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

Form 10-Q

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

For the quarterly period ended: **September 30, 2006**

OR

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

For the transition period from to

Commission file number: 1-13759

REDWOOD TRUST, INC.

(Exact name of Registrant as specified in its Charter)

Maryland

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

68-0329422

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

One Belvedere Place, Suite 300

Mill Valley, California

(Address of principal executive offices)

94941

(Zip Code)

(415) 389-7373

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer

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

Indicate the number of shares outstanding of each of the issuer's classes of stock, as of the last practicable date.

Common Stock (\$0.01 par value per share)

26,155,375 as of November 1, 2006

REDWOOD TRUST, INC.

FORM 10-Q

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PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

(Unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Real estate loans	\$ 9,874,964	\$ 13,934,484
Real estate securities	2,912,365	2,418,917
Cash and cash equivalents	112,926	175,885
Total earning assets	12,900,255	16,529,286
Restricted cash	139,441	72,421
Accrued interest receivable	67,304	76,469
Interest rate agreements	29,692	31,220
Principal receivable	1,075	225
Deferred tax asset	3,205	5,384
Deferred asset-backed security issuance costs	46,945	54,125
Other assets	11,885	7,830
Total Assets	\$ 13,199,802	\$ 16,776,960
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Redwood debt	\$ 509,994	\$ 169,707
Asset-backed securities issued	11,554,259	15,585,277
Accrued interest payable	51,304	41,027
Interest rate agreements	6,080	507
Accrued expenses and other liabilities	17,267	27,889
Dividends payable	18,237	17,593
Total liabilities	12,157,141	15,842,000
Commitments and contingencies (Note 11)		
STOCKHOLDERS' EQUITY		
Common stock, par value \$0.01 per share, 50,000,000 shares authorized; 26,053,016 and 25,132,625 issued and outstanding	261	251
Additional paid-in capital	874,847	824,365
Accumulated other comprehensive income	94,780	73,731
Cumulative earnings	773,320	681,479
Cumulative distributions to stockholders	(700,547)	(644,866)
Total stockholders' equity	1,042,661	934,960
Total Liabilities and Stockholders' Equity	\$ 13,199,802	\$ 16,776,960

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share data)

(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income				
Real estate loans	\$ 149,483	\$ 194,025	\$ 469,028	\$ 600,282
Real estate securities	72,759	48,811	189,656	127,095
Cash and cash equivalents	1,872	990	7,220	2,374
Interest income before provision for credit reserve	224,114	243,826	665,904	729,751
(Provision for) reversal of credit reserve	(465)	805	1,865	1,307
Total interest income	223,649	244,631	667,769	731,058
Interest expense				
Redwood debt	(9,422)	(3,789)	(13,316)	(8,272)
Asset-backed securities issued	(165,251)	(192,802)	(515,531)	(559,341)
Total interest expense	(174,673)	(196,591)	(528,847)	(567,613)
Net interest income	48,976	48,040	138,922	163,445
Operating expenses	(13,455)	(12,364)	(42,074)	(35,618)
Net recognized gains and valuation adjustments	433	24,916	4,556	42,973
Net income before provision for income taxes	35,954	60,592	101,404	170,800
Provision for income taxes	(3,538)	(4,693)	(9,563)	(13,424)
Net income	\$ 32,416	\$ 55,899	\$ 91,841	\$ 157,376
Basic earnings per share:	\$ 1.25	\$ 2.26	\$ 3.60	\$ 6.41
Diluted earnings per share:	\$ 1.22	\$ 2.21	\$ 3.51	\$ 6.26
Regular dividends declared per common share	\$ 0.70	\$ 0.70	\$ 2.10	\$ 2.10
Special dividends declared per common share	—	—	—	—
Total dividends declared per common share	\$ 0.70	\$ 0.70	\$ 2.10	\$ 2.10
Basic weighted average shares outstanding	25,869,743	24,712,536	25,525,054	24,554,475
Diluted weighted average shares outstanding	26,624,532	25,314,315	26,132,000	25,159,619

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	\$ 32,416	\$ 55,899	\$ 91,841	\$ 157,376
Other comprehensive income:				
Net unrealized gains (losses) on available-for-sale securities	31,342	(16,200)	29,962	34,578
Reclassification adjustment for net (gains) losses included in net income	30	(18,137)	686	(31,100)
Net unrealized gains (losses) on cash flow hedges	(27,576)	13,891	(3,261)	7,901
Reclassification of net realized cash flow hedge (gains) losses to interest expense on asset-backed securities issued and net recognized gains and valuation adjustments	47	109	(6,338)	307
Total other comprehensive income	<u>3,843</u>	<u>(20,337)</u>	<u>21,049</u>	<u>11,686</u>
Comprehensive income	<u>\$ 36,259</u>	<u>\$ 35,562</u>	<u>\$ 112,890</u>	<u>\$ 169,062</u>

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

For the Nine Months Ended September 30, 2006:

(In thousands, except share data)

(Unaudited)

	Common Stock		Additional Paid-In Capital	Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount					
December 31, 2005	25,132,625	\$ 251	\$ 824,365	\$ 73,731	\$ 681,479	\$ (644,866)	\$ 934,960
Net income	—	—	—	—	91,841	—	91,841
Net unrealized (gain) reclassification on assets AFS	—	—	—	30,648	—	—	30,648
Net unrealized gain/ reclassification on interest rate agreements	—	—	—	(9,599)	—	—	(9,599)
Issuance of common stock:							
Dividend Reinvestment & Stock Purchase Plans	862,733	9	38,563	—	—	—	38,572
Employee Option & Stock Purchase Plans	60,524	1	663	—	—	—	664
Restricted Stock & Stock DERs	(2,866)	—	11,256	—	—	—	11,256
Dividends declared:							
Common	—	—	—	—	—	(55,681)	(55,681)
September 30, 2006	<u>26,053,016</u>	<u>\$ 261</u>	<u>\$ 874,847</u>	<u>\$ 94,780</u>	<u>\$ 773,320</u>	<u>\$ (700,547)</u>	<u>\$ 1,042,661</u>

For the Nine Months Ended September 30, 2005:

(In thousands, except share data)

(Unaudited)

	Common Stock		Additional Paid-In Capital	Other Comprehensive Income	Cumulative Earnings	Cumulative Distributions to Stockholders	Total
	Shares	Amount					
December 31, 2004	24,153,576	\$ 242	\$ 773,222	\$ 105,357	\$ 481,607	\$ (496,272)	\$ 864,156
Comprehensive income:							
Net income	—	—	—	—	157,376	—	157,376
Net unrealized gain on assets AFS	—	—	—	3,478	—	—	3,478
Net unrealized gain on interest rate agreements	—	—	—	8,208	—	—	8,208
Issuance of common stock:							
Secondary Offerings	—	—	—	—	—	—	—
Dividend Reinvestment & Stock Purchase Plans	582,250	5	31,294	—	—	—	31,299
Employee Option & Stock Plans	19,969	1	739	—	—	—	740
Restricted Stock & Stock DERs	8,609	—	2,852	—	—	—	2,852
Dividends declared:							
Common	—	—	—	—	—	(52,044)	(52,044)
September 30, 2005	<u>24,764,404</u>	<u>\$ 248</u>	<u>\$ 808,107</u>	<u>\$ 117,043</u>	<u>\$ 638,983</u>	<u>\$ (548,316)</u>	<u>\$ 1,016,065</u>

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

REDWOOD TRUST, INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Nine Months Ended September 30,	
	2006	2005
Cash Flows From Operating Activities:		
Net income	\$ 91,841	\$ 157,376
Adjustments to reconcile net income to net cash provided by operating activities:		
Net amortization of premiums, discounts, and debt issuance costs	(48,611)	(61,045)
Depreciation and amortization of non-financial assets	836	622
Reversal of credit loss provision	(1,865)	(1,307)
Non-cash stock compensation	11,256	2,852
Net recognized gains and valuation adjustments	(4,556)	(42,973)
Principal payments on real estate loans held-for-sale	—	885
Net sales of real estate loans held-for-sale	—	95,841
Purchases of real estate loans held-for-sale	—	(81,804)
Net change in:		
Accrued interest receivable	9,165	(7,499)
Principal receivable	(850)	1,124
Deferred income taxes	212	2,893
Other assets	770	161
Accrued interest payable	10,277	7,141
Accrued expenses and other liabilities	(10,622)	2,387
Net cash provided by operating activities	<u>57,853</u>	<u>76,654</u>
Cash Flows From Investing Activities:		
Purchases of real estate loans held-for-investment	(1,291,989)	(1,530,510)
Proceeds from sales of real estate loans held-for-investment	8,408	181,827
Principal payments on real estate loans held-for-investment	5,303,962	7,247,574
Purchases of real estate securities available-for-sale	(818,219)	(757,870)
Proceeds from sales of real estate securities available-for-sale	241,624	141,442
Principal payments on real estate securities available-for-sale	161,790	153,971
Net increase in restricted cash	(67,020)	(22,758)
Net cash provided by investing activities	<u>3,538,556</u>	<u>5,413,676</u>
Cash Flows From Financing Activities:		
Net borrowings (repayments) on Redwood debt	340,287	(41,542)
Proceeds from issuance of asset-backed securities	1,460,572	1,998,008
Deferred asset-backed security issuance costs	(10,591)	(11,259)
Repayments on asset-backed securities	(5,431,649)	(7,307,909)
Net (purchase) of interest rate agreements	(2,186)	(2,860)
Net proceeds from issuance of common stock	39,236	32,038
Dividends paid	(55,037)	(50,892)
Net cash used in financing activities	<u>(3,659,368)</u>	<u>(5,384,416)</u>
Net (decrease) increase in cash and cash equivalents	(62,959)	105,914
Cash and cash equivalents at beginning of period	175,885	57,246
Cash and cash equivalents at end of period	<u>\$ 112,926</u>	<u>\$ 163,160</u>
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 518,570	\$ 560,692
Cash paid for taxes	\$ 7,999	\$ 8,765
Non-cash financing activity:		
Dividends declared but not paid	<u>\$ 18,237</u>	<u>\$ 17,335</u>

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

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS

September 30, 2006

(Unaudited)

NOTE 1. REDWOOD TRUST

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), is a specialty finance company that invests in and manages real estate assets. In general, we invest in real estate assets by acquiring and owning asset-backed securities backed by real estate loans. Our primary focus is credit-enhancing residential and commercial real estate loans. We credit-enhance loans by acquiring and managing the first-loss and other credit-sensitive securities that bear the bulk of the credit risk of securitized loans.

As a real estate investment trust (REIT), we are required to distribute to stockholders as dividends at least 90% of our REIT taxable income, which is our income as calculated for tax purposes, exclusive of income earned in taxable subsidiaries. In order to meet our dividend distribution requirements, we have been paying both a regular quarterly dividend and a year-end special dividend. We expect our special dividend amount to be highly variable and we may not pay a special dividend in every year. Our dividend policies and distribution practices are determined by our Board of Directors and may change over time.

Redwood was incorporated in the State of Maryland on April 11, 1994, and commenced operations on August 19, 1994. Our executive offices are at One Belvedere Place, Suite 300, Mill Valley, California 94941.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The consolidated financial statements presented herein are for September 30, 2006 and December 31, 2005 and for the three and nine month periods ended September 30, 2006 and 2005. The accompanying consolidated financial statements are unaudited. The unaudited interim consolidated financial statements have been prepared on the same basis as the annual consolidated financial statements and, in our opinion, reflect all adjustments necessary for a fair statement of our financial position, results of operations, and cash flows. These consolidated financial statements and notes thereto should be read in conjunction with our audited consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2005. The results for the three and nine months ended September 30, 2006 are not necessarily indicative of the expected results for the year ended December 31, 2006. Certain amounts for prior periods have been reclassified to conform to the September 30, 2006 presentation. The nine months ended September 30, 2005 comparable cash flow statement has been reclassified to conform with the 2005 Form 10-K cash flow presentation.

These consolidated financial statements include the accounts of Redwood and its wholly-owned subsidiaries, Sequoia Mortgage Funding Corporation, Redwood Mortgage Funding, Inc. (RMF), Redwood Asset Management, Inc. (RAM), Cypress Trust, Inc., Acacia CDO 1, Ltd. through Acacia CDO 10, Ltd., Acacia CDO CRE1, Ltd., RWT Holdings, Inc. (Holdings), and Holdings' wholly-owned subsidiaries, including Sequoia Residential Funding, Inc. and Madrona Residential Funding LLC. References to Sequoia mean Sequoia Mortgage Funding Corporation and Sequoia Residential Funding, Inc. References to Acacia mean all the Acacia CDO entities. References to the Redwood REIT mean Redwood exclusive of its taxable subsidiaries. The taxable subsidiaries of Redwood are Holdings, Holdings' wholly owned subsidiaries, RMF and RAM, and the Acacia entities. All inter-company balances and transactions have been eliminated in consolidation.

Due diligence expenses are costs for services related to re-underwriting and analyzing the loans we acquire or the loans we credit-enhance through the purchase of certain securities. In previous financial statements we recognized these expenses as a reduction in interest income. After reviewing again the nature of these costs it was determined that they did not directly relate to the specific creation of a securitization and were dependent on specific asset acquisition analysis (which may or may not result in our acquiring assets). Therefore, beginning in the second quarter of 2006, we are recognizing these due diligence costs as an operating expense, and these amounts for prior periods have been reclassified to conform to this presentation.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

Use of Estimates

The preparation of financial statements in conformity with Generally Accepted Accounting Principles in the United States of America (GAAP) requires us to make a significant number of estimates in the preparation of financial statements. These include fair value of certain assets, amount and timing of credit losses, prepayment assumptions, and other items that affect the reported amounts of certain assets and liabilities as of the date of the consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. It is likely that changes in these estimates (e.g., market values due to changes in supply and demand, credit performance, prepayments, interest rates, or other reasons; yields due to changes in credit outlook and loan prepayments) will occur in the near term. Our estimates are inherently subjective in nature and actual results could differ from our estimates and the differences may be material.

Sequoia and Acacia Securitizations

We treat the securitizations we sponsor as financings under the provisions of Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 140), as under these provisions we have retained effective control over these loans and securities. Control is maintained through our active management of the assets in the securitization entities, our retained asset transfer discretion, our ability to direct certain servicing decisions, or a combination of the foregoing. These securitization entities issue asset-backed securities (ABS) to fund their acquisitions of loans and securities. Accordingly, the underlying loans owned by the Sequoia entities are shown on our Consolidated Balance Sheets under real estate loans and the Sequoia ABS issued to third parties are shown on our Consolidated Balance Sheets under ABS issued. Assets owned by the Acacia entities are shown on our Consolidated Balance Sheets in our real estate securities portfolio. ABS issued by the Acacia entities are shown on our Consolidated Balance Sheets as ABS issued. In our Consolidated Statements of Income, we record interest income on the loans and securities and interest expense on the ABS issued. Any Sequoia ABS (CES, investment grade, or interest-only security (IO)) acquired by Redwood or Acacia from Sequoia entities and any Acacia ABS acquired by Redwood for its own portfolio are eliminated in consolidation and thus are not shown separately on our Consolidated Balance Sheets.

Earning Assets

Earning assets (as consolidated for GAAP purposes) consist primarily of real estate loans and securities. Coupon interest is recognized as revenue when earned according to the terms of the loans and securities and when, in our opinion, it is collectible. Purchase discounts and premiums related to earning assets are amortized into interest income over their estimated lives to generate an effective yield, considering the actual and future estimated prepayments of the assets. Gains or losses on the sale of earning assets are based on the specific identification method.

Real estate loans combine our consolidated residential and commercial real estate loans. Real estate securities combine our consolidated residential and commercial real estate securities including those securities we define as credit-enhancement securities (CES). CES includes below-investment grade securities. Also included in our securities portfolio are residential sub-prime, collateral debt obligation (CDO), home equity lines of credit (HELOCs), and REIT corporate debt securities.

Real Estate Loans: Held-for-Investment

Our consolidated real estate loans are classified as held-for-investment because the consolidated securitization entities that own these assets have the ability and intent to hold these loans to maturity. Real estate loans held-for-investment are carried at their unpaid principal balances adjusted for net unamortized premiums or discounts and net of any allowance for credit losses.

Pursuant to Statement of Financial Accounting Standards No. 91, *Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases* (FAS 91), we

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

use the interest method to determine an effective yield and amortize the premium or discount on loans. For loans acquired prior to July 1, 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

Real Estate Securities: Available-for-Sale

Real estate securities are classified as available-for-sale (AFS) and are carried at their estimated fair values. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive income in our Consolidated Statements of Stockholders' Equity.

When recognizing revenue on AFS securities, we employ the interest method to account for purchase premiums, discounts, and fees associated with these securities. For securities rated AAA or AA, we use the interest method as prescribed under FAS 91, while for securities rated A or lower we use the interest method as prescribed under the Emerging Issues Task Force of the Financial Accounting Standards Board 99-20, *Recognition of Interest Income and Impairment on Purchased and Retained Beneficial Interests in Securitized Financial Assets* (EITF 99-20). The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, the timing and amount of credit losses, and other factors. We review and make adjustments to our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. There can be no assurance that our assumptions used to estimate future cash flows or the current period's yield for each asset would not change in the near term.

For determining other-than-temporary impairment on our real estate securities, we use the guidelines prescribed under EITF 99-20, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (FAS 115), and Staff Accounting Bulletin No. 5(m), *Other-Than-Temporary Impairment for Certain Investments in Debt and Equity Securities* (SAB 5(m)). Any other-than-temporary impairments are reported under net recognized gains (losses) and valuation adjustments in our Consolidated Statements of Income.

Credit Reserves

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves based on estimates of credit losses inherent in these loan portfolios as of the reporting date. To calculate the credit reserve, we assess inherent losses by determining loss factors (defaults, the timing of defaults, and loss severities upon defaults) that can be specifically applied to each of the consolidated loans, loan pools, or individual loans. We follow the guidelines of Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation* (SAB 102), Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), in setting credit reserves for our real estate loans.

The following factors are considered and applied in such determinations:

- Ongoing analyses of the pool of loans — including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, geographical considerations, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant environmental factors;
- Relevant market research and publicly available third-party reference loss rates;
- Trends in delinquencies and charge-offs;

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

- Effects and changes in credit concentrations;
- Information supporting the borrowers' ability to meet obligations;
- Ongoing evaluations of fair values of collateral using current appraisals and other valuations; and
- Discounted cash flow analyses.

Once we determine applicable default amounts, the timing of the defaults, and severity of losses upon the defaults, we estimate expected losses for each pool of loans over its expected life. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable occurrence of a credit loss (such as the initial deterioration of the borrower's financial condition) and the confirmation of that loss (the actual impairment or charge-off of the loan). The losses expected to occur within the estimated loss confirmation period are the basis of our credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis, and we record provision, charge-offs, and recoveries monthly.

Additionally, if a loan becomes real estate owned (REO) or is reclassified as held-for-sale, valuations specific to that loan also include analyses of the underlying collateral.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand and highly liquid investments with original maturities of three months or less.

Other Assets

Restricted Cash

Restricted cash includes principal and interest payments from real estate loans and securities owned by consolidated securitization entities that are collateral for, or payable to, owners of ABS issued by those entities and cash pledged as collateral on interest rate agreements. Restricted cash may also include cash retained in Acacia or Sequoia securitization trusts prior to purchase of real estate loans and securities.

Deferred Tax Assets

Net deferred tax assets represent the net benefit of net operating loss (NOL) carry forwards, real estate asset basis differences, recognized tax gains on whole loan securitizations, interest rate agreement basis differences, and other temporary GAAP and tax timing differences. These temporary timing differences will be recognized in different periods for GAAP and tax purposes. Net unrealized gains and losses on securities and interest rate agreements in our taxable subsidiaries that are reported in other comprehensive income are adjusted for the effects of tax, thus creating deferred tax assets (liabilities).

Deferred Asset-Backed Securities Issuance Costs

Deferred ABS issuance costs are costs associated with the issuance of ABS from securitization entities we sponsor. These costs typically include underwriting, rating agency, legal, accounting, and other fees. Deferred ABS issuance costs are reported on our Consolidated Balance Sheets as deferred charges and are amortized as an adjustment to consolidated interest expense using the interest method based on the actual and estimated repayment schedules of the related ABS issued under the principles prescribed in Accounting Practice Bulletin 21, *Interest on Receivables and Payables* (APB 21).

Other Assets

Other assets on our Consolidated Balance Sheets include REO, fixed assets, purchased interest, and other prepaid expenses. REO is reported at the lower of cost or market value.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

Accrued Interest Receivable and Principal Receivable

Accrued interest receivable and principal receivable represent principal and interest that is due and payable to us. These are generally received within the next month.

Interest Rate Agreements and Purchase Commitments

We enter into interest rate agreements to help manage some of our interest rate risks. We report our interest rate agreements at fair value. Those with a positive value to us are reported as an asset and those with a negative value to us are reported as a liability. We may elect hedge accounting treatment under Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133), or we may account for these as trading instruments. See *Note 5* for a further discussion on interest rate agreements.

We enter into commitments to purchase loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), when applicable. These are classified as trading instruments on our Consolidated Balance Sheets until the date of settlement and changes in fair value of the commitments are recorded through Net Recognized Gains and Valuation Adjustments in the Consolidated Statements of Income.

Redwood Debt

Redwood debt is short-term debt collateralized by loans and securities. We report this debt at its unpaid principal balance. We may use Redwood debt to fund assets temporarily as we accumulate them for future sale to securitization entities. Increasingly, we will use Redwood debt to fund loans and securities that do not have significant credit risk and that we believe can generate an attractive return on the capital employed.

Asset-Backed Securities Issued

The majority of the liabilities reported on our Consolidated Balance Sheets represents ABS issued by bankruptcy-remote securitization entities sponsored by Redwood. These ABS issued are carried at their unpaid principal balances net of any unamortized discount or premium. Our exposure to loss from consolidated securitization entities (such as Sequoia and Acacia) is limited (except, in some circumstances, for limited loan repurchase obligations) to our net investment in securities we have acquired from these entities. As required by the governing documents related to each series of ABS, Sequoia and Acacia assets are held in the custody of trustees. Trustees collect principal and interest payments (less servicing and related fees) from the assets and make corresponding principal and interest payments to the issued ABS. ABS obligations are payable solely from the assets of these entities and are non-recourse to Redwood.

Other Liabilities

Accrued Interest Payable

Accrued interest payable represents interest due and payable on Redwood debt and ABS issued. It is generally paid within the next month with the exception of interest due on Acacia ABS which is generally settled quarterly.

Accrued Expenses and Other Liabilities

Accrued expenses and other liabilities on our Consolidated Balance Sheets include cash held back from borrowers, derivatives margin liability, accrued employee bonuses, executive deferred compensation, dividend equivalent rights (DERs) payable, excise and income taxes, and accrued legal, accounting, consulting, and other miscellaneous expenses.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

Dividends Payable

Dividends payable reflect any dividend declared by us but not yet distributed to our stockholders as of the financial statement date.

Income Taxes

We have elected to be taxed as a REIT under the Internal Revenue Code and the corresponding provisions of state law. In order to qualify as a REIT, we must distribute at least 90% of our annual REIT taxable income (this does not include taxable income retained in our taxable subsidiaries) to stockholders within the time frame set forth in the tax rules and we must meet certain other requirements. If these requirements are met, we generally will not be subject to Federal or state income taxation at the corporate level with respect to the REIT taxable income we distribute to our stockholders. We may retain up to 10% of our REIT taxable income and pay corporate income taxes on this retained income while continuing to maintain our REIT status.

We have recorded a provision for income taxes in our Consolidated Statements of Income based upon our estimated liability for Federal and state income tax purposes. These tax liabilities arise from estimated taxable earnings in taxable subsidiaries and from the planned retention of a portion of our estimated REIT taxable income. See *Note 8* for a further discussion on income taxes.

Net Income per Share

Basic net income per share is computed by dividing net income by the weighted average number of common shares outstanding during the period. Diluted net income per share is computed by dividing net income by the weighted average number of common shares and potential common shares outstanding during the period. Potential common shares outstanding are calculated using the treasury stock method, which assumes that all dilutive common stock equivalents are exercised and the funds generated by the exercises are used to buy back outstanding common stock at the average market price of the common stock during the reporting period.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

The following table provides reconciliation of denominators of the basic and diluted net income per share computations.

Basic and Diluted Net Income Per Share
(In thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Denominator:				
Denominator for basic earnings per share:				
Weighted average number of common shares outstanding during the period	25,869,743	24,712,536	25,525,054	24,554,475
Net effect of dilutive stock options	754,789	601,779	606,946	605,144
Denominator for diluted earnings per share	<u>26,624,532</u>	<u>25,314,315</u>	<u>26,132,000</u>	<u>25,159,619</u>
Basic Earnings Per Share:				
Net income per share	<u>\$ 1.25</u>	<u>\$ 2.26</u>	<u>\$ 3.60</u>	<u>\$ 6.41</u>
Diluted Earnings Per Share:				
Net income per share	<u>\$ 1.22</u>	<u>\$ 2.21</u>	<u>\$ 3.51</u>	<u>\$ 6.26</u>

Pursuant to EITF 03-6, *Participating Securities and the Two — Class Method* under FASB No. 128 (EITF 03-6), we determined that there was no allocation of income for our outstanding stock options as they were antidilutive during the three and nine months ended September 30, 2006 and 2005. There were no other participating securities, as defined by EITF 03-6, during the three and nine months ended September 30, 2006 and 2005. For the three and nine months ended September 30, 2006, the number of outstanding stock options that were antidilutive totaled 369,343 and 384,399, respectively. For the three and nine months ended September 30, 2005, the number of outstanding stock options that were antidilutive totaled 368,522 and 167,622, respectively.

Other Comprehensive Income

Current period net unrealized gains and losses on real estate loan CES, real estate securities available-for-sale, and interest rate agreements classified as cash flow hedges are reported as components of other comprehensive income on our Consolidated Statements of Comprehensive Income. Net unrealized gains and losses on securities and interest rate agreements held by our taxable REIT subsidiaries that are reported in other comprehensive income are adjusted for the effects of tax, thus creating deferred tax assets (liabilities).

Stock-Based Compensation

As of September 30, 2006 and December 31, 2005, we had one stock-based employee compensation plan and one employee stock purchase plan. These plans, and associated stock options and other equity awards, are described more fully in *Note 10*.

We adopted Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (FAS 123R), on January 1, 2006. With the adoption of FAS 123R, the grant date fair value of all remaining unvested stock compensation awards (stock options, deferred stock units, and restricted stock) are expensed on the Consolidated Statements of Income over the remaining vesting period. At January 1, 2006, upon adoption of FAS 123R, we had \$19.3 million of unamortized costs related to non-

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

vested equity awards (stock options, restricted stock, and deferred stock units). At September 30, 2006, the unamortized costs totaled \$11.4 million and will be expensed over the next four years, over half of which will be recognized over the next twelve months.

Beginning in 2003, in accordance with the guidance of Statement of Financial Accounting Standards No. 148, *Accounting for Stock Based Compensation — Transition and Disclosure, an amendment for FASB Statement No. 123* (FAS 148), we elected to prospectively apply the fair value method of accounting for stock-based awards issued after December 31, 2002. We accounted for all stock-based compensation awards issued prior to December 31, 2002 under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), and related interpretations. Under APB 25, when we granted option awards we did not include any stock-based employee compensation cost in net income, as all option awards granted had an exercise price equal to the fair market value of the underlying common stock on the date of grant. All other equity awards (deferred stock units and restricted stock), were valued at the grant date and expensed over the vesting period (regardless of when they were granted). Had we also applied Statement of Financial Accounting Standards No. 123, *Accounting for Stock-Based Compensation* (FAS 123), to option awards granted prior to 2003, net income and net income per share would have been the pro-forma amounts indicated in the table below for the three and nine months ended September 30, 2005. Since we adopted FAS 123R as of January 1, 2006, there is no pro-forma presentation for the three and nine months ended September 30, 2006.

Pro-Forma Net Income Under FAS 123
(In thousands, except share data)

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income, as reported	\$ 55,899	\$ 157,376
Add: Dividend equivalent right operating expenses under APB 25	2,029	5,587
Deduct: Stock option operating (expense) income under APB 25	(16)	(98)
Deduct: Stock-based employee compensation expense determined under fair value based method for awards granted prior to January 1, 2003	(201)	(671)
Pro forma net income	<u>\$ 57,711</u>	<u>\$ 162,194</u>
Earnings per share:		
Basic — as reported	\$ 2.26	\$ 6.41
Basic — pro forma	\$ 2.34	\$ 6.61
Diluted — as reported	\$ 2.21	\$ 6.26
Diluted — pro forma	\$ 2.28	\$ 6.45

The Black-Scholes option-pricing model was used in determining fair values of option grants accounted for under FAS 123R and FAS 123. The model requires the use of assumptions such as strike price, expected life, risk free rate of return, and stock price volatility. Options are generally granted over the course of the calendar year. Certain options have dividend equivalent rights (DERs) and, accordingly, the assumed dividend yield was zero for these options. Other options granted have no DERs and the assumed dividend yield was 10%. There were no options granted during the three months ended September 30, 2006 and 2005. The following table describes the weighted average of assumptions used for calculating the value of options granted during the nine months ended September 30, 2006 and

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

2005. Similar assumptions were used to calculate the pro forma information presented in the table above.

Weighted Average Assumptions used for Valuation of Options Under FAS 123R and FAS 123 Granted during period

	Nine Months Ended September 30,	
	2006	2005
Stock price volatility	25.7%	26.41%
Risk free rate of return (Treasury Rate)	4.75%	4.07%
Average life	5 years	5 years
Dividend yield assumptions	10.00%	4.45%

Recent Accounting Pronouncements

In February 2006, the FASB issued Statement 155, *Accounting for Certain Hybrid Financial Instruments*, (FAS 155), to amend FAS 133 and FAS 140. This Statement simplifies the accounting for certain financial instruments by allowing an entity to make an irrevocable election on a specific instrument basis for certain financial assets and liabilities that contain embedded derivatives that would otherwise require bifurcation and to recognize and re-measure at fair value these instruments so elected. Thus, under this election, an entity would measure the entire hybrid financial instrument at fair value with changes in fair value recognized in earnings. FAS 155 will become effective for us as of January 1, 2007. We are currently assessing the impact on our financial statements.

In March 2006, the FASB issued Statement 156, *Accounting for Servicing of Financial Assets — an amendment of FASB Statement No. 140* (FAS 156). This Statement amends FAS 140 with respect to the accounting for separately recognized servicing assets and servicing liabilities. FAS 156 requires an entity to either (i) recognize servicing assets or servicing liabilities initially at fair value and amortize this value over the period of servicing, or (ii) measure servicing assets or liabilities at fair value at each reporting date with changes in fair value reported in earnings. FAS 156 will become effective for us as of January 1, 2007. We believe FAS 156 will not have a material impact on our financial statements.

In July 2006, the FASB released *Accounting for Uncertainty In Income Taxes* (FIN 48). FIN 48 addresses the recognition and measurement of uncertain income tax positions using a “more-likely-than-not” threshold and introduces a number of new disclosure requirements. The differences between current practice and the requirements of FIN 48 are significant, and a substantial effort will be required by most companies to properly assess all material uncertain positions. Further, the impact of FIN 48 is not just technical; the interpretation may cause companies to modify their tax-related strategies. The new guidance will become effective for us January 1, 2007. We are currently assessing the impact on our financial statements.

In September 2006, the FASB issued Statement 157, *Fair Value Measurements*, (FAS 157). This statement clarifies the definition of fair value, the methods used to measure fair value, and requires expanded financial statement disclosures about fair value measurements for assets and liabilities. FAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007. The new guidance will be effective for us January 1, 2008 and we are currently assessing the impact on our financial statements.

In September 2006, the SEC’s Office of the Chief Accountant and Divisions of Corporation Finance and Investment Management released Staff Accounting Bulletin No. 108 (SAB 108), which provides interpretive guidance on how registrants should quantify financial-statement misstatements. Currently, the two methods most commonly used by preparers and auditors to quantify misstatements are the “rollover” method (which focuses primarily on the income statement impact of misstatements) and the “iron curtain” method (which focuses primarily on the balance sheet impact of misstatements). Under SAB 108, registrants will be required to consider both the rollover and iron curtain methods (i.e., a dual

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

approach) when evaluating the materiality of financial statement errors. Registrants will need to revisit their prior materiality assessments and consider them using both the rollover and iron curtain methods.

SAB 108 is effective for annual financial statements in the first fiscal year ending after November 15, 2006, therefore for us, the year ended December 31, 2006. The SAB provides transition accounting and disclosure guidance for situations in which a registrant concludes that a material error(s) existed in prior-period financial statements under the dual approach. Specifically, registrants will be permitted to restate prior period financial statements or recognize the cumulative effect of initially applying SAB 108 through an adjustment to beginning retained earnings in the year of adoption. We believe SAB 108 will not have a material impact on our annual financial statements.

In the first quarter of 2006, we became aware of a potential technical interpretation of GAAP that differs from our current accounting presentations. This issue relates to the accounting for transactions where assets are purchased from a counterparty and simultaneously financed through a repurchase agreement with that same counterparty and whether these transactions create derivatives instead of the acquisition of assets with related financing (which is how we currently present these transactions). This potential technical interpretation of GAAP does not affect the economics of the transactions but may affect how the transactions would be reported in our financial statements. Our cash flows, our liquidity, and our ability to pay a dividend would be unchanged, and we do not believe our taxable income would be affected. We have not changed our accounting treatment for this potential issue. However, if we were to change our current accounting presentations based on this interpretation, we do not believe there would be a material impact on our consolidated financial statements.

NOTE 3. EARNING ASSETS

As of September 30, 2006 and December 31, 2005 our reported earning assets (owned by us or by consolidated securitization entities) consisted of investments in adjustable-rate, hybrid, and fixed-rate real estate loans and securities. Adjustable-rate loans have coupons that reset at least annually. Hybrid loans have an initial fixed coupon rate for three to ten years followed by periodic (usually annual or semi-annual) adjustments. The original maturity of the majority of our residential real estate loans and residential real estate securities is usually twenty-five to thirty years. The original maturity of our HELOCs is generally ten years. The original maturity of our commercial real estate loans and commercial real estate securities is generally ten years. The actual maturity is subject to change based on the prepayments of the underlying loans.

For the three months ended September 30, 2006 and 2005, the average consolidated balance of earning assets was \$12.9 billion and \$20.1 billion, respectively. For the nine months ended September 30, 2006 and 2005, the average consolidated balance of earning assets was \$13.9 billion and \$22.2 billion, respectively.

Real Estate Loans

We acquire real estate loans from third party originators for sale to securitization entities sponsored by us under our Sequoia program which, in turn, issue ABS (that are shown as liabilities on our Consolidated Balance Sheets). The following tables summarize the carrying value of real estate loans, which

REDWOOD TRUST, INC. AND SUBSIDIARIES**NOTES TO FINANCIAL STATEMENTS — (Continued)**

include residential real estate loans, HELOCs, and commercial real estate loans as reported on our Consolidated Balance Sheets at September 30, 2006 and December 31, 2005.

Real Estate Loans Composition
(In thousands)

	September 30, 2006	December 31, 2005
Residential real estate loans	\$ 9,725,153	\$ 13,693,833
HELOCs	117,641	180,959
Commercial real estate loans	32,170	59,692
Carrying value	<u>\$ 9,874,964</u>	<u>\$ 13,934,484</u>

Real Estate Loans Carrying Value
(In thousands)

	September 30, 2006 Held for Investment	December 31, 2005 Held for Investment
Current face	\$ 9,761,369	\$ 13,789,333
Unamortized premium	141,062	175,948
Discount designated as credit protection	(8,141)	(8,141)
Amortized cost	9,894,290	13,957,140
Reserve for credit losses	(19,326)	(22,656)
Carrying value	<u>\$ 9,874,964</u>	<u>\$ 13,934,484</u>

Of the \$9.8 billion of face and \$141 million of unamortized premium on our real estate loans at September 30, 2006, \$6.0 billion of face and \$114 million of unamortized premium relates to loans acquired prior to July 1, 2004. The loans acquired prior to July 1, 2004 had face and unamortized premium balances of \$9.7 billion and \$138 million, respectively, at December 31, 2005. During the first nine months of 2006, 39% of these loans prepaid and we amortized 17% of the premium over the first nine months of 2006. For these loans acquired prior to July 2004, we use coupon interest rates as they change over time and anticipated principal payments to determine an effective yield to amortize the premium or discount. For real estate loans acquired after July 1, 2004, the face and unamortized premium was \$3.8 billion and \$27 million at September 30, 2006 and \$4.1 billion and \$38 million at December 31, 2005, respectively. For these loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments to calculate an effective yield to amortize the premium or discount.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

The following table provides detail of the activity of reported real estate loans for the three and nine months ended September 30, 2006 and 2005.

Real Estate Loans Activity

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 10,491,014	\$ 19,672,359	\$ 13,934,484	\$ 22,559,244
Acquisitions	966,673	346,268	1,291,989	1,612,316
Settled commitment deducted from loan basis	(133)	—	(133)	—
Sales (other than to consolidated ABS trusts)	—	(263,096)	(8,408)	(277,666)
Principal repayments	(1,570,389)	(3,127,329)	(5,303,962)	(7,248,463)
Transfers to REO	(1,093)	(2,005)	(7,026)	(3,334)
Net premium amortization	(11,232)	(14,507)	(35,261)	(32,038)
Reversal of credit loss provision, net of charge-offs	124	930	3,295	1,552
Net recognized gains (losses) and valuation adjustments	—	(201)	(14)	808
Balance at end of period	<u>\$ 9,874,964</u>	<u>\$ 16,612,419</u>	<u>\$ 9,874,964</u>	<u>\$ 16,612,419</u>

Some of the real estate loans we acquire from third party originators, we sell to securitization entities that finance their purchases of loans from us through the issuance of ABS. During the period that we accumulate loans for securitization, we fund these loans with equity and with short-term debt sourced through various whole loan-financing facilities available to us. Our Consolidated Statements of Cash Flows record the proceeds from any principal payments or sales in the same category as our original acquisition was recorded. The table below presents information regarding real estate loans pledged under our borrowing agreements and owned by securitization entities.

Real Estate Loans Pledged and Unpledged
(In thousands)

	September 30, 2006		December 31, 2005	
	Face Value	Carrying Value	Face Value	Carrying Value
Unpledged	\$ 155,599	\$ 147,548	\$ 60,259	\$ 51,924
Pledged for Redwood debt	373,318	375,192	—	—
Owned by securitization entities, financed through the issuance of ABS	<u>9,232,452</u>	<u>9,352,224</u>	<u>13,729,074</u>	<u>13,882,560</u>
Carrying value	<u>\$ 9,761,369</u>	<u>\$ 9,874,964</u>	<u>\$ 13,789,333</u>	<u>\$ 13,934,484</u>

Real Estate Securities

The real estate securities shown on our Consolidated Balance Sheets include residential and commercial real estate securities acquired from securitizations sponsored by others and certain other securities.

Our real estate securities portfolio includes residential CES (BB, B, and unrated residential real estate securities), commercial first-loss CES (unrated commercial real estates securities), and various other securities, as reported on our Consolidated Balance Sheets at September 30, 2006 and December 31, 2005.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

The table below presents the carrying value on the types of securities that are included in our Consolidated Balance Sheets as of September 30, 2006 and December 31, 2005, and their current credit ratings.

Real Estate Securities — Underlying Collateral Characteristics

At September 30, 2006

(In millions)

	Total	Rating						Unrated
		AAA	AA	A	BBB	BB	B	
Commercial real estate	\$ 513	\$ 5	\$ 2	\$ 18	\$ 105	\$ 195	\$ 71	\$ 117
Residential prime real estate	1,378	20	201	265	294	339	131	128
Residential Alt-A real estate	283	81	39	8	16	86	20	33
Residential HELOCs	101	3	50	37	7	4	—	—
Residential sub-prime real estate	429	5	90	227	102	2	—	3
REIT corporate debt	9	—	—	—	1	8	—	—
Real estate CDOs	199	44	28	37	72	14	—	4
Total securities	<u>\$2,912</u>	<u>\$ 158</u>	<u>\$410</u>	<u>\$ 592</u>	<u>\$ 597</u>	<u>\$ 648</u>	<u>\$ 222</u>	<u>\$ 285</u>

At December 31, 2005

(In millions)

	Total	Rating						Unrated
		AAA	AA	A	BBB	BB	B	
Commercial real estate	\$ 380	\$ 11	\$ 2	\$ 20	\$ 129	\$ 130	\$ 30	\$ 58
Residential prime real estate	1,185	29	197	195	232	281	113	138
Residential Alt-A real estate	117	—	46	1	—	50	3	17
Residential HELOCs	108	—	49	54	5	—	—	—
Residential sub-prime real estate	442	5	86	292	59	—	—	—
REIT corporate debt	32	—	—	—	24	8	—	—
Real estate CDOs	155	37	25	37	44	11	—	1
Total securities	<u>\$2,419</u>	<u>\$ 82</u>	<u>\$405</u>	<u>\$ 599</u>	<u>\$ 493</u>	<u>\$ 480</u>	<u>\$ 146</u>	<u>\$ 214</u>

The table below presents the face value, unamortized discount, the portion of the discount designated as credit protection, the unrealized gains and losses, and the carrying value of real estate securities reported on our Consolidated Balance Sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

Real Estate Securities — September 30, 2006
(In millions)

	Total Real Estate Securities Available-for-Sale	Residential CES and Commercial First-Loss CES Available-for-Sale	Other Securities Available-for-Sale
Current face	\$ 3,679,693	\$ 1,533,697	\$ 2,145,996
Unamortized premium — interest-only certificates	8,764	—	8,764
Unamortized discount, net	(222,256)	(111,412)	(110,844)
Discount designated as credit protection	(642,779)	(642,779)	—
Amortized cost	2,823,422	779,506	2,043,916
Gross unrealized gains	112,919	91,228	21,691
Gross unrealized losses	(23,976)	(11,612)	(12,364)
Carrying value	<u>\$ 2,912,365</u>	<u>\$ 859,122</u>	<u>\$ 2,053,243</u>

Real Estate Securities — December 31, 2005
(In thousands)

	Total Real Estate Securities Available-for-Sale	Residential CES and Commercial First-Loss CES Available-for-Sale	Other Securities Available-for-Sale
Current face	\$ 3,021,363	\$ 1,211,217	\$ 1,810,146
Unamortized premium — interest-only certificates	14,866	—	14,866
Unamortized discount, net	(177,438)	(107,337)	(70,101)
Discount designated as credit protection	(496,416)	(496,416)	—
Amortized cost	2,362,375	607,464	\$ 1,754,911
Gross unrealized gains	93,322	80,122	13,200
Gross unrealized losses	(36,780)	(17,250)	(19,530)
Carrying value	<u>\$ 2,418,917</u>	<u>\$ 670,336</u>	<u>\$ 1,748,581</u>

At September 30, 2006, our residential CES provided credit-enhancement on \$225 billion of residential real estate loans, and our commercial first-loss CES provided credit-enhancement on \$36 billion of commercial real estate loans. At December 31, 2005, our residential CES provided credit-enhancement on \$170 billion of residential real estate loans, and our commercial first-loss CES provided credit-enhancement on \$26 billion of commercial real estate loans.

The amount of designated credit protection equals the amount of credit losses within the underlying loan pool that we expect to incur over the life of the loans. This estimate is determined based upon various factors affecting these assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, and external credit protection. We use a variety of internal and external credit risk cash flow modeling and portfolio analytical tools to assist in our assessments. Quarterly, we complete our assessments on each individual underlying loan pool and determine the appropriate level of credit protection required for each security we own. The designated credit protection is specific to each security. The following table presents the changes in our unamortized discount and the portion of the discount designated as credit protection for the three and nine months ended September 30, 2006 and 2005.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

Changes In Unamortized Discount and Designated Credit Protection on Residential CES and Commercial First-Loss CES
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Beginning balance of net unamortized discount	\$ 90,925	\$ 71,641	\$ 107,337	\$ 97,841
Amortization	(14,946)	(10,291)	(38,144)	(26,038)
Calls, sales, and other	(3,177)	(14,153)	(2,759)	(29,544)
Re-designation of credit protection to discount	33,277	19,242	50,481	41,432
Acquisitions	5,333	(18,137)	(5,503)	(35,389)
Ending balance of net unamortized discount	<u>\$ 111,412</u>	<u>\$ 48,302</u>	<u>\$ 111,412</u>	<u>\$ 48,302</u>
Beginning balance of designated credit protection	\$ 617,712	\$ 491,390	\$ 496,416	\$ 385,762
Realized credit losses	(2,476)	(1,505)	(5,958)	(4,736)
Calls, sales, and other	(35,883)	(33,420)	(40,922)	(44,799)
Re-designation of credit protection to discount	(33,277)	(19,242)	(50,481)	(41,432)
Acquisitions	96,703	84,169	243,724	226,597
Ending balance of designated credit protection	<u>\$ 642,779</u>	<u>\$ 521,392</u>	<u>\$ 642,779</u>	<u>\$ 521,392</u>

The net unamortized discount balance at September 30, 2006 of \$111 million consists of \$147 million of net unamortized discount on the residential CES and an effective premium of \$36 million on the commercial first-loss CES. Yields recognized for GAAP for each security vary as a function of credit results, prepayment rates, and, for our securities with variable rate coupons, interest rates. If estimated future credit losses are less than our prior estimate, credit losses occur later than expected, or prepayment rates are faster than expected (meaning the present value of projected cash flows is greater than previously expected), the yield over the remaining life of the security may be adjusted upwards over time. If estimated future credit losses exceed our prior expectations, credit losses occur more quickly than expected, or prepayments occur more slowly than expected (meaning the present value of projected cash flows is less than previously expected), the yield over the remaining life of the security may be adjusted downward or we may have an other-than-temporary impairment. For the three and nine months ended September 30, 2006, we recognized other-than-temporary impairments of \$0.5 million and \$6.0 million, respectively. For the three and nine months ended September 30, 2005, we recognized other-than-temporary impairments of \$1.2 million and \$3.3 million, respectively. These impairments are included in net recognized gains and valuation adjustments in our Consolidated Statements of Income.

Gross unrealized gains and losses represent the difference between the net amortized cost and the fair value of individual securities. Gross unrealized losses represent a decline in market value for securities not deemed impaired for GAAP. The following table shows the gross unrealized losses, fair value, and length of time that any real estate securities have been in a continuous unrealized loss position as of September 30, 2006. These unrealized losses are not considered to be other-than-temporary impairments because these losses are not due to adverse changes in cash flows and we have the intent and ability to hold these securities for a period sufficient for these securities to potentially recover their values.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

Real Estate Securities with Unrealized Losses as of September 30, 2006
(In thousands)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)	Fair Value	Unrealized (Losses)
Real estate securities	\$ 548,959	\$ (13,112)	\$ 341,343	\$ (10,864)	\$ 890,302	\$ (23,976)

The following table provides detail of the activity in our real estate securities portfolio for the three and nine months ended September 30, 2006 and 2005.

Real Estate Securities Activity
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 2,661,250	\$ 2,384,429	\$ 2,418,917	\$ 1,956,232
Acquisitions	321,397	264,823	818,219	757,870
Sales (other than to consolidated ABS trusts)	(65,192)	(98,775)	(241,624)	(141,442)
Principal repayments (including calls)	(59,987)	(60,236)	(161,790)	(153,971)
Discount amortization	17,400	10,857	42,719	26,870
Net unrealized gains (losses)	32,291	(34,338)	32,402	3,478
Net recognized gains and valuation adjustments	5,206	25,010	3,522	42,733
Balance at end of period	\$ 2,912,365	\$ 2,491,770	\$ 2,912,365	\$ 2,491,770

Of the \$60 million and \$162 million of principal pay downs in the three and nine months ended September 30, 2006, \$6 million and \$12 million, respectively, represented calls of the securities in accordance with the original issue provisions of individual securitization entities. Of the \$60 million and \$154 million of principal pay downs in the three and nine months ended September 30, 2005, \$19 million and \$46 million, respectively, represented calls of the securities.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

The following tables provide the activity for the components of the securities portfolios; residential CES, commercial CES, and other securities.

Residential Credit-Enhancement Securities Activity
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 715,360	\$ 706,195	\$ 612,649	\$ 561,658
Acquisitions	78,887	57,481	220,926	213,139
Sales (other than to consolidated ABS trusts)	(47,585)	(98,775)	(67,552)	(126,068)
Principal repayments (including calls)	(32,338)	(18,403)	(77,909)	(62,735)
Discount amortization	16,616	11,193	42,181	27,695
Net unrealized gains (losses)	6,404	(18,848)	3,983	5,545
Net recognized gains and valuation adjustments	5,037	25,958	8,103	45,567
Balance at end of period	<u>\$ 742,381</u>	<u>\$ 664,801</u>	<u>\$ 742,381</u>	<u>\$ 664,801</u>

Commercial First-Loss Credit-Enhancement Securities Activity
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 75,889	\$ 29,397	\$ 57,687	\$ 14,498
Acquisitions	36,858	17,182	51,894	30,052
Sales (other than to consolidated ABS trusts)	—	—	—	—
Principal repayments (including calls)	—	—	—	—
Premium amortization	(1,670)	(902)	(4,037)	(1,657)
Net unrealized gains (losses)	5,939	(2,137)	12,761	798
Net recognized losses and valuation adjustments	(275)	—	(1,564)	(151)
Balance at end of period	<u>\$ 116,741</u>	<u>\$ 43,540</u>	<u>\$ 116,741</u>	<u>\$ 43,540</u>

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

Other Securities Activity
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 1,870,001	\$ 1,648,837	\$ 1,748,581	\$ 1,380,077
Acquisitions	205,652	190,160	545,399	514,679
Sales (other than to consolidated ABS trusts)	(17,607)	—	(174,072)	(15,374)
Principal repayments (including calls)	(27,649)	(41,833)	(83,881)	(91,236)
Discount amortization	2,454	566	4,575	832
Net unrealized gains (losses)	19,948	(13,353)	15,658	(2,866)
Net recognized gains (losses) and valuation adjustments	444	(948)	(3,017)	(2,683)
Balance at end of period	<u>\$ 2,053,243</u>	<u>\$ 1,783,429</u>	<u>\$ 2,053,243</u>	<u>\$ 1,783,429</u>

We generally fund the first-loss and second-loss interests of residential securities and first-loss commercial securities with equity capital. We sell the other interests we acquire to securitization entities (generally, Acacia) that re-securitize these assets by issuing ABS. Prior to sale to these securitization entities, we may fund some of the securities acquired on a temporary basis with short-term borrowings through various financing facilities available to us. The table below presents information regarding our securities pledged under borrowing agreements and owned by securitization entities as of September 30, 2006 and December 31, 2005.

Real Estate Securities Pledged and Unpledged
(In thousands)

	September 30, 2006	December 31, 2005
Unpledged	\$ 413,107	\$ 371,225
Pledged for Redwood debt	150,584	164,426
Owned by securitization entities, financed through issuance of ABS	2,348,674	1,883,266
Carrying value	<u>\$ 2,912,365</u>	<u>\$ 2,418,917</u>

Net Recognized Gains (Losses) and Valuation Adjustments

Fluctuations in the market value of certain of our real estate loan and security assets and interest rate agreements may also affect our net income. The table below describes the various components of our net recognized gains (losses) and valuation adjustments reported in income for the three and nine months ended September 30, 2006 and 2005.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

Net Recognized Gains and Valuation Adjustments
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Realized gains on calls:				
Real estate securities	\$ 723	\$ 2,914	\$ 1,470	\$ 14,883
Realized gains (losses) on sales:				
Real estate loans	—	(201)	(14)	808
Real estate securities	4,967	23,254	8,067	31,108
Valuation adjustments — impairments:				
Real estate securities	(484)	(1,158)	(6,015)	(3,259)
Gains (losses) on interest rate agreements	(8,475)	107	982	(567)
Purchase commitments	3,702	—	66	—
Net recognized gains and valuation adjustments	<u>\$ 433</u>	<u>\$ 24,916</u>	<u>\$ 4,556</u>	<u>\$ 42,973</u>

During the course of preparing the financial statements for the period ended June 30, 2006, we discovered two errors and under the provisions of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS 154), we analyzed the errors for each period affected. The accrual rate for interest income on certain securities and interest expense on certain ABS issued had been incorrectly applied and not correctly adjusted. The impact of this error was that on a cumulative basis we had overstated interest income by \$1.3 million and understated interest expense by \$0.2 million. Additionally, due diligence expenses for certain securities purchased had been incorrectly capitalized and amortized. The impact of this error was that on a cumulative basis we had understated operating expenses by \$0.6 million and overstated mortgages securities on the Consolidated Balance Sheets.

After carefully assessing the effect of these errors on previously reported earnings and the effect of recording a total cumulative correcting adjustment of \$2.1 million in the second quarter of 2006, we determined that the errors were not material to the financial statements for the six months ended June 30, 2006 and the year ended December 31, 2006. Accordingly, cumulative correcting adjustments for these errors were recorded in the second quarter of 2006.

NOTE 4. RESERVES FOR CREDIT LOSSES

We establish and maintain credit reserves that we believe represent probable credit losses in our consolidated real estate loans held-for-investment as of the date of the financial statements. The reserves for credit losses are reflected as a component of real estate loans on our Consolidated Balance Sheets.

Our loan servicers advance payment on delinquent loans to the extent they deem them recoverable. We generally accrue interest on delinquent loans to the extent cash is received; any potential loss is included in our credit reserve. When a loan becomes REO, we estimate the specific loss, based on estimated net proceeds from the sale of the property (including accrued but unpaid interest), and charge this specific estimated loss against the reserve for credit losses. A majority of the residential loans consolidated on our balance sheet have interest-only payments for an initial term. Any increased credit risk that these loans may contain is reflected in our analysis and determination of the appropriate credit reserves.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

The following table summarizes the activity in reserves for credit losses for our consolidated real estate loans for the three and nine months ended September 30, 2006 and 2005.

Real Estate Loans
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Balance at beginning of period	\$ 19,450	\$ 22,959	\$ 22,656	\$ 23,896
Provision for (reversal of) credit reserve	465	(805)	(1,865)	(1,307)
Charge-offs	(589)	(125)	(1,465)	(560)
Balance at end of period	<u>\$ 19,326</u>	<u>\$ 22,029</u>	<u>\$ 19,326</u>	<u>\$ 22,029</u>

Delinquencies in our consolidated residential real estate loans were \$61 million and \$37 million as of September 30, 2006 and December 31, 2005, respectively. Delinquencies include loans delinquent more than 90 days, in bankruptcy, in foreclosure, and REO. As a percentage of our residential real estate loans, delinquencies stood at 0.63% and 0.27% of our current loan balances as of September 30, 2006 and December 31, 2005, respectively. We had no delinquent commercial real estate loans as of September 30, 2006 and December 31, 2005.

Reserve for Deferred Interest

For first and second loss securities owned, backed by negatively amortizing loans, we intend to recognize interest income when we receive the cash — either currently, or at a later date, according to the terms of the loan.

To the extent we own any first- or second-loss securities with underlying loans that do not make the fully indexed payment, we do not recognize any unpaid interest as income. That is, we only recognize the actual interest paid by establishing a reserve for the amounts the loans negatively amortize. These reserves are netted against our accrued interest receivable. During the three and nine months ended September 30, 2006, we increased our reserve for deferred interest by \$1.1 million and \$2.9 million, respectively, against interest income on these securities. During both the three and nine months ended September 30, 2005, we increased our reserve for deferred interest by \$0.3 million. At September 30, 2006, the outstanding reserve for deferred interest was \$3.7 million.

One commercial loan that we own, in accordance with the contractual arrangements, began deferring interest payments in 2006, though we may receive these amounts at a later date. Consistent with our accounting practice on negatively amortizing loans, we did not recognize the \$0.1 million and \$0.5 million of interest accrued and not paid on this loan, during the three and nine months ended September 30, 2006, respectively.

NOTE 5. INTEREST RATE AGREEMENTS AND PURCHASE COMMITMENTS

We maintain an overall interest rate risk management strategy that incorporates the use of derivative interest rate agreements for a variety of reasons, including reducing significant fluctuations in earnings or market values on certain assets or liabilities that may be caused by interest rate volatility. Currently, the majority of our interest rate agreements are used to match the duration of liabilities to assets. Interest rate agreements we use as part of our interest rate risk management strategy may include interest rate options, swaps, options on swaps, futures contracts, options on futures contracts, and options on forward purchase commitments.

We may designate the interest rate agreement as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

(cash flow hedge), or (3) held for trading (trading instrument). We currently have elected cash flow hedging treatment for certain interest rate agreements and treat other interest rate agreements as trading instruments.

We discontinue hedge accounting when (1) we determine that the derivative is no longer expected to be effective in offsetting changes in the fair value or cash flows of the designated hedged item; (2) the derivative expires or is sold, terminated, or exercised; (3) the derivative is de-designated as a fair value or cash flow hedge; or (4) it is probable that the forecasted transaction will not occur by the end of the originally specified time period.

We incur credit risk to the extent that the counterparties to the interest rate agreements do not perform their obligations under the interest rate agreements. If one of the counterparties does not perform, we may not receive the cash to which we would otherwise be entitled under the interest rate agreement. In order to mitigate this risk, we only enter into interest rate agreements that are either (a) transacted on a national exchange or (b) transacted with counterparties that are either (i) designated by the U.S. Department of Treasury as a primary government dealer, (ii) affiliates of primary government dealers, or (iii) rated AA or higher. Furthermore, we generally enter into interest rate agreements with several different counterparties in order to diversify our credit risk exposure and maintain margin accounts with them.

We report our interest rate agreements at fair value as determined using third-party models and confirmed by Wall Street dealers. As of September 30, 2006 and December 31, 2005, the net fair value of interest rate agreements was \$23.6 million and \$30.7 million, respectively, and are summarized in the table below. See *Note 10* for the impact of these fair value changes on Accumulated Other Comprehensive Income.

Interest Rate Agreements

(In thousands)

	September 30, 2006			December 31, 2005		
	Fair Value	Notional Amount	Credit Exposure	Fair Value	Notional Amount	Credit Exposure
Trading Instruments						
Interest rate caps purchased	\$ 1,535	\$ 91,400	\$ —	\$ 1,913	\$ 116,400	\$ —
Interest rate caps sold	(175)	(25,000)	—	(239)	(65,000)	—
Interest rate corridors purchased	—	876,815	—	—	1,059,851	—
Interest rate swaps	320	131,234	—	148	80,400	—
Purchase commitments	200	93,250	—	—	—	—
Cash Flow Hedges						
Interest rate swaps	21,732	3,475,569	4,029	28,891	5,399,653	(2,672)
Total Interest Rate Agreements	\$ 23,612	\$ 4,643,268	\$ 4,029	\$ 30,713	\$ 6,591,304	\$ (2,672)

We have elected cash flow hedging treatment for many of our existing interest rate agreements. For these interest rate agreements, the ineffective portion of the hedging derivative is recognized immediately in earnings. We anticipate having some ineffectiveness in our hedging program, as not all terms of our hedges and not all terms of our hedged items match perfectly. We use the dollar-offset method to determine the amount of ineffectiveness. For the three and nine months ended September 30, 2006, the amount of ineffectiveness was \$0.3 million and \$0.5 million of income, respectively. For both the three and nine months ended September 30, 2005, the amount of ineffectiveness was \$0.1 million of expense.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

During the course of preparing the financial statements for the period ended September 30, 2006 we discovered an error in the valuation of certain interest rate agreements for the purpose of measuring the amount of hedge ineffectiveness under FAS 133. Under the provisions of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS 154), we analyzed the errors for each period affected. The impact of this error was that on a cumulative basis we had understated interest expense (negative ineffectiveness) by \$1.0 million and overstated other comprehensive income by \$1.0 million.

After carefully assessing the effect of this error on previously reported earnings and the effect of recording a total cumulative correcting adjustment in the third quarter of 2006, we determined that the errors were not material to the financial statements for the nine-months ended September 30, 2006 and the year ended December 31, 2006. Accordingly, a cumulative correcting adjustment for this error was recorded in the third quarter of 2006.

Should we choose to terminate a cash flow hedge, the value of that hedge is reclassified from accumulated other comprehensive income into earnings over time. The timing of the reclassification depends on the status of the hedged or forecasted transaction. If the hedged transaction no longer exists, or the forecasted transaction is no longer expected to occur, then the reclassification occurs immediately. If the hedged transaction still exists, or the forecasted transaction is still expected to occur, then the reclassification occurs over the original period of such transaction. We have terminated cash flow hedges where the hedged transaction still existed or is still expected to occur. For the three and nine months ended September 30, 2006, the amount reclassified from other comprehensive income to interest expense totaled negative \$0.1 million and positive \$0.4 million, respectively. For the three and nine months ended September 30, 2005, the amount reclassified from other comprehensive income to interest expense totaled negative \$0.1 million and negative \$0.3 million, respectively.

Also included in our interest expense in our Consolidated Statements of Income is the net cash receipts (payments) on interest rate agreements designated as cash flow hedges. For the three and nine months ended September 30, 2006, the net cash receipts credited to interest expense totaled \$3.0 million and \$9.1 million, respectively. For the three and nine months ended September 30, 2005, the net cash receipts credited to interest expense totaled \$0.8 million and \$3.4 million, respectively.

We do not elect hedge accounting treatment for some of our interest rate agreements and these are accounted for as "trading" instruments. Thus, changes in the market value of these interest rate agreements and associated income and expenses are reported through our earnings and appear in net recognized gains (losses) and valuation adjustments in our Consolidated Statements of Income.

We also enter into commitments to purchase loans. These commitments are accounted for as derivatives under Statement of Financial Accounting Standards No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149), where applicable and are accounted for as trading instruments. During the three months ended September 30, 2006 we entered into commitments to purchase \$93 million of residential hybrid loans that will settle in the fourth quarter of 2006.

For the three months ended September 30, 2006, the amount of market value changes associated with interest rate agreements accounted for as trading instruments totaled negative \$8.5 million and the fair value change on loan purchase commitments was positive \$3.7 million. For the nine months ended September 30, 2006, the amount of market value changes associated with interest rate agreements accounted for as trading instruments was positive \$1.0 million and the fair value change related to loan purchase commitments was positive \$0.1 million. For the three and nine months ended September 30, 2005, the amount of market value changes associated with interest rate agreements accounted for as trading instruments totaled positive \$0.1 million and negative \$0.6 million, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

The following table depicts the amounts included in interest expense and net recognized gains (losses) and valuation adjustments activity for the three and nine months ended September 30, 2006 and 2005 for our interest rate agreements.

Interest Rate Agreements and Purchase Commitments
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net Amounts Credited to (Included in) Interest Expense for Cash Flow Hedges				
Realized net gains (losses) due to net ineffective portion of hedges	\$ 322	\$ (49)	\$ 455	\$ (93)
Realized net gains (losses) reclassified from other comprehensive income	(47)	(109)	425	(307)
Net cash payment on interest rate swaps	3,042	782	9,096	3,369
Total	\$ 3,317	\$ 624	\$ 9,976	\$ 2,969
Net Recognized Gains (Losses) and Valuation Adjustments				
Realized net gains (losses) on interest rate agreements accounted for as trading instruments	\$ (8,475)	\$ 107	\$ 982	\$ (567)
Realized net gains (losses) on purchase commitments	3,702	—	66	—
Total	\$ (4,773)	\$ 107	\$ 1,048	\$ (567)

NOTE 6. SHORT-TERM DEBT

At September 30, 2006 the balance of outstanding Redwood debt was \$510 million and at December 31, 2005 the outstanding balance was \$170 million. We generally enter into repurchase agreements, bank borrowings, and other forms of collateralized short-term borrowings to finance assets under accumulation for future sale to securitization entities. The table below summarizes Redwood debt by collateral type as of September 30, 2006 and December 31, 2005.

Redwood Debt
(In thousands)

	September 30, 2006			December 31, 2005		
	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity	Amount Borrowed	Weighted Average Interest Rate	Weighted Average Days Until Maturity
Residential real estate loan collateral	\$ 357,893	5.67%	92	\$ —	—	—
Residential loan CES collateral	62,112	6.47%	182	38,707	4.99%	73
Real estate securities collateral	89,989	6.00%	182	131,000	5.07%	73
Total Redwood debt	\$ 509,994	5.82%	119	\$ 169,707	5.05%	73

For the three and nine months ended September 30, 2006, the average balance of Redwood debt was \$0.6 billion and \$0.3 billion, and the weighted-average interest cost was 5.82% and 6.08%, respectively. For both the three and nine months ended September 30, 2005, the average balance of Redwood debt

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

was \$0.3 billion and the weighted-average interest cost was 5.09% and 4.18%, respectively. At September 30, 2006 and December 31, 2005, accrued interest payable on Redwood debt was \$0.5 million and \$1.0 million, respectively.

As of September 30, 2006 and December 31, 2005, Redwood debt had the following remaining maturities.

Redwood Debt
(In thousands)

	September 30, 2006	December 31, 2005
Within 30 days	\$ —	\$ —
31 to 90 days	—	169,707
Over 90 days	509,994	—
Total Redwood debt	<u>\$ 509,994</u>	<u>\$ 169,707</u>

In 2005, we formed Madrona Residential Funding, LLC (“Madrona”), a special purpose entity and wholly owned subsidiary of Holdings. Madrona gives us the flexibility to access the capital markets and issue short-term debt instruments to finance the accumulation of loans prior to sale to sponsored securitization entities. Madrona is designed to fund residential loans accumulated for eventual sale to our Sequoia securitization program by issuing A1+/P1 rated commercial paper. Madrona was established to accumulate up to \$1.5 billion of loans (although the current authorization is for \$490 million) and can warehouse each loan up to 270 days. There are specific eligibility requirements for financing loans in this facility that are similar to our existing financing facilities with several banks and large investment banking firms. There is a credit reserve account for approximately 70 basis points that will serve as credit-enhancement to the commercial paper investors. In addition, we issued \$5.4 million of a BBB-rated Madrona ABS to provide further credit support. This facility has a three-year term. As of September 30, 2006 there was no commercial paper outstanding.

We have facilities available with several banks and major investment banking firms for financing real estate loans and securities and an unsecured line of credit with a bank. Additional collateral in the form of additional qualifying assets or cash may be required to meet changes in market values from time to time under these agreements. Many of these facilities for securities have no expiration date. The table below summarizes our available facilities as of September 30, 2006 and December 31, 2005 by collateral type.

Redwood Debt
(In thousands)

	September 30, 2006			
	Number of Facilities	Outstanding	Limit	Maturity
Facilities by collateral:				
Real estate loans	4	\$ 357,893	\$ 1,800,000	10/06-8/07
Real estate securities (warehouse)	1	152,101	400,000	3/07
Real estate securities (repo)	4	—	1,700,000	n/a
Unsecured line of credit	1	—	10,000	10/06
Madrona commercial paper facility	1	—	490,000	7/09
Total facilities	<u>11</u>	<u>\$ 509,994</u>	<u>\$ 4,400,000</u>	

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

	December 31, 2005			
	<u>Number of Facilities</u>	<u>Outstanding</u>	<u>Limit</u>	<u>Maturity</u>
Facilities by collateral:				
Real estate loans	4	\$ —	\$ 1,800,000	1/06-9/06
Real estate securities (warehouse)	1	169,707	300,000	3/06
Unsecured line of credit	1	—	10,000	8/06
Madrona commercial paper facility	1	—	300,000	4/08
Total facilities	<u>7</u>	<u>\$ 169,707</u>	<u>\$ 2,410,000</u>	

Borrowings under these facilities generally bear interest based on a specified margin over the one-month London Inter-Bank Offered Rate (LIBOR) interest rate. We continue to be in compliance with all of our debt covenants for all of our borrowing arrangements and credit facilities. Covenants associated with our debt generally relate to our tangible net worth, liquidity reserves, and leverage requirements. We have not had, nor do we currently anticipate having, any problems in meeting these covenants. It is our intent to renew facilities and pursue additional facilities and other types of financing as needed.

NOTE 7. ASSET-BACKED SECURITIES ISSUED

Securitization entities sponsored by us issue ABS to raise the funds to acquire assets from us and others. Each series of ABS consists of various classes that pay interest at variable and fixed rates. Substantially all of the ABS is indexed to one-, three-, or six-month LIBOR. A lesser amount of the ABS are fixed for a term and then adjust to a LIBOR rate (hybrid ABS) or are fixed for their entire term. Some of the ABS interest only (IOs) issued have a fixed spread, while others earn a coupon based on the spread between collateral owned and the ABS issued by the securitized entity. The maturity of each class is directly affected by the rate of principal prepayments on the assets of the issuing entity. Each series is also subject to redemption (call) according to the specific terms of the respective governing documents. As a result, the actual maturity of any class of ABS is likely to occur earlier than its stated maturity.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

The components of ABS issued by consolidated securitization entities as of September 30, 2006 and December 31, 2005, along with other selected information, are summarized in the table below.

Asset-Backed Securities Issued
(In thousands)

	September 30, 2006	December 31, 2005
Sequoia ABS issued — certificates with principal value	\$ 8,884,726	\$ 13,246,343
Sequoia ABS issued — interest-only certificates	90,114	142,788
Acacia ABS issued	2,575,833	2,165,840
Commercial ABS issued	—	4,250
Madrona ABS issued	5,400	5,400
Unamortized premium (discount) on ABS	(1,814)	20,656
Total consolidated ABS issued	\$ 11,554,259	\$ 15,585,277
Range of weighted average interest rates, by series — Sequoia	4.67% to 6.16%	4.23% to 5.65%
Stated Sequoia maturities	2008-2046	2007-2035
Number of Sequoia series	42	42
Range of weighted average interest rates, by series — Acacia	5.90%-6.31%	4.32%-5.40%
Stated Acacia maturities	2038-2046	2023-2046
Number of Acacia series	9	8
Weighted average interest rates — Commercial	—	12.00%
Stated commercial maturities	—	2009
Number of commercial series	—	1

The following table summarizes the accrued interest payable on ABS issued as of September 30, 2006 and December 31, 2005.

Accrued Interest Payable on Asset-Backed Securities Issued
(In thousands)

	September 30, 2006	December 31, 2005
Sequoia	\$ 23,152	\$ 26,225
Acacia	27,651	13,778
Commercial	—	44
Total accrued interest payable on ABS issued	\$ 50,803	\$ 40,047

The ABS issued by securitization entities sponsored by us are collateralized by real estate loans and securities. The ABS collateralized by residential real estate loans (and some residential securities) are typically securitized through entities with the brand name Sequoia. Residential real estate loan collateral consists primarily of conventional, 25- or 30-year, adjustable-rate and hybrid residential real estate loans secured by first liens on one- to four-family residential properties. HELOC collateral consists of adjustable-rate first and second lien residential loans with a ten-year revolving period and a maturity from origination of ten years. The ABS issued that are collateralized by real estate securities and commercial real estate loans are typically issued through entities with the brand name Acacia. Other ABS collateralized by commercial loans are issued on an individual basis. For financial reporting purposes the assets and liabilities of these entities appear on our Consolidated Balance Sheets. The ABS issued by Madrona Residential Funding LLC (Madrona ABS) represents a form of additional credit support potentially available to the purchasers of the commercial paper.

REDWOOD TRUST, INC. AND SUBSIDIARIES**NOTES TO FINANCIAL STATEMENTS — (Continued)**

Sequoia entities issued \$0.7 billion of Sequoia ABS during the three and nine months ended September 30, 2006 to fund Sequoia's acquisitions of residential real estate loans from us. During the three and nine months ended September 30, 2005, Sequoia entities issued \$0.3 billion and \$1.5 billion, respectively, of Sequoia ABS.

During the three and nine months ended September 30, 2006, Acacia entities issued \$500 million and \$800 million of Acacia ABS, respectively. During the three and nine months ended September 30, 2005, Acacia entities issued \$300 million and \$600 million of Acacia ABS, respectively.

No commercial ABS issuances occurred during the three and nine months ended September 30, 2006 and during the three months ended September 30, 2005. During the nine months ended September 30, 2005, we issued \$4.3 million of commercial ABS. No commercial ABS were paid off during the three months ended September 30, 2006 and 2005, respectively. During the nine months ended September 30, 2006 and 2005, we paid off commercial ABS in full of \$4.3 million and \$9.5 million, respectively.

The carrying value components of the collateral for ABS issued and outstanding as of September 30, 2006 and December 31, 2005 are summarized in the table below:

Collateral for Asset-Backed Securities Issued
(In thousands)

	September 30, 2006	December 31, 2005
Real estate loans	\$ 9,352,224	\$ 13,882,560
Real estate securities	2,348,674	1,883,266
Real estate owned (REO)	5,997	2,589
Restricted cash owned by consolidated securitization entities	139,441	70,276
Accrued interest receivable	62,107	71,850
Total collateral for ABS issued	<u>\$ 11,908,443</u>	<u>\$ 15,910,541</u>

NOTE 8. TAXES

For tax purposes, a REIT can deduct dividends paid from REIT taxable income, and thus effectively reduce or eliminate corporate-level income taxes on REIT income. A REIT can retain up to 10% of its REIT taxable income, maintain its REIT status, and be taxable at corporate rates on retained income. As of September 30, 2006, we had met all of the dividend distribution requirements of a REIT.

Under the Internal Revenue Code, a dividend declared by a REIT in October, November, or December of a calendar year and payable to stockholders of record as of a specified date in such year will be deemed to have been paid by the REIT and received by the stockholders on the last day of that calendar year, provided the dividend is actually paid before February 1st of the following calendar year, and provided that the REIT has any remaining undistributed REIT taxable income on the record date. Therefore, the regular dividends declared in the fourth quarter of 2005 that were paid in January 2006 are considered taxable income to stockholders in 2005 (the year declared).

Our 2005 dividend distributions declared before December 31, 2005 and distributed on or before January 31, 2006, were less than 85% of our estimated 2005 REIT taxable income. This resulted in a 4% excise tax provision on the shortfall. We anticipate following a similar pattern in 2006. For the three and nine months ended September 30, 2006, we provided for excise tax of \$0.3 million and \$0.9 million, respectively, which is reflected as a component of operating expenses on our Consolidated Statements of Income. For the three and nine months ended September 30, 2005, we provided for excise tax of \$0.3 million and \$0.9 million, respectively. As of September 30, 2006 and December 31, 2005, accrued excise tax payable was \$0.9 million and \$1.2 million, respectively, and was reflected as a component of accrued expenses and other liabilities on our Consolidated Balance Sheets.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

We currently plan to retain approximately 10% of our 2006 REIT ordinary taxable income (as we have in the previous three years) and will be subject to corporate level income taxes on any retained income for the 2006 calendar tax year. We plan to distribute any net capital gains (gains generated from calls and sales offset by losses on IOs as a result of calls) that we generate to allow our stockholders to potentially take advantage of a lower tax rate on those distributions.

The following table summarizes the tax provisions for the three and nine months ended September 30, 2006 and 2005.

Provision for Income Tax

(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Current Tax Provision:				
Federal	\$ 3,129	\$ 3,537	\$ 7,529	\$ 7,047
State	478	2,014	1,822	3,484
Total current tax provision	<u>\$ 3,607</u>	<u>\$ 5,551</u>	<u>\$ 9,351</u>	<u>\$ 10,531</u>
Deferred Tax Provision:				
Taxable REIT subsidiaries	(69)	(858)	212	2,893
Total provision for income tax	<u>\$ 3,538</u>	<u>\$ 4,693</u>	<u>\$ 9,563</u>	<u>\$ 13,424</u>

The Federal and State tax provision for corporate income tax is estimated based on the amount of REIT ordinary income that we permanently retained, or plan to retain and estimated taxable income at our taxable REIT subsidiaries. Taxable REIT subsidiaries' deferred tax provisions are attributable to temporary differences between GAAP and tax accounting treatments on securitization gains and the utilization of prior period deferred tax assets.

As of September 30, 2006 and December 31, 2005, our taxable REIT subsidiaries had net deferred tax assets as presented in the table below. Realization of the deferred tax asset is dependent on many factors including generating sufficient taxable income prior to the expirations of net operating loss carry forwards. Although realization is not assured, we believe it is more likely than not that most of the deferred tax asset will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced if revised estimates of future taxable income during the carry forward periods are lower than expectations.

Deferred Tax Assets (Liabilities)

(In thousands)

	September 30, 2006	December 31, 2005
Net operating loss carry forward — State	\$ 611	\$ 725
Real estate assets	2,448	1,970
Gains from Sequoia securitizations	1,620	2,536
Interest rate agreements	996	224
Other	188	229
Total net deferred tax assets	5,863	5,684
Valuation allowance	(314)	(300)
Total benefited deferred tax assets through tax provision	5,549	5,384
Tax effect of unrealized losses	(2,344)	—
Total benefited deferred tax assets	<u>\$ 3,205</u>	<u>\$ 5,384</u>

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

In accordance with FAS 109, "Accounting for Income Taxes," deferred tax assets (liabilities) are recognized for GAAP items relating to unrealized gains (losses) recognized through other comprehensive income. Deferred tax assets (liabilities) are recognized for these items in order to take into account potential tax effects if these unrecognized gains (losses) are realized in the future through the Consolidated Statements of Income. Any deferred tax assets (liabilities) recognized for these items are booked through equity as opposed to the provision for income taxes in the Consolidated Statements of Income.

Holdings' state NOLs were \$8.7 million and \$10.1 million at September 30, 2006 and December 31, 2005, respectively. These state NOLs will expire by 2012, unless utilized. At September 30, 2006 and December 31, 2005, the valuation allowance relates exclusively to Holdings' state NOLs which may expire before being utilized.

The statutory combined Federal and state corporate tax rate is 42%. This rate is applied to the amount of estimated REIT taxable income retained and to taxable income earned at the taxable subsidiaries. Thus, as a REIT, our effective tax rate is significantly less than the statutory combined rate as we are allowed to deduct dividend distributions. In addition, there are some permanent and temporary differences (including accounting for securitizations, stock options and other equity compensation, and other employee compensation expenses) between GAAP income and taxable income that result in changes in our effective rate from the statutory rates.

NOTE 9. FAIR VALUE OF FINANCIAL INSTRUMENTS

We estimate the fair value of our financial instruments using available market information and other appropriate valuation methodologies. These fair value estimates generally incorporate discounted future cash flows at current market discount rates for comparable investments. We validate our fair value estimates on a quarterly basis by obtaining fair value estimates from dealers who make a market in these financial instruments. We believe the estimates we use reasonably reflect the values we may be able to receive should we choose to sell them. Many factors must be considered in order to estimate market values, including, but not limited to interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, and other market factors. Accordingly, our estimates are inherently subjective in nature and involve uncertainty and judgment to interpret relevant market and other data. Amounts realized in actual sales may differ from the fair values presented.

The following table presents the carrying values and estimated fair values of our financial instruments as of September 30, 2006 and December 31, 2005.

Fair Value of Financial Instruments
(In thousands)

	September 30, 2006		December 31, 2005	
	Carrying Value	Fair Value	Carrying Value	Fair Value
Assets				
Real estate loans held-for-investment	\$ 9,874,964	\$ 9,802,467	\$ 13,934,484	\$ 13,855,709
Real estate securities available-for-sale	\$ 2,912,365	\$ 2,912,365	\$ 2,418,917	\$ 2,418,917
Interest rate agreements	\$ 29,492	\$ 29,492	\$ 31,220	\$ 31,220
Commitments to purchase	\$ 200	\$ 200	\$ —	\$ —
Cash and cash equivalents	\$ 112,926	\$ 112,926	\$ 175,885	\$ 175,885
Restricted cash	\$ 139,441	\$ 139,441	\$ 72,421	\$ 72,421
Accrued interest receivable	\$ 67,304	\$ 67,304	\$ 76,469	\$ 76,469
Liabilities				
Redwood debt	\$ 509,994	\$ 509,994	\$ 169,707	\$ 169,707
ABS issued	\$ 11,554,259	\$ 11,508,429	\$ 15,585,277	\$ 15,519,383
Interest rate agreements	\$ 6,080	\$ 6,080	\$ 507	\$ 507
Accrued interest payable	\$ 51,304	\$ 51,304	\$ 41,027	\$ 41,027

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

Methodologies we use to estimate fair market values for various asset types are described below.

- Real estate loans
 - Residential loan and HELOC fair values are determined by available market quotes and discounted cash flow analyses and are confirmed by third party/dealer pricing indications.
 - Commercial loan fair values are determined by appraisals on underlying collateral and discounted cash flow analyses.
- Real estate securities
 - Real estate securities fair values are determined by discounted cash flow analyses and other valuation techniques using market pricing assumptions confirmed by third party dealer/pricing indications.
- Interest rate agreements
 - Fair values on interest rate agreements are determined by third party vendor modeling software and from valuations provided by dealers active in derivative markets.
- Cash and cash equivalents
 - Includes cash on hand and highly liquid investments with original maturities of three months or less. Fair values equal carrying values.
- Restricted cash
 - Includes interest-earning cash balances in ABS entities for the purpose of distribution to bondholders and reinvestment. Due to the short-term nature of the restrictions, fair values approximate carrying values.
- Accrued interest receivable and payable
 - Includes interest due and receivable on assets and due and payable on our liabilities. Due to the short-term nature of when these interest payments will be received or paid, fair values approximate carrying values.
- Redwood debt
 - All Redwood debt is adjustable and matures within one year; fair values approximate carrying values.
- ABS issued
 - Fair values are determined by discounted cash flow analyses and other valuation techniques confirmed by third party/dealer pricing indications.
- Commitments to purchase
 - Fair values are determined by discounted cash flow analyses and other valuation techniques confirmed by third party/dealer pricing indications.

NOTE 10. STOCKHOLDERS' EQUITY

Accumulated Other Comprehensive Income

Certain assets are marked to market through accumulated other comprehensive income on our Consolidated Balance Sheets. These adjustments affect our book value but not our net income. As of September 30, 2006 and December 31, 2005, we reported net accumulated other comprehensive income of \$94.8 million and \$73.7 million, respectively.

REDWOOD TRUST, INC. AND SUBSIDIARIES**NOTES TO FINANCIAL STATEMENTS — (Continued)**

This account include the fair value of our earning assets and changes during a period include the impact of calls of our securities, write downs to fair value of a portion of our securities, premium or discount amortization of our securities agreements.

Also included in accumulated other comprehensive income at September 30, 2006, was a net gain balance of \$0.1 million related to terminated cash flow hedges to be reclassified into earnings over the original period of the transaction. This net gain consisted of \$4.1 million of hedges terminated at a gain and \$4.0 million of hedges terminated at a loss. Of this net amount, \$0.2 million will be recognized as interest expense on our Consolidated Statements of Income over the next twelve months. At September 30, 2006, the maximum length of time over which we are hedging our exposure to the variability of future cash flows for forecasted transactions is ten years, and all forecasted transactions are expected to occur within the next year.

The following table provides a summary of the components of accumulated other comprehensive income as of September 30, 2006 and December 31, 2005.

(In thousands)

	September 30, 2006	December 31, 2005
Net unrealized gains on real estate securities	\$ 87,190	\$ 56,542
Net unrealized gains on interest rate agreements accounted for as cash flow hedges	7,590	17,189
Total accumulated other comprehensive income	<u>\$ 94,780</u>	<u>\$ 73,731</u>

Stock Option Plan

In March 2006, we amended the previously amended 2002 Redwood Trust, Inc. Incentive Stock Plan (Incentive Plan, or IP) for executive officers, employees, and non-employee directors. This amendment was approved by our stockholders in May 2006. The IP authorizes our Board of Directors (or a committee appointed by our Board of Directors) to grant incentive stock options as defined under Section 422 of the Code (ISOs), options not so qualified (NQSOs), deferred stock, restricted stock, performance shares, stock appreciation rights, limited stock appreciation rights (awards), and DERs to eligible recipients other than non-employee directors. ISOs and NQSOs awarded to employees have a maximum term of ten-years and generally vest ratably over a four-year period. NQSOs awarded to non-employee directors have a maximum term of ten years and generally vest immediately or ratably over a three- or four-year period. Non-employee directors are automatically provided annual awards under the IP. The IP has been designed to permit the Compensation Committee of our Board of Directors to grant and certify awards that qualify as performance-based and otherwise satisfy the requirements of Section 162(m) of the Code. In addition, this latest amendment incorporated the addition of performance units as a type of award under the Plan, which may be awarded to officers, directors, and employees of Redwood or any of its subsidiaries, and other persons expected to provide significant services to Redwood or any of its subsidiaries. Performance units are intended to be used for annual cash bonus payments granted to Executive Committee members who are named executive officers (the Chief Executive Officer and other four most highly compensated officers) in an amount not to exceed \$5 million per grantee per year, so as to qualify as performance-based compensation under the Code. As of September 30, 2006 and December 31, 2005, 849,407 and 315,866 shares of common stock, respectively, were available for grant.

ISOs

Of the total shares of common stock available for grant, no more than 963,637 shares of common stock are cumulatively available for grant as ISOs. As of both September 30, 2006 and December 31, 2005, 551,697 ISOs had been granted. The exercise price for ISOs granted under the IP may not be less than the fair market value of shares of common stock at the time the ISO is granted.

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

DERs

Redwood has granted stock options that pay cash DERs. Cash DERs per applicable option are cash payments made that are equal to the per share dividends paid on common stock to our shareholders. As of September 30, 2006 and December 31, 2005, there were 1,366,462 and 1,491,403 unexercised options with cash DERs, respectively. With the adoption of FAS 123R on January 1, 2006, the grant date fair value of all remaining unvested stock options (which includes the value of any future DERs, if any) is expensed on the Consolidated Statements of Income over the remaining vesting period of each option. As of September 30, 2006, there was \$2.0 million of unrecognized compensation cost related to nonvested stock options. These costs will be expensed over a weighted-average period of 1.0 years.

Redwood had granted stock options that accrue stock DERs, but no longer grants those awards. Stock DERs represented shares of stock that were issuable when the holders exercised the underlying stock options, the amount of which was based on prior dividends paid per share on common stock and the market value of the stock on the various dividend payable dates. In November 2005, all options with stock DERs were converted to options with cash DERs to comply with Internal Revenue Code Section 409A deferred compensation rules.

Redwood has also granted stock options with no DERs or where the DERs do not extend beyond the vesting period. As of September 30, 2006 and December 31, 2005, there were 135,288 and 57,009 of unexercised options with no right to DERs, respectively.

For the three and nine months ended September 30, 2006 expenses related to stock option compensation were \$0.5 million and \$1.5 million. For the three and nine months ended September 30, 2005, expenses related to stock option compensation were and \$2.0 million and \$6.2 million.

A summary of the stock option activity during the three and nine months ended September 30, 2006 and 2005 is presented below. *Note 2* provides a discussion on the assumptions used to value stock options at grant date.

Stock Option Activity

	Three Months Ended September 30,			
	2006		2005	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Stock Options Outstanding				
Outstanding options at beginning of period	1,507,226	\$ 33.19	1,602,040	\$ 31.71
Options granted	—	—	—	—
Options exercised	(5,375)	\$ 32.25	(3,525)	\$ 36.86
Options forfeited	(101)	\$ 33.13	(494)	\$ 31.84
Stock dividend equivalent rights earned	—	—	5,103	—
Outstanding options at end of period	<u>1,501,750</u>	<u>\$ 33.20</u>	<u>1,603,124</u>	<u>\$ 31.59</u>
Options exercisable at period-end	1,317,160	\$ 30.65	1,197,548	\$ 27.40
Weighted average fair value of options granted during the period	\$ —		\$ —	

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

	Nine Months Ended September 30,			
	2006		2005	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Stock Options Activity				
Outstanding options at beginning of period	1,548,412	\$ 32.60	1,624,465	\$ 31.77
Options granted	33,871	\$ 41.09	3,601	\$ 51.70
Options exercised	(79,016)	\$ 24.68	(26,070)	\$ 21.33
Options forfeited	(1,517)	\$ 40.63	(13,853)	\$ 43.22
Stock dividend equivalent rights earned	—	—	14,981	—
Outstanding options at end of period	<u>1,501,750</u>	\$ 33.20	<u>1,603,124</u>	\$ 31.59
Options exercisable at period-end	1,317,160	\$ 30.65	1,197,548	\$ 27.40
Weighted average fair value of options granted during the period	\$ 3.41		\$ 10.84	

The following table summarizes information about stock options outstanding at September 30, 2006.

Stock Option Exercise Prices as of September 30, 2006

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life in Years	Weighted Average Exercise Price	Number Exercisable	Weighted Average Exercise Price
\$10 to \$20	351,783	2.93	\$ 12.75	351,783	\$ 12.75
\$20 to \$30	385,881	3.93	\$ 24.15	359,337	\$ 23.93
\$30 to \$40	264,000	0.65	\$ 37.49	264,000	\$ 37.49
\$40 to \$50	130,743	2.55	\$ 44.38	130,593	\$ 44.38
\$50 to \$60	368,542	7.39	\$ 55.08	210,646	\$ 54.82
\$60 to \$63	801	5.87	\$ 62.54	801	\$ 62.54
\$10 to \$63	<u>1,501,750</u>	3.85	\$ 33.20	<u>1,317,160</u>	\$ 30.65

Restricted Stock

As of September 30, 2006 and December 31, 2005, 17,750 and 21,038 shares, respectively, of restricted stock were outstanding. Restrictions on this shares lapse through July 1, 2010. Restricted stock activity for the three and nine months ended September 30, 2006 and 2005 is presented in the table below. The cost of these grants is amortized over the vesting term using an accelerated method in accordance with FASB Interpretation No. 28 *Accounting for Stock Appreciation Rights and Other Variable Stock Options or Award Plans* (FIN 28), and FAS 123R. As of September 30, 2006, there was \$0.4 million of unrecognized compensation cost related to nonvested restricted stock. This cost will be recognized over a weighted average period of 1.2 years. For the three and nine months ended September 30, 2006 and 2005, the expenses related to restricted stock were negligible.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

Restricted Stock Outstanding

	Three Months Ended September 30,			
	2006		2005	
	Units	Weighted Average Grant Date Fair Value	Units	Weighted Average Grant Date Fair Value
Restricted stock outstanding at the beginning of period	18,186	\$ 45.57	3,616	\$ 56.75
Restricted stock granted	—	—	—	—
Stock for which restrictions lapsed	—	—	—	—
Restricted stock forfeited	(436)	46.13	(317)	52.23
Restricted stock outstanding at end of period	<u>17,750</u>	<u>\$ 45.55</u>	<u>3,299</u>	<u>\$ 56.80</u>

Restricted Stock Outstanding

	Nine Months Ended September 30,			
	2006		2005	
	Units	Weighted Average Grant Date Fair Value	Units	Weighted Average Grant Date Fair Value
Restricted stock outstanding at the beginning of period	21,038	\$ 45.96	5,912	\$ 45.47
Restricted stock granted	247	40.49	—	—
Stock for which restrictions lapsed	(972)	53.74	(1,750)	18.62
Restricted stock forfeited	(2,563)	45.32	(863)	56.63
Restricted stock outstanding at end of period	<u>17,750</u>	<u>\$ 45.55</u>	<u>3,299</u>	<u>\$ 56.80</u>

Deferred Stock Units

The IP allows for the granting of Deferred Stock Units (DSUs) through the 2002 Redwood Trust, Inc., Executive Deferred Compensation Plan (EDCP). These are discussed below.

Executive Deferred Compensation Plan

In May 2002, our Board of Directors approved the 2002 EDCP. The EDCP allows eligible employees and directors to defer portions of current salary and certain other forms of compensation. Redwood may match some deferrals up to certain levels. Compensation deferred under the EDCP are assets of Redwood and subject to the claims of the general creditors of Redwood. For the three and nine months ended September 30, 2006, deferrals of \$0.5 million and \$2.4 million, respectively, were made under the EDCP. For the three and nine months ended September 30, 2005, deferrals of \$0.1 million and \$0.8 million, respectively, were made under the EDCP. The EDCP allows for the investment of deferrals in either an interest crediting account or DSUs. The rate of accrual in the interest crediting account is set forth in the EDCP. For deferrals prior to July 1, 2004, the accrual rate is based on a calculation of the marginal rate of return on our portfolio of earning assets. This accrual rate will continue for these deferred amounts through July 1, 2007 and then will be based on references to publicly traded mutual funds or the applicable federal rate (AFR). For deferrals after July 1, 2004, the accrual rate is based on

REDWOOD TRUST, INC. AND SUBSIDIARIES

NOTES TO FINANCIAL STATEMENTS — (Continued)

references to publicly traded mutual funds or the AFR. The following table provides detail on changes in participants' accounts in the EDCP for the three and nine months ended September 30, 2006 and 2005.

EDCP Activity
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Cash accounts transfer in of participants' payroll deductions from the EDCP	\$ 494	\$ 83	\$ 2,418	\$ 786
Accrued interest earned in EDCP	269	265	773	959
Participant withdrawals	—	—	(2,120)	(225)
Net change in participants' equity	<u>\$ 763</u>	<u>\$ 348</u>	<u>\$ 1,071</u>	<u>\$ 1,520</u>
Balance at beginning of period	\$ 7,313	\$ 6,100	\$ 7,005	\$ 4,928
Balance at end of period	\$ 8,076	\$ 6,448	\$ 8,076	\$ 6,448

The following table provides detail on the financial position of the EDCP at September 30, 2006 and December 31, 2005.

Net Assets Available for EDCP Participant Benefits
(In thousands)

	September 30, 2006	December 31, 2005
Cash Accounts		
Participants' deferrals	\$ 5,277	\$ 4,064
Accrued interest credited	2,799	2,941
Net assets available for participants' benefit	<u>\$ 8,076</u>	<u>\$ 7,005</u>

Deferred Stock Units

DSUs are granted or purchased by participants in the EDCP. Some of the DSU awarded may have a vesting period associated with them. As of September 30, 2006 and December 31, 2005, 493,396 and 418,126 of DSUs were outstanding, respectively. As of September 30, 2006 and December 31, 2005, the number of these DSUs in the EDCP that had vested was 135,628 and 44,981, respectively. Restrictions on the remaining shares of outstanding DSUs lapse through July 1, 2010. For the three and nine months ended September 30, 2006, expenses related to DSUs were \$2.0 million and \$6.5 million. For the three and nine months ended September 30, 2005, expenses related to DSUs were \$0.3 million and \$1.1 million. As of September 30, 2006, there was \$9.0 million of unrecognized compensation cost related to nonvested DSUs. This cost will be recognized over a weighted-average period of 1.0 years. The tables below provide summaries of the balance and activities of the DSUs in the EDCP.

Deferred Stock Units
(In thousands)

	September 30, 2006	December 31, 2005
Value of DSUs at grant	\$ 22,816	\$ 19,199
Participant forfeitures	(110)	(110)
Participant distributions	(347)	—
Change in value at period end since date of grant	2,493	(1,837)
Value of DSUs at end of period	<u>\$ 24,852</u>	<u>\$ 17,252</u>

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)

Deferred Stock Units Activity
(In thousands, except unit amounts)

	Three Months Ended September 30,					
	2006			2005		
	Units	Fair Value	Weighted Average Grant Date Fair Value	Units	Fair Value	Weighted Average Grant Date Fair Value
Balance at beginning of period	492,371	\$ 24,042	\$ 45.31	124,836	\$ 6,442	\$ 51.37
Transfer in of DSUs (value of grants)	1,025	50	48.46	7,000	357	50.96
Distribution of DSUs	—	—	—	—	—	—
Change in valuation during period	—	760	—	—	(220)	—
Participant forfeitures	—	—	—	—	—	—
Net change during period	1,025	810	—	7,000	137	—
Balance at end of period	<u>493,396</u>	<u>\$ 24,852</u>	<u>\$ 45.32</u>	<u>131,836</u>	<u>\$ 6,579</u>	<u>\$ 51.35</u>

Deferred Stock Units Activity
(In thousands, except unit amounts)

	Nine Months Ended September 30,					
	2006			2005		
	Units	Fair Value	Weighted Average Grant Date Fair Value	Units	Fair Value	Weighted Average Grant Date Fair Value
Balance at beginning of period	418,126	\$ 17,252	\$ 45.65	92,161	\$ 5,722	\$ 50.52
Transfer in of DSUs (value of grants)	86,741	3,617	41.70	41,564	2,224	53.51
Distribution of DSUs	(11,471)	(347)	30.27	—	—	—
Change in valuation during period	—	4,330	—	—	(1,257)	—
Participant forfeitures	—	—	—	(1,889)	(110)	58.23
Net change during period	75,270	7,600	—	39,675	857	—
Balance at end of period	<u>493,396</u>	<u>\$ 24,852</u>	<u>\$ 45.32</u>	<u>131,836</u>	<u>\$ 6,579</u>	<u>\$ 51.35</u>

Employee Stock Purchase Plan

In May 2002, our stockholders approved the 2002 Redwood Trust, Inc. Employee Stock Purchase Plan (ESPP), effective July 1, 2002. The purpose of the ESPP is to give our employees an opportunity to acquire an equity interest in Redwood through the purchase of shares of common stock at a discount. The ESPP allows eligible employees to have up to 15% of their annual gross compensation (including base salary, bonus, and cash DERs, and subject to certain other limitations) withheld to purchase common stock at 85% of its market value. The maximum gross compensation that any participant can contribute to the ESPP in any calendar quarter is \$6,250. Market value as defined under the ESPP is the lesser of the closing market price of the common stock as of the start of an offering period in the ESPP or the closing market price on the quarterly purchase date. The offering period starts on January 1st of each calendar year and consists of four quarterly purchase periods.

The ESPP allows a maximum of 100,000 shares of common stock to be purchased. As of September 30, 2006, 31,967 shares have been purchased. As of September 30, 2006 and December 31, 2005,

REDWOOD TRUST, INC. AND SUBSIDIARIES**NOTES TO FINANCIAL STATEMENTS — (Continued)**

there remained a negligible amount of uninvested employee contributions in the ESPP. The table below presents the activity in the ESPP for the three and nine months ended September 30, 2006 and 2005.

Employee Stock Purchase Plan Activity
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Transfer in of participants' payroll deductions from the ESPP	\$ 99	\$ 68	\$ 283	\$ 179
Cost of common stock issued to participants under ESPP	(102)	(64)	(294)	(172)
Net change in participants' equity	\$ (3)	\$ 4	\$ (11)	\$ 7
Balance at beginning of period	\$ 5	\$ 6	\$ 13	\$ 3
Balance at end of period	\$ 2	\$ 10	\$ 2	\$ 10

Direct Stock Purchase and Dividend Reinvestment Plan

For the three and nine months ended September 30, 2006, we issued 377,632 and 862,733 shares of common stock, respectively, through our Direct Stock Purchase and Dividend Reinvestment Plan (DSPP) for net proceeds of \$18.1 million and \$38.6 million, respectively. For the three and nine months ended September 30, 2005 112,694 and 582,250 shares were issued through our DSPP for total proceeds of \$5.7 million and \$31.3 million, respectively. For the three and nine months ended September 30, 2006 and 2005, we did not undertake any equity offerings.

Stock Repurchases

Our Board of Directors has approved the repurchase of a total of 7,455,000 shares of our common stock. A total of 6,455,000 shares were repurchased in 1998 and 1999. As of September 30, 2006 and December 31, 2005, there remained 1,000,000 shares available under the authorization for repurchase. Repurchased shares have been returned to the status of authorized but unissued shares of common stock.

NOTE 11. COMMITMENTS AND CONTINGENCIES

As of September 30, 2006, we were obligated under non-cancelable operating leases with expiration dates through 2018 for \$17.2 million. The majority of the future lease payments relate to a ten-year operating lease for our executive offices, which expires in 2013, and a lease for additional office space at our executive offices beginning January 1, 2008 and expiring May 31, 2018. Prior to the beginning of the lease of the additional office space, we are subleasing this office space from another tenant through December 31, 2007. The total lease payments to be made under the lease expiring in 2013 and the sublease, including certain free-rent periods, are being recognized as office rent expense on straight-line basis over the lease term. Leasehold improvements for our executive offices are amortized into expense over the ten-year lease term. The unamortized leasehold improvement balance at September 30, 2006 was \$1.8 million. We will incur additional leasehold improvements as we prepare the additional office space.

REDWOOD TRUST, INC. AND SUBSIDIARIES
NOTES TO FINANCIAL STATEMENTS — (Continued)**Future Lease Commitments by Year**
(In thousands)

	September 30, 2006
2006 (last three months)	\$ 371
2007	1,350
2008	1,636
2009	1,680
2010	1,709
2011 and thereafter	10,405
Total	\$ 17,151

As of September 30, 2006, there were no pending legal proceedings to which we were a party or to which any of our properties were subject.

The table below shows our commitments to purchase loans and securities as of September 30, 2006. The loan purchase commitments represent derivative instruments with an estimated value of \$0.2 million at September 30, 2006 under FAS No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities* (FAS 149). This is included in net recognized gains and valuation adjustments on our Statements of Income. See *Note 9* for the fair value of those commitments.

Commitments to Purchase
(In thousands)

	September 30, 2006
Real estate loans	\$ 93,250
Real estate securities	—
Total	\$ 93,250

In November 2005, we entered into an agreement to purchase certain certificates in a commercial mortgage loan securitization to be issued by a securitization entity to be formed at a later date. We anticipate that this will require us to purchase up to 50% of any BB+ and lower grade certificates issued by this entity, on between \$150 million to \$200 million of loan collateral, pursuant to the underwriting criteria set forth in the agreement. As of September 30, 2006, there were approximately \$150 million of commercial mortgage loans originated, but not yet securitized under this agreement. Additionally, we may be required to purchase at least 50% of a third party's junior participation interest in this securitization, under certain circumstances (primarily where underlying loan collateral is required to be repurchased due to poor loan performance). As of September 30, 2006, we have not been required to purchase any junior participation interest; all loans funded to date are performing as expected. At September 30, 2006, we estimate the value of this commitment to be negligible.

NOTE 12. RECENT DEVELOPMENTS

In October 2006, we purchased or committed to purchase \$62 million residential real estate loans, and \$102 million real estate securities.

In October 2006, we exercised our option to call Acacia CDO 3, and committed to sell \$124 million real estate securities. The estimated GAAP gains on these sales was \$5 million.

In October 2006, we called Sequoia 7 and 8. The principal balance of the residential whole loans at the time of call was \$235 million.

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

CAUTIONARY STATEMENT

This Form 10-Q contains forward-looking statements within the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Statements that are not historical in nature, including the words "anticipated," "estimated," "should," "expect," "believe," "intend," and similar expressions, are intended to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties, including, among other things, those described in our Annual Report on Form 10-K for the year ended December 31, 2005 under the caption "Risk Factors." Other risks, uncertainties, and factors that could cause actual results to differ materially from those projected are detailed from time to time in reports filed by us with the Securities and Exchange Commission (SEC), including Forms 10-K, 10-Q, and 8-K.

We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise. In light of these risks, uncertainties, and assumptions, the forward-looking events mentioned or discussed in, or incorporated by reference into, this Form 10-Q might not occur. Accordingly, our actual results may differ from our current expectations, estimates, and projections.

Important factors that may impact our actual results include changes in interest rates and market values; changes in prepayment rates; general economic conditions, particularly as they affect the price of earning assets and the credit status of borrowers; the level of liquidity in the capital markets as it affects our ability to finance our real estate asset portfolio; and other factors not presently identified. This Form 10-Q contains statistics and other data that in some cases have been obtained from, or compiled from information made available by, servicers and other third-party service providers.

SUMMARY AND OUTLOOK

Redwood Trust, Inc., together with its subsidiaries (Redwood, we, or us), invests in and manages real estate assets. We invest in residential and commercial real estate loans and in asset-backed securities backed by real estate loans. Our primary focus is credit-enhancing residential and commercial real estate loans. We credit-enhance loans by acquiring and managing the first-loss and other credit-sensitive securities that bear the bulk of the credit risk of securitized loans.

We seek to invest in assets that have the potential to generate high long-term cash flow returns to help support our goal of distributing an attractive level of dividends per share to shareholders over time. For tax purposes, we are structured as a real estate investment trust (REIT).

Net Income

Net income for the third quarter was \$32 million (\$1.22 per share) — a decline from the \$56 million (\$2.21 per share) we earned in the third quarter of 2005 but an increase from the \$31 million (\$1.20 per share) we earned in the second quarter of 2006. For the first nine months of 2006, our net income was \$92 million (\$3.51 per share), a decline from the \$157 million (\$6.26 per share) we earned in the first nine months of 2005.

The largest factor in the decline in net income has been a significant drop in income from gains generated on the sale or calls of assets. For the comparable nine month periods, income from this source dropped by \$38 million. In addition, for these nine month periods, net interest income dropped by \$25 million, operating expenses rose by \$6 million, and tax provisions declined by \$4 million.

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Table 1 Net Income

(In thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Total interest income	\$ 223,649	\$ 244,631	\$ 667,769	\$ 731,058
Total interest expense	(174,673)	(196,591)	(528,847)	(567,613)
Net interest income	48,976	48,040	138,922	163,445
Operating expenses	(13,455)	(12,364)	(42,074)	(35,618)
Net recognized gains and valuation adjustments	433	24,916	4,556	42,973
Provision for income taxes	(3,538)	(4,693)	(9,563)	(13,424)
Net income	\$ 32,416	\$ 55,899	\$ 91,841	\$ 157,376
Diluted common shares	26,624,532	25,314,315	26,132,000	25,159,619
Net income per share	\$ 1.22	\$ 2.21	\$ 3.51	\$ 6.26

Financial Condition

Residential Real Estate Assets

Redwood invests in and manages residential real estate loans and securities backed by residential real estate loans. At September 30, 2006, Redwood's residential loans totaled \$9.8 billion and residential securities totaled \$2.2 billion.

An important part of Redwood's business is investing in residential securities that have credit ratings that are below investment grade. For securitizations of prime residential loans, these are typically the three securities (the first-loss, second-loss, and third-loss credit-enhancement securities) that bear the bulk of the credit risk of the underlying loans, and thus credit-enhance the other securities issued from the same entity. Due to the large amount of underlying loans, these credit-enhancement assets have concentrated credit risks, and both the upside and downside that could come from taking on concentrated risks. Redwood's residential credit-enhancement securities have grown by 21% this year, and totaled \$742 million at September 30, 2006.

The underlying loans are primarily high-quality loans but also include Alt-A (medium quality) loans. The underlying loans, which total \$225 billion, are nationwide with a large concentration in California. They continue to perform well from a credit perspective. For the third quarter of 2006, realized residential credit losses were \$2.2 million of principal value, a rate that is less than one basis point (0.01%) on an annualized basis of the current balance of loans. Delinquencies (90+ days, in foreclosure, in bankruptcy or REO) at September 30, 2006 were 0.21% of current balance and 0.14% of original balance. For loans in prime pools, delinquencies were 0.16% of current balance and 0.11% of original balance. Alt-A pools had delinquencies of 0.60% of current balance and 0.40% of original balance.

As a result of the concentrated credit risk associated with residential loan CES, we are generally able to acquire these securities at a discount to their face (principal) value. The difference between the principal value (\$1.2 billion) and carrying (market) value (\$742 million) of these residential loan CES at September 30, 2006 was \$469 million. Of this difference, \$384 million was designated as internal credit protection (reflecting our estimate of likely credit losses on the underlying loans over the life of these securities), \$147 million represented a purchase discount we are accreting into income over time and \$62 million represented net unrealized mark-to-market gains.

Redwood also invests in higher-rated investment-grade residential securities. Year-to-date growth for our investment in these residential securities has been 13%, with a total portfolio of \$1.4 billion at September 30, 2006. These investment-grade securities are backed by prime, Alt-A, and sub-prime loans. They are not directly exposed to first-loss credit risk as they benefit from credit-enhancement provided by others. The credit performance of these assets continues to be excellent.

Redwood buys residential real estate loans from originators. These generally high-quality loans totaled \$9.8 billion on September 30, 2006. Most of these loans are adjustable-rate loans using one- or six-

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month London Inter-Bank Offered Rate (LIBOR) as the adjustable-rate index. Redwood's loan balance for these loans has declined by 29% year-to-date as prepayments have exceeded new purchases. These loans have been prepaying rapidly due to the flat yield curve (short-term interest rates such as LIBOR are high relative to longer-term interest rates). Rapid prepayments of these loans have resulted in higher levels of premium amortization expense, one reason net interest income in 2006 is lower than in 2005.

Commercial Real Estate Assets

Redwood invests in commercial real estate securities and, to a lesser degree, directly in commercial real estate loans. At September 30, 2006, commercial securities totaled \$513 million and commercial loans totaled \$32 million.

Redwood's total below investment-grade commercial real estate securities were \$383 million at September 30, 2006. Of these, \$117 million were first-loss commercial securities. These credit-enhancement securities bear concentrated credit risks with respect to \$36 billion underlying loans on office, retail, multifamily, industrial, and other income-producing properties nationwide. Overall, the underlying loans continue to perform well, with some isolated credit losses due to loan specific issues.

As a result of the concentrated credit risk associated with commercial real estate CES, we are generally able to acquire these securities at a discount to their face (principal) value. The difference between the principal value (\$322 million) and carrying value (\$117 million) of our first-loss commercial CES at September 30, 2006 was \$205 million. Of this difference, \$222 million was designated as internal credit protection (reflecting our estimate of likely credit losses on the underlying loans over the life of these securities), and \$17 million represented net unrealized mark-to-market gains.

Redwood's investment in commercial real estate securities rated investment-grade has declined by 20% year-to-date to a total of \$130 million on September 30, 2006. Our investment in commercial loans has declined by 46% year-to-date to a total of \$32 million at quarter-end. These assets continue to perform well from a credit perspective.

CDO Assets

Collateralized debt obligations (CDOs) are a form of securitization in which a (usually) diverse portfolio of assets is acquired by a securitization entity that creates and sells securities (CDO securities) in order to fund its asset purchases. Redwood uses CDOs as a method of funding its assets (see below) but also acquires CDO securities created by others as an asset portfolio investment. At September 30, 2006, Redwood's portfolio of CDO securities acquired from others included \$181 million investment-grade CDO securities and \$18 million below-investment-grade (CDO equity) securities. These CDO securities are generally backed by residential and commercial real estate assets. Redwood's CDO securities portfolio has grown by 28% year-to-date in 2006. These assets are generally performing well from a credit perspective.

Asset-Backed Securities Issued

Redwood has securitized the bulk of the assets shown on its consolidated balance sheet. In a securitization, Redwood sells assets to a securitization entity that creates and sells asset-backed securities (ABS) in order to fund its asset purchases. The residential whole loan securitization entities Redwood uses are generally called Sequoia and the CDO securitization entities Redwood uses are generally called Acacia. These securitization entities are bankruptcy-remote from Redwood, so that Redwood's liabilities cannot become liabilities of the securitization entity and the ABS issued by the securitization entity cannot become obligations of Redwood Trust. Nevertheless, since according to accounting definitions Redwood controls these securitization entities, Redwood shows both the assets and liabilities of these entities on its consolidated balance sheet. On Redwood's September 30, 2006 balance sheet, \$11.9 billion (89%) of the assets shown and \$11.6 billion (95%) of the liabilities shown were the assets and obligations of securitization entities.

When we securitize assets, as opposed to owning them directly and funding them with Redwood debt and equity, our reported cost of funds is higher (the cost of ABS securities issued is generally higher than that of our debt) but we utilize less equity capital (the ABS that we acquire from the securitization

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require less of an equity investment than using our own debt to fund the securitized assets). As a result, our return on equity may increase after securitization. In addition, liquidity risks are generally reduced or eliminated, as the Redwood debt associated with the accumulation of these assets during their accumulation is paid off following securitization.

Redwood Debt

Our recourse debt obligations are shown on our balance sheet as Redwood debt. These obligations totaled \$510 million at September 30, 2006, an increase from \$170 million at the beginning of the year. All of this debt is secured by a pledge of our loans and securities. We have used Redwood debt primarily to fund the acquisition of loans and securities on a temporary basis prior to their sale to a securitization entity. In a departure from our practice in the last few years, we are starting to acquire assets as a longer-term investment that we intend to fund on an ongoing basis with Redwood debt. This accounts for a portion of the increase in Redwood debt during the third quarter. The amount of debt we would be willing to use to fund assets is determined on an asset-by-asset basis by our internal policies — on average we expect to use approximately 8% equity and 92% debt to fund high-quality liquid assets in this manner.

Interest Rate Agreements

We use interest rate agreements such as interest rate swaps to reduce the potential volatility of our earnings and book value as interest rates change. At September 30, 2006, we owned interest rate agreements with a notional value of \$5 billion and a net market value of \$24 million.

Equity Funding

We generally use equity (no debt or securitization) to fund investments in assets that have highly concentrated credit risks, including first-loss residential and commercial credit-enhancement securities, CDO equity securities, and similar illiquid assets. We also use equity to fund our working capital and other operating requirements.

As our Acacia CDO securitization program has evolved over the last few years, we have been able to securitize lower-rated assets such as second- and third-loss residential and commercial credit-enhancement securities. This reduces our equity capital requirements and frees cash, allowing us to acquire additional assets using the same capital base.

Excess Capital

We are not currently utilizing leverage to the extent possible under our internal policies. At September 30, 2006, if we had pledged assets and borrowed to the extent possible under our internal policies, we would have had \$219 million capital in excess of that needed to fund our operations and assets. We derive our excess capital figures by calculating the amount of cash we would have available for investment if we conservatively leveraged our securitization inventory and other assets. Excess capital increased by \$28 million in the third quarter, in part because we sold \$47 million equity-funded first- and second-loss 2005 and 2006 vintage residential credit-enhancement securities due to concerns about the housing credit cycle. In addition, we recycled capital and freed cash by, for the first time, securitizing in Acacia \$32 million of second-loss residential credit-enhancement securities. In addition, we are retaining (but not investing) cash for an expected special dividend likely to be paid in December.

Stockholders' Equity

Our reported book value at September 30, 2006 was \$40.02 per share, an increase from \$39.13 per share at the beginning of the quarter and \$37.20 per share at the beginning of the year. Our book value per share increased this year as a result of retained earnings and increases in the net market value of our assets and interest rate agreements. Book value per share is reduced by dividends, and thus will likely decline in the fourth quarter as a result of our special dividend.

We issue equity only when we believe equity growth will enhance long-term earnings and dividends per share, compared to what they would have been otherwise. Given the amount and quality of the asset

acquisition opportunities we anticipate seeing, we currently expect to seek additional equity (and long-term debt) capital during 2007.

Outlook

The near-term outlook for earnings, dividends, and growth depends, in part, on the how fast we employ our \$219 million of excess capital. While we carry excess capital, our earnings and dividends will be lower than they would be if this capital were employed in attractive earning assets.

We believe the outlook for employing this capital is good, although the exact timing is uncertain. In commercial real estate, we have increased our capabilities and expanded our relationships, and we expect to continue to acquire commercial credit-enhancement securities. We may also resume purchases of commercial loans. We expect to increase our acquisitions of investment-grade residential, commercial, and CDO securities. As the housing market corrects and we increase our capabilities to evaluate lower-quality residential loans, an increasing percentage of these investment-grade securities will likely be backed by Alt-A and sub-prime residential loans. We are increasing our residential whole loan purchases as a result of broadening the product types we are willing to buy (currently focusing on prime-quality hybrid loans) and expanding our relationships with originators. We have the call rights to the Sequoia residential whole loan transactions we have sponsored. As these transactions become callable (starting in the fourth quarter of 2006), we will likely call these transactions and acquire the underlying seasoned high-quality adjustable-rate whole loans as an investment for Redwood. For our acquisitions of investment-grade securities and residential whole loans, we will continue to use securitization as a funding method, but we also intend to fund a growing proportion of these assets on an ongoing basis with Redwood debt. This will utilize excess capital at an approximate rate of 8% of the assets held in this manner. As a result, Redwood debt outstanding will increase.

We currently expect to make a modest level of new investments in residential credit-enhancement securities over the next few quarters. Most likely, the bulk of these investments will be in second- and third-loss securities that will be re-securitized via Acacia CDO transactions. We expect that the risk/ reward relationship for first-loss prime residential credit enhancement securities will improve over the next year or two, at which time we expect to increase our acquisition rate of these assets. As the housing market corrects, housing prices will become less vulnerable. We expect that fewer speculators and investors will be active in the housing markets, and that loan origination standards may improve somewhat. Additionally, if there is broad stress in the housing capital markets, the prices for these assets may decline, making their acquisition more attractive. As a result of our increased capabilities, we have recently been active participants in the markets for first-loss Alt-A and sub-prime credit-enhancement securities and residuals. We expect to make a small amount of investments in this area, although our acquisitions may increase if the risk/reward relationship for these improves in our opinion (perhaps as a result of housing market stress).

In our view, in the absence of a deep housing recession, the outlook for our earnings and dividends over the next few years is reasonably good. (However, we continue to expect quarter-to-quarter GAAP and tax earnings volatility for a variety of reasons, including some technical accounting and tax issues more fully described below). Housing price increases over the past several years have reduced our risk of credit loss in the future for our existing residential assets, since, for most of our residential credit risk assets, the underlying loans were originated in 2003 and 2004. Commercial property values and cash flows are increasing in many areas. Our existing portfolio of assets as a whole has the ability to generate attractive earnings, cash flows, and dividends in the future, assuming real estate credit losses do not increase materially.

Over the long term, we believe it is reasonably likely that we will be able to continue to find attractive investment opportunities, as we believe that we are an efficient competitor and because our market segments are growing (the amount of real estate loans outstanding continues to increase and the percentage of these loans that are securitized, also continues to increase).

We declared regular quarterly dividends of \$0.70 per share in each of the first, second, and third quarters of 2006. Total regular dividends to date totaled \$56 million, of which \$52 million represented the distribution of the remainder of our 2005 REIT taxable income. Consistent with our practice in previous years, we expect to permanently retain approximately 10% of the ordinary REIT taxable income we earn during 2006, to retain the after-tax profits earned in our taxable subsidiaries, and defer

the distribution of a portion of our 2006 income so that it will be distributed by September 2007 through regular dividends. With these actions, and in order to meet our distribution requirements, we expect to declare a special dividend in the fourth quarter of 2006. Redwood's Board of Directors will set the size of any special dividend, based on evolving projections of fourth quarter REIT taxable income and other factors. If the Board authorizes the dividend based on past practice, it currently appears that the special dividend this year will likely exceed \$2.50 per share and could be close to the \$3.00 per share special dividend we paid in December 2005.

RESULTS OF OPERATIONS

THIRD QUARTER AND FIRST NINE MONTHS — 2006 AS COMPARED TO 2005

Net Income

Net income for the third quarter was \$32 million (\$1.22 per share) — a decline from the \$56 million (\$2.21 per share) we earned in the third quarter of 2005. For the first nine months of 2006, our net income was \$92 million (\$3.51 per share), a decline from the \$157 million (\$6.26 per share) we earned in the first nine months of 2005.

Interest Income

Total interest income consists of interest earned on consolidated earning assets, adjusted for amortization of discounts and premium and provisions for loan credit losses.

Table 2 Interest Income and Yield
(In thousands)

	Three Months Ended September 30, 2006				Three Months Ended September 30, 2005			
	Interest Income	Percent of Total Interest Income	Average Balance	Yield	Interest Income	Percent of Total Interest Income	Average Balance	Yield
Real estate loans, net of provision for credit losses	\$ 149,018	66.63%	\$ 9,979,261	5.97%	\$ 194,830	79.65%	\$ 17,645,610	4.42%
Real estate securities	72,759	32.53%	2,697,903	10.79%	48,811	19.95%	2,305,361	8.47%
Cash and cash equivalents	1,872	0.84%	183,323	4.08%	990	0.40%	134,422	2.95%
Total interest income	<u>\$ 223,649</u>	<u>100.00%</u>	<u>\$ 12,860,487</u>	<u>6.96%</u>	<u>\$ 244,631</u>	<u>100.00%</u>	<u>\$ 20,085,393</u>	<u>4.87%</u>

	Nine Months Ended September 30, 2006				Nine Months Ended September 30, 2005			
	Interest Income	Percent of Total Interest Income	Average Balance	Yield	Interest Income	Percent of Total Interest Income	Average Balance	Yield
Real estate loans, net of provision for credit losses	\$ 470,893	70.52%	\$ 11,127,318	5.64%	\$ 601,589	82.29%	\$ 19,979,127	4.01%
Real estate securities	189,656	28.40%	2,530,248	9.99%	127,095	17.39%	2,123,067	7.98%
Cash and cash equivalents	7,220	1.08%	224,418	4.29%	2,374	0.32%	127,974	2.47%
Total interest income	<u>\$ 667,769</u>	<u>100.00%</u>	<u>\$ 13,881,984</u>	<u>6.41%</u>	<u>\$ 731,058</u>	<u>100.00%</u>	<u>\$ 22,230,168</u>	<u>4.38%</u>

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The table below details how our interest income changed by portfolio as a result of changes in consolidated asset balances (“volume”) and yield (“rate”) for the three and nine months ended September 30, 2006 as compared to the three and nine months ended September 30, 2005. The reduction in total interest income due to declining balances was partially offset by increased yields.

Table 3 Volume and Rate Changes for Interest Income
(In thousands)

	Change in Interest Income Three Months Ended September 30, 2006 Versus September 30, 2005			Change in Interest Income Nine Months Ended September 30, 2006 Versus September 30, 2005		
	Volume	Rate	Total Change	Volume	Rate	Total Change
	Real estate loans, net of provisions for credit losses	\$ (84,646)	\$ 38,834	\$ (45,812)	\$ (266,536)	\$ 135,840
Real estate securities	8,311	15,637	23,948	24,375	38,186	62,561
Cash and cash equivalents	360	522	882	1,789	3,057	4,846
Total interest income	<u>\$ (75,975)</u>	<u>\$ 54,993</u>	<u>\$ (20,982)</u>	<u>\$ (240,372)</u>	<u>\$ 177,083</u>	<u>\$ (63,289)</u>

Volume change is the change in average portfolio balance between periods multiplied by the rate earned in the earlier period. Rate change is the change in rate between periods multiplied by the average portfolio balance in the prior period. Interest income changes that result from changes in both rate and volume were allocated to the rate change amounts shown in the table.

A discussion by portfolio of changes in total income, average balances, and yields for our loans and securities is provided below.

Table 4 Consolidated Real Estate Loans — Interest Income and Yield
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income	\$ 160,715	\$ 208,532	\$ 504,282	\$ 632,320
Net premium amortization expense	(11,232)	(14,507)	(35,254)	(32,038)
(Provision for) reversal of credit reserve	(465)	805	1,865	1,307
Total interest income	<u>\$ 149,018</u>	<u>\$ 194,830</u>	<u>\$ 470,893</u>	<u>\$ 601,589</u>
Average consolidated real estate loans	<u>\$ 9,979,261</u>	<u>\$ 17,645,610</u>	<u>\$ 11,127,318</u>	<u>\$ 19,979,127</u>
Yields as a result of:				
Interest income	6.44%	4.73%	6.04%	4.22%
Net premium amortization expense	(0.45)%	(0.33)%	(0.42)%	(0.21)%
Credit provision expense	(0.02)%	0.02%	0.02%	0.00%
Yield	<u>5.97%</u>	<u>4.42%</u>	<u>5.64%</u>	<u>4.01%</u>

Interest income on real estate loans decreased in the 2006 periods from the 2005 periods primarily as a result of lower average balances of real estate loans. This decline was partially offset by increased yields. Yields increased primarily due to increases in the short-term interest rates to which most of these loans are indexed.

In 2005 and prior years, our residential conduit acquired significant amounts of high-quality one- and six-month LIBOR adjustable-rate residential loans from originators, selling the loans to Sequoia securitization entities, and then sponsoring Sequoia securitizations of these loans. In today’s flat to inverted yield curve environment, however, ARMs indexed to LIBOR are not an attractive option for homeowners, causing origination volume of this product to decrease dramatically. Additionally, new forms of

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adjustable-rate mortgages (negative amortization, "option ARMs", and Moving Treasury Average (MTA) ARMs) represent an increased share of the ARM market.

The flatter yield curve has also lead to faster prepayment rates on existing ARM loans. Borrowers are more inclined to refinance out of ARMs and into hybrid or fixed rate loans when the effective interest rates on ARMs are not significantly lower than the alternatives. Prepayment rates for residential ARM loans owned by Sequoia entities increased from an average CPR of 39% in the third quarter of 2005 to an average CPR of 45% in the third quarter of 2006.

Loan premium amortization expenses for residential loans acquired prior to July 2004 are influenced by prepayment rates but also are driven in a significant manner directly by trends in short-term interest rates. As short-term rates increase, premium amortization slows; as short-term rates decrease, premium amortization expenses could accelerate in a material way. For the (smaller amount of) loans acquired after July 2004, interest rate trends are less of a factor except as they may influence prepayment rates. Comparing the two third-quarter periods, premium amortization decreased by \$3.3 million. Comparing the two nine-month periods, premium amortization expenses increased by \$3.2 million. See Critical Accounting Policies later in this document for further explanation of loan premium amortization.

Although the overall real estate loan balance declined during the quarter, the provision for credit losses increased due to a rise in delinquencies as a percentage of the current loan balance from 0.46% as of June 30, 2006 to 0.63% as of September 30, 2006. This increase in delinquencies is in line with expectations as our loan portfolio seasons and the current balance decreases.

Table 5 Real Estate Securities — Interest Income and Yield
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income	\$ 54,920	\$ 37,291	\$ 145,338	\$ 98,619
Net discount amortization income	17,839	11,520	44,318	28,476
Total interest income	\$ 72,759	\$ 48,811	\$ 189,656	\$ 127,095
Average earning assets	\$ 2,697,903	\$ 2,305,361	\$ 2,530,248	\$ 2,123,067
Yield as a result of:				
Interest income	8.15%	6.47%	7.65%	6.19%
Net discount amortization income	2.64%	2.00%	2.34%	1.79%
Total	10.79%	8.47%	9.99%	7.98%

Interest income recognized from our real estate securities increased in the third quarter and first nine months of 2006 as compared to the third quarter and first nine months of 2005 due to growth in our portfolio over the past year and increased yields. Portfolio growth reflected our ability to find new assets at a pace in excess of our sales, calls, and principal prepayments. Yields increased for a variety of reasons, including continued rising short-term interest rates, strong credit performance and fast prepayments.

During the course of preparing the financial statements for the period ended June 30, 2006, we discovered two errors and under the provisions of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB Opinion No. 20 and FASB Statement No. 3 (FAS 154), we analyzed the errors for each period affected. The accrual rate for interest income on certain securities and interest expense on certain ABS issued had been incorrectly applied and not correctly adjusted. The impact of this error was that on a cumulative basis we had overstated interest income by \$1.3 million and understated interest expense by \$0.2 million. Additionally, due diligence expenses for certain securities purchased had been incorrectly capitalized and amortized. The impact of this error was that on a cumulative basis we had understated operating expenses by \$0.6 million and overstated mortgages securities on the Consolidated Balance Sheets.

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After assessing the effect of these errors on previously reported earnings and the effect of recording a total cumulative correcting adjustment of \$2.1 million in the second quarter of 2006, we determined that the errors were not material to the financial statements for the six months ended June 30, 2006 and the year ended December 31, 2006. Accordingly, cumulative correcting adjustments for these errors were recorded in the second quarter of 2006.

The tables below present the income and yields of the components of our securities portfolio: residential CES, commercial first-loss CES, and other securities.

Table 5a Residential Credit-Enhancement Securities — Interest Income and Yield
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income	\$ 19,259	\$ 13,175	\$ 50,891	\$ 35,736
Net discount amortization income	16,616	11,193	42,181	27,695
Total interest income	\$ 35,875	\$ 24,368	\$ 93,072	\$ 63,431
Average earning assets	\$ 669,181	\$ 585,663	\$ 613,538	\$ 543,516
Yield as a result of:				
Interest income	11.52%	9.00%	11.06%	8.77%
Net discount amortization income	9.93%	7.64%	9.17%	6.79%
Total	21.45%	16.64%	20.23%	15.56%

Interest income recognized from residential CES increased due to growth in our portfolio over the past year and increased yields. Portfolio growth reflected our ability to find new assets at a pace in excess of our sales, calls, and principal prepayments. Yields increased as the securities within our portfolio are beginning to season and benefit from continued strong credit performance and fast prepayment rates.

Table 5b Commercial First-Loss Credit-Enhancement Securities — Interest Income and Yield
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income	\$ 3,807	\$ 1,355	\$ 8,810	\$ 3,347
Net premium amortization expense	(1,670)	(902)	(4,037)	(1,657)
Total interest income	\$ 2,137	\$ 453	\$ 4,773	\$ 1,690
Average earning assets	\$ 88,681	\$ 32,192	\$ 70,340	\$ 25,558
Yield as a result of:				
Interest income	17.17%	16.84%	16.70%	17.46%
Net premium amortization expense	(7.53)%	(11.21)%	(7.65)%	(8.64)%
Total	9.64%	5.63%	9.05%	8.82%

Interest income recognized from commercial first-loss CES increased due to the growth in this portfolio and higher yields on these securities. Our commercial portfolio is performing well; the fundamentals of the commercial real estate business are strong.

Table 5c Other Securities — Interest Income and Yield
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest income	\$ 31,854	\$ 22,761	\$ 85,637	\$ 59,536
Net discount amortization income	2,893	1,229	6,174	2,438
Total interest income	\$ 34,747	\$ 23,990	\$ 91,811	\$ 61,974
Average earning assets	\$ 1,940,041	\$ 1,687,506	\$ 1,846,370	\$ 1,553,993
Yield as a result of:				
Interest income	6.56%	5.40%	6.18%	5.11%
Net discount amortization expense	0.60%	0.29%	0.45%	0.21%
Total	7.16%	5.69%	6.63%	5.32%

Total interest income increased for the securities portfolio as the total size of the portfolio grew and as yields increased. Yields increased primarily as the coupon rates on adjustable-rate loan securities (which comprise over half of the portfolio) adjusted upward with the increase in short-term interest rates.

Interest Expense

Interest expense consists of interest payments on Redwood debt and consolidated ABS issued from sponsored securitization entities, plus amortization of deferred ABS issuance costs and expenses related to certain interest rate agreements less the amortization of ABS issuance premiums. ABS issuance premiums are created when interest-only (IO) securities and other ABS are issued at prices greater than principal value.

Table 6 Total Interest Expense
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest expense on Redwood debt	\$ 9,422	\$ 3,789	\$ 13,316	\$ 8,272
Interest expense on ABS	165,251	192,802	515,531	559,341
Total interest expense	\$ 174,673	\$ 196,591	\$ 528,847	\$ 567,613
Average Redwood debt balance	\$ 647,978	\$ 297,788	\$ 292,129	\$ 264,024
Average ABS issued balance	11,684,412	19,542,413	13,094,871	21,630,747
Average total obligations	\$ 12,332,390	\$ 19,840,201	\$ 13,387,000	\$ 21,894,771
Cost of funds of Redwood debt	5.82%	5.09%	6.08%	4.18%
Cost of funds of ABS issued	5.66%	3.95%	5.25%	3.45%
Cost of funds of total obligations	5.67%	3.96%	5.27%	3.46%

Total consolidated interest expense decreased in the 2006 periods from the 2005 periods as a result of a significant decline in consolidated ABS issued as a result of rapid prepayments of securitized loans. Offsetting a portion of the decline in balances was the higher cost of funds due to an increase in short-term interest rates as most of our debt and consolidated ABS issued is indexed to one-, three-, or six-month LIBOR. These factors are illustrated in the table below.

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During the course of preparing the financial statements for the period ended September 30, 2006 we discovered an error in the valuation of certain interest rate agreements for the purpose of measuring the amount of hedge ineffectiveness under FAS 133. Under the provisions of Statement of Financial Accounting Standards No. 154, Accounting Changes and Error Corrections, a replacement of APB

Opinion No. 20 and FASB Statement No. 3 (FAS 154), we analyzed the errors for each period affected. The impact of this error was that on a cumulative basis we had understated interest expense (negative ineffectiveness) by \$1.0 million and overstated other comprehensive income by \$1.0 million.

After carefully assessing the effect of this error on previously reported earnings and the effect of recording a total cumulative correcting adjustment in the third quarter of 2006, we determined that the errors were not material to the financial statements for the nine-months ended September 30, 2006 and the year ended December 31, 2006. Accordingly, a cumulative correcting adjustment for this error was recorded in the third quarter of 2006.

Table 7 Volume and Rate Changes for Interest Expense

(In thousands)

	Change in Interest Expense Three Months Ended September 30, 2006 vs. September 30, 2005			Change in Interest Expense Nine Months Ended September 30, 2006 vs. September 30, 2005		
	Volume	Rate	Total Change	Volume	Rate	Total Change
Interest expense on Redwood debt	\$ 4,456	\$ 1,177	\$ 5,633	\$ 881	\$ 4,163	\$ 5,044
Interest expense on ABS	(77,526)	49,975	(27,551)	(220,726)	176,916	(43,810)
Total interest expense	<u>\$ (73,070)</u>	<u>\$ 51,152</u>	<u>\$ (21,918)</u>	<u>\$ (219,845)</u>	<u>\$ 181,079</u>	<u>\$ (38,766)</u>

Volume change is the change in average balance of obligations between periods multiplied by the rate paid in the earlier period. Rate change is the change in rate between periods multiplied by the average outstanding obligations in the current period. Interest expense changes that resulted from changes in both rate and volume were allocated to the rate change amounts shown in the table.

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The table below presents the different components of our interest costs on ABS issued for the three and nine months ended September 30, 2006 and 2005.

Table 8 Cost of Funds of Asset-Backed Securities Issued
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
ABS interest expense	\$ 165,177	\$ 190,996	\$ 515,018	\$ 556,108
ABS issuance expense amortization	5,786	5,162	17,772	15,821
Net ABS interest rate agreement expense (income)	(3,317)	(623)	(9,975)	(2,968)
Net ABS issuance premium amortization (income) on ABS issue	(2,395)	(2,733)	(7,284)	(9,620)
Total ABS interest expense	\$ 165,251	\$ 192,802	\$ 515,531	\$ 559,341
Average balance of ABS	\$ 11,684,412	\$ 19,542,413	\$ 13,094,871	\$ 21,630,747
ABS interest expense	5.65%	3.91%	5.24%	3.43%
ABS issuance expense amortization	0.20%	0.11%	0.18%	0.10%
Net ABS interest rate agreement expense (income)	(0.11)%	(0.01)%	(0.10)%	(0.02)%
Net ABS issuance premium amortization (income) on ABS issued	(0.08)%	(0.06)%	(0.07)%	(0.06)%
Cost of funds of ABS	5.66%	3.95%	5.25%	3.45%

Operating Expenses

Total operating expenses increased by 9% in the third quarter of 2006 as compared to the third quarter of 2005 and by 18% from the first nine months of 2005 to the first nine months of 2006.

Table 9 Operating Expenses
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2006	2005	2006
Components of total operating expense:				
Fixed compensation expense	\$ 3,437	\$ 2,802	\$ 10,183	\$ 8,203
Variable compensation expense	5,209	4,241	14,308	13,980
Systems	1,954	1,612	5,498	4,037
Due diligence	384	1,075	3,503	1,949
Office costs	1,021	900	3,223	2,693
Accounting and legal	626	929	2,903	2,739
Other	824	805	2,456	2,017
Total operating expenses	\$ 13,455	\$ 12,364	\$ 42,074	\$ 35,618

Generally, operating expenses increased as we added personnel, systems and additional internal controls to lay the foundation for future growth. We have expanded our product lines and made significant investments in further developing our business processes and information technologies. Our efforts to build for future growth are ongoing and we expect that our operating expenses will continue to increase.

Fixed compensation expense includes employee salaries and related employee benefits. Fixed compensation expense has increased in 2006 as compared to 2005 due to increased staffing levels. Our headcount increased from 76 at September 30, 2005 to 89 at September 30, 2006. Variable compensa-

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tion expense includes employee bonuses (which are generally based on the adjusted return on equity earned by Redwood and, to a lesser degree, on individual performance) and the expense of equity awards granted to employees and directors.

Due diligence expenses are costs for services related to re-underwriting and analyzing the loans we acquire or the loans we credit-enhance through the purchase of securities. These costs fluctuate from period to period, depending on the level of asset acquisitions and other factors. Our office costs, fees, and other costs have increased as a result of increases in the scale of our operations.

Net Recognized Gains (Losses) and Valuation Adjustments

The reduction in net recognized gains and valuation adjustments for 2006 compared to 2005 is primarily due to lower gains on sales and calls of residential securities. In addition, market values of interest rate agreements have fluctuated, and we are not always able to mark-to-market all of the associated assets or liabilities. We expect increasing volatility in mark-to-market income and expenses in the future for a variety of reasons, including expected increases in residential whole loans purchase commitments, interest rate agreements not accounted for as cash flow hedges, securities accounted for as "trading", calls of Sequoia transactions that may accelerate market value losses relative to our basis in the underlying loans, and EITF 99-20 write-downs as assets come under stress due to the housing market recession. As a result of the timing of call dates, we are not expecting to realize significant amounts of call income from our residential credit-enhancement securities during 2007.

The table below provides a detail of the net recognized gains (losses) and valuation adjustments for the three and nine months ended September 30, 2006 and 2005.

Table 10 Net Recognized Gains and Valuation Adjustments
(In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Realized gains on calls:				
Real estate securities	\$ 723	\$ 2,914	\$ 1,470	\$ 14,883
Realized gains (losses) on sales:				
Real estate loans	—	(201)	(14)	808
Real estate securities	4,967	23,254	8,067	31,108
Valuation adjustments — impairment:				
Real estate securities	(484)	(1,158)	(6,015)	(3,259)
Gains (losses) on interest rate agreements	(8,475)	107	982	(567)
Purchase commitments	3,702	—	66	—
Net recognized gains and valuation adjustments	<u>\$ 433</u>	<u>\$ 24,916</u>	<u>\$ 4,556</u>	<u>\$ 42,973</u>

The decrease in net recognized gains and valuations adjustments in the 2006 periods as compared to the 2005 periods is primarily due to lower gains on sales and calls of residential securities. Furthermore, during 2006, a portion of the recognized gains recognized were offset by the losses in derivative instruments we had entered into to manage some of the risks associated with our purchase commitments and certain securities.

Other Comprehensive Income

Our real estate securities are accounted for as AFS and are reported on our Consolidated Balance Sheets at fair market value. Many of our derivative instruments are accounted for as cash flow hedges and are reported on our Consolidated Balance Sheets at fair market value. The differences between the value of these assets and our amortized cost bases are shown as a component of Stockholders' Equity as Accumulated Other Comprehensive Income. Periodic changes in the value of these assets are included in Other Comprehensive Income.

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There are a number of factors that affect the fair value of our assets. For certain securities and derivative instruments, changes in interest rates can have an impact on the current value. As a result of changes in market conditions (including a decrease in longer term rates) during the third quarter of 2006, the change in the value of our assets on AFS securities reported as Other Comprehensive Income increased by \$31 million and the change in value of derivative instruments reported through Other Comprehensive Income decreased by \$28 million.

Taxes

Provisions for Income Taxes

As a REIT, we are able to pass through substantially all of our earnings at the REIT level to stockholders without paying federal income tax at the corporate level. We pay income tax on the REIT taxable income we retain and the income we earn at our taxable subsidiaries. We provide for income taxes for GAAP purposes based on our estimates of our taxable income, the amount of taxable income we plan to permanently retain, and the taxable income we estimate was earned at our taxable subsidiaries. A portion of our income tax provision is based on current tax provisions and another portion may include changes in our deferred taxes arising from timing differences between our GAAP and taxable income recognition.

Our income tax provision in the third quarter of 2006 was \$3.5 million, a decrease from the \$4.7 million income tax provision taken in the third quarter of 2005. For the first nine months of 2006, our income tax provision was \$9.6 million, a decrease from the \$13.4 million income tax provision taken in the first nine months of 2005. Our provision for income taxes decreased for the three and nine months ending September 30, 2006 as compared to similar periods of 2005 generally due to an overall decline in earnings we are retaining at the REIT and a decline in earnings at our taxable REIT subsidiaries.

Taxable Income and Dividends

Total taxable income is not a measure calculated in accordance with GAAP. It is the pre-tax income calculated for tax purposes. Estimated REIT taxable income is an important measure as it is the basis of our dividend distributions to shareholders. REIT taxable income is that portion of our taxable income that we earn in our parent (REIT) company and its REIT subsidiaries. It does not include taxable income earned in taxable subsidiaries.

Taxable income calculations differ from GAAP income calculations in a variety of ways. For us, the most significant differences include the timing of amortization of premium and discounts and the timing of the recognition of gains or losses on assets. The rules for both GAAP and tax accounting for loans and securities are technical and complicated, and the impact of changing interest rates, actual and projected prepayment rates, and actual and projected credit losses can have a very different impact on the amount of GAAP and tax income recognized in any one period. See further discussion under Potential Tax Earnings Volatility.

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The table below reconciles GAAP income to total taxable income and REIT taxable income for the three and nine month periods ended September 30, 2006 and 2005.

Table 11 Differences between GAAP Net Income and Total Taxable Income and REIT Taxable Income

(In thousands, except per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
GAAP net income	\$ 32,416	\$ 55,899	\$ 91,841	\$ 157,376
GAAP/tax differences in accounting for:				
Interest income and interest expense	10,589	1,353	32,326	(23,606)
Credit losses	(635)	(1,367)	(4,653)	(3,044)
Operating expenses	2,545	576	3,861	5,033
Gains (losses) and valuation adjustments	1,947	(6,318)	6,165	(1,502)
Provisions for taxes	4,123	5,013	6,685	8,182
Total taxable income (pre-tax)	50,985	55,156	136,225	142,439
Earnings from taxable subsidiaries	(5,234)	(8,038)	(10,052)	(10,923)
REIT taxable income (pre-tax)	\$ 45,751	\$ 47,118	\$ 126,173	\$ 131,516
GAAP net income per share	\$ 1.22	\$ 2.21	\$ 3.51	\$ 6.26
Total taxable income per share	\$ 1.95	\$ 2.23	\$ 5.29	\$ 5.78
REIT taxable income per share	\$ 1.76	\$ 1.90	\$ 4.90	\$ 5.33

Total taxable income per share and REIT taxable income per share are measured as the estimated pretax total taxable income and REIT taxable income, respectively, earned in a calendar quarter divided by the number of shares outstanding at the end of each quarter. Total taxable income per share and REIT taxable income per share for the first nine months are the sum of the first three quarters' total taxable income per share and REIT taxable income per share, respectively.

Based on our 2005 REIT taxable income and the first nine months of 2006 estimated REIT taxable income, we estimate we had \$111 million of undistributed REIT taxable income at September 30, 2006. We plan to distribute the bulk of this income as dividends to our stockholders during the remainder of 2006 and through September 2007 as we continue to meet our REIT dividend distribution requirements.

Potential GAAP Earnings Volatility

Going forward, we expect quarter-to-quarter GAAP earnings volatility for a variety of reasons, including the timing of sales and calls of assets, changes in interest rates, prepayments, credit losses, and capital utilization. In addition, volatility may occur because of technical accounting issues described below.

Loan Premium

Our unamortized loan premium on our consolidated residential loans at September 30, 2006 was \$141 million and will be expensed over the remaining life of these loans. This represents a cost basis of 101.45 on the \$9.8 billion of principal of these loans. For a variety of technical accounting reasons, the premium balance for these loans has not been amortized as quickly as these loans have prepaid, so our reported earnings have been higher than they would have been if, for example, the proportion of total premium amortized equaled the proportion of total principal prepaid on loans, and our accounting cost basis per loan has been increasing over time. Amortization for a significant portion of this premium balance is driven by effective yield calculations that depend on interest rates and prepayments (see Critical Accounting Policies for further details). Loan premium amortization was \$11.2 million and \$35.3 million in the third quarter and first nine months of 2006, respectively. Declines in short-term interest rates could cause a significant increase in required amortization in subsequent quarters.

In addition, a premium amortization adjustment could occur if we reclassify a portion of the underlying loans from held-for-investment to held-for-sale, as the GAAP carrying value of these loans are currently in excess of their fair value and the carrying value may continue to increase. This reclassification could

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occur over time as the various underlying pools of loans become callable and we decide to sell the loans, or it could occur if there is a change in accounting principles.

Real Estate Securities

Currently, all of our real estate securities are classified as available-for-sale (AFS) and are carried on our balance sheet at their estimated fair value. Cumulative unrealized gains and losses are reported as a component of accumulated other comprehensive income in our Consolidated Statements of Stockholders' Equity.

We could experience significant earnings volatility from our real estate securities. Adverse changes to projected cash flows related to poor credit performance or adverse changes to prepayment speeds could create an other-than-temporary impairment and cause any market value losses that have not been reported in income to be expensed through the income statement.

Earnings volatility related to real estate securities may also occur if we changed the GAAP classification for existing securities from AFS to "trading" or if we use "trading" accounting for new securities acquired. Generally, changes in the fair value of "trading" securities are required to flow through our income statement. In the fourth quarter and going forward, we anticipate that certain real estate securities we acquire (those we intend to hold as an investment funded with Redwood debt) will be classified as trading securities.

Derivative Instruments

We could experience significant earnings volatility from our derivative instruments. Currently we have two classifications for derivative instruments; "trading" and cash flow hedges. All derivative instruments, regardless of classification, are reported on the Balance Sheet at fair market value. Changes to the fair value of "trading" derivative instruments are recognized through the Income Statement. To the extent we elect to hedge "trading" securities, we might increase our usage of "trading" derivative instruments. If we elect to classify our derivative instruments as cash flow hedges, we defer the effective portion of the change in fair value of our derivative instruments for Income Statement purposes. If the hedged item and the derivative instrument are not perfectly correlated, we will recognize the difference through the Income Statement.

Potential Tax Earnings Volatility

Total taxable and REIT taxable income may vary from quarter to quarter based on the timing for tax purposes of certain transactions and events or based on the application of technical regulations. This could occur for many reasons, three of which are discussed below.

CES and Loans

We are not permitted for tax purposes to anticipate, or reserve for, credit losses. Taxable income can only be reduced by actual losses. As a consequence, we are required to accrete the entire purchase discount on CES into taxable income over their expected life and cannot take credit loss provisions on loans. For GAAP purposes, we do anticipate credit losses and only accrete a portion of the CES discount into income and we do provide for loan losses. As a result, our income recognition on CES is faster for tax as compared to GAAP, especially in the early years of owning the assets. At September 30, 2006, the cumulative difference between the GAAP and tax bases on our CES was \$87 million. In addition, as of September 30, 2006, we have a credit reserve of \$27 million for GAAP on our residential and commercial loans, and none for tax. As we have no credit reserves for tax and a higher CES basis, any future credit losses on our CES or loans would have a more significant impact on tax earnings as compared to GAAP.

Sequoia Interest-Only certificates (IOs)

For technical tax reasons, at fast prepayment rates we are not permitted to amortize a portion of the cost basis on IOs we have acquired from Sequoia transactions until the underlying securitization is called. For this reason, our taxable income has been higher than it would have been otherwise, and our current tax basis in these IOs is higher than it would have been otherwise. We expect to call a number of

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Sequoia securitization entities over the next two years, at which time the remaining IO basis for tax would be recognized as a capital loss for tax. Capital losses generated will not reduce our ordinary income (or our requirement to distribute ordinary income as dividends). Capital losses would offset current or future capital gains realized from sales or calls of assets, and thus would reduce distributions of capital gains. Our taxable earnings will vary from quarter to quarter based on the exact timing of these Sequoia calls.

Compensation

Compensation expense for tax will vary depending on the timing of DER payments, the exercise of stock options, the distribution of DSUs, and withdrawals of deferred compensation.

Cash Requirements, Sources of Cash, and Liquidity

We use cash to fund our operating and securitization activities, invest in earning assets, service and repay Redwood debt, fund working capital, and fund our dividend distributions.

One primary source of cash is principal and interest payments received on a monthly basis from real estate loans and securities. Other sources of cash include proceeds from sales of assets to securitizations entities, proceeds from sales of other assets, proceeds from calls, borrowings, and issuance of common stock.

At September 30, 2006, Redwood had \$0.5 billion of debt. Redwood debt includes repurchase agreements, bank borrowings, collateralized short-term borrowings, and a non-secured line of credit. We may also issue secured commercial paper or unsecured debt. We currently use Redwood debt to finance the accumulation of assets for future sale to securitization entities. We also intend to use Redwood debt to finance the purchase of high-quality, relatively liquid securities and loans that we intend to hold on an ongoing basis to earn net interest income. For this reason, we expect Redwood debt to increase materially.

At September 30, 2006, we had \$1.0 billion of equity capital. We expect to seek to raise additional capital in 2007.

At September 30, 2006, we consolidated as liabilities on our balance sheet \$12 billion of ABS issued by securitization entities. It is unclear whether this balance will grow — we expect to acquire loans and securities and fund them through securitization but we also expect to call Sequoia and Acacia transactions at an increasing pace.

Cash flows generated and used within consolidated ABS securitization entities are not directly available to Redwood, although they are shown on our Consolidated Statement of Cash Flows. Assets consolidated from these entities are not Redwood's assets and the ABS issued by these entities are not obligations of Redwood Trust.

We have acquired credit-enhancement securities, IOs, and CDO equity securities from these securitization entities. Our investment returns on these assets depends on their contractual rights to receive distributions of principal and interest from these securitization entities, which in turn depends on the credit performance of securitization entity's assets and other factors. In addition, we own the call rights for many of these entities, generally allowing us (when certain time, prepayment, and/or performance targets have been met) if we choose to do so to pay off the ABS liabilities of these entities and to acquire their assets.

Contractual Obligations and Commitments

The table below presents our contractual obligations and commitments as of September 30, 2006, as well as the consolidated obligations of the securitization entities that we sponsored and are consolidated on our balance sheets. The operating leases are commitments that are expensed based on the terms of the related contracts.

Table 12 Contractual Obligations and Commitments as of September 30, 2006
(In thousands)

	Payments Due or Commitment Expiration by Period			
	Total	Less Than 1 Year	1 to 5 Years	After 5 Years
Redwood Obligations:				
Redwood debt	\$ 509,994	\$ 509,994	\$ —	\$ —
Accrued interest payable	501	501	—	—
Operating leases	17,151	1,382	6,733	9,036
Purchase commitments	93,250	93,250	—	—
Total Redwood obligations and commitments	<u>\$ 620,896</u>	<u>\$ 605,127</u>	<u>\$ 6,733</u>	<u>\$ 9,036</u>
Obligations of Securitization Entities:				
Consolidated asset-backed securities	\$ 11,554,259	\$ —	\$ —	\$ 11,554,259
Accrued interest payable	50,803	50,803	—	—
Total obligations of securitization entities	<u>\$ 11,605,062</u>	<u>\$ 50,803</u>	<u>\$ —</u>	<u>\$ 11,554,259</u>
Total consolidated obligations and commitments	<u>\$ 12,225,958</u>	<u>\$ 655,930</u>	<u>\$ 6,733</u>	<u>\$ 11,563,295</u>

Note: All consolidated ABS issued are collateralized by associated assets and, although the stated maturity is as shown, the ABS obligations will pay down as the principal of the associated real estate loans or securities pay down.

MARKET RISKS

We seek to manage the risks inherent in our business — including but not limited to credit risk, interest rate risk, prepayment risk, and market value risk — in a prudent manner designed to ensure Redwood's longevity. At the same time, we endeavor, to the best of our ability, to provide our stockholders with both a steady regular dividend and an attractive long-term return. In general, we seek to assume risks that can be quantified from historical experience, to actively manage such risks, to earn sufficient compensation to justify the taking of such risks, and to maintain capital levels consistent with the risks we do take.

Credit Risk

Integral to our core business is assuming the credit risk of real estate loans.

We assume credit risk with respect to real estate loans primarily through the ownership of residential and commercial real estate loans and securities. Much of our capital base is employed in owning credit-enhancement securities that have below investment-grade credit ratings due to their concentrated credit risks with respect to underlying real estate loans. Many of the loans underlying these securities are above-average in credit quality as compared to U.S. real estate loans in general, but the balance and percentage of loans with special risk factors (higher risk commercial loans, interest-only and negative amortization residential loan types, Alt-A and sub-prime residential loan quality) has been and will continue to increase. Credit losses from any of the loans in the securitized loan pools reduce the principal value of and economic returns from these lower-rated securities. We also own a wide variety of residential and commercial unsecuritized real estate loans of various quality grades — credit risks are not as concentrated in loans as they are in credit-enhancement securities, but the risks are real nevertheless. Credit losses on real estate loans can occur for many reasons. Losses rates on real

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estate loans are cyclical, and can also vary for reasons not related to the general economy. Historical experience is not always a good guide to future loan losses.

We also own investment-grade real estate securities backed by loans of various quality grades. These securities benefit from some credit protections, but if losses to the underlying loans are high enough, they could suffer credit rating downgrades, market value declines, or principal value losses.

Interest Rate Risk

Interest rates can affect the cash flows and market values of our assets, liabilities, and interest rate agreements, and thus affect our earnings and reported book value. Our general strategy with respect to interest rates is to maintain an asset/liability posture (including hedges) on a consolidated basis that assumes some interest rate risks but not to the degree that the achievement of our long-term goals would likely be affected by changes in interest rates. We are willing to accept short-term volatility of earnings and book value while seeking to achieve more attractive long-term returns.

Prepayment Risk

We seek to maintain an asset/liability posture that benefits from investments in prepayment-sensitive assets while limiting the risk of adverse prepayment fluctuations to an amount that, in most circumstances, can be absorbed by our capital base while still allowing us to make regular dividend payments. Prepayment rates are difficult to predict or anticipate, and variations in prepayment rates can materially affect our earnings and dividends in many ways. We do not believe it is possible or desirable to control these effects in the short-term. Thus our general approach is to seek to balance overall characteristics of our balance sheet so that the net present value of cash flows generated over long periods of time does not have unattractive volatility with respect to prepayment rate changes.

Market Value Risk

Most of our consolidated real estate assets are loans accounted for as held-for-investment and reported at cost. Most of these loans have been sold to Sequoia entities and, thus, changes in the market value of the loans do not have an impact on our liquidity in the long term. However, changes in market value during the accumulation period (while these loans are funded with debt) may have a short-term effect on our liquidity.

At September 30, 2006, we reported on a consolidated basis \$2.9 billion of assets that were marked-to-market through our balance sheet (i.e., available-for-sale securities) but not through our income statement. Some of these assets are credit-sensitive, and all are interest-rate sensitive. Market value fluctuations of these assets can affect the balance of our stockholders' equity base. Market value fluctuations for our securities can affect not only our earnings and book value, but also our liquidity, especially to the extent these assets are funded with short-term debt (generally prior to securitization).

Our consolidated obligations consist primarily of ABS issued. These are reported at cost, and changes in market value in these ABS have no impact on our liquidity. However, because many of our consolidated assets are funded with these ABS issued are reported at market value, the resulting reported net equity value may not necessarily reflect the true market value of our equity investments in these securitization entities.

Inflation Risk

Virtually all of our consolidated assets and liabilities are financial in nature. As a result, changes in interest rates and other factors drive our performance far more than does inflation. Changes in interest rates do not necessarily correlate with inflation rates or changes in inflation rates.

Our financial statements are prepared in accordance with GAAP. Our activities and balance sheet are measured with reference to historical cost or fair market value without considering inflation.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in conformity with GAAP requires us to make estimates and assumptions that affect the reported amounts of certain assets and liabilities at the date of the

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consolidated financial statements and the reported amounts of certain revenues and expenses during the reported period. Actual results could differ from those estimates. The critical accounting policies and the possible effect of changes in estimates on our financial results and statements are discussed below. Management discusses the ongoing development and selection of these critical accounting policies with the Audit Committee of the Board of Directors.

Revenue Recognition

When recognizing revenue on consolidated earning assets, we employ the interest method and determine an effective yield to account for purchase premiums, discounts, and other net capitalized fees and costs associated with purchasing and financing real estate loans and securities.

Loan Premium Amortization

For consolidated real estate loans, the interest method is applied as prescribed under FAS 91. For loans acquired prior to July 2004, we assume future prepayments on a pool basis and apply the current interest rate to determine the effective yield for each pool of loans. During a period of rising short-term rates, the coupon is projected to increase and results in a higher effective yield. Prior to the coupon rate resetting, (generally one to six months for these loans), the amount of amortization is lower than it will be once the coupon rate resets. Thus, for the past two years, as short-term rates increased every quarter, the amount of purchase premium we amortized was less than it would have been in a flat interest rate environment and as a result, our cost basis increased on our remaining loans. The cost basis in these loans continues to exceed the estimated fair market value.

For loans acquired after July 1, 2004, we use the initial coupon interest rate of the loans (without regard to future changes in the underlying indices) and anticipated principal payments on a pool basis to calculate an effective yield and to amortize the premium or discount. Any volatility in amortization expense is dependent only on prepayments. The cost basis of these loans is approximately equal to market value.

For our consolidated securities, the interest method to determine an effective yield is applied as prescribed under FAS 91 or EITF 99-20, using anticipated principal prepayments. The use of these methods requires us to project cash flows over the remaining life of each asset. These projections include assumptions about interest rates, prepayment rates, timing and amount of credit losses, when certain tests will be met that may allow for changes in payments made under the structure of securities, estimates regarding the likelihood and timing of calls of securities at par, and other factors. We review our cash flow projections on an ongoing basis and monitor these projections based on input and analyses received from external sources, internal models, and our own judgment and experience. We constantly review our assumptions and make adjustments to the cash flows as deemed necessary. There can be no assurance that our assumptions used to generate future cash flows, or the current period's yield for each asset, will prove to be accurate.

Under the interest method, decreases in our projected credit loss assumptions could result in increasing yields being recognized from residential and commercial real estate securities in the current period. In addition, faster-than-anticipated prepayment rates on residential loans would also tend to increase realized yields. In contrast, increases in our credit loss assumptions and/ or slower than anticipated prepayment rates could result in lower yields being recognized and an adverse change in cash flows may represent an other-than-temporary impairment under GAAP, in which case the asset may be written down to its fair value through our Consolidated Statements of Income.

Redwood applies APB 21 and APB 12 in determining its periodic amortization for the premium on its debt, including the issuance of IO securities and deferred bond issuance cost (DBIC). We arrive at a periodic interest cost that represents a level effective rate based on projected repayment rates.

Establishing Valuations and Accounting for Changes in Valuations

Changes to the fair value of securities available-for-sale are reported through our Consolidated Balance Sheets as cumulative unrealized gains and losses classified as accumulated other comprehensive income in stockholders' equity. The exception to this treatment is when a specific impairment is

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identified and the resulting decrease in fair value is recorded in net recognized gains (losses) and valuation adjustments on our Consolidated Statements of Income.

We estimate the fair value of assets and interest rate agreements using available market information and other appropriate valuation methodologies. We believe that the estimates we use reflect market values that we may be able to receive should we choose to sell assets. Our estimates are inherently subjective in nature and involve matters of uncertainty and judgment in interpreting relevant market and other data. Many assumptions are necessary to estimate market values, including, but not limited to, interest rates, prepayment rates, amount and timing of credit losses, supply and demand, liquidity, and other market factors. We apply these factors to each of our assets, as appropriate, in order to determine market values.

We review our fair value calculations on an ongoing basis. We monitor the critical performance factors for each of our assets. Our expectations of future performance are shaped by input and analyses received from external sources, internal models, and our own judgment and experience. We review our existing assumptions relative to our and the market's expectations of future events and make adjustments to the assumptions that may change our market values. Changes in perceptions regarding future events can have a material impact on the value of our assets. Should such changes or other factors result in significant decreases in the market values, our net income and book value could be adversely affected.

In addition to our valuation processes, we are active acquirers, issuer of debt securities, and occasional sellers of assets. Thus, we believe that we have the ability to understand and determine changes in assumptions that are taking place in the marketplace and make appropriate changes in our assumptions for valuing assets. In addition, we use third party sources to validate our valuation estimates.

There are certain other valuation estimates we make that have an impact on current period income. One such area is the valuation of certain equity grants. Under FAS 123R, we estimate the value of options, which is based on a number of assumptions, including forfeitures. Currently, most of our equity awards are restricted stock and deferred stock units and the fair values at grant equal the market value of Redwood's common stock at the date of grant.

Credit Reserves

For consolidated real estate loans held-for-investment, we establish and maintain credit reserves that we believe represent probable credit losses that will result from inherent losses existing in our consolidated real estate loans held-for-investment as of the date of the financial statements. The reserves for credit losses are adjusted by taking provisions for credit losses recorded as a reduction in interest income on real estate loans on our Consolidated Statements of Income. The reserves consist of estimates of specific loan impairment and estimates of collective losses on pools of loans with similar characteristics.

To calculate the credit reserve for credit losses for real estate loans, we determine inherent losses by applying loss factors (default, the timing of defaults, and the loss severity upon default) that can be specifically applied to each pool of loans. The following factors are considered and applied in such determination:

- Ongoing analysis of the pool of loans, including, but not limited to, the age of the loans, underwriting standards, business climate, economic conditions, geographic considerations, and other observable data;
- Historical loss rates and past performance of similar loans;
- Relevant environmental factors;
- Relevant market research and publicly available third-party reference loss rates;
- Trends in delinquencies and charge-offs;
- Effects and changes in credit concentrations;
- Information supporting borrowers' ability to meet obligations;

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- Ongoing analyses of each individual loan — including, but not limited to, the age of loans, underwriting standards, business climate, economic conditions, geographical considerations and other observable data;
- Ongoing evaluation of fair values of collateral using current appraisals and other valuations; and,
- Discounted cash flow analyses.

Once we determine the applicable default rate, the timing of defaults, and the severity of loss upon the default, we estimate the expected losses of each pool of loans over their expected lives. We then estimate the timing of these losses and the losses probable to occur over an effective loss confirmation period. This period is defined as the range of time between the probable occurrence of a credit loss (such as the initial deterioration of the borrower's financial condition) and the confirmation of that loss (the actual charge-off of the loan). After further review, we revised and shortened our estimate of this confirmation in the second quarter of 2006. The losses expected to occur within the estimated loss confirmation period are the basis of our credit reserves because we believe those losses exist as of the reported date of the financial statements. We re-evaluate the level of our credit reserves on at least a quarterly basis and record provision, charge-offs, and recoveries monthly.

If a loan becomes REO or becomes impaired, or loans are reclassified as held-for-sale, specific valuations are primarily based on analyses of the underlying collateral.

Certain securities issued by an ABS securitization entity bear most of the initial credit risk of the underlying pool of loans that was securitized. As a result of the relatively high credit risks of these investments, we are able to purchase these securities at a discount to principal (par) value. A portion of the purchase discount is subsequently accreted as interest income under the interest method while the remaining portion of the purchase discount is considered as a form of credit protection. The amount of credit protection is based upon our assessment of various factors affecting our assets, including economic conditions, characteristics of the underlying loans, delinquency status, past performance of similar loans, and external credit protection. We use a variety of internal and external credit risk analyses, cash flow modeling, and portfolio analytical tools to assist us in our assessments. If cumulative credit losses in the underlying pool of loans exceed the principal value of the first-loss piece, we may never receive a principal payment from that security. The maximum loss for the owner of these securities, however, is limited to the investment made in purchasing these securities. In addition to the amount of losses, the timing of future credit losses is also important. In general, the longer credit losses are delayed, the better our economic returns, as we continue to earn coupon interest on the face value of our security.

Accounting for Derivative Instruments

We use derivative instruments to manage certain risks such as market value risk and interest rate risk. The derivative instruments we employ include, but are not limited to, interest rate swaps, interest rate options, options on swaps, futures contracts, options on futures contracts, options on forward purchases, and other similar derivatives. We collectively refer to these derivative instruments as "interest rate agreements."

On the date an interest rate agreement is entered into, we designate each interest rate agreement under GAAP as (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment (fair value hedge), (2) a hedge of a forecasted transaction or of the variability of cash flows to be received or paid related to a recognized asset or liability (cash flow hedge), or (3) held for trading (trading instrument).

We currently elect to account for most of our interest rate agreements as cash flow hedges. We record these derivatives at their estimated fair market values, and record changes in their fair values in accumulated other comprehensive income on our Consolidated Balance Sheets. These amounts are reclassified to our Consolidated Statements of Income over the effective hedge period as the hedged item affects earnings. Any ineffective portions of these cash flow hedges and are included in our Consolidated Statements of Income.

The remainder of our interest rate agreements are currently accounted for as trading investments. We record these derivatives at their estimated fair values with any changes in the fair values recorded in our Consolidated Statements of Income.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Discussions about our quantitative and qualitative disclosures about market risk are included in our Management's Discussion and Analysis included herein.

Item 4. Controls and Procedures

We have carried out an evaluation, under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures, as that term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended. Based on that evaluation, our principal executive officer and principal financial officer concluded that as of September 30, 2006, which is the end of the period covered by this Form 10-Q, our disclosure controls and procedures are effective.

There has been no change in Redwood's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rule 13a-15 that occurred during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, Redwood's internal control over financial reporting.

PART II. OTHER INFORMATION**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

Period	Issuer Purchases of Equity Securities			Maximum Number of Shares Available for Purchase Under Publicly Announced Programs
	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Programs	
July 1 - July 31, 2006	—	—	—	—
August 1 - August 31, 2006	—	—	—	—
September 1 - September 30, 2006	—	—	—	—
Total	—	—	—	1,000,000

No shares were purchased for the three months ended September 30, 2006. The Company announced stock repurchase plans on various dates from September 1997 through November 1999 for the total repurchase of 7,455,000 shares. None of these plans have expiration dates on repurchases. Shares totaling 1,000,000 are currently available for repurchase under those plans.

Item 6. Exhibits

Exhibit 10.1	Office building lease, second floor, dated July 31, 2006
Exhibit 10.2	Office building sublease, second floor, dated July 31, 2006
Exhibit 10.3	Second amendment to office building lease, third floor, dated July 31, 2006
Exhibit 31.1	Certificate of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 31.2	Certificate of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (filed herewith).
Exhibit 32.1	Certificate of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
Exhibit 32.2	Certificate of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

REDWOOD TRUST, INC.

Dated: November 1, 2006

By: /s/ Douglas B. Hansen

Douglas B. Hansen
President

(authorized officer of registrant)

Dated: November 1, 2006

By: /s/ Martin S. Hughes

Martin S. Hughes
Vice President, Chief Financial Officer,
Treasurer, and Secretary
(principal financial officer)

Dated: November 1, 2006

By: /s/ Raymond S. Jackson

Raymond S. Jackson
Vice President and Controller
(principal accounting officer)

BELVEDERE PLACE
DATED AS OF JULY 31st, 2006

BETWEEN

BENTLY HOLDINGS CALIFORNIA LP,

AS LANDLORD,

AND

REDWOOD TRUST, INC.

AS TENANT

BELVEDERE PLACE
BASIC LEASE INFORMATION

1. Date: July 31st ,2006
2. Landlord: Bently Holdings California LP
3. Tenant: Redwood Trust, Inc., a Maryland corporation
4. Property: The real property legally described on Exhibit A attached hereto
5. Project: The Property, together with the buildings known as One and Two Belvedere Place and all other improvements located thereon, commonly known as the Belvedere Place Office Center containing approximately 103,598 rentable square feet
6. Building: That certain office building located within the Project located at One Belvedere Place, Mill Valley, California containing approximately 43,258 rentable square feet
7. Premises: Subject to Section 1(b) of the Lease, approximately 21,887 rentable square feet located on the second floor of the Building, as outlined on the floor plan attached hereto as Exhibit B
8. Load Factor: 1.23 (23%)
9. Initial Term: Ten (10) years and five (5) months
10. Estimated Delivery Date: N/A
11. Outside Delivery Date: N/A
12. Commencement Date : January 1, 2008
13. Expiration Date: May 31, 2018, as the same may be extended pursuant to the provisions of Section 40 of the Lease.
14. Initial Basic Rental Rate: \$79,012.00/month
15. Fair Market Rental Value: The rental rate per rentable square foot per month (taking into account additional rent and all other monetary payments and considering any base year or expense stop applicable thereto), including all escalations, for all leases for comparable, unencumbered

space for approximately the same lease term, executed at the Project and/or any other comparable Class A building in terms of size, quality, level of services, amenities, age and appearance located within the Southern Marin County area from the northern border of Corte Madera and Larkspur south to the Golden Gate Bridge (collectively, “Comparable Buildings”), during the twelve (12) month period immediately preceding the date upon which the determination of Fair Market Rental Value is made, and having a commencement date within six (6) months of the date that the Fair Market Rental Value will commence under this Lease, and taking into account any free rent, tenant improvements, tenant improvement allowances, moving allowances and other concessions granted to tenants under leases of such comparable space in Comparable Buildings and the value, if any, of the existing tenant improvements (with such value being judged with respect to the utility of such existing tenant improvements to the general business office user and not this particular Tenant), provided that the Fair Market Rental Value shall not include consideration of the value of any Tenant Improvements made to the Premises by Tenant under Section 30 below costing in excess of the Tenant Improvement Allowance or the value of any Alterations to the Premises made at the expense of Tenant. The Fair Market Rental Value shall be determined in accordance with the terms and provisions of this Lease below.

- 16. Security Deposit: \$79,012.00
- 17. Base Year: 2008
- 18. Tenant’s Proportionate Share: The ratio which the rentable area of the Premises bears to the rentable area of the entire Project, which, subject to Section 1(b) of the Lease, is agreed to be 21%.
- 19. Tenant Improvement Allowance: Subject to Section 1(b) of the Lease, \$35.00 per rentable square foot multiplied by 21,887 rentable square feet = \$766,045.00.
- 20. Space Plan Deadline: N/A
- 21. Working Drawing Deadline: N/A
- 22. Landlord’s Broker: None
- 23. Tenant’s Broker: None

24. Extension Term: Two five (5) year options, in accordance with Section 40 below
25. Guarantor: None

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EXHIBITS

Exhibit A	Legal Description of Property
Exhibit B	Description of Premises
Exhibit C	Notice of Lease Term Dates
Exhibit D	Form of Tenant Estoppel Certificate
Exhibit E	Rules and Regulations
Exhibit F	Base Building Standard Shell Construction Specifications

BELVEDERE PLACE OFFICE LEASE

THIS LEASE is entered into by and between Landlord and Tenant, as specified in the Basic Lease Information, which is incorporated herein by reference, as of the date shown in Paragraph 1 of the Basic Lease Information.

1. PREMISES.

(a) Initial Premises. Landlord hereby leases to Tenant and Tenant hereby leases from Landlord the Premises (as defined in Paragraph 7 of the Basic Lease Information) upon and subject to the terms, covenants and conditions herein set forth. Tenant covenants, as a material part of the consideration for this Lease, to keep and perform each and all of said terms, covenants and conditions for which Tenant is responsible and that this Lease is entered into upon the condition of such performance.

(b) Verification of Usable Square Feet of Premises, Building and Project. For the purposes of this Lease, “usable square feet” for the Premises shall be calculated pursuant to the Standard Method for Measuring Floor Area in Office Buildings, [ANSI Z65.1 — 1996], and “rentable square feet” shall equal (i) the usable square feet contained within the Premises multiplied by (ii) the sum of (x) one (1) plus (y) the Load Factor (as defined in Paragraph 8 of the Basic Lease Information). The usable square feet and rentable square feet of the Premises, Building and the Project are subject to verification by Tenant’s architect within ninety (90) days following the Commencement Date. The usable square feet and rentable square feet of the Premises are subject to verification from time to time by Landlord’s planner/designer only in the event of a change in the boundaries of the Premises and the parties hereby agree that the usable square footage and rentable square footage of the Premises shall be as specified in the Basic Lease Information unless and until (i) there is such a change in the boundaries of the Premises from as shown on Exhibit B attached hereto and/or (ii) Tenant exercises its right to remeasure as provided above. Notwithstanding the foregoing, Landlord shall have the right to verify the usable and rentable square feet in the Premises after completion of the Tenant Improvements. In the event either Landlord or Tenant elects to remeasure as provided herein, Tenant’s architect may consult with Landlord’s planner/designer regarding any such verification (if applicable) as it pertains to the Premises and such verification shall be subject to the approval of Tenant’s architect (which approval shall not be unreasonably withheld, conditioned or delayed), and Landlord’s architect may consult with Tenant’s architect regarding any such verification as it pertains to the Premises and such verification shall be subject to the approval of Landlord’s architect. In the event Landlord’s architect and Tenant’s architect cannot agree on the square footage of the Premises, Landlord and Tenant shall select a mutually acceptable independent architect to measure the Premises in accordance with this Section 1(b) and the decision of such architect shall be binding on Landlord and Tenant. Landlord and Tenant shall equally share the cost of such independent architect. In the event of such a change in the usable and rentable square footage in the Premises as provided herein, all amounts, percentages and figures appearing or referred to in this Lease based upon such incorrect amount (including, without limitation, the amount of rent) shall be modified in accordance with such determination. If such determination is made, it will be confirmed in writing by Landlord to Tenant.

2. **TERM.**

(a) **Initial Term.** Except as otherwise provided herein, the term of this Lease shall be the Initial Term as set forth in Paragraph 9 of the Basic Lease Information, commencing on the Commencement Date, and ending as of the Expiration Date, as set forth in Paragraph 12 and Paragraph 13, respectively, of the Basic Lease Information. The Initial Term, together with any extension term as to which a right has been properly exercised, shall be referred to as the “**Term.**” Notwithstanding anything to the contrary set forth in this Lease, in the event that Landlord has not delivered the Premises to Tenant in the Delivery Condition by the Outside Delivery Date, as set forth in Paragraph 11 of the Basic Lease Information, Tenant shall have the right, at Tenant’s sole option, to elect to terminate this Lease by delivery to Landlord of a notice (the “**Termination Notice**”), which termination shall be effective thirty (30) days after Tenant’s delivery of the Termination Notice to Landlord, unless within such thirty (30) day period Landlord shall deliver the Premises to Tenant in the Delivery Condition. In the event Tenant shall elect to terminate this Lease, Tenant must deliver to Landlord the Termination Notice prior to the date the Premises are delivered to Tenant in the Delivery Condition.

(b) **Confirmation of Lease Term.** When the Commencement Date and the Expiration Date have been ascertained, the parties shall promptly complete and execute a Notice of Lease Term Dates in the form of Exhibit C attached hereto; provided, however, that the failure of the parties to confirm same shall not affect the Commencement Date or otherwise invalidate this Lease.

(c) **Lease Years.** The term “**Lease Year**” when used herein shall mean the twelve months commencing on the Commencement Date and each subsequent period of twelve months; provided, however, that if the Commencement Date does not occur on the first day of the calendar month, the first Lease Year shall mean the twelve months commencing on the first day of the calendar month following the Commencement Date. As provided above, if the Commencement Date does not occur on the first day of the calendar month, the first Lease Year shall include the period, if any, from the Commencement Date to the end of the month in which the Commencement Date occurs.

3. **BASIC RENT.**

(a) **Basic Rent Payments.** Tenant agrees to pay Landlord each calendar month, as base monthly rent, the Basic Rent as set forth in Paragraph 14 of the Basic Lease Information, subject to adjustment pursuant to subsection (b) below. Each monthly installment of Basic Rent shall be payable in advance on the first day of each calendar month during the Term. If the Term commences or ends on a day other than the first day of a calendar month, then the rent for the months in which this Lease commences or ends shall be prorated (and paid at the beginning of each such month) in the proportion that the number of days this Lease is in effect during such month bears to the total number of days in such month, and such partial month’s installment shall be paid no later than the commencement of the subject month except for the first month’s rent which shall be paid no later than the Commencement Date. In addition to the Basic Rent, Tenant agrees to pay as additional rent the amount of additional rent and rent adjustments and other charges required by this Lease. All rent shall be paid to Landlord, without prior demand and without any deduction or offset (except as otherwise provided in this Lease), in lawful

money of the United States of America, at the address of Landlord designated in Section 31 below or to such other person or at such other place as Landlord may from time to time designate in writing. Except as otherwise provided in this Lease, in the event of a remeasurement or adjustment of the area of the Premises, the Basic Rent shall be recalculated using the Basic Rental Rate referenced in Paragraph 14 of the Basic Lease Information.

(b) Adjustment in Basic Rent. The Basic Rent payable by Tenant shall be increased at the end of each twelve (12) month period by an amount to equal one hundred three percent (103%) of the Basic Rent in effect immediately prior to the applicable adjustment date in accordance with the following schedule (subject to modification based on a remeasurement as provided in Section 1(b)):

Months	Monthly Basic Rent
1-12	\$ 79,012.00
13-24	\$ 81,382.36
25-36	\$ 83,823.83
37-48	\$ 86,338.55
49-60	\$ 88,928.70
61-72	\$ 91,596.56
73-84	\$ 94,344.46
85-96	\$ 97,174.79
97-108	\$ 100,090.04
109-120	\$ 103,092.74

(c) Late Charge. If Tenant fails to pay any installment of Basic Rent, additional rent or other charges or otherwise fails to make any other payment for which Tenant is obligated under this Lease within five (5) days after Tenant's receipt of notice that Tenant failed to pay same when due, then Tenant shall pay to Landlord a late charge equal to five percent (5%) of the amount so payable; provided, however, that if Tenant fails to pay any installment of Basic Rent or additional rent when due more than three (3) times in any twelve (12) month period, Landlord shall no longer be required to give Tenant notice before imposing the late charge and Tenant shall pay to Landlord a late charge equal to five percent (5%) of the amount due for any amount not paid within five (5) days after the date due. Tenant acknowledges that late payments will cause Landlord to incur costs not contemplated by this Lease, the exact amount of which costs are extremely difficult and impracticable to calculate. The parties agree that the late charge described above represents a fair and reasonable estimate of the extra costs incurred by Landlord as a result of such late payment. Such late charge shall not be deemed a consent by Landlord to any late payment, nor a waiver of Landlord's right to insist upon timely payments at any time, nor a waiver of any remedies to which Landlord is entitled hereunder. In addition, all amounts payable by Tenant to Landlord hereunder, exclusive of the late change described above, if not paid within five (5) days after such amounts are due, shall bear interest from the due date until paid at the lesser of (i) the rate of ten percent (10%) per annum or (ii) the maximum rate of interest permitted to be collected by the Landlord by law ("**Interest Rate**").

4. **ADDITIONAL RENT.** In addition to the Basic Rent provided in Section 3 of this Lease, Tenant shall pay Tenant's Proportionate Share as specified in Paragraph 18 of the Basic Lease Information, of the increase in (Actual Operating Expenses for each Operating Year over the Base Amount (as such terms are defined below). Tenant's Proportionate Share of the Building may change based on remeasurement or adjustment of the area of the Project or the Premises as described in Section 1(b). In addition, whenever additional space is added to the Premises, Tenant's Proportionate Share of the Project shall increase accordingly.

(a) **Estimated Operating Expenses.** Within ninety (90) days after the close of each Operating Year during the Term following the Base Year, Landlord shall furnish Tenant a written statement of the "**Estimated Operating Expenses**" for the then current Operating Year, and a corresponding calculation of additional rent, which shall be one-twelfth (1/12) of Tenant's Proportionate Share of the amount, if any, by which the Estimated Operating Expenses exceed the Base Amount. Such additional amount shall be added to the monthly installment of Basic Rent payable by Tenant under this Lease for each month during such Operating Year.

(b) **Actual Operating Expenses.** Within ninety (90) days after the close of each Operating Year (including the Base Year) during the Term, Landlord shall deliver to Tenant a written statement setting forth the Actual Operating Expenses during the preceding Operating Year and the amount by which such Actual Operating Expenses exceed the Base Amount (the "Operating Expense Increase"). If Tenant's Proportionate Share of the Operating Expense Increase for any Operating Year exceeds the Estimated Operating Expenses paid by Tenant to Landlord pursuant to Section 4(a) Tenant shall pay the amount of such excess to Landlord as additional rent within thirty (30) days after receipt by Tenant of such statement. If such statement shows Tenant's Proportionate Share of the Operating Expense Increase to be less than the amount paid by Tenant to Landlord pursuant to Section 4(a), then the amount of such overpayment shall be paid by Landlord to Tenant within thirty (30) days following the date of such statement or, at Landlord's option, credited by Landlord to the payment of rent next due. Additionally, promptly following the reassessment of the value of the Project by any such governmental authority subsequent to the leasing and occupancy of a substantial portion of the Project, Landlord shall provide Tenant with a written statement reflecting the adjusted Actual Operating Expenses for the Base Year. If, as a result of Landlord's recalculation of the Actual Operating Expenses for the Base Year Landlord determines that the amount paid by Tenant pursuant to this Section 4 for any Operating Year was less than the amount owed by Tenant for such Operating Year, Tenant shall pay to Landlord the amount of such shortfall within thirty (30) days after the date of Tenant's receipt of such statement, and if, as a result of Landlord's recalculation of the Actual Operating Expenses for the Base Year Landlord determines that amounts paid by Tenant pursuant to this Section 4 for any Operating Year exceeded the amount owed by Tenant for such Operating Year, then the amount of such overpayment shall be paid by Landlord to Tenant within thirty (30) days following the date of such statement or, at Landlord's option, credited by Landlord to the payment of rent next due. Prior to the date that is one (1) year after Tenant's receipt of Landlord's statement of Actual Operating Expenses for any Operating Year, Landlord shall provide Tenant with reasonable access, upon reasonable prior notice and during normal business hours, to inspect and photocopy Landlord's books and records with respect to the Actual Operating Expenses for such Operating Year ("**Tenant's Audit**"), provided: (i) Tenant is not in default under any of the material provisions of the Lease (remaining uncured following the expiration of any applicable period for cure under this Lease),

(ii) Tenant shall pay any amounts owing hereunder when due, (iii) Tenant's Audit is performed by an employee of Tenant or certified, public accountant who is not paid on a contingency fee basis, (iv) Tenant and any Tenant Party (as defined in Section 6(c) hereof) performing Tenant's Audit execute a confidentiality agreement in a form reasonably acceptable to Landlord and Tenant, (v) Tenant's Audit shall be performed at Tenant's sole cost and expense unless otherwise provided herein and (vi) Tenant's Audit shall be completed within such sixty (60) days after Landlord gives Tenant access to its books and records. If, within such sixty (60) day period, Tenant delivers to Landlord the written results of Tenant's Audit which states that Actual Operating Expenses are less than Landlord's determination of Actual Operating Expenses (the "**Discrepancy**"), Landlord shall, promptly after its receipt of the written results of Tenant's Audit either (A) reimburse Tenant for the amount of any overpayment made by Tenant to Landlord pursuant to this Section 4(b) and for Tenant's reasonable out-of-pocket costs and expenses incurred in performing the Tenant's Audit in the event the Discrepancy is greater than five percent (5%) or (B) notify Tenant in writing that Landlord disagrees with the result of Tenant's Audit, in which event the Landlord and Tenant shall submit their respective calculations of the Actual Operating Expenses to a neutral certified public accountant appointed with the consent of both Landlord and Tenant, who shall review the respective determinations of Actual Operating Expenses, and shall make a final determination of the Actual Operating Expenses for the year in question which shall be binding on both Landlord and Tenant, and if such accountant determines that there is a Discrepancy, Landlord, promptly after its receipt of such final determination, shall reimburse Tenant for the amount of any overpayment made by Tenant to Landlord pursuant to this Section 4(b) and for Tenant's reasonable out-of-pocket costs and expenses incurred in performing the Tenant's Audit in the event the Discrepancy is greater than five percent (5%).

(c) Determinations. The determination of Actual Operating Expenses and Estimated Operating Expenses shall be made by Landlord reasonably and in good faith. Any payments pursuant to this Section 4 shall be additional rent payable by Tenant hereunder, and in the event of nonpayment thereof, Landlord shall have the same rights with respect to such nonpayment as it has with respect to any other nonpayment of rent hereunder.

(d) End of Term. If this Lease shall terminate on a day other than the last day of an Operating Year, the amount of any adjustment between Estimated Operating Expenses and Actual Operating Expenses with respect to the Operating Year in which such termination occurs shall be prorated on the basis which the number of days from the commencement of such Operating Year, to and including such termination date, bears to three hundred sixty-five (365); and any amount payable by Landlord to Tenant or Tenant to Landlord with respect to such adjustment shall be payable within thirty (30) days after delivery of the statement of Actual Operating Expenses with respect to such Operating Year.

(e) Definitions. The following terms shall have the respective meanings hereinafter specified:

(1) "**Base Amount**" shall mean an amount equal to the Actual Operating Expenses for the Base Year (as defined in Paragraph 17 of the Basic Lease Information); provided that, if the Project is not ninety-five percent (95%) occupied (with all tenants paying full rent, as contrasted with free rent, half rent and the like) during the entire Base Year, then the

Actual Operating Expenses actually incurred for the Base Year shall be annualized to reflect the Actual Operating Expenses that would have been incurred had the Project been ninety-five percent (95%) occupied (with all tenants paying full rent, as contrasted with free rent, half rent and the like).

(2) **“Operating Year”** shall mean a calendar year commencing January 1 and ending December 31.

(3) **“Operating Expenses”** shall mean all expenses paid or incurred by Landlord for maintaining, owning, operating and repairing the Project (as defined in Paragraph 5 of the Basic Lease Information), including, without limitation, the Building, and the personal property used in conjunction therewith, including, but not limited to expenses incurred or paid for: (i) Property Taxes (as hereinafter defined); (ii) utilities for the Project, including but not limited to electricity, power, gas, steam, oil or other fuel, water, sewer, lighting, heating, air conditioning and ventilating; (iii) permits, licenses and certificates necessary to operate, manage and lease the Project; (iv) insurance Landlord reasonably deems appropriate to carry or is required to carry by any mortgagee under any mortgage encumbering the Project or any portion thereof or interest therein or encumbering any of Landlord’s or the property manager’s personal property used in the operation of the Project; (v) supplies, tools, equipment and materials used in the operation, repair and maintenance of the Project; (vi) accounting, legal, inspection, consulting, concierge and other services; (vii) equipment rental (or installment equipment purchase or equipment financing agreements); (viii) management agreements (including the cost of any management fee actually paid thereunder and the fair rental value of any office space provided thereunder, up to customary and reasonable amounts); (ix) wages, salaries and other compensation and benefits (including the fair value of any parking privileges provided) for all persons (not higher than Project manager) engaged in the operation, maintenance or security of the Project, and employer’s Social Security taxes, unemployment taxes or insurance, and any other taxes which may be levied on such wages, salaries, compensation and benefits (provided that if an employee spends a portion of his or her time on projects other than the Project, then the wages, salaries, compensation and benefits of such employee and taxes thereon pursuant hereto shall be reasonably and equitably prorated); (x) payments under any easement, operating agreement, declaration, restrictive covenant, or instrument pertaining to the sharing of costs in any planned development or similar arrangement; (xi) operation, repair, and maintenance of all systems and equipment and components thereof (including replacement of components); (xii) janitorial service, alarm and security service, window cleaning, trash removal, elevator maintenance, and cleaning of walks, parking facilities and building walls (provided that janitorial service to the premises of other Project occupants shall not be included in Operating Expenses if Tenant separately provides janitorial service to the Premises at Tenant’s cost); (xiii) replacement of wall and floor coverings, ceiling tiles and fixtures in lobbies, corridors, rest rooms and other common or public areas or facilities; (xiv) maintenance and replacement of shrubs, trees, grass, sod and other landscape items, irrigation systems, drainage facilities, fences, curbs, and walkways; (xv) maintenance of parking facilities; (xvi) roof repairs and (xvii) capital expenditures, which capital expenditures shall be amortized for purposes of this Lease over their respective useful lives (together with interest thereon at the rate of 10% per annum), made (A) primarily to reduce Operating Expenses, or (B) to comply with any laws or other governmental requirements (except that Operating Expenses shall specifically exclude work required to correct any non-compliance of the Project with applicable laws or requirements existing as of the

Commencement Date where correction of such noncompliance was then legally required as of the Commencement Date). Notwithstanding the foregoing, Operating Expenses shall not include (a) depreciation, interest and amortization on mortgages or other debt costs or ground lease payments, if any; (b) legal fees in connection with leasing, tenant disputes or enforcement of leases; (c) real estate brokers' leasing commissions; (d) improvements or alterations to tenant spaces or allowances, inducements or other concessions for any tenant; (e) the cost of providing any service directly to and paid directly by, any tenant; (f) costs of any items to the extent Landlord receives reimbursement from insurance proceeds or from a third party (such proceeds to be deducted from Operating Expenses in the year in which received); (g) costs incurred by Landlord in connection with the correction of structural and/or latent defects in the original construction materials or installations for the Building; (h) costs incurred by Landlord to lease space to new tenants or to retain existing tenants including all marketing, advertising and promotional expenditures; (i) costs arising from the presence of Hazardous Materials on or about the Building, the Project or the land not placed on or about the Premises, Project, land or the Building by the Tenant or any Tenant Party; (j) any amount billed separately to another tenant, whether or not the tenant actually pays such amount; (k) the cost of charitable or political contributions; (l) the cost of sculpture, paintings or other objects of art; (m) expenses incurred by Landlord in respect of a development or buildings other than the Project; (n) salaries and benefits of executives and management personnel above the level of the Project manager; (o) increased costs of performance to the extent resulting from the negligence or willful misconduct of Landlord or its agents, employees or contractors; (p) capital expenditures except those capital expenditures made primarily to reduce Operating Expenses (as to which the amortized cost to be included in Operating Expenses in any Operating Year shall be limited to the amount of the actual reduction in Operating Expenses during such Operating Year as a result thereof), or to comply with any laws or other governmental requirements (provided that Operating Expenses shall specifically exclude costs of work required to correct any non-compliance of the Project with applicable laws or requirements existing as of the Commencement Date where correction of such noncompliance was then legally required as of the Commencement Date), which capital expenditures (together with interest thereon at the rate of 10% per annum) shall be amortized for purposes of this Lease over their respective useful lives; (q) rentals for items (except when needed in connection with normal repairs and maintenance of permanent systems) which if purchased, rather than rented, would constitute a capital expenditure which is specifically excluded in (p) above (excluding, however, equipment not affixed to the Building or Project which is used in providing janitorial or similar services); (r) costs incurred by Landlord for the repair of damage to the Building or Project, to the extent that Landlord is or should be reimbursed by insurance proceeds, and costs of all capital repairs, replacements or restorations resulting from a casualty, regardless of whether such repairs are covered by insurance and costs due to repairs resulting from an earthquake or flood to the extent such costs exceed \$25,000; (s) expenses in connection with services or other benefits which are not offered to Tenant or for which Tenant is charged for directly; (t) overhead and profit increment paid to Landlord or to subsidiaries or affiliates of Landlord for goods and/or services in or to the Building and Project to the extent the same exceeds the costs of such goods and/or services rendered by unaffiliated third parties on a competitive basis; (u) Landlord's general corporate overhead and general and administrative expenses; (v) advertising and promotional expenditures, and costs of signs in or on the Project or the Building identifying the owner of the Project or Building or other tenants' signs; (w) costs incurred in connection with upgrading the Building or Project to comply with

life, fire and safety codes, ordinances, statutes or other laws in effect prior to the Commencement Date, including, without limitation, the ADA, including penalties or damages incurred due to such non compliance; (x) tax penalties incurred as a result of Landlord's failure to make payments and/or to file any tax or informational returns when due; (y) costs for which Landlord has been compensated by a management fee, and any management fees in excess of those management fees which are normally and customarily charged by landlords of Comparable Buildings; (z) costs associated with the operation of the business of the partnership or entity which constitutes Landlord as the same are distinguished from the costs of operation of the Building and Project, including partnership accounting and legal matters, costs of defending any lawsuits with or claims by any mortgagee (except as the actions of Tenant may be in issue), costs of selling, syndicating, financing, mortgaging or hypothecating any of Landlord's interest in the Building or Project, costs of any disputes between Landlord and its employees (if any) not engaged in Building or Project operation, disputes of Landlord with Building or Project management, or outside fees paid in connection with disputes with other tenants; (aa) any increase of, or reassessment in, real property taxes and assessments in excess of two percent (2%) of the taxes for the previous year, resulting from either (1) any sale, transfer, or other change in ownership of the Building or the Project during the Term or from major alterations, improvements, modifications or renovations to the Building or the Project; (bb) the cost of any item included in Operating Expenses to the extent that such cost is attributable solely to the use, management, repair, service, insurance, condition, operation or maintenance of other office buildings in the Project; or (cc) reserves for bad debts or for future improvements, repairs, additions, etc.

(4) **"Estimated Operating Expenses"** shall mean Landlord's estimate of Operating Expenses for the following Operating Year, adjusted as if ninety-five percent (95%) of the total rentable area of the Property will be occupied for the entire Operating Year, Base Year or Operating Year, as applicable, with all tenants paying full rent, as contrasted with free rent, half rent and the like.

(5) **"Actual Operating Expenses"** shall mean the actual Operating Expenses for the Base Year or any Operating Year, as applicable, adjusted, (a) if less than ninety-five percent (95%) of the total rentable area of the Project had been occupied for the entire Base Year or Operating Year, as applicable, as if ninety-five percent (95%) of the total rentable area of the Project had been occupied for the entire Base Year or Operating Year, with all tenants paying full rent, as contrasted with free rent, half rent and the like, and (b) if the Property Taxes component of the Base Year or Operating Year, as applicable, are based on an assessment of the value of the Project made by a governmental authority prior to completion of the Project and/or prior to leasing and occupancy of a substantial portion of the Project, then the Property Taxes component of the Actual Operating Expenses for such Operating Year or Base Year, as applicable, shall be adjusted by Landlord, in Landlord's reasonable discretion, as if the Project had been fully assessed in such Base Year or Operating Year with all improvements completed therein.

(6) **"Property Taxes"** shall mean all real and personal property taxes and assessments imposed by any governmental authority or agency on the Project; any assessments levied in lieu of such taxes; any non-progressive tax on or measured by gross rents received from the rental of space in the Project; and any other costs levied or assessed by, or at the direction of,

any federal, state, or local government authority in connection with the use or occupancy of the Project or the Premises or the parking facilities serving the Project; any tax on any document to which Tenant is a party creating or transferring an interest in the Premises, and any expenses, including the reasonable cost of attorneys or experts, incurred by Landlord in seeking reduction by the taxing authority of the above-referenced taxes, less any tax refunds obtained as a result of an application for review thereof; but shall not include any net income, franchise, estate, excess profits, documentary transfer or inheritance taxes.

5. SECURITY DEPOSIT. Tenant has deposited with Landlord the Security Deposit specified in Section 16 of the Basic Lease Information. Said sum shall be held by Landlord as security for the faithful performance by Tenant of all of Tenant's obligations under this Lease. If Tenant defaults with respect to any provision hereof, including but not limited to the provisions relating to payment of rent, Landlord may (but shall not be required to) use, apply or retain all or part of the Security Deposit for the payment of any rent or any other sum in default, or for the payment of any other amount which Landlord may incur by reason of Tenant's default or to compensate Landlord for any other loss or damage which Landlord may suffer by reason of Tenant's default. If any portion of the deposit is so used or applied, Tenant shall, upon demand, immediately deposit cash with Landlord in an amount sufficient to restore the Security Deposit to its original amount. Tenant's failure to do so shall be a material breach of this Lease. Landlord shall not be obligated to keep the Security Deposit separate from its general funds, and Tenant shall not be entitled to interest on such deposit. If Tenant fully and faithfully performs all of its obligations under this Lease, the Security Deposit or any balance thereof shall be returned to Tenant (or, at Landlord's option, to the last assignee of Tenant's interests hereunder) after the expiration of the Term, provided that Landlord may retain all or a portion of the Security Deposit in an amount reasonably determined by Landlord to be necessary to cover any amounts owed by Tenant for the clean-up and repair of the Premises if Tenant has failed to satisfy its obligations under Section 7(b) of this Lease, and Actual Operating Expenses during the Term.

6. USES; HAZARDOUS MATERIAL.

(a) Use. Landlord agrees that the Premises may be used for (i) the sale and trading of securities (including, without limitation) stocks and bonds, (ii) providing private banking services, investment banking services, trust services and other diversified financial services, (iii) the sale of insurance, (iv) office use, including conference and computer facilities, employee and visitor cafeteria and dining areas (including related kitchen facilities) and/or (v) and other legally permitted use consistent with the character of the Project and Comparable Buildings. Tenant, at its sole cost and expense, shall promptly comply with all local, state and federal laws, statutes, ordinances and governmental rules, regulations or requirements now in force or which may hereinafter be in force relating to the use of the Premises, including, without limitation, the Americans with Disabilities Act, 42 U.S.C. § 12101 et seq. and any governmental regulations relating thereto (collectively, the "ADA"), including any required alterations within the Premises for purposes of "public accommodations" under such statute. However, notwithstanding anything to the contrary contained in this Lease, Landlord (and not Tenant), at Landlord's cost but as an item of Operating Expenses (subject to the provisions of Section 4(e) above establishing certain exclusions from Operating Expenses), shall be required to make any alterations or improvements to the Premises constituting capital expenditures (including, without limitation, alterations or improvements to the Premises in order to comply with the ADA

constituting capital expenditures) and to the Building Structure and Building Systems (as those terms are defined in Section 7(a) below) to the extent such alterations or improvements are required to cause the Premises to comply with applicable laws, except that Tenant (and not Landlord), at Tenant's sole cost, shall be responsible for performing such alterations or improvements work to the extent such compliance work is necessitated by the particular use of the Premises by Tenant, any subtenant of Tenant or any of their respective employees, agents, contractors, licensees or invitees (collectively, "**Tenant Parties**") (as opposed to mere occupancy for general office use) or by any Alterations to the Premises under Section 8 below to the extent such Alterations are not normal and customary business office improvements. Tenant shall not use or permit the Premises to be used in any manner nor do any act which would increase the existing rate of insurance on the Project (unless Tenant agrees to pay such increased cost) or cause the cancellation of any insurance policy covering the Project, nor shall Tenant permit to be kept, used or sold, in or about the Premises, any article which may be prohibited by the standard form of fire insurance policy, unless Tenant obtains an endorsement to the policy allowing such activity. Tenant shall not during the Term (i) commit or allow to be committed any waste upon the Premises, or any public or private nuisance in or around the Project, (ii) allow any sale by auction upon the Premises, (iii) place any loads upon the floor, walls, or ceiling of the Premises which endanger the Building, (iv) use any apparatus, machinery or device in or about the Premises which will cause any substantial noise or vibration or in any manner damage the Building, (v) place any harmful liquids in the drainage system or in the soils surrounding the Project, or (vi) disturb or unreasonably interfere with other tenants of the Project. If any of Tenant's office machines or equipment unreasonably disturbs the quiet enjoyment of any other tenant in the Building, then Tenant shall provide adequate insulation, or take such other action as may be reasonably necessary to eliminate the disturbance, all at Tenant's sole cost and expense.

(b) Hazardous Material. As used herein, the term "Hazardous Material" means any hazardous or toxic substance, material or waste which is or becomes regulated by, or is dealt with in, any local governmental authority, the State of California or the United States Government. Accordingly, the term "Hazardous Material" includes, without limitation, any material or substance which is (i) defined as a "hazardous waste," "extremely hazardous waste" or "restricted hazardous waste" under Sections 25115, 25117 or 25122.7, or listed pursuant to Section 25140 of the California Health and Safety Code, Division 20, Chapter 6.5 (Hazardous Waste Control Law), (ii) defined as a "hazardous substance" under Section 25316 of the California Health and Safety Code, Division 20, Chapter 6.95 (Hazardous Materials Release Response Plans and Inventory), (iii) defined as a "hazardous substance" under Section 25281 of the California Health and Safety Code, Division 20, Chapter 6.7 (Underground Storage of Hazardous Substances), (iv) petroleum, (v) asbestos, (vi) listed under Article 9 or defined as hazardous or extremely hazardous pursuant to Article 11 of Title 22 of the California Administrative Code, Division 4, Chapter 20, (vii) designated as a "hazardous substance" pursuant to Section 311 of the Federal Water Pollution Control Act (33 U.S.C. § 1317), (viii) defined as a "hazardous waste" pursuant to Section 1004 of the Federal Resource Conservation and Recovery Act, 42 U.S.C. § 6902 et seq., or (ix) defined as a "hazardous substance" pursuant to Section 101 of the Compensation and Liability Act, 42 U.S.C. § 9601 et seq. Tenant shall not (either with or without negligence) cause or permit the escape, disposal or release of any Hazardous Materials in or on the Premises or the Project by any Tenant Parties. Tenant shall not allow the storage or use of Hazardous Materials in any manner not sanctioned by law or by the highest standards prevailing in the industry for the storage or use of such substances or materials,

nor allow to be brought onto the Building or Project any such materials or substances, except that Tenant may maintain products in the Premises which are incidental to the operation of its offices, such as photocopy supplies, secretarial supplies and limited janitorial supplies which products contain chemicals which are categorized as Hazardous Materials, provided that the use of such products in the Premises by Tenant shall be in compliance with applicable laws and shall be in the manner in which such products are designed to be used. In addition, Tenant shall execute affidavits, representations and the like from time to time at Landlord's request concerning Tenant's best knowledge and belief with no independent investigation regarding the presence of Hazardous Materials on the Premises. The covenants of this Section 6(b) shall survive the expiration or earlier termination of the Lease. To the best of Landlord's actual knowledge, there are no Hazardous Materials in the Building, the Project or the Premises as of the date hereof.

(c) Environmental Obligations. Landlord and Tenant shall notify each other in writing of (i) any enforcement, clean-up, removal or other governmental action instituted with regard to Hazardous Materials involving the Project, (ii) any claim made by any person against either of the parties related to Hazardous Materials in the Premises or the Project, (iii) any reports made to any governmental agency arising out of or in connection with Hazardous Materials in the Premises or the Project including, without limitation, any complaints, notices or warnings, and (iv) any spill, release, discharge or disposal of Hazardous Materials in the Premises or the Project that is required to be reported to any governmental agency or authority under any applicable governmental law, rule or regulation. Tenant shall indemnify and hold Landlord and its affiliates harmless with respect to any environmental claims or liabilities which occur as a result of the breach by Tenant of any of Tenant's covenants set forth in Section 6(b) above or this Section 6(c) and from any escape, seepage, leakage, spillage, discharge, emission, release from, onto or into the Premises, the Building or the Project of any Hazardous Materials to the extent caused by Tenant or any of Tenant Parties. Landlord shall indemnify and hold Tenant and the Tenant Parties harmless with respect to any environmental claims or liabilities which occur as a result of the breach by Landlord of any of Landlord's covenants, representations or warranties set forth in Section 6(b) above or this Section 6(c) and from any escape, seepage, leakage, spillage, discharge, emission, release from, onto or into the Premises, the Building or the Project of any Hazardous Materials to the extent caused by Landlord or its employees, agents, contractors, licensees or invitees.

7. MAINTENANCE AND REPAIRS.

(a) Landlord's Obligations. Landlord shall maintain and keep in first-class condition and state of repair (comparable to other Comparable Buildings) and, subject to Section 6 above, in compliance with applicable laws, the foundations, exterior walls, structural portions of the roof and other structural portions of the Building (including the floor/ceiling slabs, curtain wall, exterior glass and mullions, columns, beams, shafts (including elevator shafts), stairs, parking facilities, stairwells, escalators, elevator cabs, plazas, pavement, sidewalks, curbs, entrances, landscaping, art work, sculptures, restrooms, mechanical, electrical and telephone closets, and all common and public areas) (collectively, the "**Building Structure**"), and shall maintain the electrical, plumbing, heating, ventilating, sprinkler and life-safety equipment in the Building (collectively, the "**Building Systems**"); and except that all damage or injury to the Premises, the Building or the equipment and improvements therein caused by any act, neglect, misuse or omission of any duty by any Tenant Parties shall be paid by Tenant except to the extent the cost

of same is covered by insurance carried by Landlord hereunder (or would have been covered had Landlord carried the insurance required hereunder). Subject to the provisions of Section 42(i) below, Landlord shall commence performance of any such required repairs promptly (but in any event within ten (10) days or sooner if required by reason of an emergency situation, unsafe condition or threat to person or property) following receipt of written notice from Tenant of the need for such repairs and shall thereafter diligently prosecute the work of such repairs to completion. Subject to the following provisions of this Section 7(a), Tenant hereby waives and releases its right to make repairs at Landlord's expense under Sections 1941 and 1942 of the California Civil Code or under any similar law, statute or ordinance now or hereafter in effect. Landlord makes no warranty as to the quality, continuity or availability of the telecommunications services in the Building, and Tenant hereby waives any claim against Landlord for any actual or consequential damages (including damages for loss of business) if Tenant's telecommunications services in any way are interrupted, damaged or rendered less effective, except to the extent caused by the negligence or willful misconduct of Landlord, its agents, contractors or employees. However, if Landlord fails to perform any of Landlord's obligations under this Section 7(a) promptly after receipt of written notice of the need therefore from Tenant, and (1) such failure results in a situation which materially and adversely affects the operation of Tenant's business from the Premises or an material risk of injury to persons or material property damage, (2) such failure is susceptible of cure by Tenant without work upon or otherwise affecting the exterior appearance of the Building, or adversely affecting the structural elements of the Building or the integrated Building mechanical or utility systems, and (3) within three (3) business days (or such shorter period as is reasonable under the circumstances if relating to an emergency situation, unsafe condition or threat to person or property) following Landlord's receipt of a second written notice from Tenant of the existence of such situation stating Tenant's intent to exercise its rights under this Section if such situation is not cured, Landlord fails to commence and thereafter diligently prosecute to completion the cure thereof, then Tenant shall have the right, but not the obligation, to promptly take such measures as are necessary to cure such situation (using qualified, licensed contractors reasonably experienced in performance of comparable work in Comparable Buildings), and Landlord shall reimburse Tenant for the reasonable costs of completing such cure, plus interest at the ten percent (10%) per annum (or such lesser rate as is the then maximum lawful rate of interest) from the date such costs were incurred by Tenant until such reimbursement by Landlord, within thirty (30) days following Tenant's submission to Landlord of reasonable evidence of the amount of such costs. If within thirty (30) days following Tenant's completion of such cure and submission of such evidence of the costs thereof, Landlord does not either pay to Tenant the amount requested or deliver written notice (an "**Objection Notice**") to Tenant objecting to Tenant's claim that Landlord was required to perform such work under this Lease and/or the amount requested for reimbursement (provided that if Landlord so objects to a portion of the amount requested for reimbursement, Landlord shall pay to Tenant the undisputed amount), then, notwithstanding anything to the contrary contained in this Lease, Tenant may offset the amount so requested, including interest, for reimbursement from Tenant's rental obligations next coming due under this Lease; provided that if Landlord so delivers an Objection Notice, Tenant shall not be entitled to any such offset (other than as to undisputed amounts if the Objection Notice objects only to a portion of the amount requested for reimbursement) and as Tenant's sole remedy for amounts not so reimbursed or offset, Tenant may proceed to claim a default by Landlord. Any dispute as to

which Landlord delivers an Objection Notice pursuant hereto shall be resolved by arbitration in accordance with the provisions of Section 37 below.

(b) Tenant's Obligations. Tenant shall at its expense maintain, repair and replace all portions of the Premises and the equipment or fixtures therein, except to the extent specified in Section 7(a), above, at all times in first-class condition and state of repair, all in accordance with the laws of the State of California and all health, fire, police and other ordinances, regulations and directives of governmental agencies having jurisdiction over such matters. However, notwithstanding anything to the contrary contained in this Lease, Landlord (and not Tenant), at Landlord's cost as an item of Operating Expenses (subject to the provisions of Section 4(e) above establishing certain exclusions from Operating Expenses), shall be required to make any alterations, additions or improvements to the Premises constituting capital expenditures (including, without limitation, alterations, additions or improvements to the Premises constituting capital expenditures required in order to comply with the ADA) and to the Building Structure and Building Systems to the extent such alterations, additions or improvements are required to cause the Premises to comply with applicable laws, except that Tenant (and not Landlord), at Tenant's sole cost, shall be responsible for performing such alterations, additions or improvements work to the extent such compliance work is necessitated by the particular use of the Premises by Tenant or any of the Tenant Parties (as opposed to mere occupancy for general office use) or by any Alterations to the Premises under Section 8 below to the extent such Alterations are not normal and customary business office improvements. Tenant shall replace at Tenant's sole expense any glass that may be broken in the Premises with glass of the same size, specifications and quality, with signs thereon, if required. At the expiration of the Term, Tenant shall surrender the Premises in good and reasonably clean condition, normal wear and tear and damage by fire, other casualty or condemnation excepted; provided, however, that Tenant shall have no obligation to repaint, install new floor coverings or patch wall and floor penetrations.

8. ALTERATIONS.

(a) Landlord's Consent. Tenant shall not make any alterations, additions or improvements (collectively, "**Alterations**") in or to the Premises or make changes to locks on doors or add, disturb or in any way change any plumbing or wiring without obtaining the prior written consent of Landlord, which consent shall not be withheld provided that the Alterations would (i) not adversely affect the Building Structure or Building Systems, (ii) not affect the exterior appearance of the Building or (iii) comply with applicable laws (individually and collectively, a "**Design Problem**"). Notwithstanding anything to the contrary set forth herein, Tenant shall not be required to obtain Landlord's prior consent with respect to any strictly cosmetic work performed within the Premises by Tenant (i.e., paint, carpet and other similar alterations that do not affect the Building Systems and Building Standard items).

(b) Performance of Work. All Alterations shall be made at Tenant's sole expense and by contractors or mechanics selected by Tenant, subject to Landlord's reasonable approval, except that Landlord shall have the right to require use of Building standard contractors or mechanics for work affecting the Building Systems or items under warranty (including, but not limited to, the Building roof). All Alterations shall be made at such times and in such manner as Landlord may from time to time reasonably designate, and shall become the property of Landlord without its obligation to pay therefore at the expiration or earlier termination of this

Lease. All work with respect to any Alterations shall be performed in a good and workmanlike manner, shall be of a quality equal to or exceeding the then existing construction standards for the Project and must be of a type, and the floors and ceilings must be finished in a manner, customary for general office use. Alterations shall be diligently prosecuted to completion to the end that the Premises shall be at all times a complete unit except during the period necessarily required for such work. All Alterations shall be made strictly in accordance with all laws, regulations and ordinances relating thereto and if interior improvements installed in the Premises shall be removed, Tenant shall either replace same with interior improvements of the same or better quality or repair the damage caused by the removal so the Premises is in good condition. Landlord hereby reserves the right to require any contractor or mechanic working in the Premises to provide lien waivers and liability insurance covering the Alterations to the Premises. In addition to the foregoing, Tenant shall provide Landlord with evidence that Tenant or its contractor carries "Builder's All Risk" insurance in an amount reasonably approved by the Landlord covering the construction of such Alterations, and such other insurance as the Landlord may reasonably require, it being understood and agreed that all of such Alterations shall be insured by Tenant pursuant to Section 14(a) of this Lease immediately upon completion thereof. Prior to the performance of any Alterations, Tenant shall allow Landlord to enter the Premises and post appropriate notices to avoid liability to contractors or material suppliers for payment for any Alterations. All Alterations shall remain in and be surrendered with the Premises as a part thereof at the expiration or earlier termination of this Lease, without disturbance, molestation or injury; provided, however, that all of Tenant's personal property, including furniture, trade fixtures, and equipment, may be removed by Tenant at any time during the Term. Landlord may not require Tenant to remove any Alterations (including cabling) or the Tenant Improvements from the Premises upon the expiration or earlier termination of this Lease.

(c) Landlord's Expenses: Administrative Fee. Tenant shall pay to Landlord, as additional rent, any out-of-pocket costs incurred by Landlord in connection with the review and approval of the Alterations and for any additional Building services provided to Tenant or to the Premises in connection with any such alterations, additions or improvements which are beyond the normal services provided to occupants of the Building as part of Operating Expenses. Under no circumstances shall Landlord be liable to Tenant for any damage, loss, cost or expense incurred by Tenant on account of Tenant's plans and specifications, Tenant's contractors or subcontractors, or Tenant's design of any work, construction of any work or delay in completion of any work.

9. TENANT'S PROPERTY.

(a) Removal Upon Expiration of Lease. All articles of personal property and all business and trade fixtures, machinery and equipment, furniture and movable partitions owned by Tenant or installed by Tenant at its expense in the Premises shall be and remain the property of Tenant and may be removed by Tenant at any time during the Term, subject to the other requirements of this Lease. If Tenant shall fail to remove all of such property from the Premises at the expiration of the Term or within ten (10) days after any earlier termination of this Lease for any cause whatsoever, Landlord may, at its option, on five (5) days' notice to Tenant, remove the same in any manner that Landlord shall choose, and store such property without liability to Tenant for loss thereof. In such event, Tenant agrees to pay Landlord upon demand any and all reasonable expenses incurred in such removal, including reasonable court costs and attorneys'

fees and storage charges on such property for any length of time that the same shall be in Landlord's possession. Landlord may, at its option, without notice, sell said property or any of the same, at private sale and without legal process, for such price as Landlord may obtain and apply the proceeds of such sale to any amounts due under this Lease from Tenant to Landlord and to the expense incident to the removal and sale of said property.

(b) Personal Property Taxes. Tenant shall be liable for and shall pay, at least five (5) days before delinquency, all taxes levied against any personal property or trade fixtures placed by Tenant in or about the Premises. If any such taxes on Tenant's personal property or trade fixtures are levied against Landlord or Landlord's property or if the assessed value of the Premises or Landlord's obligations are increased by a value placed upon such personal property or trade fixtures of Tenant and if Landlord, after written notice to Tenant, pays the taxes or obligations based upon Tenant's personal property or trade fixtures, which Landlord shall have the right to do regardless of the validity thereof, but only under proper protest if requested by Tenant, Tenant shall, within thirty (30) days of Landlord's demand, repay to Landlord the taxes or obligations so levied against Landlord, or the portion of such taxes or obligations resulting from such increase in the assessment.

10. ENTRY BY LANDLORD. After not less than twenty four (24) hours prior notice (which may be oral or written notice, notwithstanding anything to the contrary in this Lease governing the manner of delivery of notices, and except that in the event of an emergency, Landlord may provide shorter notice as may be required under the circumstances, which may be no prior notice, if applicable under the circumstances of the applicable emergency situation), Landlord, its authorized agents, contractors, and representatives shall at any and all times have the right to enter the Premises to inspect the same, to supply janitorial service and any other service to be provided by Landlord to Tenant hereunder, to show the Premises to prospective purchasers or (only during the final six (6) months of the Term) tenants, to post notices, to alter, improve or repair the Premises or any other portion of the Building, all without being deemed guilty of any eviction of Tenant and without abatement of rent (except as otherwise provided in this Lease). Except in the event of an emergency, Landlord shall endeavor to coordinate any such entry with Tenant, so as to minimize the extent of any unreasonable interference with Tenant's business operations to the extent practicable under the circumstances. Landlord may, in order to carry out such purposes, erect scaffolding and other necessary structures where reasonably required by the character of the work to be performed, provided that the business of Tenant shall be interfered with as little as is reasonably practicable. Landlord shall at all times have and retain a key with which to unlock all doors in the Premises, excluding Tenant's vaults and safes, Landlord shall have the right to use any and all means which Landlord may deem proper to open said doors in an emergency in order to obtain entry to the Premises. Any entry to the Premises obtained by Landlord pursuant to the terms hereof shall not be deemed to be a forcible or unlawful entry into the Premises, or an eviction of Tenant from the Premises or any portion thereof, and Tenant hereby waives any claim for damages for any injury or inconvenience to or interference with Tenant's business, any loss of occupancy or quiet enjoyment of the Premises, and any other loss in, upon and about the Premises except to the extent caused by the gross negligence or willful misconduct of Landlord. Notwithstanding anything to the contrary set forth above, Tenant may designate certain areas of the Premises as "**Secured Areas**" should Tenant require such areas for the purpose of securing certain valuable property or confidential information. Landlord may not enter such Secured Areas except in the

case of emergency or in the event of a Landlord inspection, in which case Landlord shall provide Tenant with five (5) days' prior written notice of the specific date and time of such Landlord inspection.

11. LIENS. Tenant shall keep the Premises, the Building and the Project free from any liens or encumbrances of any kind or nature arising out of any work performed, materials ordered or obligations incurred by or on behalf of Tenant.

12. INDEMNIFICATION.

(a) Indemnity by Tenant. Except to the extent caused by the negligence or willful misconduct of Landlord or its members, partners, managers, shareholders, officers, directors, trustees, employees, agents or contractors (collectively, the "**Landlord Parties**") and not covered by the insurance maintained by Tenant (and which would not have been so covered had Tenant maintained the insurance required to be maintained by Tenant under this Lease), Tenant shall indemnify, defend, and hold harmless Landlord, Landlord's members, shareholders, partners, trustees and the Landlord's Parties from and against all losses, liabilities, damages, costs, expenses and claims arising from or relating to (a) Tenant's use of the Premises or the conduct of its business or any activity, work, or thing done, permitted or suffered by Tenant in or about the Premises, (b) any act, neglect, fault or omission of any of the Tenant Parties, and (c) all reasonable costs, attorneys' fees, expenses and liabilities incurred in or about such claims or any action or proceeding brought thereon. In case any action or proceeding shall be brought against any of the Landlord Parties by reason of any such claim, Tenant upon written notice from Landlord shall defend the same at Tenant's expense by counsel reasonably approved in writing by Landlord. Tenant, as a material part of the consideration to Landlord, hereby assumes all risk of and waives all claims against the Landlord Parties with respect to damage to property or injury to persons in, upon or about the Premises from any cause whatsoever except that which is caused by the negligence or willful misconduct of Landlord or the Landlord Parties or by the failure of Landlord to observe any of the terms and conditions of this Lease where such failure has persisted for an unreasonable period of time after written notice to Landlord of such failure.

(b) Indemnity by Landlord. Except to the extent caused by the negligence or willful misconduct of Tenant or any of the Tenant Parties or any of Tenant's members, partners, managers, shareholders, officers, directors, trustees or agents (all of the foregoing including Tenant and Tenant Parties are collectively referred to herein as the "**Tenant Indemnitees**") and not covered by the insurance maintained by Landlord (and which would not have been so covered had Landlord maintained the insurance required to be maintained by Landlord under this Lease), Landlord shall indemnify, defend, and hold harmless Tenant and the Tenant Indemnitees from and against all losses, liabilities, damages, costs, expenses and claims arising from or relating to (a) any occurrence on the common areas of the Project, or (b) any claim arising from the negligence or willful misconduct of Landlord or any of the Landlord Parties and not covered by the insurance maintained by Tenant (and which would not have been so covered had Tenant maintained the insurance required to be maintained by Tenant under this Lease), and (c) all reasonable costs, attorneys' fees, expenses and liabilities incurred in or about such claims or any action or proceeding brought thereon. In case any action or proceeding shall be brought against any of the Tenant Indemnitees by reason of any such claim, Landlord upon written notice from

Tenant shall defend the same at Landlord's expense by counsel reasonably approved in writing by Tenant.

13. DAMAGE TO TENANT'S PROPERTY. Notwithstanding anything to the contrary in this Lease, the Landlord Parties shall not be liable for (a) any damage to any property entrusted to employees of the Project or its property managers, (b) loss or damage to any property by theft or otherwise, (c) any injury or damage to persons or property resulting from fire, explosion, falling plaster, steam, gas, electricity, water or rain which may leak from any part of the Building or from the pipes, appliances or plumbing work therein or from the roof, street or sub-surface or from any other place or resulting from dampness or any other cause whatsoever, or (d) any damage or loss to the business or occupation of Tenant arising from the acts or neglect of other tenants or occupants of, or invitees to, the Project, except to the extent that such damage is due to the negligence or willful misconduct of Landlord or any of the Landlord Parties or the breach of this Lease by Landlord. Tenant shall give prompt written notice to Landlord in case of fire or accident in the Premises or in the Building or of defects therein or in the fixtures or equipment.

14. INSURANCE.

(a) Tenant's Insurance. Tenant shall, during the entire Term of this Lease and any other period of occupancy, at its sole cost and expense, keep in full force and affect the following insurance:

(1) Standard form property insurance insuring against the perils of fire, vandalism, malicious mischief, cause of loss-special form ("All-Risk"), sprinkler leakage and earthquake sprinkler leakage. This insurance policy shall be upon all trade fixtures and other property owned by Tenant, for which Tenant is legally liable and/or that was installed by or on behalf of Tenant, and which is located in the Building, including, without limitation, Alterations, furniture, fittings, installations, fixtures, Tenant Improvements and any other personal property, in an amount not less than the full replacement cost thereof. If there shall be a dispute as to the amount which comprises full replacement cost, the decision of Landlord or any mortgagees of Landlord shall be presumptive.

(2) Commercial General Liability Insurance insuring Tenant against any liability arising out of the lease, use, occupancy, or maintenance of the Premises and all areas appurtenant thereto. Such insurance shall be in the amount of Two Million Dollars (\$2,000,000) Combined Single Limit for injury to or death of one or more persons in an occurrence and Three Million Dollars (\$3,000,000) aggregate, and for damage to tangible property (including loss of use) in an occurrence, with an Additional Insured — Landlord Endorsement. The policy shall insure the hazards of premises and operations, independent contractors, contractual liability (covering the indemnity contained in Section 12 hereof) and shall (i) name Landlord as an additional insured, (ii) contain a cross-liability provision, (iii) contain a provision that "the insurance provided the landlord hereunder shall be primary and noncontributing with any other insurance available to the landlord," and (iv) include fire legal liability coverage in the amount of One Million Dollars (\$1,000,000).

(3) Workers' Compensation and Employer's Liability Insurance (as required by state law).

(4) If Tenant installs with prior approval of the landlord, any boiler, pressure object, machinery, fire suppression system, supplemental air conditioning or other mechanical equipment within the Premises, Tenant shall also obtain and maintain at Tenant's expense, boiler and machinery insurance covering loss arising from the use of such equipment.

(5) Any other form or forms of insurance as Tenant or Landlord or any mortgagees of Landlord may reasonably require from time to time in form, amounts and for insurance risks against which a prudent tenant would protect itself and then being required by other reasonable and prudent landlords of Comparable Buildings of tenants comparable to Tenant.

(6) Notwithstanding the foregoing or any other provision of this Lease, Tenant shall have the right to self insure. Tenant shall have the option, either alone or in conjunction with any subsidiaries or affiliates of Tenant, to maintain self insurance and/or provide or maintain any insurance required by this Lease under blanket insurance policies maintained by Tenant or provide or maintain insurance through such alternative risk management programs as Tenant may provide or participate in from time to time.

All such policies shall be written in a form reasonably satisfactory to Landlord and shall be taken out with insurance companies qualified to issue insurance in the State of California and holding an A.M. Best's Rating of "A-" and a Financial Size Rating of "VII" or better, as set forth in the most current issue of Best's Key Rating Guide. Such insurance shall provide that it is primary insurance, and not contributory with any other insurance in force for or on behalf of Landlord. Prior to the commencement of the Term, Tenant shall deliver to Landlord certificates of insurance evidencing the existence of the amounts and forms of coverage required above and, except for the All-Risk insurance, naming Landlord and any other person specified by Landlord, as an additional insured. No such policy shall be cancelable, terminable or reducible in coverage except after thirty (30) days prior written notice to Landlord. Tenant shall, within ten (10) days prior to the expiration of such policies, furnish Landlord with renewals or "binders" thereof, or Landlord may, on five (5) days notice to Tenant, order such insurance and charge the cost thereof to Tenant as additional rent, if Tenant fails to so notify Landlord. If Landlord obtains any insurance that is the responsibility of Tenant under this Section 14, Landlord shall deliver to Tenant a written statement setting forth the cost of any such insurance and showing in reasonable detail the manner in which it has been computed.

(b) Landlord's Insurance. Landlord shall, during the entire term of this Lease, as an item of Operating Expenses, keep in full force and affect the following insurance:

(1) All Risk insurance (including a vandalism and malicious mischief endorsement and sprinkler leakage coverage, and also covering such other risks as Landlord or Landlord's lender may require) upon the Project (excluding any property which Tenant is obligated to insure under Section 14(a) above) in an amount not less than the full replacement cost thereof (excluding footings, foundations and excavation), and including commercially reasonable rental loss coverage for losses covered by such insurance policy. Such insurance policy or policies shall name Landlord as a named insured. The deductible under the All Risk policy shall not exceed such commercially reasonable amount as Landlord reasonably

determines to be appropriate given prudent risk management practices and the practices of comparable landlords of Comparable Buildings.

(2) Commercial general liability insurance coverage, including personal injury, bodily injury, broad form property damage, automobile, Premises operations hazard, contractual liability, and products and completed operations liability, in the amount of One Million Dollars (\$1,000,000) Combined Single Limit for injury to or death of one or more persons in an occurrence and Five Million Dollars (\$5,000,000) aggregate.

Landlord may satisfy its insurance obligations under this Lease by blanket, umbrella and/or, as to liability coverage in excess of One Million Dollars (\$1,000,000), excess liability coverage. All such policies shall be taken out with insurance companies qualified to issue insurance in the State of California and holding an A.M. Best's Rating of "A" and a Financial Size Rating of "VIII" or better, as set forth in the most current issue of Best's Key Rating Guide. Upon request, Landlord shall deliver to Tenant certificates evidencing Landlord's maintenance of insurance in compliance with Landlord's insurance requirements set forth in this Lease.

15. WAIVER OF SUBROGATION. Whether any loss or damage to or within the Project, the Building and/or the Premises is due to the negligence of either of the parties hereto, their agents or employees, Landlord and Tenant do each herewith and hereby release and relieve the other from responsibility for, and waive their entire claim of recovery, for any loss or damage to the real or personal property of the other located anywhere in the Project and including the Project itself, arising out of or incident to the occurrence of any of the perils which are covered by any fire insurance policy covering the Project (or would have been covered by any fire insurance policy covering the Project had the applicable party carried the insurance required to be carried hereunder). To the extent that such risks above are, in fact, covered by insurance, each party shall cause its insurance carriers to consent to such waiver and to waive all rights of subrogation against the other party. Notwithstanding the foregoing, no such release shall be effective unless the aforesaid insurance policy or policies shall expressly permit such a release or contain a waiver of the carrier's right to be subrogated.

16. CASUALTY. If the Building and/or the Premises are damaged by fire or other perils covered by insurance carried by Landlord, Landlord and Tenant shall have the following rights and obligations:

(a) Repair and Restoration.

(1) If the Building and/or the Premises are damaged or destroyed by any such peril to the extent that the Building and/or the Premises cannot reasonably be repaired, reconstructed and restored within one hundred eighty (180) days from the date of such damage or destruction, Landlord shall, at its sole option, as soon as reasonably possible thereafter, either (i) commence or cause the commencement of the repair, reconstruction and restoration of the Building and/or the Premises to substantially their condition existing immediately prior to such casualty, and prosecute or cause the same to be prosecuted diligently to completion, in which event this Lease shall remain in full force and effect; or (ii) within thirty (30) days after such damage or destruction, elect not to so repair, reconstruct or restore the Building and/or the Premises, in which event this Lease shall terminate. In either event, Landlord shall give Tenant

written notice of its intention within said thirty (30) day period. If Landlord elects not to restore the Building and/or the Premises, this Lease shall be deemed to have terminated as of the date of such damage or destruction.

(2) If the Building and/or the Premises are partially damaged or destroyed by any such peril to the extent that the Building and/or the Premises reasonably may be repaired, reconstructed or restored within a period of one hundred eighty (180) days from the date of such damage or destruction, then Landlord shall commence or cause the commencement of and diligently complete or cause the completion of the work of repair, reconstruction and restoration of the Building and/or the Premises to substantially their condition existing immediately prior to such casualty and this Lease shall continue in full force and effect.

(b) Uninsured Casualties. If damage or destruction of the Building and/or the Premises is due to any cause not covered by collectible insurance carried by Landlord at the time of such damage or destruction and the costs of such repair exceed Five Hundred Thousand Dollars (\$500,000.00), Landlord may elect to terminate this Lease, provided that Landlord may only elect to terminate this Lease if Landlord also terminates the leases of all of Building tenants. If the repairing or restoring of the damage is delayed or prevented for longer than two hundred forty (240) days after the occurrence of such damage or destruction by reason of weather, acts of God, war, governmental restrictions, inability to procure the necessary labor or materials, or any cause that is beyond the reasonable control of Landlord, Landlord may elect to be relieved of its obligation to make such repairs or restoration and terminate this Lease, in which case Landlord shall provide Tenant with thirty (30) days written notice of its intent to terminate this Lease. Further, Landlord shall not have any obligation to repair, reconstruct or restore the Premises and may terminate this Lease when the damage resulting from any casualty covered under this Section 16 occurs during the last twelve (12) months of the Term and the Premises cannot be repaired, reconstructed or restored within thirty (30) days after the date of the casualty.

(c) Tenant's Termination Right. Notwithstanding anything to the contrary contained in this Lease, in the event of material casualty damage to the Premises not resulting in termination of this Lease by Landlord, Landlord shall deliver written notice to Tenant within thirty (30) days following such casualty damage or occurrence setting forth Landlord's good faith estimate of the time required for completion of repair and/or restoration of the Premises, and if such estimated time exceeds one hundred eighty (180) days from the occurrence of the casualty, Tenant may elect to terminate this Lease by written notice to Landlord delivered within twenty (20) days following Tenant's receipt of such estimate notice. In addition, in the event such repair and/or restoration of the Premises is not actually completed within two hundred forty (240) days from the occurrence of the casualty (or such longer time period as may have been estimated in such notice to Tenant), Tenant may elect to terminate this Lease upon thirty (30) days prior written notice to Landlord, provided that if such repair and/or restoration is completed within such thirty (30) day period, such election to terminate shall be nullified and this Lease shall continue in full force and effect. In addition, and notwithstanding anything to the contrary contained in this Lease, if the Premises or the Building is wholly or partially damaged or destroyed within the final twelve (12) months of the Term of this Lease so that Tenant shall be prevented from using the Premises for thirty (30) consecutive days due to such damage or destruction, then Tenant may, at its option, by notice to Landlord within sixty (60) days after the occurrence of such damage or destruction, elect to terminate this Lease.

(d) Termination of Lease. Upon any termination of this Lease under any of the provisions of this Section 16, Landlord and Tenant shall each be released without further obligation to the other from the date possession of the Premises is surrendered to Landlord or such other date as is mutually agreed upon by Landlord and Tenant except for payments or other obligations which have theretofore accrued and are then unpaid or unperformed.

(e) Rent Abatement. In the event of repair, reconstruction and restoration by or through Landlord as herein provided, the rent payable under this Lease (including Basic Rent and Tenant's Proportionate Share of Operating Expenses) shall be abated in the proportion that the rentable area of the portion of the Premises that Tenant is prevented from using, and does not use, bears to the total rentable area of the Premises. However, in the event that Tenant is prevented from conducting, and does not conduct, its business in any portion of the Premises and the remaining portion of the Premises is not sufficient to allow Tenant to effectively conduct its business therein, and if Tenant does not conduct its business from such remaining portion, then the rent for the entire Premises shall be abated. Tenant's abatement period shall continue until Tenant has been given sufficient time, and sufficient access to the Premises, the parking facilities and/or the Building, to rebuild such portion it is required to rebuild, to install its property, furniture, fixtures, and equipment to the extent the same shall have been removed and/or damaged as a result of such damage or destruction. Tenant shall not be entitled to any compensation or damages for loss of the use of the whole or any part of the Premises and/or any inconvenience or annoyance occasioned by such damage, repair, reconstruction or restoration, nor shall Tenant be entitled to any insurance proceeds, including those in excess of the amount required by Landlord for such repair, reconstruction or restoration. Tenant shall not be released from any of its obligations under this Lease due to damage or destruction of the Building and/or the Premises except to the extent and upon the conditions expressly stated in this Section 16.

(f) Extent of Repair Obligation. If Landlord is obligated to or elects to repair or restore as herein provided, Landlord shall be obligated to make repair or restoration only of those portions of the Building and the Premises which were originally provided at Landlord's expense, and the repair and restoration of items not provided at Landlord's expense shall be the obligation of Tenant, except that Tenant shall be responsible for the repair of all Tenant Improvements performed by Tenant under Section 30 below. Tenant shall be entitled to all insurance proceeds payable to or received by Tenant in connection with the Tenant Improvements or any other improvements insured by the Tenant pursuant to Section 14 hereof.

(g) Waiver. The provisions of California Civil Code § 1932(2) and § 1933(4), which permit termination of a lease upon destruction of the Premises, are hereby waived by Tenant; and the provisions of this Section 16 shall govern in case of such destruction.

17. CONDEMNATION.

(a) Complete Taking. If the whole of the Project, the Building or the Premises or so much thereof shall be taken by condemnation or in any other manner for any public or quasi-public use or purpose so that the Premises will no longer be reasonably suitable for Tenant's continued occupancy (as reasonably determined by Tenant), this Lease and the term and estate hereby granted shall terminate as of the date that possession of the Project, the Building or the

Premises is so taken (herein called "**Date of the Taking**"), and the Basic Rent and other sums payable hereunder shall be prorated and adjusted as of such termination date.

(b) Partial Taking. If only a part of the Building, the Project or the Premises shall be so taken and the remaining part thereof after reconstruction is reasonably suited for Tenant's continued occupancy (as reasonably determined by Tenant), this Lease shall be unaffected by such taking, except that Landlord may, at its option, terminate this Lease by giving Tenant written notice to that effect within sixty (60) days after the Date of the Taking provided that in such event, Landlord also terminates the leases of all other Building tenants. In such event, this Lease shall terminate on the date that such notice from the Landlord to Tenant shall be given, and the Basic Rent and other sums payable hereunder shall be prorated and adjusted as of such termination date. Upon a partial taking after which this Lease continues in force as to any part of the Premises, the Basic Rent and other sums payable hereunder shall be adjusted according to the rentable area remaining.

(c) Award. Landlord shall be entitled to receive the entire award or payment in connection with any taking without deduction therefrom for any estate vested in Tenant by this Lease, and Tenant shall receive no part of such award, including any award for the "leasehold bonus value" of this Lease, provided that Tenant shall be entitled to make a separate claim for its relocation expenses, the value of its personal property and fixtures belonging to Tenant actually taken, the value of the Tenant Improvements and other improvements to the extent paid for by Tenant and for the interruption of or damage to Tenant's business (not attributable to the "leasehold bonus value" of this Lease). Tenant hereby expressly assigns to Landlord all of its right, title and interest in and to any award or payment attributable to the "leasehold bonus value" of this Lease.

(d) Waiver. Except as may be otherwise provided herein, Tenant hereby waives and releases any right to terminate this Lease under Sections 1265.120 and 1265.130 of the California Code of Civil Procedure or under any similar law, statute or ordinance now or hereafter in effect relative to eminent domain, condemnation or takings.

18. ASSIGNMENT OR SUBLETTING

(a) Landlord's Consent. Without the express prior written consent of Landlord, which consent shall not be unreasonably withheld, conditioned or delayed, Tenant shall not directly or indirectly, voluntarily or by operation of law, sell, assign, encumber, pledge, or otherwise transfer or hypothecate all of its interest in or rights with respect to the Premises (collectively, "**Assignment**"), or permit all or any portion of the Premises to be occupied by anyone other than Tenant or sublet all or any portion of the Premises or transfer a portion of its interest in or rights with respect to the Premises (collectively, "**Sublease**").

(b) Notice to Landlord. If Tenant desires to enter into an Assignment or a Sublease, Tenant shall give written notice to Landlord of its intention to do so (the "**Transfer Notice**"), containing (i) the name of the proposed assignee or subtenant (collectively, "**Transferee**"), (ii) the nature of the proposed Transferee's business to be carried on in the Premises, (iii) the material terms of the proposed Assignment or Sublease, including, without limitation, the commencement and expiration dates thereof and the rent payable thereunder, (iv) the portion of

the Premises proposed to be assigned or subleased (the “**Transfer Space**”), (v) and the most recent financial statement or other equivalent financial information reasonably available to Tenant concerning the proposed Transferee. Within fifteen (15) days after Landlord’s receipt of the Transfer Notice, Landlord shall, by written notice to Tenant, elect to (1) consent to the Sublease or Assignment, or (2) disapprove the Sublease or Assignment; provided, however, that Landlord agrees not to unreasonably withhold its consent to the Sublease or Assignment. Landlord’s consent shall not be deemed to have been unreasonably withheld if the Transferee is a new concern with no previous business history or if the Transferee intends to use the Premises (x) for executive suites or any other use inconsistent with Section 6 or the operation of a first- class office building or (y) in a manner which would increase the use of, or the possibility of disturbance of, Hazardous Substances on the Property. Landlord’s failure to make such election within fifteen (15) days after Landlord’s receipt of the Transfer Notice shall be deemed to be Landlord’s approval of the proposed Sublease or Assignment.

(c) Permitted Transfers. If Landlord consents to any Sublease or Assignment as set forth in Section 18(b):

(1) Tenant may thereafter, within one hundred eighty (180) days after Landlord’s consent, enter into such Assignment or Sublease, but only with the party and upon substantially the same terms as set forth in the Transfer Notice, provided, however, that the financial terms contained in the Assignment or Sublease shall be no less favorable to Tenant than those set forth in the Transfer Notice.

(2) In the case of a Sublease, Tenant shall pay to Landlord fifty percent (50%) of the difference between (x) any and all sums actually received by Tenant in connection with such Sublease (including key money, bonus money and any payment in excess of fair market value for (A) services rendered by Tenant in connection with such Sublease or (B) assets, fixtures, inventory, equipment or furniture transferred by Tenant in connection with such Sublease, but expressly excluding any payment up to the fair market value for the items referenced in the foregoing clauses (A) and/or (B)), minus (y) the sum of the proportionate amount (on a rentable square footage basis) of rent (including Basic Rent and Tenant’s Proportionate Share of Operating Expenses) payable by Tenant under this Lease for the Transfer Space plus any actual and reasonable out-of-pocket costs incurred by the Tenant in connection with such Sublease (including brokerage commissions, legal fees, improvement costs for work for the benefit of the subtenant, improvement allowances or other monetary concessions or inducements provided to the subtenant, the gross revenue as to the Transfer Space paid to Landlord by Tenant for all days the Transfer Space was vacated from the date that Tenant first vacated the Transfer Space until the date the subtenant was to pay rent, costs of advertising the space for sublease and unamortized cost of initial and subsequent improvements to the Premises by Tenant [collectively, the “**Transfer Costs**”]), which amounts shall not be paid by Tenant to Landlord until Tenant has recovered its Transfer Costs. Once Tenant has recouped its Transfer Costs, Tenant shall pay Landlord its share of the amounts due hereunder on a monthly basis.

(3) In the case of an Assignment, Tenant shall pay to Landlord fifty percent (50%) of any transfer or assignment fee, purchase price or other consideration received by Tenant in connection with the Assignment attributable to the value of this Lease (but Landlord shall not be entitled to any proceeds paid for the sale of Tenant’s business which are not related

to the value of this Lease or for the fair market value of any assets, fixtures, inventory, equipment or furniture transferred by Tenant in connection with such Assignment) less the Transfer Costs, which amounts shall be paid by Tenant to Landlord as provided in Section 18(c)(2) above.

(4) Any Sublease or Assignment shall be subject to all of the provisions of this Lease, and Landlord's consent to any Sublease or Assignment shall not be construed as a consent to any terms thereof which conflict with any of the provisions of this Lease except to the extent that Landlord specifically agrees in writing to be bound by such conflicting terms.

(d) Continuing Liability. Tenant shall not be relieved of any obligation to be performed by Tenant under this Lease, including the obligation to obtain Landlord's consent to any other Assignment or Sublease, regardless of whether Landlord consented to any Assignment or Sublease. Any Assignment or Sublease that fails to comply with this Section 18 shall be void. The acceptance of Basic Rent or other sums by Landlord from a proposed Transferee shall not constitute Landlord's consent to such Assignment or Sublease.

(e) Assumption by Transferee. Each Transferee under an Assignment shall assume all obligations of Tenant under this Lease and shall be and remain liable jointly and severally with Tenant for the payment of Basic Rent, additional rent and other charges, and for the performance of all other provisions of this Lease. Each Transferee under a Sublease shall be subject to this Lease. No Assignment shall be binding on Landlord unless Landlord shall receive a counterpart of the Assignment and an instrument that contains a covenant of assumption by the Transferee reasonably satisfactory in substance and form to Landlord and consistent with the requirements of this Section 18 but the failure of the Transferee to execute such instrument shall not release the Transferee from its liability as set forth above. Tenant shall reimburse Landlord, within thirty (30) days after Tenant's receipt of an invoice therefore, for any reasonable costs (not to exceed \$1,000) that Landlord may incur in connection with any proposed Assignment or Sublease, including Landlord's reasonable attorneys' fees and the costs of investigating the acceptability of any proposed Transferee.

(f) Default; Waiver. Any Assignment or Sublease in violation of this Section 18 shall be void. The acceptance of rent or additional charges by Landlord from a purported assignee or sublessee shall not constitute a waiver by Landlord of the provisions of this Section 18.

(g) Intentionally Omitted.

(h) Use by Affiliates. Tenant shall have the right, without consent of Landlord, to assign this Lease or to sublease all or any portion of the Premises, to (i) any person or entity which, directly or indirectly, controls Tenant or is controlled by Tenant or is under common control with Tenant, (ii) any successor to Tenant by merger, consolidation or other operation of law, (iii) any person or entity to whom all or substantially all of the assets of Tenant are conveyed or (iv) any person or entity purchasing the business which the Tenant conducts at the Premises so long as the Premises are used in a manner consistent with the requirements of this Lease. The term "**control**" shall mean ownership, directly or indirectly, of more than fifty percent (50%) of the equity and voting interests of Tenant or such entity, as the case may be.

(i) Recognition Agreement. To the extent that Tenant enters into a Sublease for all of the Premises, Landlord, if it grants its consent to such Sublease, shall also simultaneously execute and deliver a recognition agreement pursuant to which Landlord shall agree that in the event Tenant defaults under this Lease and this Lease is terminated, the Sublease shall be recognized as a direct lease between Landlord and the subtenant on the terms and conditions of the sublease to the extent same are not inconsistent with, or contrary to, the provisions of this Lease and at a rental rate which is the higher of the rental rate under this Lease or the rental rate under the sublease.

(j) Occupancy By Others. Tenant may allow any person or company which is a client or customer of Tenant or which is providing service to Tenant or one of Tenant's clients to occupy certain portions of the Premises without such occupancy being deemed an assignment or subleasing as long as no new demising walls are constructed to accomplish such occupancy and as long as such relationship was not created as a subterfuge to avoid the obligations set forth in this Section 18.

19. SUBORDINATION AND NON-DISTURBANCE. Subject to the last sentence of this Section 19, Tenant agrees that this Lease is and shall be subordinate to any mortgage, deed of trust, ground lease, underlying lease or other prior lien (hereinafter "**Prior Lien**") that may heretofore or hereafter be placed upon the Project or the Building, and all renewals, replacements and extensions thereof. If any Prior Lien holder wishes to have this Lease prior to its Prior Lien, then and in such event, upon such Prior Lien holder's notifying Tenant to that effect, this Lease shall be deemed prior to the Prior Lien. If any ground lease or underlying lease terminates for any reason or any mortgage or deed of trust is foreclosed or a conveyance in lieu of foreclosure is made for any reason, Tenant shall, notwithstanding any subordination, attorn to and become the tenant of the successor in interest to Landlord, provided that such successor in interest recognizes the interest of Tenant under this Lease if no default under this Lease then exists beyond all applicable notice and cure periods. Within fifteen (15) days of presentation, Tenant shall execute any documents which any such Prior Lien holder may require to effectuate the provisions of this Section 19. Notwithstanding anything to the contrary contained herein, Tenant's obligation to subordinate this Lease to the holder of any Prior Lien hereafter placed upon the Project or the Building shall be conditioned upon such Prior Lien holder's executing and delivering to Tenant an agreement of subordination, non-disturbance and adornment with Tenant in commercially reasonable form reasonably designated by such Prior Lien holder and reasonably acceptable to Tenant in which the Prior Lien holder agrees not to disturb Tenant in its possession of the Premises. Landlord represents and warrants to Tenant that as of the date hereof, the Building and Project are not subject to any ground lease, mortgage or lien.

20. ESTOPPEL CERTIFICATE. Tenant will, upon ten (10) business days prior request by Landlord, execute, acknowledge and deliver to Landlord a statement in writing executed by Tenant, substantially in the form of Exhibit D attached hereto, certifying, among other things, the date of this Lease, that this Lease is unmodified and in full force and effect (or, if there have been modifications, that this Lease is in full force and effect as modified, and setting forth such modifications) and the date to which the Basic Rent and additional rent and other sums payable hereunder have been paid, and either stating that to the knowledge of Tenant no default exists hereunder on the part of Landlord or Tenant or specifying each such default of which Tenant may have knowledge and such other matters as may be reasonably requested by Landlord. The

parties agree and intend that any such statement by Tenant may be relied upon by any prospective purchaser or mortgagee of the Building or the Project. Tenant's failure to timely deliver such a statement shall be deemed to be an acknowledgment by Tenant that this Lease is in full force and effect without modification (except as set forth by Landlord), there are no uncured defaults under this Lease by Landlord and no more than one monthly installment of Basic Rent and additional rent and other sums payable hereunder have been paid in advance. Landlord will, upon ten (10) business days prior request by Tenant, execute, acknowledge and deliver to Tenant a statement in writing executed by Landlord substantially in the form of Exhibit D attached hereto with such changes as may be required when Tenant is the requesting party.

21. SERVICES.

(a) Standard Services. Landlord shall maintain the public and common areas of the Project and the Building, such as lobbies, stairs, corridors and restrooms, in first-class condition and state of repair consistent with Comparable Buildings, except for damage occasioned by the acts or omissions of the Tenant Parties, which shall be repaired at Tenant's sole cost and expense except to the extent the cost of such repair is covered by insurance carried by Landlord (or would have been covered had Landlord carried the insurance required to be carried hereunder). Landlord shall be solely responsible for providing janitorial services to the Premises comparable to janitorial services provided in Comparable Buildings. Notwithstanding the foregoing, Tenant may elect, from time to time with respect to any calendar month(s), by delivery of written notice to Landlord not less than forty-five (45) calendar days prior to the commencement of such month(s), to be responsible for providing janitorial services to the Premises, or to a portion thereof as specified in such notice, which janitorial services shall be consistent with those janitorial services provided by Landlord to other tenants in the Building, in which event Tenant shall be responsible to perform such janitorial services in such month(s) and Tenant shall receive a monthly credit to the Basic Rent due hereunder for such respective month(s), on a month-by-month basis, in an amount equal to \$.07 per rentable square foot of space for that portion of the Premises as specified in such notice for which Tenant so elects to provide such janitorial services. Tenant shall have access to the Premises and Project parking garage at all times. Landlord shall furnish the Premises with a minimum of seven (7) watts consumed load per rentable square foot within the Premises of electric power (in addition to the electrical power required for lighting and base Building HVAC) for operation of typical general office machines, hot and cold running water to restrooms, hot and cold water to the kitchen facility within the Premises (through piping to be installed as a part of the Tenant Improvements) and elevator service (including the use of one elevator as a freight elevator for deliveries and construction purposes, but subject to availability based upon common use of such elevator with other Building occupants) at all times during the Term. Landlord shall furnish the Premises with heating or normal office air conditioning comparable to the amounts being provided by comparable landlords of Comparable Buildings between the hours of 6:00 a.m. and 6:00 p.m., Monday through Friday, except for New York Stock Exchange-recognized holidays, and between the hours of 9:00 a.m. and 12:00 p.m. on Saturday. Supplemental air conditioning units and electricity therefore or special air conditioning requirements, such as for any computer centers, and after-hours heating and air conditioning shall be at Tenant's expense at an hourly rate established by the Landlord as its Actual Cost (as hereinafter defined). For purposes hereof, "**Actual Cost**" shall mean the actual out-of-pocket incremental extra cost to Landlord to provide

additional services without markup for profit, overhead, depreciation or administration (to the extent Landlord's administration costs are duplicative of amounts being paid by Tenant as part of Operating Expenses). After hours heating and air conditioning shall be charged by the Landlord to the Tenant at the rate of \$37.00/hour and shall be payable by the Tenant as Additional Rent within thirty (30) days after receipt of an invoice therefore. Tenant shall be solely responsible for the repair and maintenance of any separate heating, ventilating, air conditioning or other equipment installed in the Premises by the Tenant (with the Landlord's consent). Landlord shall also provide lighting replacement for Landlord-furnished lighting, toilet room supplies, window washing with reasonable frequency as is provided in other Comparable Buildings and janitorial service to all common areas and garages of the Property comparable to that provided in Comparable Buildings. Landlord shall not be liable to Tenant for any loss or damage caused by or resulting from any variation, interruption or failure of said services due to any cause whatsoever; and no temporary interruption or failure of such services incident to the making of repairs, Alterations or improvements due to accident or strike or conditions or events not under Landlord's control shall be deemed an eviction of Tenant or relieve Tenant from any of Tenant's obligations hereunder unless otherwise provided in this Lease.

(b) Overstandard Use. Tenant shall not, without the Landlord's prior written consent, use heat-generating machines, machines other than normal office machines, or equipment or lighting located in the Premises, which may materially affect the temperature otherwise maintained by the air conditioning system or increase the water normally furnished for the Premises by Landlord. If such consent is given, Landlord shall have the right to install supplementary air conditioning units or other facilities in the Premises, including supplementary or additional metering devices, and the Actual Cost thereof, including the Actual Cost of installation, operation and maintenance shall be paid by Tenant to Landlord within thirty (30) days of billing by Landlord. If Tenant uses water or electricity in excess of that supplied by Landlord pursuant to subsection (a) above, Tenant shall pay to Landlord, within thirty (30) days of billing, the Actual Cost of such excess consumption, the cost of the installation, operation and maintenance of equipment which is installed in order to supply such excess consumption; and Landlord may install devices to separately meter any increased use and in such event Tenant shall pay the increased cost directly to Landlord, within thirty (30) days of demand, including the Actual Cost of such additional metering devices (including installment costs).

(c) Abatement of Rent. Notwithstanding the foregoing or anything in this Lease to the contrary, in the event that Tenant is prevented from using, and does not use, the Premises or any portion thereof, for three (3) consecutive business days or ten (10) business days in any twelve (12) month period (the "**Eligibility Period**") as a result of (i) any repair, maintenance or alteration performed by Landlord after the Commencement Date that substantially interferes with Tenant's use of the Premises, the parking facility and/or the Building, or (ii) any failure by Landlord to provide Tenant with services or access to the Premises, the Parking Facility and/or the Building, then Tenant's Rent shall be abated or reduced, as the case may be, after expiration of the Eligibility Period for such time that Tenant continues to be so prevented from using, and does not use, the Premises or a portion thereof, in the proportion that the rentable area of the portion of the Premises that Tenant is prevented from using, and does not use, bears to the total rentable area of the Premises. However, in the event that Tenant is prevented from conducting, and does not conduct, its business in any portion of the Premises for a period of time in excess of the Eligibility Period, and the remaining portion of the Premises is not sufficient to allow Tenant

to effectively conduct its business therein, and if Tenant does not conduct its business from such remaining portion, then for such time after expiration of the Eligibility Period during which Tenant is so prevented from effectively conducting its business therein, the Rent for the entire Premises shall be abated; provided, however, if Tenant reoccupies and conducts its business from any portion of the Premises during such period, the Rent allocable to such reoccupied portion, based on the proportion that the rentable area of such reoccupied portion of the Premises bears to the total rentable area of the Premises, shall be payable by Tenant from the date such business operations commence.

22. SIGNS AND ADVERTISING. Landlord shall provide Tenant, at Landlord's sole cost and expense, with Building standard signage (as such standard is established from time to time by Landlord) on the Building directory in the lobby of the Building and at the entry to the Premises for Tenant. In addition, Tenant shall have the right to install, at Tenant's sole cost and expense, signage on or adjacent to the entry to the Premises, in the lobby and corridor of any floor in which any part of the Premises are located and on the exterior monument sign for the Building in the top tenant location ("**Additional Tenant Signage**"); provided, however, that Tenant must present the desired signage to Landlord for its review and approval, which shall not be unreasonably withheld. Any Additional Tenant Signage shall comply with Landlord's signage program for the Building; provided, however, that Tenant shall be permitted to use its standard font and logo in connection with the Additional Tenant Signage. Tenant shall not erect or install or otherwise utilize signs, lights, symbols, canopies, awnings, window coverings or other advertising or decorative matter (collectively, "**Signs**") on the windows, walls or exterior doors or otherwise visible from the exterior of the Premises without first (a) submitting its plans to Landlord and obtaining Landlord's written approval thereof, which approval shall not be unreasonably withheld, conditioned or delayed, and (b) obtaining any required approval of any applicable governmental authority with jurisdiction at Tenant's sole cost and expense. All Signs approved by Landlord shall be professionally designed and constructed in a first-class workmanlike manner. Subject to Tenant's right to use its standard font and logo, Landlord shall have the right to promulgate from time to time additional reasonable and non-discriminatory rules, regulations and policies relating to the style and type of said advertising and decorative matter which may be used by any occupant, including Tenant, in the Building, and may change or amend such rules and regulations from time to time as in its discretion it deems advisable. Tenant agrees to abide by such rules, regulations and policies. At the expiration or earlier termination of this Lease, all such signs, lights, symbols, canopies, awnings or other advertising or decorative matter attached to or painted by Tenant upon the Premises, whether on the exterior or interior thereof, shall be removed by Tenant at its own expense, and Tenant shall repair any damage or injury to the Premises or the Building, and correct any unsightly condition, caused by the maintenance and removal thereof.

23. PARKING. Subject to the rules and regulations of the Town of Mill Valley and the County of Marin, Tenant shall have the right to use, without payment of additional rent for such parking (provided that nothing contained in this [Section 23](#) shall be deemed to limit Landlord's right to include costs relating to the Project parking areas in Operating Expenses to the extent permitted under the provisions of [Section 4](#) above), four (4) parking spaces for every 1,000 rentable square feet in the Premises in the parking facilities for the Project in common with other tenants, guests and invitees of the Project during the Term of this Lease and otherwise subject to the reasonable rules and regulations applicable to the parking facilities, including, without

limitation, hours of operation. The Project shall contain approximately four (4) parking spaces for each 1,000 square feet of usable office space. Access to and from the parking facilities shall be available twenty-four (24) hours per day, seven (7) days per week in accordance with the Landlord's reasonable and nondiscriminatory rules and regulations established therefore from time to time.

24. RULES AND REGULATIONS. Tenant agrees to observe and be bound by the Rules and Regulations applicable to the Project, a copy of which is attached hereto as Exhibit E. Landlord reserves the right to amend said Rules and Regulations in a reasonable and nondiscriminatory manner, as Landlord in its reasonable judgment may from time to time deem to be necessary or desirable for the safety, care and cleanliness of the Project and the preservation of good order therein, and Tenant agrees to comply therewith provided that no amendments to the Rules and Regulations shall interfere with Tenant's use of the Premises. Landlord may make concessions requested by a tenant without granting the same concessions to any other tenant. To the extent the Rules and Regulations conflict with this Lease, this Lease shall control.

25. TIME. Time is of the essence of this Lease.

26. QUIET ENJOYMENT. Landlord covenants to control its activities and personnel such that if and so long as no Event of Default by Tenant is in existence under this Lease, Tenant shall hold and enjoy the Premises peaceably and quietly, subject to the provisions of this Lease.

27. DEFAULTS AND REMEDIES.

(a) Defaults. The occurrence of any one or more of the following events shall constitute a default hereunder by Tenant (each an "**Event of Default**"):

(1) The failure by Tenant to make any payment of Basic Rent, additional rent, other charges or any other payment required to be made by Tenant hereunder, as and when due, where such failure shall continue for a period of ten (10) days after written notice thereof from Landlord to Tenant; provided, however, that any such notice shall be in lieu of, and not in addition to, any notice required under California Code of Civil Procedure § 1161 regarding unlawful detainer actions.

(2) The failure by Tenant to observe or perform any of the express or implied covenants or provisions of this Lease to be observed or performed by Tenant, other than as specified in Section 27(a) above, where such failure shall continue for a period of thirty (30) days after written notice thereof from Landlord to Tenant. Any such notice shall be in lieu of, and not in addition to, any notice required under California Code of Civil Procedure § 1161 regarding unlawful detainer actions. If the nature of Tenant's default (other than a default specified in Section 27(a)(1) above) is such that more than thirty (30) days are reasonably required for its cure, then Tenant shall not be deemed to be in default if Tenant shall promptly commence such cure within said thirty (30) day period and thereafter diligently prosecute such cure to completion.

(b) Remedies. If an Event of Default exists, in addition to any other remedies available to Landlord at law or in equity, Landlord shall have the following rights and remedies:

recover (1) The right to terminate the Lease and pursue its rights and remedies provided by California Civil Code Section 1951 .2, in which event Landlord may

(A) The worth at the time of award of any unpaid rent which had been earned at the time of such termination; plus

(B) The worth at the time of award of the amount by which the unpaid rent which would have been earned after termination until the time of award exceeds the amount of such rental loss that Tenant proves could have been reasonably avoided; plus

(C) The worth at the time of award of the amount by which the unpaid rent for the balance of the Term after the time of award exceeds the amount of such rental loss that Tenant proves could have been reasonably avoided; plus

(D) Any other amount necessary to compensate Landlord for all the detriment proximately caused by Tenant's failure to perform its obligations under this Lease or which in the ordinary course of things would be likely to result therefrom, specifically including, but not limited to, brokerage commissions and advertising expenses incurred, expenses of remodeling the Premises or any portion thereof for a new tenant, whether for the same or a different use, and any special concessions made to obtain a new tenant; plus

(E) At Landlord's election, such other amounts in addition to or in lieu of the foregoing as may be permitted from time to time by applicable law so long as not duplicative of other amounts paid or payable by Tenant.

The term "rent" as used hereinabove shall be deemed to be and to mean all sums of every nature required to be paid by Tenant pursuant to the terms of this Lease, whether to Landlord or to others. As used herein, the "worth at the time of award" for (A) and (B) above shall be computed by allowing interest at the Interest Rate. As used herein, the "worth at the time of award" for (C) above shall be computed by discounting such amount at the discount rate of the Federal Reserve Bank of San Francisco at the time of award plus one percent (1%).

(2) The rights and remedies provided by California Civil Code Section 1951.4, that allow Landlord to continue this Lease in effect and to enforce all of its rights and remedies under this Lease, including the right to recover Basic Rent, additional rent and other charges as they become due, for so long as Landlord does not terminate Tenant's right to possession. Acts of maintenance or preservation, efforts to re-let the Premises or the appointment of a receiver upon Landlord's initiative to protect its interest under this Lease shall not constitute a termination of Tenant's right to possession;

(3) The right to enter the Premises and remove therefrom all persons and property, store such property in a public warehouse or elsewhere at the cost of and for the

account of Tenant, and sell such property and apply the proceeds therefrom pursuant to applicable California law; and

(4) The right to take steps necessary or appropriate to have a receiver appointed for Tenant in order to take possession of the Premises and apply any rental collected and exercise all other rights and remedies granted to Landlord.

(c) **Re-entry.** If an Event of Default exists, Landlord shall also have the right, with or without terminating this Lease, to re-enter the Premises and remove all persons and property from the Premises; such property may be removed and stored in a public warehouse or elsewhere at the cost of and for the account of Tenant. No re-entry or taking possession of the Premises by Landlord pursuant to this Section 27(c) shall be construed as an election to terminate this Lease unless a written notice of such intention is given to Tenant or unless the termination thereof is decreed by a court of competent jurisdiction.

(d) **Remedies Cumulative; Waiver.** All rights, options and remedies of Landlord contained in this Lease or provided by law or in equity shall be construed and held to be cumulative, and no one of them shall be exclusive of the other. No waiver of any default hereunder shall be implied from any acceptance by Landlord of any Basic Rent, additional rent or other charges due hereunder or any omission by Landlord to take any action on account of such default, and no express waiver shall affect any default other than as specified in said waiver. The consent or approval of Landlord to or of any act by Tenant requiring Landlord's consent or approval shall not be deemed to waive or render unnecessary Landlord's consent or approval to or of any subsequent similar acts by Tenant.

28. TRANSFER OF LANDLORD'S INTEREST. In the event of any transfer or transfers of Landlord's interest in the Project or the Building, other than a transfer for security purposes only, and the assumption in writing by the transferee of the obligations of Landlord under this Lease accruing with respect to the period from and after the date of such transfer, Tenant agrees that Landlord shall be automatically relieved of any and all obligations and liabilities on the part of Landlord accruing with respect to the period from and after the date of such transfer and Tenant agrees to attorn to the transferee.

29. RIGHT TO PERFORM. If Tenant shall fail to pay any sum of money, other than Basic Rent required to be paid by it hereunder, or shall fail to perform any other act on its part to be performed hereunder, and such failure shall continue for thirty (30) days after written notice thereof by Landlord (or such shorter period as may be reasonably appropriate in an emergency situation of imminent risk of injury to persons or property damage), Landlord may, but shall not be obligated so to do, and without waiving or releasing Tenant from any obligations of Tenant, make any such payment or perform any such other act on Tenant's part to be made or performed as provided in this Lease. Tenant shall reimburse Landlord for all costs incurred in connection with such payment or performance within thirty (30) days of demand.

30. TENANT IMPROVEMENTS.

(a) Certain Definitions.

(1) Tenant Improvements. “**Tenant Improvements**” shall mean all improvements, alterations and additions desired by Tenant to be made initially in and to the Premises in excess of and addition to the Base Building Work.

(2) Tenant Improvement Allowance. “**Tenant Improvement Allowance**” shall have the meaning set forth in Paragraph 19 of the Basic Lease Provisions and shall be credited toward the cost of the Tenant Improvements and Construction Costs in accordance with the provisions of this Section 30.

(3) Substantial Completion: Punch List Items. “**Substantial Completion**” shall mean, and the Tenant Improvements shall be deemed to be “**Substantially Complete**”, when all of the following have occurred: (i) Tenant has completed the Tenant Improvements in accordance with the Final Plans and all applicable Laws so that Tenant may occupy the Premises for their intended business purpose and conduct Tenant’s normal business operations from the Premises, subject only to minor and customary punch list items which so not materially interfere with Tenant’s occupancy thereof and conduct of its normal business operations therein (Collectively “**Punch List Items**”); (ii) the County of Marin has issued a certificate of occupancy (or is equivalent) for the Premises; and (iii) Tenant is able to receive at the Premises all utilities and other building services to be provided to Tenant by Landlord pursuant to the Lease.

(4) Construction Costs. “**Construction Costs**” shall mean all costs incurred by Tenant in the design and construction of its Tenant Improvements including costs for signage, communication systems and cabling.

(5) Building Plans. “**Building Plans**” shall mean the Building plans and specifications sufficient to allow Tenant’s Architect to complete a Space Plan and Working Drawings. Landlord shall submit to Tenant the Building Plans prior to the execution of this Lease.

(6) Base Building Work. “**Base Building Work**” shall mean the work to be performed by Landlord at its sole cost and expense (without deduction from the Tenant Improvement Allowance) shown on Exhibit F.

(7) Delivery Condition. “**Delivery Condition**” shall mean (i) the Base Building Work is substantially complete such that Tenant may construct its Tenant Improvements without interference from Landlord and its contractors and (ii) the Building, Premises, Building Structure and Building Systems are in first class condition and operating order, free of hazardous materials and asbestos and in compliance with all laws applicable to new construction, disregarding variances and grandfathered rights.

(8) Force Majeure Delay. “**Force Majeure Delay**” shall mean any delay incurred by Tenant in the design and construction of its Tenant Improvements or its move into the Premises attributable to any: (i) actual delay or failure to perform attributable to any strike,

lockout or other labor or industrial disturbance (whether or not on the part of the employee of either party hereto), civil disturbance, further order claiming jurisdiction, act of public enemy, war, riot, sabotage, blockade, embargo; (ii) delay due to changes in any applicable laws (including, without limitation, the ADA) or Building Plans, or the interpretation thereof; or (iii) delay attributable to lightning, earthquake, fire, storm, hurricane, tornado, flood, washout, explosion, or any other similar industry-wide or Building-wide cause beyond the reasonable control of the party from whom performance is required, or any of its contractors or other representatives.

(9) Landlord Delay. "**Landlord Delay**" shall mean any delay incurred by Tenant in the design and construction of its Tenant Improvements or its move into the Premises caused by (i) Landlord's failure to approve the Space Plan or Working Drawings or any revisions to either the Space Plan or Working Drawings within the time periods specified in Section 30(c) below; (ii) deficiencies in the Base Building Work or failure of the Base Building Work to substantially comply with the Building Plans; (iii) any material breach by Landlord or any of the Landlord Parties of any provision of this Lease; (iv) any other delay to the extent requested or caused by Landlord or the Landlord Parties; delay in the giving of authorizations or approvals by Landlord; (v) delay attributable to the acts or failures to act, whether willful, negligent or otherwise, of Landlord, its agents or contractors; (vi) delay attributable to the interference of Landlord, its agents or contractors with the design of the Tenant Improvements or the failure or refusal of any such party to permit Tenant, its agents or contractors, access to and priority use of the Building or any Building facilities or services, including freight elevators, passenger elevators, and loading docks, which access and use are required for the orderly and continuous performance of the work necessary for Tenant to complete its move in into the Premises during the Construction Period; (vii) delay by Landlord in the substantial completion of the Base Building Work prior to the commencement of the move into the Premises; (viii) delay attributable to Landlord's failure to allow Tenant sufficient access to the Building and/or the Premises to move into the Premises over one (1) weekend; and (ix) delay caused by the failure of the base Building to comply with the ADA; provided, however, that no such Landlord Delay shall be deemed to have occurred unless and until the matter giving rise to such claimed Landlord Delay is not cured within one (1) business day following Landlord's receipt of written notice thereof (provided, however, that notwithstanding anything to the contrary in this Lease as to the manner of giving notices, such notice shall be given by facsimile to (415) 288-0203).

(10) Tenant's Contractor. "**Tenant's Contractor**" shall mean _____. Tenant's Contractor may also be another general contractor selected and retained by Tenant and approved by Landlord to construct and install the Tenant Improvements within the Premises.

(11) Material Change Order. "**Material Change Order**" shall mean any change order or modification which increases the Construction Costs by more than _____.

(12) Tenant's Architect. "**Tenant's Architect**" shall be _____.

(b) Plans and Drawings. Tenant shall submit to Landlord Tenant's proposed space plan for the Premises (the "**Space Plan**"). Landlord shall approve or disapprove the Space Plan within five (5) business days after delivery of the Space Plan to Landlord, which approval shall

not be withheld unless a Design Problem (as defined in Section 8(a)) exists or conditioned. If Landlord reasonably disapproves the Space Plan because of a Design Problem, Landlord shall return the Space Plan to Tenant with Landlord's specific requested changes noted thereon. Tenant shall revise and resubmit the Space Plan to Landlord and Landlord shall approve or disapprove such revised Space Plan if a Design Problem exists within five (5) business days of receipt. After Landlord's approval of the Space Plan, Tenant shall deliver to Landlord for Landlord's approval working drawings consisting of a floor plan, reflected ceiling plan, interior elevations and electrical plan (the "**Working Drawings**"), which Working Drawings shall be consistent with the Space Plan. Landlord shall approve or disapprove the Working Drawings within five (5) business days after delivery of the Working Drawings to Landlord, which approval shall not be withheld unless a Design Problem exists or conditioned. If Landlord disapproves the Working Drawings, Landlord shall return the Working Drawings to Tenant with Landlord's specific requested changes noted thereon. Tenant shall revise and resubmit the Working Drawings to Landlord and Landlord shall approve or disapprove such revised Working Drawings if a Design Problem exists within five (5) business days after receipt. The Working Drawings as finally approved by Landlord are referred to as the "**Final Plans.**" The Space Plan and Working Drawings may be submitted by Tenant in one or more stages and at one or more times, and the time periods for Landlord's approval shall apply with respect to each such portion submitted. Tenant shall obtain all permits and approvals necessary for all of the Tenant Improvements and construct and install all Tenant Improvements within the Premises using Tenant's Contractor in accordance with all applicable Laws and the Final Plans, in a first-class and workmanlike manner. In the event Tenant needs to make changes to the Final Plans, Tenant shall submit all Material Change Orders to Landlord for Landlord's approval, which approval shall be given or denied (and if denied, only if a Design Problem exists and specifying the reasons for denial) within three (3) to five (5) business days following Landlord's receipt of any Material Change Order; provided, however, that Landlord agrees to use commercially reasonable efforts to respond to a request for a Material Change Order within three (3) business days. Any Construction Costs which are paid or incurred by Tenant by reason of deficiencies in the Base Building Work shall be paid solely by Landlord and shall not be charged against the Tenant Improvement Allowance or otherwise be paid by Tenant.

(c) Payment of Tenant Improvement Allowance. The Tenant Improvement Allowance shall be disbursed to Tenant by Landlord within twenty (20) days of receipt of Tenant's request accompanied by paid invoices and lien free endorsements executed by the appropriate payee. Landlord's sole obligation to reimburse for Tenant Improvements shall not exceed that amount set forth in the Paragraph 19 of the Basic Lease Information. If any installment is not paid when due, the same shall bear interest at the Interest Rate from the due date until the payment date, and Tenant shall have the right to setoff the amount of such installments and such interest against the rent due under the Lease. Landlord acknowledges that Tenant will be occupying the Premises prior to the Commencement Date pursuant to a Sublease Agreement with MarketTools, Inc. (the "Sublease"), which Sublease has been approved by Landlord. Notwithstanding any provision of this Lease to the contrary, but subject to the terms and conditions of this Section 30, Tenant shall be permitted to construct some or all of the Tenant Improvements to the Premises during the term of the Sublease, and Landlord agrees to make the Tenant Improvement Allowance available during such time period for such purposes. Landlord further agrees that (i) Tenant may use a portion of the Tenant Improvement Allowance to construct an interior staircase connecting the Premises with the premises leased by Tenant on

the third floor of the Building, and (ii) subject to Landlord's approval as to the location, capacity and means of installing the same, Tenant may install, at its cost, an emergency back-up generator at a location mutually acceptable to Landlord and Tenant in compliance with all applicable governmental regulations. The generator shall support all Building Systems, including electrical, plumbing, heating, ventilating, sprinkler and life-safety equipment, serving the Building, including the Premises and any common areas of the Building. Landlord will cooperate with Tenant in obtaining any permits or other governmental approvals required by the City of Mill Valley to install and operate the emergency back-up generator.

(d) Miscellaneous Charges. Neither Tenant nor Tenant's Contractor shall be charged for, and Landlord shall provide, parking (to the extent parking is available) for Tenant's Architect, designers, contractors and subcontractors (including those people working on the Tenant Improvements), electricity, water, toilet facilities, HVAC, security and elevators during the design and construction of the Tenant Improvements and the move into the Premises. All such equipment, areas, elevators and utilities shall be made reasonably available to Tenant during the design and construction of the Tenant Improvements and the move into the Premises. The HVAC systems for the Premises shall be run continuously twenty-four (24) hours per day, seven (7) days per week during the move into the Premises to flush out and purge new finish odors.

(e) Use of Conduits, Risers and Raceways. Landlord shall make available to Tenant for the initial Tenant Improvements and any later Alterations non-exclusive use of all existing conduit, risers and vertical and horizontal raceways in the Building for Tenant's telecommunications and cabling requirements between the Premises and the roof of the Building,

(f) Codes/Hazardous Materials. If Tenant cannot obtain or is delayed in obtaining any permit required for construction of its Tenant Improvements or occupancy of the Premises because the Building and/or the Premises (x) are not in full compliance with all applicable laws and/or (y) contains Hazardous Materials and/or asbestos, then Landlord shall pay for or reimburse Tenant for all increased costs paid or incurred by Tenant on account thereof in addition to the Tenant Improvement Allowance and any delay in the completion of Tenant's improvements shall be deemed a Landlord Delay. Further, Landlord shall, at its sole cost and expense, immediately correct any deficiencies as to legal compliance and the presence of Hazardous Materials and asbestos.

(g) Fee to Landlord. Landlord's management fee is three percent (3%).

31. NOTICES. All notices under this Lease shall be in writing and sent to the parties at the following addresses or at such other address as any party hereto may designate to the other by notice delivered as provided herein:

To Landlord: Bently Holdings CA LP
240 Stockton Street, 3rd Floor
San Francisco, California 94108
Telephone No.: (415) 288-0202
Facsimile No.: (415) 288-0203

To Tenant: Redwood Trust, Inc.
One Belvedere Place, Suite 300
Mill Valley, CA 94941

Any such notices shall be sent by (i) U.S. certified mail, postage prepaid, return receipt requested, in which case notice shall be deemed delivered three business days after timely deposit in the mail, (ii) a nationally recognized overnight courier, in which case notice shall be deemed delivered one business day after timely deposit with such courier; (iii) personally delivered, in which case notice shall be deemed delivered upon receipt or refusal of receipt, or (iv) electronic communication, whether by telex, telegram or telecopying, in which case notice shall be deemed delivered on the date of confirmed dispatch provided such electronic communication is followed up with a notice sent by mail.

32. ATTORNEYS' FEES. If either party places the enforcement of this Lease or any part hereof, or the collection of any Basic Rent, additional rent or other charges due or to become due hereunder, or recovery of the possession of the Premises, in the hands of an attorney, or files suit or brings an arbitration upon the same, the non-prevailing (or defaulting) party shall pay the other party's reasonable legal and attorneys' fees, costs and expenses, including legal and attorneys' fees, costs and expenses incurred in connection with any appeals and any bankruptcy or insolvency proceedings involving Tenant or this Lease. If Landlord is named as a defendant in any suit brought against Tenant in connection with or arising out of Tenant's occupancy hereunder, Tenant shall pay to Landlord its reasonable costs and expenses in such suit, including its reasonable attorneys' fees. Any such attorneys' fees and other expenses incurred by either party in enforcing a judgment in its favor under this Lease shall be recoverable separately from and in addition to any other amount included in such judgment, and such attorneys' fees obligation is intended to be severable from the other provisions of this Lease and to survive and not be merged into any such judgment. The terms "attorneys' fees" and "attorneys' fees, costs and expenses" shall mean the fees, costs and expenses of counsel to the parties hereto, which may include printing, photostating, duplicating and other expenses, air freight charges, and fees billed for law clerks, paralegals and other persons not admitted to the bar but performing services under the supervision of an attorney, and the costs and fees incurred in connection with the enforcement or collection of any judgment obtained in any such proceeding, and shall include, specifically, all fees, costs and expenses of expert witnesses. For purposes of this Section 32, the term "prevailing party" shall include a prevailing party as defined in California Code of Civil Procedure Section 998.

33. HOLDING OVER. If Tenant holds over after the expiration or earlier termination of the Term without the express prior written consent of Landlord, Tenant shall become a tenant from month to month only, at a rental rate equal to one hundred twenty-five percent (125%) of the Basic Rent, additional rent and other charges in effect upon the date of such expiration (subject to adjustment as provided in Section 4 hereof and prorated on a daily basis), and otherwise subject to the terms, covenants and conditions herein specified, so far as applicable; provided, however, that such percentage shall increase from one hundred twenty-five percent (125%) to one hundred fifty percent (150%) following the first ninety (90) days of any such holding over. Acceptance by Landlord of rent after such expiration or earlier termination shall not result in a renewal of this Lease and shall not waive Landlord's right to bring an unlawful detainer action against Tenant or otherwise remove Tenant from the Premises. If Tenant fails to

surrender the Premises upon the expiration of this Lease despite demand to do so by Landlord, Tenant shall indemnify, defend and hold Landlord harmless from all loss or liability, including without limitation, any claim made by any succeeding tenant founded on or resulting from such failure to surrender.

34. SURRENDER OF PREMISES. Subject to Section 18(i), the voluntary or other surrender of this Lease by Tenant, or a mutual cancellation hereof, shall not work a merger, and shall, at the option of Landlord, operate as an assignment to it of any subleases or subtenancies.

35. NON-WAIVER. Neither the acceptance of rent nor any other act or omission of Landlord or Tenant at any time or times after the happening of any event authorizing the cancellation or forfeiture of this Lease shall operate as a waiver of any past or future violation, breach or failure to keep or perform any covenant, agreement, term or condition hereof, or deprive the other party of its rights and remedies under this Lease, or be construed so as to at any future time stop Landlord or Tenant from promptly exercising any other option, right or remedy that it may have under any term or provision of this Lease.

36. MORTGAGE PROTECTION. In the event of any default on the part of Landlord, Tenant will give written notice by registered or certified mail to any beneficiary of a deed of trust or mortgagee under a mortgage covering the Project or the Building whose address shall have been furnished to Tenant, and shall offer such beneficiary or mortgagee a reasonable opportunity to cure the default (if such beneficiary or mortgagee is acting in good faith to cure the Landlord's default (if curable)), including time to obtain possession of the Project or the Building by power of sale or a judicial foreclosure, if such should prove necessary to effect a cure. For purposes hereof, a reasonable opportunity shall mean thirty (30) days after receipt of Tenant's notice or such longer period as may be necessary so long as the cure is commenced within said thirty (30) day period and is being diligently pursued to completion.

37. EXPEDITED DISPUTE RESOLUTION. With the exception of the arbitration provisions which shall specifically apply to the determination of the Fair Market Rental Value and Landlord's exercise of unlawful detainer remedies, the provisions of this Section 37 contain the sole and exclusive method, means and procedure to resolve any and all disputes or disagreements, including whether any particular matter constitutes, or with the passage of time would constitute, an Event of Default. The parties hereby irrevocably waive any and all rights to the contrary and shall at all times conduct themselves in strict, full, complete and timely accordance with the provisions of this Section 37. Any and all attempts to circumvent the provisions of this Section 37 shall be absolutely null and void and of no force or effect whatsoever. As to any matter submitted to arbitration to determine whether it would, with the passage of time, constitute an Event of Default, such passage of time shall not commence to run until any such affirmative determination, so long as it is simultaneously determined that the challenge of such matter as a potential Event of Default was made in good faith, except with respect to the payment of money. With respect to the payment of money, such passage of time shall not commence to run only if the party which is obligated to make the payment does in fact make the payment to the other party. Such payment can be made "under protest," which shall occur when such payment is accompanied by a good faith notice stating why the party has elected to make a payment under protest. Such protest will be deemed waived unless the subject matter identified in the protest is submitted to arbitration as set forth in the following:

(a) Arbitration Panel. Within ten (10) days after delivery of written notice (“**Notice of Dispute**”) of the existence and nature of any dispute given by any party to the other party, and unless otherwise provided herein in any specific instance, the parties shall each: (i) appoint one (1) lawyer actively engaged in the licensed and full time practice of law, specializing in real estate, in the County of Marin for a continuous period immediately preceding the date of delivery (“**Dispute Date**”) of the Notice of Dispute of not less than ten (10) years, but who has at no time ever represented or acted on behalf of any of the parties, and (ii) deliver written notice of the identity of such lawyer and a copy of his or her written acceptance of such appointment and acknowledgment of and agreement to be bound by the time constraints and other provisions of this Section 37 (“**Acceptance**”) to the other parties hereto. The party who selects the lawyer may not consult with such lawyer, directly or indirectly, to determine the lawyer’s position on the issue which is the subject of the dispute. In the event that any party fails to so act, such arbitrator shall be appointed pursuant to the same procedure that is followed when agreement cannot be reached as to the third arbitrator. Within ten (10) days after such appointment and notice, such lawyers shall appoint a third lawyer (together with the first two (2) lawyers, “**Arbitration Panel**”) of the same qualification and background and shall deliver written notice of the identity of such lawyer and a copy of his or her written Acceptance of such appointment to each of the parties. In the event that agreement cannot be reached on the appointment of a third lawyer within such period, such appointment and notification shall be made as quickly as possible by any court of competent jurisdiction, by any licensing authority, agency or organization having jurisdiction over such lawyers, by any professional association of lawyers in existence for not less than ten (10) years at the time of such dispute or disagreement and the geographical membership boundaries of which extend to the County of Marin or by any arbitration association or organization in existence for not less than ten (10) years at the time of such dispute or disagreement and the geographical boundaries of which extend to the County of Marin, as determined by the party giving such Notice of Dispute and simultaneously confirmed in writing delivered by such party to the other party. Any such court, authority, agency, association or organization shall be entitled either to directly select such third lawyer or to designate in writing, delivered to each of the parties, an individual who shall do so. In the event of any subsequent vacancies or incapacities to perform among the Arbitration Panel, the lawyer or lawyers involved shall be replaced in accordance with the provisions of this Section 37 as if such replacement was an initial appointment to be made under this Section 37 within the time constraints set forth in this Section 37, measured from the date of notice of such vacancy or inability, to the person or persons required to make such appointment, with all the attendant consequences of failure to act timely if such appointed person is a party hereto.

(b) Duty. Consistent with the provisions of this Section 37, the members of the Arbitration Panel shall utilize their utmost skill and shall apply themselves diligently so as to hear and decide, by majority vote, the outcome and resolution of any dispute or disagreement submitted to the Arbitration Panel as promptly as possible, but in any event on or before the expiration of thirty (30) days after the appointment of the members of the Arbitration Panel. None of the members of the Arbitration Panel shall have any liability whatsoever for any acts or omissions performed or omitted in good faith pursuant to the provisions of this Section 37.

(c) Authority. The Arbitration Panel shall (i) enforce and interpret the rights and obligations set forth in the Lease to the extent not prohibited by law, (ii) fix and establish any and all rules as it shall consider appropriate in its sole and absolute discretion to govern the

proceedings before it, including any and all rules of discovery, procedure and/or evidence, and (iii) make and issue any and all orders, final or otherwise, and any and all awards, as a court of competent jurisdiction sitting at law or in equity could make and issue, and as it shall consider appropriate in its sole and absolute discretion, including the awarding of monetary damages (but shall not award consequential damages to either party and shall not award punitive damages except in situations involving knowing fraud or egregious conduct condoned by, or performed by, the person who, in essence, occupies the position which is the equivalent of the chief executive officer of the party against whom damages are to be awarded), the awarding of reasonable attorneys' fees and costs to the prevailing party as determined by the Arbitration Panel and the issuance of injunctive relief. If the party against whom the award is issued complies with the award, within the time period established by the Arbitration Panel, then no Event of Default will be deemed to have occurred, unless the Event of Default pertained to the non payment of money by Tenant or Landlord, and Tenant or Landlord failed to make such payment under protest.

(d) Appeal. The decision of the Arbitration Panel shall be final and binding, may be confirmed and entered by any court of competent jurisdiction at the request of any party and may not be appealed to any court of competent jurisdiction or otherwise except upon a claim of fraud on the part of the Arbitration Panel, or on the basis of a mistake as to the applicable law. The Arbitration Panel shall retain jurisdiction over any dispute until its award has been implemented, and judgment on any such award may be entered in any court having appropriate jurisdiction.

38. CHANGES TO THE PROJECT. Landlord reserves the right at any time to make changes, alterations, reductions and additions to the Project, including the construction of other buildings or improvements in the Project, the leasing of space to restaurant uses, the building of additional stories on any building, without any liability or responsibility to Tenant. Landlord will not block ingress and egress to the Premises. No rights to any view or to light or air over any property, whether belonging to Landlord or any other person, are granted to Tenant by this Lease. If at any time any windows of the Premises are temporarily darkened or the light or view therefrom is obstructed by reason of any repairs, improvements, maintenance or cleaning in or about the Project, the same shall be without liability to the Landlord and without any reduction or diminution of Tenant's obligations under this Lease. Notwithstanding the foregoing, Landlord agrees that it shall not make or permit any permanent modification to the Building (as built substantially in accordance with the Building Plans), on any changes, alterations, reductions and additions to the Project, which change the nature of the Building to something other than a first class office building, materially obstructs the natural light to the Premises or which materially adversely affects (a) use or occupancy of the Premises, (b) parking serving the Building, or (c) ingress, egress or access to or from the Building and the Premises.

39. WAIVER OF JURY TRIAL. EACH PARTY HEREBY WAIVES ANY RIGHT TO A TRIAL BY JURY IN ANY ACTION TO ENFORCE THE SPECIFIC PERFORMANCE OF THIS LEASE, FOR DAMAGES FOR THE BREACH HEREOF, OR OTHERWISE FOR ENFORCEMENT OF ANY REMEDY HEREUNDER. If either party commences litigation against the other for the specific performance of this Lease, for damages for the breach hereof or otherwise for enforcement of any remedy hereunder, the prevailing party shall be entitled to recover from the other party such costs and reasonable attorneys' fees as may have been

incurred, including any and all costs incurred in enforcing, perfecting and executing such judgment.

40. OPTIONS TO EXTEND THE TERM

(a) Extension Terms.

(1) First Extension Term. Landlord grants to Tenant an option to extend the Initial Term (the "**First Extension Option**") with respect to all (but not less than all) of the rentable area of the Premises leased by Tenant as of the Expiration Date of the Initial Term for five (5) years (the "**First Extension Term**"). The First Extension Term shall commence immediately following the Expiration Date of the Initial Term. The First Extension Option shall be exercised, if at all, by written notice to Landlord at any time during the Initial Term on or before the date that is one hundred eighty (180) days prior to the Expiration Date, which notice shall be irrevocable by Tenant. Notwithstanding the foregoing, if an Event of Default (following the expiration of all applicable cure period without cure) exists under this Lease either at the time Tenant exercises the First Extension Option or at any time thereafter prior to on upon the commencement of the First Extension Term, Landlord shall have, in addition to all of Landlord's other rights and remedies under this Lease, the right to terminate the First Extension Option and to cancel unilaterally Tenant's exercise of the First Extension Option, in which event the Expiration Date of this Lease shall be and remain the then scheduled Expiration Date, and Tenant shall have no further rights under this Lease to renew or extend the Term.

(2) Second Extension Term. Landlord grants to Tenant an option to extend Term of this Lease (the "**Second Extension Option**") with respect to all (but not less than all) of the rentable area of the Premises leased by Tenant as of the Expiration Date of the First Extension Term for five (5) years (the "**Second Extension Term**"). The Second Extension Term shall commence immediately following the Expiration Date of the First Extension Term. The Second Extension Option shall be exercised, if at all, by written notice to Landlord at any time during the First Extension Term on or before the date that is one hundred eighty (180) days prior to the Expiration Date of the First Extension Term, which notice shall be irrevocable by Tenant. Notwithstanding the foregoing, if an Event of Default (following the expiration of all applicable cure period without cure) exists under this Lease either at the time Tenant exercises the Second Extension Option or at any time thereafter prior to or upon the commencement of the Second Extension Term, Landlord shall have, in addition to all of Landlord's other rights and remedies under this Lease, the right to terminate the Second Extension Option and to cancel unilaterally Tenant's exercise of the Second Extension Option, in which event the Expiration Date of this Lease shall be and remain the then scheduled Expiration Date of the First Extension Term, and Tenant shall have no further rights under this Lease to renew or extend the Term.

(b) Extension Term Rent.

(1) The First Extension Term and Second Extension Term (each an "**Extension Term**") shall be upon and subject to all of the terms, covenants and conditions of this Lease; provided, however, that Basic Rent for each Extension Term shall be equal to ninety-five percent (95%) of the Fair Market Rental Value and the Base Year for each Extension Term shall be the calendar year in which such Extension Term commences unless the Extension Term

commences on or after October 1 of such calendar year, in which event the Base Year shall be the calendar year following the calendar year in which the Extension Term commences. Such Basic Rent shall be determined by Landlord in good faith not later than four (4) months prior to the commencement of the applicable Extension Term. Tenant shall send to Landlord a written notice, within thirty (30) days after the date of Landlord's notice setting forth the Fair Market Rental Value for the Extension Term, which notice shall state that Tenant either (x) agrees with Landlord's determination of Fair Market Rental Value for the Extension Term or (y) disagrees with Landlord's determination of Fair Market Rental Value for the Extension Term and elects to resolve the disagreement as provided in Section 40(b)(2) below. If Tenant does not send to Landlord a notice as provided in the previous sentence within the said thirty (30) day period, Tenant will be deemed to have elected (y) above and the Fair Market Rental Value shall be resolved in accordance with Section 40(b)(2) below. Until the disagreement is resolved as provided in Section 40(b)(2) below, Tenant's monthly payments of Basic Rent during the then applicable Extended Term shall be in an amount not less than the greater of (x) Tenant's determination of the Fair Market Rental Value and (y) the Basic Rent payable for the twelve (12) month period immediately preceding the commencement of the Extension Term. Within ten (10) business days following the resolution of such dispute by the parties or the decision of the brokers, one party shall make any necessary payment to the other party in order to adjust the amount previously paid by Tenant during the Extension Term to the Fair Market Rental Value as determined. Tenant shall in any event pay all applicable additional charges with respect to the Premises, in the manner and at the times provided in this Lease, effective upon the commencement of the Extension Term, and notwithstanding any dispute regarding the Basic Rent for the Extension Term.

(2) Any disagreement regarding the Fair Market Rental Value as defined in this Section 40 shall be resolved as follows:

(i) Within twenty (20) days after Tenant's response to Landlord's notice of the Landlord's initial determination of the Fair Market Rental Value, Landlord and Tenant shall meet no less than two (2) times, at a mutually agreeable time and place, to attempt to resolve any such disagreement.

(ii) If, within the twenty (20) day consultation period described in subsection (i) above, Landlord and Tenant cannot reach an agreement as to the Fair Market Rental Value, they shall each make a separate determination of the Fair Market Rental Value within five (5) business days after the expiration of the said twenty (20) day period, and such determinations shall be submitted to arbitration in accordance with subsection (iii) below; provided that, if only one (1) determination of Fair Market Rental Value is submitted to arbitration within the said five (5) business day period, then such determination shall equal the Basic Rent for the Extension Term and the parties shall not proceed with arbitration.

(iii) If the Basic Rent has not been determined pursuant to the procedures outlined above, Landlord and Tenant shall each appoint one arbitrator who is unaffiliated with Landlord or Tenant and who shall be a real estate broker and shall have been active over the five (5) year period ending on the date of such appointment in the leasing of commercial mid-rise and/or high-rise properties in the greater San Francisco metropolitan area. Each such arbitrator shall be appointed within five (5) business days after the expiration of the

twenty (20) day period described in subsection (ii) above. The two (2) arbitrators so appointed shall within ten (10) days of the date of appointment of the last appointed arbitrator agree upon and appoint a third arbitrator who shall be qualified under the same criteria set forth hereinabove for qualification of the first two (2) arbitrators. The determination of the arbitrators shall be limited solely to the issue of whether the Landlord's or the Tenant's submitted Fair Market Rental Value (using the criteria for determining Fair Market Rental Value set forth in Paragraph 15 of the Basic Lease Provisions) is the closest to the actual Fair Market Rental Value of the Premises, as determined by the arbitrators. The three (3) arbitrators shall within thirty (30) days of the appointment of the third arbitrator reach a decision as to whether the parties shall use the Landlord's or the Tenant's submitted Fair Market Rental Value as the Basic Rent for the Extension Term, and shall notify Landlord and Tenant thereof. The decision of the majority of the three (3) arbitrators shall be binding upon Landlord and Tenant. If either Landlord or Tenant fails to appoint an arbitrator within the five (5) business day period provided above, then the arbitrator appointed by one of them shall reach a decision, notify Landlord and Tenant thereof, and such arbitrator's decision shall be binding upon Landlord and Tenant. If the two (2) arbitrators fail to agree upon and appoint a third arbitrator within the ten (10) day period provided above, or both parties fail to appoint an arbitrator within the five (5) business day period provided above, then the Landlord shall prepare and submit to Tenant a list of three (3) proposed arbitrators that possess the required qualifications as set forth above; provided that none of such proposed arbitrators nor the firm for which any of them works shall be a current or past affiliate of either the Landlord or the Tenant or currently retained or employed by the Landlord or the Tenant. Within five (5) business days after receipt of such list, the Tenant shall select an arbitrator therefrom and such person shall be the third or single, as the case may be, arbitrator hereunder. If Tenant fails to make such selection with such five (5) business day period, then the Landlord shall select the third or single, as the case may be, arbitrator from such list. Each party shall pay the cost of the arbitrator which it first selects and the parties shall share equally the cost of the third arbitrator.

41. GENERAL PROVISIONS.

- (a) Entire Agreement. This Lease contains all of the agreements of the parties, and there are no verbal or other agreements which modify or affect this Lease. This Lease supersedes any and all prior agreements made or executed by or on behalf of the parties hereto regarding the Premises.
- (b) Terms and Headings. The words "**Landlord**" and "**Tenant**" include the plural as well as the singular, and words used in any gender include all genders. The titles to sections of this Lease are not a part of this Lease and shall have no effect upon the construction or interpretation of any part hereof.
- (c) Successors and Assigns. All of the covenants, agreements, terms and conditions contained in this Lease shall inure to and be binding upon Landlord and Tenant and their respective permitted successors in interest and assigns.
- (d) Brokers. Each of Landlord and Tenant represents and warrants to the other party that it has not engaged any broker, finder or other person who would be entitled to any commission or fees in respect of the negotiation, execution or delivery of this Lease other than

Landlord's Broker and Tenant's Broker (as defined in Paragraphs 22 and 23, respectively, of the Basic Lease Information) (collectively, the "Brokers") and shall indemnify, defend and hold harmless the other party from and against any claim, demand, damage, loss, cost, liability or expense incurred by such other party as a result of any claim asserted by any other broker, finder or other person other than Brokers on the basis of any arrangements or agreements made or alleged to have been made by or on behalf of such representing party, respectively.

(e) Liability of Landlord. Landlord's obligations and liability to Tenant under this Lease shall be limited solely to Landlord's interest in the Project, all post-judgment rents, issues and profits arising therefrom and the proceeds from the sale thereof, and any available insurance proceeds and neither Landlord nor any of the members in Landlord, nor any officer, director, shareholder or partner of or in Landlord or any members in Landlord shall have or incur any personal liability whatsoever with respect to this Lease.

(f) Independent Covenants. Subject to the provisions of Section 7(a) above, this Lease shall be construed as though the covenants herein between Landlord and Tenant are independent and not dependent and Tenant agrees that if Landlord fails to perform its obligations set forth herein, Tenant shall not be entitled to make any repairs or perform any acts hereunder at Landlord's expense or to any setoff of amounts owing hereunder against Landlord except as otherwise provided in this Lease; provided, however, that the foregoing shall in no way impair the right of Tenant to commence a separate action against Landlord for any violation by Landlord of the provisions hereof so long as notice is first given to Landlord and any holder of a mortgage or deed of trust covering the Building or the Project or any portion thereof, and an opportunity is granted to Landlord and such mortgage holder to correct such violations as provided above.

(g) Waiver of Redemption by Tenant. Tenant hereby waives, for Tenant and for all those claiming under Tenant, any and all rights now or hereafter existing to redeem by order or judgment of any court or by any legal process or writ, Tenant's right of occupancy of the Premises after any termination of this Lease.

(h) Severability. Any provision of this Lease which shall prove to be invalid, void or illegal shall in no way affect, impair or invalidate any other provision hereof, and the remaining provisions hereof shall nevertheless remain in full force and effect.

(i) Force Majeure. Except as may be otherwise specifically provided herein, time periods for Landlord's or Tenant's performance under any provisions of this Lease not involving the payment of money shall be extended for periods of time during which the non-performing party's performance is prevented due to circumstances beyond the party's control, including, without limitation, strikes, embargoes, governmental regulations, acts of God, weather, war or other strife. Tenant hereby waives and releases its right to terminate this Lease under Section 1932(1) of the California Civil Code or under any similar law, statute or ordinance now or hereafter in effect.

(j) Intentionally Omitted.

(k) Examination of Lease. Submission of this instrument for examination or signature by Tenant does not constitute a reservation of or option to lease, and it is not effective as a lease or otherwise until execution by and delivery to both Landlord and Tenant.

(l) No Warranty. In executing and delivering this Lease, Tenant has not relied on any representations, including, but not limited to, any representation as to the amount of any item comprising additional rent or the amount of the additional rent in the aggregate or that Landlord is furnishing the same services to other tenants, at all, on the same level or on the same basis, or any warranty or any statement of Landlord which is not set forth herein or in one or more of the exhibits attached hereto.

(m) Right to Lease. Landlord reserves the absolute right to effect such other tenancies in the Project as Landlord in the exercise of its sole business judgment shall determine to best promote the interests of the Building and the Belvedere Place office center so long as the Building remains a first-class office building comparable to Comparable Buildings. Tenant does not rely on the fact, nor does Landlord represent, that any specific tenant or type or number of tenants shall, during the Term, occupy any space in the Building or the Belvedere Place office center.

(n) Transportation Management. Tenant shall exercise commercially reasonable efforts to comply with all present or future programs intended to manage parking, transportation or traffic in and around the Project, and in connection therewith, Tenant shall take reasonable and responsible action for the transportation planning and management of all employees located at the Project by working directly with Landlord, any governmental transportation management organization or any other transportation-related committees or entities. Such programs may include, without limitation (i) restrictions on the number of peak-hour vehicle trips generated by Tenant; (ii) increased vehicle occupancy; (iii) implementation of an in-house ridesharing program and an employee transportation coordinator; (iv) working with employees and any Project, Building or area-wide ridesharing program manager; and (v) utilizing flexible work shifts for employees.

(o) Modification for Lender. If, in connection with Landlord's obtaining construction, interim or permanent financing for the Building or Project, the lender shall request reasonable modifications in this Lease as a condition to such financing, Tenant will not unreasonably withhold, delay or defer its consent thereto, provided that such modifications do not increase the obligations of Tenant hereunder, decrease Tenant's rights or adversely affect the leasehold interest hereby created or Tenant's rights hereunder.

(p) Requirements of Law. Landlord shall comply with all laws, rules and regulations (including, without limitation, the Americans with Disabilities Act) applicable to the common areas of the Building, other than such laws, rules and regulations with which Tenant is obligated to comply under the terms of this Lease.

(q) Recording. Neither Landlord nor Tenant shall record this Lease nor a short form memorandum hereof without the consent of the other, which consent shall not be unreasonably withheld.

- (r) Applicable Laws. This Lease shall be governed by and construed pursuant to the laws of the State of California.
- (s) Relationship of Parties. Nothing contained in this Lease shall be deemed or construed by the parties hereto or by any third party to create the relationship of principal and agent, partnership, joint venture or any association between Landlord and Tenant, it being expressly understood and agreed that neither the method of computation of rent nor any act or omission of the parties hereto shall be deemed to create any relationship between Landlord and Tenant other than the relationship of landlord and tenant.
- (t) Landlord's Title. Landlord's title is and always shall be paramount to the title of Tenant. Nothing herein contained shall empower Tenant to do any act which can, shall or may encumber the title of Landlord.
- (u) Project or Building Name and Storage. Landlord shall have the right at any time to change the name of the Building or Project and to install, affix and maintain any and all signs on the exterior and on the interior of the Project or Building as Landlord may, in Landlord's sole discretion, desire. Tenant shall not use the name of the Project or the Building (including the name Belvedere Place) or use pictures or illustrations of the Project or the Building in advertising or other publicity, without the prior written consent of the Landlord (which consent shall not be unreasonably withheld).
- (v) Survival of Obligations. All provisions of this Lease which require the payment of money or the delivery of property after the termination of this Lease or require either party to indemnify, defend or hold the other harmless shall survive the termination of this Lease.
- (w) Authority. Each individual executing this Lease represents that it has all requisite power and authority to execute and deliver this Lease on behalf of the entity for which it is signing, and by his or her signature, will bind such party to the terms of this Lease.
- (x) Execution in Counterparts. This Agreement may be executed in any number of counterparts and by different parties hereto in separate counterparts, each of which when so executed shall be deemed to be an original and all of which taken together shall constitute one and the same agreement.
- (y) Consent/Duty to Act Reasonably. Any time the consent of Landlord or Tenant is required, such consent shall not be unreasonably withheld, conditioned or delayed. Whenever this Lease grants Landlord or Tenant the right to take action, exercise discretion, establish rules and regulations or make allocations or other determinations (other than decisions to exercise expansion, contraction, cancellation, termination or renewal options), Landlord and Tenant shall act reasonably and in good faith and take no action which might result in the frustration of the reasonable expectations of a sophisticated tenant or landlord concerning the benefits to be enjoyed under this Lease.
- (z) Landlord Bankruptcy Proceeding. In the event that the obligations of Landlord under this Lease are not performed during the pendency of a bankruptcy or insolvency proceeding involving the Landlord as the debtor, or following the rejection of this Lease in accordance with Section 365 of the United States Bankruptcy Code, then notwithstanding any

provision of this Lease to the contrary, and in addition to any and all other remedies permitted by this Lease and/or by applicable laws Tenant shall have the right to set off against Rents next due and owing under this Lease (a) any and all damages caused by such non-performance of Landlord's obligations under this Lease by Landlord, debtor-in-possession, or the bankruptcy trustee, and (b) any and all damages caused by the non-performance of Landlord's obligations under this Lease following any rejection of this Lease in accordance with Section 365 of the United States Bankruptcy Code.

(aa) Access. Tenant shall be granted access to the Building, the Premises and the parking provided to the Building twenty-four (24) hours per day, seven (7) days per week, every day of the year.

(bb) Prohibited Persons and Transactions. Tenant and Landlord (each, a "**Representing Party**") each represents and warrants to the other (i) that neither the Representing Party nor any person or entity that directly owns a 10% or greater equity interest in it nor any of its officers, directors or managing members is a person or entity (each, a "**Prohibited Person**") with whom U.S. persons or entities are restricted from doing business under regulations of the Office of Foreign Asset Control ("**OFAC**") of the Department of the Treasury (including those named on OFAC's Specially Designated and Blocked Persons List) or under any statute, executive order (including Executive Order 13224 (the "**Executive Order**") signed on September 24, 2001 and entitled "Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit, or Support Terrorism," or other governmental action, (ii) that the Representing Party's activities do not violate the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001 or the regulations or orders promulgated thereunder (as amended from time to time, the "**Money Laundering Act**"), and (iii) that throughout the Term the Representing Party shall comply with the Executive Order and with the Money Laundering Act.

(cc) When Payment Is Due. Whenever in this Lease a payment is required to be made by one party to the other, but a specific date for payment is not set forth or a specific number of days within which payment is to be made is not set forth, or the words "immediately", "promptly" and/or "on demand", or the equivalent, are used to specify when such payment is due, then such payment shall be due thirty (30) days after the party which is entitled to such payment sends written notice to the other party demanding payment.

IN WITNESS WHEREOF, the parties hereto have executed this Lease as of the date first above written.

LANDLORD:

BENTLY HOLDINGS CALIFORNIA LP,
a California limited partnership

By: /s/ Chris Bently

Name: Chris Bently

Its: CEO

By: /s/ Amber Marie Bently

Name: Amber Marie Bently

Its: President

TENANT:

REDWOOD TRUST, INC., a Maryland corporation

By: /s/ Harold F. Zagunis

Name: Harold F. Zagunis

Its: CFO

EXHIBIT A

LEGAL DESCRIPTION OF THE PROPERTY

All that certain real property situated in the County of Marin, State of California, described as follows:

PARCEL ONE:

PARCEL 2, as shown upon that certain map entitled, "Parcel Map, Bernard J. Schoenberg, 2514 O.R. 36 and 2721 O.R. 177, Marin County, California", filed for record August 22, 1974 in Volume 10 of Parcel Maps, at Page 54, Marin County Records.

PARCEL TWO:

A NON-EXCLUSIVE EASEMENT for roadway and public utility purposes over the following described property:

BEGINNING at a point called true point of beginning in the Memorandum of Lease recorded in Book 1965 of Official Records, at Page 240; thence along the Easterly line of Belvedere Drive on a curve to the left, having a radius of 188.16 feet, whose center bears North 12° 57' 25" West through an angle of 25° 24' 25" 83.44 feet; thence leaving said Drive on a curve to the left having a radius of 20 feet, whose center bears South 38° 21' 50" East through an angle of 48° 12' 10" 16.83 feet; thence South 03° 26' West 155.95 feet to the Lands of Millard Development Company recorded February 4, 1966 in Book 2022 of Official Records, at Page 393; thence along said Lands, South 50° 20' 34" West 52.37 feet to an angle point in said Lands; thence leaving said Lands, North 0° 20' 17" West 13.69 feet to the corner of said Lands in the Memorandum of Lease; thence along said Lands, North 03° 26' East 133.47 feet; thence on a curve to the left, having a radius of 20 feet, whose center bears North 8° 34' West through an angle of 106° 23' 25" a distance of 37.14 feet to the point of beginning.

EXHIBIT B
DESCRIPTION OF THE PREMISES

EXHIBIT C
NOTICE OF LEASE TERM DATES

To: _____

Re: Office Lease dated _____, 2006, between Bently Holdings California LP, a California limited partnership ("Landlord"), and Redwood Trust, Inc., a Maryland corporation ("Tenant"), concerning Suite 200 on the Second Floor of the office building located within the Belvedere Place office center at Two Belvedere Place, Mill Valley, California

Ladies and Gentlemen:

In accordance with the referenced Office Lease (the "Lease"), we wish to advise you and/or confirm as follows:

1. The Substantial Completion of the Premises has occurred, and the Term shall commence on or has commenced on _____ for a term of _____ months ending on _____.
2. Rent commenced to accrue on _____, in the amount of \$ _____ [INSERT BASIC RENT AND ADDITIONAL RENT].
3. If the Commencement Date is other than the first day of the month, the first billing will contain a pro rata adjustment. Each billing thereafter, with the exception of the final billing, shall be for the full amount of the monthly installment as provided for in the Lease.
4. Your rent checks should be made payable to _____ at _____.

Initially capitalized terms used herein without definition shall have the respective meanings given such terms in the Lease.

LANDLORD:

Bently Holdings California LP,
a California limited partnership

By: /s/ Chris Bently
Name: Chris Bently
Title: CEO

EXHIBIT D

FORM OF TENANT ESTOPPEL CERTIFICATE

TENANT ESTOPPEL CERTIFICATE

To: _____

Ladies and Gentlemen:

_____, a _____ ("Tenant") hereby certifies as follows:

1. The undersigned is the Tenant under that certain Office Lease dated _____ (the "Lease"), executed by BENTLY HODLINGS CALIFORNIA LP, a California limited partnership ("Landlord"), as Landlord, and the undersigned, as Tenant, covering a portion of the building located at _____ Belvedere Place, Mill Valley, California designated as Suite 200 and located on Second Floor (the "Premises"). Initially capitalized terms used herein without definition shall have the respective meanings given such terms in the Lease.

2. The Premises consists of approximately _____ rentable square feet of space. Tenant has paid to Landlord a security deposit of \$ _____. The Term of the Lease commenced on _____ and the expiration of the Lease is _____. Tenant has paid rent through _____. The next rental payment in the amount of \$ _____ is due on _____. Tenant is required to pay _____ percent (_____%) of all annual operating expenses for the Project in excess of _____.

3. The Lease provides for an option to extend the Term of the Lease for _____ years. The rental rate for such extension term is as follows: _____. Except as expressly provided in the Lease, and other documents attached hereto, Tenant does not have any right or option to renew or extend the Term of the Lease, to lease other space at the Project, nor any preferential right to purchase all or any part of the Premises, the Building or the Project.

4. True, correct and complete copies of the Lease and all amendments, modifications and supplements thereto are attached hereto and the Lease, as so amended, modified and supplemented is in full force and effect, and represents the entire agreement between Tenant and Landlord with respect to the Premises, the Building and the Project. There are no amendments, modifications or supplements to the Lease, whether oral or written, except as follows (include the date of such amendment, modification or supplement): _____

5. All space and improvements leased by the Tenant have been completed and furnished in accordance with the provisions of the Lease, and the Tenant has accepted and taken possession of the Premises.

6. To Tenant's actual knowledge, Landlord is not in any respect in default in the performance of the terms and provisions of the Lease. Tenant is not in any respect in default under the Lease beyond all applicable notice and cure periods and has not assigned, transferred or hypothecated the Lease or any interest therein or subleased all or any portion of the Premises.

7. There are no offsets or credits against rentals payable under the Lease and no free rent periods or rental concessions have been granted to Tenant, except as follows:

8. If Tenant is a corporation or partnership, each individual executing this Certificate on behalf of Tenant hereby represents and warrants that Tenant is a duly formed and existing entity qualified to do business in the State of California and that Tenant has full right and authority to execute and deliver this Certificate and that each person signing on behalf of Tenant is authorized to do so.

9. This Certificate is given to _____ with the understanding that _____ will rely hereon in connection with the conveyance/financing of the Building or Project of which the Premises is a part. Following any such conveyance/financing, Tenant agrees that this Lease shall remain in full force and effect and shall bind and inure to the benefit of _____ and its lenders, successors and assigns. Tenant hereby expressly acknowledges and agrees that _____ is relying upon this Certificate.

"Tenant"

a

By: _____

Name: _____

Title: _____

EXHIBIT E
RULES AND REGULATIONS

1. Tenant shall have access to the Building and the Premises at all times during the Term, except to the extent otherwise necessary for emergencies, maintenance or repairs, which maintenance and repairs shall be accomplished with as little interference to Tenant as commercially reasonable. On all hours other than normal business hours for the Project (as defined in Paragraph 19(iii) of these Rules and Regulations below), or such other hours as Landlord shall determine from time to time, access to the Project and/or to the passageways, entrances, exits, shipping areas, halls, corridors, elevators or stairways and other areas in the Project may be restricted and access gained by use of a key/card key to the outside doors of the Project, or pursuant to such security procedures as Landlord may from time to time impose. All such areas, and all roofs, are not for use of the general public, and Landlord shall in all cases retain the right to control and prevent access thereto by all persons whose presence in the judgment of Landlord shall be prejudicial to the safety, character, reputation and interests of the Project and its tenants, provided, however, that nothing herein contained shall be construed to prevent such access to persons with whom Tenant deals in the normal course of Tenant's business unless such persons are engaged in activities which are illegal or violate these Rules. No Tenant Parties shall enter into areas reserved for the exclusive use of Landlord Parties. Tenant shall keep doors to corridors and lobbies closed except when persons are entering or leaving.

2. Tenant shall not paint, display, inscribe, maintain or affix any sign, placard, picture, advertisement, name, notice, lettering or direction on any part of the outside or inside of the Project, or on any part of the inside of the Premises which can be seen from the outside of the Premises, without the prior consent of Landlord, and then only such name or names or matter and in such color, size, style, character and material as may be first approved by Landlord in writing. Landlord shall prescribe the suite number and identification sign for the Premises (which shall be prepared and installed by Landlord at Tenant's expense). Landlord reserves the right to remove at Tenant's expense all matter not so installed or approved without notice to Tenant.

3. Tenant shall not in any manner use the name of the Project for any purpose other than that of the business address of the Tenant, or use any picture or likeness of the Project, in any letterheads, envelopes, circulars, notices, advertisements, containers or wrapping material without Landlord's express written consent.

4. Tenant shall not place anything or allow anything to be placed in the Premises near the glass of any door, partition, wall or window which may be unsightly from outside the Premises, and Tenant shall not place or permit to be placed any article of any kind on any window ledge or on the exterior walls. Blinds, shades, awnings or other forms of inside or outside window ventilators or similar devices, shall not be placed in or about the outside windows in the Premises except to the extent, if any, that the character, shape, color, material and make thereof are first approved by Landlord in writing.

5. Furniture, freight and other large or heavy articles, and all other deliveries may be brought into the Project only at times and in the manner designated by Landlord, and always at Tenant's sole responsibility and risk. Landlord may impose reasonable charges for use of freight

elevators after or before normal business hours. All damage done to the Project by moving or maintaining such furniture, freight or articles shall be repaired by Landlord at Tenant's expense. Landlord may inspect items brought into the Project or Premises with respect to weight or dangerous nature. Landlord may require that all furniture, equipment, cartons and similar articles removed from the Premises or the Project be listed and a removal permit therefor first be obtained from Landlord. Tenant shall not take or permit to be taken in or out of other entrances or elevators of the Project any item normally taken, or which Landlord otherwise reasonably requires to be taken, in or out through service doors or on freight elevators. Tenant shall not allow anything to remain in or obstruct in any way, any lobby, corridor, sidewalk, passageway, entrance, exit, hall, stairway, shipping area, or other such area. Tenant shall move all supplies, furniture and equipment as soon as received directly to the Premises, and shall move all such items and waste (other than waste customarily removed by Project employees) that are at any time being taken from the Premises directly to the areas designated for disposal. Any handcarts used at the Project shall have rubber wheels.

6. Tenant shall not overload any floor or part thereof in the Premises, or Project, including any public corridors or elevators therein bringing in or removing any large or heavy articles, and Landlord may direct and control the location of safes and all other heavy articles and require supplementary supports at Tenant's expense of such material and dimensions as Landlord may deem necessary to properly distribute the weight.

7. Tenant shall not attach or permit to be attached additional locks or similar devices to any door or window, change existing locks or the mechanism thereof, or make or permit to be made any keys for any door other than those provided by Landlord. If more than two keys for one lock are desired, Landlord will provide them upon payment therefor by Tenant. Tenant, upon termination of its tenancy, shall deliver to Landlord all keys of offices, rooms and toilet rooms which have been furnished Tenant or which Tenant shall have had made, and in the event of loss of any keys so furnished shall pay Landlord therefor.

8. If Tenant desires signal, communication, alarm or other utility or similar service connections installed or changed, Tenant shall not install or change the same without the prior approval of Landlord, and then only under Landlord's direction at Tenant's expense. Tenant shall not install in the Premises any equipment which requires more electric current than Landlord is required to provide under this Lease, without Landlord's prior written approval, and Tenant shall ascertain from Landlord the maximum amount of load or demand for or use of electrical current which can safely be permitted in the Premises, taking into account the capacity of electric wiring in the Building and the Premises and the needs of tenants of the Building, and shall not in any event connect a greater load than such safe capacity.

9. Tenant shall not obtain for use upon the Premises ice, drinking water, towel, janitorial and other similar services, except from Persons approved by Landlord in writing. Any Person engaged by Tenant to provide janitor or other services shall be subject to direction by the manager or security personnel of the Project.

10. The toilet rooms, urinals, washbowls and other such apparatus shall not be used for any purpose other than that for which they were constructed, and no foreign substance of any kind whatsoever shall be thrown therein, and the expense of any breakage, stoppage or damage resulting from the violation of this Rule shall be borne by Tenant who, or whose employees or invitees, shall have caused it. Tenant shall not cause any unnecessary labor by reason of

Tenant's carelessness or indifference in the preservation of good order and cleanliness in and around the Project.

11. The janitorial closets, utility closets, telephone closets, broom closets, electrical closets, storage closets, and other such closets, rooms and areas shall be used only for the purposes and in the manner designated by Landlord, and may not be used by tenants, or their contractors, agents, employees, or other parties, without Landlord's prior written consent.

12. Landlord reserves the right to exclude or expel from the Project any person who, in the judgment of Landlord, is intoxicated or under the influence of liquor or drugs, or who shall in any manner do any act in violation of any of these Rules. Tenant shall not at any time manufacture, sell, use or give away, any spirituous, fermented, intoxicating or alcoholic liquors on the Premises, nor permit any of the same to occur (except in connection with occasional social or business events conducted in the Premises which do not violate any laws nor bother or annoy any other tenants). Tenant shall not at any time sell, purchase or give away food in any form by or to any of the other Tenant Parties or any other parties on the Premises, nor permit any of the same to occur (other than in lunchrooms or kitchens for employees).

13. Tenant shall not make any room-to-room canvass to solicit business or information or to distribute any article or material to or from other tenants or occupants of the Project and shall not exhibit, sell or offer to sell, use, rent or exchange any products or services in or from the Premises unless ordinarily embraced within the Tenant's use of the Premises specified in the Lease.

14. Tenant shall not waste electricity, water, heat or air conditioning or other utilities or services, and agrees to cooperate fully with Landlord to ensure the most effective and energy-efficient operation of the Project and shall not allow the adjustment (except by Landlord's authorized Project personnel) of any controls. Tenant shall keep corridor doors closed and shall not open any windows, except that if the air circulation shall not be in operation, windows which are openable may be opened with Landlord's consent. As a condition to claiming any deficiency in the air-conditioning or ventilation services provided by Landlord, Tenant shall close any blinds or drapes in the Premises to prevent or minimize direct sunlight.

15. Tenant shall conduct no auction, fire or "going out of business" sale or bankruptcy sale in or from the Premises, and such prohibition shall apply to Tenant's creditors.

16. Tenant shall cooperate and comply with any reasonable safety or security programs, including fire drills and air raid drills, and the appointment of "fire wardens" developed by Landlord for the Project, or required by law. Before leaving the Premises unattended, Tenant shall close and securely lock all doors or other means of entry to the Premises and shut off all lights and water faucets in the Premises (except heat to the extent necessary to prevent the freezing or bursting of pipes).

17. Tenant will comply with all municipal, county, state, federal or other governmental laws, statutes, codes, regulations and other requirements, including without limitation, environmental health, safety and police requirements and regulations respecting the Premises, now or hereinafter in force, at its sole cost, and will not use the Premises for any immoral purposes.

18. Tenant shall not carry on any business, activity or service except those ordinarily embraced within the permitted use of the Premises specified in the Lease and more particularly, but without limiting the generality of the foregoing, shall not install or operate any internal combustion engine, boiler, machinery, refrigerating, heating or air conditioning equipment in or about the Premises except as permitted by the Lease, use the Premises for housing, lodging or sleeping purposes or for the washing of clothes, place any radio or television antennae other than inside of the Premises except as permitted by the Lease, operate or permit to be operated any musical or sound producing instrument or device which may be heard outside the Premises, use any source of power other than electricity, operate any electrical or other device from which may emanate electrical or other waves which may interfere with or impair radio, television, microwave, or other broadcasting or reception from or in the Project or elsewhere, bring or permit any bicycle or other vehicle, or dog (except in the company of a blind person or except where specifically permitted) or other animal or bird in the Project, make or permit objectionable noise or odor to emanate from the Premises, do anything in or about the Premises tending to create or maintain a nuisance or do any act tending to injure the reputation of the Project, throw or permit to be thrown or dropped any article from any window or other opening in the Building, use or permit upon the Premises anything that will invalidate or increase the rate of insurance on any policies of insurance now or hereafter carried on the Project or violate the certificates of occupancy issued for the Premises or the Project, use the Premises for any purpose, or permit upon the Premises anything, that may be dangerous to persons or property (including but not limited to flammable oils, fluids, paints, chemicals, firearms or any explosive articles or materials), do or permit anything to be done upon the Premises in any way tending to disturb any other tenant at the Project or the occupants of neighboring property, or at any time go upon the roof of the Building without prior approval from Landlord.

19. The following Rules shall apply regarding the parking area:

(i) Parking shall be available in areas designated generally for tenant parking. Tenant shall have card-key access to the parking facilities 24 hours a day, seven day a week. In all cases, parking for Tenant and the other Tenant Parties shall be on a "first come, first served," unassigned basis, with Landlord and other tenants at the Project, and their employees and visitors, and other Persons to whom Landlord shall grant the right or who shall otherwise have the right to use the same, all subject to these Rules, as the same may be amended or supplemented, and applied on a non-discriminatory basis. Notwithstanding the foregoing to the contrary, Landlord reserves the right to assign specific spaces, and to reserve spaces for visitors, small cars, handicapped individuals, and other tenants, visitors of tenants or other Persons, and Tenant Parties shall not park in any such assigned or reserved spaces. Landlord may restrict or prohibit full size vans and other large vehicles.

(ii) In case of any violation of these provisions, Landlord may refuse to permit the violator to park, and may remove the vehicle owned or driven by the violator from the Project without liability whatsoever, at such violator's risk and expense. Landlord reserves the right to temporarily close all or a portion of the parking areas or facilities in order to make repairs or perform maintenance services, or to alter, modify, re-stripe or renovate the same, or if required by casualty, strike, condemnation, act of God, law or governmental requirement, or any other reason beyond Landlord's reasonable control. In the event access is denied for any reason, any monthly parking charges shall be abated to the extent access is denied, as Tenant's sole recourse. Tenant acknowledges that such parking areas or facilities may be operated by an independent contractor not affiliated with Landlord, and Tenant acknowledges that in such event,

Landlord shall have no liability for claims arising through acts or omissions of such independent contractor.

(iii) Normal business hours for the Project shall be 7 A.M. to 6 P.M., Monday through Friday, and 9:00 A.M. to 12:00 P.M. on Saturdays, or such other hours as may be reasonably established by Landlord or its parking operator from time to time. During such normal business hours, cars must be parked entirely within the stall lines, and only small cars may be parked in areas reserved for small or compact cars; all directional signs and arrows must be observed; the speed limit shall be 5 miles per hour; spaces reserved for handicapped parking must be used only by vehicles properly designated; every parker is required to park and lock his own car; washing, waxing, cleaning or servicing of any vehicle is prohibited; parking spaces may be used only for parking automobiles; parking is prohibited in areas: (a) not striped or designated for parking, (b) aisles, (c) where "no parking" signs are posted, (d) on ramps, and (e) loading areas and other specially designated areas. Delivery trucks and vehicles shall use only those areas designated therefor.

20. The directory of the Building will be provided for the display of the name and location of tenants only, and Landlord reserves the right to exclude any other names therefrom. Any additional name that Tenant shall desire to be placed upon the directory must first be approved by Landlord, and if so approved, a charge will be made therefor.

21. Landlord may waive any one or more of these Rules for the benefit of a particular tenant, but no such waiver by Landlord shall be construed as a waiver of these Rules in favor of any other tenant nor prevent Landlord from thereafter enforcing any such Rules against any or all of the tenants of the building.

22. Landlord reserves the right to make such other and reasonable rules as in its sole and absolute discretion may from time to time be needed for the safety, care, efficiency, cleanliness, management and operation of the building, and for the preservation of good order therein; provided, however, that no such changes shall interfere with Tenant's permitted use of the Premises. In the event of a conflict between these Rules and Regulations and the Lease, the Lease shall control.

EXHIBIT F

BASE BUILDING STANDARD SHELL CONSTRUCTION SPECIFICATIONS

Floor:	Current floor covering is carpet.
Exterior Bldg. Walls:	Walls are insulated, finished with taped drywall and are painted.
Interior Demising Walls:	Demising walls are finish taped drywall and ready to receive tenant's wall finish.
Ceiling:	Ceilings are left open to underside of slab above.
Fire Sprinklers:	Fire sprinklers are in upright pendant heads in general protective pattern.
Structural Elements:	Columns and roof trusses are exposed and can be used as architectural elements by the tenant or encased in drywall. (These elements do not require fireproofing.)
Mechanical:	Each floor contains a central water loop with approximately one zone per 2,000 square feet of space. The tenant is responsible for the distribution and thermostatic controls in the tenant space. Tenants may add additional zones (which require additional heat pumps) for private offices, heat-generating equipment or special requirements.
Electrical:	<p>A panel board at the designated building electrical room is provided.</p> <p>The building has specified a 2 x 4-foot parawedge fluorescent fixture to be used by the tenant improvement contractors. The building will stipulate the layout of the lighting along the curtain wall for consistency.</p>
Telecommunications:	The building provides phone and cable connections to the designated main electrical/communications room for each floor.
Drapery:	A building standard window covering is provided.
Toilet rooms:	Toilet rooms are fully improved.
Multi-Tenant Floor:	The Building provides exit corridors, elevator lobbies and an entry door to each tenant space. Doors are wood birch, door frames are hollow metal, lobbies have a stone floor with carpet inset, door hardware is brushed

aluminum and the storefront and railings are aluminum and glass.

Landscaping

Paving and landscaping are existing on exterior portions of the Project.

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SUBLEASE

1. PARTIES. This Sublease, dated July 31, 2006 (the "Effective Date"), is made by and between MarketTools Inc., a Delaware corporation ("**Sublessor**"), and Redwood Trust, Inc., a Maryland corporation ("**Sublessee**").

This Sublease is made in reference to the Master Lease (as defined in Section 7.1 below) entered into between the Master Lessor and Sublessor as of May 23, 2000 as amended as of February 1, 2002, June 14, 2002, September 30, 2003 and May 1, 2004 (as amended, the "Master Lease"). Capitalized terms used herein and not defined will have the same meanings as set forth in the Master Lease.

2. PREMISES. Sublessor hereby subleases to Sublessee and Sublessee hereby subleases from Sublessor for the term, at the rental, and upon all of the conditions set forth herein, that certain real property, including all improvements therein, which is covered by the Master Lease and commonly known by the street address of Suite 200, One Belvedere Place, located in the City of Mill Valley, County of Marin, State of California, and generally described as approximately 21,300 rentable square feet, second floor office space ("**Premises**").

In consideration of Sublessee's obligations hereunder, Sublessor hereby transfers, assigns and delivers to Sublessee certain workstations, chairs, tables, and other personal property located on the Premises and designated for assignment and delivery to Sublessee and all of Sublessor's right, title and interest therein and thereto (collectively, the "Personal Property") on the terms set forth in that certain Bill of Sale signed and delivered by Sublessor to Sublessee on the Commencement Date. Following the Effective Date, Sublessor will have no further interest in or responsibility or liability for the Personal Property.

3. TERM.

3.1 Term. The term of this Sublease ("Term") shall be for seventeen (17) months commencing on August 1, 2006 (the "Commencement Date") and ending on December 31, 2007, unless sooner terminated pursuant to any provision hereof.

3.2 Delay in Commencement. Sublessor agrees to use its best commercially reasonable efforts to deliver possession of the Premises to Sublessee by the Commencement Date. If, despite said efforts, Sublessor is unable to deliver possession of the Premises by the Commencement Date, the Term of this Sublease shall commence on the date that possession of the Premises is actually delivered to Sublessee (the "Delivery Date") and Sublessee shall be entitled to one day of free Base Rent for each day from the Commencement Date to the Delivery Date.

3.3 **No Subletting.** Sublessee may not assign this Sublease, sublet the Premises, transfer any interest of Sublessee therein or permit any use of the Premises by another party (collectively, "Transfer") without the prior written consent of Sublessor and, as set forth in Section 9 below, Master Lessor and subject to any restrictions set forth in the Master Lease. Any Transfer without such consent shall be void and, at Sublessor's option, shall terminate this Sublease; provided that no Transfer shall release Sublessee of its obligations or alter its primary liability to pay Rent and perform Sublessee's Assumed Obligations hereunder.

4. RENT.

4.1 **Base Rent.** Sublessee shall pay to Sublessor as Base Rent for the Premises equal monthly payments of Forty Seven Thousand Nine Hundred Twenty Five and 00/100 dollars (\$47,925.00) in advance, no less than three business days prior to the first day of each calendar month during the Term, except that Sublessee shall pay Sublessor upon the execution hereof Forty Seven Thousand Nine Hundred Twenty Five and 00/100 dollars (\$47,925.00) as Base Rent for the first month of the Term. Base Rent for any period during the term hereof which is for less than one month shall be a pro rata portion of the monthly installment. Notwithstanding anything to the contrary in the Master Lease, the Base Rent will not increase during the Term. During the Term, Base Rent shall be inclusive of Tenant's Proportionate Share of the Actual Operating Expenses for the Project in accordance with Section 4 of the Master Lease. However, Sublessee will pay and be fully liable for any and all other operating expenses incurred by Sublessee with respect to the Premises which are not included in the Actual Operating Expenses, i.e., telecommunications services, office equipment and supplies. In addition, Sublessee shall obtain and keep in full force and effect, at Sublessee's sole cost and expense, during the Term, the insurance which Sublessor is required to obtain and maintain under the Master Lease.

4.2 **Rent Defined.** All monetary obligations of Sublessee to Sublessor under the terms of this Sublease (except for the Security Deposit) are deemed to be rent ("Rent"). Rent shall be payable in lawful money of the United States to Sublessor at the address stated herein or to such other persons or at such other places as Sublessor may designate in writing.

5. **SECURITY DEPOSIT.** Sublessee shall deposit with Sublessor upon execution hereof of Forty Seven Thousand Nine Hundred Twenty Five and 00/100 dollars (\$47,925.00) as security for Sublessee's faithful performance of Sublessee's obligations hereunder. Sublessor shall have the right to use or apply all or part of the Security Deposit for (a) the payment of any Base Rent, additional rent or other sum in default; (b) the payment of any costs or expenses incurred by Sublessor by reason of Sublessee's default; (c) any other amounts necessary to compensate Sublessor for all detriment

proximately caused by Sublessee's failure to perform its obligations under the Sublease or which in the ordinary course of things would be likely to result therefrom, (d) any other amounts which Sublessor may be entitled to recover under Section 1951.2 of the California Civil Code (and/or (e) as otherwise set forth in the Master Lease. Subject to deduction or other adjustment as set forth above, Sublessor shall return the Security Deposit to Sublessee within thirty (30) days after the expiration or sooner termination of this Sublease.

6. USE.

6.1 **Agreed Use.** The Premises shall be used and occupied only for general office purposes and for no other purpose. Sublessee shall not do or permit anything to be done in or about the Premises which would injure or damage the Premises.

6.2 **Compliance.** Except as may be specifically provided herein, Sublessor shall deliver and sublease the Premises to Sublessee strictly in their present (as of the Effective Date) "as-is" and "with all faults" condition. However, to Sublessor's actual knowledge, the electrical, plumbing, HVAC and other building systems and equipment serving the Premises are in good working order and condition as of the Effective Date, although Sublessor does not represent that any particular capacity is available at the Premises. Any and all repairs to and maintenance of the Premises during the Term will be as set forth in Section 7 of the Master Lease. Sublessee, by acceptance of possession of the Premises, conclusively acknowledges that it has otherwise satisfied itself as to the condition of the Premises.

6.3 **Acceptance of Premises.** Sublessee acknowledges that, except as expressly set forth in this Sublease, neither Sublessor, Sublessor's agents, nor any Broker has made any representations or warranties with respect to the Premises.

Sublessor acknowledges that: (a) Broker has made no representations, promises or warranties concerning Sublessee's ability to honor the Sublease or suitability to occupy the Premises, and (b) it is Sublessor's sole responsibility to investigate the financial capability and/or suitability of all proposed tenants.

6.4 **No Improvements.** No alteration or improvements shall be made to the Premises, except in accordance with the Master Lease, including but not limited to Section 8 (a) therein, and with the prior written consent of both Master Lessor and Sublessor, which approval by Sublessor shall not be unreasonably withheld or denied.

7. MASTER LEASE.

7.1 Sublessor is the lessee of the Premises by virtue of a lease, hereinafter the "**Master Lease**," a copy of which is attached hereto marked Exhibit 1, wherein Bently

Holdings, California LP, a California Limited Partnership , as successor in interest to LB Strawberry, LLC, is the lessor, hereinafter the "Master Lessor."

7.2 This Sublease is and shall be at all times subject and subordinate to the Master Lease.

7.3 Except as provided in this Sublease, all terms and conditions of the Master Lease are incorporated into and made a part of this Sublease as if Sublessor were the "Lessor" thereunder and Sublessee the "Lessee" thereunder, except that (i) the following shall be excluded: paragraphs 1(b), 2(a), 2(b), 3(b), 5, 30, and 40; (ii) all references to "Lessor" in paragraphs 7(a), 16,17,19, and 21(a), 22, 24, 38, and 41(e) of the Master Lease shall be deemed to refer to Master Lessor only; (iii) all references to "Lessor" in paragraphs 8(a), 8(c) (except that the second sentence of paragraph 8(c) shall be applicable to Master Lessor only), 10,12,13,18, and 20 of the Master Lease shall be deemed to refer to both Master Lessor and Sublessor; and (iv) in the event that any term or condition contained in this Sublease conflicts with any term or condition of the Master Lease incorporated herein, then, as between Sublessor and Sublessee, the term or condition in this Sublease shall control. Notwithstanding the fact that a provision of the Master Lease is not made a part of this Sublease, this Sublease is nevertheless subject and subordinate to all of the terms of the Master Lease.

7.4 Sublessee agrees to observe, comply with, and perform, all of the terms and conditions applicable to Sublessor as Lessee under the Master Lease as the same have been incorporated by reference herein and which accrue on and after the Commencement Date of this Sublease.

7.5 Sublessee shall hold Sublessor free and harmless from all liability, judgments, costs, damages, claims or demands, including reasonable attorneys fees, arising out of Sublessee's failure to comply with or perform any of its obligations under this Sublease.

7.6 Sublessor agrees to maintain the Master Lease during the entire term of this Sublease, subject, however, to any earlier termination of the Master Lease without the fault of the Sublessor, and to comply with or perform its obligations under the Master Lease and to hold Sublessee free and harmless from all liability, judgments, costs, damages, claims or demands arising out of Sublessor's failure to comply with or perform any of its obligations under the Master Lease. Neither party will be liable to the other party hereunder for any incidental, consequential or punitive damages incurred or suffered by such other party hereunder, including damages arising out of any business interruption or loss of use. In addition, neither Sublessor nor any of its shareholders, officers, directors, employees, contractors, representatives and agents shall have or incur any personal liability whatsoever with respect to this Sublease.

7.7 Sublessor represents to Sublessee that the Master Lease is in full force and effect and has not been further amended since May 1, 2004 and that no default exists on the part of any Party to the Master Lease.

8. ASSIGNMENT OF SUBLEASE AND DEFAULT.

8.1 Sublessor hereby assigns and transfer to Master Lessor the Sublessor's interest in this Sublease, subject, however, to the provisions of Paragraph 8.2 hereof.

8.2 Master Lessor, by executing this document, agrees that until a Default shall occur in the performance of Sublessor's Obligations under the Master Lease, the Sublessor may receive, collect and enjoy the Rent accruing under this Sublease. However, if Sublessor shall Default in the performance of its obligations to Master Lessor then Master Lessor may, at its option, receive and collect, directly from Sublessee, all Rent owing and to be owed under this Sublease. Master Lessor shall not, by reason of this assignment of the Sublease nor by reason of the collection of the Rent from the Sublessee, be deemed liable to Sublessee for any failure of the Sublessor to perform and comply with Sublessor's Remaining Obligations.

8.3 Sublessor hereby irrevocably authorizes and directs Sublessee upon receipt of any written notice from the Master Lessor stating that a Default exists in the performance of Sublessor's obligations under the Master Lease, to pay to Master Lessor the Rent due and to become due under the Sublease. Sublessor agrees that Sublessee shall have the right to rely upon any such statement and request from Master Lessor, and that Sublessee shall pay such Rent to Master Lessor without any obligation or right to inquire as to whether such Default exists and notwithstanding any notice from or claim from Sublessor to the contrary and Sublessor shall have no right to claim against Sublessee for any such Rent so paid by Sublessee.

8.4 No changes or modifications shall be made to this Sublease without the consent of Master Lessor, which consent shall not be unreasonably withheld or delayed.

8.5 **Default by Sublessee; Remedies.** Sublessee shall be in material default of its obligations under this Sublease if any of the events set forth in Section 27(a)(l) — (3) of the Master Lease occur. On any default by Sublessee hereunder, Sublessor shall have all remedies provided to Master Lessor under the Master Lease and under law or in equity which Sublessor may pursue cumulatively or in the alternative.

9. CONSENT OF MASTER LESSOR.

9.1 This Sublease shall not be effective unless, within 15 days of the date hereof, Master Lessor signs this Sublease thereby giving its consent to this Subletting.

9.2 In the event that Master Lessor does give such consent then:

(a) Such consent shall not release Sublessor of its obligations or alter the primary liability of Sublessor to pay the Rent and perform and comply with all of the obligations of Sublessor to be performed under the Master Lease.

(b) The acceptance of Rent by Master Lessor from Sublessee or anyone else liable under the Master Lease shall not be deemed a waiver by Master Lessor of any provisions of the Master Lease.

(c) The consent to this Sublease shall not constitute a consent to any subsequent subletting or assignment.

(d) In the event of any Default of Sublessor under the Master Lease, Master Lessor may proceed directly against Sublessor, any guarantors or anyone else liable under the Master Lease or this Sublease without first exhausting Master Lessor's remedies against any other person or entity liable thereon to Master Lessor.

(f) In the event that Sublessor shall Default in its obligations under the Master Lease, then Master Lessor, at its option and without being obligated to do so, may require Sublessee to attorn to Master Lessor in which event Master Lessor shall undertake the obligations of Sublessor under this Sublease from the time of the exercise of said option to termination of this Sublease but Master Lessor shall not be liable for any prepaid Rent nor any Security Deposit paid by Sublessee, nor shall Master Lessor be liable for any other Defaults of the Sublessor under the Sublease.

9.3 The signatures of the Master Lessor at the end of this document shall constitute its consent to the terms of this Sublease.

9.4 Master Lessor acknowledges that, to the best of Master Lessor's knowledge, no Default presently exists under the Master Lease of obligations to be performed by Sublessor and that the Master Lease is in full force and effect.

9.5 In the event that Sublessor Defaults under its obligations to be performed under the Master Lease by Sublessor, Master Lessor agrees to deliver to Sublessee a copy of any such notice of default. Sublessee shall have the right, but not the obligation, to cure any Default of Sublessor described in any notice of default within ten days after service of such notice of default on Sublessee. If such Default is cured by Sublessee then Sublessee shall have the right of reimbursement and offset from and against Sublessor.

10. BROKERS FEE.

10.1 Upon execution hereof by all parties, Sublessor shall pay to Spallino & Associates Commercial Real Estate a licensed real estate broker ("**Broker**"), a fee as set forth in a separate agreement between Sublessor and Broker, or in the event there is no such separate agreement, the sum of Six Percent (6%) of the rental income for the sublease term for brokerage services rendered by Broker to Sublessor in this transaction.

10.2 —Any transferee of Sublessor's interest in this Sublease, by accepting an assignment thereof, shall be deemed to have assumed the obligations of Sublessor under this Paragraph 10. Broker shall be deemed to be a third-party beneficiary of this Paragraph 10.

11. ATTORNEY'S FEES. If any party or the Broker named herein brings an action to enforce the terms hereof or to declare rights hereunder, the prevailing party in any such action, on trial and appeal, shall be entitled to his reasonable attorney's fees to be paid by the losing party as fixed by the Court.

Executed at: San Francisco, CA

on: 8/9/2006

Address: _____

Executed at: Mill Valley, CA

on: 8/9/2006

Address: _____

Executed at: San Francisco, CA

on: 8/9/06

Address: _____

MARKETTOOLS, INC.

By /s/ Casey Eichler

By Casey Eichler, CFO
"Sublessor"

REDWOOD TRUST, INC., a Maryland corporation

By /s/ Loren Picard

By Loren Picard
"Sublessee"

By /s/ Chris Bently

By /s/ Amber Marie Bently
"Master Lessor"

MarketTools
Philip R Strauss
VP & General Counsel
8/9/2006

Philip Strauss

From: Loren Picard [loren.picard@redwoodtrust.com]
Sent: Wednesday, August 09, 2006 1:23 PM
To: Brandt, Nancy L; Philip Strauss; csalomon
Subject: RE: Belvedere Place/MarketTools Sublease to Redwood Trust

All,

The change is acceptable to Redwood. Jack Spallino is currently circulating 4 sets of the sublease for signature. Feel free to substitute the appropriate pages to align with the below email.

Thanks,
Loren

From: Brandt, Nancy L [mailto:nancy.brandt@berliner.com]
Sent: Wednesday, August 09, 2006 12:46 PM
To: philip.strauss@markettools.com; csalomon
Cc: Loren Picard
Subject: Belvedere Place/MarketTools Sublease to Redwood Trust
Importance: High

Phil and Charlotte,

Attached is an unmarked copy of the corrected sublease. Please print and sign three (3) originals of this copy. As the parties have agreed that section 12 of the sublease is no longer applicable, it is my understanding that Phil will strike out this paragraph on the originals and initial the change. I will ask that Loren Picard confirm to both of you by e-mail that this change is acceptable to Redwood Trust. Please let me know if you have any further questions.

Thanks for your assistance in wrapping this up.

Nancy Brandt
Berliner Cohen
(4080 286-5800)
nancy.brandt@berliner.com

SECOND AMENDMENT TO LEASE

This Second Amendment to Lease ("Second Amendment"), dated as of July 3rd, 2006 (the "Effective Date"), is entered into by and between Bently Holdings California LP, a California limited partnership ("Landlord"), and Redwood Trust, Inc., a Maryland corporation ("Tenant").

RECITALS

A. LB Strawberry LLC, as landlord, and Tenant entered into that certain Belvedere Place Office Lease dated February 27, 2003, and amended by that certain First Amendment to Belvedere Place Office Lease dated April 10, 2003 (collectively, the "Lease") for the premises consisting of approximately nineteen thousand nine hundred eighty-two (19,982) rentable square feet (the "Premises") on the third floor of the building located at One Belvedere Place, Mill Valley California (the "Building").

B. In November 2003, Landlord acquired the Building, together with the other building and improvements known as Belvedere Place, and all right, title and interest of LB Strawberry in and to the Lease, as landlord, was assigned to Landlord.

C. The Term of the Lease is scheduled to expire on May 31, 2013. The Lease provides Tenant with one option to extend the Term of the Lease for an additional period of sixty (60) months.

D. Landlord and Tenant now desire to enter into this Second Amendment to amend the Lease to grant Tenant one additional option to extend the Term of the Lease for a period of five (5) years.

AGREEMENT

In consideration of the mutual covenants set forth herein, and other valuable consideration, Landlord and Tenant agree as follows:

1. Notwithstanding anything to the contrary to contained in the Lease:

A. Options to Extend the Term. Section 40(a) of the Lease is hereby deleted and replaced with the following:

(i) Extension Terms.

(1) First Extension Term. Landlord grants to Tenant an option to extend the Initial Term (the "**First Extension Option**") with respect to all (but not less than all) of the rentable area of the Premises leased by Tenant as of the Expiration Date of the Initial Term for five (5) years (the "**First Extension Term**"). The First "Extension Term shall commence immediately following the Expiration Date of the Initial Term. The First Extension Option shall be exercised, if at all, by written notice to Landlord at any time during the Initial Term on or before the date that is one hundred eighty (180) days prior to the Expiration Date, which notice shall be irrevocable by Tenant, Notwithstanding the foregoing, if an Event of Default (following the expiration of all applicable cure period without cure) exists under this Lease either at the time Tenant exercises the First Extension Option or at any time thereafter prior to on upon the commencement of the First Extension Term, Landlord shall have, in addition to all of Landlord's other rights and remedies under this Lease, the right to terminate the First Extension Option and to cancel unilaterally Tenant's exercise of the First Extension Option, in which event the Expiration Date of this Lease shall be and remain the then scheduled Expiration Date, and Tenant shall have no further rights under this Lease to renew or extend the Term.

(2) Second Extension Term. Landlord grants to Tenant an option to extend Term of this Lease (the "**Second Extension Option**") with respect to all (but not less than all) of the rentable area of the Premises leased by Tenant as of the Expiration Date of the First Extension Term for five (5) years (the "**Second Extension Term**"). The Second Extension Term shall commence

immediately following the Expiration Date of the First Extension Term. The Second Extension Option shall be exercised, if at all, by written notice to Landlord at any time during the First Extension Term on or before the date that is one hundred eighty (180) days prior to the Expiration Date of the First Extension Term, which notice shall be irrevocable by Tenant. Notwithstanding the foregoing, if an Event of Default (following the expiration of all applicable cure period without cure) exists under this Lease either at the time Tenant exercises the Second Extension Option or at any time thereafter prior to or upon the commencement of the Second Extension Term, Landlord shall have, in addition to all of Landlord's other rights and remedies under this Lease, the right to terminate the Second Extension Option and to cancel unilaterally Tenant's exercise of the Second Extension Option, in which event the Expiration Date of this Lease shall be and remain the then scheduled Expiration Date of the First Extension Term, and Tenant shall have no further rights under this Lease to renew or extend the Term

- B. No Other Modifications. Except as amended and modified herein, the Lease shall remain unmodified and in full force and effect. In the event of any conflict or inconsistency between the terms and provisions of this Second Amendment and the terms and conditions of the Lease, the terms and conditions of this Second Amendment shall govern and control.

IN WITNESS WHEREOF, the parties hereto have executed this Second Amendment as of the date first above written.

LANDLORD

BENTLY HOLDINGS CA LP,
A California Limited Partnership

By: /s/ Chris Bently

Name: Chris Bently

Date: 7/27/06

By: /s/ Amber Marie Bently

Name: Amber Marie Bently

Date: 7/27/06

TENANT

REDWOOD TRUST, INC.
a Maryland Corporation

By: /s/ Harold F. Zagunis

Name: Harold F. Zagunis, CFO

Date: 7/31/06

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

I, George E. Bull, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Redwood Trust, 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 officers 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 the financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's control over financial reporting.
5. The registrant's other certifying officers 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.

Date: November 1, 2006

/s/ George E. Bull

George E. Bull
Chief Executive Officer

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

I, Martin S. Hughes, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Redwood Trust, 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 officers 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 the financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and we have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's control over financial reporting.
5. The registrant's other certifying officers 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.

Date: November 1, 2006

/s/ Martin S. Hughes

Martin S. Hughes
Chief Financial Officer

**Certification of Chief Executive Officer pursuant to 18 USC Section 1350
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report of Redwood Trust, Inc. (the "Company") on Form 10-Q for the quarterly period ended September 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, George E. Bull, Chief Executive Officer of the Company, certify, pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report 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.

/s/ George E. Bull

George E. Bull
Chief Executive Officer

November 1, 2006

This Certification is made solely for the purpose of 18 USC Section 1350, subject to the knowledge standard contained therein, and not for any other purpose.

**Certification of Chief Financial Officer pursuant to 18 USC Section 1350
as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002**

In connection with the Quarterly Report of Redwood Trust, Inc. (the "Company") on Form 10-Q for the quarterly period ended September 30, 2006, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), I, Martin S. Hughes, Chief Financial Officer of the Company, certify, pursuant to 18 USC Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) The Report 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.

/s/ Martin S. Hughes

Martin S. Hughes
Chief Financial Officer

November 1, 2006

This Certification is made solely for the purpose of 18 USC Section 1350, subject to the knowledge standard contained therein, and not for any other purpose.