

RACKABLE SYSTEMS, INC.

FORM 10-K (Annual Report)

Filed 03/19/09 for the Period Ending 01/03/09

Address	46600 LANDING PARKWAY FREMONT, CA 94538
Telephone	408-240-8300
CIK	0001316625
Symbol	RACK
SIC Code	3571 - Electronic Computers
Industry	Computer Hardware
Sector	Technology
Fiscal Year	12/31

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

Form 10-K

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

For the fiscal year ended January 3, 2009

or

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

For the transition period from

to

Commission File Number 0-51333

Rackable Systems, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

32-0047154
(I.R.S. Employer
Identification No.)

4660 Landing Parkway
Fremont, California 94538
(Address of principal executive offices, including zip code)

(510) 933-8300
(Registrant's telephone number, including area code)

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

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, \$0.001 par value per share	The NASDAQ Stock Market, Inc.

Indicate by check mark whether 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 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 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 definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of June 27, 2008, the aggregate market value of the voting stock held by non-affiliates of the registrant, computed by reference to the last sale price of such stock as of such date on the NASDAQ Global Select Market, was approximately \$268,871,953. Excludes an aggregate of 9,762,232 shares of common stock held by officers and directors and by each person known by the registrant to own 5% or more of the outstanding common stock as of June 27, 2008. Exclusion of shares held by any of these persons should not be construed to indicate that such person possesses the power, direct or indirect, to direct or cause the direction of the management or policies of the registrant, or that such person is controlled by or under common control with the registrant.

As of March 6, 2009, there were 30,116,040 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE.

Portions of the registrant's definitive proxy statement for its 2009 Annual Meeting of Stockholders to be filed with the Commission within 120 days after the close of the registrant's fiscal year are incorporated by reference into Part III of this report.

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FOR THE FISCAL YEAR ENDED JANUARY 3, 2009
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SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS AND TRADEMARKS

This Annual Report on Form 10-K contains 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. All statements included or incorporated by reference in this Form 10-K other than statements of historical fact, are forward-looking statements. Investors can identify these and other forward-looking statements by the use of words such as “estimate,” “may,” “will,” “could,” “anticipate,” “expect,” “intend,” “believe,” “continue” or the negative of such terms, or other similar expressions. Forward-looking statements also include the assumptions underlying or relating to such statements.

Our actual results could differ materially from those projected in the forward-looking statements included herein as a result of a number of factors, risks and uncertainties, including, among others, the risk factors set forth in “Item 1A—Risk Factors,” and Item 7—“Management’s Discussion and Analysis of Financial Condition and Results of Operations” in this Form 10-K and elsewhere in this Form 10-K and the risks detailed from time to time in Rackable Systems, Inc.’s future U.S. Securities and Exchange Commission reports. The information included in this Form 10-K is as of the filing date with the Securities and Exchange Commission and future events or circumstances could differ materially from the forward-looking statements included herein. We assume no duty to update any of the forward-looking statements after the date of this report or to conform these statements to actual results except as required by law. Accordingly, we caution readers not to place undue reliance on such statements.

“Rackable Systems,” “Eco-Logical,” “MicroSlice,” “MobiRack,” “OmniStor,” “Rapidscale,” “CloudRack,” “Roamer,” “Concentro,” “ICE Cube” and the Rackable Systems logo are trademarks or registered trademarks of Rackable Systems, Inc. All other trademarks or service marks appearing in this report are trademarks or service marks of their respective owners.

PART I

Item 1. Business

Overview

We are a leading provider of servers, storage and data center solutions targeting large-scale data center deployments. Our products are designed to provide benefits in the areas of density, power efficiency, thermal management, ease of serviceability and remote management. We also offer a high degree of flexibility and control in component selection to match the specific environmental and application requirements of our customers. Our products are designed to reduce total cost of ownership through strategic sourcing of components and reduced deployment and operating expenses. We refer to these advantages as “Eco-Logical”, a term we trademarked to best describe our environmentally-friendly, efficient products “eco” that enable smart, practical solutions for our end users “logical”. We base our products on the x86 platform—which means we leverage open standard components such as processors from Advanced Micro Devices “AMD” and Intel Corporation “Intel” and operating systems such as Linux and Windows in order to leverage the continuing price-performance improvements associated with high-volume computer components.

Our flagship half-depth servers are high-density, rack-mounted systems designed specifically for large-scale data center environments. This line of servers utilizes our patented half-depth, back-to-back chassis design to increase physical server density, reducing floor space requirements. When deployed in our cabinets, we are generally able to offer approximately twice the server or processor density of traditional rack-mount solutions. We provide a range of power and heat management techniques that enable our servers to operate effectively at these density levels. These servers also provide configurable components, front-facing cable connections for enhanced serviceability, and our proprietary Roamer remote management solution. We also offer a line of blade-like rack-mount servers, which can offer even higher density levels for various configurations as well as improve

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thermal and cable management. In addition, we selectively use reseller and original equipment manufacturer “OEM” relationships to provide additional server offerings that our customers may request from time to time.

We sell low-cost, high-capacity storage servers, which leverage many of our core server technologies, to help enterprises cost-effectively meet their increasing data storage requirements. If requested by our customers, we also provide storage products that combine our hardware with software layers provided by third parties under OEM software license arrangements.

In March of 2007, we launched and sold our first modular data center, a self-contained, portable data center featuring extreme server and storage density with highly efficient cooling and easy serviceability. Later that year, we released the newest generation of the product, known as “ICE Cube”. Designed to augment or replace traditional brick-and-mortar data centers of any size and ideal for data centers facing power and space limitations, ICE Cube features system density levels of up to 2,800 of our half-depth, rack-mount servers in a 40’x8’ container, or up to 7.1 Petabytes or one million gigabytes of storage. Leveraging quad-core processors, a 2,800 server density enables up to 22,400 processing cores in this self-contained data center environment. Our introduction marked the first-ever known deployment of a modular data center, and we are seeing strong interest in this model given the growing challenges many large-scale data centers face today around power, cooling and space.

We market our systems primarily through our direct sales force predominantly to companies within the United States. We continue to pursue the creation of an international sales and operational presence, focusing initially on Europe and Japan. We focus our sales and marketing activities on companies that typically purchase hundreds of servers and tens to thousands of terabytes of storage per year. To date, we have sold our products to over 600 customers. We have concentrated our marketing efforts on Internet companies, as well as customers with high-performance computing requirements in vertical markets such as financial services, enterprise software, federal government, oil and gas exploration, biotechnology and pharmaceuticals.

Corporate Information

Rackable Systems, Inc. was incorporated in the state of Delaware in December 2002 in connection with the acquisition of substantially all the assets and liabilities of Rackable Systems’ predecessor company referred to herein as Old Rackable. We have subsidiaries in Canada, Hong Kong, Ireland and the People’s Republic of China (“PRC”). Our principal executive offices are located at 46600 Landing Parkway, Fremont, California and our telephone number is (510) 933-8300.

Additional information about Rackable Systems, Inc. is available on our website at www.rackable.com. We make available free of charge, on or through our website, our Annual Report on Form 10-K, our Quarterly Reports on Form 10-Q, our Current Reports on Form 8-K, and any amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act, as soon as reasonably practicable after electronically filing such reports with, or furnishing such reports to, the Securities and Exchange Commission. Information contained on our website is not incorporated by reference in, or made part of this Annual Report on Form 10-K or our other filings with or reports furnished to the Securities and Exchange Commission.

The terms “Rackable,” “Rackable Systems,” “we,” “us” and “our” as used in this Form 10-K, refer to Rackable Systems, Inc. and its subsidiaries.

Innovation and Intellectual Property Creation

We design, market and support a comprehensive suite of servers, storage and data center solutions that are optimized for large-scale data centers. Our Eco-Logical rack-mount server and storage systems are based on industry-standard components and open-standard operating systems. We offer a broad selection of core system component technologies, which enables us to tailor systems to specific customer requirements. Our innovative

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designs enable our customers to maximize server density while optimizing thermal and power management within the data center. We design our solutions to be installed on a turnkey basis with remote management capabilities that minimize ongoing maintenance expenses. By embracing the benefits of modular, open-standards computing and storage solutions, we enable our customers to expand capacity and improve performance in the data center at a lower total cost of ownership.

Key benefits of our systems include:

Higher density levels. Our systems are designed to alleviate inefficient use of floor and rack space and thermal management issues, problems that are found in major data center installations today. Our primary line of rack-mount servers are approximately half as deep as traditional rack-mount systems, known as our “half-depth” servers and storage systems. By deploying these half-depth servers in our cabinets with our patented “back-to-back” mounting technology, we are able to offer twice the density of traditional rack-mount solutions. Our portable ICE Cube modular data center leverages our half-depth servers and storage to achieve unprecedented density levels of up to 2,800 systems in a 40’x8’ footprint, enabling data centers to save valuable floor space and reduce real estate costs. Our Scale Out Series also offers high density levels by making use of both “back-to-back” and “side-to-side” mounting technologies. Our CloudRack solution increases both CPU and local storage density with up to 44 trays containing two dual socket servers with four 3.5” drives each or MicroSlice configurations with as many as six single socket servers with one 2.5” drive each.

Improved cooling and thermal management. With increased density comes increasing needs for optimized thermal management. We use a range of thermal management technologies to vent server heat output from the cabinet as well as reduce heat inside the server. For example, our patented back-to-back mounting design enables a central air space, or plenum, which draws heat to the center of the cabinet and exhausts it from the top of the cabinet, enabling more efficient cooling and heat evacuation in the data center. We also reduce server-level heat by leveraging our high efficiency AC and DC power supplies, which improve efficiency and thereby reduce heat output. Our ICE Cube modular data center features a closed-loop liquid cooling technology, providing dramatic cooling cost savings over a traditional brick-and-mortar data center HVAC installation.

Improved power management. Our server and storage lines include a range of design innovations to reduce power consumption and enable flexible power management schemes. Because we build servers to order, we are sometimes able to eliminate components that draw power but may not be needed by the customer and to match the selection of a particular power supply to the load drawn by the system, which can improve power conversion efficiency. Our Roamer™ remote management technology offers the ability to stagger the start-up of systems, which reduces the aggregate power draw at system boot time and allows the customer to increase the number of systems attached to a power circuit without overloading the circuit. All server components use DC power, and our DC power options allow cabinet- and data center-level bulk power conversion to enable higher overall power efficiency, as well as improved redundancy schemes, such as the ability to withstand complete loss of an AC circuit. Our DC power solutions are designed to be compatible with data centers that have either AC- or DC-based power distribution infrastructure. We also provide high efficiency AC power supply options to provide the flexibility that customers demand.

Remote monitoring and improved serviceability. Our Roamer lights-out remote management solution or equivalent on-board solutions enable the administration of large-scale server farms from any network-connected off-site location. Roamer enables rapid identification and location of failed servers and is designed to significantly reduce in the need for onsite maintenance technicians. In addition, our products are designed for improved serviceability through a variety of means including front facing input-output (“I/O”) ports on our systems and integrated cable troughs in our racks. The CloudRack solution includes additional benefits such as its coverless tray-based, “toolless” design which dramatically improves serviceability. These design innovations allow us to significantly reduce installation and maintenance time and to decrease the need for multiple technicians to service our systems.

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Flexible platforms that address customer-specific requirements. Our servers and storage systems are based on highly flexible platforms that enable our customers to select the configuration, operating system, processor and other key components based on their requirements. Because our solutions are build-to-order at the component level, they are designed to meet our customers' performance requirements without bundling unnecessary features or components that increase cost. Our systems utilize industry-standard components wherever possible and are compatible with popular operating systems such as Linux and Windows, enabling our customers to achieve optimal performance in a cost-effective manner while minimizing vendor dependence associated with proprietary systems. Our ICE Cube modular data center can be deployed with any combination of Rackable Systems servers and storage, enabling flexibility and customization for the end user.

High capacity, cost-effective storage systems. Our storage servers utilize industry-standard components and lower-cost operating systems. We offer storage servers that allow our customers to run their own storage software or storage management applications. If requested by our customers we also offer storage servers that include pre-installed storage software appliances that we source from third parties. Our storage platforms leverage many of the same design principles and component technologies as our compute server platforms. We also source storage hardware technologies from third parties under both OEM and resale arrangements including the full line of Network Appliance ("Net App"), storage appliances and software.

Customers

We have sold our products to more than 600 customers, primarily to large Internet businesses, and companies in vertical markets such as financial services, enterprise software, federal government, oil and gas exploration and biotechnology. Because we generally sell to customers with large-scale data center deployments that may procure hundreds or thousands of systems at a time, a single customer in any given quarter can account for a large portion of our sales. However, because our revenue has largely been generated in connection with these customers' decisions to deploy large-scale server and storage farms, their capacity requirements can become fulfilled, whether temporarily or otherwise, and as a result they could purchase significantly fewer or no products from us in subsequent periods. For fiscal year ended January 3, 2009, Microsoft and Amazon accounted for approximately 14% and 35% of revenues, respectively. For the fiscal year ended December 29, 2007, Microsoft, Amazon and Yahoo! accounted for approximately 36%, 16% and 12% of our revenues, respectively. For the fiscal year ended December 30, 2006, Microsoft and Yahoo! accounted for approximately 34% and 26% of our revenues, respectively. No other customers accounted for more than 10% of our revenues in 2008, 2007 and 2006.

Products

We focus on three key product families: (1) servers, (2) storage and (3) technology solutions that include modular data center infrastructure solutions. In 2008, we continued to make key advancements in our server designs, including the introduction of new Eco-Logical chassis form factors and configuration updates in conjunction with new technology launches from our partners and suppliers. We saw continued traction in our storage server sales and signed a partnership agreement with NetApp expanding our Enterprise storage capabilities. We expanded our data center infrastructure solutions with the introduction of the new tray-based CloudRack solution and MobiRack mobile data center enclosures. We also continued to refine our back-to-back racks DC power distribution techniques and ICE Cube modular data center technology.

Servers

Our high-density rack-mount servers offer a range of component choices and are typically built-to-order, providing a high degree of flexibility to our customers. We believe we offer a broader range of product configurations than larger global x86 server market competitors. We continually qualify new configurations as new motherboard, processor, dynamic random access memory, ("DRAM"), disk drive and other component technologies become available. Our servers are categorized into five main lines: half-depth rack-mount, standard-depth rack-mount, ICE Cube-optimized rack-mount, Scale Out blade and CloudRack systems.

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Half-Depth Rack-Mount Servers. We introduced our half-depth server line in early 2000. This product line adheres to rack-mount standards but increases density levels and improves serviceability when deployed back-to-back in our proprietary, purpose-built cabinet. These 1U, 2U, 3U and 4U chassis designs are approximately half the depth of traditional rack-mount servers. A “U” is an industry unit of measure equal to approximately 1.75 inches and is used to measure the height of the server chassis. Our half-depth server line is comprised of the base chassis models C1001, C1002 (new in 2008), C2000, C2002, C2004, C2005 (new in 2008), C3001, H2002 and H4002.

Because we adhere to rack-mount height and width standards, our customers can deploy these servers in most industry standard 19-inch cabinets or two-post “telco racks.” However, when deployed in our purpose-built, proprietary cabinet technology, our customers are able to achieve twice the density of traditional rack-mount solutions because we enable back-to-back mounting. Back-to-back mounting of our half-depth systems also enables improved thermal management and serviceability. We hold patents around the use of back-to-back mounting, the resulting air flow patterns and the front-facing I/O placement. We are able to deploy up to 88 servers in a seven foot tall cabinet. These density levels are reduced if a customer elects to include networking or other equipment in the cabinet.

In our cabinet technology, the back-to-back mounting technique creates an enclosed air plenum for heat exhaust, and we evacuate heat through the top of the cabinet, which often enables our customers to direct heat to air return systems in a more organized and efficient fashion. Our chassis and cabinet technology also offers additional benefits versus traditional rack-mount solutions such as elimination of guide rails, the use of front facing I/O and an integrated cable trough to improve cable management and system serviceability, and integrated power-mating brackets to internalize power connections and power cabling.

We currently offer our half-depth servers with single or dual processor motherboards supporting AMD and Intel 64-bit processors, such as the AMD Opteron and Intel Xeon. We also offer configurations featuring four processor motherboards supporting the 32/64-bit AMD Opteron 8000 Series processors. We make server configurations also available with dual-core and quad-core processors from both AMD and Intel, enabling even higher density and processing cores per system. We offer single processor, MicroSlice configurations optimized for their cost effectiveness. We also customize our systems to meet customer-specific requirements.

Standard-Depth Rack-Mount Servers. We currently offer two compute-specific, standard-depth servers of our own design, specifically our C1104 and C2104. We also selectively leverage reseller and OEM relationships to provide additional standard-depth chassis offerings, including our H2104 (new in 2008) and H4108. Standard-depth servers are generally deployed in situations requiring redundant power supplies, installed into existing third-party racks with front-to-back cooling (also known as “hot aisle/cold aisle” deployments), and/or offer a broader range of add-in card or disk drive expansion options than what can be accommodated in our half-depth offerings. We can use both half-depth and standard-depth servers in a single cabinet by modifying our cabinet’s brackets and placing the standard-depth equipment at the bottom of the rack to avoid obstructing the air plenum created by the half-depth equipment.

ICE Cube Optimized Rack-Mount Servers. In June, 2008, we introduced the XE2208 server, our first model specifically designed for the ICE Cube modular data center. While our full half-depth server and storage lines are compatible, every XE2208 contains four independent servers, each with two 3.5” hard drives. This allowed us to double the density level attainable in the ICE Cube from 11,200 to its current 22,400 core limit.

Scale Out Series Blade. Our Scale Out Series server was introduced in August 2004 and utilizes a proprietary server form factor that is approximately half the width, half the depth and twice the height of a traditional 1U server. We mount the servers back-to-back and side-by-side in our proprietary, purpose-built cabinet. This product line does not adhere to the traditional rack-mount standard but still enables the use of open-standard components at the motherboard, processor, DRAM and disk drive level. The Scale Out series also offers advantages in thermal efficiency and serviceability, most notably as a result of the use of taller heat dissipation

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sinks inside the servers and a toolless mounting design. We have applied for patent protection for a number of innovations introduced by the Scale Out Series line. This design offers advantages for select data center environments.

CloudRack. We introduced the CloudRack solution in December 2008. Sold as a rack-level solution, CloudRack cabinets support up to 44 trays—a proprietary, coverless form factor that yields a high degree of flexibility and server density while conforming to industry-standard hot-aisle, cold-aisle data center environments. In addition to improved serviceability due to easy access to server components, the tray form factor enables CloudRack to optimize for use of open-standard components at the motherboard, processor, DRAM and disk drive level. CloudRack’s advanced thermal design eliminates all cooling fans at the server level, instead relying on larger, cabinet-level cooling technology. This increases reliability while reducing power consumption. We have applied for patent protection for a number of innovations introduced by the CloudRack solution. This design offers advantages for many data center environments, especially those focused on cloud computing.

CloudRack trays are available in a variety of single and dual processor configurations utilizing AMD and Intel processors. Our CloudRack solution increases both CPU and local storage density with up to 44 trays containing two dual socket servers with four 3.5” drives each. Trays implementing the MicroSlice architecture are available with up to six single socket servers with one 2.5” drive each and AMD Athlon X2, Phenom X3 or Phenom X4 processors. The MicroSlice architecture combines desktop-class components with server-class featuresets in a unique approach that yields superior price/performance for many cloud computing applications including web serving. Sales of our compute servers accounted for 85%, 92% and 91% of our revenues in fiscal years ending on January 3, 2009, December 29, 2007 and December 30, 2006, respectively.

Storage

Our storage servers leverage the key design advantages of our servers, including back-to-back mounting for higher density, improved thermal efficiency and flexible DC and AC power options. Our storage servers are available in a variety of 3U half-depth and standard-depth configurations, supporting from six to eighteen disk drives. Our OmniStor line of storage arrays includes the SE3016 which makes it easy to add high-density storage expansion to our half-depth server products. Through our partnership with NetApp we also offer their entire line of storage products integrated with our server solutions.

Half-Depth and Standard-Depth Storage Servers. Our half-depth storage servers include the S3006, S3009 and S3012. Standard-depth configurations include the S2108 and S3118. All our storage servers are largely based on Serial Attached SCSI (SAS) infrastructure, compatible with both SAS and Serial ATA II (SATA-II) drive technology. Many of our customers run their own software applications on our storage servers, but we may also qualify specific third-party software applications that we pre-install on our hardware.

OmniStor Storage Arrays. Our OmniStor SE3016 provides a high-density SAS-attached external expansion solution in a 3U half-depth rack-mount chassis with 16 SAS or SATA-II hot swap disk drives. Host servers may daisy chain up to eight SE3016 systems per server controller card, which provides a rack-density up to 432TB. In 2008 we enhanced the solution, adding Roamer remote management capability to the system.

NetApp storage appliances and software. We announced a partnership with NetApp in September 2008 enhancing our storage portfolio with the full NetApp product line. The combination of Rackable Systems servers and NetApp storage enables us to offer integrated solutions of servers and storage, including in ICE Cube modular data centers.

Sales of our storage servers accounted for 15%, 8% and 9% of our revenues in fiscal years ending on January 3, 2009, December 29, 2007 and December 30, 2006, respectively.

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Our Technology Solutions

We continue to maintain a core technology focus on mechanical chassis, cabinet and environmental design to enable higher density, improved thermal management and better serviceability. We also have technologies focused on power management and power distribution, as well as hardware- and firmware-based remote management. In 2007, we brought to market our first self-contained, modular data center, which was designed to augment or replace traditional brick-and-mortar data centers faced with power and space limitations.

Power Management and Distribution. We employ a range of techniques to minimize power consumption and enable more servers to be deployed per circuit or per power distribution unit (“PDU”). We offer a DC-powered option for both our servers and storage systems.

Our power management techniques include:

- *DC power option.* We offer the ability to deploy DC powered solutions in data centers that support either AC- or DC-based power. In an AC environment, we conduct aggregated AC-DC power conversion at the top of our cabinets using removable AC-DC rectifiers. These rectifiers convert input AC power to -48V DC power, which is then distributed to the servers through bus bars internalized in the cabinets. Each server has a -48V DC power supply which is more efficient than the AC power supplies, so less input power is lost as heat. This reduces heat dissipation in the server, which generally increases the life span of components in the server. In a DC environment, we can connect directly to DC current feeds. Conducting AC-DC rectification outside of the server significantly reduces the amount of heat inside the server. Bulk AC-DC conversion at the cabinet- or PDU-level can increase power conversion efficiency versus smaller individual power supplies typically housed in the server chassis. Finally, our DC technology allows us to deploy redundancy schemes such as the ability to withstand the loss of an entire AC circuit.
- *Stagger-start time delay.* Our remote management solution enables the setting of a power on time delay so that systems attached to a single AC circuit can be set to start up in a staggered fashion as opposed to all at once. This reduces aggregate power draw at system boot time and can enable additional servers to be attached to a power circuit.
- *Matching of power supply to system power draw.* Because our servers are built to order, we are able to specify a power supply that is well matched to the actual system power draw, which can improve power supply efficiency.
- *Elimination of unnecessary components.* By building servers to order, we are able to exclude components that draw power but are not needed by a particular customer.

Roamer Remote Management. Our Roamer remote management technology is designed to provide a range of out-of-band and in-band remote management features to our customers. Our out-of-band features work even if the system is not functional, due to the failure of either hardware or the operating system. Out-of-band features include reboot/power cycling, stagger-start up, temperature monitoring, flashing of an LED, scripting messages to an optional LCD and changing basic input/output system (“BIOS”) settings. In-band features are only accessible if both the hardware and the operating system that is running on the hardware are functional. In-band features include full serial console access to the operating system and the ability to write messages from within the operating system to the optional LCD. Roamer enables rapid identification and location of failed servers and results in a significant reduction in the need for onsite maintenance technicians. Because Roamer includes both in-band and out-of-band features, it can offer significant cost advantages versus alternative remote management solutions that may require both managed power strips and keyboard, video and mouse (“KVM”) and Ethernet based server remote management solutions. In addition to our serial- and Ethernet-based Roamer remote management options, we now offer a KVM version. We also enable Intelligent Platform Management Interface (“IPMI”), as supported by particular motherboard platforms, upon customer request.

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We provide application programming interfaces to our remote management solution and offer a “shell mode” that enables our customers to create software scripts and integrate our remote management with their data center automation software platforms. For example, many of our customers utilize readily-available third-party software, such as grid, cluster and utility computing applications, in conjunction with our compute servers. Our remote management solution is based on serial or Ethernet access techniques and is compatible with any industry standard motherboard that supports a serial header and serial BIOS redirection. We are able to support serial console operating system access for Linux, Solaris, FreeBSD and current versions of Windows including Windows Server 2008.

Server Virtualization. We offer a line of fully certified, high performance rack-mount servers based on VMware’s full suite of server virtualization capabilities. First released in 2007, the V Series line leverages our build-to-order half-depth and standard-depth rack-mount servers with the full virtualization capabilities of VMware ESX. Virtualized systems can enable data centers to achieve higher server utilization and improved efficiency rates while managing systems more effectively in mission-critical environments. Our line of virtualized servers is comprised of four configurations from our Workgroup Edition and two configurations specific to our higher capacity Enterprise Edition. The Enterprise Edition features greater memory and storage capacity. All V Series systems have the same key benefits around density, thermal management, power efficiency and serviceability of our half-depth and standard-depth rack-mount servers.

Mobile, Modular Data Center Technology. In March 2007, we launched and sold our first modular data center, a self-contained, mobile data center, featuring extreme server and storage density with highly efficient cooling and easy serviceability. In September 2007, we released the newest generation of the product, known as the ICE Cube. The new release featured a 20% increase in density levels, the introduction of a 20’ container size and a broader range of configuration options.

Designed to augment or replace traditional brick-and-mortar data centers of any size and ideal for data centers facing power and space limitations, ICE Cube features system density levels of up to 2,800 servers in a 40’x8’ container, or up to 7.1 Petabytes of storage. In addition to our full line of half-depth server solutions, compatible products include our XE series (“Extreme Efficiency”) servers, V series virtualized servers, storage servers and OmniStor products. Leveraging quad-core processors, a container deployed with 2,800 of our 1U half-depth servers features 22,400 processing cores in this self-contained data center environment. ICE Cube features a closed-loop liquid cooling design, which can enable up to 80% reduction in cooling costs compared with a traditional brick-and-mortar data center environment. A wide central aisle enables ample room to service and access our half-depth servers and storage systems. Self-contained UPS technology and the use of DC Power improve power efficiency, which can enable further cost savings for the end user.

ICE Cube is deployed in a non-descript, secure, weather tight shipping container. It can be transported via truck, rail or ship to any location where power and networking are provided. We believe this modular data center model is ideal for a range of deployment scenarios, such as disaster recovery, business continuity, military applications and basic data center expansion. This is innovative technology and we are encouraged by the level of interest we are seeing thus far from existing and prospective customers. We believe the need for alternative, less expensive data center solutions will drive adoption of modular data center technology in the future.

Service and Support

We offer a range of service and support packages, primarily associated with installation and deployment, hardware break-fix support and onsite hardware service. We offer several standard levels of support that vary depending on specific services, response times, coverage hours and duration. In addition to our standard offerings, we also customize our warranty and support agreements to meet the specific needs of customers. In addition, we often contract with third parties to provide support services to our customers, particularly in regions where we have limited customer concentrations and it is more cost-effective for us to do so.

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We offer a range of professional services such as onsite cabling assistance and installation of third-party software such as grid, clustering and utility computing applications. We intend to expand the range of professional services that we offer, and we may do so through growing our internal staff or partnering with or acquiring other companies. We also intend to implement new technology tools that allow customers to better serve themselves and to better access remote service personnel that can provide faster response and higher leverage to a large population of customers.

While we desire to expand our support and services revenues, we also employ a number of techniques that mitigate the cost associated with deployment and maintenance. Our compute and storage server products are designed to be shipped in a turnkey fashion, pre-racked and pre-cabled in our cabinets. We use specifically designed shipping crates to reduce the potential for shipping damage. While we also ship smaller installations in boxes, the majority of our shipments are delivered in this turnkey fashion. This enables us to minimize the time and effort associated with onsite deployment work.

On occasion, at the request of a customer that has informed us that one of our products is defective; we will ship a replacement product to that customer prior to the customer returning the defective product to us. This enables the customer to use the replacement product until the defective product is repaired and returned to the customer. Generally, we do not charge for this service, unless the customer fails to return the defective product to us, in which case we will charge the customer for the replacement product.

Sales and Marketing

We focus our sales and marketing activity on large companies that need to purchase hundreds or thousands of servers per year. We have historically targeted accounts primarily within the United States, and we continue to expand our sales and operations model internationally, with a focus on building a broader sales base in Europe and Japan.

We currently sell our products through our direct sales team, which allows us to maintain close client contact and feedback throughout the entire sales process. Our sales process begins with leads generated through targeted marketing programs, which are then logged, qualified and assigned to an account executive. After an initial lead qualification, our sales executives and sales engineers collect information regarding the customer's data center environment and application requirements. We then collaborate with the customer's technical point of contact and our own internal technical resources to agree upon a particular system configuration for the customer. For larger customers, we allow evaluation of one or more hardware configurations to enable the customer to conduct their own benchmarking analyses. While we tailor solutions for most customers, there is substantial commonality in underlying components, so we are able to mitigate the impact on our manufacturing and sourcing operations.

In addition to our current sales team, our long-term plan for growing sales includes expanding distribution channels, such as value added resellers, systems integrators and independent software vendors. We plan to focus our sales efforts in Europe and Japan primarily through the value added reseller community. We are also exploring the potential of working with large scale OEMs both domestically and internationally.

See Note 10 of our "Notes to Consolidated Financial Statements" included under Part II, Item 8. "Financial Statements and Supplementary Data" for additional geographic and segment information, which is incorporated herein by reference, including long-lived assets by geographic area as well as revenue from external customers attributable to segments and geographic areas during the last three years.

Product Development

Our engineering staff is responsible for the design, development, quality, documentation and release of our products. Our product development efforts focus on addressing the needs of customers deploying large

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computing infrastructure. These needs include density, performance, power efficiency and thermal management. We have developed cooperative working relationships with many of the world's most advanced technology companies, such as AMD and Intel, to leverage their research and development capabilities. Additionally, we work closely with our customers to develop product innovations and incorporate these into subsequent product design. This cooperative approach allows us to develop products that meet our customers' needs in a cost-effective manner. We monitor new technology developments, new component availability and the impact of evolving standards through customer and supplier collaboration.

Our total research and development expense was \$14.9 million, \$13.8 million and \$11.9 million for the years ended January 3, 2009, December 29, 2007 and December 30, 2006, respectively.

Manufacturing and Operations

Our operational strategy is to provide our customers with built-to-order, high-quality turnkey solutions. Our operations are based on a hybrid manufacturing model that maintains control of key processes, including procurement, product configuration validation, quality assurance and testing, while leveraging the labor resources of our contract manufacturers. As a result, we are able to maintain the flexibility to scale operations as needed while minimizing capital expenditures and fixed operating costs.

Personnel in our California facilities currently manage procurement, warehousing, operations planning, validation of product configuration, assembly and testing. We have established relationships with key technology vendors and distributors for the supply of our core components and sub-assemblies, including chassis metal fabrication, memory, processors, hard disk drives, printed circuit boards, fans and power supplies. We generally use multiple vendors on commodity products in order to obtain competitive pricing.

As part of our hybrid manufacturing model, we maintain in-house capabilities that we typically use to build prototypes and first articles of new products and evaluation units for customers. In order to reduce our reliance on a single vendor, we established relationships with three contract manufacturers, E-Cycle, Synnex and Realtime Technologies. During 2008, 2007 and 2006, Synnex and E-Cycle manufactured and assembled the majority of our products. Toward the end of 2008, E-Cycle ceased operations and those manufacturing activities were moved to Synnex. We continue to evaluate additional contract manufacturers in order to expand capacity, address new geographic markets and to better serve our existing customers. None of our contract manufacturers are the sole manufacturer of our products. We maintain staff at each of the manufacturing facilities to assist in maintaining adequate control over the manufacturing process and quality control.

We perform final testing, cabling and packaging onsite at our contract manufacturers' facilities, as well as in our facilities. We deliver our cabinet-level products in specially designed shipping crates, and generally ship them fully racked, cabled and tested. This simplifies the delivery and installation process, allowing field delivery staff to roll the cabinets out of the crate and quickly connect them to the datacenter power grid and network environment.

We generally only manufacture products after receipt of orders from our customers. However, customers may generally cancel or reschedule orders without penalty, and delivery schedules requested by customers in these orders frequently vary based upon each customer's particular needs. For these reasons, orders may not constitute a firm backlog and may not be a meaningful indicator of future revenues.

Competition

The market for our products is highly competitive, rapidly evolving and subject to changing technology, customer needs and new product introductions. In the server market, we compete primarily with large and built-to-order vendors of x86 servers based in the United States, such as Dell Inc. ("Dell"), Hewlett-Packard Company ("HP"), International Business Machines Corporation ("IBM"), Sun Microsystems, Inc ("Sun") and

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Super Micro Computer, Inc (“Super Micro”). In the storage market, we compete primarily with EMC Corporation (“EMC”) and Hitachi Data Systems, Inc. (“HDS”). In all of our markets we compete principally on the basis of product features and performance, built-to-order capabilities, total cost of ownership, customer service, configurability and manageability and the ability to deliver “Eco-Logical” solutions. The ability of competitors to leverage multiple business lines, which we do not offer, allows them to target customers with benefits and deeper discounted pricing. Also, as we enter international markets, we anticipate facing additional competition from foreign vendors.

Intellectual Property

We rely on a combination of patent, trademark, copyright and trade secret laws and disclosure restrictions to protect our intellectual property rights. We also enter into confidentiality and proprietary rights agreements with our employees, consultants and other third parties and control access to our proprietary information. As of March 18, 2009, we have sixteen issued patents and a number of patent applications pending in the United States and internationally. Our most important patent relates to back-to-back positioning, front facing I/O and multi-directional air flow cooling, which expires in January 2020. If a claim is asserted that we have infringed the intellectual property of a third party, we may be required to seek licenses to that technology, if available, pay damages and/or redesign our products. In addition, we have a number of non-exclusive licenses from third party hardware and software vendors that allow us to resell certain hardware products and incorporate their computer software products in our product offerings.

Employees

As of January 3, 2009, we had 318 full-time employees, consisting of 77 in manufacturing, 60 in research and development, 51 in service and support, 70 in sales and marketing and 60 in general and administrative functions within the organization. These totals include 12 temporary or contract employees. We consider our relationships with our employees to be good.

Executive Officers of the Registrant

Our executive officers, their ages and positions as of March 6, 2009, are as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Mark J. Barrenechea	44	Chief Executive Officer, President and Director
Anthony Carrozza	54	Senior Vice President of Worldwide Sales and Marketing
Giovanni Coglitore	41	Co-founder, SVP of Engineering and Chief Technology Officer
Maurice Leibenstern	48	General Counsel, SVP and Corporate Secretary
James Wheat	51	Senior Vice President and Chief Financial Officer
Jonathan J. Skoglund	39	Vice President, Corporate Controller and Principal Accounting Officer
David M. Yoffie	49	Senior Vice President of Manufacturing Operations and Service

Mark Barrenechea joined Rackable Systems in November 2006 as a member of our board of directors, and in April 2007 became our President and Chief Executive Officer. Previously, Mr. Barrenechea served as Executive Vice President and CTO for CA, Inc. (“CA”), (formerly Computer Associates International, Inc.), a software company, from 2003 to 2006 and was a member of the executive management team. Prior to CA, Mr. Barrenechea served as Senior Vice President of Applications Development at Oracle Corporation, an enterprise software company, from 1997 to 2003, managing a multi-thousand person global team while serving as a member of the executive management team. From 1994 to 1997, Mr. Barrenechea served as Vice President of Development at Scopus, an applications company. Prior to Scopus, Mr. Barrenechea was with Tesseract, an applications company, where he was responsible for reshaping the company’s line of human capital management software as Vice President of Development. Mr. Barrenechea holds a Bachelor of Science degree in computer science from Saint Michael’s College.

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Anthony Carrozza joined Rackable in March 2008. In his role as Senior Vice President of Sales and Marketing, Mr. Carrozza is responsible for Rackable Systems' product sales for both direct and in-direct customers on a worldwide basis. Mr. Carrozza brings more than twenty five years of worldwide sales experience in the technology sector. Prior to joining Rackable, Mr. Carrozza was with Neterion, Inc., a company that designed and manufactured 10GB Ethernet ASIC's from 2006 to 2008, where he was vice president, sales. Mr. Carrozza formerly served with Quantum Corporation, a manufacturer of storage systems, from 1987 to 2006. When Mr. Carrozza left Quantum, he held the title of senior vice president, worldwide sales and was a member of the executive management team. Mr. Carrozza holds a Bachelor of Arts degree in political science from Iona College.

Giovanni Coglitore co-founded Rackable Systems in 1999 and has held the position of Senior Vice President of Engineering since August 2008 in addition to serving as our Chief Technology Officer since December 2002. Mr. Coglitore was a member of our board of directors from our formation until January 2006. From September 1999 to December 2002, Mr. Coglitore served as Chief Executive Officer. From April 1992 to September 1999, Mr. Coglitore served as co-founder and General Partner of International Computer Systems, a server and storage company. Mr. Coglitore holds a Bachelor of Arts in History from the University of California at Los Angeles.

Maurice Leibenstern joined Rackable Systems in September 2007 as General Counsel and Senior Vice President and Corporate Secretary. Mr. Leibenstern brings more than 20 years of high tech legal experience to Rackable Systems. Most recently, he was at CA, Inc. from 1998 to 2007, as the Chief Legal Counsel for Worldwide Sales, while serving as a Senior Vice President and member of the company's Senior Leadership Team. Prior to CA, Mr. Leibenstern worked at IBM, a computer hardware and software company, from 1992 to 1997. He holds a Bachelor of Arts in History from Brooklyn College of the City University of New York and a J.D. from New York University School of Law.

James Wheat joined Rackable Systems in April 2008 and in May was named as our Senior Vice President and Chief Financial Officer. From 2006 to 2008, Mr. Wheat served as the Vice President and Corporate Controller at Lam Research, a publicly traded company engaged in designing, manufacturing, marketing and servicing semiconductor processing equipment. Mr. Wheat served as Corporate Controller at Asyst Technologies, Inc. from 2004 to 2006, a publicly traded company that develops, manufactures, sells and supports integrated hardware and software automation systems and he also served as acting principal financial officer in 2006. From 2003 to 2004, Mr. Wheat served as Senior Director of Finance for Sybase, Inc., an enterprise software company. Prior to 2003, Mr. Wheat held senior financial management positions at various public and private companies including Tele-Video, Sunterra Corporation, Raychem, Core-Mark International, Spectra Physics and Honeywell. Mr. Wheat holds a B.B.A. in Accounting and Business from the University of Michigan and a Masters of Business Administration from the Wharton School of the University of Pennsylvania and is a Certified Public Accountant in California.

Jonathan J. Skoglund joined Rackable Systems in November 2008 as our Vice President, Corporate Controller and Principal Accounting Officer. Mr. Skoglund brings more than 15 years of high-growth public company experience to Rackable Systems. From 2003 to 2008 Mr. Skoglund served as the Corporate Controller at Intuitive Surgical, a publicly traded company engaged in the design, manufacture and marketing of robotic surgical systems. Mr. Skoglund held the Corporate Controller position with Sipex Corporation a semiconductor company in 2003 and various senior finance positions with Cable and Wireless (formerly Exodus Communications, Inc.) from 1999 to 2003. He holds a Bachelor of Arts degree in Business and Economics from the University of California, Santa Barbara and a Masters of Business Administration from Santa Clara University. Mr. Skoglund is a Certified Public Accountant in California.

David Yoffie joined Rackable in August 2007 as our Senior Vice President of Manufacturing Operations and Service. Mr. Yoffie brings extensive experience in manufacturing, customer service and operations to the Rackable Systems team. Prior to joining Rackable, between 2005 and 2007, Mr. Yoffie was vice president of

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customer operations at SS8 Networks, a telecommunications and law enforcement software and equipment company. From 2002 to 2005 Mr. Yoffie was a principal in Yoffie Advisory Services, a consulting company to the telecommunications industry. Mr. Yoffie was senior vice president of manufacturing at Kestrel Solutions, a fiber telecommunications equipment company, from 2000 to 2002. Mr. Yoffie was vice president of operations at GoDigital Networks, a telecommunications equipment company, from 1999 to 2000. He has held key management roles at a variety of rapid-growth organizations, including Aspect Communications, a customer contact center equipment and software company, and Pittiglio, Rabin, Todd and McGrath, a leading operational strategy, manufacturing and customer experience provider. Mr. Yoffie holds Masters of Science and Bachelors of Science degrees from Stanford University.

Item 1A. Risk Factors

Risks Related To Our Business and Industry

Our quarterly operating results have fluctuated significantly in the past and will continue to fluctuate in the future, which could cause our stock price to decline.

Our quarterly operating results have fluctuated significantly in the past, and we believe that they will continue to fluctuate in the future, due to a number of factors, many of which are beyond our control. For example, our revenues were \$71.4 million for the quarter ended March 31, 2007, increased to \$111.3 million for the quarter ended December 29, 2007 and decreased to \$67.8 million for the quarter ended March 29, 2008 and then increased to \$75.8 million for the quarter ended June 28, 2008 and then decreased to \$65.1 million for the quarter ended September 27, 2008 and then decreased further to \$38.8 million for the quarter ended January 3, 2009. The decrease in revenue in the fourth quarter of fiscal 2008 is attributed to a variety of reasons including a slowing of the global economy. Further, our gross margin decreased dramatically in the second quarter of 2008 as a result of competition for the business of a principal customer. We expect that our revenues, gross margin and earnings per share will fluctuate on a quarterly basis in future periods. If in future periods our operating results do not meet the expectations of investors or analysts who choose to follow our company, our stock price may fall. Factors that may affect our quarterly operating results include the following:

- fluctuations in the buying patterns and sizes of customer orders from one quarter to the next;
- increased competition causing us to sell our products or services at decreasing margins;
- location and timing requirements for the delivery of our products and services;
- addition of new customers or loss of existing customers, especially involving our largest customers;
- gross margin obtained on the sales of products and services, especially to our largest customers;
- write-off of excess and obsolete inventory;
- impairment and shortening of the useful life of components from our suppliers;
- unexpected changes in the price for, and the availability of, components from our suppliers;
- our ability to enhance our products with new and better designs and functionality;
- costs associated with obtaining components to satisfy customer demand;
- productivity and growth of our sales force;
- actions taken by our competitors, such as new product announcements or introductions or changes in pricing;
- revenues and gross margin disparity among our lines of server product and storage product lines;
- market acceptance of our newer products, such as ICE Cube and CloudRack

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- technology regulatory compliance, certification and intellectual property issues associated with our products;
- the payment of unexpected legal fees and potential damages or settlements resulting from protecting or defending our intellectual property or other matters;
- the payment of significant damages or settlements resulting from faulty or malfunctioning products or the provision of services unsatisfactory to our customers;
- the departure and acquisition of key management and other personnel; and
- general economic trends, including changes in information technology spending or geopolitical events such as war or incidents of terrorism.

We are substantially dependent on a concentrated number of customers, specifically Internet companies that purchase in large quantities. If we are unable to maintain or replace our relationships with these customers and/or diversify our customer base, our revenues may fluctuate and our growth may be limited.

Historically, a significant portion of our revenues has come from a limited number of customers. There can be no guarantee that we will be able to sustain our revenue levels from these customers because our revenues have largely been generated in connection with these customers' decisions to deploy large-scale server and storage farms and their capacity requirements may become fulfilled. In 2007, our three largest customers accounted for 64% of our revenues. In 2008, our three largest customers accounted for 56% of our revenue. Moreover, the proportion of our revenues derived from a limited number of customers may be even higher in any future quarter. If we cannot maintain or replace the customers that purchase large amounts of our products, or if they do not purchase products at the levels or at the times that we anticipate, our ability to maintain or grow our revenues will be adversely affected. To maintain our relationships with our largest customers, and to continue to win their business, we may from time to time sell products to them at less than optimal gross margins. For example, in the second quarter of 2008 our gross margin was negatively impacted by an order shipped in the quarter to a significant customer priced at unfavorable gross margins with the intent of preserving an existing and significant customer relationship. In addition, customer concentration may expose us to credit risk, as a large portion of our accounts receivable may be from a small number of customers. For example, as of January 3, 2009, 77% of our accounts receivable were owed to us from our three largest customers.

In 2007 and 2008, a substantial majority of our revenues were generated from companies that compete in the Internet market. A significant part of our growth has been due to the fact that these companies are doing well and, in many cases, expanding and, as a result, have been purchasing large quantities of products from us. If economic factors change for these Internet companies, as they have before, our ability to maintain or grow our revenues will be adversely affected. The recent economic downturn, volatile business environment and continued unpredictable and unstable market conditions adversely impact the internet sector and our key customers, negatively affecting our business and outlook.

We face intense competition from the leading enterprise computing companies in the world as well as from emerging companies. If we are unable to compete effectively, we might not be able to achieve sufficient market penetration, revenue growth or profitability.

The markets for compute server products and storage products are highly competitive. In addition to intensely competitive smaller companies, we face challenges from some of the most established companies in the computer industry, such as Dell, Inc, Hewlett-Packard Company ("H-P"), International Business Machines Corporation and Sun Microsystems, Inc in the computer server market. In the storage market, we compete primarily with EMC Corporation, H-P, Hitachi Data Systems, Inc, Super Micro Computer, Inc and Network Appliance, Inc. These larger competitors have at least the following advantages over us:

- substantially greater market presence and greater name recognition;

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- substantially greater financial, technical, research and development, sales and marketing, manufacturing, distribution and other resources;
- longer operating histories;
- a broader offering of products and services;
- more established relationships with customers, suppliers and other technology companies; and
- the ability to acquire technologies or consolidate with other companies in the industry to compete more effectively.

Because these competitors may have greater financial strength than we do and are able to offer a more diversified bundle of products and services, they may have the ability to severely undercut the pricing of our products or provide additional products or servicing at little or no cost, which would make us less competitive or force us to reduce our average selling prices, negatively impacting our margins. In the past, we have had transactions where one or more competitors undercut our prices causing us to reduce our price, which negatively impacted our gross margin on that transaction and our overall gross margin. In addition, we have on occasion lost sales opportunities due to a competitor undercutting the pricing of our products or maintaining superior brand recognition. These competitors may be able to develop products that are superior to the commercially available components that we incorporate into our products, or may be able to offer products that provide significant price advantages over those we offer. For instance, a competitor could use its resources to develop proprietary motherboards with specifications and performance that are superior in comparison with the platforms that are currently available to the marketplace, which could give that competitor a distinct technological advantage. In addition, if our competitors' products become more accepted than our products, our competitive position will be impaired.

As the enterprise computing industry evolves, we expect to encounter additional competitors, including companies in adjacent technology businesses such as storage and networking infrastructure and management, companies providing technology that is complementary to ours in functionality, such as datacenter management software, contract manufacturers, and other emerging companies that may announce server product offerings. Moreover, our current and potential competitors, including companies with whom we currently have strategic alliances, may establish cooperative relationships among themselves or with other third parties. If this occurs, new competitors or alliances may emerge that could negatively impact our competitive position.

Our products incorporate open standard, commoditized components and materials that we obtain in spot markets, and, as a result, our cost structure and our ability to respond in a timely manner to customer demand are sensitive to volatility of the market prices for these components and materials.

A significant portion of our cost of goods sold is directly related to the pricing of commoditized materials and components utilized in the manufacture of our products, such as memory, hard drives, central processing units ("CPUs"), or power supplies. As part of our procurement model, we generally do not enter into long-term supply contracts for these materials and components, but instead, purchase these materials and components in a competitive bid purchase order environment with suppliers or on the open market at spot prices. As a result, our cost structure is affected by the availability and price volatility in the marketplace for these components and materials, especially for Dynamic Random Access Memory ("DRAM"), and new versions of hard drives and CPUs that are introduced by our suppliers. In the fourth quarter of 2006, we experienced volatility in DRAM prices that caused us to procure DRAM at prices higher than anticipated, which negatively impacted our overall gross margin for the quarter. In 2007 and 2008, prices of DRAM decreased. This volatility makes it difficult to predict expense levels and operating results and may cause them to fluctuate significantly. In addition, if we are successful in growing our business, we may not be able to continue to procure components solely on the spot market, which would require us to enter into contracts with component suppliers to obtain these components. This could increase our costs and decrease our gross margins. Also, if we try to take advantage of favorable pricing of a particular component by purchasing a large quantity, there is the risk that a shift in our customers' preferred components may render any stockpiled components of little value to us. For example, we recorded a

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\$16.6 million expense related to the write down for excess and obsolete inventory during fiscal year 2007, contributed in part by customer driven technology platform shift from AMD to Intel, affecting demand for memory, motherboards, CPUs and chassis that we had previously purchased.

In addition, because our procurement model involves our ability to maintain a low inventory and to acquire materials and components as needed, and because we do not enter into long-term supply contracts for these materials and components, our ability to effectively and efficiently respond to customer orders may be constrained by the then-current availability or the terms and pricing of these materials and components. Our industry has experienced component shortages and delivery delays in the past, and in the future we may experience shortages or delays of critical components as a result of strong demand in the industry or other factors. As one example, DRAM can represent a significant portion of our cost of revenues, and both the price and availability of various kinds of DRAM are subject to substantial volatility in the spot market. In the fourth quarter of 2006 we encountered situations where we were forced to pay higher prices than we anticipated for DRAM and we have encountered situations where DRAM was in tight supply and we were unable to deliver customer orders on their anticipated delivery dates. As another example, the industry in the past has experienced a shortage of selected Intel chips, which caused some of our motherboard suppliers to reduce or suspend shipments of motherboards using these chips. This impacted our ability to ship selected configurations to some of our customers, and in some cases accelerated a transition to other platforms. If shortages or delays arise, the prices of these components may increase or the components may not be available at all. We may not be able to secure enough components at reasonable prices or of acceptable quality to build new products to meet customer demand, which could adversely affect our business and financial results. In addition, if any of our suppliers, such as Intel or AMD, were to increase the costs to Rackable for components we use, we would either pass these price increases on to our customers, which could cause us to lose business from these customers, or we would need to absorb these price increases, which would cause our margins to decrease, either of which could adversely affect our business and financial results.

We intend to expand our operations and increase our expenditures in an effort to grow our business. If we are not able to manage this growth and expansion, or if our business does not grow as we expect, our operating results may suffer.

We intend to continue to grow our business by entering new markets, acquisitions, developing new product and service offerings and pursuing new customers. In connection with this growth, we expect that our annual operating expenses may increase over the next several years to the extent we expand our sales and marketing, research and development, manufacturing and production infrastructure, and our customer service and support efforts. Our failure to timely or efficiently expand operational and financial systems and to implement or maintain effective internal controls and procedures could result in additional operating inefficiencies that could increase our costs and expenses more than we had planned and might cause us to lose the ability to take advantage of market opportunities, enhance existing products, develop new products, satisfy customer requirements, respond to competitive pressures or otherwise execute our business plan. Additionally, if we do increase our operating expenses in anticipation of the growth of our business and this growth does not meet our expectations, our financial results could be negatively impacted.

If we acquire or invest in other companies, assets or technologies and we are not able to integrate them with our business, or we do not realize the anticipated financial and strategic goals for any of these existing or future transactions, our financial performance may be impaired.

If appropriate opportunities present themselves, as they have in the past, we may consider acquiring or making investments in companies, assets or technologies that we believe are strategic. We only have limited experience in doing so, and for any such company, asset or technology which we successfully acquire or invest in, we will be exposed to a number of risks, including:

- we may find that the acquired company, asset or technology does not further our business strategy, that we overpaid for the company, asset or technology or that the economic conditions underlying our acquisition decision have changed;

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- we may have difficulty integrating the assets, technologies, operations or personnel of an acquired company, or retaining the key personnel of the acquired company;
- our ongoing business and management's attention may be disrupted or diverted by transition or integration issues and the complexity of managing geographically or culturally diverse enterprises;
- we may encounter difficulty entering and competing in new product or geographic markets or increased competition, including price competition or intellectual property litigation; and
- we may experience significant problems or liabilities associated with product quality, technology and legal contingencies relating to the acquired business or technology, such as intellectual property or employment matters.

For example, in connection with our acquisition of Terrascale Technologies, Inc., we expended a great deal of effort and resources, but have been unable to generate revenue, increase gross profit or contribute positive cash flow into our business, sufficient to realize our investment, causing us to exit this product line. This resulted in an impairment charge of \$17.5 million for the year ended January 3, 2009. We have shown the results of this product line as a discontinued operation in our consolidated financial statements.

If we were to proceed with one or more significant acquisitions or investments in which the consideration included cash, we could be required to use a substantial portion of our available cash. To the extent we issue shares of capital stock or other rights to purchase capital stock, including options and warrants, existing stockholders might be diluted and earnings per share might decrease. In addition, acquisitions and investments may result in the incurrence of debt, large one-time write-offs, such as of acquired in-process research and development costs, and restructuring charges.

We intend to further expand our sales into additional international markets, which may be more difficult than we expect, and if we are unable to do so successfully, our revenues and operating results may be adversely impacted.

One component of our growth strategy is to continue to expand into international markets. However, we have limited experience in selling our systems overseas, and we may encounter unexpected difficulties in doing so. To date, our sales to these geographies have been primarily originated from our U.S. based multi-national customers. If we are not able to successfully expand into international markets, our ability to grow our business will be adversely affected. Some of the factors that may impact our ability to initiate and maintain sales in foreign markets include:

- our ability to establish international manufacturing, support and service, which could be costly and time consuming;
- our ability to establish channel relationships with resellers in international markets;
- adoption of new laws or changes to existing international laws;
- our ability to service international installations;
- compliance with local laws, regulations and requirements for doing business in such jurisdictions;
- tax liabilities and currency fluctuations; and
- political and economic instability.

Our business depends on decisions by potential customers to adopt our modular, open standard-based products and to replace their legacy server systems with our products, and they may be reluctant to do so, which would limit our growth.

Our business depends on companies moving away from large proprietary RISC/UNIX servers to standardized servers that utilize commercially available x86 processor architectures and can deploy a variety of operating systems, including Linux and Microsoft Windows. Excluding sales to Microsoft Corporation, we

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believe that a majority of the server systems that we sold in 2008, 2007 and 2006 ran on the Linux operating system and are subject to the GNU General Public License. While litigation involving the SCO Group's claim against IBM that Linux is an unauthorized derivative work of the UNIX[®] operating system has been stayed due to SCO's bankruptcy filing, if it ultimately results in a ruling that users of Linux must pay royalties to SCO or others, that could impede broader Linux adoption and could materially harm our ability to sell our products based on the Linux operating system. In addition, Microsoft has publicly claimed that Linux infringes 235 or more of Microsoft's patents and has entered into transactions with Novell inc. and other Linux distributors under which the parties reportedly agree, among other things, not to sue each other's customers for potential patent infringements related to Linux. It is possible that a party (including Microsoft) could prove a claim for proprietary rights in the Linux operating system or other programs developed and distributed under the GNU General Public License. In addition, the GNU General Public License is a subject of litigation, and it is possible that a court could hold these licenses to be unenforceable in that litigation. Any ruling by a court that the Linux operating system or significant portions of it may not be copied, modified or distributed subject only to the minimal restrictions contained in these licenses, that users or distributors of Linux must pay royalties to Microsoft or others or that these licenses are not enforceable could also impede broader Linux adoption and materially harm our ability to sell our products based on the Linux operating system. Further, because potential customers have often invested significant capital and other resources in existing systems, many of which run mission-critical applications, customers may be hesitant to make dramatic changes to their datacenter systems. The failure of our customers and potential customers to replace their legacy server systems and adopt open standard-based modular technologies could have a material adverse impact on our ability to maintain or generate additional revenues.

We rely primarily on our direct sales force to generate revenues, and may be unable to hire additional qualified sales personnel in a timely manner or retain our existing sales representatives.

To date, we have relied primarily on our direct sales force to sell our products in the United States. Because we are looking to expand our customer base and grow our sales to existing customers, we will need to continue to hire qualified sales personnel if we are to achieve our anticipated revenue growth. The competition for qualified sales personnel in our industry, and particularly in Silicon Valley, is very intense. If we are unable to hire, train, deploy and manage qualified sales personnel in a timely manner, our ability to grow our business will be impaired. For example, in the past it has taken us up to six months to hire a qualified sales executive and it may take a newly-hired sales executive up to nine months after hiring to become productive, resulting in aggregate lag time between the commencements of the search to productivity, in excess of one year. In addition, if we are unable to retain our existing sales personnel, or if our sales personnel are ineffective, our ability to maintain or grow our current level of revenues will be adversely affected. In addition, a large percentage of our revenue is generated from a small number of customers. If we are unable to retain the sales personnel who are responsible for those customer accounts, our business could be negatively impacted.

We are continuing to develop and execute upon a channel strategy to generate additional sales and revenues, and the failure to successfully expand channel sales might affect our ability to sustain revenue growth and may harm our business and operations.

An increasing portion of our sales strategy is to develop our sales efforts through the use of resellers and other third parties to sell our systems. We may not be successful in building or expanding relationships with these third parties. Further, even if we do develop and expand these relationships, they may conflict with our direct sales efforts in some territories. Ineffective marketing of our products by our resellers or disruptions in our distribution channels could lead to decreased sales or slower than expected growth in revenues and might harm our business and operations.

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Our sales cycle requires us to expend a significant amount of resources, and could have an adverse effect on the amount, timing and predictability of future revenues.

The sales cycle of our products, beginning from our first customer contact to closing of the sale, often ranges from three to six months. We may expend significant resources during the sales cycle and ultimately fail to close the sale. The success of our product sales process is subject to factors, over which we have little or no control, including:

- the timing of our customers' budget cycles and approval processes;
- our customers' existing use of, or willingness to adopt, open standard server products, or to replace their existing servers or expand their processing capacity with our products;
- the announcement or introduction of competing products; and
- established relationships between our competitors and our potential customers.

We expend substantial time, effort and money educating our current and prospective customers as to the value of our products. Even if we are successful in persuading lower-level decision makers within our customers' organizations of the benefits of our products, senior management might nonetheless elect not to buy our products after months of sales efforts by our employees or resellers. If we were unsuccessful in closing sales after expending significant resources, our revenues and operating expenses will be adversely affected.

If we are unable to protect our intellectual property adequately, we may not be able to compete effectively.

Our intellectual property is critical to our success and our ability to compete. If we fail to protect our intellectual property rights adequately, our competitors might gain access to our technology. Unauthorized parties may attempt to copy or otherwise obtain and use our proprietary technology despite our efforts to protect our intellectual property. For example, in September 2005, we filed a patent infringement action against one defendant in response to which the defendant counterclaimed that two of our patents are invalid and not infringed. In addition, we previously initiated two patent infringement actions against six defendants, seeking to enforce our intellectual property rights. We obtained consent judgments and permanent injunctions against five of the defendants, and reached a confidential settlement with the sixth.

However, litigation is inherently uncertain, and there is no assurance that any litigation we initiate will have a successful outcome. Monitoring unauthorized use of our technology is difficult, and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where we have two patent applications pending but do not have any issued patents, and the laws may not protect our proprietary rights as fully as the laws of the United States. Any claims or litigation that we have initiated or that we may initiate in the future to protect our proprietary technology could be time consuming and expensive and divert the attention of our technical and management resources whether or not the claims or litigation are decided in our favor. We currently have a small number of patents issued in the United States and a number of utility patent applications pending. These patents may be limited in value in asserting our intellectual property rights against more established companies in the computer technology sector that have sizeable patent portfolios and greater capital resources. In addition, patents may not be issued from these patent applications, and even if patents are issued, they may not benefit us or give us adequate protection from competing products. For example, issued patents might be circumvented or challenged, and could be declared invalid or unenforceable. Moreover, if other companies develop unpatented proprietary technology similar to ours or competing technologies, our competitive position will be weakened.

If we are found to have violated the intellectual property rights of others, we could be required to indemnify our customers, resellers or suppliers, redesign our products, pay significant royalties and enter into license agreements with third parties.

Our industry is characterized by a large number of patents, copyrights, trade secrets and trademarks and by frequent litigation based on allegations of infringement or other violation of intellectual property rights. As we

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continue our business, expand our product lines and our product functionality, and expand into new jurisdictions around the world, third parties may assert that our technology or products violate their intellectual property rights. Any claim, regardless of its merits, could be expensive and time consuming to defend against. It would also divert the attention of our technical and management resources. Successful intellectual property claims against us could result in significant financial liability, impair our ability to compete effectively, or prevent us from operating our business or portions of our business. In addition, resolution of claims may require us to redesign our technology, to obtain licenses to use intellectual property belonging to third parties, which we may not be able to obtain on reasonable terms, to cease using the technology covered by those rights, and to indemnify our customers, resellers or suppliers. Any of these events could negatively affect our competitive position and materially harm our business, financial condition and results of operations.

If we lose the services of one or more members of our current executive management team or other key employees, or if we are unable to attract additional executives or key employees, we may not be able to execute on our business strategy.

Our future success depends in large part upon the continued service and enhancement of our executive management team and other key employees, including, for example, Mark Barrenechea, who joined our company as our chief executive officer, at the end of April 2007. Changes in management can be disruptive within a company, which could negatively affect our operations, our culture and our strategic direction. All of our employees are “at will” and their employment can be terminated by us or them at any time. The failure of our management team to seamlessly manage employee transitions, or the loss of services of any of these executives or of one or more other members of our executive management or sales team or other key employees could seriously harm our business. Competition for qualified executives is intense, particularly in Silicon Valley, and if we are unable to continue expanding our management team, or successfully integrate new additions to our management team in a manner that enables us to scale our business and operations effectively, our ability to operate effectively and efficiently could be limited or negatively impacted. In addition, in January 2009 we reduced our workforce by approximately 15% as part of our efforts to reduce costs and improve the efficiency and profitability of our business. This reductions in our workforce may impair our ability to recruit and retain qualified employees. If we need to rehire terminated individuals or hire individuals with similar skills, we may be unable to do so.

If we fail to maintain or expand our relationships with our suppliers, we may not have adequate access to new or key technology necessary for our products, and, as a result, our ability to deliver leading-edge products may be impaired.

In addition to the technologies we develop, our suppliers develop product innovations at our direction that are requested by our customers. In many cases, we retain the ownership of the intellectual property developed by these suppliers. In addition, we rely heavily on our component suppliers, such as Intel and AMD, to provide us with leading-edge components. If we are not able to maintain or expand our relationships with our suppliers or continue to leverage their research and development capabilities to develop new technologies desired by our customers, our ability to deliver leading-edge products may be impaired and we could be required to incur additional research and development expenses.

We depend on our compute server products for the majority of our revenues. If market acceptance of our compute server products does not continue, we may not be able to achieve growth.

Sales of our compute server products accounted for 85% of our revenues during fiscal 2008, 92% of revenues in fiscal 2007 and 91% in fiscal 2006. If our compute server products fail to maintain market acceptance, or if we are unsuccessful in developing improved products or products to replace or supplement our current server product lines, we may not be able to achieve expected financial results. Further, because our customers are engaged in large-scale data center implementations, if customers believe that new generations of our products will become available in the near future, this perception may cause customers to delay or cancel existing orders, which would affect our ability to generate revenues in accordance with forecasted levels.

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We rely on contract manufacturers to manufacture our products, and our failure to successfully manage our relationships with these contract manufacturers could impair our ability to deliver our systems in a manner consistent with required volumes or delivery schedules, which could damage our relationships with our customers and decrease our revenues.

We rely on a very small number of contract manufacturers to assemble and test a majority of our products. None of these third-party contract manufacturers are obligated to perform services or supply products to us for any specific period, or in any specific quantities, except as may be provided in a particular purchase order. Moreover, none of our contract manufacturers has provided contractual assurances to us that adequate capacity will be available to us to meet future demand for our products. If our contract manufacturers are not able to maintain our high standards of quality, are not able to increase capacity as needed, or are forced to shut down a factory, our ability to deliver quality products to our customers on a timely basis may decline, which would damage our relationships with customers, decrease our revenues and negatively impact our growth.

Our customers require a high degree of reliability in our products and services, and if we cannot meet their expectations our relationships with our customers could be damaged and demand for our products and services will decline.

Because our customers rely on our products and services for their enterprise or mission critical applications, any failure to provide high quality products and reliable services, whether caused by our own failure or failures by our suppliers or contract manufacturers, could damage our reputation and reduce demand for our products and services. Some of our products, such as our ICE cube line, are particularly complex and carry a higher per unit price. A failure of products in our ICE cube line would therefore potentially be more costly to us, with the risk and potential cost to us increasing proportionately with the number of products we sell from this line. In addition, delays in our ability to fill product orders as a result of quality control issues, such as an increase in failure rates or the rate of product returns, may negatively impact our relationships with our customers and harm our revenues and growth.

Unstable market and economic conditions may have serious adverse consequences on our business.

Our general business strategy may be adversely affected by the recent economic downturn and volatile business environment and continued unpredictable and unstable market conditions. If the current equity and credit markets deteriorate further, or do not improve, it may make any necessary debt or equity financing more difficult, more costly, and more dilutive. We believe we are well positioned with significant capital resources to meet our current working capital and capital expenditure requirements. However, a prolonged or profound economic downturn may result in adverse changes to demand for our products, or our customers' ability to pay for our products, which would harm our operating results. There is also a risk that one or more of our current service providers, manufacturers and other partners may not survive these difficult economic times, which would directly affect our ability to attain our operating goals on schedule and on budget. Failure to secure any necessary financing in a timely manner and on favorable terms could have a material adverse effect on our financial performance and stock price and could require us to change our business plans.

Uncertainty in the credit market may negatively affect the value of auction rate securities owned by us and our ability to liquidate these securities.

Our investment portfolio as of January 3, 2009 includes various auction rate securities ("ARS"). ARS are variable-rate debt securities. While the underlying security has a long-term maturity, the interest rate is reset through Dutch auctions that are held at pre-determined intervals, usually every 28 days. In the past, liquidity for ARS was provided by this auction process that allowed investors to roll over their holdings or obtain immediate liquidity by selling the ARS at market. Recent uncertainty in the credit market has negatively affected these auctions and these auctions have not had sufficient bidders to allow investors to complete a sale of ARS. In February 2008, auctions related to the \$9.1 million of ARS currently owned by us failed. These are the only ARS

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investments in our portfolio as of January 3, 2009. Due to the uncertainty of liquidity, we have classified these investments of \$8.7 million as long term and have included such investments in long term investments. We have recorded an unrealized loss of \$0.4 million on such investments to other comprehensive income. In the future, failed auctions for our ARS may affect our ability to liquidate these ARS until a future auction is successful, a buyer is found outside of the auction process, the underlying securities have matured or the securities are recalled by the issuer. In addition, failed auctions may affect the fair value of our ARS and may result in an impairment charge.

Maintaining and improving our financial controls and the requirements of being a public company may strain our resources and divert management's attention.

We are subject to the reporting requirements of the Securities Exchange Act of 1934 or the Exchange Act, the Sarbanes-Oxley Act of 2002 and The NASDAQ Stock Market Rules. The requirements of these rules and regulations have increased our legal and financial compliance costs, make some activities more difficult, time-consuming or costly and may also place undue strain on our personnel, systems and resources.

The Sarbanes-Oxley Act requires, among other things, that we maintain effective disclosure controls and procedures and internal control over financial reporting. This can be difficult to do. As a result of this and similar activities, management's attention may be diverted from other business concerns, which could have a material adverse effect on our business, financial condition and results of operations. In addition, if we are unable to continue to meet these requirements, we may not be able to remain listed on the NASDAQ Global Select Market.

We have a material weakness in our internal control over financial reporting, and this material weakness creates a reasonable possibility of material misstatements in our financial statements.

Effective internal controls over financial reporting are necessary for us to provide reliable financial reports and effectively prevent fraud. As a publicly traded company we must maintain effective disclosure controls and procedures and internal control over financial reporting. This can be difficult to do. 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:

- pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

A *material weakness* is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the Company's annual or interim financial statements will not be prevented or detected on a timely basis.

In connection with the preparation of our financial statements for the year ended January 3, 2009, we determined that we had a material weakness, and therefore determined that our internal control over financial reporting was not effective, and therefore created a reasonable possibility of material misstatements in our financial statements. This material weakness related to our accounting for inventory valuation as more fully explained in Part II "Item 9A. Controls and Procedures" in this Annual Report on Form 10-K and has not yet been remediated.

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In order to improve and to maintain the effectiveness of our internal control over financial reporting and disclosure controls and procedures, significant resources and management oversight will be required. We began the process of remediating this material weakness when first identified in connection with the preparation of our financial statements for the fiscal year ended December 29, 2007, but this process takes time, and we will not be able to assert that we have remediated this material weakness until the procedures that we put in place have been working for a sufficient period of time for us to determine that they are effective. As a result of this and similar activities, management's attention may be diverted from other business concerns, which could have a material adverse effect on our business, financial condition and results of operations. If we are unable to remediate this material weakness, or in a future report one or more additional material weaknesses, there is a reasonable possibility that a material misstatement of our annual or interim financial statements will not be prevented or detected on a timely basis.

Even after corrective actions are implemented, the effectiveness of our controls and procedures may be limited by a variety of risks including:

- faulty human judgment and simple errors, omissions or mistakes;
- collusion of two or more people;
- inappropriate management override of procedures; and
- the risk that enhanced controls and procedures may still not be adequate to assure timely and reliable financial information

A failure to have effective internal controls and procedures for financial reporting in place could result in a restatement of our financial statements, as it did in our Form 10-Q for the quarterly period ended March 29, 2008, or impact our ability to accurately report financial information on a timely basis, which could adversely affect our stock price.

Risk Related to Owning Our Stock

Our stock price in the past has been volatile, and may continue to be volatile or may decline regardless of our operating performance, and investors may not be able to resell shares at or above the price at which they purchased the shares.

Our stock has been publicly traded for a relatively short period of time, having first begun trading in June 2005. During that time our stock price has fluctuated significantly, from a low of approximately \$3.61 per share to a high of approximately \$56 per share. At times the stock price has changed very quickly. For example, most recently, our stock has dropped from a high of more than \$10 per share at the end of September 2008 to a low of less than \$4 per share towards the end of December 2008. If investors purchase shares of our common stock, they may not be able to resell those shares at or above the price at which they purchase them. The market price of our common stock may fluctuate significantly in response to numerous factors, many of which are beyond our control including:

- price and volume fluctuations in the overall stock market;
- purchases of shares of our common stock pursuant to our share repurchase program;
- the financial projections we may provide to the public, any changes in these projections or our failure to meet these projections;
- actual or anticipated fluctuations in our operating results;
- changes in operating performance and stock market valuations of other technology companies generally, or those that sell enterprise computing products in particular;
- changes in financial estimates by any securities analysts who follow our company, our failure to meet these estimates or failure of those analysts to initiate or maintain coverage of our stock;

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- ratings downgrades by any securities analysts who follow our company;
- the public's response to our press releases or other public announcements, including our filings with the SEC;
- announcements by us or our competitors of significant technical innovations, customer wins or losses, acquisitions, strategic partnerships, joint ventures or capital commitments;
- introduction of technologies or product enhancements that reduce the need for our products;
- market conditions or trends in our industry or the economy as a whole;
- the loss of one or more key customers;
- the loss of key personnel;
- the development and sustainability of an active trading market for our common stock;
- lawsuits threatened or filed against us;
- future sales of our common stock by our officers, directors and significant stockholders; and
- other events or factors, including those resulting from war, incidents of terrorism or responses to these events.

In addition, the stock markets, and in particular the NASDAQ Stock Market, have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many technology companies. Stock prices of many technology companies have fluctuated in a manner unrelated or disproportionate to the operating performance of those companies. In the past, stockholders have instituted securities class action litigation following periods of market volatility. If we were involved in securities litigation, it could have substantial costs and divert resources and the attention of management from our business.

Due to these factors, sales of a substantial number of shares of our common stock in the public market could occur at any time. These sales, or the perception in the market that the holders of a large number of shares intend to sell shares, could reduce the market price of our common stock.

In February 2009, we announced that our board of directors had authorized a stock repurchase program providing for the repurchase of up to \$40 million of our common stock. The duration of the repurchase program is open ended. Under the program, we are able to purchase shares of common stock through open market transactions and privately negotiated purchases at prices deemed appropriate by management. The timing and amount of repurchase transactions under this program will depend on market conditions, corporate and regulatory considerations, alternative investment opportunities, and other relevant considerations. The program may be discontinued at any time by our board of directors. There can be no assurance that we will continue to buy any of our common stock under our share repurchase program or that any future repurchases will have a positive impact on our stock price. Important factors that could cause us to discontinue our share repurchases include, among others, unfavorable market conditions, the market price of our common stock, the nature of other investment opportunities presented to us from time to time, and the availability of funds necessary to continue purchasing common stock.

Some provisions in our certificate of incorporation and bylaws may deter third parties from acquiring us.

Our certificate of incorporation and bylaws contain provisions that may make the acquisition of our company more difficult without the approval of our board of directors, including the following:

- limitations on persons authorized to call a special meeting of stockholders;
- our stockholders may take action only at a meeting of stockholders and not by written consent;
- our certificate of incorporation authorizes undesignated preferred stock, the terms of which may be established and shares of which may be issued without stockholder approval; and

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- advance notice procedures required for stockholders to nominate candidates for election as directors or to bring matters before an annual meeting of stockholders.

These anti-takeover defenses could discourage, delay or prevent a transaction involving a change in control of our company. These provisions could also discourage proxy contests and make it more difficult for stockholders to elect directors of their choosing and cause us to take other corporate actions they desire.

We do not expect to pay any cash dividends for the foreseeable future.

We do not anticipate that we will pay any cash dividends to holders of our common stock in the foreseeable future. Accordingly, investors must rely on sales of their common stock after price appreciation, which may never occur, as the only way to realize any future gains on their investment. Investors seeking cash dividends in the foreseeable future should not purchase our common stock.

Item 1B. Unresolved Staff Comments

Not applicable.

Item 2. Properties

Our properties consist of leased facilities used for manufacturing, warehouse, sales and marketing, research and development, services and support and administrative purposes.

<u>Location</u>	<u>Size (sq. ft.)</u>	<u>Function</u>	<u>Lease expires</u>
Fremont, CA	157,820	Corporate Headquarters, manufacturing	December, 2013
Shanghai, China	12,830	Engineering Office	January, 2011
New York City, NY	3,694	Sales and Service Office	September, 2013
Redmond, WA	2,950	Software and Engineering Office	August, 2009

We believe that our facilities will be adequate for our needs for at least the next twelve months, and we expect that additional facilities will be available on reasonable terms in other jurisdictions to the extent we determine to add new offices.

Item 3. Legal Proceedings

We are involved in various legal proceedings and disputes that arise in the normal course of business. We do not know whether we will prevail in these matters nor can we assure that any remedy could be reached on commercially viable terms, if at all. Based on currently available information, we believe that we have meritorious defenses to these actions and that the resolution of these cases is not likely to have a material adverse effect on our business, financial position or future results of operations. In accordance with Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (SFAS 5), we record a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case.

On October 28, 2008, Acceleron, LLC brought an action against us in the United States District Court, Eastern District of Texas, seeking monetary and injunctive relief for the Company's alleged infringement of U.S. Patent No. 6,948,021. Rackable answered the Complaint on January 23, 2009, asserting that the '021 Patent was not infringed and invalid. A claim construction hearing has been scheduled for March 11, 2010, and trial has been scheduled to begin October 12, 2010.

In January, 2009, the Company was sued in the United States District Court, Northern District of California, in a matter captioned *Dull v. Rackable, Inc.* The complaint includes claims of violations of both (i) Section 10(b)

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of the Exchange Act and Rule 10b-5 promulgated thereunder, and (ii) Section 20(a) of the Exchange Act. The allegations relate to the drops in the Company's share price in early 2007 relating to their earnings reports for 2006 and Q4 2006 .

In March 2009, the Company and certain of its present and former directors and officers were sued in the Superior Court of the State of California for Alameda County, in a shareholder derivative lawsuit captioned *Milo v. Barton, et al*, Case No. R30944-0474. The complaint alleges that the defendants engaged in various acts and omissions that resulted in the drops of the Company's share price in early 2007, and asserts claims for alleged breaches of defendants' fiduciary duties, waste of corporate assets, and unjust enrichment. The complaint seeks compensatory damages in an unspecified amount, unspecified equitable or injunctive relief, disgorgement of unspecified compensation earned by the defendants, and an award of an unspecified amount for plaintiff's costs and attorneys fees.

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

No matters were submitted to a vote of our security holders during the quarter ended January 3, 2009.

PART II

Item 5. Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchase of Equity Securities

Market Information

Our common stock started trading on the NASDAQ National Market under the symbol "RACK" on June 10, 2005. Commencing in 2006, our common stock is traded on the NASDAQ Global Select Market. Prior to June 10, 2005, there was no public market for our common stock. The following table sets forth for the periods indicated the high and low sale prices of our common stock, as reported by the NASDAQ Markets.

<u>Year Ending January 3, 2009</u>	<u>High</u>	<u>Low</u>
First Quarter	\$10.17	\$ 7.76
Second Quarter	14.48	8.88
Third Quarter	13.80	9.81
Fourth Quarter	10.33	3.61
<u>Year Ending December 29, 2007</u>	<u>High</u>	<u>Low</u>
First Quarter	\$32.48	\$15.96
Second Quarter	17.24	11.25
Third Quarter	14.49	11.25
Fourth Quarter	14.66	9.48

Holdings

On March 6, 2009, the last reported sale price of our common stock on the NASDAQ Global Select Market was \$3.51. As of March 6, 2009, there were 30,116,040 shares of our common stock outstanding held by 19 holders of record.

Dividends

We have never declared or paid any dividends on our capital stock. We currently intend to retain any future earnings to fund the development and expansion of our business, and therefore we do not anticipate paying cash dividends on our common stock in the foreseeable future. Any future determination to pay dividends will be at the discretion of our board of directors.

Recent Sale of Unregistered Securities

None

Issuer Purchases of Equity Securities

None

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Performance Graph (1)

The following graph shows the cumulative total stockholder return of an investment of \$100 in cash on June 10, 2005, the date our common stock first started trading on the NASDAQ National Market through January 3, 2009, for (i) our common stock, (ii) the NASDAQ Composite Index and (iii) the RDG Technology Composite Index. Pursuant to applicable SEC rules, all values assume reinvestment of the full amount of all dividends, however no dividends have been declared on our common stock to date. The stockholder return shown on the graph below is not necessarily indicative of future performance, and we do not make or endorse any predictions as to future stockholder returns.



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- (1) This Section is not “soliciting material,” is not deemed “filed” with the SEC and is not to be incorporated by reference in any filing of Rackable Systems under the 1933 Act or the 1934 Act whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

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Item 6. Selected Financial Data

The following selected summary consolidated financial data should be read in conjunction with Part II, Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and with Part II, Item 8. “Financial Statements and Supplementary Data” in this Annual Report on Form 10-K.

	January 1, 2005 (1)	Year ended			January 3, 2009 (1) (2)
		December 31, 2005 (1)	December 30, 2006 (1) (2)	December 29, 2007 (1) (2)	
(in thousands, except for per share data)					
Consolidated Statements of Operations Data:					
Revenue	\$109,743	\$ 214,985	\$ 359,569	\$ 350,684	\$247,430
Gross profit	20,989	49,656	76,446	47,244	29,438
Income (loss) from continuing operations	(1,616)	23,617	16,206	(37,640)	(34,049)
Income tax provision from continuing operations	2,994	9,908	10,589	12,531	376
Net income (loss) from continuing operations	(55,390)	8,512	13,917	(41,580)	(31,287)
Loss from discontinued operations	—	—	(4,662)	(33,941)	(25,896)
Income tax benefit from discontinued operations	—	—	(2,217)	(5,964)	(2,955)
Net loss from discontinued operations, net of tax	—	—	(2,445)	(27,977)	(22,941)
Net income (loss)	(55,390)	8,512	11,472	(69,557)	(54,228)
Net income (loss) per common share:					
Basic					
Continuing operations	\$ (11.43)	\$ 0.86	\$ 0.52	\$ (1.45)	\$ (1.06)
Discontinued operations	\$ —	\$ —	\$ (0.09)	\$ (0.97)	\$ (0.77)
Total	\$ (11.43)	\$ 0.86	\$ 0.43	\$ (2.42)	\$ (1.83)
Diluted					
Continuing operations	\$ (11.43)	\$ 0.47	\$ 0.49	\$ (1.45)	\$ (1.06)
Discontinued operations	\$ —	\$ —	\$ (0.09)	\$ (0.97)	\$ (0.77)
Total	\$ (11.43)	\$ 0.47	\$ 0.40	\$ (2.42)	\$ (1.83)
Shares used in computing net income (loss) per share:					
Basic	4,848	9,947	26,948	28,786	29,583
Diluted	4,848	18,040	28,618	28,786	29,583

(1) Includes non-cash share-based compensation as follows:

	January 1, 2005	Year ended			January 3, 2009 (2)
		December 31, 2005	December 30, 2006 (2)	December 29, 2007 (2)	
(in thousands)					
Cost of revenue	\$ 74	\$ 91	\$ 3,583	\$ 2,152	\$ 1,120
Research and development	44	70	4,480	3,160	1,811
Sales and marketing	155	261	6,087	5,040	1,568
General and administrative	4,505	131	5,858	10,731	4,653
Continuing operations	4,778	553	20,008	21,083	9,152
Discontinued operations	—	—	747	2,152	435
Total	\$ 4,778	\$ 553	\$ 20,755	\$ 23,235	\$ 9,587

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- (2) Information has been restated to present the results of our Rapidscale product line as a discontinued operation. See Note 8 Discontinued Operations of these consolidated financial statements. The Rapidscale product line was purchased in 2006.

	Year ended				January 3, 2009
	January 1, 2005	December 31, 2005	December 30, 2006 (in thousands)	December 29, 2007	
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 17,111	\$ 29,099	\$ 30,446	\$ 49,897	\$171,954
Working capital	12,220	112,326	268,180	249,929	216,315
Total assets	56,309	176,042	406,770	352,458	285,493
Mandatorily redeemable preferred stock	23,651	—	—	—	—
Embedded derivatives in preferred stock	103,639	—	—	—	—
Total liabilities	161,064	52,777	91,081	76,340	54,004
Total stockholders' equity (deficit)	(104,755)	123,265	315,689	276,118	231,489

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

The following discussion should be read in conjunction with, and is qualified in its entirety by reference to, our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K. The discussions in this section contain forward-looking statements that involve risks and uncertainties, and actual results could differ materially from those discussed below. See "Item 1A—Risk Factors" and "Special Note Regarding Forward-Looking Statements and Trademarks" at the beginning of this Annual Report on Form 10-K for a discussion of these risks and uncertainties.

Company Background

We develop, market and sell compute server, storage systems and data center infrastructure purpose-built for large-scale data center deployments. Recently, enterprises have begun to deploy large-scale computing and storage farms by aggregating large numbers of relatively inexpensive, open-standard modular computing and storage systems. These systems typically run low-cost operating systems such as Linux and Windows and, we believe, enable enterprises to meet their computing and storage requirements at a lower total cost of ownership and provide enterprises with greater flexibility and scalability.

We have developed innovative technologies in the areas of chassis and cabinet design, power distribution techniques and hardware-based remote management technology. We offer compute servers using our half-depth design, enabling back-to-back mounting for higher server density and improved thermal management. In August 2004, we expanded our product line of compute servers, which we designed to further increase density levels, improve thermal management, and enhance cable management and system serviceability. In September of 2007, we released the newest generation of our modular data center products, known as "ICE Cube," designed to augment or replace traditional brick-and-mortar data centers of any size and is ideal for data centers facing power and space limitations. We also sell low-cost, high-capacity storage servers, which leverage many of our core compute server technologies, to help enterprises cost-effectively meet their increasing data storage requirements. Our compute servers represented approximately 85%, 92% and 91% of revenue for the years ended January 3, 2009, December 29, 2007 and December 30, 2006 respectively. Our storage servers represented approximately 15%, 8% and 9% of our revenue for the year ended January 3, 2009, December 29, 2007 and December 30, 2006 respectively. In addition, we selectively use reseller and OEM relationships to provide additional compute server and storage offerings that our customers may request. Service revenues were approximately 3%, 2% and 1% of total revenues for the years ended January 3, 2009, December 29, 2007 and December 30, 2006 respectively.

We market our systems primarily through our direct sales force predominantly to enterprises within the United States. In the years ended January 3, 2009, December 29, 2007 and December 30, 2006, international

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sales were approximately 8%, 6% and 9% of our revenues respectively. We are in the early stages of developing an international sales and operational presence, focusing initially on Europe and Japan. We focus our sales and marketing activities on enterprises that typically purchase hundreds of servers and tens to thousands of terabytes of storage per year. To date, we have sold our products to over 600 customers. We have concentrated our marketing efforts on leading Internet companies, as well as customers with high-performance computing requirements in vertical markets such as semiconductor design, enterprise software, federal government, media, financial services, oil and gas exploration, biotechnology and pharmaceuticals.

Fiscal Year

We have a 52-week fiscal year ending on the Saturday nearest to December 31, with 13 week quarters ending on the last Saturday of the period. Our fiscal years 2008, 2007 and 2006 ended on January 3, 2009 (“FY 2008”), December 29, 2007 (“FY 2007”) and December 30, 2006 (“FY 2006”), respectively.

2008 Synopsis

Our revenues in FY 2008 declined to \$247 million from \$351 million in FY 2007. A primary cause of our decline in revenues was our reliance on two of our large customers, whose total purchases from the Company decreased approximately 34% year-over-year. Our storage sales in FY 2008 increased 32% compared to FY 2007 while compute servers decreased 35%. Our service business in FY 2008 grew by approximately 45%. Our net loss was \$54 million in FY 2008 as compared with \$70 million in FY 2007. In conjunction with the decreased revenues discussed above, other key contributors to our losses in FY 2008 included the following:

- Our gross profit in FY 2008 of \$29 million was approximately \$18 million less than in FY 2007. Most of the decline was due to the effect of a \$104 million decrease in revenues, with the remaining difference reflecting shifts in product and customer mix year-over-year;
- Our operating expenses decreased by approximately \$21 million in FY 2008, to \$63 million. We increased our investment in research and development expenditures to strengthen our competitive position through increased innovation and new product development. For example, we introduced the XE series for extreme efficiency servers, the C2005 as the core to our build-to-order 2U solutions, the C1002 as a highly flexible web-server, the CloudRack as a scalable cost-effective solution for large scale cloud environments, the MobiRack for mobile solutions, and our latest offering, MicroSlice architecture for cost-effective web-based applications. Decreases in sales and marketing and general and administrative expenses accounted for most of the net decrease in expenses in 2008 and reflect a 15% decrease in headcount company wide in 2008, to 318 from 374 at the end of 2007;
- We ceased operations in Canada and discontinued our Rapidscale product line during FY’08. The results of this product line have been reflected as a discontinued operation in our financial statements. The Rapidscale product line incurred a net loss of approximately \$22.9 million during fiscal 2008, comprised primarily of impairment of long lived assets, costs related to the employment agreements in connection with our acquisition of Rapidscale, severance to former employees and occupancy-related expenses;
- We experienced a significant decrease overall in share based compensation expense due to a declining stock price and employee turnover. Share based compensation expense from both continuing and discontinued operations decreased by approximately \$13.6 million in FY 2008.

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Results of Operations

The following table sets forth our financial results, as a percentage of revenue, for the years ended January 3, 2009, December 29, 2007 and December 30, 2006:

	Year Ended		
	January 3, 2009	December 29, 2007	December 30, 2006
Revenue	100.0%	100.0%	100.0%
Cost of revenue	88.1	86.5	78.7
Gross margin	11.9	13.5	21.3
Operating expenses:			
Research and development	6.0	3.9	3.4
Sales and marketing	9.5	9.3	7.4
General and administrative	9.9	10.2	6.0
Impairment of long-lived assets	—	0.8	—
Restructuring charges	0.3	—	—
Total operating expenses	25.7	24.2	16.8
Income (loss) from operations	(13.8)	(10.7)	4.5
Total other income, net	1.3	2.4	2.3
Income (loss) from continuing operations before income tax	(12.5)	(8.3)	6.8
Income tax provision from continuing operations	0.1	3.5	2.9
Net income (loss) from continuing operations	(12.6)	(11.8)	3.9
Loss from discontinued operations	(10.5)	(9.7)	(1.3)
Income tax provision/(benefit)	(1.2)	(1.7)	(0.6)
Net loss from discontinued operations	(9.3)	(8.0)	(0.7)
Net income (loss)	(21.9)%	(19.8)%	3.2%

Comparison of the Years Ended January 3, 2009 and December 29, 2007

Revenue.

	Year ended		Change	
	January 3, 2009	December 29, 2007	\$	%
	(in thousands, except percentages)			
Revenue	\$247,430	\$ 350,684	\$(103,254)	(29)%
Percentage of revenue from top three customers	56%	64%		
Units shipped	68,490	102,951	(34,461)	(33)%

We derive our revenues from the sale of our products and services to end users as well as through resellers. Our revenue recognition policy is described in more detail under “Critical Accounting Policies, Significant Judgments and Estimates” below. Our product revenue is derived from the sale of server and storage systems. The main factors which impact our revenue are unit volumes shipped and average selling prices. We generate service revenue from the sale of standard maintenance contract service offerings as well as custom maintenance contracts that are tailored to individual customers’ needs. We recognize service revenue ratably over the service periods. Maintenance contracts are priced as a percentage of the list price of the underlying products to which the service relates. Maintenance contracts are typically one to three years in length, and we will actively pursue renewals of these contracts. Our customers may change to a different maintenance contract upon renewal. We also generate service revenue from implementation services.

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The decline in revenue for the year ended January 3, 2009, compared to the year ended December 29, 2007, reflects the economic downturn which we believe has impacted the timing of our customers' buying decisions. For the year ended January 3, 2009, revenue from our top three historical customers fell by 38% to \$138.5 million or 56% of total revenue as compared with \$223.2 million or 64% of total revenue in the year ended December 29, 2007. While the number of units shipped decreased 34% from the number shipped in FY 2007, the average selling price increased 6% reflecting customer and product configuration mix changes. However, overall, we expect average selling prices for similar products to decline over time as competitive pricing pressure increases, and our products mature in the market and are replaced with new products with increased performance and superior features.

Cost of Revenue and Gross profit.

	Year ended		Change	
	January 3, 2009	December 29, 2007	\$	%
	(in thousands, except percentages)			
Cost of revenue	\$217,992	\$ 303,440	\$(85,448)	(28)%
Gross profit	\$ 29,438	\$ 47,244	\$(17,806)	(38)%
Gross margin	11.9%	13.5%	n/a	

The decrease in gross profit for the year ended January 3, 2009 as compared to the prior year was primarily due to the lower revenue mentioned above due to fewer systems shipped and due to lower gross margin earned on these shipments. The primary cause for the decrease in gross margin for the year ended January 3, 2009 as compared to the same period in 2007, was due to increased excess and obsolete inventory charges as a percentage of revenue in fiscal 2008 which was partially offset by an increase in the mix of higher margin customers. Excess and obsolete inventory charges decrease in absolute dollars primarily due to power supplies.

Changes in customer and product mix, pricing actions by our competitors and general commodity prices significantly impact our gross margin from period to period. In addition, significant shifts in technology and declining shipments and revenues will depress gross profits and gross margin because certain manufacturing costs are fixed or semi-variable in nature, and we may not be able to reduce them in proportion to the reductions in our revenues.

Operating expenses.

	Year ended		Change	
	January 3, 2009	December 29, 2007	\$	%
	(in thousands, except percentages)			
OPERATING EXPENSES:				
Research and development	\$ 14,864	\$ 13,802	\$ 1,062	8%
Sales and marketing	23,412	32,461	(9,049)	(28)%
General and administrative	24,526	35,801	(11,275)	(31)%
Impairment of long-lived assets	—	2,820	(2,820)	(100)%
Restructuring charge	685	—	685	n/a
	\$ 63,487	\$ 84,884	\$(21,397)	

Research and development expense. Research and development expense consists primarily of employee, contractor, and related personnel costs, new component testing and evaluation, test equipment, new product design and testing and other product development activities. The increase in research and development expenses for the year ended January 3, 2009 compared to the prior year was primarily due to increased employee and

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related expenses due to overall higher headcount throughout the year as compared to prior year, higher material usage related to the development of future product lines, and higher depreciation expense as a result of the addition of test systems to support engineering activities. These increases were partially offset by a decrease in share-based compensation during the period primarily due to the decline in our stock price and employee turnover. We expect research and development expense will decrease or remain in flat, in absolute dollars, in future periods due to our reduction in force.

Sales and marketing expense . Sales and marketing expense consists primarily of salaries, bonus and commissions paid to our sales and marketing employees and salaries paid to our sales engineers who work with our sales and marketing employees to help determine the components and configuration requirements for new products. We also incur marketing expenses for marketing activities such as trade shows, direct mail and print advertising.

The decrease in sales and marketing expenses for the year ended January 3, 2009 compared to the year ended December 29, 2007, was primarily due to reduced share-based compensation expense due to the decline in our stock price and employee turnover, lower commission and sales expense due to lower revenue, and lower expense related to fewer evaluation units used to present and market our products to new customers.

We expect to continue to expand our sales presence in the United States and internationally. We will continue to focus our efforts on expanding our sales and sales support organizations to cover key new verticals such as federal, oil and gas, media and entertainment and financial services. We expect sales and marketing expenses to remain flat or decrease in absolute dollars.

General and administrative expense . General and administrative expense consists primarily of salaries and overhead of our administrative staff as well as legal costs. The reduction of general and administrative expense for the year ended January 3, 2009 compared to the prior year was primarily due to reduced share-based compensation due to the decline in our stock price and employee turnover, a sales and use tax filing settlement resolved in fiscal 2007 which was not present in fiscal 2008, and reduced expense related to the amortization of intangibles related to the “Old Rackable” acquisition that became fully amortized by the end of fiscal 2007.

We will continue to focus on cost control in fiscal 2009 and expect our general and administrative expenses to remain flat or slightly increase in future periods.

Restructuring charges . In the six months ended June 28, 2008, we relocated certain engineering activities that were being performed at our Milmont, California facility, which was under lease through June 30, 2009. We negotiated and completed a lease termination agreement with the lessor, releasing us from any further responsibilities in exchange for a payment of \$0.7 million. There were no such charges in the prior year.

Other income (expense), net.

	Year ended		Change	
	January 3, 2009	December 29, 2007	\$	%
Other income (expenses)—net:	\$ 3,138	\$ 8,591	\$(5,453)	(63)%

The decrease in other income (expense), net was primarily due to lower interest income earned on our investment portfolio due to declining interest rates and the economic downturn in 2008 as well as an increase in foreign exchange losses during the year.

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Provision for income taxes.

	Year ended		Change	
	January 3, 2009	December 29, 2007	\$	%
Tax provision from continuing operations	\$ 376	\$ 12,531	\$(12,155)	(97)%

Our income tax provision recorded for the year ended January 3, 2009 consists primarily of current year refunds of prior taxes paid offset by the recording of a valuation allowance for deferred tax asset balances due to the Company's current loss position. Our effective tax rate for the year ended January 3, 2009 differs from the combined federal and state statutory rate primarily due to the recording of the valuation allowance.

Our effective tax rate for the year ended December 29, 2007 differs from the combined federal and state statutory rate primarily due to increases in our valuation allowance for deferred tax assets and the write-off of goodwill, a majority of which is not deductible or amortizable for U.S. tax purposes.

Discontinued Operation.

During fiscal 2008, we classified our Rapidscale product line as a discontinued operation as a result of discontinuing this product line. Our decision was a result of a change in strategic direction, as well as an inability to license certain third party software on reasonable commercial terms. During the first three quarters of 2008, the company recorded an impairment charge of \$17.5 million of long lived assets due to significantly lowered projected revenue and cash flow from the Rapidscale product line. As of September 2008, all of the long lived assets related to Rapidscale were fully impaired. In October 2008, a formal plan to abandon the Rapidscale product line was reviewed and approved by management with appropriate authority and was communicated to the affected employees. Costs associated with closing down these operations in 2008 were not significant, and we do not anticipate any further costs associated with this to be significant.

We do not believe this discontinued operation will negatively impact our future results of operations. We will no longer experience the significant losses present in fiscal 2008 and fiscal 2007 for this product line, which were \$23 million and \$28 million, respectively. Furthermore, the revenue contribution from this product line was not significant at \$0.7 million and \$2.5 million for fiscal 2008 and fiscal 2007, respectively.

Comparison of the Years Ended December 29, 2007 and December 30, 2006

Revenue.

	Year ended		Change	
	December 29, 2007	December 30, 2006	\$	%
Revenue	\$ 350,684	\$ 359,569	\$(8,885)	-2%
Percentage of revenue from top three customers	64%	67%		
Units shipped	102,951	93,777	9,174	10%

The decline in revenue for the year ended December 29, 2007, compared to the year ended December 30, 2006, was due in large part to more competitive pricing as well as reduced purchases from a primary customer. While units increased to approximately 103,000 in 2007 from approximately 93,800 in 2006, the ASP of units sold declined approximately 11% due primarily to a more competitive pricing environment in our compute server business. Approximately 87% of our revenues in 2007 were attributed to sales to customers that had also purchased our products in 2006. Service revenues were 2% of total revenues in 2007 and slightly over 1% of total revenues in 2006.

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Cost of Revenue and Gross profit.

	Year ended		Change	
	December 29, 2007	December 30, 2006	\$	%
	(in thousands, except percentages)			
Cost of revenue	\$ 303,440	\$ 283,123	\$ 20,317	7%
Gross profit	\$ 47,244	\$ 76,446	\$(29,202)	-38%
Gross margin	13.5%	21.3%	n/a	

The decrease in the gross profit for the year ended December 29, 2007, compared to the year ended December 30, 2006 was primarily attributable to \$16.6 million of excess and obsolescence (“E&O”) charges related to inventory and a more competitive pricing environment, as discussed above. Total gross E&O charges increased \$23.3 million in fiscal 2007 as compared to fiscal 2006 with the majority of this increase consisting of a \$20.6 million write down of inventory primarily from a customer driven technology platform shift from AMD to Intel along with next generation power supplies. These higher E&O charges were partially offset by a \$6.7 million benefit from the sales of previously written off inventory. While we were able to partially offset lower ASP’s due to significant declines in memory pricing, a major component of our material cost, we were not able to lower other material and manufacturing costs to fully offset the decrease in the ASP.

The decrease in gross margin for the year ended December 29, 2007 as compared to the same period in the prior year, was primarily due a 5.5% decline related to the E&O and inventory charges, net of sales of previously written down inventory, and a 4.2% decline due to higher manufacturing and service and support related costs, similarly discussed above.

Operating expenses.

	Year ended		Change	
	December 29, 2007	December 30, 2006	\$	%
	(in thousands, except percentages)			
OPERATING EXPENSES:				
Research and development	\$ 13,802	\$ 11,929	\$ 1,873	16%
Sales and marketing	32,461	26,681	5,780	22%
General and administrative	35,801	21,630	14,171	66%
Impairment of long-lived assets	2,820	—	2,820	n/a
	\$ 84,884	\$ 60,240	\$24,644	

Research and development expense. The increase in research and development expenses for the year ended December 29, 2007, compared to the same period in the prior year, was primarily driven by increased employee and related expenses due to higher headcount, an increase in facilities expense also related to the increased headcount, and higher consulting and depreciation expense due to increase engineering and development activities. These increases were partially offset by a decrease in share-based compensation expenses in fiscal 2007, primarily due to lower fair values of stock awards at grant dates during that period.

Sales and marketing expense. The increase in sales and marketing expenses for the year ended December 29, 2007, compared to the same period the prior year, was primarily driven by increased employee and related expenses due to higher headcount needed to support sales and marketing activities, higher expense related to more evaluation units used to present and market our products to new customers, and higher facilities expensed related to increased headcount. These increases were partially offset by a decrease in share-based compensation expenses in fiscal 2007, primarily due to lower fair values at grant dates during that period.

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General and administrative expense. The increase in general and administrative expenses for the year ended December 29, 2007, compared to the year ended December 30, 2006, was primarily due to increased share-based compensation expenses related to new executives; higher sales tax expenses as a result of a sales tax settlement in fiscal 2007; higher compensation and related expenses related to additional headcount needed to support finance and administrative activities; higher audit, tax, and compliance costs as fiscal 2007 marked our second year of compliance with Section 404 of the Sarbanes-Oxley Act of 2002; and higher facilities costs, such as rent and maintenance due to relocating to a new corporate office.

Impairment of long lived assets. For the year ended December 29, 2007, we had a \$23.9 million charge related to impairment of goodwill. This charge was the result of our market capitalization at December 29, 2007, which was less than our net assets, including goodwill, at that time. In accordance with SFAS No. 142, "Goodwill and Other Intangible Assets," we determined the current fair value of our assets and liabilities and concluded that the entire recorded amount of goodwill had been impaired.

Other income (expense), net.

	Year ended		Change	
	December 29, 2007	December 30, 2006	\$	%
	(in thousands, except percentages)			
Other income (expenses)—net:	\$ 8,591	\$ 8,300	\$291	4%

The increase in other income (expense), net was primarily due to higher average cash, cash equivalents and short-term investment balances related to operating cash in flows as well as higher interest rates in fiscal 2007 as compared to fiscal 2006 partially offset by lower foreign currency exchange gains resulting from lower balances held in Euros for our European operations.

Provision for income taxes.

	Year ended		Change	
	December 29, 2007	December 30, 2006	\$	%
Tax provision from continuing operations	\$ 12,531	\$ 10,589	\$1,942	18%

Our income tax provision recorded for the year ended December 29, 2007 includes approximately \$13.2 million of charges relating to our valuation allowance for deferred tax assets recorded in prior years. During the second quarter of 2007 we revised our assessment of the realizability of our deferred tax assets and we concluded that it was more likely than not that our net deferred tax assets in excess of amounts recoverable through loss carry-backs and certain deferred tax liabilities would not be realizable. In addition, during 2007, tax benefits associated with current year losses have been recorded only to the extent of recoverable income taxes.

Our effective tax rate for the year ended December 29, 2007 differs from the combined federal and state statutory rate primarily due to increases in our valuation allowance for deferred tax assets and the write-off of goodwill, a majority of which is not deductible or amortizable for U.S. tax purposes.

The effective tax rate for the year ended December 30, 2006 differed from the combined federal and state net statutory income tax rates primarily due to certain stock compensation expenses for which deferred tax assets could not be recorded in accordance with SFAS 123R.

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Liquidity and Capital Resources

Historically, we have required capital principally to fund our working capital needs. We anticipate that our cash and cash equivalents as of January 3, 2009 will be sufficient to meet our working capital requirements and technology development projects for at least the next 12 months. We had \$180.6 million in cash and cash equivalents and investments at January 3, 2009, \$198.1 million at December 29, 2007, and \$160.5 million at December 30, 2006. At January 3, 2009, we held \$8.7 million of long-term investments consisting of various auction rate municipal bonds and variable rate municipal demand notes ("ARS"). Substantially all of these securities were collateralized by guaranteed student loans, and insured or reinsured by the federal government. The credit markets are currently experiencing significant uncertainty, and some of this uncertainty has impacted the markets where our auction rate securities would be offered. For additional information related to our investments in ARS investments see Note 13 in our Consolidated Financial Statements in this Form 10-K. The adequacy of these resources to meet our liquidity needs beyond the next 12 months will depend on our growth, operating results and capital expenditures required to meet demand for our products. If we fail to reduce cash consumed by operations, or generate additional cash from our operations on a timely basis, we may not have the cash resources required to run our business and we may need to seek additional sources of funds to meet our needs. Cash flows from our discontinued operations have been included in our consolidated statement of cash flows with continuing operations within each cash flow category. The absence of cash flows from discontinued operations is not expected to affect our future liquidity or capital resources.

	January 3, 2009	Year Ended	
		December 29, 2007	December 30, 2006
		(in thousands)	
Consolidated Statements of Cash Flows Data:			
Net cash provided by (used in) operating activities	\$ (15,699)	\$ 46,075	\$ (17,584)
Net cash provided by (used in) investing activities	137,433	(32,145)	(140,904)
Net cash provided by financing activities	148	5,547	159,870

Operating Activities

During the year ended January 3, 2009, cash used in operating activities totaled \$15.7 million due to our net loss exceeding both our non-cash charges and changes in operating assets and liabilities. Our net loss included substantial non-cash charges in the form of stock compensation of \$9.6 million, impairment of long-lived assets of \$17.5 million and depreciation and amortization of long-lived assets of \$5.6 million, partially offset by the decrease in deferred tax liabilities of \$1.5 million. These non-cash charges totaled \$31.9 million. Changes in operating assets and liabilities offset our net loss by approximately \$6.6 million, primarily in accounts receivable, prepaid and other assets, accounts payable, and deferred revenue and deferred cost of sales.

Accounts receivable decreased \$22 million, reflecting decreased revenue and the timing of sales in FY 2008 over FY 2007. Revenue in the fourth quarter of 2007 was \$111.3 million versus \$38.7 million in the fourth quarter of 2008. Prepaid and other assets decreased \$14.1 million, primarily due to a substantial decrease in prepaid taxes as well as a reduction in supplier rebates over the prior year. Accounts payable decreased \$26 million primarily due to our timing of inventory purchases. We reduced our inventory purchase activity in the fourth quarter of FY 2008 versus the same period in prior year. Deferred revenue and deferred cost of sales increased \$11.1 million and \$10.5 million respectively, reflecting a large customer order that did not meet revenue recognition criteria.

Despite a net loss of \$69.6 million in the year ended December 29, 2007, net cash provided by operating activities was \$46.1 million. This increase was due primarily to non-cash charges of \$67.7 million. Non cash charges included an impairment of goodwill of \$23.9 million, share-based compensation of \$23.2 million, deferred income taxes of \$14.5 million and depreciation and amortization of \$7.4 million. Changes in operating assets and liabilities offset our net loss by \$47.9 million, primarily in accounts receivable, inventories, and accounts payable.

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Accounts receivable decreased by \$54.0 million in FY 2007 primarily due to very linear sales in the fourth quarter of 2007 compared to the back-end loaded fourth quarter of 2006. Through improved supply chain management we decreased our inventory levels and purchases to respond to the sales trends in 2007, resulting in lower inventory and accounts payable balances. Improvements in our supply chain management are intended to ensure sufficient supply on hand to meet expected demand for our products. The decrease was predominantly in raw materials, where we took a net charge against of excess and obsolete inventory of \$16.6 million. The improved supply chain management and more linear inventory purchases in the fourth quarter of 2007 as compared to the fourth quarter of 2006, allowed us to decrease inventory by approximately \$13.8 million and accounts payable by \$13.9 million.

Cash used for operating activities in the year ended December 30, 2006 was mainly to due to the changes in operating assets and liabilities, which resulted in a decrease of \$46.9 million, offset by net income \$11.5 million, and non-cash charges of \$17.9 million. Accounts receivable increased \$53.8 million, primarily driven by significantly higher sales in 2006 due to a substantial portion of sales occurring in December 2006 as compared to December 2005. Inventory increased \$27.2 million in response to sales increases in 2006. The increase was predominantly in raw materials, intended to ensure sufficient supply on hand to meet expected demand for our products. Increases in accounts receivable and inventory were partially offset by the an increase in accounts payable of \$32 million resulting from significantly higher purchases and spending for the increased sales activities in 2006.

Non-cash charges primarily consisted of share-based compensation of \$20.8 million, deferred income taxes of \$5.4 million, and depreciation and amortization of \$3.6 million, partially offset by excess tax benefits from stock options exercised of \$15 million.

Investing Activities

During the year ended January 3, 2009, net cash provided by investing activities was \$137.4 million and consisted primarily of proceeds from sales and maturities of marketable securities of \$165.4 million, offset by purchases of marketable securities of \$26.3 million and purchases of property and equipment of \$1.6 million. We invest predominantly in high quality, fixed income securities. Our investment portfolio may at any time contain investments in U.S Treasury and U.S government agency securities, taxable and or tax exempt municipal notes, corporate notes and bonds, commercial paper and money market funds. Our purchases of property and equipment in 2008 related mainly to tenant improvements and asset additions to our new Shanghai office. We reduced our investment in auction rate securities from \$64.6 million at December 29, 2007 to \$8.7 million at January 3, 2009.

During the year ended December 29, 2007, net cash used in investing activities was \$32.1 million. We purchased \$584 million of securities and received proceeds from sales and maturities of securities of approximately \$566 million. We also paid \$9.1 million to the former Terrascale shareholders for additional intangible property not acquired as part of the initial acquisition of Terrascale. We purchased approximately \$4.5 million for property and equipment primarily related to research and development projects, as well as our corporate office relocation.

During the year ended December 30, 2006, net cash used in investing activities was \$140.9 million. We purchased \$547 million of securities and received proceeds from sales and maturities of securities of approximately \$442.1 million. In addition, we completed our acquisition of Terrascale in September 2006 and paid \$31.9 million in cash. We also purchased \$3.9 million of property, plant and equipment due to investments in our infrastructure and systems, including the implementation of a new financial accounting system.

Financing Activities

Cash provided by financing activities during the year ended January 3, 2009 was \$0.1 million. Cash generated from financing activities included \$1.8 million from stock option exercises and employee stock purchases, largely offset by \$1.7 million of restricted stock repurchases.

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Cash provided by financing activities during the year ended December 29, 2007 was \$5.5 million. Cash generated from financing activities included \$4.5 million in proceeds from stock option exercises and employee stock purchases, and \$1.6 million of excess tax benefits related to stock option exercises, partially offset by \$0.6 million of restricted stock repurchases.

Cash provided by financing activities during the year ended December 30, 2006 was \$159.9 million, mainly due to the proceeds of \$138.5 million from a follow-on public offering completed in March 2006. Cash generated from financing activities also included \$15.0 million of excess tax benefits related to stock option exercises and proceeds of \$6.4 million from stock option exercises and employee stock purchases.

In February 2009, our Board of Directors authorized a share repurchase program of up to \$40 million of our common stock. The duration of the repurchase program is open ended. Under the program, we are able to purchase shares of common stock through open market transactions and privately negotiated purchases at prices deemed appropriate by management. The timing and amount of repurchase transactions under this program will depend on market conditions, corporate and regulatory considerations, alternative investment opportunities, and other relevant considerations. The program may be discontinued at any time by the Board of Directors. Shares we repurchase will be held in treasury for general corporate purposes, including issuances under employee equity incentive plans.

We expect to continue to invest in the business including working capital, capital expenditures and operating expenses. We intend to fund these activities with our cash reserves and cash generated from operations, if any. Increases in operating expenses may not result in an increase in our revenue and our anticipated revenue may not be sufficient to support these increased expenditures. We anticipate that operating expenses and working capital will constitute a material use of our cash resources.

Credit Facility

In September 2006, we entered into a line of credit agreement with a bank that provides for borrowings not to exceed \$25.0 million. The line of credit agreement matured on September 29, 2007. There were no borrowings under the line of credit when it expired. We decided not to renew or replace the facility.

Contractual Obligations and Commitments

The following are contractual obligations and commitments at January 3, 2009, associated with lease obligations and contractual commitments (in thousands):

	Payments due by period				
		Less than	1 - 3	3 - 5	More than
	Total	1 year	years	years	5 years
Operating leases	\$ 9,556	\$ 1,973	\$3,776	\$3,807	\$ —
Purchase obligations	7,516	7,516	—	—	—
Total	<u>\$17,072</u>	<u>\$ 9,489</u>	<u>\$3,776</u>	<u>\$3,807</u>	<u>\$ —</u>

Operating Leases —In November 2006, the Company signed an operating lease for a 40,316 square foot facility to serve as the Company's headquarters in Fremont, California. Lease payments escalate annually and the total future minimum lease payments amount to \$2.2 million over the lease term. The stated term of the lease is six years and ten months, commencing on March 1, 2007. The Company can extend the lease an additional 3 years. Pursuant to the lease the Company is required to maintain a cash deposit of approximately \$40,000 which is included in other assets in the accompanying consolidated balance sheet as of January 3, 2009.

The Company signed a seven-year operating lease, commencing in December 2006, for an 117,500 square foot facility which serves as the Company's manufacturing and warehouse facility in Fremont, California. Lease

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payments escalate annually and the total future minimum lease payments amount to \$5.6 million over the lease term. The stated term of the lease is seven years, but the Company may extend the lease for an additional three years at 95% of the then current market rate. As part of this agreement, the Company is required to maintain a \$100,000 cash deposit or an unconditional and irrevocable fully cash-collateralized letter of credit as a form of security. The cash deposit for the lease building is included in other assets in the accompanying consolidated balance sheet as of January 3, 2009.

In addition, the Company has operating leases for office space in New York City and Shanghai, China. The Company signed a five-year operating lease, commencing in September 2008 for a 3,694 square foot facility to serve as a sales and service office in New York City, New York. Lease payments remain flat for three years and escalate thereafter and the total future minimum lease payments amount to \$1 million over the lease term. The Company also signed a three year operating lease commencing in February 2008 for a 12,830 square foot facility which serves as the Company's international engineering office also known as our "Shanghai Technology Center" in Shanghai, China. Lease payments remain flat for the entire term of the lease and total future minimum lease payments amount to \$0.4 million.

From time to time, we issue blanket purchase orders to our contract manufacturers for the procurement of materials to be used for upcoming orders, particularly for those components that have long lead times. Blanket purchase orders vary in size depending on the projected requirements of the company. If we do not consume these materials on a timely basis or if our relationship with one of our contract manufacturers was to terminate, we could experience an abnormal increase to our inventory carrying amount and related accounts payable.

In connection with supplier agreements, the Company agreed to purchase certain units of inventory and non- inventory through 2009. As of January 3, 2009, there was a remaining commitment of approximately \$2.9 million and \$4.6 million respectively.

Other than the contractual obligations and commitments described above, we have no significant unconditional purchase obligations or similar instruments. We are not a guarantor of any other entities' debt or other financial obligations.

We believe that our current cash balance will be sufficient to meet our needs for at least the next 12 months. If we require additional capital resources to expand our business internally or to acquire complementary technologies and businesses at any time in the future, we may seek to sell additional equity or debt securities or obtain other debt financing. The sale of additional equity or convertible debt securities could result in more dilution to our stockholders. Financing arrangements may not be available to us, or may not be available in amounts or on terms acceptable to us.

Off Balance Sheet Arrangements

We have no off balance sheet arrangements.

Critical Accounting Policies, Significant Judgments and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the amounts reported in our combined financial statements and accompanying notes. Management bases its estimates on historical experience and various other assumptions believed to be reasonable. Although these estimates are based on management's best knowledge of current events and actions that may impact us in the future, actual results may be different from the estimates. Our critical accounting policies are those that affect our financial statements materially and involve difficult, subjective or complex judgments by management. Those policies are revenue recognition, valuation of intangible assets and goodwill, reserve for sales returns and allowance for doubtful accounts, inventory valuation, warranty liabilities, accounting for income taxes and share-based compensation.

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Revenue Recognition

We account for our revenues under the provisions of Staff Accounting Bulletin (“SAB”) No. 104, *Revenue Recognition in Financial Statements* (“SAB 104”), FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (“FTB 90-1”) and Statement of Position No. 97-2, *Software Revenue Recognition* (“SOP 97-2”).

Under the provisions of SAB 104, we recognize revenues from sales of products when persuasive evidence of an arrangement exists, shipment has occurred and title has transferred, the sales price is fixed and determinable, collection of the resulting receivable is reasonably assured, and all significant obligations have been met. Generally, this occurs at the time of shipment when risk of loss and title has passed to the customer.

Service revenue includes hardware maintenance and installation. Pursuant to SAB 104, we recognize revenue from the sale of our products prior to completion of these services, as our product sales are not dependent on these services to be functional. Under FTB 90-1, we recognize revenue from hardware maintenance contracts, which are sold and invoiced separately, ratably over the contract term, generally one to three years. Installation services are typically requested by our new customers who have limited history with our products. Installation and related services are usually performed within one day after product delivery.

Where software is integrated with hardware and sold as a hardware appliance the Company provides unspecified software updates and enhancements to the software through service contracts. As a result, the Company accounts for revenue in accordance with SOP 97-2 for transactions involving the sale of software. Revenues earned on software arrangements involving multiple-elements are allocated to each element based on the Vendor Specific Objective Evidence (“VSOE”) of fair value. The VSOE of fair value of the undelivered elements (maintenance and support services) is generally determined based on the price charged for the undelivered element when sold separately or renewed. If VSOE cannot be obtained to determine fair value of the undelivered elements, revenue from the entire arrangement would be deferred and recognized as these elements are delivered.

Valuation of Intangible Assets and Goodwill

We periodically evaluate our intangible assets and goodwill in accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* (“SFAS No. 142”), for indications of impairment whenever events or changes in circumstances indicate that the carrying value may not be recoverable. Intangible assets include goodwill, patents, customer list, customer backlog and tradename. Factors we consider important that could trigger an impairment review include significant under-performance relative to historical or projected future operating results, significant changes in the manner we use the acquired assets or the strategy for our overall business, or significant negative industry or economic trends. We have chosen the end of our fiscal month of December as the date of our annual impairment test. In accordance with SFAS No. 142, goodwill is evaluated for impairment at the reporting unit level. We consider the company to be a single reporting unit. While the CEO, who is our chief operating decision maker, monitors the sales of various products, operations are managed and financial performance evaluated based upon the sales and production of multiple products employing common manufacturing and research and development resources, sales and administrative support, and facilities. We believe that any allocation of such shared expenses to various products would be impractical and arbitrary and we currently do not make such allocations internally. In testing for a potential impairment of goodwill, the provisions of SFAS No. 142 require the application of a fair value based test at the reporting unit level. We performed the annual goodwill impairment test as of December 29, 2007 and determined that goodwill was fully impaired at that date. The goodwill impairment resulted in a charge of approximately \$23.9 million. In accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-lived Assets* (“SFAS No. 144”) long-lived intangible assets with determinable economic life are tested for recoverability whenever events or circumstances indicate that their carrying amounts may not be recoverable. We recognized an impairment charge of \$17.5 million in the year ended January 3, 2009, which is included in net loss from discontinued operations in the Consolidated Statements of Operations.

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Reserve for Sales Returns and Allowance for Doubtful Accounts

We record estimated reductions in revenue for potential returns of products by customers and other allowances. As a result, management must make estimates of potential future product returns and other allowances related to current period product revenue. In making such estimates, management analyzes historical returns, current economic trends and changes in customer demand and acceptance of our products. We review and update our estimates for sales returns on a quarterly basis to reflect our experience regarding the historical sales returns. If management were to make different judgments or utilize different estimates, material differences in the amount of reported revenue could result.

Similarly, management makes estimates of the uncollectibility of accounts receivables, especially analyzing accounts receivable and historical bad debts, customer concentrations, customer credit-worthiness, current economic trends and changes in customer payment terms, when evaluating the adequacy of the allowance for doubtful accounts. Credit evaluations are undertaken for all major sale transactions before shipment is authorized. On a quarterly basis, we evaluate aged items in the accounts receivable aging report and provide allowance in an amount we deem adequate for doubtful accounts. If management were to make different judgments or utilize different estimates, material differences in the amount of our reported operating expenses could result.

Inventory Valuation

We value our inventories at the lower of cost or market with cost determined on a first-in, first-out basis. We assess the valuation of all inventories, including raw materials, work-in-process, finished goods and spare parts, on a periodic basis. We write down obsolete inventory or inventory in excess of our estimated usage to its estimated market value less cost to sell, if less than its cost. We record the inventory write-downs as an inventory valuation allowance established on the basis of obsolete inventory or specific identified inventory in excess of established usage. Inherent in our estimates of market value in determining inventory valuation are estimates related to future demand for our products and technological obsolescence of our products. If actual market conditions are less favorable than our projections, additional inventory write-downs may be required. If we write down the inventory value to its net realizable value and subsequently there is an increased demand for the inventory at a higher value, we do not realize the increased value of the inventory until we sell the inventory either as a component of a system or as separate inventory.

Warranty Liabilities

We net against the warranty expense any cost recoveries from warranties offered to us by our suppliers covering defective components. Warranty costs include labor to repair faulty systems and replacement parts for defective items, as well as other costs incidental to warranty repairs. We sell our products without a right of return or price protection rights. Our standard warranty period for products is typically one year, although in July 2007 we began offering a three year warranty. We also offer extended service warranties. We calculate the liability for product warranties based on estimated future failures and repair costs. We review and update our estimated warranty costs on a quarterly basis.

Accounting for Income Taxes

The determination of our tax provision is subject to judgments and estimates. The carrying value of our net deferred tax assets, which is comprised primarily of future tax deductions, is subject to management judgment as to whether it is more likely than not our deferred tax assets will be realized. In determining whether the realization of these deferred tax assets may be impaired, we evaluate both positive and negative evidence as required in accordance with Financial Accounting Standards Board ("FASB") Statement No. 109. As of January 3, 2009, management has concluded that it is more likely than not that our U.S. deferred tax assets in excess of recoverable income taxes and certain deferred tax liabilities will not be realized and we have therefore, recorded a valuation allowance for such excess U.S. deferred tax assets.

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In the first quarter of 2007, we adopted FASB Interpretation No. 48, “*Accounting for Uncertainty in Income Taxes—an interpretation of SFAS No. 109*” (“FIN 48”), and related guidance. See Note 10 “Income Taxes” in this Form 10-K. As a result of the implementation of FIN 48, we recognize liabilities for uncertain tax positions based on the two-step process prescribed in the interpretation. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step requires us to estimate and measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement with the taxing authorities. We reevaluate these uncertain tax positions on a quarterly basis. This evaluation is based on factors including, but not limited to, changes in facts or circumstances, changes in tax law, effectively settled issues under audit, new audit activity and lapses in the statutes of limitations on assessment. Such a change in recognition or measurement would result in the recognition of a tax benefit or an additional charge to the tax provision in the period that such event occurs.

Share-Based Compensation

We account for our employee stock purchase and stock incentive plans under the provisions of FASB Statement No. 123 (revised 2004), *Share-Based Compensation*, (“SFAS No. 123R”). SFAS No. 123R requires the recognition of the fair value of share-based compensation in net income. The fair values of our unvested stock units are calculated based on the fair value of our common stock at the dates of grant. The fair values of our stock options and employee stock purchase plan awards are estimated using the Black-Scholes option-pricing model, which requires the input of subjective assumptions. These assumptions include estimating the length of time employees will retain their vested stock options before exercising them, the estimated volatility of the our common stock price over the expected term and the number of options that will ultimately not complete their vesting requirements (i.e. forfeitures). Adjustments in the estimated forfeiture rates can have a significant effect on our reported share-based compensation, as we recognize the cumulative effect of the rate adjustments for all expense amortization in the period the estimated forfeiture rates were adjusted.

Recently Adopted Accounting Standards

See Note 2 in our Consolidated Financial Statements in this Form 10-K.

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

Foreign Exchange Risk

We do not make material sales or have material purchase obligations outside of the United States and therefore do not generally have significant exposure to foreign currency exchange risks. As of January 3, 2009 and December 29, 2007, our main exposures to foreign currency risks were related to foreign cash accounts, primarily in Euros and Hong Kong dollars, of \$0.8 million and \$0.7 million, respectively.

Investment Risk

The primary objective of our investment activities is to preserve principal while at the same time maximize the income we receive from our investments without significantly increasing risk. To achieve this objective, we maintain our portfolio of cash, cash equivalents, and investments in a variety of high quality securities, including U.S. treasuries and government agencies, corporate debt, money market funds and commercial paper. Our exposure to market risks for changes in interest rates relates primarily to our investment portfolio. As of January 3, 2009, our cash and cash equivalents consisted of money market funds in the amount of \$144.6 million. Subsequent to January 3, 2009 approximately \$141.0 million of the balance was moved to U.S. Treasury securities. Due to the short term nature of our investment portfolio, we believe that our exposure to interest rate risk is minimal.

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There has been significant deterioration and instability in the financial markets during 2008. This period of extraordinary disruption and readjustment in the financial markets exposes us to additional investment risk. The value and liquidity of the securities in which we invest could deteriorate rapidly and the issuers of such securities could be subject to credit rating downgrades. In light of the current market conditions and these additional risks, we actively monitor market conditions and developments specific to the securities and security classes in which we invest. We believe that we take a conservative approach to investing our funds in that we invest only in highly-rated securities with relatively short maturities and do not invest in securities we believe involve a higher degree of risk. While we believe we take prudent measures to mitigate investment related risks, such risks cannot be fully eliminated as there are circumstances outside of our control. Currently, we believe the current credit market difficulties do not have a material impact on our investment portfolio. However, future degradation in credit market conditions could have a material adverse affect on our financial position.

At January 3, 2009, we held \$8.7 million of long-term investments, consisting of various auction rate municipal bonds and variable rate municipal demand notes (“ARS”), after recording a temporary impairment charge of \$0.4 million. Auction rate securities are securities that are structured with short-term interest rate reset dates of generally less than ninety days but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to thirty-five days, investors can sell or continue to hold the securities at par subject to a successful interest rate reset. In the first and second quarters of fiscal year 2008, certain auction rate securities failed auction due to sell orders exceeding buy orders. Our auction rate securities consist of investments that are backed by pools of student loans ultimately guaranteed by the U.S. Department of Education. We believe that the credit quality of these securities is high based on these guarantees. Based on an analysis of other-than-temporary impairment factors, we recorded a temporary impairment within accumulated other comprehensive loss of approximately \$0.4 million at January 3, 2009 related to these auction rate securities. The Company intends and has the ability to hold these securities until the value of such securities recovers. The funds associated with failed auctions will not be accessible until a successful auction occurs, a buyer is found outside of the auction process, the underlying securities have matured or the securities are recalled by the issuer. Given the recent disruptions in the credit markets and the fact that the liquidity for these types of securities remains uncertain, the Company has classified all of its auction rate securities (\$8.7 million, net of unrealized loss), as long-term investments in our consolidated balance sheet, as our ability to liquidate such securities in the next 12 months is uncertain.

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Item 8. Financial Statements and Supplementary Data

Unaudited Selected Quarterly Consolidated Financial Information

The following tables set forth our unaudited quarterly consolidated statements of operations data for each of the eight quarters in the period ended January 3, 2009. These tables should be read in conjunction with our consolidated financial statements and accompanying notes included in this Annual Report on Form 10-K. We have prepared this unaudited information on the same basis as our audited consolidated financial statements. These tables include all adjustments, consisting only of normal recurring adjustments that we consider necessary for a fair presentation of our operating results for the quarters presented. Operating results for any quarter are not necessarily indicative of results for any subsequent periods.

	Quarter Ended							
	March 31, 2007 (1)	June 30, 2007 (1)	September 29, 2007 (1)	December 29, 2007 (1)	March 29, 2008 (1)	June 28, 2008 (1)	September 27, 2008 (1)	January 3, 2009 (1)
	(Unaudited)							
	(in thousands, except per share data)							
Revenue	\$ 71,435	\$ 81,179	\$ 86,723	\$ 111,347	\$ 67,801	\$ 75,768	\$ 65,097	\$ 38,764
Gross profit (loss)	8,628	(7,628)	18,453	27,791	17,581	6,829	11,038	(6,010)
Income (loss) from operations	(15,065)	(27,695)	350	4,770	651	(10,151)	(5,193)	(19,356)
Income (loss) from continuing operations	(13,261)	(25,662)	2,707	7,167	2,681	(9,305)	(4,503)	(19,784)
Income tax provision (benefit) from continuing operations	(4,240)	14,435	(1,674)	4,010	72	1,454	462	(1,612)
Net (loss) income from continuing operations	(9,021)	(40,097)	4,381	3,157	2,609	(10,759)	(4,965)	(18,172)
Income (loss) from discontinued operations	(2,811)	(3,342)	(3,035)	(24,753)	(3,542)	(19,945)	(1,905)	(504)
Income tax provision (benefit)	(1,675)	(2,991)	1,341	(2,639)	(167)	(2,774)	(881)	867
Net (loss) income from discontinued operations, net of tax	(1,136)	(351)	(4,376)	(22,114)	(3,375)	(17,171)	(1,024)	(1,371)
Net income (loss)	(10,157)	(40,448)	5	(18,957)	(766)	(27,930)	(5,989)	(19,543)
Net income (loss) per share:								
Basic								
Continuing operations	(0.32)	(1.41)	0.15	0.11	0.09	(0.37)	(0.17)	(0.61)
Discontinued operations	(0.04)	(0.01)	(0.15)	(0.76)	(0.12)	(0.58)	(0.03)	(0.05)
Basic net loss per share	<u>\$ (0.36)</u>	<u>\$ (1.42)</u>	<u>\$ —</u>	<u>\$ (0.65)</u>	<u>\$ (0.03)</u>	<u>\$ (0.95)</u>	<u>\$ (0.20)</u>	<u>\$ (0.66)</u>
Diluted								
Continuing operations	(0.32)	(1.41)	0.15	0.11	0.09	(0.37)	(0.17)	(0.61)
Discontinued operations	(0.04)	(0.01)	(0.15)	(0.75)	(0.12)	(0.58)	(0.03)	(0.05)
Diluted net loss per share	<u>\$ (0.36)</u>	<u>\$ (1.42)</u>	<u>\$ —</u>	<u>\$ (0.64)</u>	<u>\$ (0.03)</u>	<u>\$ (0.95)</u>	<u>\$ (0.20)</u>	<u>\$ (0.66)</u>
Shares used in computing net income (loss) per share:								
Basic	<u>28,221</u>	<u>28,564</u>	<u>29,125</u>	<u>29,233</u>	<u>29,352</u>	<u>29,419</u>	<u>29,502</u>	<u>29,790</u>
Diluted	<u>28,221</u>	<u>28,564</u>	<u>29,317</u>	<u>29,470</u>	<u>29,453</u>	<u>29,419</u>	<u>29,502</u>	<u>29,790</u>

(1) Prior year and quarterly information have been restated to present the results of our Rapidscale product line as a discontinued operation. See Note 8 of these consolidated financial statements

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Rackable Systems, Inc.
Fremont, California

We have audited the accompanying consolidated balance sheets of Rackable Systems, Inc. and subsidiaries (the “Company”) as of January 3, 2009 and December 29, 2007, and the related consolidated statements of operations, stockholders’ equity, and cash flows for each of the three years in the period ended January 3, 2009. These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements 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 examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at January 3, 2009 and December 29, 2007, and the results of its operations and its cash flows for each of the three years in the period ended January 3, 2009, in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 2 to the consolidated financial statements, effective December 31, 2006, the Company adopted FASB Interpretation No. 48, “*Accounting for Uncertainty in Income Taxes—an Interpretation of FASB No. 109*.”

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the Company’s internal control over financial reporting as of January 3, 2009, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 18, 2009 expressed an adverse opinion on the Company’s internal control over financial reporting because of a material weakness.

/s/ DELOITTE & TOUCHE LLP

San Jose, California
March 18, 2009

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(In thousands, except per share amounts)

	<u>January 3,</u> <u>2009</u>	<u>December 29,</u> <u>2007</u>
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 171,954	\$ 49,897
Short-term investments	—	148,215
Accounts receivable, net of allowance for doubtful accounts of \$470 and \$434 at January 3, 2009 and December 29, 2007, respectively	27,782	49,957
Inventories	50,051	52,528
Deferred income taxes	—	499
Deferred cost of revenue	10,952	456
Prepays and other current assets	4,872	19,000
Total current assets	<u>265,611</u>	<u>320,552</u>
PROPERTY AND EQUIPMENT, Net	6,941	8,285
LONG-TERM INVESTMENTS	8,664	—
INTANGIBLE ASSETS, Net	3,487	22,732
OTHER ASSETS	790	889
TOTAL ASSETS	<u>\$ 285,493</u>	<u>\$ 352,458</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 21,639	\$ 47,780
Accrued expenses	10,886	16,382
Deferred revenue	16,771	5,190
Total current liabilities	<u>49,296</u>	<u>69,352</u>
DEFERRED INCOME TAXES	812	3,031
DEFERRED RENT AND OTHER LONG-TERM LIABILITIES	1,240	868
DEFERRED REVENUE	2,656	3,089
Total liabilities	<u>54,004</u>	<u>76,340</u>
COMMITMENTS AND CONTINGENCIES (NOTE 12)		
STOCKHOLDERS' EQUITY:		
Preferred stock, \$0.001 par value; 12,000 shares authorized and none outstanding	—	—
Common stock, \$0.001 par value; 120,000 shares authorized; 29,955 and 29,526 shares issued and outstanding at January 3, 2009 and December 29, 2007, respectively	30	29
Additional paid-in capital	450,589	440,725
Accumulated other comprehensive loss	(277)	(11)
Accumulated deficit	(218,853)	(164,625)
Total stockholders' equity	<u>231,489</u>	<u>276,118</u>
Total liabilities and stockholders' equity	<u>\$ 285,493</u>	<u>\$ 352,458</u>

See accompanying notes to consolidated financial statements.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share amounts)

	Year Ended		
	January 3, 2009	December 29, 2007	December 30, 2006
REVENUE	\$247,430	\$ 350,684	\$ 359,569
COST OF REVENUE	217,992	303,440	283,123
GROSS PROFIT	<u>29,438</u>	<u>47,244</u>	<u>76,446</u>
OPERATING EXPENSES			
Research and development	14,864	13,802	11,929
Sales and marketing	23,412	32,461	26,681
General and administrative	24,526	35,801	21,630
Impairment of long-lived assets	—	2,820	—
Restructuring charges	685	—	—
Total operating expenses	<u>63,487</u>	<u>84,884</u>	<u>60,240</u>
INCOME (LOSS) FROM OPERATIONS	(34,049)	(37,640)	16,206
OTHER INCOME—Net:	3,138	8,591	8,300
Income (loss) from continuing operations before income tax provision	(30,911)	(29,049)	24,506
Income tax provision from continuing operations	376	12,531	10,589
Net income (loss) from continuing operations	(31,287)	(41,580)	13,917
Discontinued operations (see note 8):			
Loss from discontinued operations	(25,896)	(33,941)	(4,662)
Income tax benefit	(2,955)	(5,964)	(2,217)
Net loss from discontinued operations, net of tax	<u>(22,941)</u>	<u>(27,977)</u>	<u>(2,445)</u>
NET INCOME (LOSS)	<u>\$ (54,228)</u>	<u>\$ (69,557)</u>	<u>\$ 11,472</u>
NET INCOME (LOSS) PER SHARE			
Basic			
Continuing operations	(1.06)	(1.45)	0.52
Discontinued operations	(0.77)	(0.97)	(0.09)
Basic net income (loss) per share	<u>\$ (1.83)</u>	<u>\$ (2.42)</u>	<u>\$ 0.43</u>
Diluted			
Continuing operations	(1.06)	(1.45)	0.49
Discontinued operations	(0.77)	(0.97)	(0.09)
Diluted net income (loss) per share	<u>\$ (1.83)</u>	<u>\$ (2.42)</u>	<u>\$ 0.40</u>
SHARES USED IN NET INCOME (LOSS) PER SHARE			
Basic	<u>29,583</u>	<u>28,786</u>	<u>26,948</u>
Diluted	<u>29,583</u>	<u>28,786</u>	<u>28,618</u>

See accompanying notes to consolidated financial statements.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(In thousands, except for share amounts)

	Common Stock		Additional Paid-In Capital	Deferred Stock-Based Compensation	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Stockholders' Equity
	Shares	Amount					
BALANCE—December 31, 2005	23,040,449	\$ 23	\$ 231,972	\$ (1,805)	\$ 1	\$ (106,926)	\$ 123,265
Net income	—	—	—	—	—	11,472	11,472
Unrealized gain on short-term investments	—	—	—	—	31	—	31
Cumulative translation adjustment	—	—	—	—	(35)	—	(35)
Total comprehensive income							11,468
Issuance of common stock in connection with a follow on public offering net of issuance costs of \$736	4,230,850	4	138,448	—	—	—	138,452
Issuance of common stock under employee stock option and employee stock purchase plan, net of taxes	839,486	1	6,447	—	—	—	6,448
Restricted common stock grants	120,000	—	—	—	—	—	—
Income tax benefit relating to stock option exercises	—	—	14,971	—	—	—	14,971
Stock-based compensation in connection with employee stock option plans and other	—	—	21,085	—	—	—	21,085
Reversal of deferred stock-based compensation	—	—	(1,805)	1,805	—	—	—
BALANCE—December 30, 2006	28,230,785	\$ 28	\$ 411,118	\$ —	\$ (3)	\$ (95,454)	\$ 315,689
Cumulative effect relating to adoption of FIN 48	—	—	—	—	—	386	386
BALANCE—December 30, 2006	28,230,785	\$ 28	\$ 411,118	\$ —	\$ (3)	\$ (95,068)	\$ 316,075
Net loss	—	—	—	—	—	(69,557)	(69,557)
Unrealized gain on short-term investments	—	—	—	—	16	—	16
Cumulative translation adjustment	—	—	—	—	(24)	—	(24)
Total comprehensive loss							(69,565)
Issuance of common stock under employee stock option and employee stock purchase plan, net of taxes	1,062,012	1	3,907	—	—	—	3,908
Restricted common stock grants	232,764	—	—	—	—	—	—
Income tax benefit relating to stock option exercises	—	—	1,839	—	—	—	1,839
Stock-based compensation in connection with employee stock option plans and other	—	—	23,861	—	—	—	23,861
BALANCE—December 29, 2007	29,525,561	\$ 29	\$ 440,725	\$ —	\$ (11)	\$ (164,625)	\$ 276,118
Net loss	—	—	—	—	—	(54,228)	(54,228)
Unrealized loss on short-term investments	—	—	—	—	(442)	—	(442)
Cumulative translation adjustment	—	—	—	—	176	—	176
Total comprehensive loss							(54,494)
Issuance of common stock under employee stock option and employee stock purchase plan, net of taxes	225,100	1	146	—	—	—	147
Restricted common stock grants	204,683	—	—	—	—	—	—
Stock-based compensation in connection with employee stock option plans and other	—	—	9,718	—	—	—	9,718
BALANCE—January 3, 2009	29,955,344	\$ 30	\$ 450,589	\$ —	\$ (277)	\$ (218,853)	\$ 231,489

See accompanying notes to consolidated financial statements.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year ended		
	January 3, 2009	December 29, 2007	December 30, 2006
CASH FLOWS FROM OPERATING ACTIVITIES:			
Net income (loss)	\$ (54,228)	\$ (69,557)	\$ 11,472
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	5,647	7,473	3,566
Loss on disposal of fixed assets	280	73	—
Impairment of fixed assets	—	107	—
Impairment of long-lived assets	17,519	23,872	—
Impairment of cost method investment	350	—	—
Provision for doubtful accounts receivable	36	105	311
Deferred income taxes	(1,503)	14,495	5,351
Excess tax benefit of stock options exercised	—	(1,639)	(14,971)
Write-off of acquired in-process research and development	—	—	2,840
Stock-based compensation expense	9,587	23,235	20,755
Changes in operating assets and liabilities:			
Accounts receivable	22,139	54,008	(53,833)
Inventories	168	15,042	(27,197)
Prepays and other assets	14,128	(5,919)	(8,889)
Other long term assets	837	—	—
Accounts payable and other payables	(26,153)	(13,853)	32,055
Sales tax payable	(2,136)	—	—
Accrued expenses	(3,104)	(2,563)	11,199
Income taxes payable	114	392	(2,932)
Deferred cost of sales	(10,529)	1,910	6,200
Deferred revenue	11,149	(1,106)	(3,511)
Net cash provided by (used in) operating activities	<u>(15,699)</u>	<u>46,075</u>	<u>(17,584)</u>
CASH FLOWS FROM INVESTING ACTIVITIES:			
Purchases of marketable securities	(26,278)	(584,009)	(547,017)
Proceeds from sales and maturities of marketable securities	165,387	565,836	442,089
Purchases of property and equipment	(1,593)	(4,500)	(3,938)
Terrascale acquisition, net of cash acquired	—	(350)	(31,886)
Expenditures for intangibles	(83)	(9,122)	(152)
Net cash provide by (used in) investing activities	<u>137,433</u>	<u>(32,145)</u>	<u>(140,904)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:			
Proceeds from issuance of common stock upon follow on offering—net of issuance costs	—	—	138,452
Excess tax benefit of stock options exercised	—	1,639	14,971
Repurchase of restricted stock	(1,681)	(617)	—
Proceeds from issuance of common stock upon exercise of stock options	536	2,682	4,906
Proceeds from issuance of common stock upon ESPP purchase	1,293	1,843	1,541
Net cash provided by financing activities	<u>148</u>	<u>5,547</u>	<u>159,870</u>
Effect of exchange rate changes on cash and cash equivalents	175	(26)	(35)
NET INCREASE IN CASH AND CASH EQUIVALENTS	122,057	19,451	1,347
CASH AND CASH EQUIVALENTS—Beginning of period	49,897	30,446	29,099
CASH AND CASH EQUIVALENTS—End of period	<u>\$171,954</u>	<u>\$ 49,897</u>	<u>\$ 30,446</u>
NON CASH INVESTING AND FINANCING ACTIVITIES:			
Unrealized (loss) gain on investments	(442)	16	32
SUPPLEMENTAL DISCLOSURE OF OTHER CASH FLOW INFORMATION:			
Cash paid (refund) for income taxes	178	(68)	6,035

See accompanying notes to consolidated financial statements.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BUSINESS

Rackable Systems, Inc. (“Rackable Systems” or the “Company”) was incorporated in the state of Delaware in December 2002 in connection with the acquisition of substantially all the assets and liabilities of Rackable Systems’ predecessor company referred to herein as Old Rackable. The Company has subsidiaries in Canada, Hong Kong, Ireland and the People’s Republic of China (“PRC”). The Company’s headquarters are located in Fremont, California. The principal business of the Company is the design, manufacture and implementation of highly scalable compute servers and high-capacity storage systems, which are sold to customers such as large internet businesses, and companies in vertical markets such as semiconductor design, enterprise software, federal government, entertainment, financial services, oil and gas, biotechnology and pharmaceuticals.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Fiscal Year. The Company has a 52-week fiscal year ending on the Saturday nearest to December 31, with 13 week quarters ending on the last Saturday of the period. Fiscal 2008 ended on January 3, 2009, fiscal 2007 ended on December 29, 2007 and fiscal 2006 ended on December 30, 2006.

Basis of Consolidation. The consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All material inter-company balances and transactions have been eliminated.

Foreign Currency Transactions. The Company uses the U.S. dollar as its functional currency for its Ireland, Hong Kong and PRC subsidiaries and therefore translation of its financial statements is not required. Currency transaction gains (losses) are recognized in current operations resulting from re-measuring its financial statements at the reporting date. The Company uses the Canadian dollar as its functional currency for its Canada subsidiary. Assets and liabilities denominated in non-U.S. dollars are re-measured into U.S. dollars at the rates of exchange in effect at the balance sheet dates. Revenue and expenses are translated at average exchange rates in effect during each period. Translation adjustments are included in stockholders’ equity in the consolidated balance sheet as a component of accumulated other comprehensive income (loss).

Change in Presentation of Financial Statements. In accordance with Statement of Financial Accounting Standards (“SFAS” or “Statement”) No. 144, “*Accounting for the Impairment or Disposal of Long-lived Assets*”, the Company has accounted for the Rapidscale product line as a discontinued operation. The results of operations of the Rapidscale product line have been reclassified and presented as “discontinued operations, net of tax”, for all periods presented. The cash flows of the Rapidscale product line have not been reported separately within the Company’s Consolidated Statement of Cash Flows.

Use of estimates. The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the amounts reported in the Company’s combined financial statements and accompanying notes. Management bases its estimates on historical experience and various other assumptions believed to be reasonable. Although these estimates are based on management’s best knowledge of current events and actions that may impact us in the future, actual results may be different from the estimates. The Company’s critical accounting policies are those that affect the Company’s financial statements materially and involve difficult, subjective or complex judgments by management which include revenue recognition, valuation of intangible assets and goodwill, allowance for sales returns and doubtful accounts, inventory valuation, warranty liabilities, accounting for income taxes and share-based compensation.

Cash and cash equivalents. The Company classifies highly liquid investments with original maturity of 90 days or less as cash equivalents.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Marketable Securities. The Company accounts for short-term marketable securities in accordance with the Financial Accounting Standards Board (“FASB”), Statement of Financial Accounting Standard (“SFAS”) No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. The Company classifies marketable securities as available-for-sale at the time of purchase and re-evaluates such designation as of each consolidated balance sheet date. Our marketable securities include commercial paper, corporate bonds, government securities and auction rate securities. Auction rate securities are securities that are structured with short-term interest rate reset dates of generally less than ninety days but with contractual maturities that can be well in excess of ten years.

Our marketable securities are reported at fair value with the related unrealized gains and losses included in accumulated other comprehensive income (loss), a component of shareholders’ equity, net of tax. Realized gains or losses on the sale of marketable securities are determined using the specific-identification method and were not material for fiscal 2008, 2007 and 2006. We evaluate our investments periodically for possible other-than-temporary impairment by reviewing factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and our ability and intent to hold the investment for a period of time which may be sufficient for anticipated recovery of market value. We record an impairment charge to the extent that the carrying value of our available for sale securities exceeds the estimated fair market value of the securities and the decline in value is determined to be other-than-temporary.

Effective December 30, 2007, the Company adopted the provisions of SFAS No. 157, *Fair Value Measurements* (“SFAS No. 157”), which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements required under other accounting pronouncements. Issued in February 2008, FSP 157-1 *Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13*, removed leasing transactions accounted for under Statement 13 and related guidance from the scope of SFAS No. 157. FSP 157-2 *Partial Deferral of the Effective Date of Statement 157* (“FSP 157-2”), deferred the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities to fiscal years beginning after November 15, 2008.

SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. SFAS No. 157 also requires that a fair value measurement reflect the assumptions market participants would use in pricing an asset or liability based on the best information available. Assumptions include the risks inherent in a particular valuation technique (such as a pricing model) and/or the risks inherent in the inputs to the model. The adoption of SFAS No.157 did not have a significant impact on our financial statements.

SFAS No.157 establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under SFAS No. 157 are described below:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices in markets that are not active or financial instruments for which all significant inputs are observable, either directly or indirectly; and
- Level 3 - Prices or valuations that require inputs that are both significant to the fair value measurement and unobservable.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Accounts receivable. Accounts receivable are recorded at the invoiced amount and do not bear interest. Our accounts receivable have been reduced by an allowance for doubtful accounts, which is our best estimate of the amount of probable credit losses in our existing accounts receivable. We determine the allowance based on customer specific experience and the aging of our receivables, among other factors.

Inventories. Inventories, consisting primarily of server chassis, hard drives, microprocessors, memory chips, cooling fans and other equipment used in the manufacture of networking servers, are stated at the lower of first-in, first-out cost or market. Cost components include materials, labor and manufacturing overhead costs.

We assess the valuation of our inventory, including demonstration inventory, on a quarterly basis based upon estimates about future demand and actual usage. To the extent that we determine that we are holding excess or obsolete inventory, we write down the value of our inventory to its net realizable value. Such write-downs are reflected in cost of products and can be material in amount. Our inventory assessment involves difficult estimates of future events and, as a result, additional write-downs may be required. If actual market conditions are more favorable than anticipated, inventory previously written down may be sold to customers, resulting in lower cost of products and higher income from operations than expected in that period. Excess and obsolete inventory resulting from shifts in demand or changes in market conditions for raw materials and components can result in significant volatility in our costs of products.

In our inventory valuation analysis, we also include inventory that we could be obligated to purchase from our suppliers based on our production forecasts. To the extent that our committed inventory purchases exceed our forecasted productions needs, we write down the value of those inventories by taking a charge to our cost of products and increasing our supplier liability.

Property and Equipment. Property and equipment are stated at cost and are depreciated on a straight-line basis over their estimated useful lives (generally two to seven years). Leasehold improvements and assets acquired under capital leases are amortized using the straight-line method over the shorter of the estimated useful lives of the respective assets or the lease term. When assets are retired or disposed of, the assets and related accumulated depreciation and amortization are removed from our general ledger and the resulting gain or loss is reflected in the consolidated statement of operations.

Maintenance and repairs are charged to expense as incurred and improvements and betterments that enhance the life of the asset are capitalized. When assets are retired or otherwise disposed of, the cost and accumulated depreciation and amortization are removed.

Restructuring Charges. The Company recognizes restructuring costs resulting from excess manufacturing or administrative facilities that it chooses to close or consolidate, as well as from other exit activities. In connection with the Company's exit activities, the Company records restructuring charges for employee termination costs, long-lived asset impairments, costs related to leased facilities to be abandoned or subleased, and other exit-related costs. These charges are incurred pursuant to formal plans developed and approved by management and accounted for in accordance with SFAS No. 146, "Accounting for Costs Associated with Exit or Disposal Activities", and EITF 95-3, "Recognition of Liabilities in Connection with a Purchase Business Combination". When applicable, employee termination costs are recorded pursuant to SFAS No. 112, "Employer's Accounting for Postemployment Benefits". Pursuant to SFAS No. 112, restructuring costs related to employee severance are recorded when probable and estimable. The recognition of restructuring charges requires the Company's management to make judgments and estimates regarding the nature, timing, and amount of costs associated with the planned exit activity, including estimating sublease income and the fair value, less selling costs, of property, plant and equipment to be disposed of. Estimates of future liabilities may change, requiring the Company to record additional restructuring charges or to reduce the amount of liabilities already recorded. At the

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

end of each reporting period, the Company evaluates the remaining accrued balances to ensure their adequacy, that no excess accruals are retained and that the utilization of the provisions is for the intended purpose in accordance with developed exit plans. In the event circumstances change and the provision is no longer required, the provision is reversed.

Goodwill and intangible assets. In accordance with SFAS No. 142 *Goodwill and Other Intangible Assets*, (“SFAS No. 142”) goodwill is not amortized and is tested for impairment annually or whenever events or changes in circumstances indicate that the carrying value may not be recoverable in accordance with the Company’s policy. The Company has chosen the end of its fiscal month of December as the date of its annual impairment test. In accordance with SFAS No. 142, goodwill is evaluated for impairment at the reporting unit level. The Company considers itself a single reporting unit. The Chief Executive Officer (“CEO”), who is the Company’s chief operating decision maker, monitors the sales of various products. Operations are managed and financial performance is evaluated based upon the sales and production of multiple products employing common manufacturing and research and development resources, sales and administrative support, and facilities. The Company believes that any allocation of such shared expenses to various products would be impractical and arbitrary and it currently does not make such allocations internally.

Intangible assets are carried at cost less accumulated amortization. Amortization is computed using the straight-line method over the economic lives of the respective assets, generally two to seven years.

The process of evaluating the potential impairment of goodwill and other intangibles is highly subjective and requires significant judgment. We estimate expected future cash flows then compare the carrying value including goodwill and other intangibles to the discounted future cash flows. If the total of future cash flows is less than the carrying amount of the assets, we recognize an impairment loss based on the excess of the carrying amount over the fair value of the assets. Estimates of the future cash flows associated with the assets are critical to these assessments. Changes in these estimates based on changed economic conditions or business strategies could result in material impairment charges in future periods.

Impairment of Long-Lived Assets. The Company accounts for its long-lived assets in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (“SFAS No. 144”). The Company evaluates its long-lived assets for indicators of possible impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. An impairment loss would be recognized when estimated undiscounted future cash flows expected to result from the use of an asset and its eventual disposition are less than its carrying amount. Impairment, if any, is measured using discounted cash flows.

Revenue Recognition. The Company accounts for its revenues under the provisions of Staff Accounting Bulletin (“SAB”) No. 104, *Revenue Recognition in Financial Statements* (“SAB No. 104”), FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (“FTB 90-1”) and Statement of Position No. 97-2, *Software Revenue Recognition* (“SOP 97-2”).

Under the provisions of SAB No. 104, the Company recognizes revenues from sales of products, when persuasive evidence of an arrangement exists, shipment has occurred and title has transferred, the sales price is fixed and determinable, collection of the resulting receivable is reasonably assured, and all significant obligations have been met. Generally, this occurs at the time of shipment when risk of loss and title has passed to the customer.

Service revenue includes hardware maintenance and installation. Pursuant to SAB No. 104, the Company recognizes revenue from the sale of its products prior to completion of these services, as the Company’s product

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

sales are not dependent on these services to be functional. Under FTB 90-1, revenue from hardware maintenance contracts, which are sold and invoiced separately, is recognized ratably over the contract term, generally one to three years. Installation services are typically requested by the Company's new customers who have limited history with the products. Installation and related services are usually performed within one day after product delivery.

Where software is integrated with hardware and sold as a hardware appliance the Company provides unspecified software updates and enhancements to the software through service contracts. As a result, the Company accounts for revenue in accordance with SOP 97-2 for transactions involving the sale of software. Revenues earned on software arrangements involving multiple-elements are allocated to each element based on the Vendor Specific Objective Evidence ("VSOE") of fair value. The VSOE of fair value of the undelivered elements (maintenance and support services) is generally determined based on the price charged for the undelivered element when sold separately or renewed. If VSOE cannot be obtained to determine fair value of the undelivered elements, revenue from the entire arrangement would be deferred and recognized as these elements are delivered.

On occasion, when a customer informs the Company that a product is defective, the Company will ship a replacement product at the customer's request prior to the customer returning the defective product for repair. This enables the customer to use the replacement product until the defective product is repaired and returned to the customer. Generally, the Company does not charge for this service unless the customer fails to return the defective product, in which case the customer is billed for the replacement product and revenue is recognized at that time.

Estimated sales returns and warranty costs, based on historical experience, changes in customer demand, and other factors, are recorded at the time product revenue is recognized in accordance with SFAS No. 48, *Revenue Recognition When Right of Return Exists* and SFAS No. 5, *Accounting for Contingencies*, respectively.

Shipping and handling costs. Our shipping and handling costs charged to customers are included in net revenue and the associated expense is recorded in cost of revenue in the consolidated statements of operations for all years presented.

Deferred revenue. Deferred revenue is primarily comprised of extended warranty, revenue deferred for installations yet to be completed, and advanced billing and customer deposits for service, support and maintenance agreements, as well as product revenue for which performance obligations or customer acceptance is required. Deferred revenue is recorded when products or services provided are invoiced prior to the Company's completion of the related performance obligations or customer acceptance. Deferred revenue is not recognized as revenue until the completion of those performance and acceptance criteria. Extended warranty and service support and VSOE deferrals are recognized ratably over the prerequisite service period.

Deferred costs of revenue. Deferred costs of revenue primarily consist of product costs related to revenue deferred in accordance with the Company's revenue recognition policy.

Product Warranty. The Company's warranty period for its products is generally one to three years. The Company accrues for estimated warranty costs concurrent with the recognition of revenue. The initial warranty accrual is based upon the Company's historical experience and is included in accrued expenses and cost of revenue.

Share-based compensation. Effective January 1, 2006, the Company began accounting for its employee stock purchase and stock incentive plans under the provisions of SFAS No. 123 (revised 2004), *Share-Based Compensation*, ("SFAS No. 123R"), using the modified-prospective-transition method. SFAS No. 123R requires

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

the recognition of the fair value of share-based compensation in net income. For grants subsequent to the adoption of SFAS No. 123R, the fair values of the Company's unvested stock units are calculated based on the fair value of the Company's common stock at the dates of grant. The fair values of the Company's stock options and employee stock purchase plan awards are estimated using the Black-Scholes option-pricing model. Share-based compensation expense for awards granted after January 1, 2006, was recorded on a straight-line vesting basis in accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, ("FIN 28") using the multiple-option approach, reduced for estimated forfeitures.

Research and development. Costs related to research, design and development of our products are charged to research and development expense as they are incurred.

Accounting for income taxes. The Company recorded a tax provision for the anticipated tax consequences of the reported results of operations. In accordance with SFAS No. 109, *Accounting for Income Taxes* ("SFAS No. 109"), the provision for income taxes is computed using the asset and liability method, under which deferred tax assets and liabilities are recognized for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities, and for operating losses and tax credit carry-forwards. Deferred tax assets and liabilities are measured using the currently enacted tax rates that apply to taxable income in effect for the years in which those tax assets are expected to be realized or settled.

The Company is required to assess the realization of its net deferred tax assets and the need for a valuation allowance. This assessment requires that management make judgments and assess the weight of positive and negative evidence in accordance with the requirements of SFAS No. 109 for purposes of concluding whether it is more likely than not that the deferred tax assets will be realized. In 2008 and 2007, the Company concluded that it was more likely than not that the U.S. deferred tax assets in excess of recoverable income taxes and certain deferred tax liabilities would not be realized. Accordingly, a valuation allowance was recorded for the excess deferred tax assets.

The effective tax rate varies based on a variety of factors, including overall profitability, the geographical mix of income before taxes and the related tax rates in the jurisdictions where we operate, restructuring and other one-time charges, as well as discrete events, such as settlements of future audits. The Company is subject to audits and examinations of tax returns by tax authorities in various jurisdictions, including the Internal Revenue Service. The Company regularly assesses the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes.

In June 2006, the FASB issued interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* ("FIN 48"). The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation also provides guidance on de-recognition, classification, interest and penalties, accounting for interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006 and was adopted by the Company in the first quarter of fiscal 2007. The cumulative effects of applying FIN 48 was recorded as an adjustment to retained earnings as of the beginning of the period of adoption. The adoption of FIN 48 did not have a material impact on the Company's consolidated results of operations, financial position and cash flows.

Recently Issued Accounting Standards. In December 2007, the FASB issued SFAS No. 141 (revised 2007), *Business Combinations* ("SFAS No. 141(R)"). SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any non-controlling interest in the acquiree and the goodwill acquired. SFAS No. 141(R) also

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008. The Company expects to adopt SFAS No. 141(R) in the beginning of fiscal year 2009 and is currently evaluating the potential impact, if any, of the adoption of SFAS No. 141(R) on its consolidated results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, *Disclosures About Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133* ("SFAS No. 161"). SFAS No. 161 expands quarterly disclosure requirements in SFAS No. 133 about an entity's derivative instruments and hedging activities. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008. The implementation of this standard will not have a material impact on our consolidated results of operations or financial position.

In October 2008, the FASB issued FASB Staff Position (FSP) FAS 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active* ("FSP 157-3"). The FSP clarifies the application of FASB Statement No. 157, Fair Value Measurements, in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The FSP is effective October 10, 2008, and for prior periods for which financial statements have not been issued. The Company has adopted the provisions of FSP 157-3 in its financial statements for the year ended January 3, 2009. The adoption did not have a material impact on the Company's consolidated results of operations or financial position.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

3. BALANCE SHEET

Short-Term and Long-Term Investments

At January 3, 2009 and December 29, 2007, all of the Company's marketable debt securities were classified as available-for-sale and were carried at fair market value. Auction rate securities are securities that are structured with short-term interest rate reset dates of generally less than ninety days but with contractual maturities that can be well in excess of ten years. At the end of each reset period, which occurs every seven to thirty-five days, investors can sell or continue to hold the securities at par subject to a successful interest rate reset.

Beginning in the first and second quarters of fiscal year 2008, certain auction rate securities failed auction due to sell orders exceeding buy orders. Our auction rate securities consist of investments that are backed by pools of student loans ultimately guaranteed by the U.S. Department of Education. We believe that the credit quality of these securities is high based on these guarantees. Based on an analysis of other-than-temporary impairment factors, we recorded a temporary impairment within accumulated other comprehensive loss of approximately \$0.4 million at January 3, 2009 related to these auction rate securities. Given the recent disruptions in the credit markets and the fact that the liquidity for these types of securities remains uncertain, the Company has classified all of its auction rate securities (\$8.7 million, net of unrealized loss), as long-term assets in our condensed consolidated balance sheet, as our ability to liquidate such securities in the next 12 months is uncertain.

The Company utilized the guidance and procedures as provided by SFAS No. 157 in determining the current fair value. The Company also relied on the more recent guidance provided by FSP 157-3 for assessing fair value in inactive markets, such guidance confirms the unchanged measurement objective: to determine the exit price at the balance sheet date for an orderly transaction that is not a forced liquidation or distressed sale. As required, the Company's measurement included appropriate risk adjustments that market participants would make for nonperformance and liquidity risks.

We determined that this decline and duration represents a temporary impairment based on the FASB Staff Position (FSP) FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments ("FSP 115-1/124-1")*.

Among the factors used in this determination were the following:

- The decline in the auction rate securities was not attributable to adverse conditions specifically related to the security or to specific conditions in and industry or geographic area;
- Management possesses both the intent and the ability to hold the security for a period of time sufficient to allow for any anticipated recovery in fair value;
- The financial condition of the issuers has not deteriorated; and
- All scheduled interest payments have been made pursuant to the reset terms and conditions.

Our auction rate securities consist of investments that are backed by pools of student loans, the majority of which are ultimately guaranteed by the U.S. Department of Education. We believe that the credit quality of these securities is high based on these guarantees, minimizing nonperformance risk. The Company has the positive intent and ability to hold these securities until their value recovers, and has not sold any at a loss. The Company's valuation model assumes that a liquidity event will occur within the next 36 months.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The unrealized gains (losses) on available-for-sale securities are recorded in accumulated other comprehensive income (loss). Short- and long-term investments consisted of the following (in thousands):

	Purchase/ Amortized Cost	Gross Unrealized Gain	Gross Unrealized Loss	Aggregate Fair Value
January 3, 2009				
Long-term investments-auction rate securities	9,056	—	(392)	8,664
Total investments	<u>\$ 9,056</u>	<u>\$ —</u>	<u>\$ (392)</u>	<u>\$ 8,664</u>
December 29, 2007				
U.S. notes and bonds	\$ 10,206	\$ 25	\$ —	\$ 10,231
Federal agency notes	50,437	37	—	50,474
Commercial paper	22,969	—	(13)	22,956
Auction rate securities	64,554	—	—	64,554
Total short-term investments	<u>\$ 148,166</u>	<u>\$ 62</u>	<u>\$ (13)</u>	<u>\$ 148,215</u>

Accounts Receivable, net

Accounts receivable from Microsoft, Amazon and Getco accounted for 39%, 27% and 11% of total accounts receivable at January 3, 2009, respectively. Accounts receivable from Microsoft and Facebook accounted for 49% and 18% of total accounts receivable at December 29, 2007, respectively.

Revenue from customers representing 10% or more of total revenue was as follows:

	Year ended		
	January 3, 2009	December 29, 2007	December 30, 2006
Amazon	35%	16%	*
Microsoft	14%	36%	34%
Yahoo	*	12%	26%

* less than 10% of total revenue

A summary of the activity in the reserves relating to doubtful accounts receivable and sales returns is as follows (in thousands):

	Beginning			Ending Balance
	Balance	Additions	Reductions	
Allowance for Doubtful Accounts				
Year ended December 30, 2006	\$ 17	\$ 355	\$ (44)	\$ 328
Year ended December 29, 2007	\$ 328	\$ 299	\$ (193)	\$ 434
Year ended January 3, 2009	\$ 434	\$ 66	\$ (30)	\$ 470
Sales Return Reserve				
Year ended December 30, 2006	\$ 398	\$ 1,040	\$ (1,301)	\$ 137
Year ended December 29, 2007	\$ 137	\$ 1,284	\$ (1,091)	\$ 330
Year ended January 3, 2009	\$ 330	\$ 169	\$ (250)	\$ 249

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Inventories

Inventories consist of the following (in thousands):

	January 3, 2009	December 29, 2007
Finished goods	\$ 11,438	\$ 5,820
Work in process	771	16,385
Raw materials	37,842	30,323
Total inventories	<u>\$ 50,051</u>	<u>\$ 52,528</u>

Prepaid and other current assets (in thousands)

	January 3, 2009	December 29, 2007
Prepaid taxes	\$ 3,442	\$ 8,845
Other prepaid expenses	1,430	10,155
Total prepaid and other current assets	<u>\$ 4,872</u>	<u>\$ 19,000</u>

Property and Equipment, net

Property and equipment consists of the following (in thousands):

	January 3, 2009	December 29, 2007
Leasehold improvements	\$ 2,160	\$ 1,484
Manufacturing equipment	4,490	3,303
Furniture and fixtures	911	1,127
Computer equipment	7,600	6,858
Construction in progress	78	362
Vehicles	104	118
	<u>15,343</u>	<u>13,252</u>
Less accumulated depreciation	<u>(8,402)</u>	<u>(4,967)</u>
Total property and equipment, net	<u>\$ 6,941</u>	<u>\$ 8,285</u>

Depreciation of property and equipment for the years ended January 3, 2009, December 29, 2007 and December 30, 2006 was, \$3.2 million, \$3.0 million, and \$1.3 million, respectively.

Goodwill

Goodwill consisted of the excess cost related to the acquisition of Old Rackable in December 2002 and Terrascale in September 2006, as follows (in thousands):

As of December 30, 2006	\$ 22,871
Additions	1,001
Impairment	(23,872)
As of December 29, 2007	<u>\$ —</u>

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In the year ended December 29, 2007, the Company recorded an increase to goodwill related to the Terrascale acquisition totaling \$1.0 million. In the fourth quarter of 2007, pursuant to the Company's accounting policy, the Company performed the annual goodwill impairment analysis. The goodwill impairment test is a two-step process. The first step of the impairment analysis compares our fair value to our net book value. In determining fair value, the accounting guidance allows for the use of several valuation methodologies, although it states quoted market prices are the best evidence of fair value. Due to the decline of our market capitalization in December 2007, primarily as a result of tax attributes based on quoted market prices, the fair value was less than the net book value. If this occurs, the second step of the goodwill impairment analysis is conducted. The second step of the analysis compares the implied fair value of our goodwill to its carrying amount. If the carrying amount of goodwill exceeds its implied fair value, we recognize an impairment loss equal to that excess amount. The determination of the fair value of the goodwill is determined by valuing all of our other tangible and intangible assets and using a residual approach to determine the fair value of goodwill. As a result of this analysis, the Company concluded that the carrying amounts of goodwill exceeded their implied fair values and recorded an impairment loss of approximately \$23.9 million. Of the \$23.9 million impairment charge recorded in 2007, \$21.1 million relates to the Rapidscale product line and has been presented in the statement of operations as well as in note 8 as part of discontinued operations.

Intangible Assets, net

Intangible assets are recorded at cost, less accumulated amortization. The following tables present details of the Company's intangible assets as of January 3, 2009 and December 29, 2007, (dollars in thousands):

	Useful Life		Accumulated	
	(Years)	Gross	Amortization	Net
As of January 3, 2009				
Rackable Systems				
Patents	5.00	\$ 4,948	\$ 4,948	\$ —
Other intangibles	3.00	41	41	—
		<u>4,989</u>	<u>4,989</u>	<u>—</u>
Tradenname		<u>\$ 3,487</u>	<u>—</u>	<u>\$ 3,487</u>
As of December 29, 2007				
Rackable Systems				
Patents	5.00	\$ 4,891	\$ 4,626	\$ 265
Other intangibles	3.00	41	33	8
		<u>4,932</u>	<u>4,659</u>	<u>273</u>
Terrascale Acquisition				
Existing technology	7.00	8,256	1,540	6,716
Distributed Parity Engine "DPE"	7.00	13,097	1,404	11,693
Customer relationships	4.00	633	207	426
Maintenance contracts	6.00	35	8	27
Non-compete agreements	2.00	319	209	110
		<u>22,340</u>	<u>3,368</u>	<u>18,972</u>
Tradenname		<u>3,487</u>	<u>—</u>	<u>3,487</u>
Total		<u>\$30,759</u>	<u>\$ 8,027</u>	<u>\$22,732</u>

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RACKABLE SYSTEMS, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

In December 2002, as a part of the acquisition of Old Rackable, the Company also recorded an intangible asset allocated to tradename in the amount of \$3.5 million. This intangible asset is not amortizable.

Long-lived intangible assets with determinable economic life are tested for recoverability whenever events or circumstances indicate that their carrying amounts may not be recoverable. We determined that long-lived intangible assets were not impaired at December 29, 2007 and December 30, 2006. For the year ended January 3, 2009, an impairment charge of \$17.5 million was recognized and charged to discontinued operations as described in Note 8.

In the year ended January 3, 2009, December 29, 2007 and December 30, 2006 amortization of intangible assets was \$2.4 million, \$4.4 million and \$2.2 million respectively. Amortization is computed using the straight-line method over the estimated useful life of the intangible asset.

Warranty Accrual

The changes in our warranty accrual for the years fiscal years ended 2008, 2007 and 2006 are as follows (in thousands):

	January 3, 2009	December 29, 2007	December 30, 2006
Balance—beginning of period	\$ 2,038	\$ 868	\$ 726
Current period accrual	1,540	3,117	2,088
Warranty expenditures charged to accrual	(789)	(1,947)	(1,946)
Balance—end of period	<u>\$ 2,789</u>	<u>\$ 2,038</u>	<u>\$ 868</u>

Accrued Expenses

Accrued expenses consist of the following (in thousands):

	January 3, 2009	December 29, 2007
Accrued payroll and related expenses	\$ 3,074	\$ 5,754
Accrued warranty	2,789	2,038
Accrued sales and use tax	1,951	3,828
Accrued commission	660	2,137
Other accrued expenses	2,412	2,625
Total accrued expenses	<u>\$ 10,886</u>	<u>\$ 16,382</u>

During 2007, the Company made payments for sale and use tax of \$11.7 million to various states and the State of California, and accrued an additional \$2.6 million. The additional accrual was a result of additional information received from customers during the year relating to the tax disposition of their transactions with the Company in the various states and California.

Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss consists of the following (in thousands):

	Accumulated Other Comprehensive Loss
Unrealized loss on investments	\$ (392)
Cumulative translation adjustment	115
January 3, 2009	<u>\$ (277)</u>

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

4. RESTRUCTURING CHARGES

The Company incurred restructuring charges of \$0.7 million for the year ended January 3, 2009 related to future lease commitments for excess facilities vacated during the quarter ended June 28, 2008. There were no such charges in any other periods. These charges were paid in full in fiscal year 2008.

5. EARNINGS PER SHARE

In accordance with SFAS No. 128, *Earnings Per Share*, basic net income (loss) per common share has been computed by using the weighted average number of shares of common stock outstanding during the period, less the shares subject to repurchase. The following table sets forth the computation of basic and diluted net income (loss) per share (in thousands, except share and per share data):

	<u>January 3, 2009</u>	<u>Year ended December 29, 2007</u>	<u>December 30, 2006</u>
Numerators:			
Income (loss) from continuing operations	\$ (31,287)	\$ (41,580)	\$ 13,917
Loss from discontinued operations, net of tax	(22,941)	(27,977)	(2,445)
Net income (loss)	<u>\$ (54,228)</u>	<u>\$ (69,557)</u>	<u>\$ 11,472</u>
Denominators:			
Weighted-average common shares outstanding	29,582,961	28,785,807	26,987,778
Unvested common shares subject to repurchase	—	—	(39,890)
Weighted-average shares—Basic	29,582,961	28,785,807	26,947,888
Common stock equivalents	—	—	1,670,421
Weighted-average shares—Diluted	<u>29,582,961</u>	<u>28,785,807</u>	<u>28,618,309</u>
Basic net income (loss) per common share from:			
Continuing operations	\$ (1.06)	\$ (1.45)	\$ 0.52
Discontinued operations	\$ (0.77)	\$ (0.97)	\$ (0.09)
Net income (loss)	\$ (1.83)	\$ (2.42)	\$ 0.43
Diluted net income (loss) per common share from:			
Continuing operations	\$ (1.06)	\$ (1.45)	\$ 0.49
Discontinued operations	\$ (0.77)	\$ (0.97)	\$ (0.09)
Net income (loss)	\$ (1.83)	\$ (2.42)	\$ 0.40

For the year ended January 3, 2009, December 29, 2007 and December 30, 2006 the Company had stock options outstanding which could potentially dilute basic earnings per share in the future, but the incremental shares from the assumed exercise of these stock options were excluded in the computation of diluted net loss per share, as their effect would have been anti-dilutive. The number of such outstanding stock options consisted of the following:

	<u>January 3, 2009</u>	<u>Year ended December 29, 2007</u>	<u>December 30, 2006</u>
Stock options	<u>3,205,373</u>	<u>2,892,480</u>	<u>1,257,796</u>

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

6. SHARE BASED COMPENSATION

Share-Based Benefit Plans

In 2005, the Company's Board of Directors adopted and its stockholders approved the Company's 2005 Equity Incentive Plan (the "2005 Plan"), 2005 Non-Employee Directors' Stock Option Plan and 2005 Employee Stock Purchase Plan (the "2005 ESPP"). The aggregate number of shares of common stock authorized for grant under each plan is 4,592,938, 121,412 and 722,564 shares, respectively. Each plan contains a provision that automatically increases the number of shares of common stock reserved for issuance on January 1 of each year. During the year ended January 3, 2009 the number of stock options authorized for issuance under each Plan was increased by 1,180,516, 16,581 and 282,796, respectively.

Rackable Systems adopted the 2006 New Recruit Equity Incentive Plan (the "2006 Plan") in January 2006 which allows the Company to grant non-statutory stock awards for up to 1,000,000 shares of common stock. The aggregate number of shares of common stock authorized for grant under the 2006 Plan is 1,971,270. The total shares of common stock reserved for the 2006 Plan was increased by 500,000 shares in August 2006 and by another 500,000 shares in January 2007 with no increase in 2008. Terrascale options were converted into options to purchase 30,419 shares of Rackable common stock at \$5.86 per share and were issued from the 2006 Plan, in September 2006. The 2006 Plan provides for the grant of the following stock awards: (i) non-statutory stock options, (ii) stock purchase awards, (iii) stock bonus awards, (iv) stock appreciation rights, (v) stock unit awards, and (vi) other stock awards. The exercise price of each non-statutory stock option shall be not less than one hundred percent (100%) of the fair market value of the common stock subject to the option on the date the option is granted. Stock awards expire ten years from the date of grant, or such shorter period specified in the option agreement. The options generally vest at a rate of 25% per year over four years from the date the option is granted. The Company issues new shares of its common stock upon exercise of stock options, issuance of restricted stock awards ("RSA"), restricted stock units ("RSU") and issuance of shares purchased under its 2005 ESPP. RSAs differ from RSUs in that RSAs result in issuance of common stock with all rights upon grant, with the exception of the ability to sell the common stock. Among those rights, are rights to vote and to receive dividends RSAs are included in shares outstanding at issuance. Common stock to be issued for grants of RSUs are not issued until the RSU vests and do not have rights of voting or to receive dividends.

In connection with the stock options granted to employees under the 2002 Stock Option Plan (the "2002 Plan"), Rackable Systems recorded cumulative deferred share-based compensation which represents the difference between the option exercise price and the deemed fair market value of the common stock determined for financial reporting purposes on the grant date. The unamortized balance of \$1.8 million at December 30, 2005 was offset against additional paid in capital in the first fiscal quarter of 2006 with the adoption of SFAS No. 123R.

Adoption of SFAS 123R

On January 1, 2006, the Company adopted the provisions of SFAS 123R requiring the Company to recognize expenses related to the fair value of the Company's share-based compensation awards. The Company elected to use the modified prospective application method. Under this method, SFAS 123R is applied to new awards and to awards modified, repurchased, or cancelled after the effective date. Additionally, compensation cost for the portion of awards for which the requisite service has not been rendered (such as unvested options) that was outstanding as of the date of adoption shall be recognized as the remaining requisite services are rendered. The compensation cost relating to unvested awards at the date of adoption is based on the grant-date fair value of those awards as calculated for pro forma disclosures under the original SFAS 123. Additionally, under SFAS 123R, the 2005 ESPP is considered a compensatory plan, which requires the recognition of compensation cost for grants made under the ESPP. The Company recognizes compensation expense for all

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

share-based payment awards over the requisite service period for each separately vesting portion of the award as if the awards were, in-substance, multiple awards. As required by SFAS 123R, management made an estimate of expected forfeitures and is recognizing compensation costs only for those equity awards expected to vest.

Tender Offer

On June 11, 2007, the Company filed a tender offer on Schedule TO (“Tender Offer”) with the SEC under which holders of options with exercise prices greater than \$16.00 per share could tender their options in exchange for restricted stock unit awards granted under the 2005 Equity Incentive Plan based upon the following exchange ratios:

<u>Exercise Price Range</u>	<u>Stock Options Shares per Restricted Stock Unit</u>
\$16.00 - \$24.99	2 to 1
\$25.00 - \$34.99	3 to 1
\$35.00 and above	3.5 to 1

The restricted stock unit awards are subject to vesting in equal quarterly installments through August 15, 2009 (if the grant date of the option being tendered was prior to October 1, 2006) or August 15, 2010 (if the grant date of the option being tendered was after October 1, 2006). The tender offer provided that the option holder could and must submit their election to participate in the tender offer no later than July 10, 2007, and could amend their election up to that date. Furthermore, this tender offer was not available to the Company’s then current directors or named executive officers and the Company could at its sole discretion amend, extend or withdraw the tender offer at any time prior to closing.

The Company completed the Tender Offer on July 10, 2007. As a result, the Company accepted for exchange options to purchase an aggregate of 2,238,883 shares of the Company’s common stock from 187 eligible participants, representing 87% of the shares subject to options that were eligible to be exchanged in the Offer to Exchange as of May 31, 2007. Upon the terms and subject to the conditions set forth in the Tender Offer to Exchange, the Company issued restricted stock unit awards covering an aggregate of 893,828 shares of the Company’s common stock in exchange for the options surrendered pursuant to the Tender Offer to Exchange.

The fair value of the restricted stock unit awards was measured as the total of the unrecognized compensation cost of the original options tendered and the incremental compensation cost of the restricted stock unit awards on July 10, 2007, the date of cancellation. The incremental compensation cost was measured as the excess of the fair value of the restricted stock unit awards over the fair value of the options immediately before cancellation based on the share price and other pertinent factors at that date. The incremental cost of the 893,828 restricted stock unit awards was approximately \$145,000. The unrecognized compensation costs of the 2,238,883 options cancelled were \$17.1 million. The total fair value of the restricted stock unit awards on July 10, 2007 was \$17.2 million and these costs will be amortized over the service period of the restricted stock unit awards. The service period of the restricted stock unit awards is longer than the service period of the options tendered.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Determining Fair Value

The fair value of share-based awards was estimated using the Black-Scholes model with the following weighted-average assumptions for the years ended January 3, 2009, December 29, 2007 and December 30, 2006, respectively.

	Year Ended		
	January 3, 2009	December 29, 2007	December 30, 2006
Option Plan Shares			
Risk-free interest rate	2.9%	4.6%	4.8%
Volatility	59%	60%	60%
Weighted average expected life (in years)	5.2	5.41	5.61
Weighted average fair value	\$ 5.30	\$ 9.04	\$ 18.78
ESPP shares			
Risk-free interest rate	2.2%	4.5%	4.9%
Volatility	50.0%	50.0%	54.0%
Weighted average expected life (in years)	1.25	1.25	1.25
Weighted average fair value	\$ 3.82	\$ 4.97	\$ 11.02

The computation of expected life for the year ended January 3, 2009 is based on an analysis of the relevant industry sector post-vest termination rates and the exercise factors. The expected volatility is based on a combination of the implied and historical volatility for both the Company and its peer group. The interest rate is based on the implied yield currently available on U.S. Treasury zero-coupon issues with an equivalent remaining term. Where the expected term of the Company's share-based awards do not correspond with the terms for which interest rates are quoted, the Company performed a straight-line interpolation to determine the rate from the available term maturities. As stock-based compensation expense recognized in the consolidated statements of income during the years ended January 3, 2009, December 29, 2007 and December 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimated.

Stock Based Compensation

The following table summarizes stock-based compensation charges (in thousands):

	Year ended		
	January 3, 2009	December 29, 2007	December 30, 2006
Cost of revenue	\$ 1,120	\$ 2,152	\$ 3,583
Research and development	1,811	3,160	4,480
Selling and marketing	1,568	5,040	6,087
General and administrative	4,653	10,731	5,858
Total continuing operations	9,152	21,083	20,008
Discontinued operations	435	2,152	747
Total	\$ 9,587	\$ 23,235	\$ 20,755

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Stock Options and Restricted Stock Awards Activity

A summary of stock option activity as of January 3, 2009 is as follows:

	Shares Available for Future Grants	Outstanding Options			Aggregate Intrinsic Value
		Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual term in years	
Balance at December 31, 2005	333,211	3,505,978	\$ 7.30		
Additional shares authorized for grant	2,688,041	—	—		
Options granted (weighted average fair value of \$18.78 per share)	(2,638,917)	2,638,917	32.03		
Restricted awards granted	(120,000)	—	—		
Options exercised	—	(1,191,200)	4.77		
Options cancelled	182,224	(182,224)	28.82		
Balance at December 30, 2006	444,559	4,771,471	20.78		
Additional shares authorized for grant	1,667,395	—	—		
Options granted (weighted average fair value of \$9.04 per share)	(3,410,081)	3,410,081	15.87		
Restricted awards granted	(1,339,993)	—	—		
Options exercised	—	(895,178)	3.00		
Options cancelled	4,393,894	(4,393,894)	25.63		
Restricted awards cancelled	265,925	—	—		
Restricted awards forfeited for taxes	53,915	—	—		
Balance at December 29, 2007	2,075,614	2,892,480	13.13		
Additional shares authorized for grant	1,197,097	—	—		
Options granted (weighted average fair value of \$5.30 per share)	(1,158,873)	1,158,873	9.83		
Restricted awards granted	(1,137,600)	—	—		
Options exercised	—	(75,884)	7.06		
Options cancelled	770,096	(770,096)	12.45		
Restricted awards cancelled	515,903	—	—		
Restricted awards forfeited for taxes	174,225	—	—		
Balance at January 3, 2009	<u>2,436,462</u>	<u>3,205,373</u>	<u>\$ 12.24</u>	7.63	\$80,127
Vested and expected to vest at January 3, 2009		<u>2,752,192</u>	<u>\$ 12.36</u>	7.55	\$75,831
Exercisable at January 3, 2009		<u>1,116,793</u>	<u>\$ 12.91</u>	6.8	\$65,126

The total intrinsic value of options exercised for the fiscal years ended January 3, 2009, December 29, 2007, and December 30, 2006 was \$0.4 million, \$10.1 million and \$37.2 million respectively.

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RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

As of January 3, 2009, there was \$7.4 million of total unrecognized compensation cost related to non-vested stock options. That cost is expected to be recognized over a weighted average period of 1.4 years.

Exercise Price Range	Options Outstanding			Options Exercisable	
	Number of Outstanding Options	Weighted Average Remaining Contractual Life (In Years)	Weighted Average Exercise Price	Number of Options Exercisable	Weighted Average Exercise Price
\$ 0.71-\$ 8.35	386,473		\$ 6.13	129,358	\$ 4.89
\$ 8.98-\$ 9.68	328,000		\$ 9.39	1,875	\$ 8.98
\$ 9.75-\$11.40	385,033		\$ 10.68	63,062	\$ 10.51
\$11.61-\$12.18	334,773		\$ 11.95	155,594	\$ 11.96
\$12.20-\$12.82	407,180		\$ 12.74	221,347	\$ 12.79
\$13.15-\$13.15	63,000		\$ 13.15	18,578	\$ 13.15
\$13.23-\$13.23	700,000		\$ 13.23	291,666	\$ 13.23
\$13.44-\$14.15	374,373		\$ 13.97	93,846	\$ 14.10
\$14.41-\$37.91	224,541		\$ 22.61	140,135	\$ 20.81
\$48.24-\$48.24	2,000		\$ 48.24	1,332	\$ 48.24
\$ 0.71-\$48.24	3,205,373	7.63	\$ 12.24	1,116,793	\$ 12.91

The following table summarizes the Company's restricted stock awards ("RSA") activity for the years ended January 3, 2009, December 29, 2007 and December 30, 2006:

	Weighted Average Grant Date	
	Number of Shares	Fair Value
Balance at December 31, 2005	—	\$ —
Awarded	120,000	27.36
Balance at December 30, 2006	120,000	27.36
Awarded	343,040	17.03
Released	(69,128)	18.82
Forfeited	(154,378)	25.82
Balance at December 29, 2007	239,534	16.03
Released	(59,531)	15.28
Forfeited	(51,877)	20.03
Balance at January 3, 2009	128,126	\$ 14.75

As of January 3, 2009, there was \$2.5 million of total unrecognized compensation cost related to RSA. That cost is expected to be recognized over a weighted average period of 2.25 years.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table summarizes the Company’s restricted stock units (“RSU”) activity for the year ended January 3, 2009:

	Shares	Weighted Average Remaining Contractual term in years	Aggregate Intrinsic Value
Balance at December 29, 2007	801,164		
Awarded	1,137,600		
Released	(430,953)		
Forfeited	(464,026)		
Balance at January 3, 2009	<u>1,043,785</u>	1.44	\$4,289,956
Vested and expected to vest at January 3, 2009	<u>810,231</u>	1.27	\$3,330,050

As of January 3, 2009, there was \$9.7 million of total unrecognized compensation cost related to RSU’s. That cost is expected to be recognized over a weighted average period of 2.8 years.

During the fiscal year end January 3, 2009, December 29, 2007 and December 30, 2006, the weighted average grant date fair value per share for restricted stock awards and units was \$8.86, \$18.22 and \$27.36 respectively.

During the fiscal year ended January 3, 2009, 174,225 shares of RSA’s and RSU’s were delivered to the Company in payment of \$1.7 million withholding tax obligations arising from the release of RSA’s and RSU’s. The withholding tax obligations were based upon the fair market value of the Company’s common stock on the vesting date.

As of January 3, 2009, the total compensation cost related to options to purchase the Company’s common stock under the 2005 ESPP but not yet recognized was approximately \$0.3 million. This cost will be amortized on a straight-line basis over periods of up to 1.25 years.

The following table shows the shares issued, and their respective weighted-average purchase price per share, pursuant to the 2005 ESPP during the twelve months ended January 3, 2009 and December 29, 2007.

	January 3, 2009	December 29, 2007
Shares issued	<u>162,823</u>	<u>166,834</u>
Weighted-average purchase price per share	\$ 7.94	\$ 11.04

The Company has reserved the following shares of authorized but un-issued common stock as of January 3, 2009:

Options available for grant under stock option plans	2,436,462
Employee stock purchase plan	722,564
Shares reserved and available for future grants	<u>3,159,026</u>
Restricted stock units issued and outstanding	1,043,785
Options issued and outstanding under stock option plans	<u>3,205,373</u>
Total	<u>7,408,184</u>

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

7. EMPLOYEE BENEFIT PLANS

Defined Contribution Plans —Effective September 1, 2003, Rackable Systems established a 401(k) retirement plan covering substantially all employees. The plan provides for voluntary salary reduction contributions up to the maximum allowed under Internal Revenue Service rules. The Company can make annual contributions to the plan at the discretion of the Board of Directors. The Company contributed \$0.2 million and \$0.1 million for the year ended January 3, 2009 and December 29, 2007 respectively. There were no contributions for the year ended December 30, 2006.

8. DISCONTINUED OPERATIONS

In October 2008, the Company committed to a formal plan to abandon the Rapidscale product line which was reviewed and approved by management with appropriate authority, and was communicated to the affected employees. The Company will continue to honor service contracts with existing Rapidscale customers but had no other significant continuing involvement in the operations of the Rapidscale product line subsequent to the abandonment.

In accordance with SFAS No. 144, the abandonment of the Rapidscale product line qualifies as a discontinued operation. Accordingly, the results of operations of the Rapidscale product line have been reclassified and included in “discontinued operations, net of tax”, within the Consolidated Statements of Operations for the fiscal years ended January 3, 2009, December 29, 2007 and December 30, 2006 respectively.

Results of discontinued operations (in thousands):

	January 3, 2009	December 29, 2007	December 30, 2006
Revenue	\$ 730	\$ 2,471	\$ 807
Cost of revenue	133	743	277
Gross profit	597	1,728	530
Operating expenses			
Research and Development	8,436	12,480	4,555
Sales and marketing	60	1,784	371
General and administrative	251	351	263
Impairment of long-lived assets	17,519	21,051	—
Total operating expenses	26,266	35,666	5,189
Loss from discontinued operations	(25,669)	(33,938)	(4,659)
Other expense, net	(227)	(3)	(3)
Loss from discontinued operations before taxes	(25,896)	(33,941)	(4,662)
Benefit from income taxes	(2,955)	(5,964)	(2,217)
Net loss from discontinued operations, net of tax	<u>\$ (22,941)</u>	<u>\$ (27,977)</u>	<u>\$ (2,445)</u>

9. DEFERRED REVENUE AND DEFERRED COST OF GOODS SOLD

At January 3, 2009, the Company had total deferred revenue of \$19.4 million; this deferred revenue includes product revenue of \$12.2 million. These product deferrals are related to shipments to customers pending acceptance or deferrals related to sales which did not qualify for immediate revenue recognition. The remaining deferred revenue of \$7.2 million pertains to revenue from maintenance and extended warranty arrangements that

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

are recognized ratably over the contract period and professional support services which had not been completed as of the balance sheet date. Deferred product costs associated with deferred revenue were \$11 million at January 3, 2009.

At December 29, 2007, the Company had total deferred revenue of \$8.3 million, this deferred revenue includes product revenue of \$1.1 million. These product deferrals are related to shipments to customers pending acceptance or deferrals related to sales which did not qualify for immediate revenue recognition. The remaining deferred revenue of \$7.2 million pertains to revenue from maintenance and extended warranty arrangements that are recognized ratably over the contract period and professional support services which had not been completed as of the balance sheet date. Deferred product costs associated with deferred revenue were \$0.5 million at December 29, 2007.

10. ENTERPRISE AND RELATED GEOGRAPHIC INFORMATION

The Company is managed by its executive officers in Fremont, California. The Company's chief operating decision maker is the Chief Executive Officer ("CEO"). Based on the financial information reviewed by the CEO, the Company has determined that it operates in a single reportable segment. Revenue from both domestic and international customers (based on the address of the customer on the invoice) was as follows (in thousands):

	Year Ended		
	January 3, 2009	December 29, 2007	December 30, 2006
Domestic revenue	\$227,141	\$ 330,958	\$ 327,627
International revenue	20,289	19,726	31,942
Total revenue	<u>\$247,430</u>	<u>\$ 350,684</u>	<u>\$ 359,569</u>

Sales revenues for high-density compute servers and high-capacity storage systems for the years ended January 3, 2009, December 29, 2007 and December 30, 2006 were as follows (in thousands):

	Year Ended		
	January 3, 2009	December 29, 2007	December 30, 2006
Compute servers	\$210,831	\$ 322,926	\$ 325,537
Storage systems	36,599	27,758	34,032
Total revenue	<u>\$247,430</u>	<u>\$ 350,684</u>	<u>\$ 359,569</u>

Over 86% and 90% of the Company's property, plant and equipment were located in the US for the years ended January 3, 2009 and December 29, 2007 respectively.

11. INCOME TAXES

Income (loss) from continuing operations before income taxes consisted of the following (in thousands):

	January 3,	December 29,	December 30,
	2009	2007	2006
Domestic	\$(30,522)	\$ (29,096)	\$ 22,127
Foreign	(389)	47	2,379
Total	<u>\$(30,911)</u>	<u>\$ (29,049)</u>	<u>\$ 24,506</u>

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The income tax provisions from continuing operations for the years ended January 3, 2009, December 29, 2007 and December 30, 2006 consisted of the following in (thousands):

	January 3, 2009	December 29, 2007	December 30, 2006
Current:			
Federal	\$ (1,222)	\$ (2,446)	\$ 15,138
State	(4)	(32)	3,230
Foreign	74	8	94
Total	\$ (1,152)	\$ (2,470)	\$ 18,462
Deferred:			
Federal	\$ 1,539	\$ 13,167	\$ (6,978)
State	(11)	1,834	(895)
Foreign	—	—	—
Total	\$ 1,528	\$ 15,001	\$ (7,873)
Total provision for income taxes from continuing operations	\$ 376	\$ 12,531	\$ 10,589

Current tax provision (benefit) in 2007 and 2006 includes \$1.8 million and \$15 million respectively, of tax benefits from stock options and other employee incentive plan awards which has been recorded to additional paid-in capital.

The following table provides a reconciliation of statutory income tax rate for the years ended January 3, 2009, December 29, 2007 and December 30, 2006:

	January 3, 2009	December 29, 2007	December 30, 2006
Federal statutory rate provision (benefit)	35%	35%	35%
Stock based compensation	—	(4)%	1%
State tax, net of federal tax benefit	2%	3%	5%
Goodwill impairment	—	(3)%	—
Valuation allowance	(35)%	(77)%	—
Other	(3)%	3%	2%
	<u>(1)%</u>	<u>(43)%</u>	<u>43%</u>

The Company accounts for income taxes using an asset and liability approach. Deferred income tax assets and liabilities result from temporary differences between the tax basis of assets and liabilities and their reported amounts in the financial statements that will result in taxable or deductible amounts in future years valuation allowances are provided when necessary to reduce deferred tax assets to the amount expected to be realized.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

Significant components of the deferred tax assets and liabilities at January 3, 2009 and December 29, 2007, were as follows (in thousands):

	January 3, 2009	December 29, 2007
Deferred tax assets		
Inventories	\$ 11,942	\$ 5,522
Accrued expenses and reserves	1,938	3,241
Deferred revenue	1,478	316
Deferred rent	465	346
Stock based compensation	13,041	12,894
Purchase accounting	—	11,136
Intangible assets	13,426	—
Depreciation	575	—
Net operating losses and tax credit carryforwards	7,711	3,260
Other	365	148
Valuation allowance	(50,941)	(31,552)
Total deferred tax assets	—	5,311
Deferred tax liabilities		
Intangible assets	(812)	(7,300)
Deferred expenses	—	(184)
Depreciation	—	(140)
Other	—	(2)
Total deferred tax liabilities	(812)	(7,626)
Net deferred tax liabilities	<u>\$ (812)</u>	<u>\$ (2,315)</u>

Classified in the Consolidated Balance Sheet as follows (in thousands):

	January 3, 2009	December 29, 2007
Current deferred income taxes	\$ —	\$ 499
Non-current other assets	—	217
Non-current deferred income taxes	(812)	(3,031)
Net deferred tax assets (liabilities)	<u>\$ (812)</u>	<u>\$ (2,315)</u>

The valuation allowance for deferred tax assets increased from \$31.6 million in 2007 to \$50.9 million in 2008. There was no valuation allowance in 2006. The valuation allowance was recorded in 2008 and 2007 based on management's judgment that it was more likely than not that deferred tax assets in excess of recoverable income taxes and certain deferred tax liabilities would not be realized. The non-current deferred tax liability relates to deferred taxes for indefinite-lived intangibles.

As of January 3, 2009, the Company has federal, state and foreign tax net operating loss carry forwards and foreign research credit carryovers of \$12.6 million, \$22.8 million, \$4.3 million and \$0.5 million, respectively. If not utilized, the federal NOL carryforward will begin to expire in 2028. If not utilized, certain of the state and foreign net operating loss carry forwards start to expire in 2012 and 2009, respectively, and the foreign research credit carry forwards start to expire in 2016. Approximately \$0.6 million and \$4.9 million of the federal and state

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

tax net operating loss carry forwards are attributable to excess tax benefits associated with stock option and other equity plans, the benefit of which will be credited to additional paid-in capital when and if realized, respectively.

In June 2006, the FASB issued FIN 48. This interpretation clarifies the accounting and disclosures relating to the uncertainty about whether a tax return position will ultimately be sustained by the tax authorities. The Company adopted this interpretation on December 31, 2006. As of December 29, 2007, there was no unrecognized tax benefits recorded. During 2008, \$95,000 of unrecognized tax expenses relating to prior years' were recorded, and the balance of unrecognized tax benefits at January 3, 2009 was \$95,000. The total \$95,000 of unrecognized tax benefits would favorably affect the effective income tax rate in any future periods if unrecognized.

The Company classifies interest expense and penalties related to unrecognized tax benefits and interest income on tax overpayments as components of income tax expense. As of January 3, 2009, The Company had \$7,000 accrued for estimated interest on the Company's consolidated balance sheet. No penalties have been accrued as of January 3, 2009.

The Company's U.S. federal returns for 2004 and prior years are no longer subject to examination. The Company's state returns for years prior to 2003 are no longer subject to examination.

The Company's foreign subsidiaries file income tax returns in the countries in which they have operations. Generally, these countries have statutes of limitations ranging from 4 to 6 years. Years still open to examination by foreign tax authorities in the Company's major filing jurisdiction of Canada are 2003 through 2008.

12. COMMITMENTS AND CONTINGENCIES

Operating Leases —In November 2006, the Company signed an operating lease for a 40,316 square foot facility to serve as the Company's headquarters in Fremont, California. Lease payments escalate annually and the total future minimum lease payments amount to \$2.2 million over the lease term. The stated term of the lease is six years and ten months, commencing on March 1, 2007. The Company can extend the lease an additional 3 years. Pursuant to the lease the Company is required to maintain a cash deposit of approximately \$40,000 which is included in other assets in the accompanying consolidated balance sheets as of January 3, 2009.

The Company signed a seven-year operating lease, commencing in December 2006, for 117,500 square foot facility which serves as the Company's manufacturing and warehouse facility in Fremont, California. Lease payments escalate annually and the total future minimum lease payments amount to \$5.6 million over the lease term. The stated term of the lease is seven years, but the Company may extend the lease for an additional three years at 95% of the then current market rate. As part of this agreement, the Company is required to maintain a \$100,000 cash deposit or an unconditional and irrevocable fully cash-collateralized letter of credit as a form of security. The cash deposit for the lease building is included in other assets in the accompanying consolidated balance sheet as of January 3, 2009.

In addition, the Company has operating leases for office space in New York City and Shanghai, China. The Company signed a five-year operating lease, commencing in September 2008 for a 3,694 square foot facility to serve as a sales and service office in New York City, New York. Lease payments remain flat for three years and escalate thereafter and the total future minimum lease payments amount to \$1 million over the lease term. The Company also signed a three year operating lease commencing in February 2008 for a 12,830 square foot facility which serves as the Company's international engineering office also known as our "Shanghai Technology Center" in Shanghai, China. Lease payments remain flat for the entire term of the lease and total future minimum lease payments amount to \$0.4 million.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

It is the Company's policy to record rent expense over the term of the lease using a straight-line method, including any rent holiday periods. Leasehold improvements are capitalized and amortized over the shorter of the estimated life of the improvements or the term of the lease.

Future minimum lease payments under operating leases are as follows (in thousands):

Year ending January 2, 2010	1,973
Year ending January 1, 2011	1,956
Year ending December 31, 2011	1,820
Year ending December 29, 2012	1,883
Year ending December 28, 2013	1,924
Thereafter	—
Total	<u>\$9,556</u>

Total rent expense for the years ended January 3, 2009, December 29, 2007 and December 30, 2006 was approximately 2.5 million, \$2.2 million and \$0.8 million respectively.

Purchase Commitments —In connection with supplier agreements, the Company agreed to purchase certain units of inventory and non-inventory through 2009. As of January 3, 2009, there was a remaining commitment of approximately \$2.9 million and \$4.6 million respectively.

Contingencies —The Company is subject to various legal proceedings and disputes that arise in the normal course of business. The Company does not know whether it will prevail in these matters nor can it assure that any remedy could be reached on commercially viable terms, if at all. Based on currently available information, the Company believes that it has meritorious defenses to these actions and that the resolution of these cases is not likely to have a material adverse effect on its business, financial position, or future results of operations. In accordance with SFAS No. 5, "Accounting for Contingencies," the Company records a liability when it is both probable that a liability has been incurred and the amount of the loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case.

Effective December 31, 2006, the Company adopted the provisions of FIN 48. As of January 3, 2009, the liability for uncertain tax positions, net of offsetting tax benefits associated with the correlative effects of state income taxes and interest deductions was \$95,000. As of January 3, 2009, the Company has accrued \$7,000 of interest associated with its uncertain tax positions. No penalties associated with its uncertain tax positions have been accrued. The Company can not conclude on the range of cash payments that will be made within the next twelve months associated with its uncertain tax positions.

Indemnification Agreements —The Company enters into standard indemnification agreements with its customers and certain other business partners in the ordinary course of business. These agreements include provisions for indemnifying the customer against any claim brought by a third party to the extent any such claim alleges that the Company's product infringes a patent, copyright or trademark, or misappropriates a trade secret, of that third party. The agreements generally limit the scope of the available remedies in a variety of industry-standard methods, including, but not limited to, product usage and geography-based limitations, a right to control the defense or settlement of any claim, and a right to replace or modify the infringing products to make them non-infringing. The Company has not incurred significant expenses related to these indemnification agreements and no material claims for such indemnifications were outstanding as of January 3, 2009. As a result, the Company believes the estimated fair value of these indemnification agreements, if any, to be de minimus; accordingly, no liability has been recorded with respect to such indemnifications as of January 3, 2009.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

13. FAIR VALUE MEASUREMENTS

The financial assets of the Company measured at fair value on a recurring basis are cash equivalents, short-term and long-term investments. The Company’s cash equivalents and short-term investments are generally classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency. The Company’s long-term investments are classified within Level 3 of the fair value hierarchy because they are valued using unobservable inputs, due to the fact that observable inputs are not available, or situations in which there is little, if any, market activity for the asset or liability at the measurement date.

- Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2: Quoted prices in markets that are not active, or inputs which are observable, either directly or indirectly, for substantially the full term of the asset or liability; or
- Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and are unobservable.

The following table sets forth the Company’s short- and long-term investments as of January 3, 2009 which are measured at fair value on a recurring basis by level within the fair value hierarchy. As required by SFAS No. 157, these are classified based on the lowest level of input that is significant to the fair value measurement, (in thousands):

<u>(In thousands)</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>	<u>Assets at fair value</u>
Cash and cash equivalents	\$171,954	\$ —	\$ —	\$ 171,954
Long-term investments	—	—	8,664	8,664
Total	\$171,954	\$ —	\$8,664	\$ 180,618

The Company’s Level 3 assets consist of long-term auction rate securities for which the Company used a discounted cash flow model to value these investments. There were no other financial instruments (asset or liability) requiring disclosure under SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (“SFAS 107”), as of January 3, 2009 and December 29, 2007.

Our cash, short-term trade receivables and payables all have carrying amounts which approximate fair value, and we have neither short-term nor long-term debt.

Historically, the fair value of ARS investments approximates par value due to the frequent resets through the auction process. While the Company continues to earn interest on its ARS investments at the contractual rate, these investments are not currently trading and therefore do not have a readily determinable market value. Accordingly, the estimated fair value of the ARS no longer approximates par value. At January 3, 2009, the Company’s investment advisors provided a valuation based on Level 3 inputs for the ARS investments. The investment advisors utilized a discounted cash flow approach to arrive at this valuation, which was corroborated by a separate and comparable discounted cash flow analysis prepare by the Company.

The assumptions used in preparing the discounted cash flow model include estimates, based on data available as of January 3, 2009, of interest rates, timing and amount of cash flows, credit and liquidity premiums, and expected holding periods of the ARS. The Company estimated a holding period of 36 months and a discount rate of 5.0%. The assumptions used in valuing the ARS’s are volatile and subject to change as the underlying sources of these assumptions and market conditions change.

RACKABLE SYSTEMS, INC. AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS—(Continued)

The following table provides a summary of changes in the fair value of the Company’s Level 3 financial assets as of January 3, 2009, (in thousands):

December 29, 2007	\$ —
Unrealized loss included in other comprehensive loss	(392)
Transfers in to Level 3	9,125
Redemption at par value	(69)
January 3, 2009	<u>\$8,664</u>

14. SUBSEQUENT EVENTS

In February 2009, the Board of Directors authorized a share repurchase program of up to \$40 million of the Company’s common stock. The duration of the repurchase program is open ended. Under the program, the Company is able to purchase shares of common stock through open market transactions and privately negotiated purchases at prices deemed appropriate by management. The timing and amount of repurchase transactions under this program will depend on market conditions, corporate and regulatory considerations, alternative investment opportunities, and other relevant considerations. The program may be discontinued at any time by the Board of Directors. Shares the Company repurchases will be held in treasury for general corporate purposes, including issuances under employee equity incentive plans.

In January 2009, the company announced a reduction in its workforce of 15%. The costs of restructuring are not expected to be material.

In January, 2009, the Company was sued in the United States District Court, Northern District of California, in a matter captioned *Dull v. Rackable, Inc.* The complaint includes claims of violations of both (i) Section 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder, and (ii) Section 20(a) of the Exchange Act. The allegations relate to the drops in the Company’s share price in early 2007 relating to their earnings reports for 2006 and Q4 2006 .

In March 2009, the Company and certain of its present and former directors and officers were sued in the Superior Court of the State of California for Alameda County, in a shareholder derivative lawsuit captioned *Milo v. Barton, et al*, Case No. R30944-0474. The complaint alleges that the defendants engaged in various acts and omissions that resulted in the drops of the Company’s share price in early 2007, and asserts claims for alleged breaches of defendants’ fiduciary duties, waste of corporate assets, and unjust enrichment. The complaint seeks compensatory damages in an unspecified amount, unspecified equitable or injunctive relief, disgorgement of unspecified compensation earned by the defendants, and an award of an unspecified amount for plaintiff’s costs and attorneys fees.

These lawsuits are still in their preliminary stages thus the Company is unable to determine the ultimate outcomes at this time. However, the Company believes it has meritorious defenses and intends to vigorously defend against them. No provision has been recorded in the consolidated financial statements for these matters.

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

None.

Item 9A. *Controls and Procedures*

Disclosure Controls and Procedures

As required by Exchange Act Rule 13a-15(b), as of the close of the year ended January 3, 2009, we carried out an evaluation, under the supervision and with the participation of our management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures as defined in Rule 13a-15(e). Disclosure controls and procedures are controls and procedures designed to ensure that the information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, including, without limitation, controls and procedures designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Securities Exchange Act of 1934 is accumulated and communicated to our management, including our principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. As discussed in more detail below, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures are ineffective as of January 3, 2009, due to a material weakness that we identified in internal control over financial reporting, specifically related to inventory valuation.

Management's Report on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) and 15d-15(f). Management has used the framework set forth in the report entitled "*Internal Control—Integrated Framework*" published by the Committee of Sponsoring Organizations of the Treadway Commission to evaluate the effectiveness of our internal control over financial reporting. In performing the assessment, our management has identified one material weakness in internal control over financial reporting as of January 3, 2009, as follows:

Inventory Valuation

During the year ended January 3, 2009, the Company did not perform certain of its designed controls over the period-end accounting process related to inventory valuation with sufficient precision, as evidenced by misstatements that were detected after management had completed its financial closing and reporting process related to the quarterly financial statements. Although the misstatements were not deemed to be individually material, their occurrence is indicative that the controls related to the inventory accounting process were not operating in an effective manner. Because the Company's controls over the inventory accounting process had not operated consistently for a sufficient period of time, management has concluded that these internal control deficiencies constitute a material weakness in our internal control over financial reporting because there is a reasonable possibility that a material misstatement of the annual financial statements would not have been prevented or detected on a timely basis.

Due to this material weakness, management has concluded that our internal control over financial reporting was not effective as of January 3, 2009. The Company's independent registered public accounting firm has audited our internal control over financial reporting, as stated in their report, which appears in this Item under the heading "Report of Independent Registered Public Accounting Firm."

Changes in Internal Control over Financial Reporting

There have been changes in our internal control over financial reporting in the fourth quarter of fiscal 2008, as described below that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Remediation of Material Weaknesses in Accounting for Income Taxes

During the year ended January 3, 2009, our management completed the corrective actions to remediate the material weakness in accounting for income taxes discussed in our 2007 Form 10-K. During the fourth quarter of fiscal 2008, our management's testing of controls over accounting for income taxes indicated that the corrective actions put in place to remediate this material weakness have been implemented and are operating effectively. Therefore, we believe the previously reported material weakness related accounting for income taxes has been remediated as of January 3, 2009. In fiscal 2008, we completed the following remedial actions:

- We hired a senior tax manager, with income tax accounting experience in public accounting and public companies, who oversees all income tax functions;
- We redesigned our income tax calculation model to improve the data collection process and automate key components of the calculation of income taxes; and
- We improved the quality and timing of our accounting close process and financial reporting to allow for increased preparation and review time.

Inventory Valuation

We are continuing the remediation efforts highlighted in our 2007 Form 10-K to remediate the material weakness in inventory valuation. These efforts will continue and include the following:

- We are automating the key components of our calculation for the provision for excess and obsolete inventory and purchase price variances;
- We are enhancing the training and education of our inventory and cost accounting personnel; and
- We are improving our review processes for various calculations relating to inventory valuation.

Effectiveness of Controls

Future events affecting our business may cause us to modify our disclosure controls and procedures or internal control over financial reporting. The effectiveness of controls cannot be absolute because the cost to design and implement a control to identify errors or mitigate the risk of errors occurring should not outweigh the potential loss caused by the errors that would likely be detected by the control. Moreover, we believe that a control system cannot be guaranteed to be 100% effective all of the time. Accordingly, a control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of
Rackable Systems, Inc.
Fremont, California

We have audited the internal control over financial reporting of Rackable Systems, Inc. and subsidiaries (the “Company”) as of January 3, 2009, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company’s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company’s internal control over financial reporting based on our audit.

We conducted our audit 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 effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on that risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company’s internal control over financial reporting is a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, or persons performing similar functions, and effected by the company’s board of directors, management, and other personnel 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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company’s assets that could have a material effect on the financial statements.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis. The following material weakness has been identified and included in management’s assessment:

- During the year ended January 3, 2009, certain controls over period-end inventory accounting did not operate with sufficient precision. Misstatements were detected relating to inventory obsolescence and other reserves. Because the Company’s controls over the inventory accounting process had not operated consistently for a sufficient period of time, as of January 3, 2009, there is a reasonable possibility that a material misstatement of the interim and annual financial statements would not have been prevented or detected on a timely basis by the Company’s controls.

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This material weaknesses was considered in determining the nature, timing, and extent of audit tests applied in our audit of the consolidated financial statements as of and for the year ended January 3, 2009, of the Company and this report does not affect our report on such consolidated financial statements.

In our opinion, because of the effect of the material weakness identified above on the achievement of the objectives of the control criteria, the Company has not maintained effective internal control over financial reporting as of January 3, 2009, based on the criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements as of and for the year ended January 3, 2009, of the Company and our report dated March 18, 2009 expressed an unqualified opinion on those financial statements.

/ s / DELOITTE & TOUCHE LLP

San Jose, California
March 18, 2009

Item 9B. Other Information

None.

PART III

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

The information required by this Item is incorporated herein by reference from the sections entitled “Proposal 1—Election of Directors,” “Section 16(a) Beneficial Ownership Reporting Compliance” and “Code of Conduct and Ethics” and “Information Regarding the Board of Directors and Corporate Governance” contained in our proxy statement for our 2009 Annual Meeting of Stockholders (the “Proxy Statement”) provided however, that the information required by this Item with respect to our executive officers is contained in Item 1 of Part I of this Annual Report under the heading “Executive Officers.”

Item 11. *Executive Compensation*

The information required by this Item is incorporated herein by reference from the sections entitled “Compensation Committee” in “Proposal 1—Election of Directors,” and “Executive Compensation and Related Information,” of in the Proxy Statement.

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

The information required by this Item is incorporated herein by reference from the section entitled “Security Ownership of Certain Beneficial Owners and Management” and “Equity Compensation Plan Information” of the Proxy Statement.

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

The information required by this Item is incorporated herein by reference from the section entitled “Certain Relationships and Related Transactions” and “Proposal 1—Election of Directors” in the Proxy Statement.

Item 14. *Principal Accounting Fees and Services*

The information required by this Item is incorporated herein by reference from the section entitled “Principal Accountant Fees and Services” in the Proxy Statement.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) 1. Financial Statements

See Index to Consolidated Financial Statements in Item 8 of this Annual Report on Form 10-K, which is incorporated herein by reference.

2. Financial Statement Schedules

All other financial statement schedules have been omitted because they are either not applicable or the required information is shown in the consolidated financial statements or notes thereto.

3. Exhibits

See the Exhibit Index which follows the signature page of this Annual Report on Form 10-K, which is incorporated herein by reference.

(b) Exhibits

See Item 15(a) (3) above.

(c) Financial Statement Schedules

See Item 15(a) (2) above.

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EXHIBIT INDEX

Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date	Filed Herewith
		Form	Ex. No.	File No.		
2.1	Asset Acquisition Agreement, dated December 23, 2002, by and between GNJ, Inc. (f.k.a. Rackable Systems, Inc.) and Registrant	S-1	2.1	333-122576	2/4/2005	
2.2	Share Purchase Agreement dated as of August 29, 2006, by and among Rackable Systems, Inc., Rackable Systems Canada Acquisition ULC, Terrascale Technologies Inc. and the other parties identified on Schedule A thereto.	8-K	2.1	000-51333	8/30/2006	
3.1	Amended and Restated Certificate of Incorporation.	10-Q	3.1	000-51333	8/12/2005	
3.2	Amended and Restated Bylaws.	8-K	3.2	000-51333	3/7/2008	
4.1	Reference is made to Exhibits 3.1, and 3.2.					
4.2	Form of Specimen Stock Certificate.	S-1A/2	4.2	333-122576	5/2/2005	
10.1	Securities Purchase Agreement by and among the Registrant and the other purchasers set forth therein dated as of December 23, 2002, as amended through April 28, 2005.	S-1	10.1	333-122576	2/4/2005	
10.2	Registration Agreement, dated December 23, 2002, by and among the Registrant and certain investors and founders named therein.	S-1	10.2	333-122576	2/4/2005	
10.3	Amendment No. 1 to Registration Agreement, dated February 2, 2005, among the Registrant, Rackable Investment LLC and the founders named therein.	S-1	10.3	333-122576	2/4/2005	
10.4	Amendment No. 2 to Registration Agreement, dated May 19, 2005, among the Registrant, Rackable Investment LLC and the founders named therein.	S-1A/4	10.44	333-122576	5/27/2005	
10.5	Founders Repurchase and Rights Agreement, dated December 23, 2002, by and among Registrant, GNJ, Inc. (f.k.a. Rackable Systems, Inc.), Rackable Investments LLC and the founders named therein.	S-1	10.4	333-122576	2/4/2005	
10.6	Amendment No. 1 to the Founders Repurchase and Rights Agreement, dated May 19, 2005, among the Registrant, Rackable Investments LLC and the founders named therein.	S-1A/4	10.43	333-122576	2/4/2005	
10.7	Amendment to Registration Agreement and Founder Repurchase and Rights Agreement, dated November 16, 2005, by and among Registrant, Rackable Investment LLC, Parthenon Investors II, L.P. and the founders named therein.	S-1A/1	10.7	333-129573	11/17/2005	
10.8*	Form of Indemnity Agreement entered into by Registrant with each of its directors and certain executive officers.	S-1	10.7	333-122576	2/4/2005	

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Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date	Filed Herewith
		Form	Ex. No.	File No.		
10.9*	2002 Stock Option Plan and form of related agreements.	S-1	10.8	333-122576	3/30/2005	
10.10*	2005 Equity Incentive Plan.	S-1	10.9	333-122576	2/4/2005	
10.11*	2005 Non-Employee Directors' Stock Option Plan.	S-1	10.10	333-122576	2/4/2005	
10.12*	2005 Employee Stock Purchase Plan.	S-1	10.11	333-122576	2/4/2005	
10.13	Lease Agreement, dated as of November 27, 2001, by and between the Registrant and EOP-Industrial Portfolio, L.L.C.	S-1	10.12	333-122576	2/4/2005	
10.14	First Amendment to Lease Agreement, dated as of April 22, 2004, by and between the Registrant and EOP-Industrial Portfolio, L.L.C.	S-1	10.13	333-122576	2/4/2005	
10.15	Second Amendment to Lease Agreement dated October 26, 2005, by and between Registrant and RREEF America Reit II Corp. (as successor in interest to EOP-Industrial Portfolio, L.L.C.).	S-1	10.16	333-129573	11/9/2005	
10.16*	Employment Agreement, dated as of December 23, 2002, by and between the Registrant and Giovanni Coglitore.	S-1	10.17	333-122576	2/4/2005	
10.17*	First Amendment to the Employment Agreement, dated November 16, 2005, by and between Registrant and Giovanni Coglitore.	S-1A/1	10.27	333-129573	11/9/2005	
10.18*	Executive Compensation Summary.					X
10.19	Director Compensation Arrangements.	10-K	10.31	000-51333	2/28/2007	
10.20	Promissory Note dated December 31, 2004, issued by the Registrant to Giovanni Coglitore.	S-1	10.29	333-122576	2/4/2005	
10.21	Stock Repurchase Agreement, dated February 2, 2005, between the Registrant and Giovanni Coglitore.	S-1	10.32	333-122576	2/4/2005	
10.22*	Offer letter, dated August 18, 2004, from the Registrant to Hagi Schwartz.	S-1	10.35	333-122576	2/4/2005	
10.23*	Offer letter, dated November 4, 2004, from the Registrant to Gary Griffiths.	S-1	10.37	333-122576	2/4/2005	
10.24*	Offer letter dated March 18, 2005, from the Registrant to Ronald D. Verdoorn.	S-1A/2	10.42	333-122576	5/2/2005	
10.25	Stockholders' Voting Agreement by and among the Registrant, Rackable Investment LLC, GNJ, Inc., and the founders named therein dated December 23, 2002.	S-1	10.40	333-122576	2/4/2005	

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Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date	Filed Herewith
		Form	Ex. No.	File No.		
10.26*	Form of Stock Option Agreement under the 2006 New Recruit Equity Incentive Plan.	8-K	10.2	000-51333	1/30/2006	
10.27*	Offer letter dated October 28, 2005 from the Registrant to Madhu Ranganathan.	10-K	10.58	000-51333	2/22/2006	
10.28*	2006 Management Bonus Plan.	10-K	10.60	000-51333	2/22/2006	
10.29	Amendment to Registration Agreement, dated February 28, 2006, by and between Rackable Systems, Inc., Rackable Investment LLC, Parthenon Investors II, L.P. and the founders named therein.	S-1/A1	10.8	333-131977	3/1/2006	
10.30	Net Lease Agreement dated June 26, 2006 by and among Rackable Systems, Inc. and Fremont Landing Investors, LLC.	8-K	10.62	000-51333	8/25/2006	
10.31*	Amended and Restated 2006 New Recruit Equity Incentive Plan.					
10.32*	Executive Change in Control Benefit Plan and Form of Participation Notices.	8-K	10.1	000-51333	9/5/2006	
10.33*	Form of Option Agreement and Grant Notices under the 2005 Equity Incentive Plan.	8-K	10.2	000-51333	9/5/2006	
10.34*	Form of Stock Bonus Award Agreement and Grant Notice under the 2005 Equity Incentive Plan.	8-K	10.3	000-51333	9/5/2006	
10.35	Loan Agreement, dated September 29, 2006, between Rackable Systems, Inc. and HSBC Bank USA, National Association.	8-K	10.01	000-51333	10/4/2006	
10.36	Revolving Note, dated September 29, 2006 executed by the Company in favor of HSBC Bank USA, National Association.	8-K	10.02	000-51333	10/4/2006	
10.37*	Form of Stock Option Agreement and Grant Notice with Outside Directors under the 2002 Stock Option Plan.	10-Q	10.10	000-51333	11/14/2006	
10.38*	Form of Non-statutory Stock Option Agreement under the 2005 Non-Employee Directors' Stock Option Plan.	10-Q	10.11	000-51333	11/14/2006	
10.39*	Separation Letter, executed as of December 7, 2006, by and between the Registrant and Tom Gallivan.	8-K	10.1	000-51333	12/11/2006	
10.40*	Retention Agreement, dated January 9, 2007, by and between Rackable Systems, Inc. and Giovanni Coglitore.	8-K	10.1	000-51333	1/11/2007	

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<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Incorporated by Reference</u>			<u>Filing Date</u>	<u>Filed Herewith</u>
		<u>Form</u>	<u>Ex. No.</u>	<u>File No.</u>		
10.41*	Retention Bonus Agreement, dated September 12, 2006, by and between Rackable Systems, Inc. and Giovanni Coglitore.	8-K	10.2	000-51333	1/11/2007	
10.42*	First Amendment to Retention Bonus Agreement, dated January 9, 2007, by and between Rackable Systems, Inc. and Giovanni Coglitore.	8-K	10.3	000-51333	1/11/2007	
10.43*	Offer Letter, dated August 21, 2006, by and between the Registrant and Charles Boesenberg.	10-K	10.6	000-51333	2/28/2007	
10.44*	Offer Letter, dated November 17, 2006, by and between the Registrant and Mark Barrenechea.	10-K	10.61	000-51333	2/28/2007	
10.45*	Change in Control Severance Benefit Plan.	8-K	10.1	000-51333	10/6/2006	
10.46	Lease, dated November 1, 2006, between Renco Bayside Investors and the Registrant.	8-K	10.10	000-51333	11/6/2006	
10.47*	Management Bonus Plan for the Second Half of 2007.	8-K	—	000-51333	9/8/2007	
10.48	First Amendment to the Employment Agreement, dated September 19, 2007, by and between Rackable Systems, Inc. and Madhu Ranganathan.	8-K	10.1	000-51333	9/26/2007	
10.49	Second Amendment to Employment Agreement, dated June 28, 2007, by and between Rackable Systems, Inc. and Giovanni Coglitore.	10-Q	10.7	000-51333	8/9/2007	
10.50	Employment Agreement, dated August 22, 2007, by and between Rackable Systems, Inc. and Maurice Leibenstern	10-Q	10.5	000-51333	11/8/2007	
10.51	First Amendment to Employment Agreement, dated September 19, 2007, by and between Rackable Systems, Inc. and Maurice Leibenstern	10-Q	10.6	000-51333	11/8/2007	
10.52	Employment Agreement, dated May 24, 2007, between Rackable Systems Inc and Mark J. Barrenechea	8-K	10.1	000-51333	5/30/2007	
10.53*	Officer Compensation Changes in First Quarter 2007	8-K	—	000-51333	1/31/2007	
10.54*	Compensation arrangements in connection with April 29, 2007 management changes	8-K	—	000-51333	5/1/2007	
10.55	Waiver and Amendment to Loan Agreement, dated March 31, 2007, between Rackable Systems, Inc. and HSBC Bank, USA National Association.	10-Q	10.7	000-51333	5/10/2007	

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Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date	Filed Herewith
		Form	Ex. No.	File No.		
10.56	Change in Compensation for Gautham Sastri	8-K	—	000-51333	5/1/2007	
10.57	Separation Agreement, dated May 15, 2007, by and between Rackable Systems, Inc. and Tom Barton	8-K	10.1	000-51333	5/22/2007	
10.58	Separation Agreement dated May 23, 2007, between Rackable Systems Inc and Todd Ford	8-K	10.1	000-51333	5/28/2007	
10.59*	Form of 2005 Equity Incentive Plan Restricted Stock Unit Grant Notice and Restricted Stock Unit Award Agreement	8-K	10.1	000-51333	6/8/2007	
10.60*	Cash compensation arrangements with the non-employee Directors	10-Q	10.6	000-51333	8/9/2007	
10.61*	Compensation Arrangements with Named Executive Officers	8-K		000-51333	2/6/08	
10.62*	Compensation Arrangements with Named Executive Officers	8-K		000-51333	3/21/08	
10.63*	Compensation Arrangements with Named Executive Officers	8-K		000-51333	4/3/08	
10.64*	Compensation Arrangements with Named Executive Officers	8-K		000-51333	4/24/08	
10.65*	Offer Letter made by Rackable Systems, Inc. to Jonathan J. Skoglund, dated October 14, 2008	8-K	10.1	0000-51333	11/28/08	
10.66*	First Amendment to Employment Agreement, dated December 31, 2008, between Rackable Systems, Inc. and Mark J. Barrenechea	8-K	10.3	000-51333	1/6/09	
10.67*	Second Amendment to Employment Agreement, dated November 17, 2008, between Rackable Systems, Inc. and Maurice Leibenstern					X
10.68*	First Amendment to Retention Agreement, dated December 31, 2008, between Rackable Systems, Inc. and Giovanni Coglitore	8-K	10.4	000-51333	1/6/09	
10.69*	Employment Agreement, dated March 31, 2008, between Rackable Systems, Inc. and James Wheat					X
10.70*	Amendment #1 to Employment Agreement, dated March 31, 2008, between Rackable Systems, Inc. and James Wheat					X
10.71*	First Amendment to Employment Agreement, dated December 31, 2008, between Rackable Systems, Inc. and James Wheat	8-K	10.2	000-51333	1/6/09	
10.72*	Amended and Restated Employment Agreement, dated December 30, 2008, between Rackable Systems, Inc. and Giovanni Coglitore	8-K	10.1	000-51333	1/6/09	

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Exhibit Number	Exhibit Description	Incorporated by Reference			Filing Date	Filed Herewith
		Form	Ex. No.	File No.		
10.73*	Offer Letter made by Rackable Systems, Inc. to Anthony Carrozza, dated January 24, 2008.					X
10.74*	First Amendment to Employment Agreement dated December 23, 2008 between Rackable Systems, Inc. and Anthony Carrozza.					X
10.75*	Third Amendment to Employment Agreement dated December 23, 2008 between Rackable Systems, Inc. and Maurice Leibenstern.					X
10.76*	Offer Letter made by Rackable Systems, Inc. to David Yoffie, dated July 24, 2007.					X
10.77*	Employment Agreement Restatement and Amendment #1 dated January 22, 2008 between Rackable Systems, Inc. and David Yoffie.					X
10.78*	Second Amendment to Employment Agreement dated December 23, 2008 between Rackable Systems, Inc. and David Yoffie.					X
10.79*	Offer Letter made by Rackable Systems, Inc. to Anthony Gaughan, dated June 19, 2007.					X
10.80*	Employment Agreement Restatement and Amendment #1 dated January 23, 2008 between Rackable Systems, Inc. and Anthony Gaughan.					X
10.81*	Separation Agreement, dated November 12, 2008, between Rackable Systems, Inc. and Anthony Gaughan.					X
21.1	Subsidiaries of the Company.					X
23.1	Consent of Independent Registered Public Accounting Firm.					X
24.1	Power of Attorney. (Included on the signature page hereto).					
31.1	Certification required by Rule 13a-14(a) or Rule 15d-14(a).					X
31.2	Certification required by Rule 13a-14(a) or Rule 15d-14(a).					X
32.1**	Certifications required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350)					X

* Indicates a management contract or compensatory plan or arrangement.

** The certification attached as Exhibit 32.1 accompanies the Annual Report on Form 10-K pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed "filed" by Rackable Systems, Inc. for purposes of Section 18 of the Securities Exchange

Executive Officer Summary Compensation Sheet

Annual Cash Compensation for Senior Executive Officers

The annual cash compensation for Executive Officers of Rackable Systems, Inc. as of January 3, 2009, was as follows:

<u>Executive Officers</u>	<u>Annual Base Salary</u>	<u>Annual Target Bonus</u>
Mark J. Barrenechea <i>Chief Executive Officer, President</i>	\$ 350,000	\$ 350,000
Anthony Carrozza <i>Senior Vice President of Worldwide Sales and Marketing</i>	\$ 275,000	\$ 125,000
Giovanni Coglitore <i>Co-Founder, Senior Vice President of Engineering and Chief Technology Officer</i>	\$ 250,000	\$ 100,000
Maurice Leibenstein <i>General Counsel, Senior Vice President and Corporate Secretary</i>	\$ 270,000	\$ 105,000
Jonathan J. Skoglund <i>Vice President, Corporate Controller and Principal Accounting Officer</i>	\$ 220,000	\$ 66,000
James D. Wheat <i>Senior Vice President and Chief Financial Officer</i>	\$ 270,000	\$ 105,000
David M. Yoffie <i>Senior Vice President of Manufacturing and Service Operations</i>	\$ 270,000	\$ 105,000

Cash Bonus Arrangements for Executive Officers:

- 25% of the Annual Target Bonus maybe earned each quarter. The bonus awards are determined based upon Rackable Systems' achievement of certain performance goals to be established by the Compensation Committee of the Board.

RACKABLE SYSTEMS, INC.

SECOND AMENDMENT TO THE EMPLOYMENT AGREEMENT

This SECOND AMENDMENT TO THE EMPLOYMENT AGREEMENT (the “**Second Amendment**”) dated November 17, 2008 (the “**Effective Date**”) is executed by and between Rackable Systems, Inc., a Delaware corporation (the “Company”) and Maurice Leibenstern (the “**Executive**”). The Company and the Executive are each individually referred to in this Amendment as a “**Party**” and are collectively referred to in this Amendment as the “**Parties**.”

RECITALS

A. Executive and the Company are parties to an Employment Agreement, dated August 22, 2007 (the “**Employment Agreement**”), which was subsequently amended on September 19, 2007 (the “**First Amendment**”), both of which collectively outline the general terms of employment for the Executive.

B. Pursuant to this Second Amendment and effective immediately upon the Parties’ mutual execution and delivery of this Second Amendment, the Parties desire to further amend the Employment Agreement as follows.

AGREEMENT

In consideration of the mutual promises and covenants set forth in this Amendment, the receipt and sufficiency of which are acknowledged by the Parties, the Parties agree as follows:

1. Amendment to Employment Agreement. The Parties agree that upon the Effective Date of this Amendment, the Employment Agreement will be further amended as follows:

1.1 Paragraph 4 entitled “EMPLOYEE BENEFITS”, is hereby amended to add the following sentence stating: “In addition, you will be entitled to a one-time lump sum payment of \$30,000.00 for your relocation needs provided, however, that you agree to promptly and fully repay any such reimbursement to the Company in the event your employment with the Company is terminated within one (1) year after November 17, 2008 other than a termination by you for Good Reason (as defined in the Employment Agreement and the First Amendment) or a termination by the Company without Cause (as defined in the Employment Agreement and the First Amendment).”

1.2 Except as amended herein, the Employment Agreement (as modified by the First Amendment) shall remain in full force and effect without modification thereto. In the event of a conflict between the provisions of this Second Amendment and those of the Employment Agreement or the First Amendment, the parties agree that this Second Amendment shall prevail.

IN WITNESS WHEREOF , the parties hereto have executed this Second Amendment as of the Effective Date.

RACKABLE SYSTEMS, INC.

By: _____
Name: Mark J. Barrenechea
Title: CEO

Signature Date: _____

MAURICE LEIBENSTERN

By: /s/ MAURICE L EIBENSTERN
Name: Maurice Leibenstern
Title: SVP, GC & Corp. Secretary

Signature Date: December 17, 2008



46600 Landing Parkway
Fremont, California 94538
P. 408.240.8300
F. 408.321.0293
www.rackable.com

March 31, 2008

James Wheat

Re: Employment Terms

Dear James:

Rackable Systems, Inc. (the “Company”), is pleased to offer you the position of SVP & Chief Financial Officer, on the following terms. Your employment shall commence on April 21, 2008 (“Start Date”).

POSITION. You will serve in an executive capacity and as required by the Company’s Chief Executive Officer (the “CEO”). You will be responsible for the finance, accounting and investor relations functions for the company. Partnering with the CEO and senior management, you will be a critical player in driving the evolution of the company’s business model and generating returns to stakeholders. Moreover, you will interact frequently with the company’s board of directors and numerous external constituencies to help communicate the company’s plan and progress against key strategic, financial and shareholder return objectives. You will report to the CEO. Of course, the Company may change your position, duties, and work location from time to time in its discretion subject to the terms of this offer letter agreement.

1. COMPENSATION.

- a. **Base Salary.** Your initial annual base salary will be \$270,000, less standard payroll deductions and withholdings. You will be paid bi-weekly in accordance with Company practice and policy.
- b. **Performance Bonus.** In addition, you will be eligible to earn a quarterly performance bonus ¹ of \$27,000, based upon both your performance and the Company’s performance with respect to applicable performance targets which are expected to include revenue and profitability targets and other organizational milestones (“Targets”), set solely by the CEO. The bonus payment shall be earned upon the fulfillments of Targets and is payable within a reasonable period of time. The Company will determine in its sole discretion whether the Targets have been achieved, whether you have earned a bonus, and the amount of any earned bonus. You must be employed on the bonus payment date to earn and be eligible to receive any bonus.

¹ Performance bonuses are aligned to the Company’s quarterly financial reporting periods (each such quarter, a “Company Quarter”); your initial quarterly participation will be adjusted *pro rata* based upon your Start Date.

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- c. **Review of Compensation.** Your base salary and bonus eligibility will be reviewed on an annual or more frequent basis by the Compensation Committee and are subject to change in the discretion of the Compensation Committee, subject to the terms of this offer letter agreement.

2. **OPTION GRANT.**

- a. **Equity Grants.** Subject to Compensation Committee approval, the Company will issue you an option (the “Option”) to purchase 100,000 shares of the Company’s common stock pursuant to the Company’s 2006 New Recruit Equity Incentive Plan (the “Plan”) at an exercise price equal to the fair market value of the stock as of the date of grant as determined by the Compensation Committee. In addition, subject to Compensation Committee approval, the Company will grant you the right to receive 20,000 shares of the Company’s common stock pursuant to the Plan (the “Restricted Stock Unit Award”).
- b. **Vesting Schedule.** Both the Option and the Restricted Stock Unit Award will be subject to a four-year vesting period subject to your continuous service to the Company as an employee or consultant (as defined in the Plan and the Stock Unit Award Agreement), with 25% upon completion of the first year of employment, with an additional 6.25% of such shares subject to each of the Option and the Restricted Stock Unit Award vesting for each full Company Quarter of your continuous service as an employee or consultant following the Start Date.
- c. **Governing Documents.** The Option will be governed in full by the terms and conditions of the Plan and your individual Option agreement; the Restricted Stock Unit Award will be governed in full by the terms and conditions of the Stock Unit Award Agreement.

3. **EMPLOYEE BENEFITS.** You will be eligible to participate in the Company’s standard employee benefit plans in accordance with the terms and conditions of the plans and applicable policies which may be in effect from time to time, and provided by the Company to its executive employees generally, including but not limited to group health insurance coverage, disability insurance, life insurance, ESPP, 401(k) Plan, and paid time off and paid holidays. You will be eligible for reimbursement of your legitimate and documented business expenses incurred in connection with your employment, pursuant to the Company’s standard reimbursement expense policy and practices. The Company may modify its benefits programs and policies from time to time in its discretion.

4. **PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT.** As a condition of your employment, you are required to sign and abide by the Company’s Proprietary Information and Inventions Agreement (the “Non-Disclosure Agreement”), attached hereto as **Exhibit A** .

5. SERVICE AS EMPLOYEE; OUTSIDE ACTIVITIES.

- a. Location and Duties.** You will work at the Company's corporate headquarters currently located in Fremont, California, subject to necessary business travel. During your employment with the Company, you will devote your best efforts and substantially all of your business time and attention (except for vacation periods and reasonable periods of illness or other incapacity permitted by the Company's general employment policies) to the business of the Company.
- b. Company Policies.** Your employment relationship with the Company shall also be governed by the general employment policies and practices of the Company, including but not limited to the policies contained in the Company's Employee Handbook (except that if the terms of this letter differ from or are in conflict with the Company's general employment policies or practices, this letter will control), and you will be required to abide by such general employment policies and practices of the Company.
- c. Other Activities.** Throughout your employment with the Company, you may engage in civic and not-for-profit activities so long as such activities do not interfere with the performance of your duties hereunder or present a conflict of interest with the Company. Subject to the restrictions set forth herein and with the prior written consent of the Board, you may serve as a director of other corporations and may devote a reasonable amount of your time to other types of business or public activities not expressly mentioned in this paragraph.
- d. Conflict of Interest.** During your employment by the Company, except on behalf of the Company, you will not directly or indirectly serve as an officer, director, stockholder, employee, partner, proprietor, investor, joint venturer, associate, representative or consultant for or on behalf of any other person, corporation, firm, partnership or other entity whatsoever known by you to compete with the Company (or is planning or preparing to compete with the Company), anywhere in the world, in any line of business engaged in (or planned to be engaged in) by the Company; provided, however, that you may purchase or otherwise acquire up to (but not more than) one percent (1%) of any class of securities of any enterprise (but without participating in the activities of such enterprise) if such securities are listed on any national or regional securities exchange.

6. AT-WILL EMPLOYMENT RELATIONSHIP. Your employment relationship with the Company is at-will. Accordingly, both you and the Company may terminate the employment relationship at any time, with or without Cause (as defined below), and with or without advance notice.

7. DEFINITIONS.

- a. Definition of "Cause."** For purposes of this offer letter agreement, "Cause" is defined as one or more of the following events: (i) the indictment or conviction for a felony or other crime, or any misdemeanor involving moral turpitude; (ii) the commission of any other act or omission involving fraud or intentional deceit with respect to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iii) any act or omission involving dishonesty that causes material injury to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iv) gross negligence with respect to the Company or any of its subsidiaries; (v) willful

misconduct with respect to the Company or any of its subsidiaries; (vi) any other material breach of this agreement or any other agreement referred to herein (including the Non-Disclosure Agreement); provided, however, that, it shall only be deemed Cause pursuant to clause (vi) if you are given written notice describing the basis of Cause and, if the event is reasonably susceptible of cure, you fail to cure within thirty (30) days.

- b. Definition of “Good Reason.”** For purposes of this offer letter agreement, “Good Reason” is defined as one or more of the following conditions that occur without your written consent: (i) the assignment to you, or the removal from you, of any duties or responsibilities that results in the material diminution of your authority, duties or responsibilities as SVP and Chief Financial Officer, including a Change in Control that results in your no longer serving as the SVP and Chief Financial Officer or any similar position; (ii) a material reduction by the Company of your base salary; (iii) the Company’s material breach of its obligations to you under this offer letter agreement; or (iv) your office relocation to a location more than fifty miles from your then present location; provided however that, it shall only be deemed Good Reason pursuant to the foregoing definition if (x) the Company is given written notice from you within ninety (90) days following the first occurrence of a condition that you consider to constitute Good Reason describing the condition and fails to remedy such condition within thirty (30) days following such written notice, and (y) you resign from employment within ninety (90) days following the end of the period within which the Company was entitled to remedy the condition constituting Good Reason but failed to do so.
- c. Definition of “Change in Control.”** For purposes of this offer letter agreement, “Change in Control” means the occurrence, in a single transaction or in a series of related transactions, of either of the following events:
- i.** There is consummated (A) a merger, consolidation or similar transaction involving (directly or indirectly) the Company or (B) a tender offer or exchange offer addressed to the stockholders of the Company and, in either event, immediately after the consummation of such merger, consolidation or similar transaction or such tender or exchange offer, the stockholders of the Company immediately prior thereto do not own, directly or indirectly, either (A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such transaction; or
 - ii.** There is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries to an entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition.

The term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

- 8. CHANGE IN CONTROL SEVERANCE BENEFITS.** If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”):
- a. The vesting of all unvested stock options and all unvested grants of restricted stock herein referred to and any subsequent grants of stock options, restricted stock or any other stock awards in future plans, shall accelerate in such amount equal to the number of shares that would vest over an additional twenty-four (24) month period as if you have continued to be an employee of the Company for additional twenty-four (24) months following your termination;
 - b. You will be eligible to receive severance pay in the total amount equal to the sum of twelve (12) months of your base salary in effect as of the employment termination date. For purposes of this Section 9(b), “base salary” as used herein does not include any annual performance bonus or any other bonus payment. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; and
 - c. If you timely elect and continue to remain eligible for continued group health insurance coverage under federal COBRA law or, if applicable, state insurance laws (collectively, “COBRA”), the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment termination date (including dependent coverage, if applicable) for twelve (12) months after the employment termination date; provided that, the Company’s obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Company if you become eligible for group health insurance coverage through a new employer within twelve (12) months of your employment termination date.
- 9. SEVERANCE BENEFITS.** If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”); then you shall be entitled to receive the following severance benefits (the “Severance Benefits”):
- a. Severance pay in the total amount equal to the sum of six (6) months of your base salary in effect as of the employment termination date. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in thirteen (13) equal installments over a period of six (6) months, with such payments made on the

Company's normal payroll schedule. For purposes of this Section 10(a), "base salary" as used herein does not include any annual performance bonus or any other bonus payment; and

- b. If you timely elect and continue to remain eligible for COBRA, the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment termination date (including dependent coverage, if applicable) for six (6) months after the employment termination date; provided that, the Company's obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Board if you become eligible for group health insurance coverage through a new employer within six (6) months of your employment termination date.

10. CONDITIONS TO ELIGIBILITY TO SEVERANCE BENEFITS OR CHANGE IN CONTROL SEVERANCE BENEFITS .

Notwithstanding the foregoing, you will not be eligible for the Severance Benefits or the Change in Control Severance Benefits if: (A) your employment is terminated for Cause, or if you resign for any reason that does not qualify as Good Reason; or (B) in the event that you materially breach the Non-Disclosure Agreement, the Release of claims, or any other obligations you owe to the Company after termination of your employment (including but not limited to the provisions of the Non-Disclosure Agreement), and the Company's obligation to provide the Severance Benefits or the Change in Control Benefits (or to continue to provide such benefits) will cease immediately and in full as of the date of your breach.

- 11. DEFERRED COMPENSATION.** Anything in this agreement to the contrary notwithstanding, if the Company reasonably determines that any payments hereunder fail to satisfy the distribution requirements of Section 409A(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code") and you concur with such determination in writing, then the payment of such benefit shall be delayed to the minimum extent necessary so that such payments are not subject to the provisions of Section 409A(a)(1) of the Code; provided, however, that in no event shall such delay be more than six (6) months and one (1) day from the date of termination of your employment with the Company.

12. EXCISE TAX.

- a. Anything in this agreement to the contrary notwithstanding, if any payment or benefit that you would receive pursuant to this offer letter agreement or otherwise ("Payment") would (i) constitute a "parachute payment" within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the "Excise Tax"), then such Payment shall be equal to the Reduced Amount (defined below). The "Reduced Amount" shall be either (y) the largest portion of the Payment that would result in no portion of the Payment (after reduction) being subject to the Excise Tax, or (z) the entire Payment, whichever amount after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate, net of the maximum reduction in federal income taxes which could be obtained from a deduction of such state and local taxes), results in your receipt, on an after-tax basis, of the greatest amount of the Payment to you.

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- b. If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur in the following order unless you elect in writing a different order (provided, however, that such election shall be subject to Company approval, such approval not to be unreasonably withheld or delayed, if made on or after the date on which the event that triggers the Payment occurs (the “Payment Event”)): (1) reduction of cash payments; (2) cancellation of accelerated vesting of equity awards other than stock options; (3) cancellation of accelerated vesting of stock options; and (4) reduction of other benefits paid to you. In the event that acceleration of compensation from your equity awards is to be reduced, such acceleration of vesting shall be canceled in the reverse order of the date of grant unless you elect in writing a different order for cancellation.
 - c. The accounting firm engaged by the Company for general audit purposes as of the day prior to the effective date of the Payment Event shall perform the foregoing calculations. If the accounting firm so engaged by the Company is serving as accountant or auditor for the individual, entity or group effecting the Payment Event, a nationally recognized accounting firm appointed by the Board and reasonably approved by you shall make the determinations required hereunder. The Company shall bear all expenses with respect to the determinations by such accounting firm required to be made hereunder.
 - d. The accounting firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and you within fifteen (15) calendar days after the date on which your right to a Payment is triggered (if requested at that time by the Company or you) or such other time or times as requested by the Company or you. If the accounting firm determines that no Excise Tax is payable with respect to a Payment, either before or after the application of the Reduced Amount, it shall furnish the Company and you with an opinion reasonably acceptable to you that no Excise Tax will be imposed with respect to such Payment. The Company shall be entitled to rely upon the accounting firm’s determinations, which shall be final and binding.
13. **DISPUTE RESOLUTION.** To ensure the rapid and economical resolution of disputes that may arise in connection with your employment, you and the Company agree that any and all disputes, claims, or causes of action, in law or equity, arising from or relating to the enforcement, breach, performance, execution, or interpretation of this agreement, your employment, or the termination of your employment, shall be resolved, to the fullest extent permitted by law, by final, binding and confidential arbitration in San Francisco, California conducted before a single arbitrator by Judicial Arbitration and Mediation Services, Inc. (“JAMS”) or its successor, under the then applicable JAMS rules. By agreeing to this arbitration procedure, both you and the Company waive the right to resolve any such dispute through a trial by jury or judge or by administrative proceeding. The arbitrator shall: (a) have the authority to compel adequate discovery for the resolution of the dispute and to award such relief as would otherwise be permitted by law; and (b) issue a written arbitration decision including the arbitrator’s essential findings and conclusions and a statement of the award. The Company shall pay all of JAMS’ arbitration fees. Nothing in this letter agreement shall prevent either you or the Company from obtaining injunctive relief in court if necessary to prevent irreparable harm pending the conclusion of any arbitration. The parties agree that the arbitrator shall award reasonable attorneys fees and costs to the prevailing party in any action brought hereunder, and the arbitrator shall have discretion to determine the prevailing party in an arbitration where multiple claims may be at issue.

14. MISCELLANEOUS.

- a. General Provisions.** This letter, including the attached Non-Disclosure Agreement, constitutes the complete, final and exclusive embodiment of the entire agreement between you and the Company with regard to the subject matter hereof. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein, and it supersedes any other agreements, promises, warranties or representations concerning its subject matter. Changes in your employment terms, other than those expressly reserved herein to the Company's discretion, only can be made in a writing signed by a duly-authorized member of the Company and you. This letter agreement will bind the heirs, personal representatives, successors and assigns of both you and the Company, and inure to the benefit of both you and the Company, their heirs, successors and assigns. If any provision of this letter agreement is determined to be invalid or unenforceable, in whole or in part, this determination shall not affect any other provision of this letter agreement and the provision in question shall be modified so as to be rendered enforceable in a manner consistent with the intent of the parties insofar as possible under applicable law. This letter agreement shall be construed and enforced in accordance with the laws of the State of California without regard to conflicts of law principles. Any ambiguity in this letter agreement shall not be construed against either party as the drafter. Any waiver of a breach of this letter agreement, or rights hereunder, shall be in writing and shall not be deemed to be a waiver of any successive breach or rights hereunder. This letter agreement may be executed in counterparts which shall be deemed to be part of one original, and facsimile signatures shall be equivalent to original signatures.
- b. Legal Right to Work.** As required by law, this offer is subject to satisfactory proof of your right to work in the United States.

15. ACCEPTANCE. Please sign this letter and the attached Non-Disclosure Agreement and return them to me as soon as possible to accept employment with the Company on the terms set forth herein. We are very excited about having you join us as an employee and look forward to working with you.

Sincerely,

Rackable Systems, Inc.

By: /s/ M ARK B ARRENECHEA _____

Mark Barrenechea
CEO and President

March 31, 2008 _____

Date

Understood and Agreed:

/s/ J AMES W HEAT _____

James Wheat

April 8, 2008 _____

Date

Exhibit A – Invention and Non-Disclosure Agreement

EXHIBIT A

INVENTION AND NON-DISCLOSURE AGREEMENT

RACKABLE SYSTEMS, INC.

EMPLOYEE PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT

In consideration of my employment by Rackable Systems, Inc., a Delaware corporation (the “Company”), I hereby agree to the following with respect to my use and development of information and technology of the Company, as more fully set out below.

1. *Proprietary Information.*

(a) Confidential Restrictions. I agree to hold in strict confidence and in trust for the sole benefit of the Company all Proprietary Information (as defined below) that I may have access to during the course of my employment with the Company and will not disclose any Proprietary Information, directly or indirectly, to anyone outside of the Company, or use, copy, publish, summarize, or remove from Company premises such information (or remove from the premises any other property of the Company) except: (i) during my employment as authorized by Company policy and to the extent necessary to carry out my responsibilities as an employee of the Company, or (ii) after termination of my employment, as specifically authorized in writing by the President of the Company. I further understand that the publication of any Proprietary Information through literature or speeches must be approved in advance in writing by the President of the Company.

(b) Proprietary Information. “Proprietary Information” shall mean and all confidential knowledge, data or information related to the Company’s business or its actual or demonstrably anticipated research or development, including without limitation: (i) trade secrets, inventions, ideas, processes, computer source and object code, data, formulae, programs, other works of authorship, know-how, improvements, discoveries, developments, designs, and techniques; (ii) information regarding products, services, plans for research and development, marketing and business plans, budgets, financial statements, contracts, prices, suppliers, and customers; (iii) information regarding the skills and compensation of the Company’s employees, contractors, and any other service providers of the Company; and (iv) the existence of any business discussions, negotiations, or agreements between the Company and any third party.

(c) Exclusions. Proprietary Information shall not include: (i) information which is or becomes publicly known through lawful means; (ii) information which was rightfully in my possession or part of my general knowledge prior to my employment by the Company; or (iii) information which is disclosed to me without confidential or proprietary restriction by a third party who rightfully possesses the information (without confidential or proprietary restriction) and did not learn of it, directly or indirectly, from the Company.

(d) Third Party Information. I recognize that the Company has received and in the future will receive from third parties their confidential or proprietary information subject to a duty on the Company’s part to maintain the confidentiality of such information and to use it only for certain limited purposes. I agree that I owe the Company and such third parties, during the term of my employment and thereafter, a duty to hold all such confidential or proprietary information in the strictest confidence and not to disclose it to any person, firm, or corporation (except as necessary in carrying out my work for the Company consistent with the Company’s

agreement with such third party) or to use it for the benefit of anyone other than for the Company or such third party (consistent with the Company's agreement with such third party) without the express written authorization of the President of the Company.

(e) with Business. In order to protect the Company's and its goodwill, I agree that: (i) during the term of my employment by the Company, I will not, without the Company's express written consent, engage in any employment or business activity that is competitive with, or would otherwise conflict with my employment by, the Company, and (ii) for the period of my employment by the Company and for one (1) year thereafter, I will not, either directly or indirectly, solicit, induce or encourage or attempt to solicit, induce or encourage any employee, independent contractor, or consultant of the Company to terminate his, her or its relationship with the Company in order to become an employee, consultant, or independent contractor to or for any other person or entity.

2. Inventions.

(a) Defined; Statutory Notice. I understand that during the term of my employment, there are certain restrictions on my development of technology, ideas, and inventions, referred to in this Agreement as "Invention Ideas." The term Invention Ideas means any and all ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, and all improvements, rights, and claims related to the foregoing that are conceived, developed, or reduced to practice by me alone or with others except to the extent that California Labor Code Section 2870 lawfully prohibits the assignment of rights in such ideas, processes, inventions, etc. I understand that Section 2870(a) provides:

Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer's equipment, supplies, facilities, or trade secret information except for those inventions that either:

- (1) Relate at the time of conception or reduction to practice of the invention to the employer's business, or actual or demonstrably anticipated research or development of the employer.
- (2) Result from any work performed by the employee for the employer.

(b) Records of Invention Ideas. I agree to maintain adequate and current written records on the development of all Invention Ideas and to disclose promptly to the Company all Invention Ideas and relevant records, which records will remain the sole property of the Company. I further agree that all information and records pertaining to any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, or copyright that I do not believe to be an Invention Idea, but is conceived, developed, or reduced to practice by me (alone or with others) during my period of

employment shall be promptly disclosed to the Company (such disclosure to be received in confidence). The Company shall examine such information to determine if in fact the idea, process, or invention, etc., is an Invention Idea subject to this Agreement.

(c) Assignment. I hereby assign, and agree to assign in the future, to the Company, without further consideration, my entire right, title, and interest (throughout the United States and in all foreign countries), free and clear of all liens and encumbrances, in and to each Invention Idea, which shall be the sole property of the Company, whether or not patentable. In the event any Invention Idea shall be deemed by the Company to be patentable or otherwise registrable, I will assist the Company (at its expense) in obtaining letters patent or other applicable registrations thereon and I will execute all documents and do all other things (including testifying at the Company's expense) necessary or proper to obtain letters patent or other applicable registrations thereon and to vest the Company with full title thereto. Should the Company be unable to secure my signature on any document necessary to apply for, prosecute, obtain, or enforce any patent, copyright, or other right or protection relating to any Invention Idea, whether due to my mental or physical incapacity or any other cause, I hereby irrevocably designate and appoint the Company and each of its duly authorized officers and agents as my agent and attorney-in-fact, to act for and in my behalf and stead, to execute and file any such document, and to do all other lawfully permitted acts to further the prosecution, issuance, and enforcement of patents, copyrights, or other rights or protections with the same force and effect as if executed and delivered by me.

(d) Excluded Inventions. Except as disclosed in Exhibit A, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement ("Excluded Inventions"). If no Excluded Inventions are listed in Exhibit A, I warrant that there are no Excluded Inventions. I agree that I will not incorporate, or permit to be incorporated, Excluded Inventions in any Invention Idea without the Company's prior written consent. If, in the course of my employment with the Company, I incorporate an Excluded Invention into a Company process, machine or other work, I hereby grant the Company a non-exclusive, perpetual, fully-paid and royalty-free, irrevocable and worldwide license, with rights to sublicense through multiple levels of sublicensees, to reproduce, make derivative works of, distribute, publicly perform, and publicly display in any form or medium, whether now known or later developed, make, have made, use, sell, import, offer for sale, and exercise any and all present or future rights in, such Excluded Invention.

(e) Post-Termination Period. the one (1) year period after my employment ends, I will promptly and fully disclose to the Company in writing: (i) all inventions authored, conceived, or reduced to practice by me, either alone or with others, including any that might be covered under California Labor Code Section 2870, and (ii) all patent applications filed by me or in which I am named as an inventor or co-inventor. In addition, I agree to assign in the future any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, copyright, or any improvement, rights, or claims related to the foregoing which are conceived, developed or reduced to practice at any time (including after my employment with the Company ends) to the extent any such item is based upon any Invention Ideas or portions thereof.

I understand that nothing in this Agreement is intended to expand the scope of protection provided me by Sections 2870 through 2872 of the California Labor Code.

3. Former or Conflicting Obligations. During my employment with the Company, I will not disclose to the Company, or use, or induce the Company to use, any proprietary information or trade secrets of others. I represent that my performance of this Agreement will not breach any agreement to keep in confidence proprietary information acquired by me in confidence or in trust prior to my employment by the Company. I certify that I have no outstanding agreement or obligation that is in conflict with any of the provisions of this Agreement, or that would preclude me from complying with the provisions hereof. I further represent that my employment by Company does not and will not breach any agreement with any former employer, including any noncompete agreement.

4. Government Contracts. I understand that the Company has or may enter into contracts with the government under which certain intellectual property rights will be required to be protected, assigned, licensed, or otherwise transferred and I hereby agree to execute such other documents and agreements as are necessary to enable the Company to meet its obligations under any such government contracts.

5. Termination. I hereby acknowledge and agree that all personal property, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents or materials or copies thereof, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment, belong to the Company and will be promptly returned to the Company upon termination of my employment with the Company. Following my termination, I will not retain any written or other tangible material containing any Proprietary Information or information pertaining to any Invention Idea. I understand that my obligations contained herein will survive the termination of my employment. In the event of termination of my employment, I agree to sign and deliver to the Company a Termination Certificate in the form attached hereto as Exhibit B. I further agree that I will not copy, delete, or alter any information contained upon my Company computer or Company equipment before I return it to the Company. In addition, if I have used any personal computer, server, or e-mail system to receive, store, review, prepare or transmit any Company information, including but not limited to, Proprietary Information, I agree to provide the Company with a computer-useable copy of all such Proprietary Information and then permanently delete and expunge such Proprietary Information from those systems; and I agree to provide the Company access to my system as reasonably requested to verify that the necessary copying and/or deletion is completed. I further agree that any property situated on the Company's premises and owned by the Company is subject to inspection by the Company's personnel at any time with or without further notice or consent. Prior to the termination of my employment or promptly after termination of my employment, I will cooperate with the Company in attending an exit interview.

6. Miscellaneous Provisions.

(a) Assignment. I agree that the Company may assign to another person or entity any of its rights under this Agreement, including, without limitation, any successor in interest to the Company or its business operations. This Agreement shall be binding upon me and my heirs, executors, administrators, and successors, and shall inure to the benefit of the Company's successors and assigns.

(b) Governing Law; Severability. The validity, interpretation, enforceability, and performance of this Agreement shall be governed by and construed in accordance with the laws of the State of California. If any provision of this Agreement, or application thereof to any person, place, or circumstance, shall be held by a court of competent jurisdiction to be invalid, unenforceable, or void, the remainder of this Agreement and such provisions as applied to other persons, places, and circumstances shall remain in full force and effect.

(c) Application of this Agreement. I hereby agree that my obligations set forth in Sections 1 and 2 hereof and the definitions of Proprietary Information and Invention Ideas contained therein shall be equally applicable to Proprietary Information and Invention Ideas relating to any work performed by me for the Company prior to the execution of this Agreement.

(d) Notification of New Employer. If I leave the employ of the Company, I consent to the notification of my new employer of my rights and obligations under this Agreement, by the Company providing a copy of this Agreement or otherwise.

(e) Employment. I agree and understand that nothing in this Agreement shall give me any right to continued employment by the Company, and it will not interfere in any way with my right or the Company's right to terminate my employment at any time, with or without cause and with or without advance notice.

(f) Injunctive Relief. I acknowledge that, because my services are personal and unique and because I will have access to the Proprietary Information of the Company, any breach of this Agreement by me would cause irreparable injury to the Company for which monetary damages would not be an adequate remedy and, therefore, will entitle the Company to injunctive relief (including specific performance). The rights and remedies provided to each party in this Agreement are cumulative and in addition to any other rights and remedies available to such party at law or in equity.

(g) Entire Agreement. The terms of this Agreement are the final and entire expression of my agreement with respect to the subject matter hereof and supersede any prior or contemporaneous agreements or representations. This Agreement only may be modified in a written agreement signed by both me and a duly authorized officer of the Company.

Date: April 28, 2008

/s/ Jim Wheat
Signature

Jim Wheat
Printed Name

EXHIBIT A

Employee's Prior Inventions

Except as set forth below, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or any claims, rights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement:

EXHIBIT B

**TERMINATION CERTIFICATE CONCERNING
PROPRIETARY INFORMATION AND INVENTIONS**

This is to certify that I have returned all personal property of the Company, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents and materials, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment with the Company, and that I did not make or distribute any copies of the foregoing.

I further certify that I have reviewed the Employee Proprietary Information and Inventions Agreement signed by me and that I have complied with and will continue to comply with all of its terms, including, without limitation, (i) the reporting of any invention, process, or idea, etc. conceived or developed by me and covered by the Agreement and (ii) the preservation as confidential of all Proprietary Information pertaining to the Company. This certificate in no way limits my responsibilities or the Company's rights under the Agreement.

Date: _____

Signature

Printed Name

AMENDMENT #1
to
Employment Agreement
dated March 31, 2008 (the "Agreement")
by and between
Rackable Systems, Inc. ("Company")
and
James Wheat

Effective as of the last date signed below, the parties hereby amend the Agreement as follows:

1. The definition of "Start Date" as set forth in the second sentence of the opening paragraph is hereby modified as follows:
 "Your employment shall commence on April 21, 2008 ("Start Date"), at which time you will serve in an interim capacity, becoming acquainted with the Company's personnel, systems and processes. You will assume the role of Chief Financial Officer ("CFO") immediately upon the resignation of the Company's current CFO from the position, the exact date of which will be mutually determined once you are employed with the Company."

2. Section 1 of the Agreement entitled "**COMPENSATION**" is hereby modified to add the following subsection "d" as if it were made a part of the original Agreement:
 "**d. Sign-On Bonus.** You will be entitled to a one time sign-on bonus of Twenty-Five Thousand Dollars (\$25,000) that will be paid on the first pay period following your first day of employment. This bonus is recoverable by the Company if you leave voluntarily or if you are terminated for cause within one year of your Start date. Therefore, you agree to repay the bonus upon your last day of work should your employment terminate for reasons as stated above. The sign-on bonus will be subject to statutory deductions and withholdings."

3. Except as amended herein, the Agreement remains in full force and effect, without modification.

Rackable Systems, Inc.

By: /s/ M ARK B ARRENECHEA
 Mark Barrenechea
 CEO and President

April 9, 2008
 Date

/s/ J AMES W HEAT
 James Wheat

April 14, 2008
 Date



46600 Landing Parkway
Fremont, California 94538

P. 408.240.8300
F. 408.321.0293

www.rackable.com

January 24, 2008

Anthony Carrozza

Re: Employment Terms

Dear Anthony:

Rackable Systems, Inc. (the “Company”), is pleased to offer you the position of SVP World Wide Sales, on the following terms. Your employment shall commence on February 11, 2008 (“Start Date”).

1. **POSITION.** You will serve in an executive capacity and as required by the Company’s Chief Executive Officer (the “CEO”). You will be responsible for driving the overall sales strategy, working closely with other key executives and regional sales leaders; identifying new markets and new ways to further develop the existing customer base; hiring, developing and motivating a geographically dispersed sales team with operations across all continents. You will report to the CEO. Of course, the Company may change your position, duties, and work location from time to time in its discretion subject to the terms of this offer letter agreement.
2. **COMPENSATION.**
 - a. **Base Salary.** Your initial annual base salary will be \$275,000, less standard payroll deductions and withholdings. You will be paid bi-weekly in accordance with Company practice and policy.
 - b. **Performance Bonus.** In addition, you will be eligible to earn a quarterly performance bonus ¹ of up to \$31,250, based upon both your performance and the Company’s performance with respect to applicable performance targets which are expected to include revenue and profitability targets and other organizational milestones (“Targets”), set solely by the CEO. The bonus payment shall be earned upon the fulfillments of Targets and is payable within a reasonable period of time. The Company will determine in its sole discretion whether the Targets have been achieved, whether you have earned a bonus, and the amount of any earned bonus. You must be employed on the bonus payment date to earn and be eligible to receive any bonus.

¹ Performance bonuses are aligned to the Company’s quarterly financial reporting periods (each such quarter, a “Company Quarter”); your initial quarterly participation will be adjusted *pro rata* based upon your Start Date.

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- c. **Commission.** You will participate in the 2008 Personal Sales Incentive Plan of up to \$125,000 annually based upon specific sales goals. In order to normalize cash flow, you will receive a recoverable draw against commissions and bonuses of \$2,000 per month through December 31, 2008. The precise methodology of this plan will be documented in the 2008 Sales Plan Document and your Personal Sales Plan (PSP), and forwarded to you under separate cover. Your incentive compensation is not guaranteed and will be subject to statutory deductions and withholdings.
 - d. **Review of Compensation.** Your base salary and bonus eligibility will be reviewed on an annual or more frequent basis by the Compensation Committee and are subject to change in the discretion of the Compensation Committee, subject to the terms of this offer letter agreement.

2. **OPTION GRANT.**

- a. **Equity Grants.** Subject to Compensation Committee approval, the Company will issue you an option (the “Option”) to purchase 100,000 shares of the Company’s common stock pursuant to the Company’s 2006 New Recruit Equity Incentive Plan (the “Plan”) at an exercise price equal to the fair market value of the stock as of the date of grant as determined by the Compensation Committee. In addition, subject to Compensation Committee approval, the Company will grant you the right to receive 30,000 shares of the Company’s common stock pursuant to the Plan (the “Restricted Stock Unit Award”).
- b. **Vesting Schedule.** Both the Option and the Restricted Stock Unit Award will be subject to a four-year vesting period subject to your continuous service to the Company as an employee or consultant (as defined in the Plan and the Stock Unit Award Agreement), with 25% upon completion of the first year of employment, with an additional 6.25% of such shares subject to each of the Option and the Restricted Stock Unit Award vesting for each full Company Quarter of your continuous service as an employee or consultant following the Start Date.
- c. **Governing Documents.** The Option will be governed in full by the terms and conditions of the Plan and your individual Option agreement; the Restricted Stock Unit Award will be governed in full by the terms and conditions of the Stock Unit Award Agreement.

- 3. **EMPLOYEE BENEFITS.** You will be eligible to participate in the Company’s standard employee benefit plans in accordance with the terms and conditions of the plans and applicable policies which may be in effect from time to time, and provided by the Company to its executive employees generally, including but not limited to group health insurance coverage, disability insurance, life insurance, ESPP, 401(k) Plan, and paid time off and paid holidays. You will be eligible for reimbursement of your legitimate and documented business expenses incurred in connection with your employment, pursuant to the Company’s standard reimbursement expense policy and practices. The Company may modify its benefits programs and policies from time to time in its discretion.
- 4. **PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT.** As a condition of your employment, you are required to sign and abide by the Company’s Proprietary Information and Inventions Agreement (the “Non-Disclosure Agreement”), attached hereto as **Exhibit A**.

5. SERVICE AS EMPLOYEE; OUTSIDE ACTIVITIES.

- a. Location and Duties.** You will work at the Company's corporate headquarters currently located in Fremont, California, subject to necessary business travel. During your employment with the Company, you will devote your best efforts and substantially all of your business time and attention (except for vacation periods and reasonable periods of illness or other incapacity permitted by the Company's general employment policies) to the business of the Company.
- b. Company Policies.** Your employment relationship with the Company shall also be governed by the general employment policies and practices of the Company, including but not limited to the policies contained in the Company's Employee Handbook (except that if the terms of this letter differ from or are in conflict with the Company's general employment policies or practices, this letter will control), and you will be required to abide by such general employment policies and practices of the Company.
- c. Other Activities.** Throughout your employment with the Company, you may engage in civic and not-for-profit activities so long as such activities do not interfere with the performance of your duties hereunder or present a conflict of interest with the Company. Subject to the restrictions set forth herein and with the prior written consent of the Board, you may serve as a director of other corporations and may devote a reasonable amount of your time to other types of business or public activities not expressly mentioned in this paragraph.
- d. Conflict of Interest.** During your employment by the Company, except on behalf of the Company, you will not directly or indirectly serve as an officer, director, stockholder, employee, partner, proprietor, investor, joint venturer, associate, representative or consultant for or on behalf of any other person, corporation, firm, partnership or other entity whatsoever known by you to compete with the Company (or is planning or preparing to compete with the Company), anywhere in the world, in any line of business engaged in (or planned to be engaged in) by the Company; provided, however, that you may purchase or otherwise acquire up to (but not more than) one percent (1%) of any class of securities of any enterprise (but without participating in the activities of such enterprise) if such securities are listed on any national or regional securities exchange.

6. AT-WILL EMPLOYMENT RELATIONSHIP. Your employment relationship with the Company is at-will. Accordingly, both you and the Company may terminate the employment relationship at any time, with or without Cause (as defined below), and with or without advance notice.

7. DEFINITIONS.

- a. Definition of "Cause."** For purposes of this offer letter agreement, "Cause" is defined as one or more of the following events: (i) the indictment or conviction for a felony or other crime, or any misdemeanor involving moral turpitude; (ii) the commission of any other act or omission involving fraud or intentional deceit with respect to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iii) any act or omission involving dishonesty that causes material injury to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iv) gross negligence with respect to the Company or any of its subsidiaries; (v) willful

misconduct with respect to the Company or any of its subsidiaries; (vi) any other material breach of this agreement or any other agreement referred to herein (including the Non-Disclosure Agreement); provided, however, that, it shall only be deemed Cause pursuant to clause (vi) if you are given written notice describing the basis of Cause and, if the event is reasonably susceptible of cure, you fail to cure within thirty (30) days.

- b. Definition of “Good Reason.”** For purposes of this offer letter agreement, “Good Reason” is defined as one or more of the following conditions that occur without your written consent: (i) the assignment to you, or the removal from you, of any duties or responsibilities that results in the material diminution of your authority, duties or responsibilities as SVP World Wide Sales, including a Change in Control that results in your no longer serving as the SVP of World Wide Sales or any similar position; (ii) a material reduction by the Company of your base salary; (iii) the Company’s material breach of its obligations to you under this offer letter agreement; or (iv) your office relocation to a location more than fifty miles from your then present location; provided however that, it shall only be deemed Good Reason pursuant to the foregoing definition if (x) the Company is given written notice from you within ninety (90) days following the first occurrence of a condition that you consider to constitute Good Reason describing the condition and fails to remedy such condition within thirty (30) days following such written notice, and (y) you resign from employment within ninety (90) days following the end of the period within which the Company was entitled to remedy the condition constituting Good Reason but failed to do so.
- c. Definition of “Change in Control.”** For purposes of this offer letter agreement, “Change in Control” means the occurrence, in a single transaction or in a series of related transactions, of either of the following events:
- i.** There is consummated (A) a merger, consolidation or similar transaction involving (directly or indirectly) the Company or (B) a tender offer or exchange offer addressed to the stockholders of the Company and, in either event, immediately after the consummation of such merger, consolidation or similar transaction or such tender or exchange offer, the stockholders of the Company immediately prior thereto do not own, directly or indirectly, either (A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such transaction; or
 - ii.** There is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries to an entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition.

The term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

- 8. CHANGE IN CONTROL SEVERANCE BENEFITS.** If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”):
- a. The vesting of all unvested stock options and all unvested grants of restricted stock herein referred to and any subsequent grants of stock options, restricted stock or any other stock awards in future plans, shall accelerate in such amount equal to the number of shares that would vest over an additional twenty-four (24) month period as if you have continued to be an employee of the Company for additional twenty-four (24) months following your termination;
 - b. You will be eligible to receive severance pay in the total amount equal to the sum of twelve (12) months of your base salary in effect as of the employment termination date. For purposes of this Section 9(b), “base salary” as used herein does not include any annual performance bonus or any other bonus payment. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; and
 - c. If you timely elect and continue to remain eligible for continued group health insurance coverage under federal COBRA law or, if applicable, state insurance laws (collectively, “COBRA”), the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment termination date (including dependent coverage, if applicable) for twelve (12) months after the employment termination date; provided that, the Company’s obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Company if you become eligible for group health insurance coverage through a new employer within twelve (12) months of your employment termination date.
- 9. SEVERANCE BENEFITS.** If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”); then you shall be entitled to receive the following severance benefits (the “Severance Benefits”):
- a. Severance pay in the total amount equal to the sum of six (6) months of your base salary in effect as of the employment termination date. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in thirteen (13) equal installments over a period of six (6) months, with such payments made on the Company’s normal payroll schedule. For purposes of this Section 10(a), “base salary” as used herein does not include any annual performance bonus or any other bonus payment; and

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- b. If you timely elect and continue to remain eligible for COBRA, the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment termination date (including dependent coverage, if applicable) for six (6) months after the employment termination date; provided that, the Company's obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Board if you become eligible for group health insurance coverage through a new employer within six (6) months of your employment termination date.

10. CONDITIONS TO ELIGIBILITY TO SEVERANCE BENEFITS OR CHANGE IN CONTROL SEVERANCE BENEFITS .

Notwithstanding the foregoing, you will not be eligible for the Severance Benefits or the Change in Control Severance Benefits if: (A) your employment is terminated for Cause, or if you resign for any reason that does not qualify as Good Reason; or (B) in the event that you materially breach the Non-Disclosure Agreement, the Release of claims, or any other obligations you owe to the Company after termination of your employment (including but not limited to the provisions of the Non-Disclosure Agreement), and the Company's obligation to provide the Severance Benefits or the Change in Control Benefits (or to continue to provide such benefits) will cease immediately and in full as of the date of your breach.

- 11. DEFERRED COMPENSATION.** Anything in this agreement to the contrary notwithstanding, if the Company reasonably determines that any payments hereunder fail to satisfy the distribution requirements of Section 409A(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code") and you concur with such determination in writing, then the payment of such benefit shall be delayed to the minimum extent necessary so that such payments are not subject to the provisions of Section 409A(a)(1) of the Code; provided, however, that in no event shall such delay be more than six (6) months and one (1) day from the date of termination of your employment with the Company.

12. EXCISE TAX.

- a. Anything in this agreement to the contrary notwithstanding, if any payment or benefit that you would receive pursuant to this offer letter agreement or otherwise ("Payment") would (i) constitute a "parachute payment" within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the "Excise Tax"), then such Payment shall be equal to the Reduced Amount (defined below). The "Reduced Amount" shall be either (y) the largest portion of the Payment that would result in no portion of the Payment (after reduction) being subject to the Excise Tax, or (z) the entire Payment, whichever amount after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate, net of the maximum reduction in federal income taxes which could be obtained from a deduction of such state and local taxes), results in your receipt, on an after-tax basis, of the greatest amount of the Payment to you.

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- b. If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur in the following order unless you elect in writing a different order (provided, however, that such election shall be subject to Company approval, such approval not to be unreasonably withheld or delayed, if made on or after the date on which the event that triggers the Payment occurs (the “Payment Event”)): (1) reduction of cash payments; (2) cancellation of accelerated vesting of equity awards other than stock options; (3) cancellation of accelerated vesting of stock options; and (4) reduction of other benefits paid to you. In the event that acceleration of compensation from your equity awards is to be reduced, such acceleration of vesting shall be canceled in the reverse order of the date of grant unless you elect in writing a different order for cancellation.
 - c. The accounting firm engaged by the Company for general audit purposes as of the day prior to the effective date of the Payment Event shall perform the foregoing calculations. If the accounting firm so engaged by the Company is serving as accountant or auditor for the individual, entity or group effecting the Payment Event, a nationally recognized accounting firm appointed by the Board and reasonably approved by you shall make the determinations required hereunder. The Company shall bear all expenses with respect to the determinations by such accounting firm required to be made hereunder.
 - d. The accounting firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and you within fifteen (15) calendar days after the date on which your right to a Payment is triggered (if requested at that time by the Company or you) or such other time or times as requested by the Company or you. If the accounting firm determines that no Excise Tax is payable with respect to a Payment, either before or after the application of the Reduced Amount, it shall furnish the Company and you with an opinion reasonably acceptable to you that no Excise Tax will be imposed with respect to such Payment. The Company shall be entitled to rely upon the accounting firm’s determinations, which shall be final and binding.
13. **DISPUTE RESOLUTION.** To ensure the rapid and economical resolution of disputes that may arise in connection with your employment, you and the Company agree that any and all disputes, claims, or causes of action, in law or equity, arising from or relating to the enforcement, breach, performance, execution, or interpretation of this agreement, your employment, or the termination of your employment, shall be resolved, to the fullest extent permitted by law, by final, binding and confidential arbitration in San Francisco, California conducted before a single arbitrator by Judicial Arbitration and Mediation Services, Inc. (“JAMS”) or its successor, under the then applicable JAMS rules. By agreeing to this arbitration procedure, both you and the Company waive the right to resolve any such dispute through a trial by jury or judge or by administrative proceeding. The arbitrator shall: (a) have the authority to compel adequate discovery for the resolution of the dispute and to award such relief as would otherwise be permitted by law; and (b) issue a written arbitration decision including the arbitrator’s essential findings and conclusions and a statement of the award. The Company shall pay all of JAMS’ arbitration fees. Nothing in this letter agreement shall prevent either you or the Company from obtaining injunctive relief in court if necessary to prevent irreparable harm pending the conclusion of any arbitration. The parties agree that the arbitrator shall award reasonable attorneys fees and costs to the prevailing party in any action brought hereunder, and the arbitrator shall have discretion to determine the prevailing party in an arbitration where multiple claims may be at issue.

14. MISCELLANEOUS.

- a. General Provisions.** This letter, including the attached Non-Disclosure Agreement, constitutes the complete, final and exclusive embodiment of the entire agreement between you and the Company with regard to the subject matter hereof. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein, and it supersedes any other agreements, promises, warranties or representations concerning its subject matter. Changes in your employment terms, other than those expressly reserved herein to the Company's discretion, only can be made in a writing signed by a duly-authorized member of the Company and you. This letter agreement will bind the heirs, personal representatives, successors and assigns of both you and the Company, and inure to the benefit of both you and the Company, their heirs, successors and assigns. If any provision of this letter agreement is determined to be invalid or unenforceable, in whole or in part, this determination shall not affect any other provision of this letter agreement and the provision in question shall be modified so as to be rendered enforceable in a manner consistent with the intent of the parties insofar as possible under applicable law. This letter agreement shall be construed and enforced in accordance with the laws of the State of California without regard to conflicts of law principles. Any ambiguity in this letter agreement shall not be construed against either party as the drafter. Any waiver of a breach of this letter agreement, or rights hereunder, shall be in writing and shall not be deemed to be a waiver of any successive breach or rights hereunder. This letter agreement may be executed in counterparts which shall be deemed to be part of one original, and facsimile signatures shall be equivalent to original signatures.
- b. Legal Right to Work.** As required by law, this offer is subject to satisfactory proof of your right to work in the United States.

15. ACCEPTANCE. Please sign this letter and the attached Non-Disclosure Agreement and return them to me as soon as possible to accept employment with the Company on the terms set forth herein. We are very excited about having you join us as an employee and look forward to working with you.

Sincerely,

Rackable Systems, Inc.

By: /s/ M ARK B ARRENECHEA

Mark Barrenechea
CEO and President

January 31, 2008

Date

Understood and Agreed:

/s/ A NTHONY C ARROZZA

Anthony Carrozza

January 30, 2008

Date

Exhibit A – Invention and Non-Disclosure Agreement

EXHIBIT A

INVENTION AND NON-DISCLOSURE AGREEMENT

RACKABLE SYSTEMS, INC.

EMPLOYEE PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT

In consideration of my employment by Rackable Systems, Inc., a Delaware corporation (the “Company”), I hereby agree to the following with respect to my use and development of information and technology of the Company, as more fully set out below.

1. *Proprietary Information.*

(a) Confidential Restrictions. I agree to hold in strict confidence and in trust for the sole benefit of the Company all Proprietary Information (as defined below) that I may have access to during the course of my employment with the Company and will not disclose any Proprietary Information, directly or indirectly, to anyone outside of the Company, or use, copy, publish, summarize, or remove from Company premises such information (or remove from the premises any other property of the Company) except: (i) during my employment as authorized by Company policy and to the extent necessary to carry out my responsibilities as an employee of the Company, or (ii) after termination of my employment, as specifically authorized in writing by the President of the Company. I further understand that the publication of any Proprietary Information through literature or speeches must be approved in advance in writing by the President of the Company.

(b) Proprietary Information. “Proprietary Information” shall mean and all confidential knowledge, data or information related to the Company’s business or its actual or demonstrably anticipated research or development, including without limitation: (i) trade secrets, inventions, ideas, processes, computer source and object code, data, formulae, programs, other works of authorship, know-how, improvements, discoveries, developments, designs, and techniques; (ii) information regarding products, services, plans for research and development, marketing and business plans, budgets, financial statements, contracts, prices, suppliers, and customers; (iii) information regarding the skills and compensation of the Company’s employees, contractors, and any other service providers of the Company; and (iv) the existence of any business discussions, negotiations, or agreements between the Company and any third party.

(c) Exclusions. Proprietary Information shall not include: (i) information which is or becomes publicly known through lawful means; (ii) information which was rightfully in my possession or part of my general knowledge prior to my employment by the Company; or (iii) information which is disclosed to me without confidential or proprietary restriction by a third party who rightfully possesses the information (without confidential or proprietary restriction) and did not learn of it, directly or indirectly, from the Company.

(d) Third Party Information. I recognize that the Company has received and in the future will receive from third parties their confidential or proprietary information subject to a duty on the Company’s part to maintain the confidentiality of such information and to use it only for certain limited purposes. I agree that I owe the Company and such third parties, during the term of my employment and thereafter, a duty to hold all such confidential or proprietary information in the strictest confidence and not to disclose it to any person, firm, or corporation (except as necessary in carrying out my work for the Company consistent with the Company’s

agreement with such third party) or to use it for the benefit of anyone other than for the Company or such third party (consistent with the Company's agreement with such third party) without the express written authorization of the President of the Company.

(e) with Business. In order to protect the Company's and its goodwill, I agree that: (i) during the term of my employment by the Company, I will not, without the Company's express written consent, engage in any employment or business activity that is competitive with, or would otherwise conflict with my employment by, the Company, and (ii) for the period of my employment by the Company and for one (1) year thereafter, I will not, either directly or indirectly, solicit, induce or encourage or attempt to solicit, induce or encourage any employee, independent contractor, or consultant of the Company to terminate his, her or its relationship with the Company in order to become an employee, consultant, or independent contractor to or for any other person or entity.

2. Inventions.

(a) Defined; Statutory Notice. I understand that during the term of my employment, there are certain restrictions on my development of technology, ideas, and inventions, referred to in this Agreement as "Invention Ideas." The term Invention Ideas means any and all ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, and all improvements, rights, and claims related to the foregoing that are conceived, developed, or reduced to practice by me alone or with others except to the extent that California Labor Code Section 2870 lawfully prohibits the assignment of rights in such ideas, processes, inventions, etc. I understand that Section 2870(a) provides:

Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer's equipment, supplies, facilities, or trade secret information except for those inventions that either:

- (1) Relate at the time of conception or reduction to practice of the invention to the employer's business, or actual or demonstrably anticipated research or development of the employer.
- (2) Result from any work performed by the employee for the employer.

(b) Records of Invention Ideas. I agree to maintain adequate and current written records on the development of all Invention Ideas and to disclose promptly to the Company all Invention Ideas and relevant records, which records will remain the sole property of the Company. I further agree that all information and records pertaining to any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, or copyright that I do not believe to be an Invention Idea, but is conceived, developed, or reduced to practice by me (alone or with others) during my period of

employment shall be promptly disclosed to the Company (such disclosure to be received in confidence). The Company shall examine such information to determine if in fact the idea, process, or invention, etc., is an Invention Idea subject to this Agreement.

(c) Assignment. I hereby assign, and agree to assign in the future, to the Company, without further consideration, my entire right, title, and interest (throughout the United States and in all foreign countries), free and clear of all liens and encumbrances, in and to each Invention Idea, which shall be the sole property of the Company, whether or not patentable. In the event any Invention Idea shall be deemed by the Company to be patentable or otherwise registrable, I will assist the Company (at its expense) in obtaining letters patent or other applicable registrations thereon and I will execute all documents and do all other things (including testifying at the Company's expense) necessary or proper to obtain letters patent or other applicable registrations thereon and to vest the Company with full title thereto. Should the Company be unable to secure my signature on any document necessary to apply for, prosecute, obtain, or enforce any patent, copyright, or other right or protection relating to any Invention Idea, whether due to my mental or physical incapacity or any other cause, I hereby irrevocably designate and appoint the Company and each of its duly authorized officers and agents as my agent and attorney-in-fact, to act for and in my behalf and stead, to execute and file any such document, and to do all other lawfully permitted acts to further the prosecution, issuance, and enforcement of patents, copyrights, or other rights or protections with the same force and effect as if executed and delivered by me.

(d) Excluded Inventions. Except as disclosed in Exhibit A, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement ("Excluded Inventions"). If no Excluded Inventions are listed in Exhibit A, I warrant that there are no Excluded Inventions. I agree that I will not incorporate, or permit to be incorporated, Excluded Inventions in any Invention Idea without the Company's prior written consent. If, in the course of my employment with the Company, I incorporate an Excluded Invention into a Company process, machine or other work, I hereby grant the Company a non-exclusive, perpetual, fully-paid and royalty-free, irrevocable and worldwide license, with rights to sublicense through multiple levels of sublicensees, to reproduce, make derivative works of, distribute, publicly perform, and publicly display in any form or medium, whether now known or later developed, make, have made, use, sell, import, offer for sale, and exercise any and all present or future rights in, such Excluded Invention.

(e) Post-Termination Period. the one (1) year period after my employment ends, I will promptly and fully disclose to the Company in writing: (i) all inventions authored, conceived, or reduced to practice by me, either alone or with others, including any that might be covered under California Labor Code Section 2870, and (ii) all patent applications filed by me or in which I am named as an inventor or co-inventor. In addition, I agree to assign in the future any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, copyright, or any improvement, rights, or claims related to the foregoing which are conceived, developed or reduced to practice at any time (including after my employment with the Company ends) to the extent any such item is based upon any Invention Ideas or portions thereof.

I understand that nothing in this Agreement is intended to expand the scope of protection provided me by Sections 2870 through 2872 of the California Labor Code.

3. Former or Conflicting Obligations. During my employment with the Company, I will not disclose to the Company, or use, or induce the Company to use, any proprietary information or trade secrets of others. I represent that my performance of this Agreement will not breach any agreement to keep in confidence proprietary information acquired by me in confidence or in trust prior to my employment by the Company. I certify that I have no outstanding agreement or obligation that is in conflict with any of the provisions of this Agreement, or that would preclude me from complying with the provisions hereof. I further represent that my employment by Company does not and will not breach any agreement with any former employer, including any noncompete agreement.

4. Government Contracts. I understand that the Company has or may enter into contracts with the government under which certain intellectual property rights will be required to be protected, assigned, licensed, or otherwise transferred and I hereby agree to execute such other documents and agreements as are necessary to enable the Company to meet its obligations under any such government contracts.

5. Termination. I hereby acknowledge and agree that all personal property, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents or materials or copies thereof, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment, belong to the Company and will be promptly returned to the Company upon termination of my employment with the Company. Following my termination, I will not retain any written or other tangible material containing any Proprietary Information or information pertaining to any Invention Idea. I understand that my obligations contained herein will survive the termination of my employment. In the event of termination of my employment, I agree to sign and deliver to the Company a Termination Certificate in the form attached hereto as Exhibit B. I further agree that I will not copy, delete, or alter any information contained upon my Company computer or Company equipment before I return it to the Company. In addition, if I have used any personal computer, server, or e-mail system to receive, store, review, prepare or transmit any Company information, including but not limited to, Proprietary Information, I agree to provide the Company with a computer-useable copy of all such Proprietary Information and then permanently delete and expunge such Proprietary Information from those systems; and I agree to provide the Company access to my system as reasonably requested to verify that the necessary copying and/or deletion is completed. I further agree that any property situated on the Company's premises and owned by the Company is subject to inspection by the Company's personnel at any time with or without further notice or consent. Prior to the termination of my employment or promptly after termination of my employment, I will cooperate with the Company in attending an exit interview.

6. Miscellaneous Provisions.

(a) Assignment. I agree that the Company may assign to another person or entity any of its rights under this Agreement, including, without limitation, any successor in interest to the Company or its business operations. This Agreement shall be binding upon me and my heirs, executors, administrators, and successors, and shall inure to the benefit of the Company's successors and assigns.

(b) Governing Law; Severability. The validity, interpretation, enforceability, and performance of this Agreement shall be governed by and construed in accordance with the laws of the State of California. If any provision of this Agreement, or application thereof to any person, place, or circumstance, shall be held by a court of competent jurisdiction to be invalid, unenforceable, or void, the remainder of this Agreement and such provisions as applied to other persons, places, and circumstances shall remain in full force and effect.

(c) Application of this Agreement. I hereby agree that my obligations set forth in Sections 1 and 2 hereof and the definitions of Proprietary Information and Invention Ideas contained therein shall be equally applicable to Proprietary Information and Invention Ideas relating to any work performed by me for the Company prior to the execution of this Agreement.

(d) Notification of New Employer. If I leave the employ of the Company, I consent to the notification of my new employer of my rights and obligations under this Agreement, by the Company providing a copy of this Agreement or otherwise.

(e) Employment. I agree and understand that nothing in this Agreement shall give me any right to continued employment by the Company, and it will not interfere in any way with my right or the Company's right to terminate my employment at any time, with or without cause and with or without advance notice.

(f) Injunctive Relief. I acknowledge that, because my services are personal and unique and because I will have access to the Proprietary Information of the Company, any breach of this Agreement by me would cause irreparable injury to the Company for which monetary damages would not be an adequate remedy and, therefore, will entitle the Company to injunctive relief (including specific performance). The rights and remedies provided to each party in this Agreement are cumulative and in addition to any other rights and remedies available to such party at law or in equity.

(g) Entire Agreement. The terms of this Agreement are the final and entire expression of my agreement with respect to the subject matter hereof and supersede any prior or contemporaneous agreements or representations. This Agreement only may be modified in a written agreement signed by both me and a duly authorized officer of the Company.

Date: _____

Signature

Printed Name

EXHIBIT A

Employee's Prior Inventions

Except as set forth below, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or any claims, rights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement:

EXHIBIT B

**TERMINATION CERTIFICATE CONCERNING
PROPRIETARY INFORMATION AND INVENTIONS**

This is to certify that I have returned all personal property of the Company, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents and materials, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment with the Company, and that I did not make or distribute any copies of the foregoing.

I further certify that I have reviewed the Employee Proprietary Information and Inventions Agreement signed by me and that I have complied with and will continue to comply with all of its terms, including, without limitation, (i) the reporting of any invention, process, or idea, etc. conceived or developed by me and covered by the Agreement and (ii) the preservation as confidential of all Proprietary Information pertaining to the Company. This certificate in no way limits my responsibilities or the Company's rights under the Agreement.

Date: _____

Signature

Printed Name

RACKABLE SYSTEMS, INC.

FIRST AMENDMENT TO EMPLOYMENT AGREEMENT

This FIRST AMENDMENT TO THE EMPLOYMENT AGREEMENT (the “**First Amendment**”) dated December 23, 2008 (the “**Effective Date**”) is executed by and between Rackable Systems, Inc., a Delaware corporation (the “Company”), and Anthony Carrozza (the “**Executive**”). The Company and the Executive are each individually referred to in this Amendment as a “**Party**” and are collectively referred to in this Amendment as the “**Parties**.”

RECITALS

- A. Executive and the Company have entered into an Employment Agreement dated January 24, 2008 (the “**Employment Agreement**”).
- B. The Parties desire to further amend Employment Agreement as follows.

AGREEMENT

In consideration of the mutual promises and covenants set forth in this First Amendment, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

1. Amendment to Employment Agreement. The Parties agree that upon the Effective Date, Employment Agreement is hereby amended as follows:

1.1 The first sentence of Section 8 is hereby amended to read in its entirety as follows:

“If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason, and such termination of employment constitutes a “separation from service” within the meaning of the Treas. Reg. §1.409A-1(h)(1), without regard to any alternative definitions thereunder; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”) (provided that the effective date of such Release shall be no later than sixty (60) days following your termination of employment); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”):”

1.2 The last sentence of Section 8(b) is hereby amended to read in its entirety as follows:

“The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; provided, however, that any payments delayed pending the effective date of the Release shall be paid in arrears on the payroll date next following such effective date; and”

1.3 The first sentence of Section 9 is hereby amended to read in its entirety as follows:

“If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason, and such termination of employment constitutes a “separation from service” within the meaning of the Treas. Reg. §1.409A-1(h)(1), without regard to any alternative definitions thereunder; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”) (provided that the effective date of such Release shall be no later than sixty (60) days following your termination of employment); then you shall be entitled to receive the following severance benefits (the “Severance Benefits”):”

1.4 The second sentence of Section 9(a), is hereby amended to read in its entirety as follows:

“The severance pay will be subject to required payroll deductions and withholdings, and will be paid in thirteen (13) equal installments over a period of six (6) months, with such payments made on the Company’s normal payroll schedule; provided, however, that any payments delayed pending the effective date of the Release shall be paid in arrears on the payroll date next following such effective date.”

1.5 Section 11, “Deferred Compensation”, is hereby amended to read in its entirety as follows:

“If the Company (or, if applicable, any successor entity thereto) determines that the severance payments and benefits provided to you hereunder (any such payments, the “Agreement Payments”) constitute “deferred compensation” under Section 409A of the Internal Revenue Code of 1986, as amended (together, with any state law of similar effect, “Section 409A”) and if you are a “specified employee” of the Company (or, if applicable, any successor entity thereto), as such term is defined in Section 409A(a)(2)(B)(i) (a “Specified Employee”), then, solely to the extent necessary to avoid the imposition of the adverse personal tax consequences under Section 409A, the timing of the Agreement Payments will be delayed as follows: on the earliest to occur of (1) the date that is six months and one day after the date of termination of your employment, and (2) the date of your death (such earliest date, the “Delayed Initial Payment Date”), the Company (or the successor entity thereto, as applicable) shall (i) pay to you a lump sum amount equal to the sum of the Agreement Payments that you would otherwise have received through the Delayed Initial Payment Date if the commencement of the payment of the Agreement Payments had not been delayed pursuant to this Section 10(d) and (ii) commence paying the balance of the Agreement Payments in accordance with the applicable payment schedule set forth in this Agreement. Prior to the imposition of any delay on the Agreement Payments as set forth above, it is intended that (A) each installment of the Agreement Payments be regarded as a separate “payment” for purposes of Treas. Reg. §1.409A-2(b)(2)(i), (B) all Agreement Payments satisfy, to the greatest extent possible, the exemptions from the application of Section 409A provided under Treas. Reg. §1.409A-1(b)(4) and 1.409A-1(b)(9)(iii), and (C) the Agreement Payments consisting of COBRA premiums also satisfy, to the greatest extent possible, the exemption from the application of Section 409A provided under Treas. Reg. §1.409A-1(b)(9)(v).”

1.6 Section 12(b) is hereby amended to read in its entirety as follows:

“If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur, in a manner necessary to provide you with the greatest economic benefit. If more than one manner of reduction yields the greatest economic benefit, the payments and benefits shall be reduced pro rata.”

1.7 Except as amended herein, Employment Agreement shall remain in full force and effect without modification.

IN WITNESS WHEREOF, the parties hereto have executed this First Amendment as of the Effective Date.

RACKABLE SYSTEMS, INC.

By: /s/ M A R K J. B A R R E N E C H E A
Name: Mark Barrenechea
Title: President and CEO

Signature Date: December 30, 2008

ANTHONY CARROZZA

By: /s/ A N T H O N Y C A R R O Z Z A
Name: Anthony Carrozza
Title: SVP WW Sales and Marketing

Signature Date: December 29, 2008

RACKABLE SYSTEMS, INC.

THIRD AMENDMENT TO EMPLOYMENT AGREEMENT

This THIRD AMENDMENT TO THE EMPLOYMENT AGREEMENT (the “**Third Amendment**”) dated December 23, 2008 (the “**Effective Date**”) is executed by and between Rackable Systems, Inc., a Delaware corporation (the “Company”), and Maurice Leibenstern (the “**Executive**”). The Company and the Executive are each individually referred to in this Amendment as a “**Party**” and are collectively referred to in this Amendment as the “**Parties**.”

RECITALS

- A. Executive and the Company have entered into an Employment Agreement dated August, 2007 (the “**Employment Agreement**”).
- B. The Executive and the Company are parties to a First Amendment and a Second Amendment to the Employment Agreement dated September 19, 2007 and November 17, 2008, respectively.
- C. The Parties desire to further amend the Employment Agreement as follows.

AGREEMENT

In consideration of the mutual promises and covenants set forth in this Third Amendment, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

1. Amendment to Employment Agreement. The Parties agree that upon the Effective Date, Employment Agreement is hereby amended as follows:

1.1 The first sentence of Section 9 is hereby amended to read in its entirety as follows:

“If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; such termination of employment constitutes a “separation from service” within the meaning of the Treas. Reg. §1.409A-1(h)(1), without regard to any alternative definitions thereunder; and you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”) (provided that the effective date of such Release shall be no later than sixty (60) days following your termination of employment); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”)

1.2 The last sentence of Section 9(b) is hereby amended to read in its entirety as follows:

“The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; provided, however, that any payments delayed pending the effective date of the Release shall be paid in arrears on the payroll date next following such effective date; and”

1.3 The first sentence of Section 10 is hereby amended to read in its entirety as follows:

“If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; such termination of employment constitutes a “separation from service” within the meaning of the Treas. Reg. §1.409A-1(h)(1), without regard to any alternative definitions thereunder; and you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”) (provided that the effective date of such Release shall be no later than sixty (60) days following your termination of employment); then you shall be entitled to receive the following severance benefits (the “Severance Benefits”):”

1.4 The second sentence of Section 10(a), is hereby amended to read in its entirety as follows:

“The severance pay will be subject to required payroll deductions and withholdings, and will be paid in thirteen (13) equal installments over a period of six (6) months, with such payments made on the Company’s normal payroll schedule; provided, however, that any payments delayed pending the effective date of the Release shall be paid in arrears on the payroll date next following such effective date.”

1.5 Section 12, “Deferred Compensation”, is hereby amended to read in its entirety as follows:

“If the Company (or, if applicable, any successor entity thereto) determines that the severance payments and benefits provided to you hereunder (any such payments, the “Agreement Payments”) constitute “deferred compensation” under Section 409A of the Internal Revenue Code of 1986, as amended (together, with any state law of similar effect, “Section 409A”) and if you are a “specified employee” of the Company (or, if applicable, any successor entity thereto), as such term is defined in Section 409A(a)(2)(B)(i) (a “Specified Employee”), then, solely to the extent necessary to avoid the imposition of the adverse personal tax consequences under Section 409A, the timing of the Agreement Payments will be delayed as follows: on the earliest to occur of (1) the date that is six months and one day after the date of termination of your employment, and (2) the date of your death (such earliest date, the “Delayed Initial Payment Date”), the Company (or the successor entity thereto, as applicable) shall (i) pay to you a lump sum amount equal to the sum of the Agreement Payments that you would otherwise have received through the Delayed Initial Payment Date if the commencement of the payment of the Agreement Payments had not been delayed pursuant to this Section 12 and (ii) commence paying the balance of the Agreement Payments in accordance with the applicable payment schedule set forth in this Agreement. Prior to the imposition of any delay on the Agreement Payments as set forth above, it is intended that (A) each installment of the Agreement Payments be regarded as a separate “payment” for purposes of Treas. Reg. §1.409A-2(b)(2)(i), (B) all Agreement Payments satisfy, to the greatest extent possible, the exemptions from the application of Section 409A provided under Treas. Reg. §1.409A-1(b)(4) and 1.409A-1(b)(9)(iii), and (C) the Agreement Payments consisting of COBRA premiums also satisfy, to the greatest extent possible, the exemption from the application of Section 409A provided under Treas. Reg. §1.409A-1(b)(9)(v).”

1.6 Section 13(b) is hereby amended to read in its entirety as follows:

“If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur, in a manner necessary to provide you with the greatest economic benefit. If more than one manner of reduction yields the greatest economic benefit, the payments and benefits shall be reduced pro rata.”

Except as amended herein, the Employment Agreement, as amended by the First and Second Amendments, shall remain in full force and effect without modification.

IN WITNESS WHEREOF, the parties hereto have executed this Third Amendment as of the Effective Date.

RACKABLE SYSTEMS, INC.

MAURICE LEIBENSTERN

By: /s/ M ARK B ARRENECHEA
Name: Mark Barrenechea
Title: President and CEO

By: /s/ M AURICE L EIBENSTERN
Name: Maurice Leibenstern
Title: SVP and General Counsel

Signature Date: December 30, 2008

Signature Date: December 28, 2008



46600 Landing Parkway
Fremont, California 94538

P. 408.240.8300

F. 408.321.0293

www.rackable.com

July 24, 2007

David Yoffie

Dear David,

On behalf of Rackable Systems Inc., I am pleased to offer you the position of Sr. Vice President of Operations and Service, reporting directly to the President & Chief Executive Officer.

This offer is conditioned upon our obtaining the following:

1. Your signature and date on the enclosed copy of this letter, indicating your acceptance of this offer.
2. Your signature and date on the enclosed *Employee Proprietary Information and Inventions Agreement*, which among other things requires that you have not thus far, and you will not during your employment with Rackable Systems., use or disclose to Rackable Systems any proprietary information or trade secrets of any former employer or other company nor have you or will you bring onto Rackable Systems' premises any confidential or proprietary information of any former employer or other company unless such former employer or company has consented to such action in writing.
3. Satisfactory results from any background checks.
4. Documentation verifying your identity and legal authority to work in the United States no later than three business days after the date you commence work. Enclosed is a list of Acceptable Documents that will be necessary for you to show proof of your employment eligibility.

Base Salary

Your initial compensation will include a base salary rate of \$20,000 per month, (equal to \$240,000 on an annualized basis) payable bi-weekly in accordance with the Company's regular payroll practices. Your base salary will be subject to statutory deductions and withholdings.

Incentive Compensation

You will participate in the Corporate Bonus Plan. You will be eligible for a quarterly bonus of \$21,000 (\$84,000 annual gross) based upon specific company performance targets. Your incentive compensation is not guaranteed and will be subject to statutory deductions and withholdings.

Stock Awards

It will be recommended to the Board of Directors to approve a grant for a stock option (Stock Option) to purchase 75,000 shares of the Company's common stock. The strike price of this Stock Option will be determined by the Fair Market Value of the Common Stock subject to the Stock Option on the date the Stock Option is granted. Your Stock Option will be subject to a four year vesting schedule, with vesting to commence as of your start date as an employee (Start Date). Your Stock Option shall only vest if you have been continuously employed by Rackable Systems from the Start Date through the applicable option vesting date (e.g., at the end of the first year of employment or the applicable monthly period thereafter as set forth in the next sentence). Under the vesting schedule, your Stock Option shares would vest at the rate of 25% upon completion of the first year of employment, with an additional 2.0833% of such shares vesting for each full month of continuous employment completed after the first anniversary.

In addition, it will be recommended to the Board of Directors to approve a restricted stock unit grant (RSU) of 5,000 shares of the Company's common stock. The RSU will be subject to a four year vesting schedule, with vesting to commence as of your Start Date. Under the RSU vesting schedule, your RSU would vest at the rate of 25% upon completion of the first year of employment, with an additional 6.25% of such shares vesting for each full 3 month period of continuous employment completed after the first anniversary.

Your Stock Option and RSU, if approved, shall be granted subject to all of the terms and conditions set forth in an option and award agreement prepared by Rackable Systems. Any grant of stock options or awards over time in no way alters the employment "at will" relationship described below.

Option Acceleration upon Change of Control

Upon the occurrence of both (a) a Change of Control (as defined in Appendix A) and (b) any one of the following within 12 months after a Change of Control; Termination Without Cause (as defined in Appendix A) or given a position of substantially lesser responsibility (COC Termination), 100% of the unvested shares of your Stock Option and RSU described in this letter shall immediately vest.

Other Benefits

As a full-time employee, you will be eligible to participate in the Company's benefit plans, including the medical, dental, vision, long-term disability and life insurance programs. We have put a great deal of emphasis on our benefits, and expect that they will continue to evolve as we grow and as the needs of our employees and their families change. In addition, you will begin to earn fifteen days of Paid Time Off (4.62 hours accrued per pay period) in accordance with applicable Company policy. If you accept this offer of employment, you will be given a copy of Rackable Systems' benefit plan documents which will describe more fully these and other benefits of your employment.

At-Will Employment

Employment with Rackable Systems is "at will." This means that employment is not for a specific term and can be terminated by you or by the Company at any time for any reason, with or without cause. The at will employment relationship also means that this employment offer, your job duties, title, responsibility, reporting level, compensation and benefits, as well as any other terms and conditions of employment (with the exception of the employment at will policy itself), may be modified or rescinded at any time in the sole discretion of Rackable Systems. This is the full and complete agreement between us on this term of your employment. Any contrary representations which may have been made or which may be made to you are superseded by this offer. Any modification of this term must be in writing and signed by you and the Company.

David, we are pleased that you are interested in Rackable Systems. As with all important decisions, however, you should make a decision concerning this offer based on your own independent investigation and judgment concerning Rackable Systems' financial condition and future prospects. Any representations not contained in this letter, or contrary to those contained in this letter, which have been made to you are expressly superseded by this offer.

If you accept this offer, please return to me the signed and dated copy of this letter and the *Employee Proprietary Information and Inventions Agreement* . Unless you accept on or before July 27, 2007 this offer will expire.

Sincerely,

/s/ M ARK B ARRENECHEA

Mark Barrenechea
President and Chief Executive Officer

Attachments:

Proprietary Information and Inventions Agreement
List of Acceptable Documents for I-9 Form

CANDIDATE ACCEPTANCE

I accept the offer of employment with Rackable Systems pursuant to the terms and conditions set forth in this letter. I will start work on August 9, 2007.

/s/ D AVID Y OFFIE

Candidate's Signature

July 24, 2007

Date

Appendix A

Definitions

Change of Control – means the occurrence, in a single transaction or in a series of related transactions, of either of the following events:

(i) (x) there is consummated (A) a merger, consolidation or similar transaction involving (directly or indirectly) the Company or (B) a tender offer or exchange offer addressed to the stockholders of the Company and (y), immediately after the consummation of such merger, consolidation or similar transaction or such tender or exchange offer, the stockholders of the Company immediately prior thereto do not own, directly or indirectly, either (A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such transaction; or

(ii) there is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries to an entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition.

For the avoidance of doubt, the term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

Termination Without Cause – means a termination by the Company of the Executive's employment relationship with the Company for any reason, except the following:

(a) the Executive's non-satisfactory performance of the Executive's duties and obligations to the Company, in the good faith determination of the Board of Directors, based on Executive's actions or failure to perform job duties, as opposed to failure of the Company to meet specific quantitative targets, and provided that such non-satisfactory performance is due to events that are within the Executive's control, or his willful disregard in any material respect of any lawful written financial or budgetary limitations established in good faith by the Board of Directors (Board) or the Company's Chief Executive Officer (CEO), provided the Board or CEO provides him with written notice of such failure or disregard and provides the Executive with thirty (30) days to cure such failure or disregard, and the Executive fails to cure such failure or disregard within such thirty (30) days;

(b) the Executive's willful misconduct that causes material and demonstrable injury, monetarily or otherwise, to the Company or any of its subsidiaries, including, but not limited to, misappropriation or conversion of assets of the Company or any of its subsidiaries (other than non-material assets), provided the Board or CEO provides him with written notice of such misconduct and provides the Executive with thirty (30) days to cure such misconduct, and the Executive fails to cure such misconduct within such thirty (30) days; or

(c) the Executive's conviction or plea of *nolo contendere* to a crime of moral turpitude causing material and demonstrable injury to the Company or otherwise demonstrating unfitness to serve as an officer of the Company or conviction of or entry of a plea of *nolo contendere* to a felony.

No act or failure by the Executive shall be deemed "willful" if done, or omitted to be done, in good faith and with the reasonable belief that the action or omission was in the best interest of the Company or any of its subsidiaries.

RACKABLE SYSTEMS, INC.

EMPLOYEE PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT

In consideration of my employment by Rackable Systems, Inc., a Delaware corporation (the “Company”), I hereby agree to the following with respect to my use and development of information and technology of the Company, as more fully set out below.

1. *Proprietary Information.*

(a) Confidential Restrictions. I agree to hold in strict confidence and in trust for the sole benefit of the Company all Proprietary Information (as defined below) that I may have access to during the course of my employment with the Company and will not disclose any Proprietary Information, directly or indirectly, to anyone outside of the Company, or use, copy, publish, summarize, or remove from Company premises such information (or remove from the premises any other property of the Company) except (i) during my employment to the extent necessary to carry out my responsibilities as an employee of the Company or (ii) after termination of my employment, as specifically authorized by the President of the Company. I further understand that the publication of any Proprietary Information through literature or speeches must be approved in advance in writing by the President of the Company. “Proprietary Information” shall mean all information and any idea in whatever form, tangible or intangible, whether disclosed to or learned or developed by me, pertaining in any manner to the business of the Company (or any affiliate of it that might be formed) or to the Company’s customers, suppliers, licensors and other commercial partners unless: (i) the information is or becomes publicly known through lawful means; (ii) the information was rightfully in my possession or part of my general knowledge prior to my employment by the Company; or (iii) the information is disclosed to me without confidential or proprietary restriction by a third party who rightfully possesses the information (without confidential or proprietary restriction) and did not learn of it, directly or indirectly, from the Company.

(b) Third Party Information. I recognize that the Company has received and in the future will receive from third parties their confidential or proprietary information subject to a duty on the Company’s part to maintain the confidentiality of such information and to use it only for certain limited purposes. I agree that I owe the Company and such third parties, during the term of my employment and thereafter, a duty to hold all such confidential or proprietary information in the strictest confidence and not to disclose it to any person, firm, or corporation (except as necessary in carrying out my work for the Company consistent with the Company’s agreement with such third party) or to use it for the benefit of anyone other than for the Company or such third party (consistent with the Company’s agreement with such third party) without the express written authorization of the President of the Company.

(c) Interference with Business. I hereby acknowledge that pursuit of the activities forbidden by this Section 1(c) would necessarily involve the use or disclosure of Proprietary Information in breach of Section 1, but that proof of such breach would be extremely difficult. To forestall such disclosure, use, and breach, I agree that for the term of this Agreement and for a period of one (1) year after termination of my employment with the Company, I shall not, for myself or any third party, directly or indirectly (i) divert or attempt to divert from the Company (or any affiliate of it that might be formed) any business of any kind in which it is engaged, including, without limitation, the solicitation of or interference with any of its suppliers or customers; (ii) employ, solicit for employment, or recommend for employment any person employed by the Company (or by any affiliate of it that might be formed) during the period of such person’s employment and for a period of one (1) year thereafter; or (iii) engage in any business activity that is or may be competitive with the Company (or any affiliate of it that might be formed). I understand that none of my activities will be prohibited under this Section 1(c) if I can prove that the action was taken without the use in any way of Proprietary Information.

2. *Inventions.*

(a) Defined; Statutory Notice . I understand that during the term of my employment, there are certain restrictions on my development of technology, ideas, and inventions, referred to in this Agreement as “Invention Ideas.” The term Invention Ideas means any and all ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, and all improvements, rights, and claims related to the foregoing that are conceived, developed, or reduced to practice by me alone or with others except to the extent that California Labor Code Section 2870 lawfully prohibits the assignment of rights in such ideas, processes, inventions, etc. I understand that Section 2870(a) provides:

Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer’s equipment, supplies, facilities, or trade secret information except for those inventions that either:

(1) Relate at the time of conception or reduction to practice of the invention to the employer’s business, or actual or demonstrably anticipated research or development of the employer.

(2) Result from any work performed by the employee for the employer.

(b) Records of Invention Ideas . I agree to maintain adequate and current written records on the development of all Invention Ideas and to disclose promptly to the Company all Invention Ideas and relevant records, which records will remain the sole property of the Company. I further agree that all information and records pertaining to any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, or copyright that I do not believe to be an Invention Idea, but is conceived, developed, or reduced to practice by me (alone or with others) during my period of employment or during the one-year period following termination of my employment, shall be promptly disclosed to the Company (such disclosure to be received in confidence). The Company shall examine such information to determine if in fact the idea, process, or invention, etc., is an Invention Idea subject to this Agreement.

(c) Assignment . I agree to assign to the Company, without further consideration, my entire right, title, and interest (throughout the United States and in all foreign countries), free and clear of all liens and encumbrances, in and to each Invention Idea, which shall be the sole property of the Company, whether or not patentable. In the event any Invention Idea shall be deemed by the Company to be patentable or otherwise registrable, I will assist the Company (at its expense) in obtaining letters patent or other applicable registrations thereon and I will execute all documents and do all other things (including testifying at the Company’s expense) necessary or proper to obtain letters patent or other applicable registrations thereon and to vest the Company with full title thereto. Should the Company be unable to secure my signature on any document necessary to apply for, prosecute, obtain, or enforce any patent, copyright, or other right or protection relating to any Invention Idea, whether due to my mental or physical incapacity or any other cause, I hereby irrevocably designate and appoint the Company and each of its duly authorized officers and agents as my agent and attorney-in-fact, to act for and in my behalf and

stead, to execute and file any such document, and to do all other lawfully permitted acts to further the prosecution, issuance, and enforcement of patents, copyrights, or other rights or protections with the same force and effect as if executed and delivered by me.

(d) **Exclusions.** Except as disclosed in Exhibit A, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement.

(e) **Post-Termination Period.** I acknowledge that because of the difficulty of establishing when any idea, process, invention, etc., is first conceived or developed by me, or whether it results from access to Proprietary Information or the Company's equipment, facilities and data, I agree that any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, copyright, or any improvement, rights, or claims related to the foregoing shall be presumed to be an Invention Idea if it is conceived, developed, used, sold, exploited, or reduced to practice by me or with my aid within one (1) year after my termination of employment with the Company. I can rebut the above presumption if I prove that the invention, idea, process, etc., is not an Invention Idea as defined in paragraph 2(a).

I understand that nothing in this Agreement is intended to expand the scope of protection provided me by Sections 2870 through 2872 of the California Labor Code.

3. **Former or Conflicting Obligations.** During my employment with the Company, I will not disclose to the Company, or use, or induce the Company to use, any proprietary information or trade secrets of others. I represent that my performance of this Agreement will not breach any agreement to keep in confidence proprietary information acquired by me in confidence or in trust prior to my employment by the Company. I certify that I have no outstanding agreement or obligation that is in conflict with any of the provisions of this Agreement, or that would preclude me from complying with the provisions hereof. I further certify that during the term of my employment with the Company, I will not engage in any other employment, occupation, consulting or other business activity directly related to the business in which the Company is now involved or becomes involved during the term of such employment.

4. **Government Contracts.** I understand that the Company has or may enter into contracts with the government under which certain intellectual property rights will be required to be protected, assigned, licensed, or otherwise transferred and I hereby agree to execute such other documents and agreements as are necessary to enable the Company to meet its obligations under any such government contracts.

5. **Termination.** I hereby acknowledge and agree that all personal property, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents or materials or copies thereof, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment, belong to the Company and will be promptly returned to the Company upon termination of my employment with the Company. Following my termination, I will not retain any written or other tangible material containing any Proprietary Information or information pertaining to any Invention Idea. I understand that my obligations contained herein will survive the termination of my employment. In the event of termination of my employment, I agree to sign and deliver to the Company a Termination Certificate in the form attached hereto as Exhibit B.

6. *Miscellaneous Provisions.*

(a) Assignment. I agree that the Company may assign to another person or entity any of its rights under this Agreement, including, without limitation, any successor in interest to the Company or its business operations. This Agreement shall be binding upon me and my heirs, executors, administrators, and successors, and shall inure to the benefit of the Company's successors and assigns.

(b) Governing Law; Severability. The validity, interpretation, enforceability, and performance of this Agreement shall be governed by and construed in accordance with the laws of the State of California. If any provision of this Agreement, or application thereof to any person, place, or circumstance, shall be held by a court of competent jurisdiction to be invalid, unenforceable, or void, the remainder of this Agreement and such provisions as applied to other persons, places, and circumstances shall remain in full force and effect.

(c) Entire Agreement. The terms of this Agreement are the final expression of my agreement with respect to the subject matter hereof and may not be contradicted by evidence of any prior or contemporaneous agreement. This Agreement shall constitute the complete and exclusive statement of its terms and no extrinsic evidence whatsoever may be introduced in any judicial, administrative, or other legal proceeding involving this Agreement.

(d) Application of this Agreement. I hereby agree that my obligations set forth in Sections 1 and 2 hereof and the definitions of Proprietary Information and Invention Ideas contained therein shall be equally applicable to Proprietary Information and Invention Ideas relating to any work performed by me for the Company prior to the execution of this Agreement.

Date: July 24, 2007

/s/ David Yoffie

Signature

David Yoffie

Printed Name

EXHIBIT A

Employee's Prior Inventions

Except as set forth below, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or any claims, rights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement:

EXHIBIT B

**TERMINATION CERTIFICATE CONCERNING
PROPRIETARY INFORMATION AND INVENTIONS**

This is to certify that I have returned all personal property of the Company, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents and materials, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment with the Company, and that I did not make or distribute any copies of the foregoing.

I further certify that I have reviewed the Employee Proprietary Information and Inventions Agreement signed by me and that I have complied with and will continue to comply with all of its terms, including, without limitation, (i) the reporting of any invention, process, or idea, etc. conceived or developed by me and covered by the Agreement and (ii) the preservation as confidential of all Proprietary Information pertaining to the Company. This certificate in no way limits my responsibilities or the Company's rights under the Agreement.

On termination of my employment with the Company, I will be employed by _____ [name of new employer]
_____ [in the _____ division] and I will be working in connection with the following projects:

[generally describe the projects]

Dated: _____

Signature

Printed Name



46600 Landing Parkway
Fremont, California 94538

P. 408.240.8300
F. 408.321.0293

www.rackable.com

January 22, 2008

David Yoffie

Re: Employment Agreement Restatement and Amendment #1

Dear David:

Rackable Systems, Inc. (the “Company”) and you entered into an employment agreement dated July 20, 2007 (attached as **Exhibit A**, the “Offer Letter”) governing the terms of your employment. The parties desire to restate and amend the Offer Letter based on the terms and conditions herein (“Amendment #1”). (The Offer Letter, as amended by this Amendment #1, shall be collectively referred to herein as the “Agreement”). In the event of a conflict between the provisions of this Amendment #1 and the Offer Letter, the provisions of this Amendment #1 shall prevail. The parties agree that in consideration of your continued at-will employment and the exchange and receipt by the parties of other good and valuable consideration, the following terms and conditions shall govern your employment:

1. **POSITION.** Commencing on August 9, 2007 (“Start Date”) and continuing beyond the date of this Amendment #1, you will serve in an executive capacity in the role of Senior Vice President, Operations and Service, reporting to the Company’s Chief Executive Officer (the “CEO”). Specifically, for purposes of this Agreement, your executive capacity role will be responsibility for the Company’s overall operations and service functions, including manufacturing, materials, procurement, and quality control, with members of the manufacturing and services organization reporting to you. Of course, the Company may change your position, duties, and work location from time to time in its discretion subject to the terms of this Agreement.
2. **COMPENSATION.**
 - a. **Base Salary.** Your base salary is \$240,000, less standard payroll deductions and withholdings. You will be paid bi-weekly in accordance with Company practice and policy.

-
- b. **Performance Bonus.** In addition, you will be eligible to earn a quarterly performance bonus ¹ target of \$21,000, based upon both your performance and the Company's performance with respect to applicable performance targets which are expected to include revenue and profitability targets and other organizational milestones ("Targets"), set solely by the CEO. The bonus payment shall be earned upon the fulfillments of Targets and is payable within a reasonable period of time. The Company will determine in its sole discretion whether the Targets have been achieved, whether you have earned a bonus, and the amount of any earned bonus. You must be employed on the bonus payment date to earn and be eligible to receive any bonus.
 - c. **Review of Compensation.** Your base salary and bonus eligibility will be reviewed on an annual or more frequent basis by the Compensation Committee and are subject to change in the discretion of the Compensation Committee, subject to the terms of the Agreement.

3. STOCK AWARDS.

- a. **Initial Grants.** To the extent that you have been issued an Option and/or RSU pursuant to the Offer Letter ("Initial Grants"), the provisions of the Offer Letter and your individual Option and/or Restricted Stock Unit Award Agreement relating to such the Initial Grants shall remain in full force and effect without modification by this Amendment #1. This includes, without limitation, those provisions in the Offer Letter and your individual Option and/or Restricted Stock Unit Award Agreement relating to the vesting and acceleration upon change of control of the Initial Grants. Nothing in this Amendment #1 will be construed to modify the provisions of the 2006 New Recruit Equity Incentive Plan (the "2006 Plan") and your individual Option and/or Restricted Stock Unit Award Agreement, which govern the Initial Grants.
- b. **Following Grants.** Subject to Compensation Committee approval, the Company may issue you additional awards ("Following Grants") pursuant to the 2005 Equity Incentive Plan (the "2005 Plan") in the form of options to purchase shares of the Company's common stock at an exercise price equal to the fair market value of the stock as of the date of grant as determined by the Compensation Committee; and/or the right to receive shares of the Company's common stock. Following Grants will be subject to a four-year vesting period subject to your continuous service to the Company as an employee or consultant, with one sixteenth (1/16) of the Following Grant shares vesting for each full Company quarter of your continuous service as an employee or consultant (as defined in the 2005 Plan), following the grant date of the Following Grants. Nothing in this Amendment #1 will be construed to modify the provisions of the 2005 Plan and your individual Following Grant Award Agreement(s), which will govern Following Grants.

- 4. **EMPLOYEE BENEFITS.** You are eligible to participate in the Company's standard employee benefit plans in accordance with the terms and conditions of the plans and applicable policies which may be in effect from time to time, and provided by the Company to its

¹ Performance bonuses are aligned to the Company's quarterly financial reporting periods (each such quarter, a "Company Quarter"); your initial quarterly participation will be adjusted *pro rata* based upon your Start Date.

executive employees generally, including but not limited to group health insurance coverage, disability insurance, life insurance, ESPP, 401(k) Plan, and paid time off and paid holidays. You will be eligible for reimbursement of your legitimate and documented business expenses incurred in connection with your employment, pursuant to the Company's standard reimbursement expense policy and practices. The Company may modify its benefits programs and policies from time to time in its discretion.

5. **PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT.** As a condition of your employment, you are required to abide by the Company's Proprietary Information and Inventions Agreement (the "Non-Disclosure Agreement"), attached to the Offer Letter as **Exhibit A**.
6. **SERVICE AS EMPLOYEE; OUTSIDE ACTIVITIES.**
 - a. **Location and Duties.** You will work at the Company's corporate headquarters currently located in Fremont, California, subject to necessary business travel. During your employment with the Company, you will devote your best efforts and substantially all of your business time and attention (except for vacation periods and reasonable periods of illness or other incapacity permitted by the Company's general employment policies) to the business of the Company.
 - b. **Company Policies.** Your employment relationship with the Company shall also be governed by the general employment policies and practices of the Company, including but not limited to the policies contained in the Company's Employee Handbook (except that if the terms of this letter differ from or are in conflict with the Company's general employment policies or practices, the Offer Letter as amended by this Amendment #1 will control), and you will be required to abide by such general employment policies and practices of the Company.
 - c. **Other Activities.** Throughout your employment with the Company, you may engage in civic and not-for-profit activities so long as such activities do not interfere with the performance of your duties hereunder or present a conflict of interest with the Company. Subject to the restrictions set forth herein and with the prior written consent of the Board, you may serve as a director of other corporations and may devote a reasonable amount of your time to other types of business or public activities not expressly mentioned in this paragraph.
 - d. **Conflict of Interest.** During your employment by the Company, except on behalf of the Company, you will not directly or indirectly serve as an officer, director, stockholder, employee, partner, proprietor, investor, joint venturer, associate, representative or consultant for or on behalf of any other person, corporation, firm, partnership or other entity whatsoever known by you to compete with the Company (or is planning or preparing to compete with the Company), anywhere in the world, in any line of business engaged in (or planned to be engaged in) by the Company; provided, however, that you may purchase or otherwise acquire up to (but not more than) one percent (1%) of any class of securities of any enterprise (but without participating in the activities of such enterprise) if such securities are listed on any national or regional securities exchange.

7. **AT-WILL EMPLOYMENT RELATIONSHIP.** Your employment relationship with the Company is at-will. Accordingly, both you and the Company may terminate the employment relationship at any time, with or without Cause (as defined below), and with or without advance notice.

8. **DEFINITIONS.**

- a. **Definition of “Cause.”** For purposes of the Agreement, “Cause” is defined as one or more of the following events: (i) the indictment or conviction for a felony or other crime, or any misdemeanor involving moral turpitude; (ii) the commission of any other act or omission involving fraud or intentional deceit with respect to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iii) any act or omission involving dishonesty that causes material injury to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iv) gross negligence with respect to the Company or any of its subsidiaries; (v) willful misconduct with respect to the Company or any of its subsidiaries; (vi) any other material breach of this agreement or any other agreement referred to herein (including the Non-Disclosure Agreement); provided, however, that, it shall only be deemed Cause pursuant to clause (vi) if you are given written notice describing the basis of Cause and, if the event is reasonably susceptible of cure, you fail to cure within thirty (30) days.
- b. **Definition of “Good Reason.”** For purposes of the Agreement, “Good Reason” is defined as one or more of the following conditions that occur without your written consent: (i) the assignment to you, or the removal from you, of any duties or responsibilities that results in the material diminution of your authority, duties or responsibilities as Sr. Vice President of Operations and Service, including a Change in Control that results in your no longer serving as the Sr. Vice President of Operations and Service or any similar position; (ii) a material reduction by the Company of your base salary; (iii) the Company’s material breach of its obligations to you under this offer letter agreement; or (iv) your office relocation to a location more than fifty miles from your then present location; provided however that, it shall only be deemed Good Reason pursuant to the foregoing definition if (x) the Company is given written notice from you within ninety (90) days following the first occurrence of a condition that you consider to constitute Good Reason describing the condition and fails to remedy such condition within thirty (30) days following such written notice, and (y) you resign from employment within ninety (90) days following the end of the period within which the Company was entitled to remedy the condition constituting Good Reason but failed to do so.
- c. **Definition of “Change in Control.”** For purposes of the Agreement, “Change in Control” means the occurrence, in a single transaction or in a series of related transactions, of either of the following events:
- i. There is consummated (A) a merger, consolidation or similar transaction involving (directly or indirectly) the Company or (B) a tender offer or exchange offer addressed to the stockholders of the Company and, in either event, immediately after the consummation of such merger, consolidation or similar transaction or such tender or exchange offer, the stockholders of the Company immediately prior thereto do not own, directly or indirectly, either

(A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such transaction; or

- ii. There is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries to an entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition.

The term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

9. **CHANGE IN CONTROL SEVERANCE BENEFITS.** If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”):

- a. The vesting of all unvested stock options and all unvested grants of restricted stock herein referred to and any subsequent grants of stock options, restricted stock or any other stock awards in future plans, shall accelerate in such amount equal to the number of shares that would vest over an additional twenty-four (24) month period as if you have continued to be an employee of the Company for additional twenty-four (24) months following your termination;
- b. You will be eligible to receive severance pay in the total amount equal to the sum of twelve (12) months of your base salary in effect as of the employment termination date. For purposes of this Section 9(b), “base salary” as used herein does not include any annual performance bonus or any other bonus payment. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; and
- c. If you timely elect and continue to remain eligible for continued group health insurance coverage under federal COBRA law or, if applicable, state insurance laws (collectively, “COBRA”), the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment

termination date (including dependent coverage, if applicable) for twelve (12) months after the employment termination date; provided that, the Company's obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Company if you become eligible for group health insurance coverage through a new employer within twelve (12) months of your employment termination date.

- 10. SEVERANCE BENEFITS.** If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the "Release"); then you shall be entitled to receive the following severance benefits (the "Severance Benefits"):
- a.** Severance pay in the total amount equal to the sum of twelve (12) months of your base salary in effect as of the employment termination date. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company's normal payroll schedule. For purposes of this Section 10(a), "base salary" as used herein does not include any annual performance bonus or any other bonus payment; and
 - b.** If you timely elect and continue to remain eligible for COBRA, the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment termination date (including dependent coverage, if applicable) for twelve (12) months after the employment termination date; provided that, the Company's obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Board if you become eligible for group health insurance coverage through a new employer within twelve (12) months of your employment termination date.
- 11. CONDITIONS TO ELIGIBILITY TO SEVERANCE BENEFITS OR CHANGE IN CONTROL SEVERANCE BENEFITS .** Notwithstanding the foregoing, you will not be eligible for the Severance Benefits or the Change in Control Severance Benefits if: (A) your employment is terminated for Cause, or if you resign for any reason that does not qualify as Good Reason; or (B) in the event that you materially breach the Non-Disclosure Agreement, the Release of claims, or any other obligations you owe to the Company after termination of your employment (including but not limited to the provisions of the Non-Disclosure Agreement), and the Company's obligation to provide the Severance Benefits or the Change in Control Benefits (or to continue to provide such benefits) will cease immediately and in full as of the date of your breach (in addition to any other remedies available to the Company).
- 12. DEFERRED COMPENSATION.** Anything in the Agreement to the contrary notwithstanding, if the Company reasonably determines that any payments hereunder fail to satisfy the distribution requirements of Section 409A(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code") and you concur with such determination in writing, then the payment of such benefit shall be delayed to the minimum extent necessary so that such

payments are not subject to the provisions of Section 409A(a)(1) of the Code; provided, however, that in no event shall such delay be more than six (6) months and one (1) day from the date of termination of your employment with the Company.

13. EXCISE TAX.

- a. Anything in the Agreement to the contrary notwithstanding, if any payment or benefit that you would receive pursuant to this offer letter agreement or otherwise (“Payment”) would (i) constitute a “parachute payment” within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the “Excise Tax”), then such Payment shall be equal to the Reduced Amount (defined below). The “Reduced Amount” shall be either (y) the largest portion of the Payment that would result in no portion of the Payment (after reduction) being subject to the Excise Tax, or (z) the entire Payment, whichever amount after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate, net of the maximum reduction in federal income taxes which could be obtained from a deduction of such state and local taxes), results in your receipt, on an after-tax basis, of the greatest amount of the Payment to you.
- b. If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur in the following order unless you elect in writing a different order (provided, however, that such election shall be subject to Company approval, such approval not to be unreasonably withheld or delayed, if made on or after the date on which the event that triggers the Payment occurs (the “Payment Event”)): (1) reduction of cash payments; (2) cancellation of accelerated vesting of equity awards other than stock options; (3) cancellation of accelerated vesting of stock options; and (4) reduction of other benefits paid to you. In the event that acceleration of compensation from your equity awards is to be reduced, such acceleration of vesting shall be canceled in the reverse order of the date of grant unless you elect in writing a different order for cancellation.
- c. The accounting firm engaged by the Company for general audit purposes as of the day prior to the effective date of the Payment Event shall perform the foregoing calculations. If the accounting firm so engaged by the Company is serving as accountant or auditor for the individual, entity or group effecting the Payment Event, a nationally recognized accounting firm appointed by the Board and reasonably approved by you shall make the determinations required hereunder. The Company shall bear all expenses with respect to the determinations by such accounting firm required to be made hereunder.
- d. The accounting firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and you within fifteen (15) calendar days after the date on which your right to a Payment is triggered (if requested at that time by the Company or you) or such other time or times as requested by the Company or you. If the accounting firm determines that no Excise Tax is payable with respect to a Payment, either before or after the application of the Reduced Amount, it shall furnish the Company and you with an opinion reasonably acceptable to you that no Excise Tax will be imposed with respect to such Payment. The Company shall be entitled to rely upon the accounting firm’s determinations, which shall be final and binding.

14. DISPUTE RESOLUTION. To ensure the rapid and economical resolution of disputes that may arise in connection with your employment, you and the Company agree that any and all disputes, claims, or causes of action, in law or equity, arising from or relating to the enforcement, breach, performance, execution, or interpretation of this agreement, your employment, or the termination of your employment, shall be resolved, to the fullest extent permitted by law, by final, binding and confidential arbitration in San Francisco, California conducted before a single arbitrator by Judicial Arbitration and Mediation Services, Inc. ("JAMS") or its successor, under the then applicable JAMS rules. By agreeing to this arbitration procedure, both you and the Company waive the right to resolve any such dispute through a trial by jury or judge or by administrative proceeding. The arbitrator shall: (a) have the authority to compel adequate discovery for the resolution of the dispute and to award such relief as would otherwise be permitted by law; and (b) issue a written arbitration decision including the arbitrator's essential findings and conclusions and a statement of the award. The Company shall pay all of JAMS' arbitration fees. Nothing in this letter agreement shall prevent either you or the Company from obtaining injunctive relief in court if necessary to prevent irreparable harm pending the conclusion of any arbitration. The parties agree that the arbitrator shall award reasonable attorneys fees and costs to the prevailing party in any action brought hereunder, and the arbitrator shall have discretion to determine the prevailing party in an arbitration where multiple claims may be at issue.

15. MISCELLANEOUS.

- a. General Provisions.** The Agreement, including the Non-Disclosure Agreement, constitutes the complete, final and exclusive embodiment of the entire agreement between you and the Company with regard to the subject matter hereof. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein, and it supersedes any other agreements, promises, warranties or representations concerning its subject matter. Changes in your employment terms, other than those expressly reserved herein to the Company's discretion, only can be made in a writing signed by a duly-authorized member of the Company and you. The Agreement will bind the heirs, personal representatives, successors and assigns of both you and the Company, and inure to the benefit of both you and the Company, their heirs, successors and assigns. If any provision of the Agreement is determined to be invalid or unenforceable, in whole or in part, this determination shall not affect any other provision of the Agreement and the provision in question shall be modified so as to be rendered enforceable in a manner consistent with the intent of the parties insofar as possible under applicable law. The Agreement shall be construed and enforced in accordance with the laws of the State of California without regard to conflicts of law principles. Any ambiguity in the Agreement shall not be construed against either party as the drafter. Any waiver of a breach of the Agreement, or rights hereunder, shall be in writing and shall not be deemed to be a waiver of any successive breach or rights hereunder. The Agreement may be executed in counterparts which shall be deemed to be part of one original, and facsimile signatures shall be equivalent to original signatures.

b. Legal Right to Work. As required by law, your continued employment is subject to satisfactory proof of your right to work in the United States.

16. ACCEPTANCE. Please sign this Amendment #1 and return them to me as soon as possible to indicate your acceptance of the amended terms of employment with the Company.

Sincerely,

Rackable Systems, Inc.

By: /s/ JENNIFER L. PRATT
Jennifer L. Pratt
Vice President, Human Resources

January 29, 2008
Date

Understood and Agreed:

/s/ DAVID YOFFIE
David Yoffie

January 29, 2008
Date

Exhibit A – Offer Letter, dated July 20, 2007

EXHIBIT A

OFFER LETTER, DATED JULY 20, 2007

RACKABLE SYSTEMS, INC.

SECOND AMENDMENT TO EMPLOYMENT AGREEMENT

This SECOND AMENDMENT TO THE EMPLOYMENT AGREEMENT (the “**Second Amendment**”) dated December 23, 2008 (the “**Effective Date**”) is executed by and between Rackable Systems, Inc., a Delaware corporation (the “Company”), and David Yoffie (the “**Executive**”). The Company and the Executive are each individually referred to in this Amendment as a “**Party**” and are collectively referred to in this Amendment as the “**Parties**.”

RECITALS

- A. Executive and the Company have entered into an Employment Agreement dated July 24, 2007 (the “**Employment Agreement**”).
- B. The Executive and the Company are parties to an Employment Agreement Restatement and Amendment #1 dated January 22, 2008 (“Amendment #1”).
- C. The Parties desire to further amend Amendment #1 as follows.

AGREEMENT

In consideration of the mutual promises and covenants set forth in this Second Amendment, the receipt and sufficiency of which are hereby acknowledged, the Parties agree as follows:

1. Amendment to Employment Agreement. The Parties agree that upon the Effective Date, Amendment #1 is hereby amended as follows:

1.1 The first sentence of Section 9 is hereby amended to read in its entirety as follows:

“If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason, and such termination of employment constitutes a “separation from service” within the meaning of the Treas. Reg. §1.409A-1(h)(1), without regard to any alternative definitions thereunder; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”) (provided that the effective date of such Release shall be no later than sixty (60) days following your termination of employment); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”):”

1.2 The last sentence of Section 9(b) is hereby amended to read in its entirety as follows:

“The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; provided, however, that any payments delayed pending the effective date of the Release shall be paid in arrears on the payroll date next following such effective date; and”

1.3 The first sentence of Section 10 is hereby amended to read in its entirety as follows:

“If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason, and such termination of employment constitutes a “separation from service” within the meaning of the Treas. Reg. §1.409A-1(h)(1), without regard to any alternative definitions thereunder; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”) (provided that the effective date of such Release shall be no later than sixty (60) days following your termination of employment); then you shall be entitled to receive the following severance benefits (the “Severance Benefits”):”

1.4 The second sentence of Section 10(a), is hereby amended to read in its entirety as follows:

“The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; provided, however, that any payments delayed pending the effective date of the Release shall be paid in arrears on the payroll date next following such effective date.”

1.5 Section 12, “Deferred Compensation”, is hereby amended to read in its entirety as follows:

“If the Company (or, if applicable, any successor entity thereto) determines that the severance payments and benefits provided to you hereunder (any such payments, the “Agreement Payments”) constitute “deferred compensation” under Section 409A of the Internal Revenue Code of 1986, as amended (together, with any state law of similar effect, “Section 409A”) and if you are a “specified employee” of the Company (or, if applicable, any successor entity thereto), as such term is defined in Section 409A(a)(2)(B)(i) (a “Specified Employee”), then, solely to the extent necessary to avoid the imposition of the adverse personal tax consequences under Section 409A, the timing of the Agreement Payments will be delayed as follows: on the earliest to occur of (1) the date that is six months and one day after the date of termination of your employment, and (2) the date of your death (such earliest date, the “Delayed Initial Payment Date”), the Company (or the successor entity thereto, as applicable) shall (i) pay to you a lump sum amount equal to the sum of the Agreement Payments that you would otherwise have received through the Delayed Initial Payment Date if the commencement of the payment of the Agreement Payments had not been delayed pursuant to this Section 10(d) and (ii) commence paying the balance of the Agreement Payments in accordance with the applicable payment schedule set forth in this Agreement. Prior to the imposition of any delay on the Agreement Payments as set forth above, it is intended that (A) each installment of the Agreement Payments be regarded as a separate “payment” for purposes of Treas. Reg. §1.409A-2(b)(2)(i), (B) all Agreement Payments satisfy, to the greatest extent possible, the exemptions from the application of Section 409A provided under Treas. Reg. §1.409A-1(b)(4) and 1.409A-1(b)(9)(iii), and (C) the Agreement Payments consisting of COBRA premiums also satisfy, to the greatest extent possible, the exemption from the application of Section 409A provided under Treas. Reg. §1.409A-1(b)(9)(v).”

1.6 Section 13(b) is hereby amended to read in its entirety as follows:

“If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur, in a manner necessary to provide you with the greatest economic benefit. If more than one manner of reduction yields the greatest economic benefit, the payments and benefits shall be reduced pro rata.”

1.7 Except as amended herein, Amendment #1 shall remain in full force and effect without modification.

IN WITNESS WHEREOF, the parties hereto have executed this Second Amendment as of the Effective Date.

RACKABLE SYSTEMS, INC.

DAVID YOFFIE

By: /s/ M ARK B ARRENECHEA
Name: Mark Barrenechea
Title: President and CEO

By: /s/ D AVID Y OFFIE
Name: David Yoffie
Title: SVP Operations and Service

Signature Date: December 24, 2008

Signature Date: December 24, 2008

June 19, 2007

Tony Gaughan

Dear Tony,

On behalf of Rackable Systems Inc., I am pleased to offer you the position of Sr. Vice President and Chief Products Officer, reporting directly to the President & Chief Executive Officer.

This offer is conditioned upon our obtaining the following:

1. Your signature and date on the enclosed copy of this letter, indicating your acceptance of this offer.
2. Your signature and date on the enclosed *Employee Proprietary Information and Inventions Agreement*, which among other things requires that you have not thus far, and you will not during your employment with Rackable Systems., use or disclose to Rackable Systems any proprietary information or trade secrets of any former employer or other company nor have you or will you bring onto Rackable Systems' premises any confidential or proprietary information of any former employer or other company unless such former employer or company has consented to such action in writing.
3. Satisfactory results from any background and reference checks.
4. Documentation verifying your identity and legal authority to work in the United States no later than three business days after the date you commence work. Enclosed is a list of Acceptable Documents that will be necessary for you to show proof of your employment eligibility.

Base Salary

Your initial compensation will include a base salary rate of \$22,500 per month, (equal to \$270,000 on an annualized basis) payable bi-weekly in accordance with the Company's regular payroll practices. Your base salary will be subject to statutory deductions and withholdings.

Incentive Compensation

You will participate in the Corporate Bonus Plan. You will be eligible for a quarterly bonus of up to \$33,750 (\$135,000 annual gross) based upon specific company performance targets. Your incentive compensation is not guaranteed and will be subject to statutory deductions and withholdings.

Stock Awards

It will be recommended to the Board of Directors to approve a grant for a stock option (Stock Option) to purchase 100,000 shares of the Company's common stock. The strike price of this Stock Option will be determined by the Fair Market Value of the Common Stock subject to the Stock Option on the date the Stock Option is granted. Your Stock Option will be subject to a four year vesting schedule, with vesting to commence as of your start date as an employee (Start Date). Your Stock Option shall only vest if you have been continuously employed by Rackable Systems from the Start Date through the applicable option vesting date (e.g., at the end of the first year of employment or the applicable monthly period thereafter as set forth in the next sentence). Under the vesting schedule, your Stock Option shares would vest at the rate of 25% upon completion of the first year of employment, with an additional 2.0833% of such shares vesting for each full month of continuous employment completed after the first anniversary.

In addition, it will be recommended to the Board of Directors to approve a restricted stock unit (RSU) of 10,000 shares of the Company's common stock. The RSU will be subject to a four year vesting schedule, with vesting to commence as of your Start Date. Under the RSU vesting schedule, your RSU would vest at the rate of 25% upon completion of the first year of employment, with an additional 6.25% of such shares vesting for each full 3 month period of continuous employment completed after the first anniversary.

Your Stock Option and RSU, if approved, shall be granted subject to all of the terms and conditions set forth in an option and award agreement prepared by Rackable Systems. Any grant of stock options or awards over time in no way alters the employment "at will" relationship described below.

Option Acceleration and Severance upon Change of Control

Upon the occurrence of both (a) a Change of Control (as defined in Appendix A) and (b) any one of the following within 12 months after a Change of Control; Termination Without Cause (as defined in Appendix A) or given a position of substantially lesser responsibility (COC Termination), one year of the unvested shares of your Stock Option and RSU described in this letter shall immediately vest.

In addition, in the event of a COC Termination, the Company shall provide you a lump sum payment equal to twelve (12) months of your then current base salary and payment of COBRA premiums for you and your dependents until the earlier of (a) twelve (12) months from the COC Termination date or (b) the date you commence full time employment (including self-employment and/or consulting work).

Other Benefits

As a full-time employee, you will be eligible to participate in the Company's benefit plans, including the medical, dental, vision, long-term disability and life insurance programs. We have put a great deal of emphasis on our benefits, and expect that they will continue to evolve as we grow and as the needs of our employees and their families change. In addition, you will begin to earn fifteen days of Paid Time Off (4.62 hours accrued per pay period) in accordance with applicable Company policy. If you accept this offer of employment, you will be given a copy of Rackable Systems' benefit plan documents which will describe more fully these and other benefits of your employment.

At-Will Employment

Employment with Rackable Systems is "at will." This means that employment is not for a specific term and can be terminated by you or by the Company at any time for any reason, with or without cause. The at will employment relationship also means that this employment offer, your job duties, title, responsibility, reporting level, compensation and benefits, as well as any other terms and conditions of employment (with the exception of the employment at will policy itself), may be modified or rescinded at any time in the sole discretion of Rackable Systems. This is the full and complete agreement

between us on this term of your employment. Any contrary representations which may have been made or which may be made to you are superseded by this offer. Any modification of this term must be in writing and signed by you and the Company.

Tony, we are pleased that you are interested in Rackable Systems. As with all important decisions, however, you should make a decision concerning this offer based on your own independent investigation and judgment concerning Rackable Systems' financial condition and future prospects. Any representations not contained in this letter, or contrary to those contained in this letter, which have been made to you are expressly superseded by this offer.

If you accept this offer, please return to me the signed and dated copy of this letter and the *Employee Proprietary Information and Inventions Agreement*. Unless you accept on or before June 22, 2007 this offer will expire.

Sincerely,

/s/ M ARK B ARRENECHEA
Mark Barrenechea
President & Chief Executive Officer

Attachments:

Proprietary Information and Inventions Agreement
List of Acceptable Documents for I-9 Form

CANDIDATE ACCEPTANCE

I accept the offer of employment with Rackable Systems pursuant to the terms and conditions set forth in this letter. I will start work on July 9, 2007.

/s/ T ONY G AUGHAN
Candidate's Signature

June 22, 2007
Date

Appendix A

Definitions

Change of Control – means the occurrence, in a single transaction or in a series of related transactions, of either of the following events:

(i) (x) there is consummated (A) a merger, consolidation or similar transaction involving (directly or indirectly) the Company or (B) a tender offer or exchange offer addressed to the stockholders of the Company and (y), immediately after the consummation of such merger, consolidation or similar transaction or such tender or exchange offer, the stockholders of the Company immediately prior thereto do not own, directly or indirectly, either (A) outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such transaction; or

(ii) there is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries to an entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition.

For the avoidance of doubt, the term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

Termination Without Cause – means a termination by the Company of the Executive's employment relationship with the Company for any reason, except the following:

(a) the Executive's non-satisfactory performance of the Executive's duties and obligations to the Company, in the good faith determination of the Board of Directors, based on Executive's actions or failure to perform job duties, as opposed to failure of the Company to meet specific quantitative targets, and provided that such non-satisfactory performance is due to events that are within the Executive's control, or his willful disregard in any material respect of any lawful written financial or budgetary limitations established in good faith by the Board of Directors (Board) or the Company's Chief Executive Officer (CEO), provided the Board or CEO provides him with written notice of such failure or disregard and provides the Executive with thirty (30) days to cure such failure or disregard, and the Executive fails to cure such failure or disregard within such thirty (30) days;

(b) the Executive's willful misconduct that causes material and demonstrable injury, monetarily or otherwise, to the Company or any of its subsidiaries, including, but not limited to, misappropriation or conversion of assets of the Company or any of its subsidiaries (other than non-material assets), provided the Board or CEO provides him with written notice of such misconduct and provides the Executive with thirty (30) days to cure such misconduct, and the Executive fails to cure such misconduct within such thirty (30) days; or

(c) the Executive's conviction or plea of *nolo contendere* to a crime of moral turpitude causing material and demonstrable injury to the Company or otherwise demonstrating unfitness to serve as an officer of the Company or conviction of or entry of a plea of *nolo contendere* to a felony.

No act or failure by the Executive shall be deemed "willful" if done, or omitted to be done, in good faith and with the reasonable belief that the action or omission was in the best interest of the Company or any of its subsidiaries.

RACKABLE SYSTEMS, INC.

EMPLOYEE PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT

In consideration of my employment by Rackable Systems, Inc., a Delaware corporation (the “Company”), I hereby agree to the following with respect to my use and development of information and technology of the Company, as more fully set out below.

1. *Proprietary Information.*

(a) Confidential Restrictions. I agree to hold in strict confidence and in trust for the sole benefit of the Company all Proprietary Information (as defined below) that I may have access to during the course of my employment with the Company and will not disclose any Proprietary Information, directly or indirectly, to anyone outside of the Company, or use, copy, publish, summarize, or remove from Company premises such information (or remove from the premises any other property of the Company) except (i) during my employment to the extent necessary to carry out my responsibilities as an employee of the Company or (ii) after termination of my employment, as specifically authorized by the President of the Company. I further understand that the publication of any Proprietary Information through literature or speeches must be approved in advance in writing by the President of the Company. “Proprietary Information” shall mean all information and any idea in whatever form, tangible or intangible, whether disclosed to or learned or developed by me, pertaining in any manner to the business of the Company (or any affiliate of it that might be formed) or to the Company’s customers, suppliers, licensors and other commercial partners unless: (i) the information is or becomes publicly known through lawful means; (ii) the information was rightfully in my possession or part of my general knowledge prior to my employment by the Company; or (iii) the information is disclosed to me without confidential or proprietary restriction by a third party who rightfully possesses the information (without confidential or proprietary restriction) and did not learn of it, directly or indirectly, from the Company.

(b) Third Party Information. I recognize that the Company has received and in the future will receive from third parties their confidential or proprietary information subject to a duty on the Company’s part to maintain the confidentiality of such information and to use it only for certain limited purposes. I agree that I owe the Company and such third parties, during the term of my employment and thereafter, a duty to hold all such confidential or proprietary information in the strictest confidence and not to disclose it to any person, firm, or corporation (except as necessary in carrying out my work for the Company consistent with the Company’s agreement with such third party) or to use it for the benefit of anyone other than for the Company or such third party (consistent with the Company’s agreement with such third party) without the express written authorization of the President of the Company.

(c) Interference with Business. I hereby acknowledge that pursuit of the activities forbidden by this Section 1(c) would necessarily involve the use or disclosure of Proprietary Information in breach of Section 1, but that proof of such breach would be extremely difficult. To forestall such disclosure, use, and breach, I agree that for the term of this Agreement and for a period of one (1) year after termination of my employment with the Company, I shall not, for myself or any third party, directly or indirectly (i) divert or attempt to divert from the Company (or any affiliate of it that might be formed) any business of any kind in which it is engaged, including, without limitation, the solicitation of or interference with any of its suppliers or customers; (ii) employ, solicit for employment, or recommend for employment any person employed by the Company (or by any affiliate of it that might be formed) during the period of such person’s employment and for a period of one (1) year thereafter; or (iii) engage in any business activity that is or may be competitive with the Company (or any affiliate of it that might be formed). I understand that none of my activities will be prohibited under this Section 1(c) if I can prove that the action was taken without the use in any way of Proprietary Information.

2. *Inventions.*

(a) Defined; Statutory Notice . I understand that during the term of my employment, there are certain restrictions on my development of technology, ideas, and inventions, referred to in this Agreement as “Invention Ideas.” The term Invention Ideas means any and all ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, and all improvements, rights, and claims related to the foregoing that are conceived, developed, or reduced to practice by me alone or with others except to the extent that California Labor Code Section 2870 lawfully prohibits the assignment of rights in such ideas, processes, inventions, etc. I understand that Section 2870(a) provides:

Any provision in an employment agreement which provides that an employee shall assign, or offer to assign, any of his or her rights in an invention to his or her employer shall not apply to an invention that the employee developed entirely on his or her own time without using the employer’s equipment, supplies, facilities, or trade secret information except for those inventions that either:

(1) Relate at the time of conception or reduction to practice of the invention to the employer’s business, or actual or demonstrably anticipated research or development of the employer.

(2) Result from any work performed by the employee for the employer.

(b) Records of Invention Ideas . I agree to maintain adequate and current written records on the development of all Invention Ideas and to disclose promptly to the Company all Invention Ideas and relevant records, which records will remain the sole property of the Company. I further agree that all information and records pertaining to any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, or copyright that I do not believe to be an Invention Idea, but is conceived, developed, or reduced to practice by me (alone or with others) during my period of employment or during the one-year period following termination of my employment, shall be promptly disclosed to the Company (such disclosure to be received in confidence). The Company shall examine such information to determine if in fact the idea, process, or invention, etc., is an Invention Idea subject to this Agreement.

(c) Assignment . I agree to assign to the Company, without further consideration, my entire right, title, and interest (throughout the United States and in all foreign countries), free and clear of all liens and encumbrances, in and to each Invention Idea, which shall be the sole property of the Company, whether or not patentable. In the event any Invention Idea shall be deemed by the Company to be patentable or otherwise registrable, I will assist the Company (at its expense) in obtaining letters patent or other applicable registrations thereon and I will execute all documents and do all other things (including testifying at the Company’s expense) necessary or proper to obtain letters patent or other applicable registrations thereon and to vest the Company with full title thereto. Should the Company be unable to secure my signature on any document necessary to apply for, prosecute, obtain, or enforce any patent, copyright, or other right or protection relating to any Invention Idea, whether due to my mental or physical incapacity or any other cause, I hereby irrevocably designate and appoint the Company and each of its duly authorized officers and agents as my agent and attorney-in-fact, to act for and in my behalf and

stead, to execute and file any such document, and to do all other lawfully permitted acts to further the prosecution, issuance, and enforcement of patents, copyrights, or other rights or protections with the same force and effect as if executed and delivered by me.

(d) **Exclusions.** Except as disclosed in Exhibit A, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement.

(e) **Post-Termination Period.** I acknowledge that because of the difficulty of establishing when any idea, process, invention, etc., is first conceived or developed by me, or whether it results from access to Proprietary Information or the Company's equipment, facilities and data, I agree that any idea, process, trademark, service mark, invention, technology, computer program, original work of authorship, design, formula, discovery, patent, copyright, or any improvement, rights, or claims related to the foregoing shall be presumed to be an Invention Idea if it is conceived, developed, used, sold, exploited, or reduced to practice by me or with my aid within one (1) year after my termination of employment with the Company. I can rebut the above presumption if I prove that the invention, idea, process, etc., is not an Invention Idea as defined in paragraph 2(a).

I understand that nothing in this Agreement is intended to expand the scope of protection provided me by Sections 2870 through 2872 of the California Labor Code.

3. **Former or Conflicting Obligations.** During my employment with the Company, I will not disclose to the Company, or use, or induce the Company to use, any proprietary information or trade secrets of others. I represent that my performance of this Agreement will not breach any agreement to keep in confidence proprietary information acquired by me in confidence or in trust prior to my employment by the Company. I certify that I have no outstanding agreement or obligation that is in conflict with any of the provisions of this Agreement, or that would preclude me from complying with the provisions hereof. I further certify that during the term of my employment with the Company, I will not engage in any other employment, occupation, consulting or other business activity directly related to the business in which the Company is now involved or becomes involved during the term of such employment.

4. **Government Contracts.** I understand that the Company has or may enter into contracts with the government under which certain intellectual property rights will be required to be protected, assigned, licensed, or otherwise transferred and I hereby agree to execute such other documents and agreements as are necessary to enable the Company to meet its obligations under any such government contracts.

5. **Termination.** I hereby acknowledge and agree that all personal property, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents or materials or copies thereof, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment, belong to the Company and will be promptly returned to the Company upon termination of my employment with the Company. Following my termination, I will not retain any written or other tangible material containing any Proprietary Information or information pertaining to any Invention Idea. I understand that my obligations contained herein will survive the termination of my employment. In the event of termination of my employment, I agree to sign and deliver to the Company a Termination Certificate in the form attached hereto as Exhibit B.

6. *Miscellaneous Provisions.*

(a) Assignment. I agree that the Company may assign to another person or entity any of its rights under this Agreement, including, without limitation, any successor in interest to the Company or its business operations. This Agreement shall be binding upon me and my heirs, executors, administrators, and successors, and shall inure to the benefit of the Company's successors and assigns.

(b) Governing Law; Severability. The validity, interpretation, enforceability, and performance of this Agreement shall be governed by and construed in accordance with the laws of the State of California. If any provision of this Agreement, or application thereof to any person, place, or circumstance, shall be held by a court of competent jurisdiction to be invalid, unenforceable, or void, the remainder of this Agreement and such provisions as applied to other persons, places, and circumstances shall remain in full force and effect.

(c) Entire Agreement. The terms of this Agreement are the final expression of my agreement with respect to the subject matter hereof and may not be contradicted by evidence of any prior or contemporaneous agreement. This Agreement shall constitute the complete and exclusive statement of its terms and no extrinsic evidence whatsoever may be introduced in any judicial, administrative, or other legal proceeding involving this Agreement.

(d) Application of this Agreement. I hereby agree that my obligations set forth in Sections 1 and 2 hereof and the definitions of Proprietary Information and Invention Ideas contained therein shall be equally applicable to Proprietary Information and Invention Ideas relating to any work performed by me for the Company prior to the execution of this Agreement.

Date: June 22, 2007

/s/ Tony Gaughan

Signature

Tony Gaughan

Printed Name

EXHIBIT A

Employee's Prior Inventions

Except as set forth below, there are no ideas, processes, trademarks, service marks, inventions, technology, computer programs, original works of authorship, designs, formulas, discoveries, patents, copyrights, or any claims, rights, or improvements to the foregoing that I wish to exclude from the operation of this Agreement:

EXHIBIT B

**TERMINATION CERTIFICATE CONCERNING
PROPRIETARY INFORMATION AND INVENTIONS**

This is to certify that I have returned all personal property of the Company, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents and materials, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment with the Company, and that I did not make or distribute any copies of the foregoing.

I further certify that I have reviewed the Employee Proprietary Information and Inventions Agreement signed by me and that I have complied with and will continue to comply with all of its terms, including, without limitation, (i) the reporting of any invention, process, or idea, etc. conceived or developed by me and covered by the Agreement and (ii) the preservation as confidential of all Proprietary Information pertaining to the Company. This certificate in no way limits my responsibilities or the Company's rights under the Agreement.

On termination of my employment with the Company, I will be employed by _____ [name of new employer]
_____ [in the _____ division] and I will be working in connection with the following projects:

[generally describe the projects]

Dated: _____

Signature

Printed Name



46600 Landing Parkway
Fremont, California 94538

P. 408.240.8300
F. 408.321.0293

www.rackable.com

January 23, 2008

Tony Gaughan

Re: Employment Agreement Restatement and Amendment #1

Dear Tony:

Rackable Systems, Inc. (the “Company”) and you entered into an employment agreement dated June 19, 2007 (attached as **Exhibit A**, the “Offer Letter”) governing the terms of your employment. The parties desire to restate and amend the Offer Letter based on the terms and conditions herein (“Amendment #1”). (The Offer Letter, as amended by this Amendment #1, shall be collectively referred to herein as the “Agreement”). In the event of a conflict between the provisions of this Amendment #1 and the Offer Letter, the provisions of this Amendment #1 shall prevail. The parties agree that in consideration of your continued at-will employment and the exchange and receipt by the parties of other good and valuable consideration, the following terms and conditions shall govern your employment:

1. **POSITION.** Commencing on July 16, 2007 (“Start Date”) and continuing beyond the date of this Amendment #1, you will serve in an executive capacity in the role of Chief Products Officer and Senior Vice President, reporting to the Company’s Chief Executive Officer (the “CEO”). Specifically, for purposes of this Agreement, your executive capacity role will be responsibility for the Company’s overall product functions in the corporation. This includes worldwide engineering, Rackable Labs, and RapidScale. Of course, the Company may change your position, duties, and work location from time to time in its discretion subject to the terms of this Agreement.
2. **COMPENSATION.**
 - a. **Base Salary.** Your base salary is \$270,000, less standard payroll deductions and withholdings. You will be paid bi-weekly in accordance with Company practice and policy.

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- b. **Performance Bonus.** In addition, you will be eligible to earn a quarterly performance bonus ¹ target of \$33,750, based upon both your performance and the Company's performance with respect to applicable performance targets which are expected to include revenue and profitability targets and other organizational milestones ("Targets"), set solely by the CEO. The bonus payment shall be earned upon the fulfillments of Targets and is payable within a reasonable period of time. The Company will determine in its sole discretion whether the Targets have been achieved, whether you have earned a bonus, and the amount of any earned bonus. You must be employed on the bonus payment date to earn and be eligible to receive any bonus.
 - c. **Review of Compensation.** Your base salary and bonus eligibility will be reviewed on an annual or more frequent basis by the Compensation Committee and are subject to change in the discretion of the Compensation Committee, subject to the terms of the Agreement.

3. STOCK AWARDS.

- a. **Initial Grants.** To the extent that you have been issued an Option and/or RSU pursuant to the Offer Letter ("Initial Grants"), the provisions of the Offer Letter and your individual Option and/or Restricted Stock Unit Award Agreement relating to such the Initial Grants shall remain in full force and effect without modification by this Amendment #1. This includes, without limitation, those provisions in the Offer Letter and your individual Option and/or Restricted Stock Unit Award Agreement relating to the vesting and acceleration upon change of control of the Initial Grants. Nothing in this Amendment #1 will be construed to modify the provisions of the 2006 New Recruit Equity Incentive Plan (the "2006 Plan") and your individual Option and/or Restricted Stock Unit Award Agreement, which govern the Initial Grants.
- b. **Following Grants.** Subject to Compensation Committee approval, the Company may issue you additional awards ("Following Grants") pursuant to the 2005 Equity Incentive Plan (the "2005 Plan") in the form of options to purchase shares of the Company's common stock at an exercise price equal to the fair market value of the stock as of the date of grant as determined by the Compensation Committee; and/or the right to receive shares of the Company's common stock. Following Grants will be subject to a four-year vesting period subject to your continuous service to the Company as an employee or consultant, with one sixteenth (1/16) of the Following Grant shares vesting for each full Company quarter of your continuous service as an employee or consultant (as defined in the 2005 Plan), following the grant date of the Following Grants. Nothing in this Amendment #1 will be construed to modify the provisions of the 2005 Plan and your individual Following Grant Award Agreement(s), which will govern Following Grants.

- 4. **EMPLOYEE BENEFITS.** You are eligible to participate in the Company's standard employee benefit plans in accordance with the terms and conditions of the plans and applicable policies which may be in effect from time to time, and provided by the Company to its

¹ Performance bonuses are aligned to the Company's quarterly financial reporting periods (each such quarter, a "Company Quarter"); your initial quarterly participation will be adjusted *pro rata* based upon your Start Date.

executive employees generally, including but not limited to group health insurance coverage, disability insurance, life insurance, ESPP, 401(k) Plan, and paid time off and paid holidays. You will be eligible for reimbursement of your legitimate and documented business expenses incurred in connection with your employment, pursuant to the Company's standard reimbursement expense policy and practices. The Company may modify its benefits programs and policies from time to time in its discretion.

5. **PROPRIETARY INFORMATION AND INVENTIONS AGREEMENT.** As a condition of your employment, you are required to abide by the Company's Proprietary Information and Inventions Agreement (the "Non-Disclosure Agreement"), attached to the Offer Letter as **Exhibit A**.
6. **SERVICE AS EMPLOYEE; OUTSIDE ACTIVITIES.**
- a. **Location and Duties.** You will work at the Company's corporate headquarters currently located in Fremont, California, subject to necessary business travel. During your employment with the Company, you will devote your best efforts and substantially all of your business time and attention (except for vacation periods and reasonable periods of illness or other incapacity permitted by the Company's general employment policies) to the business of the Company.
 - b. **Company Policies.** Your employment relationship with the Company shall also be governed by the general employment policies and practices of the Company, including but not limited to the policies contained in the Company's Employee Handbook (except that if the terms of this letter differ from or are in conflict with the Company's general employment policies or practices, the Offer Letter as amended by this Amendment #1 will control), and you will be required to abide by such general employment policies and practices of the Company.
 - c. **Other Activities.** Throughout your employment with the Company, you may engage in civic and not-for-profit activities so long as such activities do not interfere with the performance of your duties hereunder or present a conflict of interest with the Company. Subject to the restrictions set forth herein and with the prior written consent of the Board, you may serve as a director of other corporations and may devote a reasonable amount of your time to other types of business or public activities not expressly mentioned in this paragraph.
 - d. **Conflict of Interest.** During your employment by the Company, except on behalf of the Company, you will not directly or indirectly serve as an officer, director, stockholder, employee, partner, proprietor, investor, joint venturer, associate, representative or consultant for or on behalf of any other person, corporation, firm, partnership or other entity whatsoever known by you to compete with the Company (or is planning or preparing to compete with the Company), anywhere in the world, in any line of business engaged in (or planned to be engaged in) by the Company; provided, however, that you may purchase or otherwise acquire up to (but not more than) one percent (1%) of any class of securities of any enterprise (but without participating in the activities of such enterprise) if such securities are listed on any national or regional securities exchange.

7. **AT-WILL EMPLOYMENT RELATIONSHIP.** Your employment relationship with the Company is at-will. Accordingly, both you and the Company may terminate the employment relationship at any time, with or without Cause (as defined below), and with or without advance notice.

8. **DEFINITIONS.**

- a. **Definition of “Cause.”** For purposes of the Agreement, “Cause” is defined as one or more of the following events: (i) the indictment or conviction for a felony or other crime, or any misdemeanor involving moral turpitude; (ii) the commission of any other act or omission involving fraud or intentional deceit with respect to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iii) any act or omission involving dishonesty that causes material injury to the Company or any of its affiliates or any of their directors, stockholders, partners or members; (iv) gross negligence with respect to the Company or any of its subsidiaries; (v) willful misconduct with respect to the Company or any of its subsidiaries; (vi) any other material breach of this agreement or any other agreement referred to herein (including the Non-Disclosure Agreement); provided, however, that, it shall only be deemed Cause pursuant to clause (vi) if you are given written notice describing the basis of Cause and, if the event is reasonably susceptible of cure, you fail to cure within thirty (30) days.
- b. **Definition of “Good Reason.”** For purposes of the Agreement, “Good Reason” is defined as one or more of the following conditions that occur without your written consent: (i) the assignment to you, or the removal from you, of any duties or responsibilities that results in the material diminution of your authority, duties or responsibilities as Chief Products Officer and Sr. Vice President, including a Change in Control that results in your no longer serving as the Chief Products Officer and Sr. Vice President or any similar position; (ii) a material reduction by the Company of your base salary; (iii) the Company’s material breach of its obligations to you under this offer letter agreement; or (iv) your office relocation to a location more than fifty miles from your then present location; provided however that, it shall only be deemed Good Reason pursuant to the foregoing definition if (x) the Company is given written notice from you within ninety (90) days following the first occurrence of a condition that you consider to constitute Good Reason describing the condition and fails to remedy such condition within thirty (30) days following such written notice, and (y) you resign from employment within ninety (90) days following the end of the period within which the Company was entitled to remedy the condition constituting Good Reason but failed to do so.
- c. **Definition of “Change in Control.”** For purposes of the Agreement, “Change in Control” means the occurrence, in a single transaction or in a series of related transactions, of either of the following events:
- i. There is consummated (A) a merger, consolidation or similar transaction involving (directly or indirectly) the Company or (B) a tender offer or exchange offer addressed to the stockholders of the Company and, in either event, immediately after the consummation of such merger, consolidation or similar transaction or such tender or exchange offer, the stockholders of the Company immediately prior thereto do not own, directly or indirectly, either (A)

outstanding voting securities representing more than fifty percent (50%) of the combined outstanding voting power of the surviving entity in such merger, consolidation or similar transaction or (B) more than fifty percent (50%) of the combined outstanding voting power of the parent of the surviving entity in such merger, consolidation or similar transaction, in each case in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such transaction; or

- ii. There is consummated a sale, lease, exclusive license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries, other than a sale, lease, license or other disposition of all or substantially all of the consolidated assets of the Company and its subsidiaries to an entity, more than fifty percent (50%) of the combined voting power of the voting securities of which are owned by stockholders of the Company in substantially the same proportions as their ownership of the outstanding voting securities of the Company immediately prior to such sale, lease, license or other disposition.

The term Change in Control shall not include a sale of assets, merger or other transaction effected exclusively for the purpose of changing the domicile of the Company.

9. **CHANGE IN CONTROL SEVERANCE BENEFITS.** If, within 12 months following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the “Release”); then in lieu of any Severance Benefits set forth in Section 10 herein, you shall be entitled to receive the following severance benefits (the “Change in Control Severance Benefits”):

- a. The vesting of all unvested stock options and all unvested grants of restricted stock herein referred to and any subsequent grants of stock options, restricted stock or any other stock awards in future plans, shall accelerate in such amount equal to the number of shares that would vest over an additional twenty-four (24) month period as if you have continued to be an employee of the Company for additional twenty-four (24) months following your termination;
- b. You will be eligible to receive severance pay in the total amount equal to the sum of twelve (12) months of your base salary in effect as of the employment termination date. For purposes of this Section 9(b), “base salary” as used herein does not include any annual performance bonus or any other bonus payment. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company’s normal payroll schedule; and
- c. If you timely elect and continue to remain eligible for continued group health insurance coverage under federal COBRA law or, if applicable, state insurance laws (collectively, “COBRA”), the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment

termination date (including dependent coverage, if applicable) for twelve (12) months after the employment termination date; provided that, the Company's obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Company if you become eligible for group health insurance coverage through a new employer within twelve (12) months of your employment termination date.

- 10. SEVERANCE BENEFITS.** If, at any time other than during the 12 month period following a Change in Control, your employment is terminated by the Company without Cause, or by you for Good Reason; and if you sign, date, return to the Company and allow to become effective a release of all claims in a form satisfactory to the Company in its sole discretion (the "Release"); then you shall be entitled to receive the following severance benefits (the "Severance Benefits"):
- a.** Severance pay in the total amount equal to the sum of twelve (12) months of your base salary in effect as of the employment termination date. The severance pay will be subject to required payroll deductions and withholdings, and will be paid in twenty-six (26) equal installments over a period of twelve (12) months, with such payments made on the Company's normal payroll schedule. For purposes of this Section 10(a), "base salary" as used herein does not include any annual performance bonus or any other bonus payment; and
 - b.** If you timely elect and continue to remain eligible for COBRA, the Company will pay your COBRA premiums sufficient to continue your group health insurance coverage at the same level in effect as of your employment termination date (including dependent coverage, if applicable) for twelve (12) months after the employment termination date; provided that, the Company's obligation to pay your COBRA premiums will cease earlier if you become eligible for group health insurance coverage through a new employer and you must provide prompt written notice to the Board if you become eligible for group health insurance coverage through a new employer within twelve (12) months of your employment termination date.
- 11. CONDITIONS TO ELIGIBILITY TO SEVERANCE BENEFITS OR CHANGE IN CONTROL SEVERANCE BENEFITS.** Notwithstanding the foregoing, you will not be eligible for the Severance Benefits or the Change in Control Severance Benefits if: (A) your employment is terminated for Cause, or if you resign for any reason that does not qualify as Good Reason; or (B) in the event that you materially breach the Non-Disclosure Agreement, the Release of claims, or any other obligations you owe to the Company after termination of your employment (including but not limited to the provisions of the Non-Disclosure Agreement), and the Company's obligation to provide the Severance Benefits or the Change in Control Benefits (or to continue to provide such benefits) will cease immediately and in full as of the date of your breach (in addition to any other remedies available to the Company).
- 12. DEFERRED COMPENSATION.** Anything in the Agreement to the contrary notwithstanding, if the Company reasonably determines that any payments hereunder fail to satisfy the distribution requirements of Section 409A(a)(2) of the Internal Revenue Code of 1986, as amended (the "Code") and you concur with such determination in writing, then the payment of such benefit shall be delayed to the minimum extent necessary so that such

payments are not subject to the provisions of Section 409A(a)(1) of the Code; provided, however, that in no event shall such delay be more than six (6) months and one (1) day from the date of termination of your employment with the Company.

13. EXCISE TAX.

- a. Anything in the Agreement to the contrary notwithstanding, if any payment or benefit that you would receive pursuant to this offer letter agreement or otherwise (“Payment”) would (i) constitute a “parachute payment” within the meaning of Section 280G of the Code, and (ii) but for this sentence, be subject to the excise tax imposed by Section 4999 of the Code (the “Excise Tax”), then such Payment shall be equal to the Reduced Amount (defined below). The “Reduced Amount” shall be either (y) the largest portion of the Payment that would result in no portion of the Payment (after reduction) being subject to the Excise Tax, or (z) the entire Payment, whichever amount after taking into account all applicable federal, state and local employment taxes, income taxes, and the Excise Tax (all computed at the highest applicable marginal rate, net of the maximum reduction in federal income taxes which could be obtained from a deduction of such state and local taxes), results in your receipt, on an after-tax basis, of the greatest amount of the Payment to you.
- b. If a reduction in the Payment is to be made, the reduction in payments and/or benefits shall occur in the following order unless you elect in writing a different order (provided, however, that such election shall be subject to Company approval, such approval not to be unreasonably withheld or delayed, if made on or after the date on which the event that triggers the Payment occurs (the “Payment Event”)): (1) reduction of cash payments; (2) cancellation of accelerated vesting of equity awards other than stock options; (3) cancellation of accelerated vesting of stock options; and (4) reduction of other benefits paid to you. In the event that acceleration of compensation from your equity awards is to be reduced, such acceleration of vesting shall be canceled in the reverse order of the date of grant unless you elect in writing a different order for cancellation.
- c. The accounting firm engaged by the Company for general audit purposes as of the day prior to the effective date of the Payment Event shall perform the foregoing calculations. If the accounting firm so engaged by the Company is serving as accountant or auditor for the individual, entity or group effecting the Payment Event, a nationally recognized accounting firm appointed by the Board and reasonably approved by you shall make the determinations required hereunder. The Company shall bear all expenses with respect to the determinations by such accounting firm required to be made hereunder.
- d. The accounting firm engaged to make the determinations hereunder shall provide its calculations, together with detailed supporting documentation, to the Company and you within fifteen (15) calendar days after the date on which your right to a Payment is triggered (if requested at that time by the Company or you) or such other time or times as requested by the Company or you. If the accounting firm determines that no Excise Tax is payable with respect to a Payment, either before or after the application of the Reduced Amount, it shall furnish the Company and you with an opinion reasonably acceptable to you that no Excise Tax will be imposed with respect to such Payment. The Company shall be entitled to rely upon the accounting firm’s determinations, which shall be final and binding.

14. DISPUTE RESOLUTION. To ensure the rapid and economical resolution of disputes that may arise in connection with your employment, you and the Company agree that any and all disputes, claims, or causes of action, in law or equity, arising from or relating to the enforcement, breach, performance, execution, or interpretation of this agreement, your employment, or the termination of your employment, shall be resolved, to the fullest extent permitted by law, by final, binding and confidential arbitration in San Francisco, California conducted before a single arbitrator by Judicial Arbitration and Mediation Services, Inc. ("JAMS") or its successor, under the then applicable JAMS rules. By agreeing to this arbitration procedure, both you and the Company waive the right to resolve any such dispute through a trial by jury or judge or by administrative proceeding. The arbitrator shall: (a) have the authority to compel adequate discovery for the resolution of the dispute and to award such relief as would otherwise be permitted by law; and (b) issue a written arbitration decision including the arbitrator's essential findings and conclusions and a statement of the award. The Company shall pay all of JAMS' arbitration fees. Nothing in this letter agreement shall prevent either you or the Company from obtaining injunctive relief in court if necessary to prevent irreparable harm pending the conclusion of any arbitration. The parties agree that the arbitrator shall award reasonable attorneys fees and costs to the prevailing party in any action brought hereunder, and the arbitrator shall have discretion to determine the prevailing party in an arbitration where multiple claims may be at issue.

15. MISCELLANEOUS.

- a. General Provisions.** The Agreement, including the Non-Disclosure Agreement, constitutes the complete, final and exclusive embodiment of the entire agreement between you and the Company with regard to the subject matter hereof. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein, and it supersedes any other agreements, promises, warranties or representations concerning its subject matter. Changes in your employment terms, other than those expressly reserved herein to the Company's discretion, only can be made in a writing signed by a duly-authorized member of the Company and you. The Agreement will bind the heirs, personal representatives, successors and assigns of both you and the Company, and inure to the benefit of both you and the Company, their heirs, successors and assigns. If any provision of the Agreement is determined to be invalid or unenforceable, in whole or in part, this determination shall not affect any other provision of the Agreement and the provision in question shall be modified so as to be rendered enforceable in a manner consistent with the intent of the parties insofar as possible under applicable law. The Agreement shall be construed and enforced in accordance with the laws of the State of California without regard to conflicts of law principles. Any ambiguity in the Agreement shall not be construed against either party as the drafter. Any waiver of a breach of the Agreement, or rights hereunder, shall be in writing and shall not be deemed to be a waiver of any successive breach or rights hereunder. The Agreement may be executed in counterparts which shall be deemed to be part of one original, and facsimile signatures shall be equivalent to original signatures.

b. Legal Right to Work. As required by law, your continued employment is subject to satisfactory proof of your right to work in the United States.

16. ACCEPTANCE. Please sign this Amendment #1 and return them to me as soon as possible to indicate your acceptance of the amended terms of employment with the Company.

Sincerely,

Rackable Systems, Inc.

By: /s/ Jennifer L. Pratt
Jennifer L. Pratt
Vice President, Human Resources

February 14, 2008
Date

Understood and Agreed:

/s/ Tony Gaughan
Tony Gaughan

February 14, 2008
Date

Exhibit A –Offer Letter, dated June 19, 2007

EXHIBIT A

OFFER LETTER, DATED JUNE 19, 2007

November 12, 2008

Tony Gaughan

Dear Tony:

This Separation Agreement (the "Agreement") sets forth the terms of your separation from employment with Rackable Systems, Inc. (the "Company").

1. EMPLOYMENT STATUS AND FINAL PAYMENTS .

(a) Separation Date. Your last day of work with the Company and your employment termination date will be November 12, 2008 (the "Separation Date"). As of the Separation Date, your salary will cease, and any entitlement you have or might have under any Company-provided benefit plan, program, contract or practice (each a "Benefit Program") will terminate, except (i) as required by the terms of an applicable Benefit Program or any applicable federal or state law, or (ii) as otherwise described below.

(b) Accrued Salary and PTO. On the Separation Date, the Company will pay you all accrued salary, and all accrued and unused paid time off (PTO) earned through the Separation Date, subject to standard payroll deductions and withholdings. You are entitled to these payments by law.

(c) Expense Reimbursements. You shall submit expense reports to the Company seeking reimbursement for any business expenses incurred through the Separation Date by November 12, 2008. The Company will reimburse you for these business expenses, pursuant to its standard policies and practices, within fifteen (15) business days after the submission of your expense report.

2. SEVERANCE BENEFITS . The Company shall provide the following sole severance benefits (the "Severance Benefits"), if you timely sign, date and return this fully executed Agreement to the Company, and allow the releases contained herein to become effective (as defined in Section 13:

(a) Base Salary. The Company shall provide as severance, the equivalent of nine months of your base salary, subject to standard payroll deductions and withholdings ("Severance"). The Severance Payments will be paid on the Company's regular payroll cycle beginning on the first regularly-scheduled payroll date after the Effective Date of this Agreement as defined in paragraph 13 below, provided you have fulfilled your obligation to return Company property under Paragraph 5 of this Agreement. The Company's obligation to continue Severance payments ceases immediately if you become employed through a new employer at any time within nine (9) months after the Separation Date. You must promptly notify the Company if you become employed through a new employer.

(b) Health Insurance. To the extent provided by the federal COBRA law or, if applicable, state insurance laws (collectively, "COBRA"), and by the Company's current group health insurance policies, you will be eligible to continue your group health insurance benefits at your own expense after the Separation Date. Later, you may be able to convert to an individual policy through the provider of the Company's health insurance, if you wish. You will be provided

with a separate notice describing your rights and obligations under the applicable state and/or federal insurance laws on or after the Separation Date. Although the Company is not otherwise obligated to do so, if you timely elect to continue group health coverage after the Separation Date pursuant to COBRA, the Company will reimburse your COBRA premium payments sufficient to continue your group health coverage at its current level (including dependant coverage, if applicable) for a maximum of nine (9) months following the Separation Date; *provided, however*, that the Company's obligation to reimburse your monthly premium payments ceases immediately if you become eligible for group health insurance coverage through a new employer at any time within nine (9) months after the Separation Date. You must promptly notify the Company if you become eligible for group health insurance coverage through a new employer.

(b) Classification of Employment Termination. For purposes of eligibility for California Unemployment Insurance Benefits only, the Company will consider the termination of your employment to be involuntary, resulting from the Company's decision to eliminate your employment position. The Company will not contest your right to seek California Unemployment Insurance Benefits.

3. E Q U I T Y . Under the terms of your stock option agreement and the applicable plan documents, vesting of your stock options and restricted stock awards/units ceased as of November 12, 2008. Your right to exercise any vested options or shares, and all other rights and obligations with respect to your stock options(s) and restricted stock awards, will be as set forth in your stock option agreement, grant notice, restricted stock purchase agreement, and applicable plan documents.

4. O T H E R C O M P E N S A T I O N O R B E N E F I T S . You acknowledge that, except as expressly provided in this Agreement, you have not earned and will not receive from the Company any additional compensation (including base salary, bonus, incentive compensation, or equity), severance (including any severance pursuant to your Employment Agreement, Employment Agreement Restatement & Amendment #1 or Rackable Systems, Inc. Executive Change in Control Severance Benefit Plan (the "Severance Plan")), or any other benefits before or after the Separation Date, with the exception of any vested right you may have under the express terms of a written ERISA-qualified benefit plan (e.g., 401(k) account) or any vested options.

5. R E T U R N O F C O M P A N Y P R O P E R T Y . By November 12, 2008, You agree to return to the Company all Company documents (and all copies thereof) and other Company property which you have in your possession or control, including, but not limited to, Company files, notes, drawings, records, plans, forecasts, reports, studies, analyses, proposals, agreements, financial information, research and development information, sales and marketing information, customer lists, prospect information, pipeline reports, sales reports, operational and personnel information, specifications, code, software, databases, computer-recorded information, tangible property and equipment (including, but not limited to, computers, facsimile machines, mobile telephones, servers), credit cards, entry cards, identification badges and keys; and any materials of any kind which contain or embody any proprietary or confidential information of the Company (and all reproductions thereof in whole or in part). You agree that you will make a diligent search to locate any such documents, property and information. If you have used any personally owned computer, server, or e-mail system to receive, store, review, prepare or transmit any Company confidential or proprietary data, materials or information, by November 12, 2008, you shall provide the Company with a computer-useable copy of such information and then permanently delete and expunge such Company confidential or proprietary information from those systems; and you agree to provide the Company access to your system as requested to verify that the necessary copying and/or deletion is done. Your timely compliance with this paragraph is a condition precedent to your receipt of the Severance Benefits provided under this Agreement.

6. PROPRIETARY INFORMATION OBLIGATIONS. You agree to refrain from any use or disclosure of the Company's confidential or proprietary information or materials (including, but not limited to, sales and marketing information, customer information, product and manufacturing information, financial information, personnel and compensation information, and operational and training information). Additionally, you reaffirm your obligation to comply with the Employee Proprietary Information and Inventions Agreement (the "PIIA") you previously signed (attached hereto as Exhibit A).

8. NONDISPARAGEMENT. You agree not to disparage the Company, its officers, directors, employees, shareholders, and agents, and the Company (through its officers and directors) agrees not to disparage you, in any manner likely to be harmful to his/its business, business reputation, or personal reputation; provided that you and Company will respond accurately and fully to any question, inquiry or request for information when required by legal process.

9. COOPERATION AND ASSISTANCE. You agree that you will not voluntarily provide assistance, information or advice, directly or indirectly (including through agents or attorneys), to any person or entity in connection with any claim or cause of action of any kind brought against the Company, nor shall you induce or encourage any person or entity to bring such claims. However, it will not violate this Agreement if you testify truthfully when required to do so by a valid subpoena or under similar compulsion of law. Further, you agree to voluntarily cooperate with the Company if you have knowledge of facts relevant to any threatened or pending litigation against the Company by making yourself reasonably available without further compensation for interviews with the Company's counsel, for preparing for and providing deposition testimony, and for preparing for and providing trial testimony.

10. NO ADMISSIONS. You understand and agree that the promises and payments in consideration of this Agreement shall not be construed to be an admission of any liability or obligation by the Company to you or to any other person, and that the Company makes no such admission.

11. CONFIDENTIALITY. The provisions of this Agreement will be held in strictest confidence by you and the Company and will not be publicized or disclosed in any manner whatsoever; *provided, however*, that: (a) you may disclose this Agreement in confidence to your immediate family; (b) the parties may disclose this Agreement in confidence to their respective attorneys, accountants, auditors, tax preparers, and financial advisors; (c) the Company may disclose this Agreement as necessary to fulfill standard or legally required corporate reporting or disclosure requirements; and (d) the parties may disclose this Agreement insofar as such disclosure may be necessary to enforce its terms or as otherwise required by law. **In particular, and without limitation, you agree not to disclose the existence or terms of this Agreement to any current or former Company employee, contractor or consultant.**

12. RELEASE OF CLAIMS.

(a) General Release. In exchange for the consideration under this Agreement to which you would not otherwise be entitled, you hereby generally and completely release the Company and its directors, officers, employees, shareholders, partners, agents, attorneys, predecessors, successors, parent and subsidiary entities, insurers, affiliates, and assigns (collectively, the "Released Parties") of and from any and all claims, liabilities and obligations, both known and unknown, that arise out of or are in any way related to events, acts, conduct, or omissions occurring prior to or on the date that you sign this Agreement (collectively, the "Released Claims").

(b) Scope of Release. The Released Claims include, but are not limited to: (a) all claims arising out of or in any way related to your employment with the Company, or the termination of that employment; (b) all claims related to your compensation or benefits from the Company, including salary, bonuses, commissions, vacation pay, expense reimbursements, severance pay, fringe benefits, stock, stock options, or any other ownership interests in the Company; (c) all claims for breach of contract, wrongful termination, and breach of the implied covenant of good faith and fair dealing; (d) all tort claims, including claims for fraud, defamation, emotional distress, and discharge in violation of public policy; and (e) all federal, state, and local statutory claims, including claims for discrimination, harassment, retaliation, attorneys' fees, or other claims arising under the federal Civil Rights Act of 1964 (as amended), the federal Americans with Disabilities Act of 1990, the federal Age Discrimination in Employment Act of 1967 (as amended) (the "ADEA"), the California Labor Code (as amended), and the California Fair Employment and Housing Act (as amended).

(c) Excluded Claims. Notwithstanding the foregoing, the following are not included in the Released Claims (the "Excluded Claims"): (a) any rights or claims for indemnification you may have pursuant to any written indemnification agreement with the Company to which you are a party, the charter, bylaws, or operating agreements of the Company, or under applicable law; (b) any rights which are not waivable as a matter of law; or (c) any claims arising from the breach of this Agreement. In addition, nothing in this Agreement prevents you from filing, cooperating with, or participating in any proceeding before the Equal Employment Opportunity Commission, the Department of Labor, or the California Department of Fair Employment and Housing, except that you hereby waive your right to any monetary benefits in connection with any such claim, charge or proceeding. You hereby represent and warrant that, other than the Excluded Claims, you are not aware of any claims you have or might have against any of the Released Parties that are not included in the Released Claims.

13. ADEA WAIVER. You hereby acknowledge that you are knowingly and voluntarily waiving and releasing any rights you may have under the ADEA, and that the consideration given for the waiver and release you have given in this Agreement is in addition to anything of value to which you were already entitled. You further acknowledge that you have been advised by this writing, as required by the ADEA, that: (a) your waiver and release do not apply to any rights or claims that may arise after the date you sign this Agreement; (b) you should consult with an attorney prior to signing this Agreement (although you may voluntarily decide not to do so); (c) you have twenty-one (21) days to consider this Agreement (although you may choose voluntarily to sign this Agreement sooner); (d) you have seven (7) days following the date you sign this Agreement to revoke this Agreement (in a written revocation sent to and received by the Company's Human Resource Director); and (e) this Agreement will not be effective until the date upon which the revocation period has expired, which will be the eighth day after you sign this Agreement (the "Effective Date").

14. SECTION 1542 WAIVER. In giving the release herein, which includes claims which may be unknown to you at present, you acknowledge that you have read and understand Section 1542 of the California Civil Code, which reads as follows:

"A general release does not extend to claims which the creditor does not know or suspect to exist in his or her favor at the time of executing the release, which if known by him or her must have materially affected his or her settlement with the debtor."

You hereby expressly waive and relinquish all rights and benefits under that section and any law of any other jurisdiction of similar effect with respect to your release of claims herein, including but not limited to your release of unknown claims.

15. REPRESENTATIONS . You hereby represent that you have been paid all compensation owed and for all hours worked, have received all the leave and leave benefits and protections for which you are eligible pursuant to the Family and Medical Leave Act, the California Family Rights Act, or otherwise, and have not suffered any on-the-job injury for which you have not already filed a workers' compensation claim.

16. DISPUTE RESOLUTION . To ensure rapid and economical resolution of any disputes regarding this Agreement, the parties hereby agree that any and all claims, disputes or controversies of any nature whatsoever arising out of, or relating to, this Agreement, or its interpretation, enforcement, breach, performance or execution, your employment with the Company, or the termination of such employment, shall be resolved, to the fullest extent permitted by law, by final, binding and confidential arbitration in San Jose, CA conducted before a single arbitrator by JAMS, Inc. ("JAMS") or its successor, under the then applicable JAMS arbitration rules. **The parties each acknowledge that by agreeing to this arbitration procedure, they waive the right to resolve any such dispute, claim or demand through a trial by jury or judge or by administrative proceeding.** You will have the right to be represented by legal counsel at any arbitration proceeding. The arbitrator shall: (i) have the authority to compel adequate discovery for the resolution of the dispute and to award such relief as would otherwise be available under applicable law in a court proceeding; and (ii) issue a written statement signed by the arbitrator regarding the disposition of each claim and the relief, if any, awarded as to each claim, the reasons for the award, and the arbitrator's essential findings and conclusions on which the award is based. The arbitrator, and not a court, shall also be authorized to determine whether the provisions of this paragraph apply to a dispute, controversy, or claim sought to be resolved in accordance with these arbitration procedures. Nothing in this Agreement is intended to prevent either you or the Company from obtaining injunctive relief in court to prevent irreparable harm pending the conclusion of any arbitration.

17. MISCELLANEOUS . This Agreement, including Exhibit A (the PIIA), constitutes the complete, final and exclusive embodiment of the entire Agreement between you and the Company with regard to its subject matter. It is entered into without reliance on any promise or representation, written or oral, other than those expressly contained herein, and it supersedes any other such promises, warranties or representations, including without limitation any promises or representations regarding severance benefits contained in the Severance Plan or any compensation or benefits contained in the Retention Agreement. This Agreement may not be modified or amended except in a writing signed by both you and a duly authorized officer of the Company. This Agreement will bind the heirs, personal representatives, successors and assigns of both you and the Company, and inure to the benefit of both you and the Company, their heirs, successors and assigns. If any provision of this Agreement is determined to be invalid or unenforceable, in whole or in part, this determination will not affect any other provision of this Agreement and the provision in question will be modified so as to be rendered enforceable. This Agreement will be deemed to have been entered into and will be construed and enforced in accordance with the laws of the State of California without regard to conflict of laws principles. Any ambiguity in this Agreement shall not be construed against either party as the drafter. Any waiver of a breach of this Agreement shall be in writing and shall not be deemed to be a waiver of any successive breach. This Agreement may be executed in counterparts and facsimile signatures will suffice as original signatures.

If this Agreement is acceptable to you, please sign below and return the Company's Vice President of Human Resources. You have twenty-one (21) calendar days to decide whether you would like to accept this Agreement, and the Company's offer contained herein will automatically expire if you do not sign it within this timeframe and return the fully signed Agreement promptly thereafter.

We wish you the best in your future endeavors.

Sincerely,

RACKABLE SYSTEMS, INC.

By: /s/ MARK J. BARRENECHEA

Mark Barrenechea, President & CEO

I HAVE READ, UNDERSTAND AND AGREE FULLY TO THE FOREGOING AGREEMENT :

/s/ TONY GAUGHAN

Tony Gaughan

November 14, 2008

Date

EXHIBIT B

**TERMINATION CERTIFICATE CONCERNING
PROPRIETARY INFORMATION AND INVENTIONS**

This is to certify that I have returned all personal property of the Company, including, without limitation, all books, manuals, records, models, drawings, reports, notes, contracts, lists, blueprints, and other documents and materials, Proprietary Information, and equipment furnished to or prepared by me in the course of or incident to my employment with the Company, and that I did not make or distribute any copies of the foregoing.

I further certify that I have reviewed the Employee Proprietary Information and Inventions Agreement signed by me and that I have complied with and will continue to comply with all of its terms, including, without limitation, (i) the reporting of any invention, process, or idea, etc. conceived or developed by me and covered by the Agreement and (ii) the preservation as confidential of all Proprietary Information pertaining to the Company. This certificate in no way limits my responsibilities or the Company's rights under the Agreement.

Date: November 10, 2008

/s/ Tony Gaughan

Signature

Tony Gaughan

Printed Name

SUBSIDIARIES OF RACKABLE SYSTEMS, INC.

Rackable Systems Limited (Ireland)

Rackable Asia Pacific Ltd. (Hong Kong)

Rackable Systems Holding Corp. (Delaware)

Rackable Systems Canada Acquisition ULC (Alberta)

Terrascale Technologies ULC (Alberta)

Rackable Systems Technology (Shanghai) Co., Ltd (PRC)

CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in Registration Statement Nos. 333-150102, 333-125760, 333-131976, 333-132564, 333-135677, 333-137250 and 333-140994 on Form S-8 of our reports dated March 18, 2009, relating to (1) the consolidated financial statements of Rackable Systems, Inc. and subsidiaries (which expresses an unqualified opinion and includes an explanatory paragraph relating to the adoption of Financial Accounting Standards Board (FASB) Interpretation No. 48, “ *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB No. 109* ” effective December 31, 2006), and (2) the effectiveness of internal control over financial reporting (which report expresses an adverse opinion on the effectiveness of internal control over financial reporting because of a material weakness) appearing in the Annual Report on Form 10-K of Rackable Systems, Inc. for the year ended January 3, 2009.

/s/ DELOITTE & TOUCHE LLP

San Jose, California
March 18, 2009

CERTIFICATION

I, Mark J. Barrenechea, certify that:

1. I have reviewed this annual report on Form 10-K of Rackable Systems, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ M ARK J. B ARRENECHEA

Mark J. Barrenechea
CEO and President

Date: March 18, 2009

CERTIFICATION

I, James D. Wheat, certify that:

1. I have reviewed this annual report on Form 10-K of Rackable Systems, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ JAMES D. WHEAT
James D. Wheat
Chief Financial Officer

Date: March 18, 2009

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

In connection with the Annual Report on Form 10-K of Rackable Systems, Inc. (the "Company") for the year ended January 3, 2009, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), Mark J. Barrenechea, Chief Executive Officer of the Company, and James D. Wheat, Chief Financial Officer of the Company, each hereby certifies, to the best of his or her knowledge, pursuant to 18 U.S.C. §1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

(1) The Report, to which this Certification is attached as Exhibit 32.1, fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: March 18, 2009

/s/ M ARK J. B ARRENECHEA

Mark J. Barrenechea
President and Chief Executive Officer

/s/ J AMES D. W HEAT

James D. Wheat
Chief Financial Officer

This certification accompanies the Form 10-K to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Rackable Systems, 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 of the Form 10-K), irrespective of any general incorporation language contained in such filing.