

BIOLASE TECHNOLOGY INC

Form 10-K

March 19, 2010

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

**Form 10-K**

(Mark One)

- b** ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2009  
OR  
**o** TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the transition period from to

Commission file number 000-19627

**BIOLASE TECHNOLOGY, INC.**  
*(Exact Name of Registrant as Specified in Its Charter)*

**Delaware**  
*(State or Other Jurisdiction  
of Incorporation or Organization)*

**87-0442441**  
*(I.R.S. Employer  
Identification No.)*

**4 Cromwell  
Irvine, California 92618**  
*(Address of Principal Executive Offices, including zip code)*  
**(949) 361-1200**  
*(Registrant's telephone number, including area code)*

**Securities registered pursuant to Section 12(b) of the Act:**

<b>(Title of Each Class)</b>	<b>(Name of Each Exchange on Which Registered)</b>
<b>Common Stock, par value \$0.001 per share</b>	<b>The NASDAQ Stock Market LLC (NASDAQ Capital Market)</b>

**Securities registered pursuant to Section 12(g) of the Act:**

**None.**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in the definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates was \$40,973,333 on June 30, 2009, (the last day of the Registrant's most recently completed second fiscal quarter), based on the closing price per share of \$1.69 for the registrant's common stock as reported on the NASDAQ Stock Market LLC on such date.

As of March 17, 2010, there were 24,384,903 shares of the Registrant's common stock, par value \$0.001 per share, outstanding.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Part III of this report incorporates information from the registrant's definitive proxy statement for its annual meeting of stockholders, which proxy statement is due to be filed with the Securities and Exchange Commission no later than 120 days after December 31, 2009.

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**BIOLASE TECHNOLOGY, INC.**

**ANNUAL REPORT ON FORM 10-K  
FOR THE FISCAL YEAR ENDED DECEMBER 31, 2009**

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**CAUTIONARY STATEMENT REGARDING FORWARD LOOKING STATEMENTS**

This Annual Report on Form 10-K, particularly in Item 1, Business, and Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, and the documents incorporated by reference, include forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical fact, are statements that could be deemed forward-looking statements, and include, but are not limited to, statements and predictions regarding our operating expenses, sales and operations, anticipated cash needs, capital requirements and capital expenditures, needs for additional financing, use of working capital, plans for future products and services and for enhancements of existing products and services, anticipated growth strategies, ability to attract customers, sources of net revenue, anticipated trends and challenges in our business and the markets in which we operate, the adequacy of our facilities, the impact of economic and industry conditions on our customers and our business, customer demand, our competitive position, the outcome of any litigation against us, the perceived benefits of any technology acquisitions, critical accounting policies and the impact of recent accounting pronouncements. Additional forward-looking statements include, but are not limited to, statements pertaining to other financial items, plans, strategies or objectives of management for future operations, our financial condition or prospects, and any other statement that is not historical fact, including any statement using terminology such as may, might, will, intend, should, could, can, would, expect, believe, estimate, predict, potential, plan, or the negativities of comparable terminology. For all of the foregoing forward-looking statements, we claim the protection of the Private Securities Litigation Reform Act of 1995. These statements are only predictions and actual events or results may differ materially and adversely from our expectations. Important factors that could cause actual results to differ materially from those stated or implied by our forward-looking statements include, but are not limited to, the impact of changes in demand for our products, our effectiveness in managing manufacturing costs and expansion of our operations, the impact of competition and of technological advances, and the risks set forth under Risk Factors in Item 1A. These forward-looking statements represent our judgment as of the date hereof. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

The information contained in this Annual Report on Form 10-K is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this Annual Report and in our other reports filed with the Securities and Exchange Commission (the SEC).

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**PART I**

**Item 1. Business**

**Overview**

We are a medical technology company that develops, manufactures and markets lasers, related products and services focused on technologies for improved applications and procedures in dentistry and medicine. In particular, our Waterlase Dentistry solution is a comprehensive group of products including dental laser systems that allow general dentists, periodontists, endodontists, oral surgeons and other specialists to perform a broad range of dental procedures, including cosmetic and complex surgical applications. Our systems are designed to provide clinically superior performance for many types of dental procedures, with less pain and faster recovery times than are generally achieved with drills, scalpels and other traditional dental instruments. The Waterlase Dentistry solution offers two categories of laser system products: our Waterlase family of products and our Diode family of products which includes our *ezlase*<sup>®</sup> and iLase<sup>™</sup> systems, as well as related consumables, training and services. In addition to products developed for the dental market, in late 2009 we introduced our first product outside of our primary market, the Diolase 10<sup>™</sup>, as part of our strategic expansion into the medical specialty markets, including sports medicine, orthopedics, physical therapy and chiropractics. The Diolase 10<sup>™</sup> is a diode laser used for therapeutic applications, including temporary pain relief and is based on the *ezlase*<sup>®</sup> platform.

*Waterlase systems.* Our Waterlase systems use a patented combination of water and laser to perform most dental procedures currently performed using dental drills, scalpels and other traditional dental instruments for cutting soft and hard tissue plus bone. We refer to our patented interaction of water and laser as YSGG Laser HydroPhotonics. In October 2004, we launched the Waterlase MD. The Waterlase MD has a broad range of clinical capabilities both in dentistry and other medical disciplines. We designed the Waterlase MD to provide the clinical benefits dentists desire, while also providing the comfort sought by patients. Advanced capabilities and new features coupled with innovative, ergonomic styling and design, are part of our proprietary MD technology platform. In July 2008, our Waterlase C100 All-Tissue Dental Laser System was introduced into the market. In February 2009, we introduced the Waterlase MD Turbo<sup>™</sup> All-Tissue Dental Laser System, an upgrade to the original Waterlase MD with cutting speeds approaching that of a high speed drill.

*Diode systems.* We also offer a line of Diode laser systems which use a semiconductor diode laser to perform soft tissue, cosmetic procedures and teeth whitening in dentistry and for pain management therapy. Our dental diode systems serve the growing markets of cosmetic and hygiene procedures. In early 2007, we received U.S. Food and Drug Administration, or FDA, 510(k) clearance for and launched the *ezlase* diode laser system. The *ezlase* system's approved indications include incision, excision, vaporization, ablation and coagulation of oral soft tissues as well as laser periodontal procedures, including laser soft tissue curettage and laser removal of diseased, infected, inflamed and necrosed soft tissue within the periodontal pocket, and sulcular debridement. In December 2008, we received an additional 510(k) clearance for tooth whitening using the *ezlase*. In February 2010, we introduced our new iLase<sup>™</sup> diode laser system, the first personal, affordable dental diode laser that provides minimally invasive solutions for common everyday soft tissue surgical and hygiene procedures. Featuring patent-pending finger switch activation, battery power, our unique 940 nm wavelength and ComfortPulse cutting modality, the iLase is portable and truly personal and we believe it represents the perfect complement for every dental operator. The iLase is CE mark-approved and received FDA 510(k) clearance in the United States in March 2010.

In April 2009, we received FDA 510(k) clearance for our *ezlase* platform for pain relief and therapy with application in Sports Medicine, Orthopedics, Physical Therapy and Chiropractics. In late 2009 we broadened our product scope to

include the use of lasers in a variety of health care and therapeutic markets outside of dentistry with the release of the Diolase 10<sup>tm</sup> Diode Laser. The Diolase 10 was launched with the patented Body Contour handpiece for therapeutic applications, including temporary pain relief, topical heating for the purpose of elevating tissue temperature for a temporary relief of minor muscle and joint pain and stiffness, minor arthritis pain, or muscle spasm, minor sprains and strains, and minor muscular back pain; the temporary



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increase in local blood circulation; and the temporary relaxation of muscle. The Diolase 10 represents the first product from BIOLASE that is part of a strategic expansion into the medical specialty markets, including sports medicine, orthopedics, physical therapy and chiropractics. We will initially focus on the chiropractic market where according to recent industry reports, there are more than 60,000 chiropractors in the United States. Expansion into international markets for pain management is expected to begin during the second quarter of 2010.

We have clearance from the FDA to market our laser systems in the United States and also have the necessary approvals to sell our laser systems in Canada, the European Union and certain other international markets. We are currently pursuing regulatory approval to market and sell our Waterlase systems in Japan. Since 1998, we have sold approximately 7,700 Waterlase systems, including over 3,800 Waterlase MD systems, and over 13,800 laser systems in total in over 50 countries.

We believe there is a large market for our products in the United States and internationally. According to the American Dental Association, or ADA, there are over 160,000 practicing dentists in the United States. According to the World Federation of Dentistry, an international dental organization, there are at least 700,000 dentists worldwide, and we believe that a substantial percentage of them practice in major international markets outside the United States. The use of lasers in dentistry is growing. However, we believe only a small percentage of dentists currently use laser systems, and that there is a significant opportunity to increase sales of our products worldwide.

Our goal is to establish our laser systems as essential tools in dentistry and to continue to build a leading position in the dental laser market. Our sales and marketing efforts focus on educating dental professionals and patients on the benefits of our Waterlase Dentistry solution. In 2002, we founded the World Clinical Laser Institute, an association that includes prominent researchers, educators and practicing dentists, to formalize our efforts to educate and train dentists and specialists in laser dentistry. We participate in numerous other symposia and dental industry events to educate and stimulate demand for our products. We have also developed numerous relationships with dental schools, research facilities and dental institutes, in the United States and internationally, which use our products for education and training. We believe this will expand awareness of our products among new generations of dental professionals.

We were originally formed as Societe Endo Technic, SA, or SET, in 1984 in Marseilles, France, to develop and market various endodontic and laser products. In 1987, SET was moved to the United States and was merged with a public holding company, Pamplona Capital Corp. In 1994, we changed our name to BIOLASE Technology, Inc. Since 1998, our objective has been to become the leading designer, manufacturer and marketer of laser systems for the dental industry.

## **Industry Background**

### ***General***

We estimate that more than 200 million hard tissue procedures are performed annually in the United States. Hard tissue procedures include cavity preparation, root canals and other procedures involving bone or teeth. The survey also indicated that more than 1.2 million soft tissue procedures are performed annually in the United States. Soft tissue procedures include gum line alteration and other procedures involving soft dental tissue. According to statistics compiled by the ADA, over 90% of hard tissue procedures and 60% of soft tissue procedures in the United States are performed by general dentists, and the rest are performed by oral surgeons, endodontists, periodontists and other specialists.

The ADA estimates that the demand for dental services in the United States will continue to grow due to population growth and the increased awareness of the benefits associated with preventive dentistry in reducing the incidence of oral and systemic disease. According to the ADA, annual dental spending in the United States in 2008 was

\$99.9 billion and is expected to increase by approximately two percent to six percent per year through 2015.

We believe there is a growing awareness among consumers of the value and importance of a healthy smile and its connections to overall systemic health. As such, the dental industry has entered an era of growth

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and consideration of advanced technologies that allow dentists to perform simple or complex cosmetic dental procedures with minimal trauma, improved patient acceptance and clinically superior results. We believe our product offering corresponds with this trend, and we expect incremental growth from these pressures in the marketplace.

### ***Traditional Dental Instruments***

Dental procedures are performed on hard tissue, such as bone and teeth, and soft tissue, such as gum and other oral tissue. Dentists and other specialists choose from a variety of instruments depending on the tissue involved and the type of procedure. Most procedures require the use of multiple instruments to achieve the desired result.

*High Speed Drills.* Most dentists use high speed drills for hard tissue procedures, such as preparing cavities for filling and gaining access for performing root canals or shaving and contouring oral bone tissue. Potentially adverse effects associated with drills include thermal heat transfer, vibration, pressure and noise. The cutting and grinding action of high speed drills can cause damage to the patient's dental structure and the trauma caused to the surrounding tissues can lead to increased recovery times. Additionally, this grinding action of high speed drills may weaken the tooth's underlying structure, leading to fractures and broken cusps. Crowns and root canals may become necessary as a result of damage caused during previous dental procedures. Anesthesia is generally required for all procedures that involve the use of high speed drills. As a result, dentists often limit procedures to one or two quadrants of the mouth because of concerns relating to the use of anesthesia in several regions. This can force patients to return several times to complete their treatment plan.

*Cutting Instruments.* Soft tissue procedures, such as reshaping gum lines and grafting on new gum tissue, are typically performed by oral surgeons or periodontists using scalpels, scissors and other cutting tools. Due to the pain and discomfort associated with procedures performed with these instruments, most soft tissue procedures require the use of local anesthetic which results in numbness and discomfort, and often require stitches. Use of scalpels, scissors and other cutting tools typically cause bleeding, post-operative swelling and discomfort. Bleeding can impair the practitioner's visibility during the procedure, thereby reducing efficiency. Bleeding is a particular problem for patients with immune deficiencies or blood disorders, and patients taking blood-thinning medications.

### ***Alternative Dental Instruments***

Alternative technologies have been developed over the years to address the problems associated with traditional methods used in dentistry. Most alternatives have addressed either hard or soft tissue applications. The predominant alternative technologies are discussed below.

*Electrosurge Systems.* Electrosurge systems use an electrical current to heat a shaped tip that simultaneously cuts and cauterizes soft tissue, resulting in less bleeding than occurs with scalpels. However, electrosurge can deeply penetrate the soft tissue, which can result in unwanted damage to surrounding tissue, and is generally less precise than lasers. Electrosurge is also not suitable for hard tissue procedures and, due to the depth of penetration, generally requires use of anesthesia and involves a lengthy healing process. Use of electrosurge is generally restricted from the areas near metal fillings and dental implants. Finally, electrosurge generally cannot be used with patients with implanted pacemakers and defibrillators.

*Traditional Laser Systems.* More recently, lasers have gained acceptance for use in general and cosmetic dentistry. Most lasers used in dentistry have been adapted from other medical applications, such as dermatology, and are not designed to perform a wide range of common dental procedures. Most dental lasers use thermal energy to cut tissue and are used primarily for soft tissue procedures.

Due to the limitations associated with traditional and alternative dental instruments, we believe there is a large market opportunity for all-tissue dental laser systems that provide superior clinical results and help reduce the trauma, pain and discomfort associated with dental procedures.

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### **Our Solution**

We believe the potential for increased patient satisfaction, improved outcomes and enhanced practice profitability that can be achieved through use of our products will position our laser systems as the instruments of choice among practitioners and patients. We have developed our laser systems and related products specifically for the dental market to more effectively perform a broad range of dental procedures. We believe the skill level and dexterity necessary to operate our laser systems are similar to those necessary to operate conventional drills and other dental equipment. Our laser systems also have the advantage of being minimally invasive and able to perform procedures in narrow spaces where access by conventional instruments often is limited. Our systems are intended to complement traditional tools, such as dental drills, which perform functions that our systems do not address, such as cutting metal fillings and certain polishing and grinding functions.

Our Waterlase systems precisely cut hard tissue, such as bone and teeth, and soft tissue, such as gums, with minimal or no damage to surrounding tissue and dental structure. Our Diode systems are designed to complement the Waterlase systems, and are used in soft tissue procedures, hygiene and cosmetic applications. The Diode systems, together with our Waterlase systems, offer practitioners a broad product line with a range of features and price points.

A small percentage of dental professionals worldwide currently use lasers. Moreover, our laser systems are more expensive than traditional dental tools. However, we believe that the significant clinical advantages of our systems, patient benefits, the potential return on investment that our systems offer practitioners and the options available to finance the purchase of our systems will enable us to continue to penetrate the dental market segment. Laser technologies with similar patient benefits have become standard of care in ophthalmology, dermatology and other medical specialties.

We believe the demand for our systems will continue to expand as we increase awareness of the benefits to patients and dental professionals.

### ***Benefits to Dental Professionals***

*Expanded range of procedures and revenue opportunities.* Our laser systems often allow general dentists to perform surgical and cosmetic procedures that they are unable or unwilling to perform with conventional methods, and which would typically be referred to a specialist. These procedures include crown lengthening, frenectomy and biopsy. Our systems allow dentists to perform these procedures easily and efficiently, increasing their range of skills and professional satisfaction.

*Additional procedures through increased efficiency.* Our systems can shorten and reduce the number of patient visits, providing dental professionals with the ability to service more patients. For hard tissue procedures, our Waterlase systems can reduce the need for anesthesia, which enables the dental practitioner to perform multiple procedures in one visit. One advantage of this benefit is that it can be used to perform cavity preparations in multiple quadrants. In contrast, many dentists using high speed drills normally cannot perform cavity preparations in more than one quadrant per visit because of concerns relating to use of anesthesia in multiple regions. For soft tissue procedures, the Waterlase and Diode systems allow tissue to be cut more precisely and with minimal bleeding when compared to traditional tools such as scalpels and electrosurge systems. We recently received FDA clearance for Deep Pocket Therapy with a New Attachment using the Waterlase System. This is a minimally invasive therapy for moderate to advanced gum disease. Additionally, the *eZlase* system can be used to quickly perform tooth whitening with our proprietary whitening gel.

*Increased loyalty and expanded patient base.* We believe the improved patient comfort and convenience offered by our laser systems will help improve patient retention, attract new patients, increase revenue per

patient, increase demand for elective procedures, increase acceptance of treatment plans and increase word-of-mouth referrals.

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*Fewer post-operative complications.* Our laser systems can reduce trauma, swelling and general discomfort, resulting in fewer post-operative complications that require follow up treatment. Practitioners can devote time to new cases, rather than treating complications from prior procedures.

### ***Benefits to Patients***

*Comfort.* The Waterlase system is able to perform various types of dental procedures without causing the heat, vibration or pressure associated with traditional dental methods. As a result, patients can experience dramatically improved comfort during and after most procedures. In many cases, procedures can be performed without local anesthesia, which eliminates the pain associated with injections and the feeling of numbness following the procedure.

*Convenience.* Our Waterlase system does not require anesthesia in many cases, which allows dental practitioners to perform procedures in multiple quadrants of the mouth during a single office visit. This can reduce the number of visits necessary to complete the patient's treatment plan. Similarly, the ability to treat a wider range of procedures in the office reduces referrals with many procedures able to be treated in the same appointment as diagnosed.

*Reduced trauma.* The Waterlase system avoids the thermal heat transfer, vibration and grinding action associated with the high speed dental drill. For soft tissue applications, our laser systems cut with more precision and less bleeding than typically achieved with conventional instruments. As a result, our systems can result in less trauma, swelling and general discomfort to the patient.

*Broader range of available procedures.* Due to the improved comfort and convenience of our Waterlase system, we believe patients are more likely to consider cosmetic and other elective procedures that would generally be time consuming and uncomfortable, including osseous crown lengthening, periodontal surgeries and numerous other procedures.

### **Business Strategy**

Our objectives are to increase our leadership position in the dental laser market, to establish our laser systems as essential tools in dentistry and to leverage our existing technology platform into other medical markets where it can provide significant improvements over existing standards of care. Our business strategy consists of the following key elements:

*Increase awareness of our laser systems among dental practitioners and patients.* We intend to further penetrate the dental market by educating dental practitioners and patients about the clinical benefits of Waterlase Dentistry. We plan to increase adoption of our laser systems by dental practitioners through our continued participation in key industry trade shows, the World Clinical Laser Institute, dental schools and other educational forums. We also intend to market our systems to dental practitioners through our laser specialists and advertising. We continue to explore marketing efforts aimed directly at patients.

*Expand sales and distribution capabilities.* In the United States and Canada, we distributed our products directly to dental practitioners utilizing our direct sales force through August 31, 2006. Effective September 1, 2006, we began distributing our products through a leading U.S. dental products and equipment distributor, Henry Schein, Inc., or HSIC. In the initial agreement, we expected HSIC's large direct sales force in the U.S. and Canada to increasingly provide high quality sales leads, while our laser specialists continue to perform technical selling and deal closing. Internationally, we intend to use established dental and medical

device distributors. We are developing an infrastructure to support growth in sales and marketing. This infrastructure includes product management, information technology systems and personnel to manage our sales force, compile sales and marketing data and better serve our customers and distributors.

Additionally, on February 27, 2009, we entered into an agreement with HSIC in which HSIC became our distributor in certain international countries including Germany, Spain, Australia and New Zealand and were permitted to distribute our products in those additional markets where we did not have current



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distribution agreements in place through December 31, 2009. On March 9, 2010, we entered into another letter agreement with HSIC. This letter agreement calls for guaranteed minimum purchases by HSIC of \$18 million solely in respect of laser equipment in certain territories, plus additional laser equipment purchases on an uncapped basis in certain other territories, plus incremental purchases of consumable products and services in all applicable territories. Pursuant to this letter agreement, all dental sales will continue to be provided exclusively through HSIC in the United Kingdom, Australia, New Zealand, Belgium, Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America. This letter agreement provides incentives for HSIC to focus on its core customer base, and we will have incremental sales and margin incentives to penetrate additional dental offices. This letter agreement has an initial term of one year, after which this letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate this letter agreement upon sixty days advance written notice to the other party.

*Expand product platform and applications.* We plan to expand our product line and product applications by developing product enhancements and new laser technologies including new products for use in the medical community such as our Diolase 10 launched in late 2009. We also have an objective to increase our sales of disposable products that are used by dental practitioners when performing procedures using our dental laser systems. Additionally, we may strategically acquire complementary products and technologies.

*Expand our Er;Cr:YSGG and 940 nm diode technologies into the medical field.* Our Waterlase and ezlase lasers, their delivery systems and accessories have applications in other specialties, including but not limited to ophthalmology, sports medicine, dermatology, and podiatry. We expect to use distribution partners and other strategic partnerships to enter into these markets while maintaining our primary focus on the worldwide dental market, which we believe remains the largest potential market to be served in medicine.

*Continue high quality manufacturing and customer service.* Our manufacturing operations are focused on producing high quality dental laser systems. We intend to continually develop and refine our manufacturing processes to increase production efficiencies and product quality. We provide high quality maintenance and support services through our support hotline and dedicated staff of in-house and field service personnel. Additionally, we maintain a network of factory-trained service technicians to provide maintenance and support services to customers in Europe and other markets outside the United States.

*Strengthen and defend technology leadership.* We believe our proprietary Waterlase system and YSGG Laser HydroPhotonics technology represent significant advancements in dentistry. We will pursue the protection of our intellectual property rights by expanding our existing patent portfolio in the United States and internationally. We intend to strategically enforce our intellectual property rights worldwide.

## **Products**

Within our Waterlase Dentistry offering, we have two principal product lines. Our family of products includes the Waterlase and Diode systems, which we developed through a combination of our own research and development and intellectual property obtained via various acquisitions.

*Waterlase systems.* Our Waterlase systems consist of the Waterlase MD and Waterlase C100 All-Tissue Dental Laser systems. Each of these systems is designed around our patented YSGG Laser HydroPhotonics technology. YSGG is a shortened abbreviation referring to the unique crystal (Er, Cr: YSGG) laser used in the Waterlase system, which contains the elements erbium, chromium and yttrium, scandium, gallium and garnet. This unique crystal laser produces energy with specific absorption and tissue interaction characteristics optimized for dental applications. HydroPhotonics refers to the interaction of laser with water to produce energy to cut tissue. Through YSGG Laser HydroPhotonics, the Waterlase systems is minimally invasive and can precisely cut hard tissue, such as bone and

teeth, and soft tissue, such as gums, without the heat, vibration or pressure associated with traditional dental treatments. By eliminating heat, vibration and pressure, our

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Waterlase systems reduce and, in some instances, eliminate the need for anesthesia and also result in faster healing times versus traditional modalities of treatment.

Both Waterlase systems incorporate an ergonomic handpiece and an extensive control panel located on the front of the system with precise preset functionality to control the mix of air and water. Each system has also been designed to be easily moved from operatory to operatory within a practice office. The Waterlase MD has expanded capabilities, features and benefits including white LED handpiece illumination, a full color touch screen improving user friendliness (with a built in user Help system), a more refined water spray that improves cutting, more power, a smaller footprint, with an overall 40% reduction in size, and a Windows CE operating system. In 2008, we introduced the new clinical procedure for endodontics root canal disinfection with radial firing tips. The Waterlase MD Turbo All-Tissue Dental Laser System was introduced in the first quarter of 2009 further enhancing cutting speed to comparable levels of the high speed drill.

*Diode systems.* Our Diode laser systems consists of the *ezlase* and iLase, semiconductor diode lasers to perform soft tissue, hygiene and cosmetic procedures, including teeth whitening. Our *ezlase* system serves the growing markets of general, cosmetic, orthodontic, and hygiene procedures. The *ezlase* system was introduced in February 2007 with an award winning design, superior ergonomics and performance characteristics over previous generations of diode lasers. It features a new pulse mode, ComfortPulse, which allows the tissue to cool between pulses resulting in improved patient comfort and reduced need for anesthesia for many common procedures. Other features include wireless foot pedal control, disposable single-use tips, color touch screen activation with up to fifteen procedure based pre-sets, whitening hand piece, rechargeable battery pack and wall mount . We received FDA clearance for tooth whitening using the *ezlase* system in 2008. In February 2010, we introduced our new iLase diode laser system, the first personal, affordable dental diode laser that provides minimally invasive solutions for the most common everyday soft tissue surgical and hygiene procedures. Featuring patent-pending finger switch activation, battery power, our unique 940 nm wavelength, and ComfortPulse® cutting modality, we believe the iLase is a portable and truly personal perfect complement for every dental operatory. The iLase is CE mark-approved and received FDA 510(k) clearance in the United States in March 2010.

We currently sell our products in over 50 countries. The FDA has cleared all of our laser systems for the applications listed below, which enables us to market the systems in the United States. Our systems have the CE Mark and may be sold in the European Union. Additionally, we have approval to sell our laser systems in Canada, Australia, New Zealand and most other Pacific Rim countries.

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<b>Product</b>	<b>Selected Applications</b>	<b>Key Features</b>
<b><i>Waterlase Systems</i></b>		
Waterlase MD Turbo	<i>Hard Tissue:</i> Cavity preparation, caries removal, roughening or etching, root canal therapy and disinfection as well as other hard tissue surgical applications.	Incorporated new white LED technology to Illuminated Handpiece
<i>Laser Technology</i> Solid State Crystal, Erbium, Chromium: Yttrium, Scandium, Gallium, Garnet (Er, Cr: YSGG), Laser with Air-Water Spray	<i>Bone:</i> Cutting, shaping, contouring, resection, crown lengthening (restorative), apicoectomy or amputation of root end, and other oral osseous or bone procedures.	Full color touch screen Laser Control System
<i>Laser Wavelength</i> 2780 nm	<i>Soft Tissue:</i> Incision, excision and biopsy of soft tissue, frenectomy, troughing, fibroma removal, hemostasis, aphthous oral ulcers, operculectomy and other soft tissue surgical applications.	MD Flow <sup>TM</sup> laser detector to determine water level
<i>Power</i> 0.1 8.0 Watts	<i>Cosmetic:</i> Gingivectomy, gingivoplasty and crown lengthening.	Laser Operatory Management System smaller footprint versus the Waterlase YSGG.
<i>Repetition Rate</i> 10 50 Hz		360-degree contra-angle, rotatable handpiece
		ComfortJet <sup>TM</sup> air/water delivery system
		Window <sup>®</sup> CE operating system
		16 memory pre-sets
		LaserPain <sup>TM</sup> help system
Waterlase C100	<i>Hard Tissue:</i> Cavity preparation, caries removal, roughening or etching, root canal procedures and other hard tissue surgical applications.	Advanced fiber delivery system
<i>Laser Technology</i> Solid State Crystal, Erbium, Chromium: Yttrium, Scandium, Gallium, Garnet (Er, Cr: YSGG), Laser with Air-Water Spray	<i>Bone:</i> Cutting, shaping, contouring, resection, crown lengthening (restorative), apicoectomy or amputation of root end, and other oral osseous or bone procedures.	Ergonomic handpiece
<i>Laser Wavelength</i> 2780 nm	<i>Soft Tissue:</i> Incision, excision and biopsy of soft tissue, frenectomy, troughing, fibroma removal, hemostasis, aphthous oral ulcers, operculectomy and other soft tissue surgical applications.	Extensive control panel providing precise digital control of the air and water spray for maximum flexibility
<i>Power</i> 0.1 6.0 Watts		Ease of maneuverability from operatory to operatory
<i>Repetition Rate</i> 10 30 Hz		

*Cosmetic:* Gingivectomy,  
gingivoplasty and crown  
lengthening.

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<b>Product</b>	<b>Selected Applications</b>	<b>Key Features</b>
<b><i>Diode Systems</i></b>		
<i>eZlase System</i>	<i>Soft Tissue:</i> Incision, excision and biopsy of soft tissue, frenectomy, troughing, fibroma removal and other soft tissue surgical applications.  <i>Cosmetic:</i> Gingivectomy, gingivoplasty and tooth whitening.  <i>Hygiene:</i> Curettage and sulcular debridement  <i>Pain Therapy:</i> Temporary relief of Oral maxillofacial pain	Color touch screen with 15 pre-sets
<i>Laser Technology Semiconductor Diode Laser</i>		ComfortPulse®
<i>Laser Wavelength</i> 810 and 940 nm		Wireless foot pedal
<i>Power</i> 4.5 and 7.0 Watts		Totally portable, lightweight
<i>iLase System</i>	<i>Soft Tissue:</i> Incision, excision and biopsy of soft tissue, frenectomy, troughing, fibroma removal and other soft tissue surgical applications.  <i>Cosmetic:</i> Gingivectomy, gingivoplasty <i>Hygiene:</i> Curettage and sulcular debridement	Finger Switch Laser Actuation
<i>Laser Technology Semiconductor Diode Laser</i>		Factory-loaded pre-set values
<i>Laser Wavelength</i> 940 nm		Battery Power
<i>Power</i> 3.0 Watts CW and 5.0 Watts Pulsed		940 nm wavelength  ComfortPulse®  Bendable, disposable, multiple-length, multiple-diameter tips  User friendly display and navigation
<i>Diolase 10</i>	<i>Pain Management:</i> For therapeutic applications including temporary pain relief, muscle and joint stiffness, arthritis pain, muscle spasm, sprains and strains, muscular back pain, increase in blood flow and relaxation of muscle in sports medicine, orthopedics, physical therapy and chiropractics.	Intuitive touch screen interface
<i>Laser Technology Semiconductor Diode Laser</i>		Truly portable with battery powered option
<i>Laser Wavelength</i> 940 nm		16 one button presets simplify treatments
<i>Power</i> 10 Watts		Body Contour Handpiece with uniform distribution over entire treatment area

940 nm, the perfect combination  
of penetration and absorption

***Related Accessories and Disposable Products***

We also manufacture and sell disposable products and accessories for our laser systems. Our Waterlase and *ezlase* systems use disposable laser tips of differing sizes and shapes depending on the procedures being performed. We also market flexible fibers and hand pieces that the dental practitioner will replace at some point after initial purchase of the laser system. For our *ezlase* system, we manufacture and sell tooth whitening gel kits.

**Warranties**

Our Waterlase laser systems sold domestically are covered by a warranty against defects in material and workmanship for a period of up to one-year while our diode systems warranty is up to two years from the date

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of sale by the Distributor to the end-user. Waterlase systems sold internationally are generally covered by a warranty against defects in material and workmanship for a period of sixteen months while our diode systems warranty period is up to twenty eight months from date of sale to the Distributor. Our warranty covers parts and service for sales in our North American territories and parts only for international distributor sales. We sell service contracts to our end users that cover the period after the expiration of our standard warranty coverage for our laser systems. Extended warranty coverage provided under our service contracts varies by the type of system and the level of service desired by the customer. Product or accessories remanufactured, refurbished or sold by parties not authorized by BIOLASE, voids all warranties in place for such products and exempts us from liability issues relating to the use of such products.

## **Insurance**

We currently maintain product liability insurance on a per occurrence basis with a limit of \$11.0 million per occurrence and \$12.0 million in the aggregate for all occurrences. The insurance is subject to various standard coverage exclusions, including damage to the product itself, losses from recall of our product and losses covered by other forms of insurance such as workers compensation. We cannot be certain that we will be able to successfully defend any claims against us, nor can we be certain that our insurance will cover all liabilities resulting from such claims. In addition, we cannot assure you that we will be able to obtain such insurance in the future on terms acceptable to us, or at all.

## **Manufacturing**

Our corporate headquarters in Irvine, California is 57,000 square feet, with approximately 20,000 square feet dedicated to manufacturing and warehouse. All of our manufacturing, assembly and testing occurs at this facility. Our facility is ISO 13485:2003 certified. ISO 13485 certification provides guidelines for quality of company systems associated with the design, manufacturing, installation and servicing of company products. In addition, our U.S. facility is registered with the FDA and is compliant with the FDA's Good Manufacturing Practice guidelines.

We use an integrated approach to manufacturing, including the assembly of tips, Waterlase MD and diode laser hand pieces, fiber assemblies, laser heads, electro-mechanical subassembly, final assembly and testing. We obtain components and subassemblies for our products from third party suppliers, most of which are located in the United States. We generally purchase components and subassemblies from a limited group of suppliers through purchase orders. We generally rely on purchase orders, and do not have written supply contracts with many of our key suppliers. Three key components used in our Waterlase system: handpieces, laser crystals, and fiber components are each supplied by separate single-source suppliers. In recent years, we have not experienced material delays from the suppliers of these three key components. However, in the event that we experience an unexpected interruption from a single source supplier, manufacturing delays, re-engineering, significant costs and sales disruptions could occur, any of which could have a material adverse effect on our operations. We are currently in the process of identifying and qualifying alternate source suppliers for our key components. There can be no assurance, however, that we will successfully identify and qualify an alternate source supplier for any of our key components or that we could enter into an agreement with any such alternate source supplier on terms acceptable to us.

## **Marketing and Sales**

### ***Marketing***

We currently market our laser systems in the United States and worldwide. Our marketing efforts are focused on increasing brand and specific product awareness among dental practitioners. We continue to explore methods to increase awareness of the benefits of our products by marketing directly to patients.



*Dental Practitioners.* We currently market our laser systems to dental practitioners through regional, national and international trade publications, events, meetings and seminars. We also use brochures, direct mailers, press releases, posters and other promotional materials, as well as print and electronic media news coverage. In 2002, we founded the World Clinical Laser Institute to formalize our efforts to educate and train

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dental practitioners in laser dentistry. The Institute conducts and sponsors educational programs domestically and internationally for dental practitioners, researchers and academicians, including one, two and three-day seminars and training sessions involving in-depth presentations on the use of lasers in dentistry. In addition, we have developed relationships with research institutions, dental schools and laboratories which use our products in training and demonstrations. We believe these relationships will increase awareness of our products.

*Chiropractors, Sports Medicine.* We have recently begun to market to chiropractors, physical therapists and other pain management specialists through trade advertising, seminars and attending trade shows, primarily through a network of independent sales representatives managed by the Biolase sales management team.

*Patients.* We market the benefits of our laser systems directly to patients through marketing and advertising programs, including print and broadcast media, local television news and radio spots, as well as product placements of our laser systems on television programs. We believe that making patients aware of our laser systems and their benefits will increase demand for our products.

***Sales***

We currently sell our products primarily to dentists in general practice through our distributor network. The majority of the dentists in the United States, and the majority of our end-user customers are sole practitioners. We expect our laser systems to gain acceptance among periodontists, endodontists, oral surgeons and other dental specialists, as they become better aware of the clinical benefits and new treatment options available through the use of our laser systems. Outside of the dental market, we expect initial sales of the Diolase 10 will be to chiropractors, physical therapists and other pain management specialists.

International revenue accounts for a significant portion of our total revenue. International revenue accounted for approximately 28%, 25% and 38% of our net revenue in 2009, 2008 and 2007, respectively.

Net revenue by geographic location based on the location of customers was as follows (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
United States	\$ 31,134	\$ 48,526	\$ 41,598
International	12,213	16,099	25,291
	<b>\$ 43,347</b>	<b>\$ 64,625</b>	<b>\$ 66,889</b>

In the United States and Canada, effective September 1, 2006, we commenced selling our products through a leading U.S. dental products and equipment distributor, HSIC. We expect HSIC's large direct sales force in the U.S. and Canada to increasingly provide high quality sales leads, while our laser specialists continue to perform technical selling and deal closing. Our sales support team is comprised of regional managers and laser specialists. Each of our laser specialists receives a base salary and commissions on sales. As part of this agreement, HSIC purchases products from us at negotiated distributor pricing, and invoices the customer directly at the customer's purchase order price.

In August 2006, we entered into a distribution agreement, or License and Distribution Agreement, with Henry Schein, Inc., or HSIC, a large distributor of healthcare products to office-based practitioners, pursuant to which we granted HSIC the exclusive right to distribute our complete line of dental laser systems, accessories and services in the United

States and Canada. The agreement had an initial term of three years, following which it would automatically renew for an additional period of three years, provided that HSIC achieved its minimum purchase requirements.

On May 9, 2007, we entered into Addendum No. 1 to License and Distribution Agreement with HSIC, which addendum was effective as of April 1, 2007 and modified the License and Distribution Agreement entered into with HSIC on August 8, 2006, to add the terms and conditions under which HSIC has the exclusive right to distribute our new *ezlase* diode dental laser system in the United States and Canada. In the Addendum, separate minimum purchase requirements are established for the *ezlase* system. If HSIC has not

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met the minimum purchase requirement for any 12-month period ending on March 31, we will have the option, upon 30 days written notice, to (i) convert *eZlase* distribution rights to a non-exclusive basis for a minimum period of one year, after which period we would have the option to withdraw *eZlase* distribution rights, and (ii) reduce the distributor discount on *eZlase* products.

On March 3, 2008, we entered into a second addendum to the HSIC agreement that modifies certain terms of the initial agreement as amended. Pursuant to amendment 2 to the agreement, HSIC is obligated to meet certain minimum purchase requirements and is entitled to receive incentive payments if certain purchase targets are achieved. If HSIC has not met the minimum purchase requirements, we will have the option to (i) shorten the remaining term of the agreement to one year, (ii) grant distribution rights held by HSIC to other persons (or distribute products ourselves), (iii) reduce certain discounts on products given to HSIC under the agreement and (iv) cease paying future incentive payments. Additionally, under certain circumstances, if HSIC has not met the minimum purchase requirements, we have the right to purchase back the exclusive distributor rights granted to HSIC under the agreement. We also agreed to actively promote Henry Schein Financial Services as our exclusive leasing and financing partner.

On December 23, 2008, we entered into a letter agreement with HSIC which extended the initial term of the License and Distribution Agreement to December 31, 2010.

On February 27, 2009, we entered into a letter agreement with HSIC which adjusted the initial term of the License and Distribution Agreement through March 31, 2010. This amendment includes certain minimum purchase requirements through the term of the agreement. HSIC also has the option to extend the term of the agreement for two additional one-year terms which require certain minimum purchase requirements. In addition, HSIC became our distributor in certain international countries including Germany, Spain, Australia and New Zealand and were permitted to distribute our products in those additional markets where we did not have current distribution agreements in place.

On September 10, 2009, we entered into an amendment to the License and Distribution Agreement with HSIC, as amended, wherein we agreed to provide to HSIC certain customer warranties in respect of our products.

On January 31, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement we agreed to an extension of the time for HSIC to provide notice of its intention to renew the License and Distribution Agreement for an additional one year term, from February 1, 2010 to February 25, 2010, in accordance with the terms and conditions thereof.

On February 16, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement, we agreed to HSIC's request to make certain changes to the applicable product categories required to be purchased by HSIC through March 31, 2010, as set forth in the February 27, 2009 letter agreement. The changes include advance payments in respect of, among other things, purchases of the iLase and the provision of upgrades by us to existing products, should such upgrades be made available in the future. In connection with the advance payments described above, we agreed to grant to HSIC a security interest in our inventory as security for advance payments made under the letter agreement, such security interest to be released by HSIC upon products delivered in respect of such purchase.

On February 24, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement, we agreed to an extension of the time for HSIC to provide notice of its intention to renew the License and Distribution Agreement for an additional one year term, from February 25, 2010 to March 3, 2010, in accordance with the terms and conditions thereof.

On March 9, 2010, we entered into another letter agreement with HSIC. This letter agreement calls for guaranteed minimum purchases by HSIC of \$18 million solely in respect of laser equipment in certain territories, plus additional

laser equipment purchases on an uncapped basis in certain other territories, plus incremental purchases of consumable products and services in all applicable territories. Pursuant to this letter

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agreement, all dental sales will continue to be provided exclusively through HSIC in the United Kingdom, Australia, New Zealand, Belgium, Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America. This letter agreement provides incentives for HSIC to focus on its core customer base, and we will have incremental sales and margin incentives to penetrate additional dental offices. This letter agreement has an initial term of one year, after which this letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate this letter agreement upon sixty days advance written notice to the other party.

*International Direct Sales.* Through 2008, we sold products in Germany, Spain, Australia and New Zealand through direct sales forces from our company sales and service locations in those respective countries. In the first quarter of 2009, we transitioned sales in these countries from direct sales to distribution through HSIC.

*International Distributors.* We sell products outside the United States through a network of independent distributors and through HSIC in certain countries. Our distributors purchase systems and disposables from us at wholesale dealer prices and resell them to dentists in their sales territories. All sales to distributors are final and we can terminate our arrangements with dealers and distributors for cause or non-performance. In some select territories we have granted certain distributors the right to be our exclusive distributor in that territory. These distributors are generally required to satisfy certain minimum purchase requirements to maintain exclusivity.

*Customer Service.* We provide maintenance and support services through our support hotline, field and factory service technicians and our network of factory-trained third-party service technicians. We currently provide maintenance and support services in the United States and Canada through our employee service technicians. We provide parts to distributors at no additional charge for products covered under warranty. We maintain a network of service technicians trained at our factory locations, who provide maintenance and support services in all other countries where we do business. Our international distributors are responsible for providing maintenance and support services for products sold by them. We provide parts to distributors at no additional charge for products covered under warranty.

*Financing Options.* Many dentists finance their purchases through third-party leasing companies, banks, or lessors. In the United States and Canada, third party customers enter into a lease with a lessor who purchases the product from HSIC. We are not party to the lease. The lessee pays the lessor in installments, we do not bear the credit risk that the dentist might not make payments. The leasing companies and banks do not have recourse to us for a dentist's failure to make payments, nor do we have any obligation to take back the product at the end of the lease.

## **Engineering and Product Development**

Engineering and development activities are essential to maintaining and enhancing our business. We believe our engineering and development team has demonstrated its ability to develop innovative products that meet evolving market needs. Our research and development group consists of approximately 15 individuals with medical device and laser development experience and other relevant backgrounds, the majority of whom have degrees in physics or engineering, including two Ph.Ds. During the years ended December 31, 2009, 2008 and 2007, our engineering and development expenses were approximately \$4.1 million, \$5.6 million and \$5.1 million, respectively. Our current engineering and development activities are focused on improving our existing products and technology and extending our product range in order to provide dental practitioners and patients with less painful and clinically superior laser systems. Examples of improvements being pursued include faster cutting speed, ease of use, less need for anesthesia injections, and an expanded portfolio of consumable products for use with our laser systems. We also devoted resources in 2006 to develop a new, compact, state-of-the-art diode laser system called *ezlase*, for which we received FDA 510(k) clearance in January 2007. We started marketing and selling the *ezlase* system in February 2007. In February 2008, we received FDA 510(k) clearance for root canal disinfections using our Waterlase systems. In February 2009, we announced the release of our Waterlase MD Turbo All-Tissue Dental Laser System.



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We also devote engineering and developments resources toward markets outside of dentistry in which we might exploit our technology platform and capabilities. We believe our laser technology and developments capabilities could be applicable in the pain management, aesthetic/dermatology, veterinary and consumer products markets. For example, in February 2008, we received 510(k) clearance from the FDA to allow us to market our Waterlase MD for use in certain specific dermatological applications as well as general and plastic surgery. We received 510(k) clearance from the FDA in April 2009 to market our diode laser systems with the patented Body Contour handpiece for therapeutic applications including pain management. In late 2009 we announced the release of the Diolase 10 for therapeutic applications, including temporary pain relief. In February 2010 we introduced the iLase diode laser system, the first personal, affordable dental diode laser that provides minimally invasive solutions for the most common everyday soft tissue surgical and hygiene procedures. The iLase received 510(k) clearance from the FDA in March 2010.

In June 2006 we entered into a binding letter of intent with The Procter and Gamble Company, or P&G, and in January 2007 completed a definitive agreement pursuant to which we granted P&G rights to certain of our intellectual property for use in the development of consumer products in a number of different areas. Any consumer products developed and sold by P&G which are based upon the intellectual property we licensed would result in royalty income to us. Within the agreement we retain the rights to the professional dental channels. We are in discussions with P&G to restructure the P&G Agreement and believe we may finalize a new agreement.

## **Intellectual Property and Proprietary Rights**

We rely, in part, on a combination of patents, trademarks, trade secrets, copyrights and other intellectual property rights to protect our technology. We have approximately 131 issued patents and more than 167 pending patent applications. Approximately two-thirds of our patents were granted in the United States, and the rest were granted in Europe and other countries around the world. Our patents cover the use of laser technologies and fluids for dental, medical, cosmetic and industrial applications, as well as laser characteristics, accessories, future technological developments, fluid conditioning and other technologies and methods for dental, medical and aesthetic applications. We have numerous patent applications pending worldwide and plan to apply for other patents in the future as we develop new technologies. While we hold a variety of patents that cover a broad range of technologies and methods, approximately 70% of these patents provide market protection for our core technologies incorporated in our laser systems, including the Waterlase systems, which accounted for approximately 53% of our net revenue in 2009, approximately 62% of our net revenue in 2008 and approximately 68% of our net revenue in 2007. Existing patents related to our core technology, which are at various stages of being incorporated into our products, are scheduled to expire as follows: twelve in 2010, eight in 2011, ten in 2012, and five in 2013 with the majority having expiration dates ranging from 2014 to 2032. With more than 167 patent applications pending, we expect the number of new grants to exceed the number of patents expiring. We do not expect the expiration of the expired or soon-to-expire patents to have a material effect on our business.

In January 2005, we acquired the intellectual property portfolio of Diodem, LLC, or Diodem, consisting of certain U.S. and international patents of which four were asserted against us, and settled the existing litigation between us and Diodem, for consideration of \$3.0 million in cash, 361,664 shares of common stock (valued at the common stock fair market value on the closing date of the transaction for a total of approximately \$3.5 million) and a five-year warrant exercisable into 81,037 shares of common stock at an exercise price of \$11.06 per share which expired in January 2010.

In March 2005, we acquired a fully-paid license related to patents owned or licensed by SurgiLight, Inc. As a result of the acquisition, we received fully-paid license rights in the U.S. and international markets to patents in the fields of presbyopia and ophthalmology.



We require our employees, consultants and advisors to execute confidentiality agreements in connection with their employment, consulting or advisory relationships with us. We also require our employees, consultants and advisors who we expect to work on our products to agree to disclose and assign to us all inventions conceived during their term of employment or contract, using our property, or which relate to our

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business. Despite measures taken to protect our intellectual property, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary, or our competitors may independently develop similar technologies.

The medical device industry is characterized by the existence of a large number of patents and frequent litigation based on allegations of patent infringement. Patent litigation can involve complex factual and legal questions and its outcome is uncertain. Our success will depend in part on our not infringing patents issued to others including our competitors and potential competitors. As the number of entrants into our market increases, the risk of an infringement claim against us grows. While we attempt to ensure that our products and methods do not infringe other parties' patents and proprietary rights, our competitors may assert that our products, and the methods we employ, are covered by U.S. or international patents held by them. In addition, our competitors may assert that future products and methods we may market infringe their patents.

*BIOLASE®*, *ZipTip®*, *ezlase®*, *eztips®*, *MD Flow®*, *Comfortpulse®*, *Waterlase®* and *Waterlase MD®*, are registered trademarks of Biolase Technology, Inc., and *Diolase™*, *Comfort Jet™*, *HydroPhotonics™*, *LaserPal™*, *MD Gold™*, *WCL™*, *World Clinical Laser Institute™*, *Waterlase MD Turbo™*, *HydroBeam™*, *SensaTouch™*, *Occulase™*, *C100™*, *Diolase 10™*, *Body Contour™*, *Radial Firing Perio Tips™*, *Deep Pocket Therapy with New Attachment™* and *iLase™* are trademarks of BIOLASE Technology, Inc. All other product and company names are registered trademarks or trademarks of their respective owners.

## **Competition**

We compete with a number of companies that market traditional dental products, such as dental drills, as well as other companies that market laser technologies in dental and other medical markets. In the domestic hard tissue dental market, we believe our Waterlase systems primarily compete with laser systems manufactured by Hoya ConBio, a subsidiary of Hoya Photonics, a large Japanese manufacturer primarily of optics and crystal, Lares Research, the U.S. distributor of Fotona, a European company and Syneron, an Israeli based company primarily focused on the aesthetic device market. In the international market, our Waterlase systems compete primarily with products manufactured by several additional companies, including Fotona, KaVo and Deka Dental Corporation.

Our Waterlase systems also compete with non-laser based systems, including traditional high and low-speed dental drills and air abrasion systems that are used for dental procedures. Our Diode systems, including *ezlase* and *iLase*, compete with other semiconductor diode lasers manufactured by Ivoclar, Sirona, KaVo Hoya, AMD and Discus Dental, as well as with scalpels, scissors and a variety of other cutting tools that have been traditionally used to perform soft tissue procedures. In 2009, the combination of heavy direct advertising and economic conditions generated significant sales volumes in a competitive atmosphere while boosting overall interest and awareness in diode lasers. Other domestic and foreign laser manufacturers are expected to enter this segment in the future. The new *iLase* was specifically designed to compete in this growing segment with key differentiating features and performance. Unlike the *ezlase*, none of the lasers in this category have FDA clearance for use in pain management therapy or full mouth teeth whitening. Our *ezlase* system competes with other in-office whitening products and high intensity lights used by dentists, as well as teeth whitening strips and other over-the-counter products.

Traditional and commonly used cutting tools are less expensive for performing dental procedures. For example, a high speed drill or an electrosurge device can be purchased for less than \$1,000 each. In addition, our systems are not designed to perform certain functions that high speed drills can perform, such as cutting metal fillings and certain polishing and grinding functions. High speed drills will still be needed for these functions, and our systems are not intended to replace all applications of the high speed drill.

In general, our ability to compete in the market depends in large part on our:

acceptance by leading dental practitioners;

product performance;

product pricing;

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intellectual property protections;

customer education and support;

timing of new product research; and

development of successful national and international distribution channels.

Some of the manufacturers that develop competing laser systems have significantly greater financial, marketing and technical resources than we do. In addition, some competitors have developed, and others may attempt to develop, products with applications similar to those performed by our laser systems.

Because of the large size of the potential market for our products, we anticipate that new or existing competitors may develop competing products, procedures or clinical solutions. These products, procedures or solutions could prove to be more effective, safer or less costly than procedures using our laser systems. The introduction of new products, procedures or clinical solutions by competitors may result in price reductions, reduced margins or loss of market share and may render our products obsolete.

## **Government Regulation**

Our products are medical devices. Accordingly, our product development, testing, labeling, manufacturing processes and promotional activities are regulated extensively by government agencies in the United States and other countries in which we market and sell our products. We have clearance from the FDA to market our laser systems for specific clinical indications in the United States. We have the clearances necessary to sell our products in Canada. We also have the necessary CE Marks or clearances to sell our laser systems in the European Union and other international markets. The iLase diode laser is CE mark-approved and received FDA 510(k) clearance in the United States in March 2010.

### ***United States***

In the United States, the FDA regulates the design, manufacture, distribution, quality standards and marketing of medical devices. We have clearance from the FDA to market our Waterlase and Diode systems in the United States for dental procedures on both adult and pediatric patients. In 1998, we received FDA clearance to market the Millennium®, the earlier generation of our current Waterlase system, for certain dental hard tissue applications. This clearance allowed us to commence domestic sales and marketing of our technology for hard and soft tissue applications. During 1999 and 2000, to meet the demand for soft-tissue and cosmetic dentistry applications, we designed a semiconductor diode laser system, which is now marketed as our LaserSmile system. We received FDA clearance to market the system for a variety of soft tissue medical applications in September 1999. In 2001, we received FDA clearance to market the LaserSmile system for cosmetic teeth whitening. In October 2003, the LaserSmile received clearance for periodontal procedures for both early and advanced stages of periodontal disease.

In 2002, 2003, 2004, 2008 and 2009, our Waterlase system became the first laser system to receive FDA clearance for several new types of dental procedures. We also received clearance in 2002 to market this system for cutting, shaving, contouring and resection of oral osseous tissues, or bone. In January 2003, we received FDA clearance to market the Waterlase system for use in apicoectomy surgery, a procedure for root canal infections and complications that includes cutting gum, bone (to access the infected area) and the apex of the tooth to access the infected area. The clearance also encompasses flap surgical procedures. Flaps are frequently created in conjunction with many procedures, including periodontal, implant placement and recovery, extraction of wisdom teeth, and exposure of

impacted teeth. In January 2004, our Waterlase system received FDA clearance for several new bone, periodontal and soft tissue procedures, including removal of bone to correct defects and create physiologic contours of bone, resection of bone to restore architecture, resection of bone for grafting, preparing full, partial and split thickness flaps for periodontal surgery and removal of granulation tissue from bony defects. In February 2008, we received 510(k) clearance from the FDA for root canal disinfection using our Waterlase MD. In June 2008, our Waterlase C100 All-Tissue Dental Laser System received FDA 510(k) clearance. In February 2009, we received FDA 510(k) clearance for our Waterlase MD

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Turbo All-Tissue Dental Laser System. In December 2009, we received 510(k) clearance from the FDA to market our Waterlase MD laser system for removal of subgingival calculi to treat periodontitis.

In addition, in July 2006, we received 510(k) clearance from the FDA for our Oculase MD laser for general ophthalmic soft tissue surgical indications such as incision, excision, vaporization and coagulation of ocular tissue and tissue surrounding the eye and orbit. In January 2008, we received 510(k) clearance from the FDA to allow us to market our Waterlase MD for use in dermatological applications as well as general and plastic surgery.

In January 2007, we received 510(k) clearance from the FDA to market *eZlase*, our new soft tissue diode laser system. In November 2008, we received FDA 510(k) clearance to market a 10W version of our *eZlase*. In December 2008, we received FDA 510(k) clearance for tooth whitening using our *eZlase* system. In April 2009, we received FDA 510(k) clearance for our *eZlase* for pain relief and therapy with application in sports medicine, orthopedics, physical therapy and chiropractic medicines.

In March 2010, we received 510(k) clearance from the FDA to market iLase in the United States, the first personal, affordable dental diode laser that provides minimally invasive solutions for the most common everyday soft tissue surgical and hygiene procedures.

As we develop new products and applications or make any significant modifications to our existing products or labeling, we will need to obtain the regulatory clearances or approvals necessary to market such products for dental, cosmetic and other medical procedures in our target markets.

There are two principal methods by which FDA regulated devices may be marketed in the United States: 510(k) clearance and pre-market approval, or PMA. To obtain 510(k) clearance, we must demonstrate that our device is substantially equivalent to a previously cleared 510(k) device or a device that was in commercial distribution before May 28, 1976 for which the FDA has not yet called for the submission of PMA applications. By statute and regulation, the FDA is required to clear, deny or request additional information on a 510(k) request within 90 days of submission of the application. As a practical matter, 510(k) clearance often takes significantly longer. Domestic marketing of the product must be deferred until clearance is received from the FDA. In some instances, an Investigational Device Exemption, or an IDE, is required for clinical trials for a 510(k) clearance. If a request for 510(k) clearance is turned down by the FDA, then a PMA application may be required. We intend to utilize the 510(k) notification procedure whenever possible. To date, all of our regulated products have qualified for 510(k) clearance.

After a device receives 510(k) clearance, any modification that could significantly affect its safety or effectiveness, or that would constitute a major change in its intended use, will require a new 510(k) clearance, or could require a PMA application. The FDA requires each manufacturer to make this determination initially, but the FDA can review any such decision and can disagree with a manufacturer's determination. If the FDA disagrees with a manufacturer's determination that a new clearance or approval is not required for a particular modification, the FDA can require the manufacturer to cease marketing and/or recall the modified device until 510(k) clearance or PMA is obtained. We have made and plan to continue to make additional product enhancements to our laser systems that we believe do not require new 510(k) clearances. We cannot assure you that the FDA will agree with our determinations in these instances.

A PMA application is required for a device that does not qualify for clearance under 510(k) provisions. The FDA is required by law to review a PMA application within 180 days. As part of the approval of a PMA application, the FDA typically requires human clinical testing to determine safety and efficacy of the device. To conduct human clinical testing, typically the FDA must approve an IDE. To date, none of our products have required a PMA to support marketing approval.

After a device is placed on the market, numerous regulatory requirements apply. These include:

quality system regulations, or QSRs, which require manufacturers, including third-party manufacturers, to follow stringent design, testing, control, documentation and other quality assurance procedures during all aspects of the manufacturing process;

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labeling regulations, which prohibit the promotion of products for uncleared, unapproved or off label uses;

medical device reporting regulations, which require that manufacturers report to the FDA if their device may have caused or contributed to a death or serious injury or malfunctioned in a way that would likely cause or contribute to a death or serious injury if it were to recur;

correction and removal regulations, which require that manufacturers report to the FDA any corrections to or removals of distributed devices that are made to reduce a risk to health; and

post-market surveillance regulations, which apply when necessary to protect the public health or to provide additional safety and effectiveness data for the device.

We will need to invest significant time and other resources to ensure ongoing compliance with FDA quality system regulations and other post market regulatory requirements.

We have registered with the FDA as a medical device manufacturer and we have obtained a manufacturing license from the California Department of Health Services. Compliance with regulatory requirements is assured through periodic, unannounced facility inspections by the FDA and the Food and Drug Branch of the California Department of Health Services, and these inspections may include the manufacturing facilities of our subcontractors.

Failure to comply with applicable regulatory requirements can result in an enforcement action by the FDA, which may include any of the following sanctions:

fining, injunctions and civil penalties;

recall or seizure of our products;

operating restrictions, partial suspension or total shutdown of production;

refusing our request for 510(k) clearance of or PMA application for new products;

withdrawing 510(k) clearance or PMA applications that are already granted; and

criminal prosecution.

We are also subject to regulation under the Radiation Control for Safety and Health Act of 1968, or the Safety Act, administered by the FDA. The Safety Act regulates the energy emissions of light and sound and electronic waves from electronic products. Regulations implementing the Safety Act require a laser manufacturer to file new product and annual reports, to maintain quality control, product testing and sales records, to distribute product operation manuals, to incorporate certain design and operating features in lasers sold to end users and to certify and label each laser sold to end users as one of four classes of lasers based on the level of radiation emitted from the laser. In addition, various warning labels must be affixed to the product and certain protective features must be installed, depending upon the class of product.

Various state dental boards allow dental hygienists to use lasers to perform certain dental procedures. In addition, dental boards in a number of states are considering educational requirements regarding the use of dental lasers. The scope of these restrictions and educational requirements is not now known, and they could have an adverse effect on sales of our laser-based products.



***International***

Foreign sales of our laser system products are subject to the regulatory requirements of the foreign country or, if applicable, the harmonized standards of the European Union. These regulatory requirements vary widely among countries and may include technical approvals, such as electrical safety, as well as demonstration of clinical efficacy. We have a CE Mark for our Waterlase and Diode systems, which permits us to commercially distribute these systems throughout the European Union. We rely on export certifications from the FDA to comply with certain regulatory requirements in several foreign jurisdictions. We are currently

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working to meet certain foreign country regulatory requirements for certain of our products, including those in Japan. There can be no assurance that additional approvals in Japan or elsewhere will be obtained.

### ***Other Regulatory Requirements***

In addition to the regulatory framework for product clearances and approvals, we are subject to extensive and frequently changing regulations under many other laws administered by U.S. and foreign governmental agencies on the national, state and local levels, including requirements regarding occupational health and safety and the use, handling and disposing of toxic or hazardous substances.

### **Third Party Reimbursement**

Our products are generally purchased by dental or medical professionals who have various billing practices and patient mixes. Such practices range from primarily private pay to those who rely heavily on third party payors, such as private insurance or government programs. In the United States, third party payors review and frequently challenge the prices charged for medical services. In many foreign countries, the prices for dental services are predetermined through government regulation. Payors may deny coverage and reimbursement if they determine that the procedure was not medically necessary, such as a cosmetic procedure, or that the device used in the procedure was investigational. We believe that most of the procedures being performed with our current products generally are reimbursable, with the exception of cosmetic applications, such as tooth whitening. For the portion of dentists who rely heavily on third party reimbursement, the inability to obtain reimbursement for services using our products could deter them from purchasing or using our products. We cannot predict the effect of future healthcare reforms or changes in financing for health and dental plans. Any such changes could have an adverse effect on the ability of a dental or medical professional to generate a return on investment using our current or future products. Such changes could act as disincentives for capital investments by dental and medical professionals and could have a negative impact on our business and results of operations.

### **Employees**

At December 31, 2009, we employed approximately 151 people, of which there were 55 in manufacturing and quality and control, 15 in research and development, 34 in sales and sales support, 25 in customer technical support and 22 in administration. Our employees are not represented by any collective bargaining agreement and we believe our employee relations are good.

### **Financial Information**

The additional financial information required to be included in this Item 1 is incorporated herein by reference to Part IV, Item 15 of this report.

### **Available Information**

Copies of our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (the Exchange Act ) are available free of charge through our Web site ([www.biolase.com](http://www.biolase.com)) as soon as reasonably practicable after we electronically file the material with, or furnish it to, the SEC. You may read and copy any document we file with the SEC at the SEC's Public Reference Room at 100 F Street N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Our SEC filings are also available to the public at the SEC's web site at <http://www.sec.gov>.



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**PART I**

**Item 1A. Risk Factors**

Risk factors which could cause actual results to differ from our expectations and which could negatively impact our financial condition and results of operations are discussed below and elsewhere in this report. If any of the following risks actually occurs, our business, financial condition, results of operations and our future growth prospects could be materially and adversely affected. Under these circumstances, the trading price of our common stock could decline, and you may lose all or part of your investment. Further, additional risk not currently known to us or that we currently believe are immaterial also may impair our business, operations, liquidity and stock price materially and adversely.

**Risks Relating to Our Business**

***Our Independent Auditors Have Issued a Report Questioning our Ability To Continue as a Going Concern, Which May Impair our Ability to Raise Additional Financing and Adversely Affect the Price of our Common Stock.***

Our independent auditors have qualified their opinion with respect to our consolidated financial statements to include an explanatory paragraph related to our ability to continue as a going concern in their report for the fiscal year ended December 31, 2009. Reports of independent auditors questioning a company's ability to continue as a going concern generally are viewed very unfavorably by analysts and investors. There are a number of risks and challenges associated with such a qualified report including, but not limited to, a significant impediment to our ability to raise additional capital or seek financing from entities that will not conduct such transactions in the face of such increased level of risk of insolvency and loss, increased difficulty in attracting talent, and the diversion of the attention of our executive officers and other key employees to raising capital or financing rather than devoting time to the day-to-day operations of our business. We urge potential investors to review the report of our independent registered public accounting firm and our consolidated financial statements and related notes beginning on page F-1 of this Annual Report on Form 10-K and to seek independent advice concerning the substantial risks related thereto before making a decision to invest in us.

***The general slowdown of the economy and continued uncertainties in the global financial markets, our partial reliance on a primary distributor, and our lack of debt financing may adversely affect our liquidity, operating results, and financial condition.***

We are largely dependent on our primary distributor in North America and certain substantial international markets. The continued performance of this distributor and its willingness to continue to make purchases of our products and associated consumables under a March 9, 2010 letter agreement amending our distribution agreement, and the receipt of cash in connection with those purchases, is a critical factor in our liquidity at this time and going forward. We presently do not have any debt financing in place with a bank or other financial institution. As set forth in the March 2010 letter agreement, the distributor has agreed to make committed minimum purchases through March 9, 2011. However, the March 2010 letter agreement is subject to earlier termination at any time, upon sixty days advance written notice given by either us or the distributor to the other party.

Based upon the general economic slowdown, we believe that our primary distributor's inventory of our products has trended above historical levels. This increase could be a factor in the distributor's decision whether to elect to terminate the March 2010 letter agreement early upon written notice to us, or to decide not to extend the letter agreement beyond March 9, 2011. If the distributor elected to terminate or decided not to renew the agreement beyond March 9, 2011, such a decision, combined with an absence of debt financing availability, could materially and adversely impact our operations.

In the event the primary distributor elected to terminate the agreement early, or decided not to renew beyond March 9, 2011, we could be forced to seek alternative distribution channels for the sales of our products, including but not limited to establishing a new primary distributor relationship, a series of small

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distributor relationships, selling more of our products directly to customers through our existing sales force, or a combination thereof. To the extent that the former distributor held inventory of our products, the distributor would likely look to significantly reduce this inventory, and could possibly decide to compete aggressively with us in sales to new customers following the end of the distribution relationship, until such time as the former distributor's inventory of our products was exhausted. This distributor is a large publicly-traded company that is substantially larger in size than we are, with far greater access to capital and human resources. There can be no assurances that we would be able to compete effectively and profitably with this former distributor during this period on price and other terms, while this former distributor attempted to reduce, and likely rapidly liquidate, its inventory of our products.

Our continued obligations and operating requirements may require us to seek additional funding through public or private equity or debt financing, and we have no commitments for financing of any kind at this time. We may not be able to obtain requisite financing if necessary to fund existing obligations and operating requirements on acceptable terms or at all.

Our business is highly sensitive to changes in general economic conditions as a seller of capital equipment to end users in dental professional practices. Financial markets inside the United States and internationally have experienced extreme disruption in recent times, including, among other things, extreme volatility in security prices, severely diminished liquidity and credit availability, and declining valuations of investments. These disruptions are likely to have an ongoing adverse effect on the world economy. A continuing economic downturn and financial market disruptions may:

- reduce demand for our products and services, increase order cancellations and result in longer sales cycles and slower adoption of new technologies;

- increase the difficulty of collecting accounts receivable and the risk of excess and obsolete inventories;

- increase price competition in our served markets;

- result in supply interruptions, which could disrupt our ability to produce our products.

***We may have difficulty achieving profitability and may experience additional losses.***

We have an accumulated deficit of \$92.7 million at December 31, 2009. We recorded net losses of \$3.0 million and \$9.1 million for the years ended December 31, 2009 and 2008, respectively. In order to achieve profitability, we must control our costs and increase net revenue through new sales. Failure to increase our net revenue and decrease our costs could cause our stock price to decline.

***Dentists and patients have been hesitant in adopting laser technologies, and our inability to overcome this hesitance could limit the market acceptance of our products and market share.***

Our dental laser systems represent relatively new technologies in the dental market. Currently, only a small percentage of dentists use lasers to perform dental procedures. Our future success will depend on our ability to increase demand for our products by demonstrating the potential performance advantages of our laser systems over traditional methods of treatment and over competitive laser systems to a broad spectrum of dentists and patients. Historically, we have experienced long sales cycles because dentists have been, and may continue to be, slow to adopt new technologies on a widespread basis. As a result, we generally are required to invest a significant amount of time and resources to educate customers about the benefits of our products in comparison to competing products and technologies before completing a sale, if any.

Factors that may inhibit adoption of laser technologies by dentists include cost and concerns about the safety, efficacy and reliability of lasers. In order to invest in a Waterlase MD laser system, a dentist generally would need to invest time to understand the technology, the benefits of such technology with respect to clinical outcomes and patient satisfaction, and the return on investment of the product. Absent an immediate competitive motivation, a dentist may not feel compelled to invest the time required to learn about the potential benefits of using a laser system. We also believe that clinical evidence supporting the safety and efficiency of our products, as well as recommendations and support of our laser systems by influential dental

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practitioners, are important for market acceptance and adoption. In addition, economic pressure, caused for example by an economic slowdown, changes in healthcare reimbursement or by competitive factors in a specific market, may make dentists reluctant to purchase substantial capital equipment or invest in new technologies. Patient acceptance will depend on the recommendations of dentists and specialists, as well as other factors, including without limitation, the relative effectiveness, safety, reliability and comfort of our systems as compared to other instruments and methods for performing dental procedures. The failure of dental lasers to achieve broad market acceptance would limit sales of our products and have an adverse effect on our business and results of operations.

*Fluctuations in our revenue and operating results on a quarterly and annual basis could cause the market price of our common stock to decline.*

Our revenue and operating results fluctuate from quarter to quarter due to a number of factors, many of which are beyond our control. Historically, we have experienced fluctuations in revenue from quarter to quarter due to seasonality. Revenue in the first quarter typically is lower than average and revenue in the fourth quarter typically is stronger than average due to the buying patterns of dental professionals. In addition, revenue in the third quarter may be affected by vacation patterns which can cause revenue to be flat or lower than in the second quarter of the year. If our quarterly revenue or operating results fall below the expectations of investors, analysts or our previously stated financial guidance, the price of our common stock could decline substantially. Factors that might cause quarterly fluctuations in our revenue and operating results include, among others, the following:

- variation in demand for our products, including seasonality;
- our ability to research, develop, market and sell new products and product enhancements in a timely manner;
- our ability to control costs;
- our ability to control quality issues with our products;
- regulatory actions that impact our manufacturing processes;
- the size, timing, rescheduling or cancellation of orders from distributors;
- the introduction of new products by competitors;
- the length of and fluctuations in sales cycles;
- the availability and reliability of components used to manufacture our products;
- changes in our pricing policies or those of our suppliers and competitors, as well as increased price competition in general;
- general economic conditions including the availability of credit for our existing and potential customer base to finance purchases;
- the mix of our domestic and international sales and the risks and uncertainties associated with international business;
- costs associated with any future acquisitions of technologies and businesses;



limitations on our ability to use net operating loss carryforwards under the provisions of Internal Revenue Code Section 382 and similar state laws;

developments concerning the protection of our intellectual property rights;

catastrophic events such as hurricanes, floods and earthquakes, which can affect our ability to advertise, sell and distribute our products, including through national conferences held in regions in which these disasters strike; and

global economic, political and social events, including international conflicts and acts of terrorism.

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The expenses we incur are based, in large part, on our expectations regarding future net revenue. Since many of our costs are fixed in the short term, we may be unable to reduce expenses quickly enough to avoid losses if we experience a decrease in net revenue. Accordingly, you should not rely on quarter-to-quarter comparisons of our operating results as an indication of our future performance.

***Any failure to significantly expand sales of our products will negatively impact our business.***

We currently handle a significant portion of the marketing, distribution and sales of our products, augmented by our distribution relationship with Henry Schein, Inc. We face significant challenges and risks in expanding, training, managing and retaining our sales and marketing teams, including managing geographically dispersed operations. In addition, we rely on independent distributors to market and sell our products in a number of countries outside of the United States. These distributors may not commit the necessary resources to effectively market and sell our products, and they may terminate their relationships with us at any time with limited notice. If we are unable to expand our sales and marketing capabilities domestically and internationally, or if the relationship with Henry Schein, Inc. does not produce the expected results, we may not be able to effectively commercialize our products, which could harm our business and cause the price of our common stock to decline.

***Our distributors may cancel, reduce or delay orders of our products, any of which could reduce our revenue.***

Through 2008, we employed direct sales representatives in certain European countries, Australia and New Zealand. In the first quarter of 2009, we transitioned our sales organizations in those countries to sell through HSIC. We also rely on independent distributors for a substantial portion of our sales in other countries outside of the United States and Canada. For the year ended December 31, 2009, revenue from these international distributors accounted for approximately 20% of our total revenue. For the year ended December 31, 2008, revenue from these international distributors accounted for approximately 13% of our total sales. Our ability to maintain or increase our revenue will depend in large part on our success in developing and maintaining relationships with our distributors and upon the efforts of these third parties. Our distributors have significant discretion in determining the efforts and resources they apply to the sale of our products. Our distributors may not commit the necessary resources to market and sell our products to the level of our expectations and, regardless of the resources they commit, they may not be successful. Additionally, most of our distributor agreements can be terminated with limited notice, and we may not be able to replace any terminating distributors in a timely manner or on terms agreeable to us, if at all. If we are unable to maintain our distribution network, if our distribution network is not successful in marketing and selling our products, or if we experience a significant reduction in, cancellation or change in the size and timing of orders from our distributors, our revenues could decline significantly.

In August 2006, and as amended, we entered into a distribution agreement with Henry Schein, Inc., or Henry Schein, a large distributor of healthcare products to office-based practitioners, pursuant to which we granted Henry Schein the exclusive right to distribute our complete line of dental laser systems, accessories and services in the United States and Canada. The agreement had an initial term of three years, following which it would automatically renew for an additional period of three years, provided that Henry Schein achieved its minimum purchase requirements.

Additionally, on February 27, 2009, we entered into an agreement with HSIC in which HSIC became our distributor in certain international countries including Germany, Spain, Australia and New Zealand and will be permitted to distribute our products in those additional markets where we do not have current distribution agreements in place.

On March 9, 2010, we entered into a new letter agreement with HSIC. The letter agreement has an initial term of one year, after which it may be extended for a period of six months by mutual agreement. Either party may elect terminate the letter agreement at any time before the expiration of the one year term, upon sixty days advance written notice to

the other party. This letter agreement provides that all dental sales will continue to be provided exclusively through HSIC in the United Kingdom, Australia, New Zealand, Belgium,

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Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America, and further provides for incentives for HSIC to focus on its core customer base. In addition, the letter agreement provides us with new flexibility through sales and margin incentives to penetrate additional dental offices that are outside of HSIC's focus. The agreement also allows for higher sales organization incentives, unique financing programs and increased luminary and educational events.

There can be no guarantee that HSIC will not elect to terminate the letter agreement early upon sixty days' notice to us, or that it will decide to extend the letter agreement beyond March 9, 2011 and preserve our liquidity position. In addition, we presently do not have any debt financing in place with a bank or other financial institution. The absence of such debt financing availability could adversely impact our operations. Our obligations and operating requirements may require us to seek additional funding through public or private equity or debt financing, and we have no commitments for financing of any kind at this time. There can be no assurance that we will be able to obtain requisite financing if necessary to fund existing obligations and operating requirements on acceptable terms or at all.

We intend to continue to augment the activities of Henry Schein in the United States and Canada and other international locations with the efforts of our direct sales force; however, our future revenue will be largely dependent upon the efforts and success of Henry Schein in selling our products. We cannot assure you that Henry Schein will devote sufficient resources to selling our products or, even if sufficient resources are directed to our products, that such efforts will be sufficient to increase net revenue.

***Components used in our products are complex in design and any defects may not be discovered prior to shipment to customers, which could result in warranty obligations, reducing our revenue and increasing our cost.***

In manufacturing our products, we depend upon third parties for the supply of various components. Many of these components require a significant degree of technical expertise to design and produce. If we fail to adequately design or if our suppliers fail to produce components to specification, or if the suppliers, or we, use defective materials or workmanship in the manufacturing process, the reliability and performance of our products will be compromised. We have experienced such non-compliance with manufacturing specifications in the past and may continue to experience such in the future, which could lead to higher costs of revenue and thus reduced gross margins.

Our products may contain defects that cannot be repaired easily and inexpensively, and we have experienced in the past and may experience in the future some or all of the following:

- loss of customer orders and delay in order fulfillment;
- damage to our brand reputation;
- increased cost of our warranty program due to product repair or replacement;
- inability to attract new customers;
- diversion of resources from our manufacturing and research and development departments into our service department; and
- legal action.

The occurrence of any one or more of the foregoing could materially harm our business.

***We must continue to procure materials and components on commercially reasonable terms and on a timely basis to manufacture our products profitably. We have some single-source suppliers.***

We frequently do not use written supply contracts with our key suppliers; instead, we purchase certain materials and components included in our products from a limited group of suppliers using purchase orders. Our business depends in part on our ability to obtain timely deliveries of materials and components in acceptable quality and quantities from our suppliers. Certain components of our products, particularly specialized components used in our lasers, are currently available only from a single source or limited sources.

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For example, the crystal, fiber and hand pieces used in our Waterlase systems are each supplied by a separate single supplier. Our dependence on single-source suppliers involved several risks, including limited control over pricing, availability, quality and delivery schedules. If any one or more of our single-source suppliers cease to provide us with sufficient quantities of our components in a timely manner or on terms acceptable to us, or cease to manufacture components of acceptable quality, we would have to seek alternative sources of manufacturing. We could incur delays while we locate and engage alternative qualified suppliers and we might be unable to engage alternative suppliers on favorable terms. Any such disruption or increased expenses could harm our business efforts and adversely affect our ability to generate sales. Our reliance on these outside manufacturers and suppliers also subjects us to other risks that could harm our business, including:

we may not be able to obtain adequate supply in a timely manner or on commercially reasonable terms;

we may have difficulty locating and qualifying alternative suppliers for the various components in our laser systems;

switching components may require product redesign and submission to the FDA of a 510(k) application, which could significantly delay production;

our suppliers manufacture products for a range of customers, and fluctuations in demand for the products those suppliers manufacture for others may affect their ability to deliver components for us in a timely manner; and

our suppliers may encounter financial hardships, be acquired, or experience other business events unrelated to our demand for components, which could inhibit or prevent their ability to fulfill our orders and meet our requirements.

Any interruption or delay in the supply of components or materials, or our inability to obtain components or materials from alternate sources at acceptable prices in a timely manner, could impair our ability to meet the demand of our customers and cause them to cancel orders or switch to competitive procedures. We are currently in the process of identifying and qualifying alternate source suppliers for our key components. There can be no assurance, however, that we will successfully identify and qualify an alternate source supplier for any of our key components or that we could enter into an agreement with any such alternate source supplier on terms acceptable to us.

***We may not be able to compete successfully, which will cause our revenue and market share to decline.***

We compete with a number of domestic and foreign companies that market traditional dental products, such as dental drills, as well as companies that market laser technologies in the dental and medical markets, including Hoya ConBio, a subsidiary of Hoya Photonics, OpusDent Ltd., a subsidiary of Lumenis, KaVo, Deka Dental Corporation, Ivoclar Vivadent AG, and Fotona d.d. If we do not compete successfully, our revenue and market share may decline. Some of our competitors have greater financial, technical, sales and marketing or other resources than we have, which may allow them to respond more quickly to new or emerging technologies and to devote greater resources to the acquisition or development and introduction of enhanced products than we can. The ability of our competitors to devote greater financial resources to product development requires us to work harder to distinguish our products through improving our product performance and pricing, protecting our intellectual property, continuously improving our customer support, accurately timing the introduction of new products and developing sustainable distribution channels worldwide. In addition, we expect the rapid technological changes occurring in the healthcare industry to lead to the entry of new competitors, particularly if dental and medical lasers gain increasing market acceptance. We must be able to anticipate technological changes and introduce enhanced products on a timely basis in order to grow and remain competitive. Many of these new competitors would be practitioners focusing on a specific product or market segment, making it more difficult for us to expand our overall market position. If these companies become

successful, we expect that competition will become even more intense, leading to greater pricing pressure and making it more difficult for us to expand our sales. New competitors or technological changes in laser products and methods could cause commoditization of our products, require price discounting or otherwise adversely affect our gross margins and our financial condition.

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***Rapidly changing standards and competing technologies could harm demand for our products or result in significant additional costs.***

The markets in which our products compete are subject to rapid technological change, evolving industry standards, changes in the regulatory environment, and frequent introductions of new devices and evolving dental and surgical techniques. Competing products may emerge which could render our products uncompetitive or obsolete. The process of developing new medical devices is inherently complex and requires regulatory approvals or clearances that can be expensive, time consuming and uncertain. We cannot guarantee that we will successfully identify new product opportunities, identify new and innovative applications of our technology, or be financially or otherwise capable of completing the research and development required to bring new products to market in a timely manner. An inability to expand our product offerings or the application of our technology could limit our growth. In addition, we may incur higher manufacturing costs if manufacturing processes or standards change, and we may need to replace, modify, design or build and install equipment, all of which would require additional capital expenditures.

***Any problems that we experience with our manufacturing operations may harm our business.***

In order to grow our business, we must expand our manufacturing capabilities to produce the systems and accessories necessary to meet any demand we may experience. We may encounter difficulties in increasing production of our products, including problems involving production capacity and yields, quality control and assurance, component supply and shortages of qualified personnel. In addition, before we can begin commercial manufacture of our products, we must obtain regulatory approval of our manufacturing facilities, processes and quality systems, and the manufacture of our laser systems must comply with cGMP regulations. The cGMP regulations govern facility compliance, quality control and documentation policies and procedures. In addition, our manufacturing facilities are continuously subject to periodic inspections by the FDA, as well as various state agencies and foreign regulatory agencies. From time to time, we may expend significant resources in obtaining, maintaining and remedying our compliance with these requirements. Our success will depend in part upon our ability to manufacture our products in compliance with the FDA's Quality System regulations and other regulatory requirements. We have experienced quality issues with components of our products supplied by third parties. If we do not succeed in manufacturing our products on a timely basis and with acceptable manufacturing costs while at the same time maintaining good quality control and complying with applicable regulatory requirements, our business could be harmed.

***Changes in government regulation or the inability to obtain or maintain necessary government approvals could harm our business.***

Our products are subject to extensive government regulation, both in the United States and in other countries. To clinically test, manufacture and market products for human use, we must comply with regulations and safety standards set by the FDA and comparable state and foreign agencies. Regulations adopted by the FDA are wide ranging and govern, among other things, product design, development, manufacture and testing, labeling, storage, advertising and sales. Generally, products must meet regulatory standards as safe and effective for their intended use before being marketed for human applications. The clearance process is expensive, time-consuming and uncertain. Failure to comply with applicable regulatory requirements of the FDA can result in an enforcement action which may include a variety of sanctions, including fines, injunctions, civil penalties, recall or seizure of our products, operating restrictions, partial suspension or total shutdown of production and criminal prosecution. The failure to receive or maintain requisite approvals for the use of our products or processes, or significant delays in obtaining such approvals, could prevent us from developing, manufacturing and marketing products and services necessary for us to remain competitive.

To date, we have been successful in obtaining 510(k) clearances from the FDA to market products. However, should we develop new products and applications or make any significant modifications to our existing products or labeling,



we will need to obtain additional regulatory clearances or approvals to market such products. Any modification that could significantly affect a product's safety or effectiveness, or that would constitute a change in its intended use, will require a new 510(k) clearance, or could require a PMA application. The FDA requires each manufacturer to make this determination initially, but the FDA can review

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any such decision and can disagree with a manufacturer's determination. If the FDA disagrees with a manufacturer's determination, the FDA can require the manufacturer to cease marketing and/or recall the modified device until 510(k) clearance or PMA is obtained. If 510(k) clearance is denied and a pre-market approval application is required, we could be required to submit substantially more data, may be required to conduct human clinical testing and would very likely be subject to a significantly longer review period.

Products sold in international markets are also subject to the regulatory requirements of each respective country. The regulations of the European Union require that a device have a CE Mark, indicating conformance with European Union laws and regulations before it can be sold in that market. The regulatory international review process varies from country to country. We rely on our distributors and sales representatives in the foreign countries in which we market our products to comply with the regulatory laws of such countries. Failure to comply with the laws of such countries could have a material adverse effect on our operations and, at the very least, could prevent us from continuing to sell products in such countries. In addition, unanticipated changes in existing regulatory requirements or the adoption of new requirements could impose significant costs and burdens on us, which could increase our operating expenses and harm our financial condition.

### ***We may have difficulty managing any growth that we might experience.***

If we experience growth in our operations, our operational and financial systems, procedures and controls may need to be expanded, which will place significant demands on our management, distract management from our business plan and increase expenses. Our success will depend substantially on the ability of our management team to manage any growth effectively. These challenges may include, among others:

- maintaining our cost structure at an appropriate level based on the revenue we generate;
- managing manufacturing expansion projects;
- implementing and improving our operational and financial systems, procedures and controls; and
- managing operations and international distributors in multiple locations and multiple time zones.

In addition, we incur significant legal, accounting, insurance and other expenses as a result of being a public company. The Sarbanes-Oxley Act of 2002, as well as rules subsequently implemented by the SEC and NASDAQ, has required changes in corporate governance practices of public companies. We expect these rules and regulations will continue to result in substantial legal and financial compliance costs and some activities will continue to be more time-consuming and costly. We also expect these rules and regulations may make it more difficult and more expensive for us to maintain director and officer insurance and, from time to time, we may be required to accept reduced policy limits and coverage or incur significantly higher costs to maintain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our Board of Directors or as executive officers. We continue to evaluate and monitor developments with respect to these rules, and we cannot predict or estimate the amount of additional costs we may incur or the timing of such costs.

### ***If we fail to secure or protect our intellectual property rights, competitors may be able to use our technologies, which could weaken our competitive position, reduce our revenue or increase our costs.***

Our future success will depend, in part, on our ability to obtain and maintain patent protection for our products and technology, to preserve our trade secrets and to operate without infringing the intellectual property of others. We rely on patents to establish and maintain proprietary rights in our technology and products. We currently possess a number of issued patents and patent applications with respect to our products and technology; however, we cannot assure that

any additional patents will be issued, that the scope of any patent protection will be effective in helping us address our competition or that any of our patents will be held valid if subsequently challenged. It is also possible that our competitors may independently develop similar products, duplicate our products or design products that circumvent our patents. Additionally, the laws of foreign countries may not protect our products or intellectual property rights to the same extent as the laws of the United States. In addition, there are numerous proposed changes to the patent laws and rules of the U.S. Patent and Trademark Office which, if enacted, may have a significant impact on our ability to protect

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our technology and enforce our intellectual property rights. For example, Congress is considering several significant changes to the U.S. patent laws, including (among other things) changing from a first to invent to a first inventory to file system, limiting the time for which a patentee may file a patent suit, requiring the apportionment of patent damages, and creating a post-grant opposition process to challenge patents after they have issued. If we fail to protect our intellectual property rights adequately, our competitive position and financial condition may be harmed.

***We may be sued by third parties for alleged infringement of their proprietary rights.***

We face substantial uncertainty regarding the impact that other parties' intellectual property positions will have on the markets for dental and other medical lasers. The medical technology industry has in the past been characterized by a substantial amount of litigation and related administrative proceedings regarding patents and intellectual property rights. From time to time, we have received, and expect to continue to receive, notices of claims of infringement, misappropriation or misuse of other parties' proprietary rights. Some of these claims may lead to litigation. We may not prevail in any future intellectual property infringement litigation given the complex technical issues and inherent uncertainties in litigation. Any claims, with or without merit, may be time-consuming and distracting to management, result in costly litigation or cause product shipment delays. Adverse determinations in litigation could subject us to significant liability and could result in the loss of proprietary rights. A successful lawsuit against us could also force us to cease selling or redesign products that incorporate the infringed intellectual property. Additionally, we could be required to seek a license from the holder of the intellectual property to use the infringed technology, and it is possible that we may not be able to obtain a license on acceptable terms, or at all. Any of the foregoing adverse events could seriously harm our business.

***We are subject to a variety of litigation in the course of our business that could adversely affect our results of operations and financial condition.***

We are subject to a variety of litigation incidental to our business, including claims for damages arising out of the use of our products or services and claims relating to intellectual property matters, employment matters, commercial disputes, competition and sales and trading practices, environmental matters, personal injury and insurance coverage. Some of these lawsuits include claims for punitive as well as compensatory damages. The defense of these lawsuits may divert our management's attention, we may incur significant expenses in defending these lawsuits, and we may be required to pay damage awards or settlement or become subject to equitable remedies that could adversely affect our financial condition, operations and results of operations. Moreover, any insurance or indemnification rights that we may have may be insufficient or unavailable to protect us against potential loss exposures. In addition, developments in legal proceedings in any given period may require us to record loss contingency estimates in our financial statements, which could adversely affect our results of operations in any period.

***We have significant international sales and are subject to risks associated with operating in international markets.***

International sales comprise a significant portion of our net revenue and we intend to continue to pursue and expand our international business activities. For the fiscal year 2009, international sales accounted for approximately 28% of our net revenue, as compared to approximately 25% of our net revenue in fiscal year 2008 and approximately 38% of our net revenue in fiscal 2007. Political and economic conditions outside the United States could make it difficult for us to increase our international revenue or to operate abroad. International operations are subject to many inherent risks, including among others:

adverse changes in tariffs and trade restrictions;

political, social and economic instability and increased security concerns;

fluctuations in foreign currency exchange rates;

longer collection periods and difficulties in collecting receivables from foreign entities;

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exposure to different legal standards;

transportation delays and difficulties of managing international distribution channels;

reduced protection for our intellectual property in some countries;

difficulties in obtaining domestic and foreign export, import and other governmental approvals, permits and licenses and compliance with foreign laws;

the imposition of governmental controls;

unexpected changes in regulatory or certification requirements;

difficulties in staffing and managing foreign operations; and

potentially adverse tax consequences and the complexities of foreign value-added tax systems.

We believe that international sales will continue to represent a significant portion of our net revenue, and we intend to expand our international operations further. In international markets where our sales are denominated in U.S. dollars, an increase in the relative value of the dollar against the currency in such markets could indirectly increase the price of our products in those markets and result in a decrease in sales. We do not currently engage in any transactions as a hedge against risks of loss due to foreign currency fluctuations, although we may consider doing so in the future.

***Our products are subject to recall even after receiving FDA clearance or approval, which would harm our reputation, business and financial results.***

The FDA and similar governmental bodies in other countries have the authority to require the recall of our products in the event of material deficiencies or defects in design or manufacture. A government mandated or voluntary recall by us could occur as a result of component failures, manufacturing errors or design defects, including defects in labeling. Any recall would divert management's attention and financial resources and harm our reputation with customers. Any recall involving our laser systems could harm the reputation of the product and our company and would be particularly harmful to our business and financial results, in part because the laser systems compose such an important part of our portfolio of products.

***We may not successfully address problems encountered in connection with any future acquisition.***

We expect to continue to consider opportunities to acquire or make investments in other technologies, products and businesses that could enhance our capabilities, complement our current products or expand the breadth of our markets or customer base. We have limited experience in acquiring other businesses and technologies. Potential and completed acquisitions and strategic investments involve numerous risks, including, among others:

problems assimilating the purchased technologies, products or business operations;

problems maintaining uniform standards, procedures, controls and policies;

unanticipated costs associated with the acquisition;

diversion of management's attention from our core business;

adverse effects on existing business relationships with suppliers and customers;

risks associated with entering new markets in which we have no or limited prior experience;

potential loss of key employees of acquired businesses; and

increased legal and accounting costs as a result of the rules and regulations related to the Sarbanes-Oxley Act of 2002.

If we fail to properly evaluate and execute acquisitions and strategic investments, our management team may be distracted from our day-to-day operations, our business may be disrupted and our operating results

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may suffer. In addition, if we finance acquisitions by issuing equity or convertible debt securities, our stockholders would be diluted.

***If our customers cannot obtain third party reimbursement for their use of our products, they may be less inclined to purchase our products.***

Our products are generally purchased by dental or medical professionals who have various billing practices and patient mixes. Such practices range from primarily private pay to those who rely heavily on third party payors, such as private insurance or government programs. In the United States, third party payors review and frequently challenge the prices charged for medical services. In many foreign countries, the prices for dental services are predetermined through government regulation. Payors may deny coverage and reimbursement if they determine that the procedure was not medically necessary, such as a cosmetic procedure, or that the device used in the procedure was investigational. We believe that most of the procedures being performed with our current products generally are reimbursable, with the exception of cosmetic applications, such as tooth whitening. For the portion of dentists who rely heavily on third party reimbursement, the inability to obtain reimbursement for services using our products could deter them from purchasing or using our products. We cannot predict the effect of future healthcare reforms or changes in financing for health and dental plans. Any such changes could have an adverse effect on the ability of a dental or medical professional to generate a return on investment using our current or future products. Such changes could act as disincentives for capital investments by dental and medical professionals and could have a negative impact on our business and results of operations.

***The recent financial crisis and general slowdown of the economy may adversely affect the credit availability and liquidity of our dental customers and suppliers.***

The credit availability and liquidity of our customers and suppliers may be materially affected by the current financial crisis. If our suppliers experience credit or liquidity problems, important sources of raw materials or manufactured goods may be affected. We currently sell our products primarily to dentists in general practice. These dentists often purchase our products with funds they secure through various financing arrangements with third party financial institutions, including credit facilities and short-term loans. If interest rates increase or the availability of credit is otherwise negatively impacted by market conditions, these financing arrangements will be more expensive to our dental customers, which would effectively increase the overall cost of owning our products for our customers and, thereby, may decrease demand for our products. Any reduction in the sales of our products would cause our business to suffer.

***Product liability claims against us could be costly and could harm our reputation.***

The sale of dental and medical devices involves the inherent risk of product liability claims against us. We currently maintain product liability insurance on a per occurrence basis with a limit of \$11.0 million per occurrence and \$12.0 million in the aggregate for all occurrences. The insurance is subject to various standard coverage exclusions, including damage to the product itself, losses from recall of our product and losses covered by other forms of insurance such as workers compensation. We cannot be certain that we will be able to successfully defend any claims against us, nor can we be certain that our insurance will cover all liabilities resulting from such claims. In addition, there is no assurance that we will be able to obtain such insurance in the future on terms acceptable to us, or at all. Regardless of merit or eventual outcome, any product liability claim brought against us could result in harm to our reputation, decreased demand for our products, costs related to litigation, product recalls, loss of revenue, an increase in our product liability insurance rates or the inability to secure coverage in the future, and may cause our business to suffer.



***Our operations are consolidated primarily in one facility. A disaster at this facility is possible and could result in a prolonged interruption of our business.***

Substantially all of our administrative operations and our manufacturing operations are located at our facility in Irvine, California, which is near known earthquake fault zones. We have taken precautions to safeguard our facilities including disaster recovery planning and off-site backup of computer data; however, a

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natural disaster such as an earthquake, fire or flood, could seriously harm our business, adversely affect our operations and damage our reputation with customers. We maintain commercial insurance that includes business interruption coverage; however it may not be adequate to cover our losses and may provide only limited coverage for a natural disaster.

***Our ability to use net operating loss carryforwards may be limited.***

Section 382 of the Internal Revenue Code of 1986 generally imposes an annual limitation on the amount of net operating loss carryforwards that may be used to offset taxable income when a corporation has undergone significant changes in its stock ownership. In 2006, we completed an analysis to determine the applicability of the annual limitations imposed by Section 382 caused by previous changes in our stock ownership and determined that such limitations should not be significant. Based on our analysis, we believe that, as of December 31, 2009, approximately \$54.5 million of net operating loss carryforwards were available to us for federal income tax purposes. A detailed analysis will be required at the time we begin utilization of any net operating losses to determine if there is a Section 382 limitation. In addition, any ownership changes qualifying under Section 382 including changes resulting from or affected by our public offering or our stock repurchase plan may adversely affect our ability to use our remaining net operating loss carryforwards. If we lose our ability to use net operating loss carryforwards, any income we generate will be subject to tax earlier than it would be if we were able to use net operating loss carryforwards, resulting in lower profits.

***Our business is capital intensive and the failure to obtain capital could require that we curtail capital expenditures.***

To remain competitive, we must continue to make significant investments in the development of our products, the expansion of our sales and marketing activities and the expansion of our operating and management infrastructure as we increase sales domestically and internationally. We expect that substantial capital will be required to expand our operations and fund working capital for anticipated growth. We may need to raise additional funds through further debt or equity financings, which may affect the percentage ownership of existing holders of common stock and which may have rights, preferences or privileges senior to those of the holders of our common stock or may be issued at a discount to the market price of our common stock thereby resulting in dilution to our existing stockholders. If we raise additional funds by raising debt, we may be subject to debt covenants which could place limitations on our operations. We may not be able to raise additional capital on reasonable terms, or at all, or we may use capital more rapidly than anticipated. If we cannot raise the required capital when needed, we may not be able to satisfy the demands of existing and prospective customers and may lose revenue and market share.

The following factors among others could affect our ability to obtain additional financing on favorable terms, or at all:

- our results of operations;
- general economic conditions and conditions in the electronics industry;
- the perception of our business in the capital markets;
- our ratio of debt to equity;
- our financial condition;
- our business prospects; and
- interest rates.

If we are unable to obtain sufficient capital in the future, we may have to curtail our capital expenditures. Any curtailment of our capital expenditures could result in a reduction in net revenue, reduced quality of our products, increased manufacturing costs for our products, harm to our reputation, reduced manufacturing efficiencies or other harm to our business.

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***Our charter documents and Delaware law may inhibit a takeover that our stockholders consider favorable and could also limit the price of our stock.***

We have adopted anti-takeover defenses that could delay or prevent an acquisition of our company and may affect the price of our common stock. Certain provisions of our certificate of incorporation, and the existence of our stockholder rights plan, could make it difficult for any party to acquire us, even though an acquisition might be beneficial to our stockholders, and could limit the price that investors might be willing to pay in the future for shares of our common stock.

In December 1998, we adopted a stockholder rights plan, which was extended in December 2008, pursuant to which one preferred stock purchase right was distributed to our stockholders for each share of our common stock held. In connection with the stockholder rights plan, the Board of Directors has designated 500,000 shares of Series B Junior Participating Cumulative Preferred Stock. If any party acquires 15% or more of our outstanding common stock while the stockholder rights plan remains in place (i.e., if such party does not negotiate with the Board of Directors, which has the power to redeem the rights and terminate the plan), the holders of these rights (other than the party acquiring the 15% position) will be able to purchase shares of our common stock (or other securities or assets) at a discounted price, causing substantial dilution to the party acquiring the 15% position. Following the acquisition of 15% or more of our stock by any person (without a redemption of the rights or a termination of the stockholder rights plan by the Board of Directors), if we are acquired by or merged with any other entity, holders of these rights (other than the party acquiring the 15% position) will also be able to purchase shares of common stock of the acquiring or surviving entity if the stockholder rights plan continues to remain in place.

In addition, under our certificate of incorporation, the Board of Directors has the power to authorize the issuance of up to 500,000 shares of preferred stock that is currently undesignated, and to designate the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without further vote or action by the stockholders. Accordingly, our Board of Directors may issue preferred stock with terms that could have preference over and adversely affect the rights of holders of our common stock. The issuance of any such preferred stock may:

delay, defer or prevent a change in control of our company;

adversely affect the voting and other rights of the holders of our common stock; or

discourage acquisition proposals or tender offers for our shares without the advance approval of the Board of Directors, including bids at a premium over the market price for our common stock

We are also subject to the provisions of Section 203 of the Delaware General Corporation Law, which may prohibit certain business combinations with stockholders owning 15% or more of our outstanding voting stock or any of our associates or affiliates who at any time in the past three years have owned 15% or more of our outstanding voting stock. These provisions and the others discussed above may have the effect of entrenching our management team and deprive stockholders of the opportunity to sell their shares to potential acquirers at a premium over market prices. The potential inability to obtain a control premium could reduce the price of our common stock.

***Our common stock could be diluted by the conversion of outstanding convertible securities.***

We have issued and will continue to issue convertible securities in the form of options and warrants as incentive compensation for services performed by our employees, directors, consultants and others. As of December 31, 2009, we had options and warrants to purchase 3,631,000 shares of our common stock outstanding, of which options and warrants to purchase 2,654,000 shares of common stock were exercisable. If these options or warrants were exercised, it would dilute the ownership of our stock and could adversely affect our common stock's market price.



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***We may not be able to maintain effective internal controls.***

Management is responsible for establishing and maintaining adequate internal control over financial reporting. Our internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements in accordance with generally accepted accounting principles. In making its assessment of internal control over financial reporting as of December 31, 2009, management used the criteria described in *Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO )*. A material weakness is a control deficiency, or combination of control deficiencies, that results in a more than remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Management determined that no material weaknesses in our internal control over financial reporting existed as of December 31, 2009 and 2008, and concluded that our internal control over financial reporting was effective as of December 31, 2009 and 2008 based on the criteria of the *Internal Control – Integrated Framework* issued by COSO. Management determined that one material weakness in our internal control over financial reporting existed as of December 31, 2007, and therefore concluded that our internal control over financial reporting was not effective as of December 31, 2007. This material weakness was remediated in the first quarter of 2008.

While management will continue to review the effectiveness of our disclosure controls and procedures and internal control over financial reporting and take appropriate remediation efforts to address any identified control weaknesses or deficiencies, we cannot assure you that our disclosure controls and procedures or internal control over financial reporting will be effective in accomplishing all control objectives all of the time. Other deficiencies, particularly a material weakness in internal control over financial reporting which may occur in the future could result in misstatements of our results of operations, restatements of our financial statements, a decline in our stock price, or otherwise materially adversely affect our business, reputation, results of operations, financial condition or liquidity.

***If future data proves to be inconsistent with our clinical results, our revenues may decline.***

If new studies or comparative studies generate results that are not as favorable as our clinical results, our revenues may decline. Furthermore, physicians may choose not to purchase our laser systems until they receive additional published long-term clinical evidence and recommendations from prominent physicians that indicate our laser systems are effective for dental applications.

***If we are unable to attract and retain personnel necessary to operate our business, our ability to develop and market our products successfully could be harmed.***

Our success is dependent upon our senior management team, as well as our ability to attract and retain qualified personnel. We can provide no assurance that we will be able to retain our existing senior management team or that we will be able to attract qualified replacement personnel. Changes in our senior management and on the Board of Directors may be disruptive to our business, and, during this a transition period, there may be uncertainty among investors, vendors, customers, rating agencies, employees and others concerning our future direction and performance. In the first quarter of 2009, we issued a press release announcing that, effective March 5, 2009; Jake P. St. Philip resigned from his position as Chief Executive Officer, and the Board of Directors appointed our Chief Financial Officer, David M. Mulder, to the position of Chief Executive Officer. On July 14, 2009, we appointed Brett L. Scott as Chief Financial Officer. If we are unable to effectively manage and maintain our business through this transition in management, our results of operations and financial condition may be adversely affected.

Our future success also depends on our ability to attract and retain additional qualified management, engineering, sales and marketing and other highly skilled technical personnel.



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***Any failure in our efforts to train dental practitioners could reduce the market acceptance of Waterlase Dentistry and reduce our revenues.***

There is a learning process involved for dental practitioners to become proficient in the use of our laser systems. It is critical to the success of our sales efforts to adequately train a sufficient number of dental practitioners and to provide them with adequate instruction in the use of our laser systems. Following completion of training, we rely on the trained dental practitioners to advocate the benefits of our products in the broader marketplace. Convincing dental practitioners to dedicate the time and energy necessary for adequate training is challenging, and we cannot assure you that we will be successful in these efforts. If dental practitioners are not properly trained, they may misuse or ineffectively use our products, or fail to recognize the benefits provided by our laser systems. This may also result in unsatisfactory patient outcomes, patient injury, negative publicity or lawsuits against us, any of which could negatively affect our reputation and sales of our laser systems.

***We spend considerable time and money complying with federal, state and foreign regulations and, if we are unable to fully comply with such regulations, we could face substantial penalties.***

We are directly or indirectly, through our customers, subject to extensive regulation by both the federal government and the states and foreign countries in which we conduct our business. The laws that directly or indirectly affect our ability to operate our business include, but are not limited to, the following:

The Federal Food, Drug, and Cosmetic Act, which regulates the design, testing, manufacture, labeling, marketing, distribution and sale of prescription drugs and medical devices;

state food and drug laws;

the federal Anti-Kickback Law, which prohibits persons from knowingly and willfully soliciting, offering, receiving or providing remuneration, directly or indirectly, in cash or in kind, to induce either;

the referral of an individual, or furnishing or arranging for a good or service, for which payment may be made under federal healthcare programs such as the Medicare and Medicaid Programs;

Medicare laws and regulations that prescribe the requirements for coverage and payment, including the amount of such payment, and laws prohibiting false claims for reimbursement under Medicare and Medicaid;

the federal physician self-referral prohibition, commonly known as the Stark Law, which, in the absence of a statutory or regulatory exception, prohibits the referral of Medicare patients by a physician to an entity for the provision of designated healthcare services, if the physician or a member of the physician's immediate family has a direct or indirect financial relationship, including an ownership interest in, or a compensation arrangement with, the entity and also prohibits that entity from submitting a bill to a federal payor for services rendered pursuant to a prohibited referral;

state laws that prohibit the practice of medicine by non-physicians and fee-splitting arrangements between physicians and non-physicians, as well as state law equivalents to the Anti-Kickback Law and the Stark Law, which may not be limited to government reimbursed items; and

the Federal Trade Commission Act and similar laws regulating advertising and consumer protection.

If our past or present operations are found to be in violation of any of the laws described above or the other governmental regulations to which we or our customers are subject, we may be subject to the applicable penalty



associated with the violation, including civil and criminal penalties, damages, fines, exclusion from the Medicare and Medicaid programs and the curtailment or restructuring of our operations. If we are required to obtain permits or licensure under these laws that we do not already possess, we may become subject to substantial additional regulation or incur significant expense. Any penalties, damages, fines, curtailment or restructuring of our operations would adversely affect our ability to operate our business and our financial results. The risk of our being found in violation of these laws is increased by the fact that many of them have not been fully interpreted by applicable regulatory authorities or the courts, and their provisions are open to a

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variety of interpretations and additional legal or regulatory change. Any action against us for violation of these laws, even if we successfully defend against it, could cause us to incur significant legal expenses, divert our management's attention from the operation of our business and damage our reputation.

***Product sales or introductions may be delayed or canceled as a result of the FDA regulatory process, which could cause our sales or profitability to decline.***

The process of obtaining and maintaining regulatory approvals and clearances to market a medical device from the FDA and similar regulatory authorities abroad can be costly and time consuming, and we cannot assure you that such approvals and clearances will be granted. Pursuant to FDA regulations, unless exempt, the FDA permits commercial distribution of a new medical device only after the device has received 510(k) clearance or is the subject of an approved pre-market approval application. The FDA will clear marketing of a medical device through the 510(k) process if it is demonstrated that the new product is substantially equivalent to other 510(k)-cleared products. The pre-market approval application process is more costly, lengthy and uncertain than the 510(k) process, and must be supported by extensive data, including data from preclinical studies and human clinical trials. Because we cannot assure you that any new products, or any product enhancements, that we develop will be subject to the shorter 510(k) clearance process, significant delays in the introduction of any new products or product enhancement may occur. We cannot assure you that the FDA will not require a new product or product enhancement to go through the lengthy and expensive pre-market approval application process. Delays in obtaining regulatory clearances and approvals may:

delay or eliminate commercialization of products we develop;

require us to perform costly procedures;

diminish any competitive advantages that we may attain; and

reduce our ability to collect revenues or royalties.

Although we have obtained 510(k) clearance from the FDA to market our dental laser systems, we cannot assure you that the clearance of these systems will not be withdrawn or that we will not be required to obtain new clearances or approvals for modifications or improvements to our products.

### **Item 1B. *Unresolved Staff Comments***

None.

### **Item 2. *Properties***

In January 2006, we entered into a five-year lease for our 57,000 square foot corporate headquarters and manufacturing facility located at 4 Cromwell, Irvine, California. On September 24, 2009, we entered into an amendment to the lease which extended the facility lease term through April 20, 2015, adjusted basic rent and made modification provisions that reduced over time the amount of the security deposit held by the landlord. We believe that our current facility will be sufficient for our current needs and that suitable additional or substitute space will be available as needed to accommodate foreseeable expansion of our operations.

Our wholly-owned subsidiary owns a facility totaling approximately 20,000 square feet of space in Floss, Germany. Other than the land and building in Germany, with a recorded net book amount of approximately \$672,000, the majority of our long-lived assets are located in the United States.

**Item 3. *Legal Proceedings***

From time to time, we become involved in various claims and lawsuits of a character normally incidental to our business. In our opinion, there are no legal proceedings pending against us or any of our subsidiaries that are reasonably expected to have a material adverse effect on our financial condition or on our results of operations.

**Table of Contents****Item 4. (Removed and Reserved)****PART II****Item 5. *Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*****Market Information**

Our common stock is listed on the NASDAQ Stock Market LLC under the symbol BLTI. The following table sets forth, for the periods indicated, the high and low sale prices of our common stock as reported by the NASDAQ Stock Market LLC and the dividends per share paid by us for each quarter of 2009 and 2008:

	<b>High</b>	<b>Low</b>
Fiscal Year Ended December 31, 2009		
First Quarter	\$ 1.25	\$ 0.30
Second Quarter	1.80	0.85
Third Quarter	2.88	1.56
Fourth Quarter	2.30	1.68
Fiscal Year Ended December 31, 2008		
First Quarter	\$ 4.64	\$ 2.22
Second Quarter	4.05	2.38
Third Quarter	3.47	1.69
Fourth Quarter	2.16	0.55

No dividends were paid by us during 2009 or 2008.

As of March 11, 2009, the total number of record holders of our common stock was approximately 187. Based on information provided by our transfer agent and registrar, we believe that there are approximately 4,800 beneficial owners of our common stock.

**Dividend Policy**

In August 2005, our Board of Directors authorized to discontinue payment of a dividend indefinitely. We anticipate that we will retain any earnings to support our operations and finance any growth and development of our business. Therefore we do not expect to pay cash dividends in the future.

**Securities Authorized for Issuance under Equity Compensation Plans**

See the information incorporated by reference to Part III, Item 12 of this report for information regarding securities authorized for issuance under our equity compensation plans.

**Table of Contents****Stock Performance Graph (1)**

The graph below compares the cumulative total stockholder return on \$100 invested, assuming the reinvestment of all dividends, on December 31, 2004, the last trading day before our 2005 fiscal year, through the end of fiscal 2009 with the cumulative total return on \$100 invested for the same period in the NASDAQ Composite Index and the NASDAQ Medical Equipment Index.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN\***  
**Among Biolase Technology, Inc., The NASDAQ Composite Index**  
**And The NASDAQ Medical Equipment Index**

**ASSUMES \$100 INVESTED ON DECEMBER 31, 2004**  
**ASSUMES DIVIDENDS REINVESTED**  
**FISCAL YEAR ENDED DECEMBER 31, 2009**

	Years Ended December 31,					
	2004	2005	2006	2007	2008	2009
Biolase Technology, Inc.	\$ 100.00	\$ 73.79	\$ 80.81	\$ 21.80	\$ 13.76	\$ 17.64
NASDAQ Composite Index	100.00	101.33	114.01	123.71	73.11	105.61
NASDAQ Medical Equipment	100.00	117.06	122.50	159.63	88.67	122.59

(1) This section is not soliciting material, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of BIOLASE Technology, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

**Table of Contents****Item 6. Selected Financial Data**

The following selected consolidated financial data should be read in conjunction with our consolidated financial statements and related notes contained elsewhere in this report and in our subsequent reports filed with the SEC, as well as Item 7 titled Management's Discussion and Analysis of Financial Condition and Results of Operations.

	<b>Years Ended December 31,</b>				
	<b>2009</b>	<b>2008</b>	<b>2007</b>	<b>2006</b>	<b>2005</b>
	<b>(In thousands, except per share data)</b>				
<b>Consolidated Statements of Operations</b>					
<b>Data:</b>					
Net revenue	\$ 43,347	\$ 64,625	\$ 66,889	\$ 69,700	\$ 61,980
Cost of revenue(1)	23,285	31,963	32,364	33,211	31,051
Gross profit	20,062	32,662	34,525	36,489	30,929
Other income, net				6	80
Operating expenses:					
Sales and marketing(1)	11,041	22,040	26,648	24,400	24,730
General and administrative(1)	7,835	12,006	10,941	11,709	16,869
Engineering and development(1)	4,146	5,580	5,104	4,876	6,390
Patent infringement legal settlement(3)		1,232		348	
Impairment of intangible asset(4)		232			
Impairment of property, plant and equipment(4)		355			
Restructuring charge(2)			802		
Total operating expenses	23,022	41,445	43,495	41,333	47,989
Loss from operations	(2,960)	(8,783)	(8,970)	(4,838)	(16,980)
Non-operating income (loss)	123	(225)	1,853	311	(261)
Loss before income taxes	(2,837)	(9,008)	(7,117)	(4,527)	(17,241)
Income tax provision	119	121	163	162	269
Net loss as reported	\$ (2,956)	\$ (9,129)	\$ (7,280)	\$ (4,689)	\$ (17,510)
Net (loss) per share:					
Basic	\$ (0.12)	\$ (0.38)	\$ (0.31)	\$ (0.20)	\$ (0.76)
Diluted	(0.12)	(0.38)	(0.31)	(0.20)	(0.76)
Dividends declared and paid, per share	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.00	\$ 0.03
Shares used in computing net (loss) per share:					
Basic	24,282	24,178	23,853	23,472	23,051
Diluted	24,282	24,178	23,853	23,472	23,051
<b>Consolidated Balance Sheet Data*:</b>					
Working capital	\$ 4,802	\$ 5,023	\$ 10,993	\$ 17,299	\$ 12,822

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Total assets	22,177	35,708	44,308	48,578	45,129
Long-term liabilities	2,638	2,547	3,034	4,922	202
Stockholders equity	7,929	9,390	16,491	21,966	21,294

(1) 2009, 2008 and 2007 includes \$1.4 million, \$1.7 million and \$1.3 million, respectively, in total compensation cost related to stock options classified in cost of revenue, sales and marketing, general and administrative and engineering and development expenses.

(2) Refer to Note 11 in the notes to the Consolidated Financial Statements.

(3) Refer to Note 7 in the notes to the Consolidated Financial Statements.

(4) Refer to Note 2 in the notes to the Consolidated Financial Statements.

\* Certain amounts have been reclassified to conform to current year presentation.

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**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion of our results of operations and financial condition should be read together with the consolidated financial statements and the notes to those statements included elsewhere in this report and other information incorporated by reference in this report, if any. This discussion may contain forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from the results anticipated in any forward-looking statements as a result of a variety of factors, including those discussed in Risk Factors and elsewhere in this report.*

**Overview**

We are a medical technology company that develops, manufactures and markets lasers and related products focused on technologies for improved applications and procedures in dentistry and medicine. In particular, our principal products provide dental laser systems that allow dentists, periodontists, endodontists, oral surgeons and other specialists to perform a broad range of dental procedures, including cosmetic and complex surgical applications. Our systems are designed to provide clinically superior performance for many types of dental procedures, with less pain and faster recovery times than are generally achieved with drills, scalpels and other dental instruments. We have clearance from the U.S. Food and Drug Administration, or FDA, to market our laser systems in the United States and also have the necessary approvals to sell our laser systems in Canada, the European Union and certain other international markets. Since 1998, we have sold approximately 7,700 Waterlase systems including over 3,800 Waterlase MD systems and more than 13,800 laser systems in total in over 50 countries.

We offer two categories of laser system products: (i) Waterlase systems and (ii) Diode systems. Our flagship product category, the Waterlase system, uses a patented combination of water and laser to perform most procedures currently performed using dental drills, scalpels and other traditional dental instruments for cutting soft and hard tissue. We also offer our diode laser systems to perform soft tissue and cosmetic procedures, including tooth whitening.

On August 8, 2006, we entered into a License and Distribution Agreement with Henry Schein, Inc., or HSIC, a large distributor of healthcare products to office-based practitioners, pursuant to which we granted HSIC the exclusive right to distribute our complete line of dental laser systems, accessories and services in the United States and Canada. The agreement has an initial term of three years, following which it will automatically renew for an additional period of three years, provided that HSIC has achieved its minimum purchase requirements. Under the agreement, HSIC is obligated to meet certain minimum purchase requirements and is entitled to receive incentive payments if certain purchase targets are achieved. If HSIC has not met the minimum purchase requirements at the midpoint of each of the first two three-year periods, we will have the option, upon repayment of a portion of the license fee, to (i) shorten the remaining term of the agreement to one year, (ii) grant distribution rights held by HSIC to other persons (or distribute products ourselves), (iii) reduce certain discounts on products given to HSIC under the agreement and (iv) cease paying future incentive payments. We maintain the right to grant certain intellectual property rights to third parties, but by doing so may incur the obligation to refund a portion of the upfront license fee to HSIC.

On May 9, 2007, we entered into *Addendum 1 to License and Distribution Agreement* with HSIC, which addendum was effective as of April 1, 2007 and modified the License and Distribution Agreement entered into with HSIC on August 8, 2006, to add the terms and conditions under which HSIC has the exclusive right to distribute our new *eZlase* diode dental laser system in the United States and Canada. In the Addendum, separate minimum purchase requirements are established for the *eZlase* system. If HSIC has not met the minimum purchase requirement for any 12-month period ending on March 31, we will have the option, upon 30 days written notice, to (i) convert *eZlase* distribution rights to a non-exclusive basis for a minimum period of one year, after which period we would have the option to withdraw *eZlase* distribution rights, and (ii) reduce the distributor discount on *eZlase* products.



On March 3, 2008, we entered into a second addendum to the HSIC agreement that modifies certain terms of the initial agreement as amended. Pursuant to amendment 2 to the agreement, HSIC is obligated to meet certain minimum purchase requirements and is entitled to receive incentive payments if certain purchase

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targets are achieved. If HSIC has not met the minimum purchase requirements, we will have the option to (i) shorten the remaining term of the Agreement to one year, (ii) grant distribution rights held by HSIC to other persons (or distribute products ourselves), (iii) reduce certain discounts on products given to HSIC under the agreement and (iv) cease paying future incentive payments. Additionally, under certain circumstances, if HSIC has not met the minimum purchase requirements, we have the right to purchase back the exclusive distributor rights granted to HSIC under the agreement. We also agreed to actively promote Henry Schein Financial Services as our exclusive leasing and financing partner.

On December 23, 2008, we entered into a letter agreement with HSIC to extend the term of the agreement through December 31, 2010.

On February 27, 2009, we entered into a letter agreement with HSIC amending the term of the License and Distribution Agreement through March 31, 2010. This amendment includes certain minimum purchase requirements through the term of the agreement. HSIC also has the option to extend the term of the Agreement for two additional one-year terms based on certain minimum purchase requirements. In addition, HSIC became our distributor in certain international countries including Germany, Spain, Australia and New Zealand and were permitted to distribute our products in those additional markets where we did not have current distribution agreements in place.

On September 10, 2009, we entered into an amendment to the License and Distribution Agreement with HSIC, wherein we agreed to provide to HSIC certain customer warranties in respect of our products.

On January 31, 2010, we entered into a Letter Agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the Letter Agreement we agreed to an extension of the time for HSIC to provide notice of its intention to renew the License and Distribution Agreement for an additional one year term, from February 1, 2010 to February 25, 2010, in accordance with the terms and conditions thereof.

On February 16, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement, we agreed to HSIC's request to make certain changes to the applicable product categories required to be purchased by HSIC through March 31, 2010, as set forth in the February 27, 2009 letter agreement. The changes include advance payments in respect of, among other things, purchases of the iLase, and the provision of upgrades by us to existing products, should such upgrades be made available in the future. In connection with the advance payments described above, we agreed to grant to HSIC a security interest in our inventory as security for advance payments made under the letter agreement, such security interest to be released by HSIC upon products delivered in respect of such purchase.

On February 24, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement we agreed to an extension of the time for HSIC to provide notice of its intention to renew the License and Distribution Agreement for an additional one year term, from February 25, 2010 to March 3, 2010, in accordance with the terms and conditions thereof.

On March 9, 2010, we entered into another letter agreement with HSIC. This letter agreement calls for guaranteed minimum purchases by HSIC of \$18 million solely in respect of laser equipment in certain territories, plus additional laser equipment purchases on an uncapped basis in certain other territories, plus incremental purchases of consumable products and services in all applicable territories. Pursuant to this letter agreement, all dental sales will continue to be provided exclusively through HSIC in the United Kingdom, Australia, New Zealand, Belgium, Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America. This letter agreement provides incentives for HSIC to focus on its core customer base, and we will have incremental sales and margin incentives to penetrate additional dental offices. This letter agreement has an initial term of one year, after which this letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate this letter agreement upon sixty days

advance written notice to the other party.

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In the event that HSIC elects to terminate the letter agreement prior to the end of the first term, we would be forced to seek alternative channels for the sales of our products, including but not limited to establishing an alternative major distributor relationship, a series of small distributor relationships, selling directly to customers through a direct sales force, or a combination thereof. To the extent that the former distributor held inventory of our products, the distributor would likely look to significantly reduce such inventory, and could possibly decide to compete aggressively with us in sales to new customers following the end of this distribution relationship, until such time as the former distributor's inventory of our products was exhausted. There can be no assurances that we would be able to compete effectively and profitably with the former distributor during this period on price and other terms, while the former distributor attempted to reduce, and possibly even seek to rapidly liquidate, its inventory of our products.

We intend to augment the activities of HSIC in the United States and Canada and other international locations with the efforts of our direct sales force; however, our future revenue will be largely dependent upon the efforts and success of HSIC in selling our products. Since September 1, 2006, nearly all of our domestic sales were made through HSIC and we expect this to continue for the foreseeable future. We cannot assure you that HSIC will devote sufficient resources to selling our products or, even if sufficient resources are directed to our products, that such efforts will be sufficient to increase net revenue.

### ***Critical Accounting Policies***

The preparation of consolidated financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires us to make judgments, assumptions and estimates that affect the amounts reported. The following is a summary of those accounting policies that we believe are necessary to understand and evaluate our reported financial results.

*Revenue Recognition.* Effective September 1, 2006, nearly all of our domestic sales are to HSIC; prior to this date, we sold our products directly to customers through our direct sales force. Sales to HSIC are recorded upon shipment from our facility and payment of our invoices is generally due within 60 days or less. Internationally, we sell products through independent distributors including HSIC. We recognize revenue based on four basic criteria that must be met before revenue can be recognized: (i) persuasive evidence of an arrangement exists; (ii) delivery has occurred and title and the risks and rewards of ownership have been transferred to our customer, or services have been rendered; (iii) the price is fixed or determinable; and (iv) collectibility is reasonably assured.

Sales of our laser systems include separate deliverables consisting of the product, disposables used with the laser systems, installation and training. For these sales, we apply the residual value method, which requires us to allocate to the delivered elements the total arrangement consideration less the fair value of the undelivered elements. Revenue attributable to the undelivered elements, primarily training, is included in deferred revenue when the product is shipped and is recognized when the related service is performed or upon expiration of time offered under the agreement.

The key judgment related to our revenue recognition relates to the collectibility of payment from the customer. We evaluate the customer's credit worthiness prior to the shipment of the product. Based on our assessment of the credit information available to us, we may determine the credit risk is higher than normally acceptable, and we will either decline the purchase or defer the revenue until payment is reasonably assured.

Although all sales are final, we accept returns of products in certain, limited circumstances and record a provision for sales returns based on historical experience concurrent with the recognition of revenue. The sales returns allowance is recorded as a reduction of accounts receivable and revenue.

We recognize revenue for royalties under licensing agreements for our patented technology when the product using our technology is sold. We estimate and recognize the amount earned based on historical performance and current knowledge about the business operations of our licensees. Our estimates have been consistent with amounts historically reported by the licensees.

We may offer sales incentives and promotions on our products. We recognize the cost of sales incentives at the date at which the related revenue is recognized.

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*Accounting for Stock-Based Payments.* We generally recognize compensation cost related to all stock-based payments based on the grant-date fair value.

*Valuation of Accounts Receivable.* We maintain an allowance for uncollectible accounts receivable to estimate the risk of extending credit to customers. We evaluate our allowance for doubtful accounts based upon our knowledge of customers and their compliance with credit terms. The evaluation process includes a review of customers' accounts on a regular basis which incorporates input from sales, service and finance personnel. The review process evaluates all account balances with amounts outstanding 90 days and other specific amounts for which information obtained indicates that the balance may be uncollectible. The allowance for doubtful accounts is adjusted based on such evaluation, with a corresponding provision included in general and administrative expenses. Account balances are charged off against the allowance when we feel it is probable the receivable will not be recovered. We do not have any off-balance-sheet credit exposure related to our customers.

*Valuation of Inventory.* Inventory is valued at the lower of cost, determined using the first-in, first-out method, or market. We periodically evaluate the carrying value of inventory and maintain an allowance for excess and obsolete inventory to adjust the carrying value as necessary to the lower of cost or market. We evaluate quantities on hand, physical condition and technical functionality, as these characteristics may be impacted by anticipated customer demand for current products and new product introductions. Unfavorable changes in estimates of excess and obsolete inventory would result in an increase in cost of revenue and a decrease in gross profit.

*Valuation of Long-Lived Assets.* Property, plant and equipment, and certain intangibles with finite lives are amortized over their useful lives. Useful lives are based on our estimate of the period that the assets will generate revenue or otherwise productively support our business goals. We monitor events and changes in circumstances which could indicate that the carrying balances of long-lived assets may exceed the undiscounted expected future cash flows from those assets. If such a condition were to exist, we would recognize an impairment loss based on the excess of the carrying amount over the fair value of the assets.

*Valuation of Goodwill and Other Intangible Assets.* Goodwill and other intangible assets with indefinite lives are not amortized but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. We conducted our annual impairment analysis of our goodwill and trade names as of June 30, 2009, 2008 and 2007, and concluded there had been no impairment in trade names and no impairment in goodwill. We closely monitor our stock price and market capitalization and perform such analysis on a quarterly basis. If our stock price and market capitalization declines, we may need to impair our goodwill and other intangible assets. At December 31, 2008, as a result of our new Waterlase Dentistry branding strategy, we recorded an impairment of trade names in the amount of \$232,000. During the period June 30, 2009 through December 31, 2009, we reviewed critical indicators and determined that no other triggering events occurred that would have a material effect on the value of the remaining assets.

*Warranty Cost.* Waterlase systems sold domestically are covered by a warranty against defects in material and workmanship for a period of one year while our diode systems warranty period is up to two years from date of sale by the Distributor to the end-user. Estimated warranty expenses are recorded as an accrued liability, with a corresponding provision to cost of revenue. This estimate is recognized concurrent with the recognition of revenue on the sale to the Distributor. Effective October 1, 2009 Waterlase systems sold internationally are generally covered by a warranty against defects in material and workmanship for a period of sixteen months while our *eZlase* system warranty period is up to twenty eight months from date of sale to the Distributor. Our overall accrual is based on our historical experience and our expectation of future conditions. An increase in warranty claims or in the costs associated with servicing those claims would result in an increase in the accrual and a decrease in gross profit.

*Litigation and Other Contingencies.* We regularly evaluate our exposure to threatened or pending litigation and other business contingencies. Because of the uncertainties related to the amount of loss from litigation and other business contingencies, the recording of losses relating to such exposures requires significant judgment about the potential range of outcomes. As additional information about current or future litigation or other contingencies becomes available, we will assess whether such information warrants the

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recording of expense relating to contingencies. To be recorded as expense, a loss contingency must be both probable and reasonably estimable. If a loss contingency is material but is not both probable and estimable, we will disclose the matter in the notes to the consolidated financial statements.

*Income Taxes.* Based upon our operating losses during 2009 and 2008 and the available evidence, management determined that it is more likely than not that the deferred tax assets as of December 31, 2009 will not be realized, excluding a portion of the foreign deferred tax assets in the amount of \$17,000. Consequently, we established a valuation allowance against our net deferred tax asset, excluding a portion of the foreign operations, in the amount of \$30.2 and \$27.4 million as of December 31, 2009 and December 31, 2008, respectively. In this determination, we considered factors such as our earnings history, future projected earnings and tax planning strategies. If sufficient evidence of our ability to generate sufficient future taxable income tax benefits becomes apparent, we may reduce our valuation allowance, resulting in tax benefits in our statement of operations and in additional paid-in-capital. Management evaluates the potential realization of our deferred tax assets and assesses the need for reducing the valuation allowance periodically.

**Off-Balance Sheet Arrangements.**

We have no off-balance sheet financing or contractual arrangements.

**Results of Operations**

The following table sets forth certain data from our consolidated statements of operations for the years ended December 31, 2009, 2008 and 2007, expressed as percentages of revenue:

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Net revenue	100.0%	100.0%	100.0%
Cost of revenue	53.7	49.5	48.4
Gross profit	46.3	50.5	51.6
Operating expenses:			
Sales and marketing	25.5	34.1	39.8
General and administrative	18.0	18.5	16.4
Engineering and development	9.6	8.6	7.6
Patent infringement legal settlement		1.9	
Impairment of intangible asset		0.4	
Impairment of property, plant and equipment		0.6	
Restructuring charge			1.2
Total operating expenses	53.1	64.1	65.0
Loss from operations	(6.8)	(13.6)	(13.4)
Non-operating (loss) income, net	0.3	(0.3)	2.8
Loss before income taxes	(6.5)	(13.9)	(10.6)
Income tax provision	0.3	0.2	0.3



Net loss	(6.8)%	(14.1)%	(10.9)%
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The following table summarizes our net revenues by category for the years ended December 31, 2009, 2008 and 2007 (dollars in thousands):

	Years Ended December 31,					
	2009		2008		2007	
Waterlase systems	\$ 22,950	53%	\$ 40,328	62%	\$ 45,279	68%
Diode systems	8,813	20%	12,040	19%	9,453	14%
Consumables and service	10,374	24%	8,642	13%	8,353	12%
Products and services	42,137	97%	61,010	94%	63,085	94%
License fees and royalty	1,210	3%	3,615	6%	3,804	6%
Net revenue	\$ 43,347	100%	\$ 64,625	100%	\$ 66,889	100%

**Year Ended December 31, 2009 Compared With Year Ended December 31, 2008**

*Net Revenue.* Net revenue for the year ended December 31, 2009 was \$43.3 million, a decrease of \$21.3 million, or 33%, as compared with net revenue of \$64.6 million for the year ended December 31, 2008.

Laser system net revenues decreased by approximately 39% in 2009 compared to 2008. Sales of our Waterlase systems decreased \$17.4 million, or 43%, for the year ended December 31, 2009 compared to the prior year. Sales of our Diode systems decreased \$3.2 million, or 27% in 2009 compared to 2008. We feel the continued adverse worldwide economic environment, combined with lower purchases by HSIC, have been primary contributors to the decreased sales year over year.

Consumables and service net revenue, which includes consumable products, advanced training programs and extended service contracts and shipping revenue, increased by approximately \$1.7 million or 20% for the year ended December 31, 2009 as compared to the same period of 2008 due primarily to the release of the Waterlase MD *Turbo*<sup>™</sup> Handpiece Upgrade Kit in March 2009 as well as increased global service revenues.

Domestic revenues were \$31.1 million, or 72% of net revenue, for the year ended December 31, 2009 versus \$48.5 million, or 75% of net revenue, for the year ended December 31, 2008. International revenues for 2009 were \$12.2 million, or 28% of net revenues compared to \$16.1 million, or 25% of net revenue for 2008.

License fees and royalty income decreased \$2.4 million to \$1.2 million for 2009 from \$3.6 million for 2008. The 2008 period included \$1.5 million of amortization of the license fee from The Proctor & Gamble Company which was fully amortized as of December 31, 2008. Additionally the 2008 period included \$1.7 million of the Schein License fee recognized as compared to \$1.1 million in 2009.

We expect revenues for the first half of 2010 to be negatively impacted by the February 16, 2010 amendment that provides for orders placed and paid for by HSIC, but with delivery in subsequent quarters. As a result, we believe revenues for the first quarter of 2010 will be lower than the same period in 2009. We expect the second quarter to be an improvement over the first quarter, but prepaid orders may continue to delay some revenue recognition.

*Gross Profit.* Gross profit for the year ended December 31, 2009 was \$20.1 million, or 46% of net revenue, a decrease of \$12.6 million, as compared with gross profit of \$32.7 million, or 51% of net revenue for the year ended

December 31, 2008. Gross profit excluding license fees and royalty revenue was 45% of products and service revenue for 2009 compared to 48% for 2008. The decrease was due largely to a one-time write down of inventories in the first quarter of 2009 related to the international subsidiary closures, a shift in sales mix, lower average net pricing and a decrease in licensing and royalty revenues. These expenses were partially offset by our cost reductions implemented in late 2008 and the first quarter of 2009.

*Operating Expenses.* Operating expenses for the year ended December 31, 2009 were \$23 million, or 53% of net revenue, an \$18.4 million decrease as compared with \$41.4 million, or 64% of net revenue for the year ended December 31, 2008. In late 2008 and continuing into 2009, we implemented significant cost reductions to help offset the negative impact of current economic conditions.

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*Sales and Marketing Expense.* Sales and marketing expenses for the year ended December 31, 2009 decreased by \$11 million, or approximately 50%, to \$11.0 million, or 26% of net revenue, as compared with \$22.0 million, or 34% of net revenue, for the year ended December 31, 2008. Payroll and consulting related expenses decreased by \$1.9 million in 2009 as compared to the same period in 2008 primarily as a result of closing our foreign sales operations and restructuring our domestic sales and marketing departments. Additional major factors contributing to the reduction were a decrease in convention and seminars expenses by \$2.6 million, decreased advertising and promotional expenses by \$1.5 million, decreased travel and entertainment expenses by \$1.4 million, a commission expense decrease of \$1.2 million and a decrease in regional meeting and speaker related expenses by \$2.0 million in 2009 compared with the same period of 2008. We believe our sales and marketing expenses and programs are essential in order to grow our revenues, and therefore it is likely that these expenses, excluding commissions, will slightly increase in 2010 as compared to 2009.

*General and Administrative Expense.* General and administrative expenses for the year ended December 31, 2009 decreased by \$4.2 million, or 35%, to \$7.8 million, or 18% of net revenue, as compared with \$12.0 million, or 19% of net revenue, for the year ended December 31, 2008. The decrease in general and administrative expenses resulted primarily from decreased legal and patent related fees of \$1.6 million, decreased audit fees of \$392,000, decreased depreciation expenses of \$371,000 and decreased payroll and consulting related expenses of \$1.6 million. These decreases were partially offset by an increase in severance costs related to the termination of our CEO and reducing our foreign subsidiary operations. As we expect to see a full years benefit of our late 2008 and early 2009 cost reductions, we believe that our general and administrative expenses are likely to slightly decrease in 2010 as compared to 2009.

*Engineering and Development Expense.* Engineering and development expenses for the year ended December 31, 2009 decreased by \$1.4 million, or 25%, to \$4.2 million, or 10% of net revenue, as compared with \$5.6 million, or 9% of net revenue, for the year ended December 31, 2008. The decrease is primarily related to a reduction in payroll and consulting related expenses of \$391,000, decrease in engineering materials and supplies of \$301,000 and a reduction in intangible asset amortization expense of \$222,000. We expect to continue to invest in development projects and personnel in 2010 and expect the overall expense to slightly increase over 2009.

*Non-Operating Income (Loss)*

*Gain (Loss) on Foreign Currency Transactions.* We realized a \$176,000 gain on foreign currency transactions for the year ended December 31, 2009 compared to an \$186,000 loss on foreign currency transactions for the year ended December 31, 2008 primarily due to the changes in exchange rates between the U.S. dollar and the Euro, the Australian dollar and the New Zealand dollar.

*Interest Income.* Interest income results from interest earned on our cash and investments balances. Interest income for the year ended December 31, 2009 was \$5,000 as compared to \$118,000 for the year ended December 31, 2008 due to lower average cash balances in 2009 as compared to 2008.

*Interest Expense.* Interest expense consists primarily of interest on outstanding balances on our line of credit, standby fees under the line of credit, and the periodic use of the line during the year. Interest expense for the year ended December 31, 2009 was \$58,000 as compared to \$157,000 for the year ended December 31, 2008. The decrease in interest expense in 2009 as compared to 2008 is a result of having no line of credit balance since our line of credit was paid off on February 5, 2009.

*Income Taxes.* An income tax provision of \$119,000 was recognized for the year ended December 31, 2009 as compared to \$121,000 for the year ended December 31, 2008. As of December 31, 2009, we had net operating loss carryforwards for federal and state purposes of approximately \$54.5 million and \$25.8 million, respectively, which

will begin expiring in 2010. As of December 31, 2009, we had research and development credit carryforwards for federal and state purposes of approximately \$578,000 and \$218,000, respectively, which will begin expiring in 2011 for federal purposes and will carryforward indefinitely for state purposes. The utilization of net operating loss and credit carryforwards may be limited under the provisions of Internal Revenue Code Section 382 and similar state provisions.

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***Year Ended December 31, 2008 Compared With Year Ended December 31, 2007***

*Net Revenue.* Net revenue for the year ended December 31, 2008 was \$64.6 million, a decrease of \$2.3 million, or 3%, as compared with net revenue of \$66.9 million for the year ended December 31, 2007.

Laser system net revenues decreased by approximately 4% in 2008 compared to 2007. Sales of our Waterlase systems decreased \$5.0 million, or 11%, for the year ended December 31, 2008 compared to the prior year. We feel the continued adverse worldwide economic environment has been a significant cause for the decreased sales as dentists may be delaying their decision to purchase higher priced capital equipment. Sales of our Diode systems increased \$2.6 million, or 27% in 2008 compared to 2007. Our ezlase diode system, which was released in limited quantities in the first quarter of 2007, accounted for the increase.

Consumables and service net revenue, which includes consumable products, advanced training programs and extended service contracts and shipping revenue, increased by approximately 3% for the year ended December 31, 2008 as compared to the same period of 2007. An increase in training and services revenues was partially offset by a decrease in consumable product sales in 2008 compared to 2007.

Domestic revenues were \$48.5 million, or 75% of net revenue, for the year ended December 31, 2008 versus \$41.6 million, or 62% of net revenue, for the year ended December 31, 2007. International revenues for 2008 were \$16.1 million, or 25% of net revenues compared to \$25.3 million, or 38% of net revenue for 2007.

License fees and royalty income decreased to \$3.6 million for 2008 from \$3.8 million for 2006, as a result of lower amortization of license fees in 2008 and lower royalties received from third parties.

*Gross Profit.* Gross profit for the year ended December 31, 2008 was \$32.7 million, or 51% of net revenue, a decrease of \$1.9 million, as compared with gross profit of \$34.5 million, or 52% of net revenue for the year ended December 31, 2007. Gross profit excluding license fees and royalty revenue was 48% of products and service revenue for 2008 compared to 49% for 2007. The decrease in gross margin was a result of discounts and promotions.

*Operating Expenses.* Operating expenses for the year ended December 31, 2008 were \$41.4 million, or 64% of net revenue, a \$2.1 million decrease as compared with \$43.5 million, or 65% of net revenue for the year ended December 31, 2007. The decrease was driven mainly by our corrective actions taken in reducing sales and marketing expenses partially offset by increases in legal and legal settlement expenses.

*Sales and Marketing Expense.* Sales and marketing expenses for the year ended December 31, 2008 decreased by \$4.6 million, or approximately 17%, to \$22.0 million, or 34% of net revenue, as compared with \$26.6 million, or 40% of net revenue, for the year ended December 31, 2007. Convention and seminar expenses decreased by \$2.0 million in 2008 compared to 2007. Also decreasing were commissions as a result of lower sales and travel and entertainment expenses compared to 2007.

*General and Administrative Expense.* General and administrative expenses for the year ended December 31, 2008 increased by \$1.1 million, or 10%, to \$12.0 million, or 19% of net revenue, as compared with \$10.9 million, or 16% of net revenue, for the year ended December 31, 2007. The increase in general and administrative expenses resulted primarily from a \$665,000 increase in legal fees as well as increased payroll related expense partially offset by reduced audit fees.

*Engineering and Development Expense.* Engineering and development expenses for the year ended December 31, 2008 increased by \$476,000, or 9%, to \$5.6 million, or 9% of net revenue, as compared with \$5.1 million, or 8% of net revenue, for the year ended December 31, 2007. The increase was primarily related to an increase in payroll

related expenses of \$441,000.

*Patent infringement legal settlement.* In October 2008, we reached a settlement agreement with Diodem, LLC and recorded a charge of \$1.2 million for the settlement and associated legal fees.

*Impairment of intangible asset.* In connection with a product branding strategy, we have recorded an impairment of \$232,000 related to trademarks.

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*Impairment of property, plant and equipment.* In the first quarter of 2009, we made the decision to begin transitioning our sales in Germany from direct through our foreign subsidiary to sales through a distributor. In connection with this transition, we have placed our buildings located in Floss, Germany for sale. Based on the then current market information and economic climate in Germany, we recorded an impairment of \$355,000 on the land and building.

*Non-Operating Income (Loss)*

*Gain (Loss) on Foreign Currency Transactions.* We realized a \$186,000 loss on foreign currency transactions for the year ended December 31, 2008 due to our treatment of inter-company balances as short-term, compared to a \$1.4 million gain on foreign currency transactions for the year ended December 31, 2007. The decrease is primarily due to changes in exchange rates between the U.S. dollar and the Euro and the Australian and New Zealand dollar and an increase in foreign currency denominated transactions and balances in 2008 compared to 2007. In mid-October 2008, we significantly reduced the inter-company payable due from the foreign subsidiaries to us by making an approximately equal capital contribution which did not result in a significant change in global cash positions.

*Interest Income.* Interest income results from interest earned on our cash and investments balances. Interest income for the year ended December 31, 2008 was \$118,000 as compared to \$580,000 for the year ended December 31, 2007 due to lower interest rates on lower average cash balances.

*Interest Expense.* Interest expense consists primarily of interest on outstanding balances on our line of credit, standby fees under the line of credit, and the periodic use of the line during the year. Interest expense for the year ended December 31, 2008 was \$157,000 as compared to \$81,000 for the year ended December 31, 2007, due to increased borrowings in 2008 as compared to 2007.

*Income Taxes.* An income tax provision of \$121,000 was recognized for the year ended December 31, 2008 as compared to \$163,000 for the year ended December 31, 2007.

**Liquidity and Capital Resources**

We have incurred significant net losses and revenue has declined during the past three years. As of December 31, 2009, we had \$3.0 million in cash and cash equivalents to finance operations and satisfy our obligations. We are substantially dependent on our primary distributor and the continued performance of this distributor to make committed purchases of our products and associated consumables under our distribution agreement, and the receipt of cash in connection with those purchases, is essential to our liquidity. On March 9, 2010 we restructured this agreement with our primary distributor and it provides for lower monthly guaranteed minimum payments than during the 2009 fiscal year. The letter agreement has an initial term of one year, after which the letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate the letter agreement upon sixty days advance written notice to the other party. There can be no assurance that the distributor will not terminate this agreement prior to the end of the one year term.

Our ability to meet our obligations in the ordinary course of business is dependent upon our ability to raise additional financing through public or private equity financing, to establish profitable operations, or to secure other sources of financing to fund operations. Management intends to increase sales, or raise working capital through debt or additional equity financing in 2010. However, there can be no assurance we will be able to increase sales or that such financing can be successfully completed on terms acceptable to the Company or at all. As a result, the opinion we have received from our independent registered public accounting firm contains an explanatory paragraph stating that there is a substantial doubt regarding our ability to continue as a going concern.



The accompanying financial statements have been prepared on a going concern basis that contemplates the realization of assets and the satisfaction of liabilities in the normal course of business. The financial statements do not include adjustments relating to the recoverability of recorded asset amounts or the amounts or classification of liabilities that might be necessary should we be unable to continue as a going concern.

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We believe that during the first ten months of the initial term of the February 27, 2009 letter agreement, HSIC exceeded its bi-monthly minimum purchase commitment with total sales aggregating approximately \$36 million through December 31, 2009. Based upon this level of purchases and considering the general economic slowdown, we believe that HSIC's inventory has trended above historical levels.

On February 16, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement, we agreed to HSIC's request to make certain changes to the applicable product categories required to be purchased by HSIC through March 31, 2010, as set forth in the February 27, 2009 letter agreement. The changes include advance payments in respect of, among other things, purchases of the iLase, and the provision of upgrades by us to existing products, should such upgrades be made available in the future. In connection with the advance payments described above, we agreed to grant to HSIC a security interest in our inventory as security for advance payments made under the letter agreement, such security interest to be released by HSIC upon products delivered in respect of such purchase.

On March 9, 2010, we entered into another letter agreement with HSIC. This letter agreement calls for guaranteed minimum purchases by HSIC of \$18 million solely in respect of laser equipment in certain territories, plus additional laser equipment purchases on an uncapped basis in certain other territories, plus incremental purchases of consumable products and services in all applicable territories. Pursuant to this letter agreement, all dental sales will continue to be provided exclusively through HSIC in the United Kingdom, Australia, New Zealand, Belgium, Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America. This letter agreement provides incentives for HSIC to focus on its core customer base, and we will have incremental sales and margin incentives to penetrate additional dental offices. This letter agreement has an initial term of one year, after which this letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate this letter agreement upon sixty days advance written notice to the other party.

At December 31, 2009 and December 31, 2008, we had approximately \$4.8 million and \$5.0 million in net working capital, respectively. Our principal sources of liquidity at December 31, 2009 consisted of our cash and cash equivalents balance of \$3.0 million.

On September 28, 2006, we entered into a Loan and Security Agreement ( "Loan Agreement" ) with Comerica Bank (the "Lender" ) which replaced the loan agreement previously held with Bank of the West ( "BOW" ). Under the Loan Agreement, the Lender agreed to extend a revolving loan (the "Revolving Line" ) to us in the maximum principal amount of \$10.0 million. Advances under the Revolving Line could not exceed the lesser of \$10.0 million or the Borrowing Base (80% of eligible accounts receivable and 35% of eligible inventory), less any amounts outstanding under letters of credit or foreign exchange contract reserves. Notwithstanding the foregoing, advances of up to \$6.0 million could be made without regard to the Borrowing Base. On October 5, 2007, we entered into an Amendment to the Loan Agreement which extended the agreement for an additional year. The entire unpaid principal amount plus any accrued but unpaid interest and all other amounts due under the Loan Agreement would have been due and payable in full on September 28, 2009 (the "Maturity Date" ), but could have been extended by us for an additional year upon Lender approval. Our obligations under the Loan Agreement bore interest on the outstanding daily balance thereof at one of the following rates, to be selected by us: (i) LIBOR plus 2.50%, or (ii) prime rate, as announced by the Lender, plus 0.25%. As security for the payment and performance of our obligations under the Loan Agreement, we granted the Lender a first priority security interest in existing and later-acquired Collateral (as defined in the Loan Agreement, and which excludes intellectual property). Certain subsidiaries of ours had entered into unconditional guaranties, dated as of September 28, 2006, pursuant to which such subsidiaries had guaranteed the payment and performance of our obligations under the Loan Agreement.

The Loan Agreement required compliance with certain financial covenants, including: (i) minimum effective tangible net worth; (ii) maximum leverage ratio; (iii) minimum cash amount at Lender of \$6.0 million; and (iv) minimum

liquidity ratio. The Loan Agreement also contained covenants that required Lender's prior written consent for us, among other things, to: (i) transfer any part of its business or property; (ii) make any changes in our location or name, or replace our CEO or CFO; (iii) consummate mergers or acquisitions;

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(iv) incur liens; or, (v) pay dividends or repurchase stock. The Loan Agreement contained customary events of default, any one of which would result in the right of the Lender to, among other things, accelerate all obligations under the Loan Agreement, set-off obligations under the Loan Agreement against any balances or deposits of ours held by the bank, or sell the Collateral.

On January 30, 2009, we delivered a compliance certificate to Comerica which set forth non-compliance with certain covenants under the Loan Agreement as of December 31, 2008. The loan agreement was terminated on February 5, 2009 and all outstanding balances were repaid in full with cash available on hand, and under the terms of the Loan Agreement and related note, we and certain of our subsidiaries satisfied all of our obligations under the Loan Agreement.

We are currently pursuing other credit facilities that do not contain the cash deposit requirements set forth in the Comerica Loan Agreement; however, we cannot guarantee that we will be able to obtain such a line, or otherwise obtain additional financing to support our working capital needs.

For the year ended December 31, 2009, our operating activities used cash of approximately \$2.6 million, compared to cash used by operations of \$4.5 million for 2008. Cash flows from operating activities in 2008 were negatively impacted by the higher net loss in 2008 compared to 2009 as explained under *Results of Operations*. The most significant changes in operating assets and liabilities for the year ended December 31, 2009 as reported in our Consolidated Statements of Cash Flow were a \$3.5 million reduction in inventory and a \$5.0 million reduction in accrued liabilities and accounts payable.

In December 2009, we financed approximately \$573,000 of insurance premiums payable in ten equal monthly installments of approximately \$58,000 each, including a finance charge of 3.24%. On January 10, 2006, we entered into a five-year facility lease with initial monthly installments of \$39,000 and annual adjustments over the lease term. On September 24, 2009, we entered into a First Amendment to Lease which extended the facility lease term to April 20, 2015, adjusted basic rent and made modification provisions to the security deposit. These amounts are included in the outstanding obligations as of December 31, 2009 listed below.

The following table presents our expected cash requirements for contractual obligations outstanding as of December 31, 2009 for the years ending as indicated below (in thousands):

	<b>Less Than 1 Year</b>	<b>1 to 3 Years</b>	<b>3 to 5 Years</b>	<b>More Than 5 years</b>	<b>Total</b>
Operating leases	\$ 510	\$ 984	\$ 1,020	\$ 175	\$ 2,689
SurgiLight agreement	25				25
Insurance premium financing	573				573
<b>Total</b>	<b>\$ 1,108</b>	<b>\$ 984</b>	<b>\$ 1,020</b>	<b>\$ 175</b>	<b>\$ 3,287</b>

In addition and not included in the above table is a long term commitment to a supplier in the amount of \$2.2 million that is currently being renegotiated.

In January 2008, Jake St. Philip was appointed our Chief Executive Officer. On March 5, 2009, Mr. St. Philip resigned as our Chief Executive Officer and as a director of our Board of Directors. On March 10, 2009, we entered

into a Separation and General Release Agreement, or Agreement, with Mr. St. Philip. Pursuant to the Agreement, we agreed to pay Mr. St. Philip a severance payment of \$350,000 of which half was paid on May 9, 2009 and half will be paid in twelve consecutive equal monthly installments commencing on June 1, 2009. In addition, we agreed to pay COBRA premiums on his behalf for twelve months. The Agreement superseded the Employment Agreement we had with Mr. St. Philip dated January 2, 2008.

On April 30, 2008, we appointed David M. Mulder as Chief Financial Officer. Mr. Mulder has an employment agreement that obligates us to pay him severance benefits under certain conditions, including termination without cause and resignation with good reason. In the event Mr. Mulder is terminated by us without cause or he resigns with good reason, the total severance benefits payable would be approximately \$255,000 based on compensation in effect as of April 30, 2008, the date Mr. Mulder was appointed as our

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current Chief Financial Officer. On March 5, 2009, Mr. Mulder was appointed Chief Executive Officer and appointed to our Board of Directors. On April 3, 2009, we modified the financial terms of Mr. Mulder's employment with us, in connection with his appointment to the position of Chief Executive Officer. Under the new terms of Mr. Mulder's employment, in the event he is terminated by us without cause or he resigns with good reason, we agreed to pay Mr. Mulder his base salary then in effect (or \$250,000, his new base salary as modified on April 3, 2009) payable in twenty-four equal semi-monthly installments. In addition, we agreed to pay Mr. Mulder's COBRA premiums for twelve months.

On July 14, 2009, we appointed Brett L. Scott as Chief Financial Officer. Mr. Scott has an employment agreement that obligates us to pay him severance benefits under certain conditions, including termination without cause and resignation with good reason. In the event Mr. Scott is terminated by us without cause or he resigns with good reason, the total severance benefits payable would be approximately \$102,500 based on the employment agreement in effect as of July 14, 2009. In addition, we agreed to pay Mr. Scott's COBRA premiums for six months.

In addition to Mr. Mulder and Mr. Scott, certain other members of management are entitled to severance benefits payable upon termination following a change in control, which would approximate \$1.6 million. Also, we have agreements with certain employees to pay bonuses based on targeted performance criteria.

In addition to the amounts shown in the table above, \$108,000 of unrecognized tax benefits have been recorded as liabilities, and we are uncertain as to if or when such amounts may be settled. Related to these unrecognized tax benefits, we have also recorded a liability for potential penalties and interest of \$20,000 and \$25,000, respectively, at December 31, 2009.

Our capital requirements will depend on many factors, including, among other things, the effects of any acquisitions we may pursue as well as the rate at which our business grows, with corresponding demands for working capital and manufacturing capacity. We could be required or may elect to seek additional funding through public or private equity or debt financing. However, a credit facility, or additional funds through public or private equity or other debt financing, may not be available on terms acceptable to us or at all. Without additional funds and/or increased revenues, we may not have enough cash/financial resources to operate for the next twelve months.

**Selected Quarterly Financial Data**

The following table presents our operating results for each quarter in our last two fiscal years. This data has been derived from unaudited financial statements that, in the opinion of our management, include all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of such information when read in conjunction with our annual audited financial statements and notes thereto. These operating results are not necessarily indicative of results for any future operating period.

	<b>March 31,</b>	<b>June 30,</b>	<b>September 30,</b>	<b>December 31,</b>
	<b>(In thousands, except per share data)</b>			
<b>2009</b>				
Net revenue	\$ 6,594	\$ 14,317	\$ 12,085	\$ 10,351
Gross profit	1,768	8,098	5,833	4,363
Profit (loss) from operations(1)	(4,929)	2,474	904	(1,409)
Net income (loss)(1)	(4,676)	2,330	859	(1,469)
Net income (loss) per share(3):				
Basic	(0.19)	0.10	0.04	(0.06)

Diluted	(0.19)	0.10	0.04	(0.06)
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	<b>March 31,</b>	<b>June 30,</b>	<b>September 30,</b>	<b>December 31,</b>
	<b>(In thousands, except per share data)</b>			
<b>2008</b>				
Net revenue	\$ 19,041	\$ 18,663	\$ 15,286	\$ 11,635
Gross profit	9,582	10,107	7,531	5,442
Profit (loss) from operations(2)	(561)	386	(3,794)	(4,814)
Net income (loss)(2)	26	622	(4,490)	(5,287)
Net income (loss) per share(3):				
Basic	0.00	0.03	(0.19)	(0.22)
Diluted	0.00	0.03	(0.19)	(0.22)

- (1) Loss from operations and net loss includes \$468,000, \$317,000, \$318,000 and \$254,000 in compensation cost related to stock options for the quarters ended March 31, June 30, September 30 and December 31, 2009, respectively.
- (2) Profit (loss) from operations and net income (loss) includes \$452,000, \$440,000, \$424,000 and \$419,000 in compensation cost related to stock options for the quarters ended March 31, June 30, September 30 and December 31, 2008, respectively.
- (3) Net income (loss) per share calculations for each of the quarters were based upon the weighted average number of shares outstanding for each period, and the sum of the quarters may not necessarily be equal to the full year net (loss) income per common share amount.

We have at various times experienced fluctuations in quarterly net revenue due to seasonality. We expect to continue to experience seasonal fluctuations in our revenues. Since many of our costs are fixed in the short term, if we have a shortfall in revenue resulting from a change in our historical seasonality pattern, or otherwise, we may be unable to reduce expenses quickly enough to avoid losses.

**Recent Accounting Pronouncements**

See Note 2 of the Notes to the Consolidated Financial Statements included in this report for a discussion on recent accounting pronouncements.

**Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

Substantially all of our revenue is denominated in U.S. dollars, including sales to our international distributors. Only a small portion of our revenue and expenses is denominated in foreign currencies, principally the Euro. Our Euro expenditures primarily consist of the cost of maintaining our office in Germany, including the facility and employee-related costs. To date, we have not entered into any hedging contracts. Future fluctuations in the value of the U.S. dollar may, however, affect the price competitiveness of our products outside the United States.

Through February 5, 2009, we had a line of credit which bore interest at rates based on the Prime rate or LIBOR. At December 31, 2008, \$5.4 million was outstanding under the line of credit at a rate of 3.5%. The line of credit was terminated on February 5, 2009 and the balance was repaid in full.



Our primary objective in managing our cash balances has been preservation of principal and maintenance of liquidity to meet our operating needs. Most of our excess cash balances are invested in money market accounts in which there is minimal interest rate risk and are deposited with well capitalized financial institutions, reducing the related credit risk.

**Item 8. *Financial Statements and Supplementary Data***

All financial statements and supplementary data required by this Item are listed in Part IV, Item 15 of this Form 10-K, are presented beginning on Page F-1 and are incorporated herein by this reference. Selected

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Quarterly Financial Data are presented in Item 7 (Management's Discussion and Analysis of Financial Condition and Results of Operations) of this Form 10-K and are incorporated herein by this reference.

### **Item 9. *Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

None.

### **Item 9A(T). *Controls and Procedures***

#### **Disclosure Controls and Procedures**

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2009. Based on this evaluation, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective as of December 31, 2009.

#### **Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934. A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on our financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Under the supervision and with the participation of management, including our chief executive officer and chief financial officer, management conducted an assessment of the effectiveness of our internal control over financial reporting based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) entitled *Internal Control - Integrated Framework*. Based on our evaluation under COSO Framework, management concluded that our internal control over financial reporting was effective at a reasonable assurance level as of December 31, 2009.

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

In our Form 10-K for the fiscal year ended December 31, 2008, we disclosed management's assessment that our internal control over financial reporting contained no material weaknesses. No change in internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) occurred during the last quarter of 2009 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

This annual report does not include an attestation report of our independent registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our independent registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only management's report in this annual report.

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**Item 9B. *Other Information***

None

**PART III**

**Item 10. *Directors, Executive Officers and Corporate Governance***

There is hereby incorporated herein by reference the information appearing under the caption *Election of Directors* in the proxy statement for our 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2010.

**Item 11. *Executive Compensation***

There is hereby incorporated herein by reference the information appearing under the caption *Executive Compensation* in the proxy statement for our 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2010.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

There is hereby incorporated herein by reference the information appearing under the caption *Security Ownership of Certain Beneficial Owners and Management* in the proxy statement for our 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2010.

There is hereby incorporated herein by reference the information appearing under the caption *Equity Compensation Plan Information* in the proxy statement for our 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2010.

**Item 13. *Certain Relationships and Related Transactions, and Director Independence***

There is hereby incorporated herein by reference the information appearing under the caption *Certain Relationships and Related Transactions* in the proxy statement for our 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2010.

**Item 14. *Principal Accountant Fees and Services***

There is hereby incorporated herein by reference the information appearing under the caption *Independent Auditor Fee Information* in the proxy statement for our 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission on or before April 30, 2010.

**Table of Contents****PART IV****Item 15. Exhibits and Financial Statement Schedules**

(a) The following documents are filed as part of this Annual Report on Form 10-K beginning on the pages referenced below:

*(1) Financial Statements:*

	<b>Page</b>
Report of Independent Registered Public Accounting Firm	F-2
Consolidated Balance Sheets as of December 31, 2009 and 2008	F-3
Consolidated Statements of Operations for the years ended December 31, 2009, 2008 and 2007	F-4
Consolidated Statements of Stockholders' Equity for the years ended December 31, 2009, 2008 and 2007	F-5
Consolidated Statements of Cash Flows for the years ended December 31, 2009, 2008 and 2007	F-6
Notes to Consolidated Financial Statements	F-7

*(2) Financial Statement Schedule:*

Schedule II Consolidated Valuation and Qualifying Accounts and Reserves for the years ended December 31, 2009, 2008 and 2007	S-1
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All other schedules have been omitted as they are not applicable, not required or the information is included in the consolidated financial statements or the notes thereto.

*(3) Exhibits:*

The following exhibits are filed with this Annual Report on Form 10-K or are incorporated by reference herein in accordance with the designated footnote references.

<b>Exhibit Number</b>	<b>Description</b>
3.1	Restated Certificate of Incorporation, as amended. (Filed with Registrant's Amendment No. 1 to Registration Statement on Form S-1 filed December 23, 2005 and incorporated herein by reference.)
3.2	Fourth Amended and Restated Bylaws. (Filed with Registrant's Current Report on Form 8-K filed on December 22, 2008 and incorporated herein by reference.)
4.1	Certificate of Designations, Preferences and Rights of 6% Redeemable Cumulative Convertible Preferred Stock of Biolase Technology, Inc. (Included in Exhibit 3.1.)
4.2	Certificate of Designations, Preferences and Rights of Series A 6% Redeemable Cumulative Convertible Preferred Stock of Biolase Technology, Inc. (Included in Exhibit 3.1.)
4.3	Certificate of Correction Filed to Correct a Certain Error in the Certificate of Designation of Biolase Technology, Inc. filed in the Office of Secretary of State of Delaware on July 25, 1996. (Included in

Exhibit 3.1.)

- 4.4 Certificate of Designations of Series B Junior Participating Cumulative Preferred Stock of Biolase Technology, Inc. (Included in Exhibit 3.1.)
- 4.5 Rights Agreement, dated as of December 31, 1998, between the Registrant and U.S. Stock Transfer Corporation. (Filed with Registrant's Registration Statement on Form 8-A filed December 29, 1998 and incorporated herein by reference.)

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<b>Exhibit Number</b>	<b>Description</b>
4.6	Amendment to Rights Agreement, dated December 19, 2008, between the Registrant and Computershare Trust Company, N.A. (Filed with the Registrant's Current Report on Form 8-K filed on December 22, 2008 and incorporated herein by reference.)
4.7	Specimen of common stock certificate. (Filed with Registrant's Registration Statement on Form S-3 filed June 3, 2002 and incorporated herein by reference.)
4.8	Warrant to Purchase 81,037 shares of Common Stock of the Registrant issued to Diodem, LLC dated January 24, 2005. (Filed with Registrant's Quarterly Report on Form 10-Q filed September 30, 2005 and incorporated herein by reference.)
4.9	Registration Rights Agreement between the Registrant and Diodem, LLC dated January 24, 2005. (Filed with Registrant's Quarterly Report on Form 10-Q filed September 30, 2005 and incorporated herein by reference.)
4.10	Form of Warrant to Purchase Common Stock of Registrant issued to assignees of Diodem, LLC dated August 15, 2005. (Filed with Registrant's Quarterly Report on Form 10-Q filed November 9, 2005 and incorporated herein by reference.)
10.1	Form of Purchase Order Term and Conditions relating to domestic sales (effective for sales after August 4, 2003). (Filed with Amendment No. 2 to Registrant's Annual Report on Form 10-K/A filed December 16, 2003 and incorporated herein by reference.)
10.2*	1990 Stock Option Plan. (Filed with Registrant's Registration Statement on Form S-1 filed October 9, 1992 and incorporated herein by reference.)
10.3*	Form of Stock Option Agreement under the 1990 Stock Option Plan. (Filed with Registrant's Annual Report on Form 10-K filed July 19, 2005 and incorporated herein by reference.)
10.4*	1993 Stock Option Plan. (Filed with Registrant's Annual Report on Form 10-K filed April 14, 1994 and incorporated herein by reference.)
10.5*	Form of Stock Option Agreement under the 1993 Stock Option Plan. (Filed with Registrant's Annual Report on Form 10-K filed April 14, 1994 and incorporated herein by reference.)
10.6*	2002 Stock Incentive Plan. (Filed with Registrant's definitive Proxy Statement filed October 17, 2005 and incorporated herein by reference.)
10.7*	Form of Stock Option Agreement under the 2002 Stock Option Plan. (Filed with Registrant's Annual Report on Form 10-K filed July 19, 2005 and incorporated herein by reference.)
10.8	2002 Stock Incentive Plan (Filed with Registrant's definitive Proxy Statement filed April 10, 2007 and incorporated herein by reference.)
10.9	Definitive Asset Purchase Agreement dated January 24, 2005 by and among Diodem, LLC, BL Acquisition II, Inc. and the Registrant (Filed on January 28, 2005 with Registrant's Current Report on Form 8-K and incorporated herein by reference.)
10.10	License Agreement between SurgiLight, Inc. and the Registrant dated February 3, 2005 (Filed on March 18, 2005 with Registrant's Current Report on Form 8-K and incorporated herein by reference.)
10.11*	Form of Indemnification Agreement between Registrant and its officers and directors. (Filed with Registrant's Quarterly Report on Form 10-Q filed November 9, 2005 and incorporated herein by reference.)
10.12*	Form of Resale Restriction Agreement, dated December 16, 2005 between Registrant and certain key employees and officers. (Filed on December 22, 2005 with Registrant's Current Report of Form 8-K and incorporated herein by reference.)
10.13*	Resale Restriction Agreement, dated as of December 29, 2005 between Registrant and Jeffrey W. Jones. (Filed on January 10, 2006 with Registrant's Current Report of Form 8-K and incorporated herein by reference.)

- 10.14 Lease, dated January 10, 2006 between Registrant and The Irvine Company LLC. (Filed on January 17, 2006 with Registrant's Current Report on Form 8-K and incorporated herein by reference.)
- 10.15 Letter Agreement, dated June 28, 2006, by and between The Procter & Gamble Company and the Registrant. (Filed with Registrant's Quarterly Report on Form 10-Q filed August 9, 2006 and incorporated herein by reference.)



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<b>Exhibit Number</b>	<b>Description</b>
10.16	License Agreement, dated January 24, 2007, by and between The Procter & Gamble Company and the Registrant. (Filed with Registrant's Quarterly Report on Form 10-Q filed May 10, 2007 and incorporated herein by reference.)
10.17	License and Distribution Agreement dated as of August 8, 2006 by and among the Registrant and Henry Schein, Inc. (Filed with Registrant's Quarterly Report on Form 10-Q filed November 8, 2006 and incorporated herein by reference.)
10.18	Addendum 1 to License and Distribution Agreement dated as of April 1, 2007 by and among the Registrant and Henry Schein, Inc. (Filed with Registrant's Quarterly Report on Form 10-Q filed August 9, 2007 and incorporated herein by reference.)
10.19	Amendment to the License and Distribution Agreement dated February 29, 2008, by and between the Registrant and Henry Schein, Inc. (Filed with Registrant's Quarterly Report on Form 10-Q filed May 9, 2008 and incorporated herein by reference.)
10.20	Letter Agreement, dated as of December 23, 2008 by and among the Registrant and Henry Schein, Inc. (Filed with Registrant's Annual Report on Form 10-K filed March 16, 2009 and incorporated herein by reference.)
10.21	Employment Agreement dated April 29, 2008, by and between the Registrant and David M. Mulder (Filed with Registrant's Quarterly Report on Form 10-Q filed August 8, 2008 and incorporated herein by reference.)
10.22	Letter Agreement, dated as of February 27, 2009 by and between the Registrant and Henry Schein, Inc. (Filed with Registrant's Quarterly Report on Form 10-Q filed May 8, 2009 and incorporated herein by reference.)
10.23*	Letter Agreement, dated March 4, 2009, amending that certain Employment Agreement dated April 29, 2008 between the Registrant and David M. Mulder (Filed with Registrant's Quarterly Report on Form 10-Q filed May 8, 2009 and incorporated herein by reference.)
10.24	Separation and General Release Agreement, dated March 10, 2009, by and between the Registrant and Jake P. St. Philip (Filed with Registrant's Quarterly Report on Form 10-Q filed May 8, 2009 and incorporated herein by reference.)
10.25	Security Agreement, dated March 13, 2009, by and between the Registrant and Henry Schein, Inc. (Filed with Registrant's Current Report on Form 8-K filed March 19, 2009 and incorporated herein by reference.)
10.26	Settlement Agreement and General Mutual Release, dated March 26, 2009, by and between the Registrant and National Laser Technology, Inc. (Filed with Registrant's Quarterly Report on Form 10-Q filed on May 8, 2009 and incorporated herein by reference.)
10.27*	Second Letter Agreement, dated April 3, 2009, by and between the Registrant and David M. Mulder, amending that certain Employment Agreement, dated April 29, 2008, by and between the Registrant and David M. Mulder, as amended by that certain Letter Agreement, dated March 4, 2009 (Filed with Registrant's Quarterly Report on Form 10-Q filed August 7, 2009 and incorporated herein by reference.)
10.28*	Employment Agreement, dated July 13, 2009, by and between the Registrant and Brett L. Scott (Filed with Registrant's Quarterly Report on Form 10-Q filed November 6, 2009 and incorporated herein by reference.)
10.29	Amendment to License and Distribution Agreement, dated September 10, 2009, by and between the Registrant and Henry Schein, Inc. (Filed with Registrant's Quarterly Report on Form 10-Q filed November 6, 2009 and incorporated herein by reference.)
10.30	First Amendment to Lease, dated September 24, 2009, by and between the Registrant and The Irvine Company LLC (Filed with Registrant's Quarterly Report on Form 10-Q filed November 6, 2009 and

incorporated herein by reference.)

14.1 Biolase Technology, Inc. Code of Business Conduct and Ethics. (Filed with the Registrant's Definitive Proxy Statement for its 2004 Annual Meeting of Stockholders filed May 10, 2004 and incorporated herein by reference.)

21.1 Subsidiaries of the Registrant.

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<b>Exhibit Number</b>	<b>Description</b>
23.1	Consent of Independent Registered Public Accounting Firm, BDO Seidman, LLP
24.1	Power of Attorney (included in Signature page).
31.1	Certification of CEO pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of interim CFO pursuant to Rule 13a-14(a) and Rule 15d-14(a), promulgated under the Securities Exchange Act of 1934, as amended.
32.1	Certification of CEO pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of interim CFO pursuant to 18 U.S.C. Section 1350 as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Confidential treatment was granted for certain confidential portions of this exhibit pursuant to Rule 24b-2 under the Securities Exchange Act of 1934. In accordance with Rule 24b-2, these confidential portions were omitted from this exhibit and filed separately with the Securities and Exchange Commission.

\* Management contract or compensatory plan or arrangement.

**Table of Contents****SIGNATURES**

**Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.**

Biolase Technology, Inc.,  
a Delaware Corporation  
(registrant)

By: /s/ DAVID M. MULDER  
**David M. Mulder**  
**Chief Executive Officer**

Dated: March 19, 2010

**POWER OF ATTORNEY**

We, the undersigned officers and directors of BIOLASE Technology, Inc., do hereby constitute and appoint David M. Mulder and Brett L. Scott, and each of them, our true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite or necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby, ratifying and confirming all that each of said attorneys-in-fact and agents, or his substitute or substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated:

<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ DAVID M. MULDER <b>David M. Mulder</b>	Chief Executive Officer, (Principal Executive Officer) and Director	March 19, 2010
/s/ BRETT L. SCOTT <b>Brett L. Scott</b>	Chief Financial Officer, (Principal Financial Officer and Principal Accounting Officer)	March 19, 2010
/s/ GEORGE V. D ARBELOFF <b>George V. d Arbeloff</b>	Director and Chairman of the Board	March 19, 2010
/s/ FEDERICO PIGNATELLI <b>Federico Pignatelli</b>	President, Director and Chairman Emeritus	March 19, 2010

/s/ ROBERT M. ANDERTON, DDS

Director

March 19, 2010

**Dr. Robert M. Anderton**

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<b>Signature</b>	<b>Title</b>	<b>Date</b>
/s/ DANIEL S. DURRIE, M.D. <b>Daniel S. Durrie, M.D.</b>	Director	March 19, 2010
/s/ NEIL J. LAIRD <b>Neil J. Laird</b>	Director	March 19, 2010
/s/ JAMES R. LARGENT <b>James R. Largent</b>	Director	March 19, 2010
/s/ GREGORY D. WALLER <b>Gregory D. Waller</b>	Director	March 19, 2010

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**BIOLASE TECHNOLOGY, INC.**

**Index to Consolidated Financial Statements and Schedule**

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<u>Report of Independent Registered Public Accounting Firm</u>	F-2
<u>Consolidated Balance Sheets as of December 31, 2009 and 2008</u>	F-3
<u>Consolidated Statements of Operations for the years ended December 31, 2009, 2008 and 2007</u>	F-4
<u>Consolidated Statements of Stockholders' Equity for the years ended December 31, 2009, 2008 and 2007</u>	F-5
<u>Consolidated Statements of Cash Flows for the years ended December 31, 2009, 2008 and 2007</u>	F-6
<u>Notes to Consolidated Financial Statements</u>	F-7
SCHEDULE Schedule numbered in accordance with Rule 5.04 of Regulation S-X:	
<u>II. Consolidated Valuation and Qualifying Accounts and Reserves</u>	S-1

All Schedules, except Schedule II, have been omitted as the required information is shown in the consolidated financial statements, or notes thereto, or the amounts involved are not significant or the schedules are not applicable.

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**Report of Independent Registered Public Accounting Firm**

Board of Directors and Stockholders  
BIOLASE Technology, Inc.  
Irvine, California

We have audited the accompanying consolidated balance sheets of BIOLASE Technology, Inc. (the Company) as of December 31, 2009 and 2008 and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2009. In connection with our audits of the financial statements, we have also audited the accompanying financial statement schedule as of and for the years ended December 31, 2009, 2008 and 2007. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal controls over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal controls over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements and schedule. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of BIOLASE Technology, Inc. at December 31, 2009 and 2008, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2009, in conformity with accounting principles generally accepted in the United States of America.

Also, in our opinion, the financial statement schedule, when considered in relation to the basic consolidated financial statements taken as a whole, presents fairly, in all material respects, the information set forth therein.

The accompanying consolidated financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the consolidated financial statements, the Company has suffered recurring losses from operations, has had declining revenues, has limited financial resources at December 31, 2009 and is substantially dependent upon their primary distributor for future purchases of the Company's products. These factors raise substantial doubt about its ability to continue as a going concern. Management's plans in regard to these matters are also described in Note 1. The consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ BDO Seidman, LLP  
Costa Mesa, California  
March 19, 2010



**Table of Contents****BIOLASE TECHNOLOGY, INC.****CONSOLIDATED BALANCE SHEETS**

(in thousands, except per share data)

	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 2,975	\$ 11,235
Accounts receivable, less allowance of \$421 and \$526 in 2009 and 2008, respectively	4,229	3,758
Inventory, net	7,861	12,410
Prepaid expenses and other current assets	1,347	1,391
<b>Total current assets</b>	<b>16,412</b>	<b>28,794</b>
Property, plant and equipment, net	2,180	3,040
Intangible assets, net	472	613
Goodwill	2,926	2,926
Deferred tax asset	17	29
Other assets	170	306
<b>Total assets</b>	<b>\$ 22,177</b>	<b>\$ 35,708</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Line of credit	\$	\$ 5,404
Accounts payable	4,887	7,509
Accrued liabilities	5,600	8,255
Deferred revenue, current portion	1,123	2,603
<b>Total current liabilities</b>	<b>11,610</b>	<b>23,771</b>
Deferred tax liabilities	473	376
Deferred revenue long-term	1,975	1,875
Other liabilities long-term	190	296
<b>Total liabilities</b>	<b>14,248</b>	<b>26,318</b>
Commitments and contingencies (Note 7)		
<b>Stockholders equity:</b>		
Preferred stock, par value \$0.001; 1,000 shares authorized, no shares issued and outstanding		
Common stock, par value \$0.001; 50,000 shares authorized, 26,340 and 26,208 shares issued in 2009 and 2008, respectively; 24,376 shares and 24,244 shares outstanding in 2009 and 2008, respectively	27	27
Additional paid-in capital	117,228	115,698
Accumulated other comprehensive (loss)	(222)	(187)

Accumulated deficit	(92,705)	(89,749)
	24,328	25,789
Treasury stock (cost of 1,964 shares repurchased)	(16,399)	(16,399)
<b>Total stockholders equity</b>	7,929	9,390
<b>Total liabilities and stockholders equity</b>	\$ 22,177	\$ 35,708

See accompanying notes to consolidated financial statements.

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**Table of Contents****BIOLASE TECHNOLOGY, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(in thousands, except per share data)

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Products and services revenues	\$ 42,137	\$ 61,010	\$ 63,085
License fees and royalty revenue	1,210	3,615	3,804
Net revenue	43,347	64,625	66,889
Cost of revenue	23,285	31,963	32,364
Gross profit	20,062	32,662	34,525
Other income, net			
Operating expenses:			
Sales and marketing	11,041	22,040	26,648
General and administrative	7,835	12,006	10,941
Engineering and development	4,146	5,580	5,104
Patent infringement legal settlement		1,232	
Impairment of intangible asset		232	
Impairment of property, plant and equipment		355	
Restructuring charge			802
Total operating expenses	23,022	41,445	43,495
Loss from operations	(2,960)	(8,783)	(8,970)
Gain (loss) on foreign currency transactions	176	(186)	1,354
Interest income	5	118	580
Interest expense	(58)	(157)	(81)
Non-operating income (loss), net	123	(225)	1,853
Loss before income tax provision	(2,837)	(9,008)	(7,117)
Income tax provision	119	121	163
Net loss	\$ (2,956)	\$ (9,129)	\$ (7,280)
Net loss per share:			
Basic	\$ (0.12)	\$ (0.38)	\$ (0.31)
Diluted	\$ (0.12)	\$ (0.38)	\$ (0.31)
Shares used in the calculation of net loss per share:			
Basic	24,282	24,178	23,853

Diluted	24,282	24,178	23,853
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See accompanying notes to consolidated financial statements.

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**Table of Contents****BIOLASE TECHNOLOGY, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

(in thousands)

	Common Stock and Additional Paid-in Capital		Treasury Stock		Accumulated Other Comprehensive Gain (Loss)	Accumulated Deficit	Total Stockholders' Equity	Comprehensive Income (Loss)
	Shares	Amount	Shares	Amount				
Balances, January 1, 2007	25,741	\$ 111,441	(1,964)	\$ (16,399)	\$ 108	\$ (73,184)	\$ 21,966	\$ (4,259)
Exercise of stock options	226	727					727	
Stock-based compensation		1,265					1,265	
Other Compensation		23					23	
Net loss						(7,280)	(7,280)	(7,280)
Adjustment for uncertain tax positions						(156)	(156)	
Foreign Currency Translation adjustment					(54)		(54)	(54)
Balances, December 31, 2007	25,967	113,456	(1,964)	(16,399)	54	(80,620)	16,491	(7,334)
Exercise of stock options, net	241	532					532	
Stock-based compensation		1,735					1,735	
Other compensation		2					2	
Net loss						(9,129)	(9,129)	(9,129)
Foreign Currency Translation adjustment					(241)		(241)	(241)
Balances, December 31, 2008	26,208	115,725	(1,964)	(16,399)	(187)	(89,749)	9,390	(9,370)
Exercise of stock options, net	132	173					173	
Stock-based compensation		1,357					1,357	
Net loss						(2,956)	(2,956)	(2,956)
Foreign Currency Translation adjustment					(35)		(35)	(35)
Balances, December 31, 2009	26,340	\$ 117,255	(1,964)	\$ (16,399)	\$ (222)	\$ (92,705)	\$ 7,929	\$ (2,991)

See accompanying notes to consolidated financial statements.



**Table of Contents****BIOLASE TECHNOLOGY, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(in thousands)

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
<b>Cash Flows From Operating Activities:</b>			
Net loss	\$ (2,956)	\$ (9,129)	\$ (7,280)
Adjustments to reconcile net loss to net cash and cash equivalents used in operating activities:			
Depreciation and amortization	1,444	1,909	1,895
Residual cost of demo equipment sold	12	10	184
Loss on disposal of assets, net	1		
Impairment of property, plant and equipment		387	
Impairment of intangible asset		232	
Recovery of bad debts	(62)	(68)	(264)
Recovery of sales returns allowance	(77)		
Provision for inventory excess and obsolescence	1,090	104	89
Stock-based compensation	1,357	1,735	1,265
Other non-cash compensation		2	23
Deferred income taxes	109	52	61
Changes in operating assets and liabilities:			
Accounts receivable	(290)	7,457	4,381
Inventory	3,459	(4,887)	59
Prepaid expenses and other current assets	(275)	167	(779)
Accounts payable and accrued liabilities	(4,990)	888	(1,065)
Deferred revenue	(1,393)	(3,379)	(1,838)
Net cash and cash equivalents used in operating activities	(2,571)	(4,520)	(3,269)
<b>Cash Flows From Investing Activities:</b>			
Additions to property, plant and equipment	(449)	(981)	(775)
Proceeds from sale of property, plant and equipment	5		
Additions to other intangible assets			(100)
Net cash and cash equivalents used in by investing activities	(444)	(981)	(875)
<b>Cash Flows From Financing Activities:</b>			
Borrowings under a line of credit	4,293	29,340	4,468
Payments under a line of credit	(9,697)	(27,488)	(916)
Proceeds from exercise of stock options and warrants	173	532	727
Payment of cash dividend			
Net cash and cash equivalents (used in) provided by financing activities	(5,231)	2,384	4,279
Effect of exchange rate changes	(14)	(214)	(245)

<b>Decrease in cash and cash equivalents</b>	(8,260)	(3,331)	(110)
<b>Cash and cash equivalents, beginning of year</b>	11,235	14,566	14,676
<b>Cash and cash equivalents, end of year</b>	\$ 2,975	\$ 11,235	\$ 14,566

**Supplemental cash flow disclosure:**

Cash paid during the year for:

Interest	\$ 58	\$ 157	\$ 81
Income taxes	\$ 34	\$ 208	\$ 241

See accompanying notes to consolidated financial statements.



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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT**

**NOTE 1 BASIS OF PRESENTATION**

*The Company*

BIOLASE Technology Inc., (the Company ) incorporated in Delaware in 1987, is a medical technology company operating in one business segment that designs, manufactures and markets advanced dental, cosmetic and surgical lasers and related products.

*Basis of Presentation*

The consolidated financial statements include the accounts of BIOLASE Technology, Inc. and its wholly-owned subsidiaries. We have eliminated all material intercompany transactions and balances in the accompanying consolidated financial statements. Certain amounts for prior years have been reclassified to conform to the current year presentation.

*Use of Estimates*

The preparation of these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires us to make estimates and assumptions that affect amounts reported in the consolidated financial statements and the accompanying notes. Significant estimates in these consolidated financial statements include allowances on accounts receivable, inventory and deferred taxes, as well as estimates for accrued warranty expenses, the realizability of goodwill and indefinite-lived intangible assets, effects of stock-based compensation and the provision or benefit for income taxes. Due to the inherent uncertainty involved in making estimates, actual results reported in future periods may differ materially from those estimates.

*Fair Value of Financial Instruments*

Our financial instruments, consisting of cash, accounts receivable, accounts payable and other accrued expenses, approximate fair value because of the short maturity of these items.

*Liquidity and Management s Plans*

The accompanying consolidated financial statements have been prepared on a going concern basis, which contemplates the realization of assets and settlement of obligations in the normal course of business. We have incurred significant net losses and net revenue has declined during the past three years. As of December 31, 2009, we had \$3.0 million in cash and cash equivalents to finance operations and satisfy our obligations. We are substantially dependent on our primary distributor and the continued performance of this distributor to make committed purchases of our products and associated consumables under our distribution agreement, and the receipt of cash in connection with those purchases, is essential to our liquidity. On March 9, 2010 we restructured this agreement (See Note 3) and while it provides for lower monthly guaranteed payments it also provides more upside opportunity to expand beyond those minimums, based largely on our incremental sales performance into dental offices where we have not been working as closely with this distributor. The letter agreement has an initial term of one year, after which the letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate the letter

agreement upon sixty days advance written notice to the other party. There can be no assurance that the distributor will not terminate this agreement prior to the end of the one year term. Our ability to meet our obligations in the ordinary course of business is dependent upon our ability to raise additional financing through public or private equity financing, to establish profitable operations, or to secure other sources of financing to fund operations. Management intends to increase sales, or raise working capital through debt or additional equity financing in 2010. However, there can be no assurance we will be able to increase sales or that such financing can be successfully completed on terms acceptable to the Company or at all. As a result, the opinion we have received from our

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

independent registered public accounting firm contains an explanatory paragraph stating that there is a substantial doubt regarding our ability to continue as a going concern.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

***Cash and Cash Equivalents***

We consider all highly liquid investments with maturities of three months or less when purchased, as cash equivalents. We invest excess cash primarily in money market funds. Cash equivalents are carried at cost, which approximates fair market value.

***Accounts Receivable***

Trade accounts receivable are recorded at the invoiced amount and do not bear interest. The allowance for doubtful accounts is our best estimate of the amount of probable credit losses in our existing accounts receivable. We evaluate our allowance for doubtful accounts based upon our knowledge of customers and their compliance with credit terms. The evaluation process includes a review of customers' accounts on a regular basis which incorporates input from sales, service and finance personnel. The review process evaluates all account balances with amounts outstanding more than 60 days and other specific amounts for which information obtained indicates that the balance may be uncollectible. The allowance for doubtful accounts is adjusted based on such evaluation, with a corresponding provision included in general and administrative expenses. Account balances are charged off against the allowance when we feel it is probable the receivable will not be recovered. We do not have any off-balance-sheet credit exposure related to our customers.

***Inventory***

We value inventory at the lower of cost (determined using the first-in, first-out method) or market. We periodically review our inventory for excess quantities and obsolescence. We evaluate quantities on hand, physical condition, and technical functionality as these characteristics may be impacted by anticipated customer demand for current products and new product introductions. The allowance is adjusted based on such evaluation, with a corresponding provision included in cost of revenue. Abnormal amounts of idle facility expenses, freight, handling costs and wasted material are recognized as current period charges and our allocation of fixed production overhead is based on the normal capacity of our production facilities.

***Property, Plant and Equipment***

We state property, plant and equipment at acquisition cost less accumulated depreciation. Maintenance and repairs are expensed as incurred. Upon sale or disposition of assets, any gain or loss is included in the consolidated statements of operations.

The cost of property, plant and equipment is depreciated using the straight-line method over the following estimated useful lives of the respective assets, except for leasehold improvements, which are depreciated over the lesser of the estimated useful lives of the respective assets or the related lease terms.

Building	30 years
Leasehold improvements	3 to 5 years
Equipment and computers	3 to 5 years
Furniture and fixtures	5 years

Depreciation expense for 2009, 2008 and 2007 was approximately \$1,303,000, \$1,547,000, and \$1,534,000, respectively. In December 2008, we wrote down the building and land at our German facility by \$355,000 to reflect the market value of the asset.

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

***Goodwill and Other Intangible Assets***

Goodwill and other intangible assets with indefinite lives are not subject to amortization but are tested for impairment annually or whenever events or changes in circumstances indicate that the asset might be impaired. We operate in one operating segment and have one operating unit; therefore goodwill is tested for impairment at the consolidated level against the fair value of our Company. The fair value of a reporting unit refers to the amount at which the unit as a whole could be bought or sold in a current transaction between willing parties. Quoted market prices in active markets are the best evidence of fair value and are used as the basis for measurement, if available. We assess potential impairment on an annual basis on June 30th and compare our market capitalization to our carrying amount, including goodwill. A significant decrease in our stock price could indicate a material impairment of goodwill which, after further analysis, could result in a material charge to operations. If goodwill is considered impaired, the impairment loss to be recognized is measured by the amount by which the carrying amount of the goodwill exceeds the implied fair value of that goodwill. Inherent in our fair value determinations are certain judgments and estimates, including projections of future cash flows, the discount rate reflecting the inherent risk in future cash flows, the interpretation of current economic indicators and market valuations, and strategic plans with regards to operations. A change in these underlying assumptions would cause a change in the results of the tests, which could cause the fair value of the reporting unit to be less than its respective carrying amount.

Costs incurred to acquire and successfully defend patents, and costs incurred to acquire trademarks and trade names are capitalized. Costs related to the internal development of technologies that we ultimately patent are expensed as incurred. Intangible assets, except those determined to have an indefinite life, are amortized using the straight-line method, our best estimate of the pattern of economic benefit, over the estimated useful life of the assets and are subject to periodic review for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable.

***Long-Lived Assets***

The carrying values of long-lived assets, including intangible assets subject to amortization, are reviewed when indicators of impairment, such as reductions in demand or significant economic slowdowns in our industry, are present. Reviews are performed to determine whether carrying value of an asset is impaired based on comparisons to undiscounted expected future cash flows. If this comparison indicates that there is impairment, the impaired asset is written down to fair value, which is typically calculated using discounted expected future cash flows. Impairment is based on the excess of the carrying amount over the fair value of those assets.

***Other Comprehensive (Loss) Income***

Other comprehensive (loss) income encompasses the change in equity from transactions and other events and circumstances from non-owner sources and is included as a component of stockholders' equity but is excluded from net (loss) income. Accumulated other comprehensive gain (loss) consists of the effects of foreign currency translation adjustments and unrealized gains or losses on marketable securities classified as available for sale.

***Foreign Currency Translation and Transactions***

Transactions of our German, Spanish, Australian and New Zealand subsidiaries are denominated in their local currencies. The results of operations and cash flows are translated at average exchange rates during the period, and assets and liabilities are translated at end-of-period exchange rates. Translation gains or losses are shown as a component of accumulated other comprehensive gain (loss) in stockholders' equity. Gains and losses resulting from foreign currency transactions, which are denominated in a currency other than the entity's functional currency, are included in the consolidated statements of operations.

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

***Revenue Recognition***

On August 8, 2006, and as amended, we entered into a License and Distribution Agreement with Henry Schein, Inc., or HSIC, a large distributor of healthcare products to office-based practitioners, pursuant to which we granted HSIC the exclusive right to distribute our complete line of dental laser systems, accessories and services in the United States and Canada. As a result of this agreement, effective September 1, 2006, nearly all of our sales in the United States and Canada are made to HSIC. Sales to HSIC are recorded upon shipment from our facility and payment of our invoices is generally due within 60 days or less. Additionally, on February 27, 2009, we entered into an agreement with HSIC in which HSIC became our distributor in certain international countries including Germany, Spain, Australia and New Zealand and will be permitted to distribute our products in those additional markets where we do not have current distribution agreements in place. In other International markets we sell products primarily through independent distributors. We recognize revenue based on four basic criteria that must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred and title and the risks and rewards of ownership have been transferred to our customer or services have been rendered; (3) the price is fixed or determinable; and (4) collectibility is reasonably assured. We record revenue for all sales upon shipment assuming all other revenue recognition criteria are met.

Sales of our laser systems include separate deliverables consisting of the product, disposables used with the laser systems, installation and training. For these sales, we apply the residual value method, which requires us to allocate to the delivered elements the total arrangement consideration less the fair value of the undelivered elements. Revenue attributable to the undelivered elements, primarily training, is included in deferred revenue when the product is shipped and is recognized when the related service is performed or upon expiration of time offered under the agreement. Included in deferred revenue as of December 31, 2009 and 2008 is \$347,000 and \$731,000, respectively of deferred revenue attributable to undelivered elements, which primarily consists of training.

The key judgment related to our revenue recognition relates to the collectibility of payment from the customer. We evaluate the customer's credit worthiness prior to the shipment of the product. Based on our assessment of the credit information available to us, we may determine the credit risk is higher than normally acceptable, and we will either decline the purchase or defer the revenue until payment is reasonably assured.

Although all sales are final, we accept returns of products in certain, limited circumstances and record a provision for sales returns based on historical experience concurrent with the recognition of revenue. The sales returns allowance is recorded as a reduction of accounts receivable and revenue. As of December 31, 2009 and 2008, \$110,000 and \$187,000 was recorded as a reduction of accounts receivable for sales returns.

Extended warranty contracts, which are sold to our non-distributor customers, are recorded as revenue on a straight-line basis over the period of the contracts, which is one year. Included in deferred revenue as of December 31, 2009 and 2008 is \$775,000 and \$761,000 for our extended warranty contracts, respectively. Additionally, as part of the NLT settlement, we assumed NLT extended service contract commitments, of which \$100,000 will not be recognized into revenue until 2011 and forward.

We recognize revenue for royalties under licensing agreements for our patented technology when the product using our technology is sold. We estimate and recognize the amount sold based on historical performance and current knowledge about the business operations of our licensees. Our estimates have been historically consistent with

amounts reported by the licensees. Revenue from royalties was \$99,000, \$198,000 and \$262,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

We may offer sales incentives and promotions on our products. We recognize the cost of sales incentives at the date at which the related revenue is recognized.

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**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)*****Provision for Warranty Expense***

Waterlase systems sold domestically are covered by a warranty against defects in material and workmanship for a period of one year while our diode systems warranty period is up to two years from date of sale by the Distributor to the end-user. Estimated warranty expenses are recorded as an accrued liability, with a corresponding provision to cost of revenue. This estimate is recognized concurrent with the recognition of revenue on the sale to the Distributor. Effective October 1, 2009 Waterlase systems sold internationally are generally covered by a warranty against defects in material and workmanship for a period of sixteen months while our diode systems warranty period is up to twenty eight months from date of sale to the Distributor. Our overall accrual is based on our historical experience and our expectation of future conditions. An increase in warranty claims or in the costs associated with servicing those claims would result in an increase in the accrual and a decrease in gross profit.

Changes in the initial product warranty accrual, and the expenses incurred under our initial and extended warranties, for the years ended December 31 were as follows (in thousands):

Initial warranty accrual, January 1, 2007	\$ 2,398
Warranty expenditures	(3,438)
Provision for estimated warranty cost	3,027
Initial warranty accrual, December 31, 2007	1,987
Warranty expenditures	(4,127)
Provision for estimated warranty cost	4,752
Initial warranty accrual, December 31, 2008	2,612
Warranty expenditures	(3,197)
Provision for estimated warranty cost	2,820
Initial warranty accrual, December 31, 2009	\$ 2,235

***Shipping and Handling Costs and Revenues***

All shipping and handling costs are expensed as incurred and are recorded as a component of cost of revenue. Charges to our customers for shipping and handling are included as a component of revenue.

***Advertising Costs***

All advertising costs are expensed as incurred. Advertising costs incurred for the years ended December 31, 2009, 2008 and 2007, were approximately \$267,000, \$776,000 and \$2.1 million, respectively.

***Engineering and Development***

Engineering and development expenses consist of engineering personnel salaries and benefits, prototype supplies, contract services and consulting fees related to product development.

***Income Taxes***

Differences between accounting for income taxes for financial statement purposes and accounting for tax return purposes are stated as deferred tax assets or deferred tax liabilities in the accompanying consolidated financial statements. The provision for income taxes represents the tax payable for the period and the change during the period in deferred tax assets and liabilities. We establish a valuation allowance when it is more likely than not that the deferred tax assets are not realizable.

Table of Contents**BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

On January 1, 2007, the Company adopted the interpretations issued by FASB which establishes a single model to address accounting for uncertain tax positions. The new interpretations clarify the accounting for income taxes by prescribing a minimum recognition threshold a tax position is required to meet before being recognized in the financial statements and also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition.

***Stock-Based Compensation***

During the years ended December 31, 2009, 2008 and 2007, we recognized compensation cost related to stock options of \$1.4 million, \$1.7 million and \$1.3 million, respectively, based on the grant date fair value. The net impact to earnings for the years ended December 31, 2009, 2008 and 2007 was \$(0.06), \$(0.07) and \$(0.05) per diluted share, respectively. The following table summarizes the income statement classification of compensation expense associated with share-based payments (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Cost of revenue	\$ 137	\$ 167	\$ 134
Sales and marketing	397	473	393
General and administrative	664	932	641
Engineering and development	159	163	97
	\$ 1,357	\$ 1,735	\$ 1,265

As of December 31, 2009 and 2008, we had \$0.9 million and \$2.3 million of total unrecognized compensation cost, net of estimated forfeitures, related to unvested share-based compensation arrangements granted under our existing plans. We expect that cost to be recognized over a weighted average period of 0.9 years.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. Our options have characteristics significantly different from those of traded options, and changes in the subjective input assumptions can materially affect the fair value estimate. This option pricing model requires us to make several assumptions regarding the key variables used in the model to calculate the fair value of its stock options. The risk-free interest rate used by us is based on the U.S. Treasury yield curve in effect for the expected lives of the options at their dates of grant. Beginning July 1, 2005, we have used a dividend yield of zero as we do not intend to pay dividends on our common stock in the foreseeable future. The most critical assumption used in calculating the fair value of stock options is the expected volatility of our common stock. We believe that the historic volatility of our common stock is a reliable indicator of future volatility, and accordingly, have used a stock volatility factor based on the historical volatility of our common stock over a period of time approximating the estimated lives of our stock options. The expected term is estimated by analyzing our historical share option exercise experience over a five year period. Compensation expense is recognized using the straight-line method for all stock-based awards. Compensation expense is recognized only for those options expected

to vest, with forfeitures estimated at the date of grant based on our historical experience and future expectations. Forfeitures are estimated at the time of the grant and revised as necessary in subsequent periods if actual forfeitures differ from those estimates.

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**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

The stock option fair values were estimated using the Black-Scholes option-pricing model with the following assumptions:

	<b>2009</b>	<b>2008</b>	<b>2007</b>
Expected term (years)	4.97	5.10	4.61
Volatility	84%	68%	60%
Annual dividend per share	\$ 0.00	\$ 0.00	\$ 0.00
Risk-free interest rate	2.03%	2.80%	3.92%

***Net Loss Per Share Basic and Diluted***

Basic net loss per share is computed by dividing loss available to common stockholders by the weighted-average number of common shares outstanding for the period. In computing diluted loss per share, the weighted average number of shares outstanding is adjusted to reflect the effect of potentially dilutive securities.

Outstanding stock options and warrants to purchase 3,631,000, 4,581,000 and 4,492,000 shares were not included in the calculation of diluted loss per share amounts for the years ended December 31, 2009, 2008 and 2007, respectively, as their effect would have been anti-dilutive.

***Recent Accounting Pronouncements******Newly Adopted Accounting Standards***

In May 2009, the FASB established general standards for accounting and disclosure of events that occur after the balance sheet date but before the financial statements are issued or are available to be issued. The pronouncement required the disclosure of the date through which an entity has evaluated subsequent events and the basis for that date, whether that date represents the date the financial statements were issued or were available to be issued. On February 24, 2010, the FASB amended this standard whereby SEC filers, like the Company, are required by GAAP to evaluate subsequent events through the date its financial statements are issued, but are no longer required to disclose in the financial statements that the Company has done so or disclose the date through which subsequent events have been evaluated.

In June 2009, the FASB codified then existing accounting standards into one source of authoritative U.S. Generally Accepted Accounting Principles, or GAAP. The FASB also modified the GAAP hierarchy to include only two levels of GAAP; authoritative and non-authoritative. The adoption in 2009 did not have a material impact on our consolidated financial statements.

In August 2009, the FASB provided clarification when measuring liabilities at fair value of a circumstance in which a quoted price in an active market for an identical liability is not available. A reporting entity is required to measure fair value using one or more of the following methods: 1) a valuation technique that uses a) the quoted price of the identical liability when traded as an asset or b) quoted prices for similar liabilities (or similar liabilities when traded as assets) and/or 2) a valuation technique that is consistent with the preexisting fair value guidance. It also clarifies that

when estimating the fair value of a liability, a reporting entity is not required to adjust to include inputs relating to the existence of transfer restrictions on that liability. The adoption did not have a material impact on our consolidated financial statements.

*Accounting Standards not yet Adopted*

In October 2009, the Financial Accounting Standard Board issued an update to existing guidance on accounting for arrangements with multiple deliverables. This update will allow companies to allocate consideration received for qualified separate deliverables using estimated selling price for both delivered and undelivered items when vendor-specific objective evidence or third-party evidence is unavailable. Additional

**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

disclosures discussing the nature of multiple element arrangements, the types of deliverables under the arrangements, the general timing of their delivery, and significant factors and estimates used to determine estimated selling prices will be required. This guidance is effective prospectively for interim and annual periods ending after June 15, 2010. We have not yet determined the impact on our consolidated financial statements.

**NOTE 3 SUPPLEMENTARY BALANCE SHEET INFORMATION**

<b>ACCOUNTS RECEIVABLE (in thousands):</b>	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Components of accounts receivable, net of allowances are as follows:		
Trade	\$ 4,024	\$ 2,914
Royalties	19	41
WCLI co-sponsorship	54	92
License fee		250
Training and service receivable	43	327
Other	89	134
Total receivables	\$ 4,229	\$ 3,758

Following are the changes in the allowance for doubtful accounts and the allowance for sales returns during the years ended 2009, 2008 and 2007 (in thousands):

	<b>Balance at Beginning of Year</b>	<b>Charges (Reversals) to Cost or Expenses</b>	<b>Write-offs and returns</b>	<b>Balance at End of Year</b>
Year Ended December 31, 2007				
Allowance for doubtful accounts	1,357	(264)	(60)	1,033
Allowance for sales returns	248		(61)	187
Year Ended December 31, 2008				
Allowance for doubtful accounts	1,033	(68)	(439)	526
Allowance for sales returns	187			187
Year Ended December 31, 2009				
Allowance for doubtful accounts	526	(62)	(43)	421
Allowance for sales returns	187	(77)		110

<b>INVENTORY, NET (in thousands):</b>	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>

Raw materials	\$ 3,400	\$ 4,981
Work-in-process	1,497	1,472
Finished goods	2,964	5,957
Inventory, net	\$ 7,861	\$ 12,410

Inventory is net of the provision for excess and obsolete inventory of \$1.9 million and \$828,000 at December 31, 2009 and 2008, respectively.



**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

<b>PROPERTY, PLANT AND EQUIPMENT, NET (in thousands):</b>	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Land	\$ 273	\$ 268
Building	418	411
Leasehold improvements	914	919
Equipment and computers	6,049	5,674
Furniture and fixtures	1,019	1,027
Construction in progress	45	53
	8,718	8,352
Accumulated depreciation and amortization	(6,538)	(5,312)
Property, plant and equipment, net	\$ 2,180	\$ 3,040

In connection with our move to a new leased facility in April 2006, leasehold improvements include \$536,000 (net of a refund received from our landlord in June 2007) of tenant improvements that were paid by the landlord in connection with the facility lease during 2006.

<b>ACCRUED LIABILITIES (in thousands):</b>	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
Payroll and benefits	\$ 1,694	\$ 1,844
Warranty	2,235	2,612
Sales tax	68	11
Deferred rent credit	112	112
Accrued professional services	530	771
Accrued insurance premium	517	732
Other	444	2,173
Accrued liabilities	\$ 5,600	\$ 8,255

<b>DEFERRED REVENUE (in thousands):</b>	<b>December 31,</b>	
	<b>2009</b>	<b>2008</b>
License fee from Henry Schein, Inc. unamortized portion	\$	\$ 1,111
Royalty advances from Procter & Gamble	1,875	1,875
Undelivered elements (training, installation and product) and other	347	731
Extended warranty contracts	876	761

Total Deferred Revenue		3,098	4,478
Less Long-Term amounts:			
Extended warranty contracts		(100)	
Royalty advances from Procter & Gamble		(1,875)	(1,875)
Total Deferred Revenue Long Term		(1,975)	(1,875)
Total Deferred Revenue Current		\$ 1,123	\$ 2,603

On August 8, 2006, we entered into a License and Distribution Agreement with Henry Schein, Inc., or HSIC, a large distributor of healthcare products to office-based practitioners, pursuant to which we granted HSIC the exclusive right to distribute our complete line of dental laser systems, accessories and services in the

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

United States and Canada. Concurrent with the execution of the Agreement, HSIC paid an upfront license fee of \$5.0 million. The Agreement had an initial term of three years, following which HSIC had the option to extend the Agreement for an additional three-year period under certain circumstances, including its satisfaction of the minimum purchase requirements during the full three-year period. We amortized the initial \$5.0 million payment to license fees and royalty revenues on a straight-line basis over the three-year term of the agreement. For the years ended December 31, 2009, 2008 and 2007, we recognized \$1.1 million, \$1.7 million and \$1.7 million, respectively, of the license fee.

Under the agreement, HSIC is obligated to meet certain minimum purchase requirements and is entitled to receive incentive payments if certain purchase targets are achieved. If HSIC has not met the minimum purchase requirements at the midpoint of each of the first two three-year periods, we will have the option, upon repayment of a portion of the license fee, to (i) shorten the remaining term of the agreement to one year, (ii) grant distribution rights held by HSIC to other persons (or distribute products itself), (iii) reduce certain discounts on products given to HSIC under the agreement and (iv) cease paying future incentive payments. We maintain the right to grant certain intellectual property rights to third parties, but by doing so may incur the obligation to refund a portion of the upfront license fee to HSIC.

On May 9, 2007, we entered into Addendum 1 to License and Distribution Agreement with HSIC, which addendum is effective as of April 1, 2007 and modifies the License and Distribution Agreement entered into with HSIC on August 8, 2006, to add the terms and conditions under which HSIC has the exclusive right to distribute our new *ezlase* diode dental laser system in the United States and Canada. In the Addendum, separate minimum purchase requirements are established for the *ezlase* system. If HSIC has not met the minimum purchase requirement for any 12-month period ending on March 31, we will have the option, upon 30 days written notice, to (i) convert *ezlase* distribution rights to a non-exclusive basis for a minimum period of one year, after which period we would have the option to withdraw *ezlase* distribution rights, and (ii) reduce the distributor discount on *ezlase* products.

On March 3, 2008, we entered into a second addendum to the HSIC agreement that modifies certain terms of the initial agreement as amended. Pursuant to amendment 2 to the agreement, HSIC is obligated to meet certain minimum purchase requirements and is entitled to receive incentive payments if certain purchase targets are achieved. If HSIC has not met the minimum purchase requirements, we will have the option to (i) shorten the remaining term of the Agreement to one year, (ii) grant distribution rights held by HSIC to other persons (or distribute products ourselves), (iii) reduce certain discounts on products given to HSIC under the Agreement and (iv) cease paying future incentive payments. Additionally, under certain circumstances, if HSIC has not met the minimum purchase requirements, we have the right to purchase back the exclusive distributor rights granted to HSIC under the agreement. We also agreed to actively promote Henry Schein Financial Services as our exclusive leasing and financing partner.

On December 23, 2008, we entered into a letter agreement with HSIC amending the initial term of the License and Distribution Agreement to December 31, 2010.

On February 27, 2009, we entered into a letter agreement with HSIC which amended the License and Distribution Agreement, as amended by the first and second addendums and the brief letter agreement. This letter agreement includes certain minimum purchase requirements during the initial fourteen-month term of the agreement. In connection with the initial purchase by HSIC made under the letter agreement, on March 13, 2009, we entered into a security agreement, or Security Agreement, with HSIC, granting to HSIC a security interest in our inventory, equipment, and other assets. Pursuant to the Security Agreement, the security interest granted shall be released upon

products delivered to HSIC in respect of such initial purchase. HSIC also has the option to extend the term of the letter agreement for two additional one-year terms based on certain minimum purchase requirements. In addition, HSIC has become our distributor in certain international countries including Germany, Spain, Australia and New Zealand and will have first right of refusal in new international markets that we are interested in entering.

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

On September 10, 2009, we entered into an amendment to the License and Distribution Agreement with HSIC, wherein we agreed to provide to HSIC certain customer warranties in respect of our products.

On January 31, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement we agreed to an extension of the time for HSIC to provide notice of its intention to renew the License and Distribution Agreement for an additional one year term, from February 1, 2010 to February 25, 2010, in accordance with the terms and conditions thereof.

On February 16, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement, we agreed to HSIC's request to make certain changes to the applicable product categories required to be purchased by HSIC through March 31, 2010, as set forth in the February 27, 2009 letter agreement. The changes include advance payments in respect of, among other things, purchases of the iLase and the provision of upgrades by us to existing products, should such upgrades be made available in the future. In connection with the advance payments described above, we agreed to grant to HSIC a security interest in our inventory as security for advance payments made under the letter agreement, such security interest to be released by HSIC upon products delivered in respect of such purchase.

On February 24, 2010, we entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the letter agreement, we agreed to an extension of the time for HSIC to provide notice of its intention to renew the License and Distribution Agreement for an additional one year term, from February 25, 2010 to March 3, 2010, in accordance with the terms and conditions thereof.

On March 9, 2010, we entered into another letter agreement with HSIC. This letter agreement calls for guaranteed minimum purchases by HSIC of \$18 million solely in respect of laser equipment in certain territories, plus additional laser equipment purchases on an uncapped basis in certain other territories, plus incremental purchases of consumable products and services in all applicable territories. Pursuant to this letter agreement, all dental sales will continue to be provided exclusively through HSIC in the United Kingdom, Australia, New Zealand, Belgium, Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America. This letter agreement provides incentives for HSIC to focus on its core customer base, and we will have incremental sales and margin incentives to penetrate additional dental offices. This letter agreement has an initial term of one year, after which this letter agreement may be extended for a period of six months by mutual agreement. Either party may terminate this letter agreement upon sixty days advance written notice to the other party.

On June 29, 2006, we received a one-time payment from The Procter & Gamble Company, or P&G, of \$3.0 million for a license to certain of our patents pursuant to a binding letter agreement, subsequently replaced by a definitive agreement effective January 24, 2007, which was recorded as deferred revenue when received. In the event of a material uncured breach of the definitive agreement by us, we could be required to refund certain payments made to us under the agreement, including the \$3.0 million payment. The license fee from P&G was amortized over a two-year period commencing January 25, 2007. In each of the fiscal years ended December 31, 2008 and 2007, \$1.5 million of the license fee was recognized in license fees and royalty revenue. Additionally, P&G is required to make quarterly payments to us in the amount of \$250,000, beginning with a payment for the third quarter of 2006 and continuing until the first product under the agreement is shipped by P&G for large-scale commercial distribution in the United States. Seventy-five percent of each \$250,000 payment is treated as prepaid royalties and will be credited against royalty payments owed to us, and the remainder is credited to revenue and represents services provided by Biolase to P&G.

For the years ended December 31, 2009 and 2008, \$0 and \$250,000 of the payments received were recognized in license fees and royalty revenue.

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Table of Contents**BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

Pursuant to the terms of the P&G Agreement, after two years from the effective date of the P&G Agreement, P&G has the right, upon formal notice to us, to elect to convert its exclusive license of our patents into a non-exclusive license (and effectively allow us to license the patents to other parties), and cease making the \$250,000 quarterly payments as described above. Pursuant to the P&G Agreement, P&G has forty-five (45) days following the end of each quarter to make the quarterly payment, after which a finance charge is to be assessed, equal to the prime rate of interest then in effect plus 100 basis points. We have not received payments in 2009, nor have we received formal applicable notice from P&G required under the P&G Agreement to convert the license into a non-exclusive license. We are in discussions with P&G to restructure the P&G Agreement.

**NOTE 4 INTANGIBLE ASSETS AND GOODWILL**

We conducted our annual impairment analysis of our goodwill and trade names as of June 30, 2009 and concluded there had not been any impairment. Due to current volatility in our stock price caused by adverse equity market conditions and the general economic environment, we closely monitor our stock price and market capitalization and perform such analysis on a quarterly basis. In the quarter ended December 31, 2008, we completed our branding strategy and determined that it was likely that the Diolase trade name use would not be significant in the future. Therefore we wrote off the remaining \$232,000 related to the trade name. Other than this impairment, subsequent to June 30, 2008, we believe that no triggering events occurred that would have a material effect on the value of the remaining assets.

We believe no event has occurred that would trigger an impairment of our intangible assets with finite lives that are subject to amortization in 2009 and 2008. We recorded amortization expense for the years ended December 31, 2009, 2008 and 2007 of \$141,000, \$363,000 and \$361,000, respectively. Estimated intangible asset amortization expense (based on existing intangible assets) for the years ending December 31, 2010, 2011, 2012, 2013 and 2014 is \$130,000, \$130,000, \$130,000, \$62,000 and \$13,000, respectively, and \$7,000 thereafter.

The following table presents details of our intangible assets, related accumulated amortization and goodwill (in thousands):

	As of December 31, 2009				As of December 31, 2008			
	Gross	Accumulated Amortization	Impairment	Net	Gross	Accumulated Amortization	Impairment	Net
Patents (4-10 years)	\$ 1,914	\$ (1,442)	\$	\$ 472	\$ 1,914	\$ (1,301)	\$	\$ 613
Trademarks (6 years)	69	(69)			69	(69)		
Trade names (Indefinite life)	979		(979)		979		(979)	
Other (4 to 6 years)	593	(593)			593	(593)		
Total	\$ 3,555	\$ (2,104)	\$ (979)	\$ 472	\$ 3,555	\$ (1,963)	\$ (979)	\$ 613
Goodwill (Indefinite life)	\$ 2,926			\$ 2,926	\$ 2,926			\$ 2,926

**NOTE 5 BANK LINE OF CREDIT AND DEBT**

On September 28, 2006, we entered into a Loan and Security Agreement ( Loan Agreement ) with Comerica Bank (the Lender ) which replaced the loan agreement previously held with Bank of the West ( BOW ). Under the Loan Agreement, the Lender agreed to extend a revolving loan (the Revolving Line ) to us in the maximum principal amount of \$10.0 million. Advances under the Revolving Line could not exceed

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

the lesser of \$10.0 million or the Borrowing Base (80% of eligible accounts receivable and 35% of eligible inventory), less any amounts outstanding under letters of credit or foreign exchange contract reserves. Notwithstanding the foregoing, advances of up to \$6.0 million could be made without regard to the Borrowing Base. On October 5, 2007, we entered into an Amendment to the Loan Agreement which extended the agreement for an additional year. The entire unpaid principal amount plus any accrued but unpaid interest and all other amounts due under the Loan Agreement would have been due and payable in full on September 28, 2009 (the Maturity Date), but could have been extended by us for an additional year upon Lender approval. Our obligations under the Loan Agreement bore interest on the outstanding daily balance thereof at one of the following rates, to be selected by us: (i) LIBOR plus 2.50%, or (ii) prime rate, as announced by the Lender, plus 0.25%. As security for the payment and performance of our obligations under the Loan Agreement, we granted the Lender a first priority security interest in existing and later-acquired Collateral (as defined in the Loan Agreement, and which excludes intellectual property). Certain subsidiaries of ours had entered into unconditional guaranties, dated as of September 28, 2006, pursuant to which such subsidiaries had guaranteed the payment and performance of our obligations under the Loan Agreement.

The Loan Agreement required compliance with certain financial covenants, including: (i) minimum effective tangible net worth; (ii) maximum leverage ratio; (iii) minimum cash amount at Lender of \$6.0 million; and (iv) minimum liquidity ratio. The Loan Agreement also contained covenants that required Lender's prior written consent for us, among other things, to: (i) transfer any part of its business or property; (ii) make any changes in our location or name, or replace our CEO or CFO; (iii) consummate mergers or acquisitions; (iv) incur liens; or, (v) pay dividends or repurchase stock. The Loan Agreement contained customary events of default, any one of which would result in the right of the Lender to, among other things, accelerate all obligations under the Loan Agreement, set-off obligations under the Loan Agreement against any balances or deposits of ours held by the bank, or sell the Collateral.

As of December 31, 2008, \$5.4 million was outstanding under the Loan Agreement at an interest rate of 3.50% (the Lender's announced prime rate as of that date plus 0.25%). As of December 31, 2007, \$3.6 million was outstanding under the Loan Agreement at an interest rate of 7.5% (the Lender's announced prime rate as of that date plus 0.25%).

On January 30, 2009, we delivered a compliance certificate to Comerica which set forth non-compliance with certain covenants under the Loan Agreement as of December 31, 2008. The loan agreement was terminated on February 5, 2009 and all outstanding balances were repaid in full with cash available on hand, and under the terms of the Loan Agreement and related note, we and certain of our subsidiaries satisfied all of our obligations under the Loan Agreement.

In December 2009, we financed approximately \$573,000 of insurance premiums payable in ten equal monthly installments of approximately \$58,000 each, including a finance charge of 3.24%. In December 2008, we financed approximately \$804,000 of insurance premiums payable in eleven equal monthly installments of approximately \$75,000 each, including a finance charge of 5.65%.

Table of Contents**BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)****NOTE 6 INCOME TAXES**

The following table presents the current and deferred provision (benefit) for income taxes for the years ended December 31 (in thousands):

	<b>2009</b>	<b>2008</b>	<b>2007</b>
<b>Current:</b>			
Federal	\$ (50)	\$ (25)	\$ 39
State		(50)	7
Foreign	57	137	60
	7	62	106
<b>Deferred:</b>			
Federal	41	37	64
State	56	(4)	8
Foreign	15	26	(15)
	112	59	57
	\$ 119	\$ 121	\$ 163

The provision for income taxes differs from the amount that would result from applying the federal statutory rate as follows for the years ended December 31:

	<b>2009</b>	<b>2008</b>	<b>2007</b>
Statutory regular federal income tax rate	(34.0)%	(34.0)%	(34.0)%
Change in valuation allowance	69.8%	16.9%	1.9%
Tax return to prior year provision adjustments	(9.6)%	0.1%	13.2%
Expiration of Federal NOL	47.5%	19.5%	11.4%
Reduction of NOL attributes for ASC 740	0.3%	2.7%	4.2%
State tax benefit (net of federal effect)	(47.5)%	0.4%	(1.1)%
Research credits	(1.8)%	(0.5)%	(1.9)%
Foreign amounts with no tax benefit	(21.7)%	(6.0)%	4.2%
Non-deductible expenses	2.3%	1.4%	2.4%
Stock option-no tax benefit		0.8%	0.7%
Other	(1.1)%		1.3%

Total	4.2%	1.3%	2.3%
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**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

The components of the deferred income tax assets and liabilities as of December 31 (in thousands):

	<b>2009</b>	<b>2008</b>
Capitalized intangible assets for tax purposes	\$ 1,690	\$ 2,153
Reserves not currently deductible	2,684	2,361
Deferred revenue	806	872
Stock options	1,967	1,613
Income tax credits	846	757
Inventory	921	1,072
Property and equipment	396	213
Other comprehensive income	87	63
Unrealized gain on foreign currency	26	7
State taxes		2
Net operating losses	20,859	18,428
Total deferred tax assets	30,282	27,541
Valuation allowance	(30,177)	(27,442)
Net deferred tax assets	105	99
Capitalized intangible assets	(473)	(376)
State Tax	(1)	
Other	(87)	(70)
Total deferred tax liabilities	(561)	(446)
Net deferred tax liabilities	\$ (456)	\$ (347)

Based upon our operating losses during 2009 and 2008, and the available evidence, management determined that it is more likely than not that the deferred tax assets as of December 31, 2009 and 2008 will not be realized, excluding a portion of the foreign deferred tax asset in the amount of \$17,000 and \$29,000, respectively. Consequently, we have a valuation allowance against our net deferred tax assets, excluding a portion of the foreign operations, in the amount of \$30.2 million as of December 31, 2009. In this determination, we considered factors such as our earnings history, future projected earnings and tax planning strategies. If sufficient evidence of our ability to generate sufficient future taxable income tax benefits becomes apparent, we may reduce our valuation allowance, resulting in tax benefits in our statement of operations and in additional paid-in-capital. Management evaluates the potential realization of our deferred tax assets and assesses the need for reducing the valuation allowance periodically.

In addition to the operating loss carryforwards included in the deferred tax asset and liability schedule above are excess tax deductions relating to stock options that have not been realized. When the benefit of the operating losses containing these excess tax deductions are realized, the benefit will not affect earnings, but rather additional paid-in-capital. As of December 31, 2009, the cumulative unrealized excess tax deductions amounted to \$5.1 million.

These amounts have been excluded from the operating loss carryforward. To the extent that such excess tax deductions are realized in the future by virtue of reducing income taxes payable, we would expect to increase additional paid-in-capital by approximately \$2.0 million. We follow the appropriate ordering rules to determine when such operating loss has been realized.

As of December 31, 2009, we had net operating loss carryforwards for federal and state purposes of approximately \$54.5 million and \$25.8 million, respectively, which begin to expire in 2010. The utilization of NOL and credit carryforwards may be limited under the provisions of the Internal Revenue Code Section 382 and similar state provisions. Section 382 of the Internal Revenue Code of 1986 generally imposes an annual

Table of Contents**BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

limitation on the amount of NOL carryforwards that may be used to offset taxable income where a corporation has undergone significant changes in stock ownership. During the year ended December 31, 2006, we completed an analysis to determine the potential applicability of any annual limitations imposed by Section 382. Based on our analysis at December 31, 2006, there was no significant Section 382 limitation. As of December 31, 2009, we had research and development tax credit carryforwards for federal and state purposes of approximately \$578,000 and \$218,000, respectively, which will begin to expire in 2011 for federal purposes and will carryforward indefinitely for state purposes. An updated analysis will be required at the time we begin utilization of any net operating losses to determine if there is a Section 382 limitation.

On January 1, 2007, we adopted the interpretations issued by the FASB regarding uncertain tax positions. As a result, we recognized a \$156,000 increase in accumulated deficit as of January 1, 2007, of which \$32,000 represents estimated interest and penalties.

The following table summarizes the activity related to our unrecognized tax benefits (in thousands):

Balance at January 1, 2007	\$ 124
Additions for tax positions related to the current year	39
Additions for tax positions of prior years	
Reductions for tax positions of prior years	
Settlements	
Balance at December 31, 2007	\$ 163
Additions for tax positions related to the current year	17
Lapse of statute of limitations	(72)
Balance at December 31, 2008	\$ 108
Additions for tax positions related to the current year	
Lapse of statute of limitations	
Balance at December 31, 2009	\$ 108

Included in the balance at December 31, 2009, are \$108,000 of tax positions, which if recognized, would increase our annual effective tax rate. We also accrued potential penalties of \$0 and interest expense of \$6,000 during 2009 related to these unrecognized tax benefits and in total, as of December 31, 2009, we have recorded a liability for potential penalties and interest of \$20,000 and \$25,000, respectively. We do not expect our unrecognized tax benefits to change significantly over the next 12 months.

The federal and state net operating loss and credit carryforwards per the income tax returns filed included uncertain tax positions taken in prior years and are larger than the net operating loss and credits recognized for financial statement purposes.

We file U.S., state and foreign income tax returns in jurisdictions with varying statutes of limitations. The 2005 through 2008 tax years generally remain subject to examination by federal and most state tax authorities. In foreign jurisdictions, the 2003 through 2008 tax years remain subject to examination by their respective tax authorities.

U.S. income taxes or withholding taxes were provided for all the distributed earnings for our foreign subsidiaries as of December 31, 2009. There are no undistributed earnings from our foreign subsidiaries as of December 31, 2009. We have restructured our international operations and intend to reinvest their earnings until such time a decision is made to liquidate the foreign operations.

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**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)****NOTE 7 COMMITMENTS AND CONTINGENCIES*****Leases***

In January 2006, we entered into a five-year lease for our 57,000 square foot corporate headquarters and manufacturing facility located at 4 Cromwell, Irvine, California with initial monthly installments of \$38,692 and annual adjustments over the lease term. On September 24, 2009, we entered into a First Amendment to Lease which extended the facility lease term through April 20, 2015, adjusted basic rent and made modification provisions to the security deposit. We have projected rent expense during the five-year lease and are recognizing rent expense on a straight line basis with the difference between rent expense and rent paid recorded to deferred rent. These amounts are reflected in the commitments as of December 31, 2009 listed below. We also lease certain office equipment and automobiles under operating lease arrangements.

Future minimum rental commitments under operating leases with non-cancelable terms greater than one year for each of the years ending December 31 are as follows (in thousands):

2010	\$ 510
2011	497
2012	487
2013	501
Thereafter	694
Total future minimum lease obligations	\$ 2,689

Rent expense was \$846,000, \$980,000 and \$943,000 for the years ended December 31, 2009, 2008 and 2007, respectively.

***Licensed patent rights***

In February 2005, we purchased a license to use certain patent rights for technology in the field of presbyopia totaling \$2.0 million including related transaction costs, from SurgiLight, Inc. The entire consideration, including transaction costs, has been expensed as in-process research and development. In 2006, additional consideration totaling \$100,000 was expensed as incurred with the remaining \$100,000 to be expensed through 2010. Of this, \$25,000 was recognized as engineering and development expense in each of the fiscal years ended 2009, 2008 and 2007.

***Employee arrangements and other compensation***

In January 2008, Jake St. Philip was appointed our Chief Executive Officer. On March 5, 2009, Mr. St. Philip resigned as our Chief Executive Officer employment and as a director of our Board of Directors. On March 10, 2009, we entered into a Separation and General Release Agreement, or Agreement, with Mr. St. Philip. Pursuant to the Agreement, we agreed to pay Mr. St. Philip a severance payment of \$350,000 of which half was paid on May 9, 2009



and half will be paid in twelve consecutive equal monthly installments commencing on June 1, 2009. In addition, we agreed to pay COBRA premiums on his behalf for twelve months. The Agreement superseded the Employment Agreement we had with Mr. St. Philip dated January 2, 2008.

On April 30, 2008, we appointed David M. Mulder as Chief Financial Officer. Mr. Mulder has an employment agreement that obligates us to pay him severance benefits under certain conditions, including termination without cause and resignation with good reason. In the event Mr. Mulder is terminated by us without cause or he resigns with good reason, the total severance benefits payable would be approximately \$255,000 based on compensation in effect as of April 30, 2008, the date Mr. Mulder was appointed as our current Chief Financial Officer. On March 5, 2009, Mr. Mulder was appointed Chief Executive Officer and appointed to our Board of Directors. On April 3, 2009, we modified the financial terms of Mr. Mulder's

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

employment with us, in connection with his appointment to the position of Chief Executive Officer. Under the new terms of Mr. Mulder's employment, in the event he is terminated by us without cause or he resigns with good reason, we agreed to pay Mr. Mulder his base salary then in effect (or \$250,000, his new base salary as modified on April 3, 2009) payable in twenty-four equal semi-monthly installments. In addition, we agreed to pay Mr. Mulder's COBRA premiums for twelve months.

On July 14, 2009, we appointed Brett L. Scott as Chief Financial Officer. Mr. Scott has an employment agreement that obligates us to pay him severance benefits under certain conditions, including termination without cause and resignation with good reason. In the event Mr. Scott is terminated by us without cause or he resigns with good reason, the total severance benefits payable would be approximately \$102,500 based on the employment agreement in effect as of July 14, 2009. In addition, we agreed to pay Mr. Scott's COBRA premiums for six months.

In addition to Mr. Mulder and Mr. Scott, certain other members of management are entitled to severance benefits payable upon termination following a change in control, which would approximate \$1.6 million. Also, we have agreements with certain employees to pay bonuses based on targeted performance criteria.

***Purchase Commitments***

We obtain components and subassemblies for our products from third party suppliers. We generally purchase components and subassemblies from a limited group of suppliers through purchase orders. We rely on purchase orders, and generally do not have written supply contracts with our key suppliers. However, as of December 31, 2009 we have one long term purchase agreement with a single source supplier in the amount of \$2.2 million for delivery of products through 2010 that is currently being renegotiated. We have evaluated this purchase commitment as of December 31, 2009 and have determined that no loss accrual is required related to this agreement.

***Litigation***

In January 2005, we acquired the intellectual property portfolio of Diodem, LLC, or Diodem, consisting of certain U.S. and international patents of which four were asserted against us, and settled the existing litigation between us and Diodem, for consideration of \$3.0 million in cash, 361,664 shares of common stock (valued at the common stock fair market value on the closing date of the transaction for a total of approximately \$3.5 million) and a five-year warrant exercisable into 81,037 shares of common stock at an exercise price of \$11.06 per share which expired in January 2010.

National Laser Technology, Inc, or NLT, buys used dental lasers, predominately those originally sold by Biolase, and resells them to other dentists. On August 19, 2008, NLT brought an action against us in federal court in the Southern District of Indiana. NLT alleged that we violated Sections 1 and 2 of the Sherman Act, Section 43(a) of the Lanham Act, Section 17200 et seq. of the California Unfair Competition Act and tortiously interfered with NLT's business relationships and prospective business advantage. NLT sought a monetary award of three times the unquantified damages that NLT had allegedly sustained because of our alleged Sherman Act violations, unquantified damages for the rest of the claims, punitive damages and preliminary and permanent injunctive relief. On October 6, 2008, we answered the complaint, asserted several affirmative defenses and filed a counterclaim. We alleged that NLT violated Sections 1114 and 1125(a) of the Lanham Act and Section 17200 et seq. of the California Unfair Competition Act. We sought unquantified damages and a permanent injunction. NLT amended its Complaint on December 23, 2008, to add

a claim for conspiracy to monopolize in violation of Section 2 of the Sherman Act; we answered the Amended Complaint on January 15, 2009. We amended our counterclaims on February 19, 2009 to add a claim for federal copyright infringement and to seek associated damages. On October 21, 2008, NLT filed a motion for a preliminary injunction seeking to enjoin us from certain actions that NLT alleged violated section 1 and 2 of the Sherman Act. On November 24, 2008, we filed a motion for preliminary injunction seeking to enjoin NLT from selling modified Biolase lasers or using Biolase s

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

trademarks. Oral argument was scheduled for March 23, 2009. On March 10, 2009, we filed a motion to strike one of NLT's witnesses from testifying at the preliminary injunction hearing or, in the alternative, continuing the hearing. The preliminary injunction hearing was continued and, on April 16, 2009, the entire lawsuit including all claims and counterclaims was dismissed with prejudice pursuant to a settlement agreement that was entered into on March 25, 2009. As part of the settlement agreement, NLT was paid \$653,000 by our insurance carrier. We received a one-time payment of \$347,000 from our insurance carrier, related to the assumption of NLT's existing service contracts regarding dental lasers manufactured by us. This amount has been recorded as a liability in deferred revenue and will be amortized to service revenue over the term of the service contracts. The settlement agreement contains confidentiality provisions that limit disclosure of the terms of the settlement except as required by law.

On December 19, 2005, we entered into a Vendor Agreement with National Technology Leasing Corporation, or NTLC, in which NTLC was designated as our Preferred Leasing/Financing Provider. In September 2006, we gave notice to NTLC of the termination of the Vendor Agreement, and subsequently entered into a financing and distribution agreement with Henry Schein, Inc. On August 26, 2008, NTLC filed a lawsuit against us, Henry Schein, Inc. and a former employee of NTLC in California Superior Court in Placer County. NTLC alleged that we breached the Vendor Agreement by failing to provide the required notice of termination and asserted a claim for damages without specifying an amount. On October 10, 2008, we answered the complaint and asserted several affirmative defenses. On March 2, 2009, the lawsuit was dismissed with prejudice by NTLC pursuant to a settlement agreement among the parties which resolves all claims in the litigation and provides that we make two payments to NTLC totaling approximately \$20,000 during the first and second quarters of 2009. In the settlement agreement, we denied any wrongdoing. The settlement agreement contains confidentiality provisions that limit disclosure of the terms of the settlement except as required by SEC rule or regulation, under GAAP or pursuant to court order or law. On September 12, 2008, Henry Schein, Inc. sent Biolase a written demand for indemnity for this lawsuit. We denied that we are required to indemnify Schein, and we subsequently entered into a tolling agreement with Schein regarding this indemnification claim on November 18, 2008.

From time to time, we become involved in various claims and lawsuits of a character normally incidental to our business. In our opinion, there are no legal proceedings pending against us or any of our subsidiaries that are reasonably expected to have a material adverse effect on our financial condition or on our results of operations.

**NOTE 8 STOCKHOLDERS EQUITY**

***Preferred Stock***

The Board of Directors, without further stockholder authorization, may issue from time to time up to 1,000,000 shares of our preferred stock. Of the 1,000,000 shares of preferred stock, 500,000 shares are designated as Series B Junior Participating Cumulative Preferred Stock. None of the preferred stock is outstanding.

On December 18, 1998, our Board of Directors adopted a stockholder rights plan under which one preferred stock purchase right was distributed on January 11, 1999 with respect to each share of our common stock outstanding at the close of business on December 31, 1998. The rights provide, among other things, that in the event any person becomes the beneficial owner of 15% or more of our common stock while the rights are outstanding, each right will be exercisable to purchase shares of common stock having a market value equal to two times the then current exercise price of a right (initially \$30.00). The rights also provide that, if on or after the occurrence of such event, we are

merged into any other corporation or 50% or more of our assets or earning power are sold, each right will be exercisable to purchase common stock of the acquiring corporation having a market value equal to two times the then current exercise price of such stock. The rights are subject to redemption at \$0.001 per right at any time prior to the first date upon which they become

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

exercisable to purchase common shares. The rights had an original expiration date of December 31, 2008, unless previously triggered. On December 19, 2008, the rights plan was amended extending the term to December 31, 2018.

***Common Stock and Stock Purchase Warrants***

At December 31, 2009, we had 26,340,000 shares of common stock issued with 24,376,000 shares outstanding. 50,000,000 shares of our common stock are authorized for issuance. We have 1,964,000 shares of common stock in our treasury.

In July 2004, our Board of Directors authorized a 1.25 million share repurchase program. In August 2004, our Board of Directors authorized the repurchase of an additional 750,000 shares of our common stock, increasing the total shares repurchase program to 2.0 million shares of our common stock. During the year ended December 31, 2004, we repurchased approximately 1,964,000 shares at an average price of \$8.35 per share.

In January 2005, we issued 361,664 shares of common stock and a five year warrant exercisable into 81,037 shares of common stock and an additional 45,208 shares of common stock placed in escrow related to the legal settlement described in Note 7 to the Consolidated Financial Statements and which shares were released from escrow in July 2006. There were 81,037 warrants outstanding as of December 31, 2009 and 2008 with a weighted average exercise price per share of \$11.06. Such warrants expired in January 2010.

***Stock Options***

We have three stock-based compensation plans the 1990 Stock Option Plan, the 1993 Stock Option Plan and the 2002 Stock Incentive Plan. The 1990 and 1993 Stock Option Plans have been terminated with respect to granting additional stock options. Under the 2002 Stock Incentive Plan, as of December 31, 2009, a total of 5,950,000 shares have been authorized for issuance, of which 1,402,000 shares have been issued for options which have been exercised, 3,524,000 shares have been reserved for options that are outstanding and 1,024,000 shares are available for the granting of additional options. Total shares authorized reflect the approval of an additional 1.0 million shares at the 2007 annual meeting of our stockholders.

On January 7, 2008, we granted a nonqualified stock option of 450,000 shares to our Chief Executive Officer, at a price equal to the fair market value of our common stock on the grant date. The option was granted as an employment inducement grant outside of the adopted stock incentive plans.

Stock options may be granted as incentive or nonqualified options; however, no incentive stock options have been granted to date. The exercise price of options is at least equal to the market price of the stock as of the date of grant. Options may vest over various periods but typically vest on a quarterly basis over three years. Options expire after ten years or within a specified time from termination of employment, if earlier. We

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issue new shares of common stock upon the exercise of stock options. The following table summarizes option activity:

	<b>Shares</b>	<b>Weighted Average Exercise Price per Share</b>	<b>Weighted Average Remaining Contractual Term (Years)</b>	<b>Aggregate Intrinsic Value(1)</b>
Options outstanding, January 1, 2007	3,858,000	\$ 6.75		
Granted at fair market value	452,000	\$ 6.46		
Granted at above fair market value	747,000	\$ 4.02		
Exercised	(236,000)	\$ 3.33		
Forfeited	(410,000)	\$ 8.16		
Options outstanding, December 31, 2007	4,411,000	\$ 6.30		
Granted at fair market value	1,414,000	\$ 2.29		
Granted at above fair market value	78,000	\$ 3.95		
Exercised	(241,000)	\$ 2.21		
Forfeited	(1,162,000)	\$ 6.68		
Options outstanding, December 31, 2008	4,500,000	\$ 5.12		
Granted at fair market value	863,000	\$ 1.22		
Exercised	(133,000)	\$ 1.30		
Forfeited	(1,680,000)	\$ 4.52		
Options outstanding, December 31, 2009	3,550,000	\$ 4.60	6.82	\$ 761,000
Options exercisable, December 31, 2009	2,573,000	\$ 5.57	6.02	\$ 404,000
Options expired during 2009	1,044,000	\$ 5.53		\$ 1,000

(1) The intrinsic value calculation does not include negative values. This can occur when the fair market value on the reporting date is less than the exercise price of a grant.

The following table summarizes additional information for those options that are outstanding and exercisable as of December 31, 2009:

Range of Exercise Prices	Options Outstanding			Exercisable	
	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Life (Years)	Number of Shares	Weighted Average Exercise Price
\$ .72 \$ 1.99	975,000	\$ 1.13	9.11	384,000	\$ .86
\$ 2.00 \$ 2.99	525,000	\$ 2.58	7.51	325,000	\$ 2.67
\$ 3.00 \$ 3.99	110,000	\$ 3.10	8.24	93,000	\$ 3.08
\$ 4.00 \$ 4.99	628,000	\$ 4.00	6.47	464,000	\$ 4.00
\$ 5.00 \$ 5.99	296,000	\$ 5.67	4.61	295,000	\$ 5.67
\$ 6.00 \$ 9.99	609,000	\$ 7.50	5.30	605,000	\$ 7.51
\$10.00 \$13.99	333,000	\$ 11.21	4.65	333,000	\$ 11.21
\$14.00 \$18.99	74,000	\$ 14.14	3.94	74,000	\$ 14.14
Total	3,550,000	\$ 4.60	6.82	2,573,000	\$ 5.57

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**Table of Contents****BIOLASE TECHNOLOGY, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

Cash proceeds along with fair value disclosures related to grants, exercises and vested options are provided in the following table (in thousands, except per share amounts):

	<b>Twelve Months Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
Proceeds from stock options exercised	\$ 173	\$ 532	\$ 728
Tax benefit related to stock options exercised(1)	N/A	N/A	N/A
Intrinsic value of stock options exercised(2)	\$ 120	\$ 351	\$ 336
Weighted-average fair value of options granted	\$ 0.81	\$ 1.37	\$ 2.45
Total fair value of shares vested during the year	\$ 1,488	\$ 1,730	\$ 1,353

- (1) Excess tax benefits received related to stock option exercises are presented as financing cash inflows. We currently do not receive a tax benefit related to the exercise of stock options due to our net operating losses.
- (2) The intrinsic value of stock options exercised is the amount by which the market price of the stock on the date of exercise exceeded the market price of the stock on the date of grant.

**NOTE 9 SEGMENT INFORMATION**

We currently operate in a single business segment. For the year ended December 31, 2009, sales in the United States accounted for approximately 72% of net revenue and international sales accounted for approximately 28% of net revenue. For the year ended December 31, 2008 and 2007, sales in the United States accounted for approximately 75% and 62% of net revenue and international sales accounted for approximately 25% and 38% of net revenue, respectively.

Net revenue by geographic location based on the location of customers was as follows (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2009</b>	<b>2008</b>	<b>2007</b>
United States	\$ 31,134	\$ 48,526	\$ 41,598
International	12,213	16,099	25,291
	\$ 43,347	\$ 64,625	\$ 66,889

Long-lived assets located outside of the United States at our foreign subsidiaries were \$702,000 and \$747,000 as of December 31, 2009 and 2008, respectively.

**NOTE 10 CONCENTRATIONS**

Revenue from our Waterlase systems, our principal product, comprised 53%, 62% and 68% of our total net revenues for the years ended December 31, 2009, 2008 and 2007, respectively. Revenue from our Diode systems comprised 20%, 19%, and 14% of our total revenue for the same periods.

On August 8, 2006, we entered into a License and Distribution Agreement with Henry Schein, Inc., or HSIC, a large distributor of healthcare products to office-based practitioners, pursuant to which we granted HSIC the exclusive right to distribute our complete line of dental laser systems, accessories and services in the United States and Canada. Approximately 75%, 70% and 62% of our revenue in 2009, 2008 and 2007, respectively, was generated through sales to HSIC worldwide. On February 27, 2009, we entered into an agreement with HSIC in which HSIC has become our distributor in certain international countries including Germany, Spain, Australia and New Zealand and will be permitted to distribute our products in those additional markets where we do not have current distribution agreements in place. On March 9, 2010, we

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**BIOLASE TECHNOLOGY, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENT (Continued)**

entered into a letter agreement amending the License and Distribution Agreement, dated as of August 8, 2006, as amended. Pursuant to the Letter Agreement, all dental sales will continue to be provided exclusively through Henry Schein in the United Kingdom, Australia, New Zealand, Belgium, Luxembourg, Netherlands, Spain, Germany, Italy, Austria, and North America.

We maintain our cash and cash equivalent accounts with established commercial banks. Such cash deposits periodically exceed the Federal Deposit Insurance Corporation insured limit.

Accounts receivable concentrations from HSIC worldwide totaled \$2.5 million or 58% at December 31, 2009. Accounts receivable concentrations have resulted from sales to HSIC worldwide and one international distributor that totaled \$523,000 and \$765,000 or 14% and 20%, respectively, at December 31, 2008.

We currently buy certain key components of our products from single suppliers. Although there are a limited number of manufacturers of these key components, management believes that other suppliers could provide similar key components on comparable terms. A change in suppliers, however, could cause a delay in manufacturing and a possible loss of sales, which would adversely affect consolidated operating results.

**NOTE 11 RESTRUCTURING CHARGE**

Effective November 5, 2007, we terminated the employment of Jeffrey W. Jones, our President and Chief Executive Officer and appointed Federico Pignatelli, one of our current directors and Chairman Emeritus, as Interim President and Chief Executive Officer. On the same date, we terminated the employment of Keith G. Bateman, our Executive Vice President, Global Sales and Marketing and redirected Mr. Bateman's functions and responsibilities to existing internal management resources. In addition to these management changes, we also terminated eleven other employees across all functions, in an effort to better rationalize resources and streamline operations. In connection with the terminations, we recognized restructuring expense in the fourth quarter of 2007 of \$802,000, comprised of severance and severance-related expenses of \$702,000 and legal expense of \$100,000.

**Table of Contents****BIOLASE TECHNOLOGY, INC.****Schedule II Consolidated Valuation and Qualifying Accounts and Reserves  
For the Years Ended December 31, 2009, 2008 and 2007**

	<b>Balance at Beginning of Year</b>	<b>Charges (Reversals) to Cost or Expenses</b>	<b>Deductions</b>	<b>Balance at End of Year</b>
	<b>(In thousands)</b>			
Year Ended December 31, 2009:				
Allowance for doubtful accounts	\$ 526	\$ (62)	\$ (43)	\$ 421
Allowance for sales returns	187	(77)		110
Allowance for tax valuation	27,442	2,735		30,177
Year Ended December 31, 2008:				
Allowance for doubtful accounts	\$ 1,033	\$ (68)	\$ (439)	\$ 526
Allowance for sales returns	187			187
Allowance for tax valuation	25,783	1,659		27,442
Year Ended December 31, 2007:				
Allowance for doubtful accounts	\$ 1,357	\$ (264)	\$ (60)	\$ 1,033
Allowance for sales returns	248		(61)	187
Allowance for tax valuation	26,634	(851)		25,783

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