **Accounting Terms and Calculations.** Except as may be expressly provided to the contrary herein, all accounting terms used herein shall be interpreted and all accounting determinations hereunder shall be made in accordance with GAAP. To the extent any change in GAAP affects any computation or determination required to be made pursuant to this Agreement, such computation or determination shall be made as if such change in GAAP had not occurred, unless Company and the State agree in writing on an adjustment to such computation or determination to account for such change in GAAP.

1.3. **Other Definitional Terms.** The words "hereof", "herein" and "hereunder" and words of similar import when used in this Agreement shall refer to this Agreement as a whole and not to any particular provision of this Agreement. Unless otherwise expressly provided, references to



Sections, Exhibits, and schedules and like references are to this Agreement and references to an Article or Section constitute reference to all subsections included thereunder.

## **2 GENERAL PURPOSE AND FINANCING PLAN**

- 2.1. Actions by Company.** Company will use the Loan Proceeds to pay or reimburse Project Costs.
- 2.2. Actions by State.** Subject to the terms and conditions provided below, the State will lend to Company up to \$8,000,000 for the purposes stated above, the obligation for repayment of which sum will be evidenced by the Debenture. Per the terms of Section 4.1 of this Agreement, the State may convert all or any portion of the principal balance of the Debenture into Common Stock of the Project Company at a conversion price equal to 80% of the Average Price paid for Common Stock from the Closing Date to and including the date of conversion, subject to adjustment as provided in Article 4.

## **3 DEBENTURE LOAN TERMS**

- 3.1. Loan and Term.** Subject to the terms and conditions of this Agreement, the State agrees to lend to Company and Company agrees to borrow from the State and to repay the State the sum of up to **Eight Million Dollars (\$8,000,000)** (the "Loan") for the purposes of paying or reimbursing Company for Project Costs. The obligation of Company to repay the Loan shall be evidenced by the Debenture of Company to be executed substantially in the form of the attached Exhibit AA, dated as of the Closing Date. The term of the Loan shall be from the Closing Date to the Due Date.
- 3.2. Interest.** The outstanding principal balance of the Debenture shall bear interest at the rate of **Twenty and No Hundredths Percent (20.00%)** simple interest per annum.
- 3.3. Repayment Provisions.** A payment of all accrued and unpaid interest is due on the fifth (5<sup>th</sup>) anniversary date. Beginning on the sixth (6<sup>th</sup>) anniversary date, and on each subsequent anniversary date, a payment of \$800,000 of principal plus all accrued and unpaid interest is due. On the fifteenth (15) anniversary date, all accrued and unpaid interest and remaining principal is due and payable. Payments due upon the Debenture shall be paid in Immediately Available Funds to the State at the address set forth below in Section 13.2 hereof at no later than 2:00 p.m. on each payment date as provided in the Debenture. In the event the principal of the Debenture is converted into Common Stock, any accrued interest upon that portion of the principal converted shall become immediately due and payable as of the date of such conversion.

**3.4. Application of Payments/Proceeds.** After providing the State a 45 day notice, the Company shall have the right to prepay, without penalty, any or the entire principal sum of the Debenture, at any time. All payments received by the State will be credited first toward accrued interest with the balance, if any, of the payment being applied toward reduction of the Debenture principal in inverse order of maturity of the installments due under the Debenture. In the event that an Event of Default as provided below shall have occurred and the State has exercised any remedy provided and made available to it in Article 12 hereof, the proceeds derived by the State from the exercise of such remedy shall be applied as follows:

3.4.1. First, to the payment to the State of all costs and proper expenses (including reasonable attorneys' fees), Liabilities incurred or advances made hereunder or by law or made under the Debenture;

3.4.2. Second, to the payment to State of the amount then owing or unpaid for principal and interest due on the Debenture and, in case any such proceeds shall be insufficient to pay the whole amount so due, then first to the payment of interest and then to the payment of principal of the Debenture;

3.4.3. Third, payment of any excess to Company or to whomever may be lawfully entitled to receive the same.

**3.5. Subordination.** The indebtedness, both principal and interest, evidenced by the Debenture is subordinate and junior in right of payment of Indebtedness for Borrowed Money of Company. Indebtedness for Borrowed Money is debt of Company to any federal or state charter bank or savings and loan association, insurance corporation, or any other institutional lender regularly engaged in the business of lending ("Institutional Lender") and any and all renewals or refinancing in full or in part irrespective of the amount of unpaid principal balance of such indebtedness and the amount borrowed in any subsequent financing, specifically excluding indebtedness payable to shareholders of the Company or their respective successors or assigns or affiliates of shareholders of the Company. Notwithstanding the foregoing, payments of principal and interest may be made upon the Debenture so long as there is no payment default upon Indebtedness for Borrowed Money. The Company specifically agrees that payment upon the Debenture of principal and interest shall not by agreement with any Institutional Lender constitute a default under the document evidencing the Indebtedness for Borrowed Money unless such Indebtedness for Borrowed Money is otherwise in default and such Institutional Lender has given notice of such default. Exercise of the right to convert the Debenture into Shares of Common Stock of the Company during a period of default upon Indebtedness for Borrowed Money shall not be deemed a prohibited payment hereunder.



3.6. **Security.** The Debenture is unsecured.

3.7. **Disbursement Procedures and Conditions.** Provided that the Company is not in Default hereunder, the Loan Proceeds shall be disbursed as follows:

3.7.1. **First Disbursement.** State shall (in a single, or multiple advances of at least \$25,000 (other than the last portion of this first disbursement)) disburse up to \$2,000,000 to reimburse the Company for invoiced Project Costs. The State is not obligated to make more than one disbursement per calendar month.

3.7.2. **Second Disbursement.** Upon the Company receiving sufficient Third Party Cash Funding, the State will, in single or in multiple advances of at least \$25,000 (other than the last portion of this second disbursement), disburse up to \$6,000,000 to reimburse the Company for invoiced Project Costs. The total disbursement under this section shall never exceed 1.5 times the amount of the Third Party Cash Funding received or deemed received by the Company as of such date. The State is not obligated to make more than one disbursement per calendar month.

3.8. **Default and Acceleration.** An Event of Default and Default are defined in Article 12 of this Agreement. Upon notice of an Event of Default and failure to cure the same as provided in Section 12.2, the entire unpaid principal balance and all accrued interest upon the Debenture becomes immediately due and payable.

3.9. **Conditions of the Loan.** In addition to the terms stated in the Debenture, the Loan shall be governed by the terms, conditions, rates and purposes stated in this Agreement which may not be modified without prior written approval of the State in the manner hereinafter provided for amendment of this Agreement. In the event of a conflict between the terms of this Agreement and the Debenture, the terms of the Agreement shall govern the rights and responsibilities of the parties.

#### **4 DEBENTURE CONVERSION TERMS**

4.1. **Conversion.** All or any portion of the principal of the Debenture may be convertible at the option of the holder thereof from time to time and at any time during the term of this agreement, on or after the Project Closing Date, into a number of shares of Common Stock of the Project Company, which is equal to the principal amount of the Debenture which is to be converted divided by the Conversion Price existing on the Conversion Date.

The Conversion Price shall be adjusted whenever the Company shall at any time hereafter subdivide or split its outstanding shares of common stock into a greater number of shares, or



combine the outstanding shares of Common Stock of the Company into a smaller number of shares. In the event that the Company shall at any time hereafter subdivide or split its outstanding shares of Common Stock into a greater number of shares, the Conversion Price in effect immediately prior to such subdivision or split shall be proportionately reduced and such Conversion Price as adjusted shall become the new Conversion Price. Conversely, in case the outstanding shares of Common Stock of the Company shall be combined into a smaller number of shares, the Conversion Price in effect immediately prior to such combination shall be proportionately increased and such adjusted Conversion Price shall become the new Conversion Price.

By way of example, if the most recent Conversion Price is \$5.00 and if the Company were to subdivide its shares by issuing one share of Common Stock for each share of Common Stock outstanding and thereby double the number of shares of Common Stock outstanding, the Conversion Price of \$5.00 prior to such subdivision would be proportionately reduced and the Conversion Price would be \$2.50. In a like manner, if the Company combined the outstanding Common Stock of the Company by reducing the outstanding Common Stock of the Company by 50%, the most recent Conversion Price of \$5.00 would be adjusted to \$10.00 per share.

In order to exercise the conversion privilege, the holder of the Debenture shall give written notice to the Company that the holder elects to convert all or a specified portion of the principal balance of the Debenture. The Debenture shall be deemed to have been converted to the extent specified in such written notice on the day of the delivery of such notice ("Conversion Date").

Upon the Conversion Date, the principal balance of the Debenture shall be reduced by the aggregate Conversion Price of the Common Stock acquired and such sum shall cease to be debt and the holder of the Debenture shall be treated for all purposes as a record holder of the shares of Common Stock issuable pursuant to such notice. As promptly as practical, on or after the Conversion Date, the Company shall issue by mail or deliver to such holder a certificate or certificates representing the number of shares of Common Stock issuable upon conversion, rounded to the nearest full share and a replacement Subordinated Convertible Debenture evidencing the remaining unpaid principal balance of the Debenture, if any, shall be issued to the holder of the Debenture upon surrender of the original Debenture.

**4.2. Conversion Adjustments.** The following provisions govern additional Common Stock to be received and other consideration to be received upon the conversion of the Debenture:

- 4.2.1. Dividends. In case the Company shall declare a dividend upon its shares of Common Stock payable otherwise than in cash out of earnings or surplus (including a dividend payable in shares of Common Stock), then thereafter each holder of the Debenture upon the conversion thereof will be entitled to receive the number of shares of Common Stock into which such Debenture shall be converted and, in addition and

without payment therefore, the cash, stock or other securities and other property (including Common Stock) which such holder would have received by way of dividends or distributions (otherwise than out of earnings or surplus) as if continuously since the record date for any such dividend or distribution such holder (i) had been the record holder of the number of shares of Common Stock into which the Debenture shall be convertible, and (ii) had retained all dividends or distributions in stock or securities payable in respect of such Common Stock or in respect of any stock or securities paid as dividends or distributions and originating directly or indirectly from such Common Stock.

4.2.2. Reorganizations. If any capital reorganization or reclassification of the capital stock of the Company or consolidation or merger of the Company with another corporation, or the sale of all or substantially all of its assets to another corporation shall be effected in such a way that holders of Common Stock shall be entitled to receive stock, securities or assets with respect to or in exchange for shares of Common Stock, then, as a condition of such reorganization, reclassification, consolidation, sale or merger and in lieu of the shares of Common Stock of the corporation immediately theretofore receivable upon the conversion of the Debenture, the holders of the Debenture shall be entitled upon conversion thereof to receive such shares of stock, securities or assets as may be issued or payable with respect to or in exchange for a number of outstanding shares of Common Stock equal to the number of shares of Common Stock immediately theretofore receivable upon the conversion of the Debenture had such reorganization, reclassification, consolidation, merger or sale not taken place. In any such case appropriate provision shall be made with respect to the rights and interests of the holders of the Debenture to the end that the provisions hereof (including without limitation provisions for adjustments of the Conversion Price for the Debenture and of the number of shares receivable upon the conversion of the Debenture) shall thereafter be applicable, as nearly as may be possible, in relation to any shares of stock, securities or assets thereafter receivable upon the conversion of the Debenture. The Company shall not effect any such consolidation, merger or sale, unless prior to the consummation thereof the surviving corporation (if other than this corporation), the corporation resulting from such consolidation or the Company purchasing such assets shall assume by written instrument executed and mailed to the registered holders of the Debenture at the last address of such holders appearing on the books of the Company, the obligation to deliver to such holders such shares of stock, securities or assets as, in accordance with the foregoing provisions, such holders may be entitled to receive.

## **5 REPRESENTATIONS AND WARRANTIES BY THE COMPANY**



Except as disclosed in the Disclosure Schedule attached hereto as Exhibit B (hereinafter referred to as the "Disclosure Schedule"), the Company represents and warrants to State that:

- 5.1. **Organization and Standing.** The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Minnesota, and has the requisite corporate power and authority to own its properties and to carry on its business as now being conducted. The Company has no subsidiaries or direct or indirect ownership interest in any firm, corporation, association or business.
- 5.2. **Articles.** On the Closing Date, the Articles of Incorporation of the Company shall be in the form of the Articles set forth in Exhibit A to this Agreement.
- 5.3. **Financial Statements.** The Company was incorporated under the laws of the State of Minnesota on August 14, 2001 (the "Inception Date"). At Closing, Company shall provide State with financial statements as of September 30, 2004 and a complete list of all presently outstanding obligations of the Company absolute, accrued or contingent whether due or to become due, (the "Closing Liabilities Listing"). As of the Closing Date, there shall not have been any material adverse change in the financial condition of the Company since the September 30, 2004, financial statements.
- 5.4. **Tax Returns.** The Company is not delinquent in the payment of any federal, state or local tax or in the filing of any tax return or in the payment of any assessment or governmental charge. The Company does not have any tax deficiency proposed or assessed against it and has not executed any waiver of any statute of limitations on the assessment or collection of any tax. To the Company's knowledge, the Company has not incurred any tax or worker's compensation liabilities from the Inception Date through the date hereof except those incurred in the ordinary course of business.
- 5.5. **Title to Properties and Encumbrances.** The Company has good and marketable title to all its material properties and assets, subject to no mortgage, pledge, lien, charge, security interest, encumbrance or restriction other than as disclosed on the Disclosure Schedule. The Company has not been threatened with any action or proceeding under any zoning or other ordinance, law or regulation.
- 5.6. **Litigation.** Except as listed in the Disclosure Schedule, there are no legal actions, suits, arbitrations or other legal, administrative or governmental proceedings pending or, to the knowledge of the Company, threatened against the Company or its properties, assets or business, and neither the Company nor any of its officers is aware of any facts which might result in or form the basis for any such action, suit or other proceedings. The Company is not



in default with respect to any judgment, order or decree of any court or any governmental agency or instrumentality. The foregoing includes, without limiting the generality thereof, actions pending, threatened or having a basis involving the prior employment of any of the Company's employees or their use in connection with the Company's business of any information or techniques allegedly proprietary to a former employer.

- 5.7. **Compliance With Other Instruments.** The business and operations of the Company have been and are being conducted in accordance with all applicable laws, rules and regulations of all authorities. Neither the execution or delivery of, nor the performance of or compliance with, the Agreement and the transactions contemplated thereby will, with or without the giving of notice or passage of time, result in any breach of, or constitute a default under, or result in the imposition of any lien or encumbrance upon any asset or property of the Company pursuant to any agreement or other instrument to which the Company is a party or by which it or any of its properties, assets or rights is bound or affected, or violate the Articles or Bylaws of the Company. The Company is not in violation of its Articles or Bylaws nor in violation of, or in material default under, any material lien, indenture, mortgage, lease, agreement, instrument, commitment or arrangement, or subject to any restriction which would prohibit the Company from entering into or performing its obligations under the Agreement.
- 5.8. **Conversion Stock.** The Common Stock issuable upon conversion of the Debenture ("Conversion Stock") when issued and paid for pursuant to the terms of the Agreement, will be duly and validly authorized, issued and outstanding, fully paid, nonassessable and free and clear of all pledges, liens, encumbrances and restrictions, except as set forth in Article 7 hereof, and the shares of Conversion Stock issuable upon conversion of the Debenture have been reserved for issuance and when issued upon conversion will be duly and validly authorized, issued and outstanding, fully paid, nonassessable and free and clear of all pledges, liens, encumbrances and restrictions, except as set forth in Article 7 hereof.
- 5.9. **Securities Laws.** Assuming the representations and warranties of the State contained in Section 6.1 of this Agreement are correct, no consent, authorization, approval, permit or order of or filing with any governmental or regulatory authority is required under current laws and regulations in connection with the execution and delivery of this Agreement or the offer, issuance, sale or delivery of the Debenture or the Conversion Stock, other than the qualification thereof, if required, under applicable state securities laws, which qualification has been or will be effected as a condition of these sales. The Company has not directly or through an agent, offered securities similar to the Debenture or the Conversion Stock for sale to, or solicited any offers to acquire such securities from, persons other than the State. Under the circumstances contemplated hereby, the offer, issuance, sale and delivery of the Debenture and the Conversion Stock will not under current laws and regulations require compliance with the prospectus delivery or registration requirements of the Securities Act.

The Capital Stock described in Section 5.11 is validly issued, authorized and outstanding and has been issued pursuant to an exemption from registration under applicable federal and state security laws.

5.10. **Patents and Other Intangible Rights.** To the knowledge of the Company, the Company owns all patents, trade names, service marks, trademarks and copyrights necessary to carry on its business as currently conducted. The Disclosure Schedule sets forth a list of all patents, trade names, service marks, trademarks and copyrights which the Company owns or is licensed to use. To the knowledge of the Company, the Company is not infringing upon or otherwise acting adversely to any known right or claimed right of any person under or with respect to any patents, patent rights, trademarks, service marks, copyrights, trade names or any other third party rights.

5.11. **Capital Stock and Stock Option Agreements.** Immediately prior to Closing, the authorized capital stock of the Company consists of 1,000 shares of Common Stock with no par value. Immediately prior to Closing, 300 shares of Common Stock were issued and outstanding. Exhibit C contains a complete list of all the shareholders of the company showing their names and addresses, the number of shares held, the date(s) such shares were acquired and the price paid for such shares.

5.12. **Shareholder Agreement.**

5.12.1. **Common Stockholder Agreement.** The Common Stock of the Company issued and outstanding as of the Closing and Common Stock issuable upon the exercise of any options shall be subject to a shareholder agreement among the Company and the existing shareholders and option holders of the Company which provides in substance:

5.12.1.1. If an existing shareholder or option holder receives an offer to purchase such shareholder's shares of Common Stock, such shares shall first be offered to the Company at such purchase price and upon the terms and conditions as set forth in such offer, provided, the Company may pay the offered price, at its election, in five equal annual installments plus interest at the rate of eight percent (8%) per annum, the first such payment to be due and payable upon the closing of such transaction.

5.12.1.2. The shareholder agreement described in this Section 5.12 shall terminate upon the closing of a public offering pursuant to an effective registration statement on Form S-1 (or any successor form) by the Company of its Common Stock in which the aggregate gross proceeds to the Company are at least 10



Million Dollars (\$10,000,000) and the public offering price is not less than Two and 50/100 Dollars (\$2.50) per share (as adjusted from time to time upon the occurrence of any subdivision, stock-split, combination or change of Common Stock into a different number of shares of the same or any other class or classes of shares).

**5.12.2. Preferred Stockholder Agreement.** None.

**5.13. No Other Equity.** Except as set forth in Section 10.15, 5.9, 5.11 and 5.12, and on the Exhibit C, there are no outstanding subscriptions, options, warrants, calls, contracts, demands, commitments, conversion rights or other agreements or arrangements of any character or nature whatever under which the Company is or may be obligated to issue its Common Stock, Preferred Stock or warrants or options to purchase Common Stock or Preferred Stock. No holder of any security of the Company is entitled to any preemptive or similar rights to purchase any securities of the Company except for the State.

**5.14. Outstanding Debt.** Except as disclosed in the Disclosure Schedule, the Company does not have any Indebtedness for Borrowed Money.

**5.15. Schedule of Assets and Contracts.** Prior to execution of this Agreement, the Company shall deliver to the State the Disclosure Schedule, containing:

5.15.1. a list of all real and personal property owned by the Company;

5.15.2. a list and copies of each indenture, lease, sublease or other instrument under which the Company claims or holds a leasehold interest in real property or personal property;

5.15.3. a list and copies of all executory contracts, agreements, purchase orders, commitments and arrangements, other than the Company's contracts with Credit Suisse First Boston and Conoco-Phillips that the Company believes contains particularly sensitive third-party information and which will be made available to the State at any time for inspection but copies will not be provided to the State as otherwise required herein;

5.15.4. a list and copies of all royalty and license agreements;

5.15.5. a list and copies of all collective bargaining agreements, employment and consulting agreements, executive compensation plans, profit sharing plans, bonus plans, deferred compensation agreements, employee pension or retirement plans and employee stock



option, stock purchase or stock appreciation plans and other employee benefit plans, entered into or adopted by the Company;

5.15.6. a list and copies of all deeds of trust, mortgages, security agreements, pledge agreements and other agreements or arrangements whereby any of the assets or properties of the Company are subject to any lien, encumbrance, security interest or charge;

5.15.7. a list and copies of all loan agreements, notes, indentures or other instruments relating to, or evidencing Indebtedness for Borrowed Money;

5.15.8. a list and copies of all agreements with dealers, sales representatives, brokers, distributors, advertisers or sales agencies;

5.15.9. a list and copies of all joint venture contracts or arrangements or other agreements to which the Company is a party involving a sharing of profits or expenses;

5.15.10. a list and copies of all agreements limiting the freedom of the Company to compete in any line of business or in any geographic area or with any person;

5.15.11. a list and copies of all agreements for the disposition of the business, assets or shares of the Company, agreements of merger or consolidation to which the Company is a party or letters of intent with respect to the foregoing; and

5.15.12. a list and copies of all agreements or letters of intent with respect to the acquisition of the business, assets or shares of any other person.

5.16. **Corporate Acts and Proceedings.** This Agreement has been duly authorized by the requisite corporate action and has been duly executed and delivered by an authorized officer of the Company, and its provisions are valid and binding obligations of the Company enforceable in accordance with their terms, except as such enforceability may be limited by bankruptcy, insolvency, moratorium, reorganization or other similar laws affecting the enforcement of creditors' rights generally and as to limitations on the enforcement of the remedy of specific performance and other equitable remedies. The requisite corporate action necessary to the authorization, creation, issuance and delivery of the Debenture and the shares of the Conversion Stock has been taken by the Company.

5.17. **Insurance Coverage.** There are in full force policies of insurance issued by insurers of recognized responsibility insuring the Company and its properties and business against such losses and risks, and in such amounts, as in the Company's judgment, after advice from its

insurance broker, are acceptable for the nature and extent of the Company's business and its resources.

- 5.18. **No Brokers or Finders.** No person, firm or corporation has or will have, as a result of any act or omission of the Company, any right, interest or valid claim against the Company or State for any commission, fee or other compensation as a finder or broker in connection with the transaction contemplated by this Agreement. The Company will indemnify and hold State harmless against any and all liability with respect to any such commission, fee or other compensation which may be payable or determined to be payable in connection with the transactions contemplated by this Agreement.
- 5.19. **Conflicts of Interest.** Except as disclosed in Exhibit H attached hereto, no officer, employee or consultant, or any affiliate (as such term is defined in Rule 408 under the Securities Act) of any such person has any direct or indirect interest (a) in any entity which does business with the Company except in the ordinary course of business at competitive prices, (b) in any property, asset or right which is used by the Company in the conduct of its business, or (c) in any contractual relationship with the Company other than as an employee. For the purpose of this Section 5.19, there shall be disregarded any interest which arises solely from the ownership of less than one percent (1%) interest in a corporation whose stock is regularly traded on any national securities exchange or in the over-the-counter market.
- 5.20. **Disclosure.** The Company has not knowingly withheld from State any material facts relating to the assets, business, operations, financial condition or prospects of the Company. To the best of the Company's knowledge, no representation or warranty in this Agreement or in any letter, certificate, schedule, statement or other document furnished or to be furnished pursuant hereto or in connection with the transactions contemplated hereby contains or will contain any untrue statement of a material fact or omits or will omit to state any material fact required to be stated herein or therein or necessary to make the statements herein or therein not misleading.
- 5.21. **Registration Rights.** Other than as disclosed or provided under this Agreement, the Company has not agreed to register under the Securities Act any of its authorized or outstanding securities.
- 5.22. **Retirement Plans.** The Company has no employee retirement or welfare benefit plans except as set forth on Exhibit B.
- 5.23. **Compliance with Environmental Laws.** Without limiting the generality of Section 5.7, to the knowledge of the Company, the Company is not in violation in any material respect of any applicable statute, law or regulation relating to the environment or occupational health



and safety, and no material expenditures are or will be required in order to comply with any such existing statute, law or regulation.

- 5.24. **Licenses and Permits.** The Company possesses from the appropriate agency, commission, board or government body or authority, whether state, local or federal, all licenses, permits, authorizations, approvals and rights which (a) are necessary for it to engage in the business currently conducted by it and (b) if not possessed by the Company would not have an adverse impact on the Company's business. The Company has no knowledge that would lead it to believe that it will not be able to obtain all licenses, permits, authorizations, approvals and rights that may be required for any business the Company proposes to conduct.
- 5.25. **Continued Employment.** The Company is not aware that any officer, director or key employee, or any group of employees, of the Company has any intention of terminating employment with the Company.
- 5.26. **Contents of the Application.** The representations, statements, and other matters provided by Company relating to those activities undertaken or to be undertaken by Company which were contained in the Application for the Loan, were true and complete in all material respects as of the date of submission to the State and that such representations, statements, and other matters are true in all material respects as of the date of this Agreement, except as Company has otherwise expressly advised the State in writing prior to the Closing Date.
- 5.27. **No Vested Interest.** To the best of Company's knowledge, no member, officer, or employee of the State or its designees or agents, no consultant, member of the Iron Range Resources and Rehabilitation Agency, and no other public official of the State, who exercises or has exercised any functions or responsibilities with respect to the Application or the State's approval of the Loan during his or her tenure during the negotiations for this Agreement had, now has, or subsequently shall have any interest, direct or indirect, in any contract or subcontract, or the proceeds thereof, for work to be performed in connection with Company's business activities.
- 5.28. **Warranties by Directors.** Directors Thomas Micheletti and Julie Jorgensen extend to the State their personal warranties as to all matters contained in this Article 5 by executing the form of "Directors Warranty Agreement" attached hereto as Exhibit E.
- 5.29. **Sale By Thomas Micheletti or Julie Jorgensen.** Thomas Micheletti and Julie Jorgensen (or any other party that owns a majority interest in the Company) shall not sell more than fifty percent of their ownership interest in the Company to a third party unless (a) the third party has a net worth (exclusive of its ownership interest in the Company) of at least



\$10,000,000 or (b) the State has consented to such sale, such consent not to be unreasonably withheld.

## **6 REPRESENTATIONS AND WARRANTIES OF STATE**

**6.1. Representations and Warranties of State.** State, through the Commissioner, represents and warrants with respect to its investment:

6.1.1. The Securities being acquired by it hereunder are being purchased for its own account and not with the view to, or for resale in connection with, any distribution or public offering thereof within the meaning of the Securities Act. It understands that the Securities have not been registered under the Securities Act by reason of their contemplated issuance in transactions exempt from the registration and prospectus delivery requirements of the Securities Act pursuant to Section 4(2) thereof, and that the reliance of the Company and others upon this exemption from such registration is predicated in part upon this representation and warranty. State understands that an exemption from such registration is not presently available pursuant to Rule 144 promulgated under the Securities Act by the Commission and that in any event it may not sell the Securities pursuant to Rule 144 prior to the expiration of a two-year period after it has acquired the Securities.

6.1.2. The State, through the Commissioner and his staff and legal counsel, has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the investment to be made hereunder by it. It has had access to all of the Company's material books and records, and the Company has made available to it at a reasonable time prior to execution of this Agreement the opportunity to ask questions and receive answers concerning the terms and conditions of the sale of securities contemplated by this Agreement and to obtain any additional information as may be necessary to verify the accuracy of information furnished to it by the Company.

6.1.3. This Agreement has been duly authorized by it and has been duly executed and delivered by it, and the Agreement's provisions are valid and binding obligations of it enforceable in accordance with their terms, except as such enforceability may be limited by bankruptcy, insolvency, moratorium, reorganization or other similar laws affecting the enforcement of creditors' rights generally and as to limitations on the enforcement of the remedy of specific performance and other equitable remedies.

6.1.4. No person, firm or corporation has or will have, as a result of any act or omission by the State, any right, interest or valid claim against the Company for any commission, fee or other compensation as a finder or broker, or in any similar capacity, in connection with the transactions contemplated by this Agreement.

## **7 RESTRICTIONS ON TRANSFER**

**7.1. Legend Upon Securities.** The Debenture shall be endorsed with the following legend:

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE FEDERAL SECURITIES ACT OF 1933 AND MAY NOT BE SOLD OR OTHERWISE DISPOSED OF FOR VALUE, OR TRANSFERRED, WITHOUT (I) AN OPINION OF COUNSEL APPROVED BY THE COMPANY THAT SUCH SALE, DISPOSITION OR TRANSFER MAY LAWFULLY BE MADE WITHOUT REGISTRATION UNDER THE FEDERAL SECURITIES ACT OF 1933 AND UNDER APPLICABLE STATE SECURITIES LAWS, OR (II) SUCH REGISTRATION. THE TRANSFERABILITY OF SUCH SECURITIES IS SUBJECT TO RESTRICTIONS (A) REQUIRED BY FEDERAL AND STATE SECURITIES LAWS AND THE RULES, REGULATIONS, AND INTERPRETATIONS OF THE GOVERNMENTAL AGENCIES ADMINISTERING SUCH LAWS, AND THE PROCEDURES ESTABLISHED BY THE COMPANY TO EFFECT COMPLIANCE THEREWITH, GOVERNING UNREGISTERED SECURITIES, AND (B) AGREED TO BY THE OWNER OF SUCH SECURITIES.

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER CHAPTER 80A OF THE MINNESOTA SECURITIES LAWS OR APPLICABLE STATE BLUE SKY LAWS AND MAY NOT BE SOLD, TRANSFERRED, OR OTHERWISE DISPOSED OF FOR VALUE EXCEPT PURSUANT TO REGISTRATION OR OPERATION OF LAW.

Upon the conversion of all or any portion of the Debenture, the certificate evidencing shares of Conversion Stock shall be endorsed with the same legend, unless the Company receives an opinion of counsel satisfactory to the Company to the effect that a transfer of the Conversion Stock may be made without registration, or unless such Conversion Stock is being disposed of pursuant to a registration under the Securities Act.

Any legend endorsed on a certificate evidencing Securities pursuant to Section 7 hereof shall be removed, and the Company shall issue a certificate without such legend to the holder of the Securities, if the Securities are being disposed of pursuant to a registration under the Securities Act or if such holder provides the Company with an opinion of counsel satisfactory to the Company to the effect that a transfer of the Securities may be made without registration.

**7.2. Company Right of First Refusal.** In the event State intends or desires to dispose of its



Conversion Shares, it shall give written notice to the Company of such intention or desire, which notice shall set forth (1) the names and addresses of the persons to whom the stock should be transferred; (2) the amount of consideration to be paid for said stock; and (3) the method and manner and terms of payment for such shares. Immediately upon receipt of such notice, Company shall send copies of such notice to its other shareholders. Company and its other shareholders shall have the option, for a period of 20 days after receipt by the Company of said notice, to purchase all the offered shares at the same price, in the same method and manner and with the same terms of payment as set forth in the notice in such proportion as the Company and its other shareholders may determine. Closing of such sale and purchase of the shares shall take place at the offices of the shareholder within 10 days after the Company and/or the Company's other shareholders exercise the option. Upon closing, State shall deliver to the Company a certificate or certificates evidencing the shares, properly endorsed and assigned in writing and the Company shall pay the purchase price therefore. The foregoing agreement shall terminate upon the closing of a public offering pursuant to an effective registration statement on Form S-1 (or any successor form) by the Company of its Common Stock in which the aggregate gross proceeds to the Company are at least ten million dollars and the public offering price is not less than \$2.50 per share (as adjusted from time to time upon the occurrence of any subdivision, stocks split, combination or change of Common Stock into different number of shares of the same or any other class or classes of shares).

## **8 STATE CONDITIONS TO CLOSING**

**8.1. Conditions to State Obligation.** The obligation to purchase and pay for the Debenture which State has agreed to purchase on the Closing Date are subject to the fulfillment prior to or on the Closing Date of the following conditions, any of which may be waived in whole or in part by State:

8.1.1. The representations and warranties of the Company under this Agreement shall be true in all material respects as of the Closing Date with the same effect as though made on and as of the Closing Date.

8.1.2. The Company shall have performed and complied with all agreements or conditions required by this Agreement to be performed and complied with by it prior to or as of the Closing Date.

8.1.3. The Company shall have delivered to State a certificate, dated the Closing Date, executed by the President on behalf of the Company and certifying to the satisfaction of the conditions specified in Sections 8.1.1 and 8.1.2 hereof.



- 8.1.4. The Company shall have delivered to State an opinion of counsel for the Company, dated the Closing Date, in substantially the form attached hereto as Exhibit G.
- 8.1.5. All registrations, qualifications, permits and approvals required under applicable state and federal securities laws for the lawful execution and delivery of the Agreement and the offer, sale, issuance and delivery of the Debenture and the Conversion Stock shall have been obtained, except for the notices required or permitted to be filed after the Closing Date with certain federal and state securities commissions, which notices the Company will file on a timely basis.
- 8.1.6. All corporate and other proceedings and actions taken in connection with the transactions contemplated hereby and all certificates, opinions, agreements, instruments and documents referenced herein or incident to any such transaction shall be satisfactory in form and substance to State and its counsel.
- 8.1.7. There shall have been no material adverse change in the business or financial condition of the Company from that existing on the date of this Agreement.
- 8.1.8. The Articles in the form attached hereto as Exhibit A shall have been filed with the Minnesota Secretary of State.
- 8.1.9. Immediately following the Closing, the Board of Directors of the company shall consist of Julie Jorgensen and Thomas Micheletti.
- 8.1.10. The Directors, Thomas Micheletti and Julie Jorgensen have executed the Directors Warranty Agreement substantially in the form of Exhibit E attached hereto and the current shareholders and option holders of the Company have executed a shareholder agreement complying with the requirements of Section 5.12 hereof.
- 8.1.11. Each of the existing shareholders of the Company shall have consented in writing to all the terms of the Agreement.
- 8.1.12. Debenture, substantially in the form of the attached Exhibit AA, shall be executed by the appropriate authorized officer(s) of Company and delivered to the State; and,
- 8.1.13. A current certificate of compliance issued to Company by the State of Minnesota's Department of Human Rights pursuant to Minnesota Statutes Section 363.073, or, in the alternative, a certificate of an appropriate authorized officer of Company to State attesting that Company has forty or fewer full-time employees and is exempt from the requirement of obtaining such certificate.

8.1.14. A certified copy of a resolution(s) of Company's board of directors, in form and substance reasonably acceptable to State's Authorized Agent, authorizing the execution, delivery and performance of this Agreement and the Debenture; and designating the officer(s) of Company authorized by Company to execute on its behalf this Agreement and the Debenture, and all other certificates to be delivered pursuant to this Agreement.

## **9 COMPANY'S CONDITIONS TO CLOSING**

9.1. **Conditions.** The obligation to sell and issue the Debenture to State which the Company has agreed to issue on the Closing Date are subject to the fulfillment prior to or on the Closing Date of the following conditions, any of which may be waived in whole or in part by the Company:

9.1.1. All registrations, qualifications, permits and approvals required under applicable state and federal securities laws for the lawful execution and delivery of the Agreement and the offer, sale, issuance and delivery of the securities shall have been obtained, except for the notices required or permitted to be filed after the Closing Date with certain federal and state securities commissions, which notices the Company will file on a timely basis.

9.1.2. The Articles in the form attached hereto as Exhibit A shall have been filed with the Minnesota Secretary of State.

9.1.3. State shall purchase the Debenture for a purchase price of up to Eight Million Dollars (\$8,000,000).

9.1.4. The representations and warranties of the State under this Agreement shall be true in all material respects as of the Closing Date with the same effect as though made in and as of the Closing Date.

9.1.5. State shall have performed and complied with all agreements or conditions required by this Agreement to be performed and complied with by it prior to or as of the Closing Date.

## **10 AFFIRMATIVE COVENANTS OF THE COMPANY**

The Company covenants and agrees that so long as the Debenture or Conversion Stock is outstanding:



10.1. **Corporate Existence.** The Company will maintain its corporate existence in good standing.

10.2. **Books and Account and Reserves.** The Company will keep, and will cause any subsidiary to keep, books of record and accounts in which full, true and correct entries are made of all of its and their respective dealings, business and affairs, in accordance with generally accepted accounting principles. The Company will employ certified public accountants that are "independent" within the meaning of the accounting regulations of the Commission. The Company will have annual reviews made by such independent public accountants in the course of which such accountants shall make such examinations as will enable them to give such reports or opinions with respect to the financial statements of the Company and its subsidiaries, if any, in accordance with Generally Accepted Auditing Standards. Management will request such independent public accountants to issue to the Company a management letter of recommendations in connection with each annual review of the financial statements of the Company. In the event the services of the independent public accountants are terminated, the Company will promptly notify State of such termination and will request such independent public accountants to send a letter to State advising it in the detail requested by State of the reasons for the termination of their services.

10.3. **Furnishing of Financial Statements and Information.** So long as State holds the Debenture or shares of Conversion Stock, the Company will deliver to State:

10.3.1. Within five (5) days of their availability, but in any event within thirty (30) days after the close of each quarter, beginning with the quarter ending September 30, 2004, (i) an unaudited consolidated balance sheet of the Company and any subsidiaries as of the end of such quarter and the corresponding balance sheet, (ii) the related unaudited combined operating statements for such quarter, the fiscal year to date and the corresponding statements comparison with the budget for such quarter and the fiscal year to date, (iii) the related consolidated statement of cash flows for the current quarter, all in reasonable detail and certified by the President or Treasurer of the Company, subject to year-end adjustments, and/or (iv) the quarterly reporting form if utilized as an alternative report to subparagraph (i), (ii) and (iii) and approval of State.

10.3.2. Within five (5) days of their availability, but in any event within ninety (90) days after the end of each fiscal year, commencing with fiscal year 2004, which shall end on December 31 of each year, a consolidated balance sheet of the Company and any subsidiaries, as of the end of such fiscal year, together with the related consolidated statements of income and retained earnings and statements of cash flows for such fiscal year, setting forth in comparative form figures for the previous fiscal year, all in reasonable detail and duly audited and certified by the Company's independent certified public



accountants, which accountants shall have given the Company an unqualified opinion regarding such statements;

- 10.3.3. Concurrently with the delivery of any financial statements referred to in Sections 10.3.1 and 10.3.2, current schedules of Indebtedness for Borrowed Money together with a certificate of the President or Treasurer to the effect that such schedules are accurate and correct and that there exists no condition or event which constitutes an event of default with respect to any indebtedness of the Company, or if any such condition or event exists, specifying the nature and period of existence thereof and what action the Company is taking or proposes to take with respect thereto;
- 10.3.4. Within five (5) days after the Company learns it is in default in the due and punctual performance of any covenant or agreement related to Indebtedness for Borrowed Money, any contract for the sale of its products or any other material contract, written notice of the nature and extent of such default;
- 10.3.5. Within 15 days after the Company learns of the commencement or threatened commencement of any material suit, legal or equitable, or of any material administrative, arbitration or other proceeding against the Company or its business, assets or properties, written notice of the nature and extent of such suit or proceeding;
- 10.3.6. Promptly after the submission thereof to the Company, copies of the management letter and any other reports or recommendations submitted by independent certified public accountants in connection with any annual or interim audit of the accounts of the Company or any of its subsidiaries made by such accountants;
- 10.3.7. Promptly following the issuance of any Common Stock, any securities convertible into Common Stock or any options, warrants or other rights to purchase Common Stock, written notice of the amount of securities issued and the consideration received therefore;
- 10.3.8. Within ten days after the Company learns of any material adverse change in the Company's management, provision of equipment or supplies, competition, financial condition, properties or assets, written notice of the nature and extent of such change; and
- 10.3.9. With reasonable promptness, such other financial data relating to the business, affairs and financial condition of the Company and any subsidiaries as is available to the Company and as from time to time State may reasonably request, including but not limited to, employment data on a quarterly basis, including relevant socio-economic data of persons hired.

The Company's obligations under paragraphs 10.3(a) through (i) shall terminate upon the closing of a public offering pursuant to an effective registration statement on Form S-1 (or any successor form) by the Company of its Common Stock in which the aggregate gross proceeds to the Company are at least Ten Million Dollars (\$10,000,000) and the public offering price is not less than Two Dollars and 00/50 (\$2.50) per share (as adjusted from time to time upon the occurrence of any subdivision, stock split, combination or change of Common Stock into a different number of shares of the same or any other class or classes of shares).

10.4. **Key Person Life Insurance.** From and after December 31, 2004, so long as the Debenture or any of the Conversion Stock is outstanding, the Company will maintain "key person" life insurance on Julie Jorgensen in the amount of \$500,000, or such lesser amount the State deems sufficient to search for a replacement for Julie Jorgensen; provided that in the event that Company demonstrates to the reasonable satisfaction of the State that a suitable individual employed by the Company or its partners or affiliates has been identified to assume her duties in the event of her death or disability, then such insurance shall no longer be required.

10.5. **Inspection and Attendance.** So long as the Debenture or any of the Conversion Stock is outstanding, the Company will provide the State no less than two days written notice of all Board meetings and permit State and any of its representatives designated by it and reasonably satisfactory to the Company, to attend meetings of the Board of Directors as an observer and to visit and inspect at the expense of State, except for any expenses required to be borne by the Company under Minnesota Statutes Section 302A.461, as now in effect or hereafter amended or succeeded, any of the properties of the Company or its subsidiaries, including their books and records (and to make photocopies thereof or extracts there from), and to discuss their affairs, finances and accounts with their officers, all to such reasonable extent and at such reasonable times and intervals as it may reasonably request without disruption of the Company's operations.

10.6. **Payment of Taxes and Maintenance of Property.** The Company will, and will cause any subsidiary to:

10.6.1. Pay and discharge promptly, or cause to be paid and discharged promptly, when due and payable, all taxes, assessments and governmental charges or levies imposed upon it or upon its income or upon any of its property, real, personal or mixed, or upon any part thereof, as well as all material claims of any kind (including claims for labor, material and supplies) which, if unpaid, might by law become a lien or charge upon its property; provided, however, that neither the Company nor any subsidiary shall be required to pay any such tax, assessment, charge, levy or claim while the amount, applicability or validity thereof is being contested in good faith by appropriate proceedings, provided that the



Company or such subsidiary, as the case may be, shall have set aside on its books reserves (segregated to the extent required by generally accepted accounting principles) deemed adequate by it with respect thereto; and

10.6.2. Maintain and keep, or cause to be maintained and kept, its properties in good repair, working order and condition, and from time to time make, or cause to be made, all repairs and renewals and replacements which in the opinion of the Company are necessary and proper so that the business carried on in connection therewith may be properly and advantageously conducted at all times.

10.7. **Insurance.** The Company will, and will cause each Subsidiary to:

10.7.1. Keep or cause all of its insurable property or properties (including valuable papers) to be kept insured against loss or damage against fire and other risks;

10.7.2. Maintain general liability insurance against claims for personal injury, death or property damage suffered by others upon or in or about the premises occupied by it or occurring as a result of its maintenance or operation of any automobiles, trucks or other vehicles or other facilities; and

10.7.3. Maintain all such worker's compensation or similar insurance as may be required under the laws of any state or jurisdiction in which it may be engaged in business; and

10.7.4. Maintain products liability insurance against claims for personal injury, death or property damage caused or allegedly caused by the Company's products.

All insurance for which provision has been made in this Section 10.7 shall be maintained in the amounts and to the extent determined to be reasonable by the Board of Directors. All such insurance shall be effected and maintained in force under a policy or policies issued by insurers of recognized responsibility, except that the Company or any subsidiary may effect worker's compensation or similar insurance in respect of operations in any state or other jurisdiction either through an insurance fund operated by such state or other jurisdiction or by causing to be maintained a system or systems of self-insurance which is in accord with applicable laws. The Company will provide State from time to time upon request with evidence of the insurance policies in force.

10.8. **Payment of Indebtedness and Discharge of Obligations.** The Company will, and will cause any subsidiary to, pay or cause to be paid the principal of and interest and premium, if any, on all Indebtedness for Borrowed Money heretofore or hereafter incurred or assumed by it when and as the same shall become due and payable, unless such Indebtedness for Borrowed

Money is renewed or extended. The Company will, and will cause each subsidiary to, faithfully observe, perform and discharge all of the material covenants, conditions and obligations which are imposed on it by any and all indentures and other agreements securing or evidencing such Indebtedness for Borrowed Money or pursuant to which such Indebtedness for Borrowed Money is issued, and will not permit the continuance of any act or omission which is, or under the provisions thereof may be declared to be, a material default thereunder, unless such default is waived pursuant to the provisions thereof. Neither the Company nor any subsidiary shall be required to make any payment or to take any other action by reason of this Section 10.8 at any time while the Company is contesting in good faith by appropriate proceedings its obligations to make such payment or to take such action, provided that the Company or such subsidiary, as the case may be, shall have set aside on its books reserves (segregated to the extent required by generally accepted accounting principles) deemed adequate by it with respect thereto.

**10.9. Preparation and Approval of Budgets.** So long as State holds of record Debenture or any of the issued Conversion Stock, at least one month prior to the beginning of each fiscal year of the Company, beginning with the year 2005 fiscal year, the Company shall prepare and submit to its Board of Directors, with a copy to State, for discussion purposes a first draft of an annual plan for such year which shall include monthly capital and operating expense budgets, cash flow statements and profit and loss projections and year-end projected balance sheets, itemized in such detail as the Board of Directors may reasonably request. The final draft of such annual plan shall be presented to the Board of Directors for approval, with a copy to State, prior to the beginning of each fiscal year of the Company. Each annual plan shall be modified as often as is reasonably necessary to reflect changes required as a result of operating results and other events that occur, or may be reasonably expected to occur, during the year covered by the annual plan, and copies of such modification shall be submitted to the Board of Directors, with a copy to State.

**10.10. Replacement of Stock Certificates.** Upon receipt of evidence reasonably satisfactory to the Company of the loss, theft, destruction or mutilation of any certificate representing the Conversion Stock, and, in the case of any such loss, theft or destruction, upon delivery of a bond of indemnity satisfactory to the Company, or, in the case of any such mutilation, upon surrender and cancellation of the certificate representing Conversion Stock, the Company will issue a new certificate representing the Conversion Stock of like tenor, in lieu of such lost, stolen, destroyed or mutilated certificate.

**10.11. Completion of Transaction.** Within forty-eight (48) months of the Closing Date, the Company shall have commenced construction of the Project.

**10.12. Patents and Other Intangible Rights.** The Company will apply for and, where necessary, obtain assignments of or licenses to use, all patents, trademarks, service marks, trade



names and copyrights which in the opinion of a prudent and experienced businessman operating in the industry in which the Company is operating are desirable or necessary for the conduct and protection of the business of the Company. The Company will adopt reasonable secrecy measures and other policies to protect trade secrets and confidential information used in connection with the Company's business which in the opinion of a prudent and experienced businessman operating in the industry in which the Company is operating are desirable or necessary for the conduct and protection of the business of the Company.

10.13. **Indemnification Article and/or Bylaw.** The Articles and/or Bylaws of the Company will at all times contain a section requiring the Company to indemnify its officers and directors to the full extent permitted by the Minnesota Business Corporation Act.

10.14. **Place of Business.** The Company will establish a base of operations located within the TAA, which will serve the purposes detailed in Minn. Stat. Section 298.292, Subd. 1.

10.15. **State's Rights in Any Future Private Financing.** In any future sale of equity securities of the Company after the Project Closing Date (Capital Stock, warrants, debt convertible to Capital Stock, or other rights to Capital Stock), State shall have the right to subscribe for such number of shares at the same price and terms as would allow State to maintain its pro rata ownership in the Company's equity securities, based on the percentage of its Conversion Stock which it owns or would own if the Debentures were fully converted to Conversion Stock and any shares or units purchased in any future sale; provided, however, except as otherwise provided herein, that such rights do not include any sale of the Company's equity securities in connection with a public offering pursuant to an effective registration statement on Form S-1 (or any successor form) by the Company of its Common Stock in which the aggregate gross proceeds to the Company are at least Ten Million Dollars (\$10,000,000) and the public offering price is not less than Two and 50/100 Dollars (\$2.50) per share (as adjusted from time to time upon the occurrence of any subdivision, stock split, combination or change of Common Stock into a different number of shares of the same or any other class or classes of shares).

10.16. **Employment Practices.** The Company agrees to utilize the services of appropriate State of Minnesota agencies as the first referral source in all hirings.

10.17. **Employee Confidentiality Agreements.** The Company shall require all of its employees to execute employee confidentiality agreements containing provisions addressing confidential information similar to those contained in Exhibit D.

10.18. **Written Action of Directors and Shareholders.** Prior to the shareholders or the directors of the Company taking any written action in lieu of a meeting, the company shall deliver a true and correct copy of such written action to the holders of the Debenture and

Conversion Stock, at least two (2) days prior to the adoption of such written action; provided, however, such prior delivery may be waived by State.

10.19. **Maintenance of Business Operations.** The Company will continue business operations from its TAA facility for a minimum period of five (5) years from the Closing.

10.20. **Sale, Abandonment or Relocation of Project.** The Company will continue to own the Project. The Company will not abandon the Project. The Company will not move or relocate the proposed Project power production facilities outside the TAA. The Company will not sell or dispose of substantially all of its assets.

## **11 REGISTRATION OF STOCK**

11.1. **Incidental Registration.** Each time the Company shall determine to proceed with the actual preparation and filing of a registration statement under the Securities Act in connection with the proposed offer and sale for cash of any of its securities by it or any of its security holders, hereinafter in this Section 11.1 called "Selling Security Holders", the Company will give written notice of its determination to all record holders of the Debenture and/or Conversion Stock not theretofore registered under the Securities Act and sold. Record holders of the Debenture may, upon receipt of such notice, give notice of conversion of all or any portion of the Debenture into Conversion Stock within thirty (30) days after receipt of such notice from the Company, and all holders of record of Conversion Stock or Conversion Stock which is to be issued pursuant to conversion as aforesaid may, upon written request to the Company, within thirty (30) days after receipt of such notice from the Company, request that such Conversion Stock be registered under the Securities Act to be registered and sold. The Company will, except as herein provided, cause all such shares of Conversion Stock to be included in such registration statement, all to the extent requisite to permit the sale or other disposition by the prospective seller or sellers of the Conversion Stock to be so registered; provided, however, that nothing herein shall prevent the Company from, at any time, abandoning or delaying any registration; provided further, however, that if the Company determines not to proceed with a registration after the registration statement has been filed with the Commission and the Company's decision not to proceed is primarily based upon the anticipated public offering price of the securities to be sold by the Company, the Company shall promptly complete the registration for the benefit of those selling security holders who wish to proceed with a public offering of their securities and who bear all expenses in excess of \$50,000 incurred by the Company as the result of such registration after the Company has decided not to proceed. If any registration pursuant to this Section 11.1 shall be underwritten in whole or in part, the Company may require that the Conversion Stock requested for inclusion pursuant to this Section 11.1 be included in the underwriting on the same terms and conditions as the securities otherwise being sold through the underwriters. If in the good faith judgment of



the managing underwriter of such public offering the inclusion of all of the Conversion Stock originally covered by a request for registration would reduce the number of shares to be offered by the Company or interfere with the successful marketing of the shares of stock offered by the Company, the number of shares of Conversion Stock otherwise to be included in the underwritten public offering may be reduced pro rata among the holders thereof.

**11.2. Registration Procedures.** If and whenever the Company is required by the provisions of Section 11.1 to effect the registration of shares of Conversion Stock under the Securities Act, the Company will:

- 11.2.1. prepare and file with the Commission a registration statement with respect to such securities, and use its best efforts to cause such registration statement to become and remain effective;
- 11.2.2. prepare and file with the Commission such amendments to such registration statement and supplements to the prospectus contained therein as may be necessary to keep such registration statement effective and current for such period as may be reasonably necessary to effect the sale of such securities, not to exceed nine months;
- 11.2.3. furnish to the security holders participating in such registration and to the underwriters of the securities being registered such reasonable number of copies of the registration statement, preliminary prospectus, final prospectus and such other documents as such underwriters may reasonably request in order to facilitate the public offering of such securities;
- 11.2.4. use its best efforts to register or qualify the securities covered by such registration statement under such state securities or blue sky laws of such jurisdictions as such participating holders may reasonably request, except that the Company shall not for any purpose be required to execute a general consent to service of process or to qualify to do business as a foreign corporation in any jurisdiction wherein it is not so qualified;
- 11.2.5. promptly notify the security holders participating in such registration of the time when such registration statement has become effective or when a supplement to any prospectus included in such registration statement has been filed;
- 11.2.6. notify such holders promptly of any request by the Commission for the amending or supplementing of such registration statement or prospectus or for additional information;
- 11.2.7. promptly advise such holders of the issuance of any stop order by the Commission suspending the effectiveness of such registration statement or the initiation or threatening

of any proceeding for that purpose and promptly use its best efforts to prevent the issuance of any stop order or to obtain its withdrawal if such stop order should be issued;

11.2.8. not file any amendment or supplement to such registration statement or prospectus to which a majority in interest of such holders shall have reasonably objected on the grounds that such amendment or supplement does not comply in all material respects with the requirements of the Securities Act or the rules and regulations thereunder, after having been furnished with a copy thereof at least five business days prior to the filing thereof, unless in the opinion of counsel for the Company the filing of such amendment or supplement is reasonably necessary to protect the Company from any liabilities under any applicable federal or state law and such filing will not violate applicable law;

11.2.9. at the request of any such holder, furnish on the effective date of the registration statement and, if such registration includes an underwritten public offering, at the closing provided for in the underwriting agreement: (i) an opinion, dated each such date, of the counsel representing the Company for the purposes of such registration, addressed to the underwriters, if any, and to the holder or holders making such request, covering such matters as such underwriters and holder or holders may reasonably request, in which opinion such counsel shall state (without limiting the generality of the foregoing) that (a) such registration statement has become effective under the Securities Act, (b) to the best of such counsel's knowledge no stop order suspending the effectiveness thereof has been issued and no proceedings for that purpose have been instituted or are pending or contemplated under the Securities Act, (c) the registration statement and each amendment or supplement thereto comply as to form in all material respects with the requirements of the Securities Act and the applicable rules and regulations of the Commission thereunder (except that such counsel need express no opinion as to financial statements contained therein), (d) to the best of such counsel's knowledge neither the registration statement nor any amendment or supplement thereto contains any untrue statement of a material fact or omits to state a material fact required to be stated therein or necessary to make the statements therein not misleading (except that such counsel need express no opinion as to financial statements contained therein), (e) the description in the registration statement or any amendment or supplement thereto of legal and governmental proceedings and contracts are accurate and fairly present the information required to be shown, and (f) such counsel does not know of any legal or governmental proceedings, pending or threatened, required to be described in the registration statement or any amendment or supplement thereto which are not described as required nor of any contracts or documents or instruments of the character required to be described in the registration statement or amendment or supplement thereto or to be filed as exhibits to the registration statement, which are not described or filed as required; and (ii) a letter dated each such date, from the independent certified public accountants of the Company, addressed to the underwriters, if



any, and to the holder or holders making such request, covering such matters as such underwriters and holder or holders may reasonably request, in which letter such accountants shall state (without limiting the generality of the foregoing) that they are independent certified public accountants within the meaning of the Securities Act and that in the opinion of such accountants the financial statements and other financial data of the Company included in the registration statement or any amendment or supplement thereto comply in all material respects with the applicable accounting requirements of the Securities Act.

### **11.3. Expenses.**

11.3.1. With respect to each inclusion of shares of Conversion Stock in a registration statement pursuant to Section 11.1 hereof, all fees, costs and expenses of and incidental to such registration, inclusion and public offering (as specified in paragraph (b) below) in connection therewith shall be borne by the Company, provided, however, that any security holders participating in such registration shall bear their pro rata share of the underwriting discounts and commissions and transfer taxes.

11.3.2. The fees, costs and expenses of registration to be borne by the Company as provided in paragraph (a) above shall include, without limitation, all registration, filing and NASD fees, printing expenses, fees and disbursements of counsel and accountants for the Company, fees and disbursements of counsel for the underwriter or underwriters of such securities (if the Company and/or selling security holders are required to bear such fees and disbursements), all legal fees and disbursements and other expenses of complying with state securities or blue sky laws of any jurisdictions in which the securities to be offered are to be registered or qualified, and the premiums and other costs of policies of insurance against liability arising out of such public offering; fees and disbursements of counsel and accountants for the selling security holders and any other expenses incurred by the selling security holders not expressly included above shall be borne by the selling security holders.

### **11.4. Indemnification.**

11.4.1. The Company will indemnify and hold harmless each holder of shares of Conversion Stock which are included in a registration statement pursuant to the provisions of this Article II and any underwriter (as defined in the Securities Act) for such holder and each person, if any, who controls such holder or such underwriter within the meaning of the Securities Act, from and against, and will reimburse such holder and each such underwriter and controlling person with respect to, any and all loss, damage, liability, cost and expense to which such holder or any such underwriter or controlling person may become subject under the Securities Act or otherwise, insofar as such losses, damages, liabilities, costs or

expenses are caused by any untrue statement or alleged untrue statement of any material fact contained in such registration statement, any prospectus contained therein or any amendment or supplement thereto, or arise out of or are based upon the omission or alleged omission to state therein a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances in which they were made, not misleading; provided, however, that the Company will not be liable in any such case to the extent that any such loss, damage, liability, cost or expense arises out of or is based upon an untrue statement or alleged untrue statement or omission or alleged omission so made in conformity with information furnished by such holder, such underwriter or such controlling person in writing specifically for use in the preparation thereof.

11.4.2. Promptly after the receipt by an indemnified party pursuant to the provisions of paragraph 11.4.1 of this Section 11.4 of notice of the commencement of any action involving the subject matter of the foregoing indemnity provisions such indemnified party will, if a claim thereof is to be made against the indemnifying party pursuant to the provisions of said paragraph 11.4.1, promptly notify the indemnifying party of the commencement thereof; but the omission to so notify the indemnifying party will not relieve it from any liability which it may have to any indemnified party otherwise than hereunder. In case such action is brought against any indemnified party and it notifies the indemnifying party of the commencement thereof, the indemnifying party shall have the right to participate in, and, to the extent that it may wish, jointly with any other indemnifying party similarly notified, to assume the defense thereof, with counsel satisfactory to such indemnified party; provided, however, if the defendants in any action include both the indemnified party and the indemnifying party and if there is a conflict of interest which would prevent counsel for the identifying party from also representing the indemnified party, the indemnified party or parties shall have the right to select separate counsel to participate in the defense of such action on behalf of such indemnified party or parties. After notice from the indemnifying party to such indemnified party of its election so to assume the defense thereof, the indemnifying party will not be liable to such indemnified party pursuant to the provisions of said paragraph 11.4.1 for any legal or other expense subsequently incurred by such indemnified party in connection with the defense thereof other than reasonable costs of investigation, unless (i) the indemnified party shall have employed counsel in accordance with the proviso of the preceding sentence, (ii) the indemnifying party shall not have employed counsel satisfactory to the indemnified party to represent the indemnified party within a reasonable time after the notice of the commencement of the action, or (iii) the indemnifying party has authorized the employment of counsel for the indemnified party at the expense of the indemnifying party.

11.5 **Lock-up.** Shareholder shall agree to such reasonable "lock-up" provisions as shall be required by the managing underwriter of any public offering of the Corporation's stock



but not to exceed six months. During such lock-up period, Shareholder shall not sell, transfer or otherwise dispose of or agree to sell, transfer or otherwise dispose of, any of the shares of the stock of the Corporation beneficially held by Shareholder.

## **12 DEFAULT**

12.1. **Events of Default.** The following shall be deemed to be Events of Default for purposes of this Agreement:

12.1.1. if the Company shall fail to make any payment when due (whether by acceleration or otherwise) pursuant to the Debenture or any other monetary Obligation, and the same shall remain unpaid following notice of such Event of Default given pursuant to Section 12.2;

12.1.2. (i) if any representation or warranty made by or on behalf of the Company in this Agreement or in any certificate, report or other instrument delivered under or pursuant to this Agreement shall prove to have been intentionally untrue or incorrect or made with a disregard for its truth or accuracy as of the date of this Agreement or as of the Closing Date, or (ii) if any report, certificate, financial statement or financial schedule or other instrument prepared or purported to be prepared by the Company or any officer of the Company hereafter furnished or delivered pursuant to this Agreement shall prove to be intentionally untrue or incorrect or made with a disregard for its truth or accuracy as of the date it was made, furnished or delivered; or

12.1.3. if default shall be made in the due and punctual performance or observance of any term contained in this Agreement or the Company shall violate any of the terms or any of the covenants set forth in this Agreement, and such default or violation shall have continued following notice given pursuant to Section 12.2; and

12.1.4. any bankruptcy, reorganization, debt arrangement or other proceeding under any bankruptcy or insolvency law, shall be instituted by or against the Company and, if instituted against Company, shall not have been consented to or acquiesced in by the Company, or shall remain undismissed for sixty (60) days, or an order for relief shall have been entered against Company.

12.1.5. if an Event of Default has occurred and is continuing under the Convertible Debenture Agreement for \$1,500,000 dated April 23, 2002 between the State and the Company.

12.2. **State Notice of Default and Acceleration of Payment.** Upon the occurrence of any Event of Default as set forth in Section 12.1, the State may or shall, if it desires to declare the existence of an Event of Default, give written notice of such default and if such default or

violation continues unremedied voluntarily or involuntarily for a period of 30 days after such written notice, then, unless such Event of Default has been waived in the manner provided in Section 13.1 hereof, the entire unpaid balance of the Debenture, and the interest then accrued thereon and any other monetary Obligation, shall become and be immediately due and payable without further notice or demand by the State or its assigns, and without any requirement of presentment or protest.

In the event the State has converted all or part of the Debenture into Common Stock ("Conversion Stock") and upon the occurrence of an Event of Default as herein defined, and so long as such event continues unremedied, then, unless such Event of Default has been remedied following 30 days' notice of such default or such Event of Default has been waived in the manner provided in Section 13.1 hereof, State may upon 30 days written notice demand that the Company redeem the Conversion Stock at a price per share equal to the Conversion Price per share of such Conversion Stock and if such Event of Default or violation continues after the 30 day notice of demand for redemption, the Company shall redeem the Conversion Stock. The rights herein are in addition to any legal and equitable remedies of the holders of the Debenture and the Conversion Stock.

**12.3. Company Notice of Default.** Upon the occurrence of any Event of Default, the Company shall give written notice of the same within five (5) business days of such occurrence to the State.

**12.4. Remedies Not Waived.** No course of dealing between the Company and the holder of the Debenture or Conversion Stock, and no delay in exercising any right, power or remedy conferred hereby or now or hereafter existing at law or in equity or by statute or otherwise, shall operate as a waiver of or otherwise prejudice any such right, power or remedy; provided, however, that this Section 12.4 shall not be construed or applied so as to negate the provisions and intent of any statute which is otherwise applicable.

**12.5. Remedies Upon Failure to Maintain Place of Business and Employment.** In the event the Company should violate the affirmative covenants regarding maintenance of place of business or employment, the Debenture shall, upon notice and failure to cure as provided in Section 12.2, become immediately due and payable. In the event all or any portion of the Debenture has been converted into Conversion Stock, in the absence of a public market or marketability of the Conversion Stock, the State may, upon notice to the Company require the Company to purchase any such shares of Conversion Stock at the greater of their Conversion Price or their fair market value without discount for lack of marketability or discount for lack of control. Fair marketability will be determined by agreement and if agreement cannot be reached within thirty (30) days of the date of the notice requesting repurchase, fair market value of such shares shall be determined by an appraiser selected by the Company and the State with



experience in appraising businesses and holding American Society of Appraisers credentials. The appraiser shall be directed to value the Company as a whole and not discount the Company Stock for lack of marketability or discount for lack of control. The per share value of Conversion Stock shall be determined by dividing the total value of the Company so determined by the number of shares of Common Stock issued and outstanding.

12.6. **Suits for Enforcement.** In case any one or more Events of Default shall have occurred and be continuing, unless such Events of Default shall have been waived in the manner provided in Section 13.1 hereof, the holders of the Shares may proceed to protect and enforce their rights under this Article 12 by suit in equity or action at law. It is agreed that in the event of such action, such holders of the Debenture and Conversion Stock shall be entitled to receive all fees, costs and expenses incurred in connection therewith, including without limitation the actual fees and expenses of attorneys (whether or not litigation is commenced) and other fees, costs and expenses of appeals.

12.7. **Remedies Cumulative.** No right, power or remedy conferred upon any holder of the Debenture or Conversion Stock shall be exclusive, and each such right, power or remedy shall be cumulative and in addition to every other right, power or remedy, whether conferred hereby or by any such security or now or hereafter available at law or in equity or by statute or otherwise.

### 13 MISCELLANEOUS

13.1. **Waivers and Amendments.** With the written consent of State as expressed in an amendment of this Agreement executed by all of the required State officials who have signed this Agreement, the obligations of the Company under this Agreement may be waived (either generally or in a particular instance and either retroactively or prospectively), and with the same consent the Company may enter into a supplementary agreement for the purpose of adding any provisions to or changing in any manner or eliminating any of the provisions of this Agreement, or of any supplemental agreement or modifying in any manner the rights and obligations created hereunder or thereunder.

13.2. **Notices.** All notices, requests, consents and other communications required hereunder shall be in writing and shall be personally delivered, sent by delivery service or mailed (in either case with a 3-day delivery guaranteed), if to State at 4261 Highway 53 South, P.O. Box 441, Eveleth, Minnesota 55734-0441, if to any other holder of any of the Securities, addressed to such holder at its address as shown on the books of the Company, or at such other address as the State or any other holder may specify by written notice to the Company, or, if to the Company at 11100 Wayzata Boulevard, Suite 305, Minnetonka, Minnesota 55305, or at such other address as the Company may specify by written notice to the State or holders of the

Securities, and such notices and other communications shall for all purposes of the Agreement be treated as being effective or having been given if delivered personally, or, if sent by mail or delivery service, when received.

13.3. **Survival of Representations and Warranties.** All representations and warranties contained herein shall survive the execution and delivery of this Agreement, any investigation at any time made by or on behalf of the State, and the sale and purchase of the Debenture and payment therefore. All statements contained in any certificate, instrument or other writing delivered by or on behalf of the Company pursuant hereto or in connection with or in contemplation of the transactions herein contemplated shall constitute representations and warranties by the Company hereunder.

13.4. **Parties in Interest.** All the terms and provisions of this Agreement shall be binding upon and inure to the benefit of and be enforceable by the respective successors and assigns of the parties hereto.

13.5. **Headings.** The headings of the sections of this Agreement have been inserted for convenience of reference only and do not constitute a part of this Agreement.

13.6. **Choice of Law.** It is the intention of the parties that the internal laws of the State of Minnesota, without regard to the body of law controlling conflicts of law, shall govern the validity of this Agreement, the construction of its terms and the interpretation of the rights and duties of the parties.

13.7. **Indemnification.**

13.7.1. **In General.** Company agrees that it will indemnify, pay and hold State and the officers, directors, employees, agents, consultants, Persons engaged by State to evaluate or monitor the Loan, and attorneys of State (collectively called the "Indemnitees") harmless from and against any and all Liabilities, obligations, losses, damages, penalties, actions, judgments, suits, claims, costs, expenses and disbursements of any kind or nature whatsoever (including the fees and disbursements of counsel for such Indemnitees in connection with any investigative, administrative or judicial proceeding commenced or threatened, whether or not such Indemnitee shall be designated a party thereto) that may be imposed on, incurred by, or asserted against that Indemnitee, in any manner relating to or arising out of this Agreement, the consummation of the transactions contemplated by this Agreement, the use or intended use of the proceeds of the Loan or the exercise of any right or remedy hereunder (the "Indemnified Liabilities"); provided, however, that Company shall have no obligation to an Indemnitee hereunder with respect to Indemnified Liabilities arising from the gross



negligence or willful misconduct of that Indemnitee as determined by a court of competent jurisdiction. This covenant shall survive the payment of the Obligation and the termination of this Agreement.

**13.7.2. Indemnification Concerning Environmental Matters.** Company hereby agrees to defend, indemnify and hold the State harmless from and against any and all Liens, demands, claims, actions, suits, proceedings, disbursements, Liabilities, losses, damages, judgments, penalties, costs and expenses (including, without limitation, attorneys', consultants' and experts' fees) paid, incurred, or asserted against the State for, with respect to, or as a direct or indirect result of the following:

13.7.2.1. the presence in, on, over or under, or the escape, seepage, leakage, spillage, discharge, emission or release on or from, any real property owned or leased by the Company of any environmentally regulated substances regardless of whether or not caused by or within the control of the Company;

13.7.2.2. the violation of any environmental law relating to or affecting Company; or

13.7.2.3. the violation of any environmental law in connection with any other property owned by the Company, which violation gives or may give rise to any rights whatsoever in any party with respect to Company or its property by virtue of any of the environmental laws, whether or not such violation is caused by or within the control of Company.

**13.8. Counterparts.** This Agreement may be executed concurrently in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

**13.9. State Audits.** Pursuant to Minnesota Statutes, Section 16C.05, Subdivision 5 (1998), the books, records, documents, and accounting procedures, and practices of the Company relevant to this Agreement shall be subject to examination by the State and the State of Minnesota's Legislative Auditor as appropriate, for a minimum of six (6) years following the termination or earlier cancellation of this Agreement.

**13.10. Non-Disclosure of Confidential Information.** All data maintained by the State or received by the State from the Corporation in regards to this Agreement constitutes "government data" under the provisions of Minnesota Government Data Practices Act, cited as Minnesota Statutes, Chapter 13 (the "GDPA"). State agrees that any data received by it from Corporation will be treated as "nonpublic data" when and to the extent permitted under the

provisions of the GDPA, as the same may be amended from time to time during the term of this Agreement.

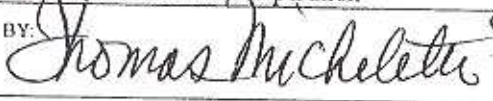



IN WITNESS WHEREOF, the State has caused this Agreement to be duly executed in its name and behalf and Company has caused this Agreement to be duly executed in its name and behalf, both intending it to become effective as of the date of the last required signature entered below.

**APPROVED:**

**1. COMPANY:**

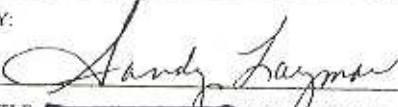
EXCELSIOR ENERGY INC.,  
a Minnesota business corporation

BY: 
TITLE: THOMAS MICHELETTI, CO-PRESIDENT and CHIEF EXECUTIVE OFFICER
DATE: November 24, 2004



BY: 
TITLE: JULIE JORGENSEN, DIRECTOR/CO- PRESIDENT
DATE: November 24, 2004

**2. STATE:**

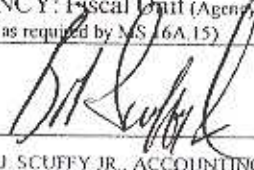
STATE OF MINNESOTA ACTING BY AND THROUGH  
ITS OFFICE OF THE COMMISSIONER OF IRON RANGE  
RESOURCES AND REHABILITATION

BY: 
TITLE:  COMMISSIONER
DATE: November 29, 2004

**3. COMMISSIONER OF ADMINISTRATION OR  
ITS DELEGATE:**

BY: 
TITLE: CONTRACT COORDINATOR 
DATE: 12/6/04

**4. STATE AGENCY: Fiscal Unit (Agency signatory certifies that funds  
have been encumbered as required by MS 16A.15)**

BY: 
TITLE: ROBERT J. SCUFFY JR., ACCOUNTING OFFICER, SR.
DATE: 12-8-04

**EXHIBIT AA**

THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE FEDERAL SECURITIES ACT OF 1933 AND MAY NOT BE SOLD OR OTHERWISE DISPOSED OF FOR VALUE, OR TRANSFERRED, WITHOUT (I) AN OPINION OF COUNSEL APPROVED BY THE COMPANY THAT SUCH SALE, DISPOSITION OR TRANSFER MAY LAWFULLY BE MADE WITHOUT REGISTRATION UNDER THE FEDERAL SECURITIES ACT OF 1933 AND UNDER APPLICABLE STATE SECURITIES LAWS, OR (II) SUCH REGISTRATION. THE TRANSFERABILITY OF SUCH SECURITIES IS SUBJECT TO RESTRICTIONS (A) REQUIRED BY FEDERAL AND STATE SECURITIES LAWS AND THE RULES, REGULATIONS, AND INTERPRETATIONS OF THE GOVERNMENTAL AGENCIES ADMINISTERING SUCH LAWS, AND THE PROCEDURES ESTABLISHED BY THE COMPANY TO EFFECT COMPLIANCE THEREWITH, GOVERNING UNREGISTERED SECURITIES, AND (B) AGREED TO BY THE OWNER OF SUCH SECURITIES.

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER CHAPTER 80A OF THE MINNESOTA SECURITIES LAWS OR APPLICABLE STATE BLUE SKY LAWS AND MAY NOT BE SOLD, TRANSFERRED, OR OTHERWISE DISPOSED OF FOR VALUE EXCEPT PURSUANT TO REGISTRATION OR OPERATION OF LAW.

\$8,000,000

**EXCELSIOR ENERGY INC. \$8,000,000  
CONVERTIBLE DEBENTURE**

**Due November \_\_, 2019**

Excelsior Energy Inc., a corporation duly organized and existing under the laws of the State of Minnesota (the "Company") for value received, hereby promises to pay to the order of the State of Minnesota acting by or through its administrative agency known as the Office of the Commissioner of Iron Range Resources and Rehabilitation (hereinafter "State") at its offices at 4261 Highway 53 South, P.O. Box 441, Eveleth, Minnesota 55734-0441 or at such other place designated at any time by the holder hereof, the principal sum of the lesser of (a) Eight Million Dollars (\$8,000,000), and (b) the total principal amount outstanding hereunder, together with interest on the unpaid balance thereof at the annual rate set forth below in accordance with the following installments and on the following terms:

1. This Debenture is issued pursuant to and subject to the terms of that certain Excelsior Energy Inc. \$8,000,000 Convertible Debenture Agreement by and between Company and State which became effective on November \_\_, 2004 (hereinafter the "Debenture Agreement"). Terms herein which begin with a capital letter and which are not otherwise defined herein shall have the meanings given such terms in said Debenture Agreement.

2. Interest shall accrue on the unpaid principal balance outstanding from time to time hereunder at the rate of twenty and 00/100 percent (20.00%) from the date hereof until all sums due under this Agreement are paid in full.



3. Repayment Provisions. The term of the Debenture shall be from the Closing Date until the Due Date. A payment of all accrued and unpaid interest shall be due and payable on the fifth (5<sup>th</sup>) Anniversary Date. Beginning on the sixth Anniversary Date, and each subsequent Anniversary Date while this Agreement is in force, a payment of \$800,000 of principal plus all accrued and unpaid interest is due. On the Due Date, a payment to the State in the full amount of all outstanding principal and accrued, but previously unpaid, interest on the Loan and of any other sums being due and payable.

4. Payments due hereunder shall be made in Immediately Available Funds as defined under the Debenture Agreement no later than 2:00 p.m., Eveleth, Minnesota time as of the Payment Date.

In the event principal of the Debenture is converted to Common Stock of the Company as provided in the Debenture Agreement, accrued and unpaid interest upon the principal amount of the Debenture converted into Common Stock of the Company shall immediately become due and payable.

5. After providing the State a 45 day notice, the Company shall have the right to prepay, without penalty, any or all of the principal. All payments received hereunder will be credited first toward accrued interest with the balance, if any, being applied as provided in the Debenture Agreement.

6. If the Company shall fail to pay, when due, any amount payable hereunder or commits or suffers to exist in an Event of Default under the terms of the Debenture Agreement, such event shall constitute a Default hereunder upon written notice by the holder to the Company pursuant to the Debenture Agreement and upon the failure of the Company to cure such default within 30 days of such notice as provided in the Debenture Agreement, the unpaid principal balance of this Debenture and all accrued interest thereon shall at the option of the State and without demand or notice of any kind, be declared and thereupon immediately shall become, due and payable as provided in the Debenture Agreement. In the event of such an Event of Default or Default, Company agrees to pay all expenses incurred by the holder, including, but not limited to, reasonable attorneys' fees and legal expenses in endeavoring to collect any of the sums due under this Debenture all as described in and pursuant to the Debenture Agreement.

7. Failure of the holder to exercise any right or remedy hereunder shall not operate as a waiver thereof, and no single or partial exercise by the State of any right or remedy shall preclude other or further exercise thereof or exercise of any other right or remedy under this Debenture or the Debenture Agreement. The Company agrees that this Debenture may not be changed orally and may only be changed by agreement in writing signed by the party against which enforcement of any waiver, change, modification or discharge is sought.

8. The principal amount of the Debenture may be converted at the option of the holder at any time from and after the Project Closing Date into shares of Common Stock of the Project Company in accordance with the terms of the Debenture Agreement, which terms are incorporated herein by reference and made a part of this Debenture. The shares of Common Stock issued upon such conversion ("Conversion Shares") are subject to the obligations set forth in the Debenture Agreement and are entitled to all the rights set forth in the Debenture Agreement.

9. In lieu of issuing any fraction of a share upon the conversion of this Debenture, the Company shall pay to the holder hereof for any fraction of a share otherwise issuable upon the conversion cash equal to the same fraction of the then conversion price of the Common Stock.

10. Presentment, notice of dishonor and protest are hereby waived by the Company.

11. The Company may treat the Person whose name or names appear on this Debenture as the absolute owner or owners hereof, for the purpose of receiving payment of, or on account of, the principal and interest due on this Debenture and for all other purposes.

12. In the event of any conflict or contradiction between any tenor or condition provided above and any term or condition contained in the Debenture Agreement, the terms and conditions of the Debenture Agreement shall control the obligations and rights of the Company and the holder of this Debenture.

IN WITNESS WHEREOF, the Company has hereunto set its hands this \_\_\_\_ day of November, 2004 ("Closing Date").

EXCELSIOR ENERGY INC.  
a Minnesota corporation ("Company")

(President or two other duly authorized  
corporate officers must sign)

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Title

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Title



**CERTIFICATE OF  
THE SECRETARY OF  
EXCELSIOR ENERGY INC.**

The undersigned, Thomas A. Micheletti, hereby certifies that he is the acting secretary of Excelsior Energy Inc, a Minnesota corporation, and that he is authorized to execute and deliver this certificate on behalf of the Corporation. As Secretary of Excelsior Energy Inc., he certifies that the Directors of Excelsior Energy Inc., pursuant to the Minnesota Business Corporation Act § 302A.239, took and consented to the following actions, effective as of November 17, 2004, without the formality of a meeting:

**BE IT RESOLVED**, that the Corporation hereby approves execution and delivery of the Convertible Debenture Agreement ("Agreement") and the Convertible Subordinated Debenture ("Debenture"), in the form presented to the Directors as of November 17, 2004, to the State of Minnesota acting by or through its Office of the Commissioner of Iron Range Resources and Rehabilitation ("IRRR"); and

**BE IT FURTHER RESOLVED**, that the Debenture, when delivered and paid for as contemplated in the Debenture Agreement dated November \_\_, 2004 (the "Agreement"), will be duly authorized, validly issued, fully paid and nonassessable; and

**BE IT FURTHER RESOLVED**, that the co-Presidents of the corporation, individually or together, are authorized to execute the Agreement and such other documents related thereto on behalf of the corporation; and

**BE IT RESOLVED FURTHER**, that all actions heretofore taken by the Board of Directors and Officers of the Corporation in connection with the entry into and delivery of the Agreement and Debenture are hereby adopted, ratified, confirmed and approved in all respects as the acts and deeds of the Corporation.

**EXCELSIOR ENERGY INC.**

By 

Thomas A. Micheletti  
Its Acting Secretary

Privileged or Confidential Information Redacted



## PROMISSORY NOTE

For value received, Excelsior Energy Inc. (the "Company") promises to pay to Thomas Micheletti or Julie Jorgensen (the "Lenders") the amount of loans outstanding from time to time from the Lenders to the Company, together with interest thereon at a rate of five percent (5%) per annum.

Such loans shall be evidenced by entries in the Company's accounts and shall be repayable from time to time when the Company receives funding .

IN WITNESS WHEREOF, the undersigned officer of the Company has executed this promissory note as of January 11, 2002.

EXCELSIOR ENERGY INC.

  
Julie Jorgensen  
Co-President and CEO