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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, 2010

Commission file number: 1-33818

ENTEROMEDICS INC.

(Exact name of registrant as specified in its charter)

Delaware	**48-1293684**
(State or other jurisdiction of incorporation)	**(IRS Employer Identification No.)**

2800 Patton Road, St. Paul, Minnesota 55113
(Address of principal executive offices, including zip code)

(651) 634-3003
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer	☐	Accelerated filer	☐
Non-accelerated filer	☒ (Do not check if a smaller reporting entity)	Smaller Reporting Company	☐

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

As of October 31, 2010, 7,478,079 shares of the registrant's Common Stock were outstanding.

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Registered Trademarks and Trademark Applications: In the United States we have registered trademarks for VBLOC, ENTEROMEDICS and MAESTRO each registered with the United States Patent and Trademark Office, and have received a Notice of Allowance and fourth extension of time to file a Statement of Use on our application to register the mark EMPOWER. In addition, the marks VBLOC, MAESTRO and ENTEROMEDICS are the subject of either a trademark registration or application for registration in Australia, Brazil, China, the European Community, Saudi Arabia and Switzerland. In Mexico, the trademarks VBLOC and ENTEROMEDICS are registered and the trademark MAESTRO SYSTEM ORCHESTRATING OBESITY SOLUTIONS is the subject of a pending application. The trademarks VBLOC, ENTEROMEDICS and MAESTRO SYSTEM are the subject of pending trademark applications in the United Arab Emirates. This Form 10-Q contains other trade names and trademarks and service marks of EnteroMedics and of other companies.

PART I – FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

ENTEROMEDICS INC.
(A development stage company)

Condensed Consolidated Balance Sheets
(Unaudited)

	September 30, 2010	December 31, 2009
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,553,884	$ 14,617,594
Series A non-voting convertible preferred stock proceeds receivable	781,251	—
Other receivables	3,653	10,007
Prepaid expenses and other current assets	316,360	474,336
Total current assets	13,655,148	15,101,937
Property and equipment, net	936,878	965,829
Other assets	150,647	146,234
Total assets	$ 14,742,673	$ 16,214,000
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of notes payable	$ 1,717,435	$ 3,880,656
Accounts payable	343,243	33,618
Accrued expenses	2,473,137	2,077,916
Accrued interest payable	386,847	288,305
Total current liabilities	4,920,662	6,280,495
Notes payable, less current portion (net discounts of $495,265 and $455,469 at September 30, 2010 and December 31, 2009, respectively)	4,114,331	3,880,810
Common stock warrant liability	—	471,585
Total liabilities	9,034,993	10,632,890
Stockholders' equity:		
Series A non-voting convertible preferred stock, $0.01 par value; 3,600,000 shares authorized; 3,394,309 shares issued and outstanding at September 30, 2010	33,943	—
Common stock, $0.01 par value; 85,000,000 shares authorized; 7,478,079 and 6,229,731 shares issued and outstanding at September 30, 2010 and December 31, 2009, respectively	74,781	62,297
Additional paid-in capital	152,358,987	138,888,080
Deferred compensation	—	(1,667)
Deficit accumulated during development stage	(146,760,031)	(133,367,600)
Total stockholders' equity	5,707,680	5,581,110
Total liabilities and stockholders' equity	$ 14,742,673	$ 16,214,000

See accompanying notes to condensed consolidated financial statements.

ENTEROMEDICS INC.
(A development stage company)

Condensed Consolidated Statements of Operations
(Unaudited)

	Three months ended September 30,		Nine months ended September 30,		Period from December 19, 2002 (inception) to September 30, 2010
	2010	2009	2010	2009	
Operating expenses:					
Research and development	$ 2,342,322	$ 4,563,666	$ 7,061,187	$ 12,420,013	$ 98,670,666
Selling, general and administrative	1,751,870	2,702,147	5,496,247	6,777,061	37,403,611
Total operating expenses	4,094,192	7,265,813	12,557,434	19,197,074	136,074,277
Other income (expense):					
Interest income	—	6,970	1,489	79,241	4,019,914
Interest expense	(286,490)	(918,032)	(975,370)	(2,469,564)	(10,556,875)
Change in value of warrant liability	—	(3,829,130)	158,834	(7,426,785)	(3,840,622)
Other, net	(4,689)	(1,918)	(19,950)	(24,896)	(177,203)
Net loss	$ (4,385,371)	$ (12,007,923)	$(13,392,431)	$(29,039,078)	$(146,629,063)
Net loss per share—basic and diluted	$ (0.59)	$ (2.40)	$ (1.81)	$ (6.35)	
Shares used to compute basic and diluted net loss per share	7,478,075	5,010,666	7,390,857	4,574,205	

See accompanying notes to condensed consolidated financial statements.

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ENTEROMEDICS INC.
(A development stage company)

Condensed Consolidated Statements of Cash Flows
(Unaudited)

	Nine months ended September 30,		Period from December 19, 2002 (inception) to September 30, 2010
	2010	2009	
Cash flows from operating activities:			
Net loss	$(13,392,431)	$(29,039,078)	$(146,629,063)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation	286,364	319,983	1,866,674
Loss on sale of equipment	6,274	2,645	26,510
Employee stock-based compensation	2,143,388	2,302,875	7,931,803
Nonemployee stock-based compensation	34,871	368,299	3,252,700
Amortization of commitment fees, debt issuance costs and original issue discount	305,395	682,645	3,569,417
Amortization of short-term investment discount	—	904	(308,051)
Change in value of warrant liability	(158,834)	7,426,785	3,840,622
Change in operating assets and liabilities:			
Interest receivable	—	57,965	—
Other receivables	6,354	19,308	(3,653)
Prepaid expenses and other current assets	157,976	80,872	(316,360)
Other assets	(60,347)	(27,015)	(60,347)
Accounts payable	48,530	101,019	92,129
Accrued expenses	395,221	11,734	2,473,137
Accrued interest payable	98,542	274,614	552,669
Net cash used in operating activities	(10,128,697)	(17,416,445)	(123,711,813)
Cash flows from investing activities:			
Purchases of short-term investments available for sale	—	—	(14,882,233)
Maturities of short-term investments available for sale	—	5,226,000	14,854,414
Purchases of short-term investments held-to-maturity	—	—	(22,414,130)
Maturities of short-term investments held-to-maturity	—	—	22,750,000
Purchases of property and equipment	(2,592)	(167,030)	(2,578,948)
Net cash (used in) provided by investing activities	(2,592)	5,058,970	(2,270,897)
Cash flows from financing activities:			
Proceeds from stock options exercised	23,697	19,801	200,854
Proceeds from warrants issued	424,289	819,400	1,259,346
Proceeds from warrants exercised	—	—	187,652
Proceeds from sale of common stock, net of underwriting fees of $3,074,315	—	—	40,874,977
Proceeds from sale of common stock in private placement and registered direct offerings	4,834,894	15,076,952	24,840,701
Common stock financing costs	(339,547)	(806,499)	(2,991,179)
Payment to shareholders for fractional shares upon reverse stock split	—	—	(355)
Proceeds from sale of Series A, B and C convertible preferred stock	5,838,211	—	63,766,564
Series A non-voting convertible preferred stock proceeds receivable	(781,251)	—	(781,251)
Series A, B and C convertible preferred stock financing costs	(42,810)	—	(1,640,793)
Proceeds from convertible notes payable	—	—	6,814,846
Proceeds from notes payable	—	5,000,000	35,831,121
Repayments on notes payable	(1,889,904)	(1,755,554)	(29,504,090)
Debt issuance costs	—	—	(321,799)
Net cash provided by financing activities	8,067,579	18,354,100	138,536,594
Net (decrease) increase in cash and cash equivalents	(2,063,710)	5,996,625	12,553,884
Cash and cash equivalents:			
Beginning of period	14,617,594	21,055,108	—
End of period	$ 12,553,884	$ 27,051,733	$ 12,553,884
Supplemental disclosure:			
Interest paid	$ 562,867	$ 1,512,307	$ 6,426,222
Noncash investing and financing activities:			
Cancellation of Alpha Medical, Inc. Series A convertible preferred stock and common stock	$ —	$ —	$ (661,674)
Issuance of Beta Medical, Inc. Series A convertible preferred stock in exchange for Alpha Medical, Inc. Series A convertible preferred stock and common stock	—	—	661,674
Value of warrants issued with debt	289,257	542,144	3,196,933
Value of warrants issued for debt commitment	—	—	636,250
Value of warrants issued with Series C financing	—	—	735,438
Value of warrants issued with private investment public equity financing	—	154,525	154,525
Cashless exercise of warrants	—	4,750,126	5,244,778
Conversion of notes payable to Series B and C convertible preferred shares	—	—	6,980,668
Options issued for deferred compensation	—	—	10,898
Common stock issued to Mayo Foundation and for deferred compensation	—	—	1,770,904

Reclassifications of warrant liability	312,751	1,529,670	2,932,766
Conversion of convertible preferred stock to common stock	—	—	103,138

See accompanying notes to condensed consolidated financial statements.

EnteroMedics Inc.
(A development stage company)

Notes to Condensed Consolidated Financial Statements
(Unaudited)

(1) Summary of Significant Accounting Policies

Description of Business

EnteroMedics Inc. (formerly Beta Medical, Inc.) (the Company) is developing implantable systems to treat obesity and other gastrointestinal disorders. The Company was incorporated in the state of Minnesota on December 19, 2002 and was reincorporated in Delaware on July 22, 2004. The Company is in the development stage and since inception has devoted substantially all of its resources to recruiting personnel, developing its product technology, obtaining patents to protect its intellectual property and raising capital, and has not derived revenues from its primary business activity. The Company is headquartered in St. Paul, Minnesota. In January 2006, the Company established EnteroMedics Europe Sárl, a wholly-owned subsidiary located in Switzerland.

Since inception, the Company has incurred losses through September 30, 2010 totaling approximately $146.6 million and has not generated positive cash flows from operations. The Company expects such losses to continue into the foreseeable future as it continues to develop and commercialize its technologies. As of September 30, 2010, the Company had approximately $12.6 million of cash and cash equivalents. Assuming the Company does not receive any additional funds, it estimates that it has sufficient funds to operate into 2011. As a result, the Company is exploring various financing options and there can be no assurance that the Company will be successful in obtaining additional financing on favorable terms, or at all. If adequate funds are not available, the Company may have to delay development or commercialization of products or license to third parties the rights to commercialize products or technologies that the Company would otherwise seek to commercialize.

Reverse Stock Split

The Company's Board of Directors and stockholders approved a 1-for-6 reverse split of the Company's outstanding common stock that became effective on July 9, 2010. The reverse stock split did not change the par value of the Company's stock or the number of common and preferred shares authorized by the Company's Fifth Amended and Restated Certificate of Incorporation. All share and per share amounts have been retroactively adjusted to reflect the stock split for all periods presented.

Basis of Presentation

The Company has prepared the accompanying condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. The Company's fiscal year ends on December 31.

The accompanying condensed consolidated financial statements and notes thereto are unaudited. In the opinion of the Company's management, these statements include all adjustments, which are of a normal recurring nature, necessary to present a fair presentation. Interim results are not necessarily indicative of results for a full year. The condensed consolidated balance sheet as of December 31, 2009 was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America. The information included in this Form 10-Q should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Comprehensive Loss

Comprehensive loss is defined as the change in equity of a company during a period from transactions and other events and circumstances excluding transactions resulting from investment owners and distributions to owners. There was no difference from reported net loss for the three and nine months ended September 30, 2010. The difference from reported net loss for the three and nine months ended September 30, 2009 related entirely to the maturity of short-term investments and the realization of net unrealized gains on short-term investments.

Fair Value of Financial Instruments

Carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, prepaid expenses and other current assets, accounts payable and accrued liabilities approximate fair value due to their short maturities. The fair value of the Company's long-term debt is approximately $6.3 million as of September 30, 2010 based on the present value of estimated future cash flows using a discount rate commensurate with borrowing rates available to the Company.

EnteroMedics Inc.
(A development stage company)

Notes to Condensed Consolidated Financial Statements—(Continued)
(Unaudited)

The Company's assets that are measured at fair value on a recurring basis are classified within Level 1 or Level 2 of the fair value hierarchy. The Company does not hold any assets that are measured at fair value using Level 3 inputs. The types of instruments the Company invests in that are valued based on quoted market prices in active markets include U.S. treasury securities. Such instruments are classified by the Company within Level 1 of the fair value hierarchy. U.S. treasuries are valued using unadjusted quoted prices for identical assets in active markets that the Company can access.

The types of instruments the Company invests in that are valued based on quoted prices in less active markets, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include the Company's U.S. agency securities, commercial paper, U.S. corporate bonds and municipal obligations. Such instruments are classified by the Company within Level 2 of the fair value hierarchy. The Company values these types of assets using consensus pricing or a weighted average price, which is based on multiple pricing sources received from a variety of industry standard data providers (e.g. Bloomberg), security master files from large financial institutions, and other third-party sources. The multiple prices obtained are then used in a distribution-curve-based algorithm to determine the daily market price.

The Company did not hold any short-term investments as of September 30, 2010. The Company recorded a financial liability in 2009 related to warrants outstanding, which is fair valued using Level 3 inputs (see "Derivative Instruments" below and Note 4).

Derivative Instruments

The Company accounts for outstanding warrants that are not indexed to the Company's stock or warrants issued when the Company has insufficient authorized and unissued stock available to share settle the outstanding warrants as derivative instruments, which require that the warrants be classified as a liability and measured at fair value with changes in fair value recognized currently in earnings and recorded separately in the condensed consolidated statements of operations.

Effective January 1, 2009, as a result of a change in accounting guidance, the Company assessed any outstanding equity-linked financial instruments and concluded that warrants issued in November 2008 with a recorded value of $1.4 million on December 31, 2008 were to be reclassified from equity to a liability. The cumulative effect of the change in accounting principle on January 1, 2009 was a $130,968 increase to the deficit accumulated during development stage. See Note 4 for details regarding the change in fair value of the warrant liability during the nine months ended September 30, 2010.

Net Loss Per Share

Basic net loss per share is computed by dividing net loss by the weighted-average number of common shares outstanding during the period. Diluted net loss per share is based on the weighted-average common shares outstanding during the period plus dilutive potential common shares calculated using the treasury stock method. Such potentially dilutive shares are excluded when the effect would be to reduce a net loss per share. The Company's potential dilutive shares, which include outstanding common stock options, unvested common shares subject to repurchase, convertible preferred stock and warrants, have not been included in the computation of diluted net loss per share for all periods as the result would be anti-dilutive.

The following table sets forth the computation of basic and diluted net loss per share for the three and nine months ended September 30, 2010 and 2009:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Numerator:				
Net loss	$(4,385,371)	$(12,007,923)	$(13,392,431)	$(29,039,078)
Denominator for basic and diluted net loss per share:				
Weighted-average common shares outstanding	7,478,075	5,010,666	7,390,857	4,574,205
Weighted-average unvested common shares subject to repurchase	—	—	—	—
Denominator for net loss per common share—basic and diluted	7,478,075	5,010,666	7,390,857	4,574,205
Net loss per share—basic and diluted	$ (0.59)	$ (2.40)	$ (1.81)	$ (6.35)

EnteroMedics Inc.
(A development stage company)

Notes to Condensed Consolidated Financial Statements—(Continued)
(Unaudited)

The following table sets forth the potential shares of common stock that are not included in the calculation of diluted net loss per share because to do so would be anti-dilutive as of the end of each period presented:

	September 30,	
	2010	2009
Stock options outstanding	911,220	919,362
Warrants to purchase common stock	4,903,728	1,379,920
Series A non-voting convertible preferred stock	3,394,309	—

Recently Issued Accounting Standards

There were no significant changes in recent accounting pronouncements during the nine months ended September 30, 2010 as compared to the recent accounting pronouncements described in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

(2) Liquidity and Management's Plans

The accompanying condensed consolidated financial statements have been prepared assuming the Company will continue as a going concern. For the period from inception (December 19, 2002) through September 30, 2010 the Company experienced net losses of $146.6 million and cash used in operations of $123.7 million. As of September 30, 2010, the Company has not emerged from the development stage and had approximately $12.6 million of cash and cash equivalents, in addition to the remaining $781,000 of funds received in early October from the September 29, 2010 sale of preferred stock and common stock warrants. Assuming the Company does not receive any additional funds, it estimates that it has sufficient funds to operate into 2011, which has raised a substantial doubt about the Company's ability to continue as a going concern. In order to fund on-going operating cash requirements beyond that point or to further accelerate and execute its business plan, including a potential new clinical trial using the next-generation Maestro RC System unconditionally approved by the U.S. Food and Drug Administration (FDA) in October 2010, the Company will need to raise significant additional funds and therefore the Company is exploring various financing options. In view of these matters, the ability of the Company to continue as a going concern is dependent upon the Company's ability to secure additional financing sufficient to support its research and development activities, approval of developed products for sale by regulatory authorities, including the FDA, and ultimately to generate revenues sufficient to cover all costs.

Since inception, the Company has financed its activities principally from the sale of equity securities, debt financing and interest earned on investments. While the Company has been successful in the past in obtaining the necessary capital to support its operations, and has similar future plans, there is no assurance that the Company will be able to obtain additional equity capital or other financing under commercially reasonable terms and conditions, or at all. Furthermore, if the Company issues equity or debt securities to raise additional funds, existing stockholders may experience dilution and the new equity or debt securities it issues may have rights, preferences and privileges senior to those of existing stockholders. In addition, if the Company raises additional funds through collaboration, licensing or other similar arrangements, it may be necessary to relinquish valuable rights to products or proprietary technologies, or grant licenses on terms that are not favorable. If the Company cannot execute its plan to raise funds on acceptable terms, the Company will not be able to continue as a going concern, develop or enhance products, obtain the required regulatory clearances or approvals, execute the Company's business plan, take advantage of future opportunities, or respond to competitive pressure or unanticipated customer requirements. If the Company is unable to obtain additional financing it may be required to reduce the scope of, delay, or eliminate some or all of, its planned research, development and commercialization activities, which could materially harm its business. Any of these events would adversely affect the Company's ability to achieve the Company's development and commercialization goals, which could have a material adverse effect on the Company's business, results of operations and financial condition. The Company's financial statements do not include any adjustments relating to the recoverability or classification of assets or the amounts of liabilities that might result from the outcome of these uncertainties.

(3) Commitments

Operating Lease

The Company rents its office, warehouse and laboratory facilities under an operating lease, which expires on September 30, 2015. At September 30, 2010 future minimum payments under the lease are as follows:

EnteroMedics Inc.
(A development stage company)

Notes to Condensed Consolidated Financial Statements—(Continued)
(Unaudited)

Years ending December 31:	
Remaining three months in 2010	$ 68,298
2011	274,564
2012	280,055
2013	285,656
2014	291,369
2015	221,789
	$1,421,731

(4) Notes Payable

On November 18, 2008 the Company entered into a Loan and Security Agreement (the Loan Agreement) with Silicon Valley Bank (SVB), Venture Lending & Leasing V, Inc. (a private equity fund under the management of Western Technology Investment (WTI)) and Compass Horizon Funding Company LLC (Horizon and, collectively with SVB and WTI, the Lenders), in an aggregate principal amount of up to $20.0 million. On November 21, 2008, SVB and WTI each funded a Term Loan in the aggregate principal amount of $10.0 million and $5.0 million, respectively. The additional $5.0 million Term Loan was automatically funded by Horizon on April 28, 2009 when the trading price of the Company's common stock on the NASDAQ Global Market exceeded a target amount specified in the Loan Agreement. On December 1, 2009, the Company repaid the outstanding principal amount due to WTI and Horizon pursuant to the Loan Agreement.

On February 8, 2010 the Company and SVB entered into a First Amendment (the Amendment) to the Loan Agreement, which reduced the annual interest rate from 11.0% to a fixed annual rate of 10.0%, payable monthly. This had the effect of reducing the monthly payment obligation from $383,532 to $380,421 commencing on March 1, 2010 and ending on December 1, 2011.

Pursuant to the Amendment, the conditions pursuant to which the Excluded Collateral (as defined in the Loan Agreement) will be deemed to be included as Collateral (as defined in the Loan Agreement) were changed from the failure to have five months of remaining liquidity to the occurrence of an Event of Default (as defined in the Loan Agreement) after the date of the Amendment or the lender's awareness after such date of an Event of Default that occurred on or before such date with written notice of such event delivered to the Company. In addition, the Amendment revised the financial covenants in the Loan Agreement to delete the covenant relating to five months of remaining liquidity and to change the liquidity ratio covenant to equal a ratio of (i) the sum of the Company's unrestricted cash and cash equivalents held with SVB and SVB's affiliates, divided by (ii) the outstanding principal amount of the Term Loan, which is not permitted to be less than 1.50:1.00. Finally, the Amendment added a new covenant, the breach of which would constitute an Event of Default. The new covenant required that the Company receive aggregate net proceeds of at least $4.0 million from new capital transactions after January 1, 2010 and before March 31, 2010 and to keep the proceeds of such transactions at SVB until used. The Company satisfied this new covenant with the closing, on January 20, 2010, of its sale of 1,239,717 shares of its common stock to certain institutional investors in a registered direct offering for gross proceeds of approximately $4.8 million, before deducting estimated offering expenses and placement agent fees.

As of September 30, 2010, Horizon had outstanding 141,025 common stock warrants with an exercise price of $3.90 per share. The fair value of the warrant liability associated with these warrants was $312,751 as of May 18, 2010, the date on which the warrants' down round protection expired. This Level 3 fair value was calculated using a weighted-average Black-Scholes valuation model and the following assumptions: volatility between 113.25% and 113.33%, dividend rate of 0%, risk-free interest rate of 3.38% and a remaining life between 8.51 and 8.95 years. As a result of the down round protection expiring, on May 18, 2010 the Company recorded a decrease of $158,834 in the change in value of the warrant liability for the nine months ended September 30, 2010 and reclassified the warrant liability to equity.

On July 8, 2010, the Company and SVB entered into a Second Amendment (the Second Amendment) to the Loan Agreement. The Second Amendment modified the repayment terms of the Term Loan such that from the date of the Second Amendment through December 31, 2010, the Company is only required to make interest only monthly payments on the Term Loan, thereby reducing its monthly debt payment. Then, beginning on January 1, 2011, the remaining balance due on the Term Loan will amortize over 30 equal payments of principal and interest, which will be payable monthly. In addition, the Second Amendment amended the interest rate due on the remaining principal amount of the Term Loan from 10.0% to a fixed annual rate of 11.0%, payable monthly. The Second Amendment also revised the terms of the financial covenants in the Prior Loan Agreement related to the liquidity ratio and new capital transactions. Pursuant to the Second Amendment, the liquidity ratio equals the ratio of (i) the sum of the Company's unrestricted cash and cash equivalents held with SVB and SVB's affiliates plus the Company's eligible accounts, divided by (ii) the outstanding principal amount of the Term Loan and is not permitted to be less than 1.00:1.00. Under the Prior Loan Agreement, the liquidity ratio was not permitted to be less than 1.50:1.00. Pursuant to the Second Amendment, the Company must receive aggregate net proceeds

EnteroMedics Inc.
(A development stage company)

Notes to Condensed Consolidated Financial Statements—(Continued)
(Unaudited)

from New Capital Transactions (as defined in the Prior Loan Agreement) of not less than $2.0 million from the date of the Second Amendment through August 31, 2010, $7.0 million from the date of the Second Amendment through October 31, 2010, $15.0 million from the date of the Second Amendment through January 31, 2011 and $35.0 million from the date of the Second Amendment through June 30, 2011. If the Company meets these financing requirements, it will satisfy the covenant; however, if it does not receive aggregate net proceeds from New Capital Transactions of at least $3.5 million from the date of the Second Amendment through August 31, 2010, $7.5 million from the date of the Second Amendment through October 31, 2010, $15.0 million from the date of the Second Amendment through January 31, 2011 and $35.0 million from the date of the Second Amendment through June 30, 2011, SVB's springing lien on the Company's intellectual property will convert to a full lien on the intellectual property as of the date such "Proposed Capital Raise" was missed. The Company received approximately $6.3 million from the sale of preferred stock and common stock warrants in a private placement transaction that closed on September 30, 2010, which was less than the amount required by the Second Amendment and resulted in the Company entering into a Third Amendment to the Loan Agreement with SVB on November 4, 2010 (see Note 7). Finally, the Second Amendment, revised the definition of "Make-Whole Premium" so that only Term Loan payments of principal made after the date of the Second Amendment will be counted for purposes of determining whether the Company has made twelve regularly scheduled monthly payments of principal in accordance with Section 2.1.1(d) of the Prior Loan Agreement when the Make-Whole Premium comes due.

The Second Amendment also required the issuance of a new warrant to SVB with an exercise price per share equal to the volume weighted average closing price of the Company's publicly traded common stock for the five trading days prior to the date of the Second Amendment. The warrant gives SVB the right to purchase a number of shares of the Company's common stock equal to $316,350 divided by the exercise price per share. On July 8, 2010, SVB was issued a warrant to purchase 150,642 shares of the Company's common stock with an exercise price of $2.10 per share.

Scheduled debt principal payments are as follows as of September 30, 2010:

Years Ending December 31:	
Remaining three months in 2010	$ —
2011	2,322,819
2012	2,594,344
2013	1,409,868
	6,327,031
Less: Original issue discount	(495,265)
Notes payable, net	$5,831,766

5) Stock-based Compensation

The fair value method of accounting for share-based payments is applied to all share-based payment awards issued to employees and where appropriate, nonemployees, unless another source of literature applies. When determining the measurement date of a nonemployee's share-based payment award, the Company measures the stock options at fair value and remeasures such stock options to the current fair value until the performance date has been reached.

Based on the application of these standards, stock-based compensation expense for stock-based awards under the Company's 2003 Stock Incentive Plan for the three and nine months ended September 30, 2010 and 2009 was allocated to operating expenses as follows:

	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Research and development	$232,622	$ 387,318	$ 767,022	$ 760,768
Selling, general and administrative	452,006	928,809	1,411,237	1,910,406
Total	$684,628	$1,316,127	$2,178,259	$2,671,174

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Notes to Condensed Consolidated Financial Statements—(Continued)
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As of September 30, 2010 there was approximately $4.1 million of total unrecognized compensation costs, net of estimated forfeitures, related to employee unvested stock option awards granted after January 1, 2006, which are expected to be recognized over a weighted-average period of 2.21 years.

The estimated grant-date fair values of the stock options were calculated using the Black-Scholes valuation model, based on the following assumptions for the three and nine months ended September 30, 2010 and 2009:

	Employees		Employees	
	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Risk-free interest rates	1.87%	2.73%	1.87%-2.62%	1.90%-2.99%
Expected life	6.25 years	6.25 years	6.00 - 6.25 years	6.00 - 6.25 years
Expected dividends	0%	0%	0%	0%
Expected volatility	124.78%	97.00%	113.20%-124.78%	88.10%-99.00%
	Nonemployees		Nonemployees	
	Three months ended September 30,		Nine months ended September 30,	
	2010	2009	2010	2009
Risk-free interest rates	2.82%	3.24%-3.64%	2.82%-3.81%	2.68%-3.64%
Expected life	9.54 years	6.00 - 9.98 years	9.01 -9.87 years	6.00 -9.98 years
Expected dividends	0%	0%	0%	0%
Expected volatility	127.93%	100.50%-108.10%	113.25%-127.93%	99.70%-108.10%

Option activity under the Plan for the nine months ended September 30, 2010 was as follows:

	Shares Available For Grant	Outstanding Options	
		Number of Shares	Weighted-Average Exercise Price
Balance, December 31, 2009	98,923	995,696	$ 18.96
Shares reserved	—	—	—
Options granted	(39,160)	39,160	2.59
Options exercised	—	(8,592)	2.76
Options cancelled	114,910	(114,910)	16.71
Reverse split rounding	134	(134)	
Balance, September 30, 2010	174,807	911,220	$ 18.69

On October 29, 2010, a special meeting of stockholders was held to vote on amendments to the Company's 2003 Stock Incentive Plan to (a) increase the number of shares authorized under the plan by 1,149,817 and (b) allow for a one-time stock option exchange program (see Note 7).

(6) Stock Purchases

Registered Direct Offering

On January 14, 2010, the Company entered into a securities purchase agreement with certain institutional investors for the sale of 1,239,717 shares of its common stock in a registered direct offering (the Offering), at a purchase price of $3.90 per share. On January 20, 2010, the Offering closed and the Company received gross proceeds of $4.8 million before deducting estimated offering expenses. No warrants were issued with the Offering.

Private Placement

On September 29, 2010, the Company entered into securities purchase agreements with several accredited investors for the sale of 3,394,309 shares of its Series A Non-Voting Convertible Preferred Stock (Preferred Stock) and 3,394,309 common stock warrants (Up Front Warrants) in a private placement transaction (the Private Placement), at a purchase price of $1.72 per share and $0.125 per warrant, respectively. On September 30, 2010, the Private Placement closed and the Company received $5.5 million of the $6.3

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million total gross proceeds before deducting estimated offering expenses. The remaining $781,000 of proceeds from the Private Placement was received in early October and was recorded as an asset on the Company's September 30, 2010 condensed consolidated balance sheet.

The Up Front Warrants purchased have an exercise price per share of $2.15, or 125% of the original purchase price of the Preferred Stock. The warrants will become exercisable upon the later to occur of the following: (i) the date that is six months and one day after the issuance of the Up Front Warrants, or (ii) the closing of an offering of equity securities producing gross proceeds of at least $15 million (excluding proceeds from the Private Placement) and will expire on the fifth anniversary of the date on which they become exercisable.

Pursuant to the securities purchase agreements, the Preferred Stock investors are entitled to additional warrants if the Preferred Stock should convert into common stock upon completion of a future equity offering that exceeds $15.0 million (Conversion Warrants). Each Preferred Stock investor will purchase additional warrants from the Company to purchase that number of shares of common stock equal to (i) the difference between $1.72 and the price per share of common stock underlying the equity securities paid by investors in a future equity offering, *multiplied by* the number of shares of Preferred Stock purchased by the investor, *divided by* (ii) the Conversion Warrant exercise price per share, which will equal $2.06 (120% of the $1.72 purchase price). The Conversion Warrants will only be issued if the Company completes a future equity offering and the purchase price is below $1.72 per share. The purchase price for each Conversion Warrant issued will equal $0.125 per share of common stock underlying the warrant.

Series A Non-Voting Convertible Preferred Stock

The following is a summary of material provisions of the Preferred Stock.

Dividends. Dividends will be paid on the Preferred Stock on an as-converted basis when, as, and if paid on the Company's common stock.

Liquidation Preference. In the event of any liquidation, dissolution or winding up of the Company, any distributions to holders of the Company's outstanding equity shall be made as follows: First, to the holder of any share of Preferred Stock up to 150% of the original purchase price plus declared and unpaid dividends on each share of Preferred Stock (liquidation value of approximately $8.8 million on September 30, 2010), and then pro rata to the holders of the common stock and Preferred Stock on an as converted basis.

No Voting Rights. Except as required by law or as otherwise set forth below the Preferred Stock shall be non-voting and shall not have any voting rights. So long as 10% of the shares of Preferred Stock are outstanding, in addition to any other vote or approval required under the Company's charter or bylaws, the Company will not, without the written consent of the holders of at least 75% of the Preferred Stock, either directly or by amendment, merger, consolidation, or otherwise: (i) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences or privileges senior to or on parity with the Preferred Stock, or increase the authorized number of shares of Preferred Stock; or (ii) purchase or redeem or pay any dividend on any capital stock prior to the Preferred Stock, other than stock repurchased from former employees or consultants in connection with the cessation of their employment/services, at the lower of fair market value or cost; other than as approved by the Board of Directors.

Conversion Rights. The Preferred Stock may be converted on a 1:1 basis into shares of common stock at any time at the option of the investor, subject to adjustments for stock dividends, splits, combinations and similar events; *provided, however,* that no investor will be permitted to convert an amount of Preferred Stock that would result in such investor owning more than 19.99% of the Company's outstanding common stock upon such conversion.

Each share of Preferred Stock will automatically be converted on a 1:1 basis into shares of common stock (subject to adjustments for stock dividends, splits, combinations and similar events): (i) immediately after the closing of an offering by the Company of equity securities producing gross proceeds of at least $15.0 million, excluding proceeds from the sale of Preferred Stock, or (ii) upon the written consent of the holders of 75% of the Preferred Stock; *provided, however,* that in the case of (i) and (ii) above, no investor will be permitted to convert an amount of Preferred Stock that would result in such investor owning more than 19.99% of the Company's outstanding common stock upon such conversion.

(7) Subsequent Events

Stock Option Exchange

On October 29, 2010, a special meeting of stockholders was held and the stockholders approved amendments to the Company's 2003 Stock Incentive Plan to (a) increase the number of shares authorized under the plan by 1,149,817 and (b) allow for a one-time stock option exchange program.

The stock option exchange program was an offer by the Company to all of its employees (including executive officers) to exchange some or all of their outstanding options to purchase the Company's common stock for fewer new options with exercise

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prices equal to the closing price per share of the Company's common stock on the NASDAQ Capital Market on the date of grant (the Offer). A stock option was eligible for exchange if: (i) it had an exercise price of greater than $6.00 per share; (ii) it was not granted in connection with the performance of consulting services for the Company; (iii) it was held by an employee of the Company who was eligible to participate in the Offer; and (iv) it remained outstanding (i.e. unexpired and unexercised) as of the date of grant of the new options (such options are referred to herein as Eligible Options). There were 481,288 Eligible Options and on October 29, 2010, the Offer expired with a total of 481,288 shares of common stock underlying Eligible Options being validly tendered and not withdrawn. The Company granted new options to purchase 384,629 shares of the Company's common stock in exchange for the cancellation of the tendered Eligible Options. The exercise price of the new stock options is $1.90 and the new options vest such that one-third of the shares underlying the option are immediately vested on the date of grant and the remaining shares vest monthly for 24 months. Each new option is a non-qualified stock option for U.S. federal income tax purposes and has a term of seven years from the date of grant.

The Eligible Options were exchanged using the below exchange ratios, which were designed to result in the fair value of the new options being approximately equal in the aggregate to the fair value of the Eligible Options that were tendered for cancellation in the exchange offer.

If the Per Share Price of the Eligible Option was	The Exchange Ratio was (Eligible Option to New Option)
$6.00 to $9.99	1.03 to 1.00
$10.00 to $19.99	1.10 to 1.00
$20.00 to $29.99	1.20 to 1.00
$30.00 to $39.99	1.26 to 1.00
$40.00 and up	1.37 to 1.00

The exchange of options pursuant to the option exchange program is characterized as a modification of the existing option awards in accordance with the fair value method of accounting for share-based payments. However, no additional expense will be recognized as the modification was value neutral. To be value neutral, the fair value of the stock options tendered as calculated immediately prior to their tender must be at least equal to the fair value of the stock options received by employees in the option exchange program. Any previously unrecognized compensation expense from the tendered stock options and incremental compensation costs associated with the new stock options received in the option exchange program will be recognized over the appropriate vesting period.

Loan Amendment

On November 4, 2010, the Company and SVB entered into a Third Amendment (the Third Amendment) to the Loan Agreement. The Third Amendment modifies the New Capital Transaction covenant such that it waives the requirements to receive aggregate net proceeds from New Capital Transactions of not less than $3.5 million from the date of the Second Amendment through August 31, 2010 and $7.5 million from the date of the Second Amendment through October 31, 2010. The Third Amendment also modifies the requirement to receive aggregate net proceeds from New Capital Transactions of not less than $15.0 million from the date of the Second Amendment through January 31, 2011 to $12.5 million and eliminates the requirement to receive aggregate net proceeds from New Capital Transactions of not less than $35.0 million from the date of the Second Amendment through June 30, 2011. Lastly, the Third Amendment suspends the liquidity ratio covenant, which was not permitted to be less than 1.00:1.00, until January 31, 2011. The Company has agreed to maintain a blocked cash collateral account with funds equal to the principal balance outstanding until such time that it has received aggregate net proceeds from New Capital Transactions of not less than $12.5 million from the date of the Second Amendment through January 31, 2011, SVB has received a financial forecast through December 31, 2012 approved by the Company's Board of Directors and the Company and SVB have agreed to new financial covenants or a new financial structure for the Company's obligations. There were no changes to the repayment terms of the Term Loan as defined in the Second Amendment.

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

The following discussion should be read in conjunction with the condensed consolidated financial statements and notes thereto appearing elsewhere in this Quarterly Report on Form 10-Q.

Except for the historical information contained herein, the matters discussed in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," are forward-looking statements that involve risks and uncertainties. In some cases, these statements may be identified by terminology such as "may," "will," "should," "expects," "could," "intends," "might," "plans," "anticipates," "believes," "estimates," "predicts," "potential," or "continue," or the negative of such terms and other comparable terminology. These statements involve known and unknown risks and uncertainties that may cause our results, level of activity, performance or achievements to be materially different from those expressed or implied by the forward-looking statements. Factors that may cause or contribute to such differences include, among others, those discussed in Part I, Item 1A "Risk Factors" of our Annual Report on Form 10-K for the year ended December 31, 2009. Except as may be required by law, we undertake no obligation to update any forward-looking statement to reflect events after the date of this report.

Overview

We are a development stage medical device company focused on the design and development of devices that use neuroblocking technology to treat obesity, its associated co-morbidities, and other gastrointestinal disorders. Our proprietary neuroblocking technology, which we refer to as VBLOC therapy, is designed to intermittently block the vagus nerve using high frequency, low energy, electrical impulses. We have a limited operating history and we currently have no products approved for sale. Our initial product under development is the Maestro System, which uses VBLOC therapy to limit the expansion of the stomach, help control hunger sensations between meals, reduce the frequency and intensity of stomach contractions and produce a feeling of early and prolonged fullness. We were formerly known as Beta Medical, Inc. and were incorporated in Minnesota on December 19, 2002. We later reincorporated in Delaware on July 22, 2004. Since inception, we have devoted substantially all of our resources to the development and commercialization of our Maestro System.

Based on our understanding of vagal nerve function and nerve blocking from our preclinical studies and the results of our initial clinical trials, we believe the Maestro System may offer obese patients a minimally-invasive treatment alternative that has the potential to result in significant and sustained weight loss. We believe that our Maestro System will allow bariatric surgeons to help obese patients who are concerned about the risks and complications associated with gastric banding and gastric bypass surgery. In addition, data from sub-group analyses demonstrate that VBLOC therapy may hold promise in improving the obesity-related co-morbidities of diabetes and hypertension. We are conducting, or plan to conduct, feasibility studies in each of these co-morbidities to assess VBLOC therapy's potential in addressing multiple indications.

We are currently evaluating the Maestro System in human clinical trials conducted in the United States, Australia, Mexico, Norway and Switzerland. To date, we have not observed any mortality or any unanticipated adverse device effects in these clinical trials. We have also not observed any long-term problematic clinical side effects in any patients, including in those patients who have been using the Maestro System for more than one year.

On October 2, 2009, we announced preliminary results from our pivotal clinical study, the EMPOWER trial; indicating that the study did not meet its primary and secondary efficacy endpoints. We also announced that there were no therapy-related serious adverse events reported during the study. The EMPOWER trial is a multi-center, randomized, double-blind, prospective, placebo-controlled pivotal study being conducted in the United States and selected international centers. We further announced on November 12, 2009, that the control arm of the trial, which was intended to be inactive, apparently provided a low-intensity blocking signal that introduced VBLOC therapy in human subjects.

In January 2010, we met with the U.S. Food and Drug Administration (FDA) to discuss the EMPOWER trial results and the regulatory process going forward. Based on this discussion, in March we submitted an Investigational Device Exemption (IDE) application for a clinical trial, called ReCharge, using our next-generation Maestro RC System in the treatment of morbid obesity and received unconditional approval from the FDA in October 2010. Our IDE approval outlines plans for conducting a randomized, double-blind, parallel-group, multicenter pivotal clinical trial of our Maestro RC System in 234 morbidly obese patients enrolled at up to 12 U.S. centers. All patients in the study will receive an implanted device and will be randomized in a 2:1 allocation to treatment or control groups. The control group will receive a device that is functional only electronically with no implanted leads. This renders the control group device inert with relation to delivery of any signaling or charge to the vagus nerve during the study period and will require the implantation of a new, complete system at the end of the 12 month study period if the control subject wishes to receive VBLOC therapy for the follow-on trial period. All patients are expected to participate in a weight management program. If we are able to obtain adequate funding, we will begin enrolling and implanting patients in ReCharge and target an acceleration of the timing of the final implant to take place around the end of 2011 at the earliest. Assuming that we successfully enroll and implant the trial and achieve favorable results, we plan to use data from that trial to support a premarket approval (PMA) application for the Maestro System, which we expect to submit no earlier than the fourth quarter of 2012. We anticipate we will be able to commercialize the Maestro System in the United States no earlier than late 2013.

As announced on August 2, 2010, we are also taking the necessary steps to commercialize the Maestro RC System in Australia which includes filing an application for approval and listing with the Australian Therapeutic Goods Administration (TGA) upon

receipt of European CE Mark certification for the Maestro RC System. On October 21, 2010, we announced that we have entered into a cooperation agreement with the Australian Institute of Weight Control (AIWC), a network of bariatric clinics specializing in laparoscopic weight loss surgery and clinical research for the morbidly obese. Under the cooperation agreement, we have designated AIWC and AIWC Member Clinics as authorized training and implantation centers for our products. The AIWC will work with us to provide research, communications, training and accreditation support related to the Maestro RC System in Australia and other international territories. Further, the two organizations will work toward TGA approval of the Maestro RC System, which we hope to receive during the second half of 2011, and collaborate on subsequent marketing and distribution efforts within this territory. The AIWC will also support our efforts in gaining reimbursement for the private sector through the Medical Services Advisory Committee (MSAC) in Australia.

We received European CE Mark approval for our Maestro RF System on March 4, 2009 and are in the process of applying for European CE Mark approval for our Maestro RC System, which we hope to receive in the first quarter of 2011. The method of assessing conformity with applicable regulatory requirements varies depending on the class of the device, but for our Maestro System (which falls into Class III), the method involved a combination of self-assessment by the manufacturer of the safety and performance of the device, and a third-party assessment by a Notified Body, usually of the design of the device and of the manufacturer's quality system. We use KEMA in the Netherlands as the Notified Body for our CE marking approval process.

If and when we obtain FDA approval of our Maestro System we intend to market our products in the United States through a direct sales force supported by field technical and marketing managers who provide training, technical and other support services to our customers. Outside the United States we intend to use direct, dealer and distributor sales models as the targeted geography best dictates. To date, we have relied on third-party manufacturers and suppliers for the production of our Maestro System. We currently anticipate that we will continue to rely on third-party manufacturers and suppliers for the production of the Maestro System.

To date, we have generated no revenue from the sale of products, and we have incurred net losses in each year since our inception. As of September 30, 2010, we had experienced net losses during the development stage of $146.6 million. We expect our losses to continue as we continue our development activities. We have financed our operations to date principally through the sale of capital stock, debt financing and interest earned on investments.

Our Board of Directors and stockholders approved a 1-for-6 reverse split of our outstanding common stock that became effective on July 9, 2010. The reverse stock split did not change the par value of our stock or the number of common and preferred shares authorized by our Fifth Amended and Restated Certificate of Incorporation. All share and per share amounts have been retroactively adjusted to reflect the stock split for all periods presented.

Financial Overview

Revenue

To date, we have not commercialized any products and we have not generated any revenue. We are taking the necessary steps to commercialize the Maestro RC System in Australia which includes the filing of an application for approval and listing with the TGA upon receipt of European CE Mark certification for the Maestro RC System. We hope to receive TGA approval during the second half of 2011. In October 2010 we received unconditional approval from the FDA of our IDE to complete a pivotal trial using the Maestro RC System. As such, we do not expect to generate revenue in the United States before late 2013 and then, only if we successfully enroll and implant the clinical trial, achieve favorable results and receive FDA approval of our Maestro System. Any revenue from initial sales of a new product in the United States or internationally is difficult to predict and in any event will only modestly reduce our continued losses resulting from our research and development and other activities.

Research and Development Expenses

Our research and development expenses primarily consist of engineering, product development and clinical and regulatory expenses, incurred in the development of our Maestro System. Research and development expenses also include employee compensation, including stock-based compensation, consulting services, outside services, materials, supplies, depreciation and travel. We expense research and development costs as they are incurred. From inception through September 30, 2010, we have incurred a total of $98.7 million in research and development expenses. Our research and development expenditures in 2010 and beyond will largely depend on our regulatory path forward.

Selling, General and Administrative Expenses

Our selling, general and administrative expenses consist primarily of compensation for executive, finance, market development and administrative personnel, including stock-based compensation. Other significant expenses include costs associated with attending medical conferences, professional fees for legal, including legal services associated with our efforts to obtain and maintain broad protection for the intellectual property related to our products, and accounting services, cash management fees, consulting fees and travel expenses. From inception through September 30, 2010, we have incurred $37.4 million in selling, general and administrative expenses.

Results of Operations

Comparison of the Three Months Ended September 30, 2010 and 2009

Research and Development Expenses. Research and development expenses were $2.3 million for the three months ended September 30, 2010, compared to $4.6 million for the three months ended September 30, 2009. The decrease of $2.2 million, or 48.7%, is primarily due to decreases of $1.5 million, $503,000 and $155,000 in professional services, compensation and benefit expense and stock-based compensation (employee and nonemployee). The ongoing financial commitment to maintain the EMPOWER trial continues to decrease as prescribed patient follow up visits become further apart. The reduction in compensation and benefits expense and employee stock-based compensation is primarily the result of a 40% reduction-in-force completed October 27, 2009. We currently do not have nonemployee stock options being expensed, whereas in 2009 there was nonemployee stock-based compensation expense that was fully expensed by September 30, 2009.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were $1.8 million for the three months ended September 30, 2010, compared to $2.7 million for the three months ended September 30, 2009. The decrease of $950,000, or 35.2%, is primarily due to decreases of $477,000, $277,000 and $112,000 in stock-based compensation (employee and nonemployee), professional services and compensation and benefit expense, respectively. The decrease in compensation and benefits expense and employee stock-based compensation is primarily the result of a 40% reduction-in-force completed October 27, 2009. The decrease in the nonemployee stock-based compensation is the result of fully expensing the one remaining nonemployee stock option, whereas, for the three months ended September 30, 2009 there were four nonemployee grants being expensed. The decrease in professional services includes decreases of $130,000 in audit and legal fees and $125,000 in general consulting services.

Interest Income. Interest income was zero for the three months ended September 30, 2010, compared to $7,000 for the three months ended September 30, 2009. The decrease is primarily due to a decrease in total cash available to invest. The cash, cash equivalents and short-term investments balance was $12.6 million at September 30, 2010, including $5.5million of funds received on September 30, 2010 from the sale of preferred stock and common stock warrants in a private placement transaction, compared to a balance of $27.1 million at September 30, 2009. The average cash, cash equivalents and short-term investments balance for the three months ended September 30, 2010, was $9.9 million compared to an average balance for the three months ended September 30, 2009 of $31.0 million.

Interest Expense. Interest expense was $286,000 for the three months ended September 30, 2010, compared to $918,000 for the three months ended September 30, 2009. The decrease of $632,000, or 68.8%, was the result of voluntarily prepaying two of the outstanding term loans in full, or approximately 50% of the outstanding principal balance, on December 1, 2009.

Change in Value of Warrant Liability. The value of the warrant liability did not change during the three months ended September 30, 2010, compared to an increase of $3.8 million for the three months ended September 30, 2009. For the three months ended September 30, 2009, the warrant liability consisted of warrants issued to Silicon Valley Bank (SVB), Western Technology Investment (WTI) and Compass Horizon Funding Company LLC (Horizon). Both SVB and WTI exercised their warrants in full in September and October 2009, respectively. As a result, only warrants issued to Horizon remained outstanding during the three month period ended September 30, 2010. The fair market value of the remaining 141,025 warrants, with a weighted-average exercise price of $3.90, was $313,000 as of May 18, 2010, the date on which the warrants' down round protection expired and the warrant liability was reclassified to equity. There was no warrant liability during the three months ended September 30, 2010.

Comparison of the Nine Months Ended September 30, 2010 and 2009

Research and Development Expenses. Research and development expenses were $7.1 million for the nine months ended September 30, 2010, compared to $12.4 million for the nine months ended September 30, 2009. The decrease of $5.4 million, or 43.1%, is primarily due to decreases of $2.8 million, $1.7 million, $368,000 and $353,000 in professional services, compensation and benefit expense, device costs and travel expense, respectively. The ongoing financial commitment to maintain the EMPOWER trial continues to decrease as prescribed patient follow up visits become further apart, which has led to decreases in both professional services and device costs. The reduction in compensation and benefits expenses along with the reduction in travel expense is primarily the result of a 40% reduction-in-force completed October 27, 2009.

Selling, General and Administrative Expenses. Selling, general and administrative expenses were $5.5 million for the nine months ended September 30, 2010, compared to $6.8 million for the nine months ended September 30, 2009. The decrease of $1.3 million, or 18.9%, is primarily made up of decreases of $499,000, $288,000 and $277,000 in stock-based compensation, compensation and benefits expense and professional services, respectively. The decreases in stock-based compensation and compensation and benefits expense are primarily the result of a 40% reduction-in-force completed October 27, 2009. The decrease in professional services includes decreases of $115,000 in audit and legal fees and $114,000 in consulting costs.

Interest Income. Interest income was $1,500 for the nine months ended September 30, 2010, compared to $79,000 for the nine months ended September 30, 2009. The decrease of $78,000, or 98.1%, is primarily due to a decrease in total cash available to invest. The cash, cash equivalents and short-term investments balance was $12.6 million at September 30, 2010, including $5.5 million of funds received on September 30, 2010 from the sale of preferred stock and common stock warrants in a private placement transaction, compared to $14.7 million at September 30, 2009. The average cash, cash equivalents and short-term investments balance was $12.8 million and $32.2 million for the nine months ended September 30, 2010 and 2009, respectively. The decrease is the result of $29.7

million in net cash used in operating and investing activities and $13.7 million in debt principal payments from January 1, 2009 through September 30, 2010, offset by net proceeds of $29.9 million from the sale of common stock and preferred stock in two private placements and common stock in two registered direct offerings and $5.0 million of debt funding during the same time period.

Interest Expense. Interest expense was $975,000 for the nine months ended September 30, 2010, compared to $2.5 million for the nine months ended September 30, 2009. The decrease of $1.5 million, or 60.5%, was primarily the result of voluntarily prepaying two of the outstanding term loans in full, or approximately 50% of the outstanding principal balance, on December 1, 2009.

Change in Value of Warrant Liability. The value of the warrant liability decreased $159,000 for the nine months ended September 30, 2010, compared to an increase of $7.4 million for the nine months ended September 30, 2010. For the nine months ended September 30, 2009 the warrant liability consisted of warrants issued to SVB, WTI and Horizon. Both SVB and WTI exercised their warrants in full in September and October 2009, respectively. As a result, only warrants issued to Horizon remained outstanding during the nine month period ended September 30, 2010. The fair market value of the remaining 141,025 warrants, with a weighted-average exercise price of $3.90, was $313,000 as of May 18, 2010, the date on which the warrants' down round protection expired and the warrant liability was reclassified to equity. The fair market value for these remaining warrants was calculated using the Black-Scholes valuation model, which resulted in a $159,000 decrease for the nine months ended September 30, 2010 as our stock price decreased from $3.36 on December 31, 2009 to $2.46 on May 18, 2010.

Liquidity and Capital Resources

We have incurred losses since our inception in December 2002 and, as of September 30, 2010 we had experienced net losses during the development stage of $146.6 million. We have financed our operations to date principally through the sale of capital stock, debt financing and interest earned on investments. Through December 31, 2009, we had received net proceeds of $122.2 million from the sale of common stock and preferred stock, including $39.1 million from our initial public offering in November 2007 and $19.9 million from private placement and registered direct offerings in 2009, and $35.8 million in debt financing, $746,000 to finance equipment purchases and $35.0 million to finance working capital. On January 20, 2010, we completed the sale of 1,239,717 shares of our common stock in a registered direct offering, at a purchase price of $3.90 per share. We received gross proceeds of $4.8 million before deducting estimated offering expenses. On September 30, 2010, we completed the sale of 3,394,309 shares of Series A non-voting convertible preferred stock, together with warrants to purchase an aggregate of 3,394,309 shares of common stock with an exercise price of $2.15 per share in a private placement transaction at a purchase price of $1.72 per share and $0.125 per share, respectively. We received gross proceeds of $6.3 million before deducting offering expenses.

As of September 30, 2010, we had $12.6 million in cash and cash equivalents. Of this amount $4.8 million was invested in short-term money market funds that are not considered to be bank deposits and are not insured or guaranteed by the federal deposit insurance company or other government agency. These money market funds seek to preserve the value of the investment at $1.00 per share; however, it is possible to lose money investing in these funds. Cash in excess of immediate requirements is invested in accordance with our investment policy, primarily with a view to liquidity and capital preservation. At times, such deposits may be in excess of insured limits. We have not experienced any losses on our deposits of cash and cash equivalents. We believe that the cash and cash equivalents balance as of September 30, 2010, in addition to the remaining $781,000 of funds received in early October from the September 29, 2010 sale of preferred stock and common stock warrants, together with any interest income we earn on these balances, will be sufficient to meet our anticipated cash requirements into 2011 assuming we do not receive any additional funds. The potential lack of liquidity through all of 2011 has raised a substantial doubt about our ability to continue as a going concern and is discussed further in "Operating Capital and Capital Expenditure Requirements" below and in Note 2 to our condensed consolidated financial statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q. In order to fund on-going operating cash requirements beyond that point or to further accelerate and execute our business plan, including a potential new clinical trial using the next-generation Maestro RC System unconditionally approved by the FDA in October 2010, we will need to raise significant additional funds and therefore we are exploring various financing options. In view of these matters, our ability to continue as a going concern is dependent upon our ability to secure additional financing sufficient to support our research and development activities, approval of developed products for sale by regulatory authorities, including the FDA, and ultimately to generate revenues sufficient to cover all costs. See further discussion in the below section titled "Operating Capital and Capital Expenditure Requirements."

As of December 31, 2009, we had repaid the outstanding principal amount due to Venture Lending & Leasing V, Inc. (a private equity fund under the management of WTI) and Horizon pursuant to the Loan and Security Agreement, effective as of November 18, 2008 (the Loan Agreement). The remaining unpaid balance of $6.3 million in debt financing as of September 30, 2010 owed to SVB pursuant to the Loan Agreement is collateralized by a first security priority lien on all of our assets, excluding intellectual property. We have entered into account control agreements in order to perfect the lender's first security interest in our cash and investment accounts.

On February 8, 2010 we entered into a First Amendment (the Amendment) to the Loan Agreement with SVB. The Amendment provided that SVB's term loan shall be repaid with a payment of $383,532 on February 1, 2010 followed by consecutive equal monthly payments of $380,421 each, commencing on March 1, 2010 and ending on December 1, 2011. It also amended the interest rate due on the remaining principal amount of the term loan from 11.0% to a fixed annual rate of 10.0%, payable monthly. Pursuant to the Amendment, the conditions pursuant to which the Excluded Collateral (as defined in the Loan Agreement) will be deemed to be

included as Collateral (as defined in the Loan Agreement) were changed from the failure to have five months of remaining liquidity to the occurrence of an Event of Default (as defined in the Loan Agreement) after the date of the Amendment or the lender's awareness after such date of an Event of Default that occurred on or before such date with written notice of such event delivered to the Company. In addition, the Amendment revised the financial covenants in the Prior Loan Agreement to delete the covenant relating to five months of remaining liquidity and to change the liquidity ratio covenant to equal a ratio of (i) the sum of our unrestricted cash and cash equivalents held with SVB and SVB's affiliates, divided by (ii) the outstanding principal amount of the term loan, which is not permitted to be less than 1.50:1.00. Finally, the Amendment added a new covenant, the breach of which would constitute an Event of Default. The new covenant required that we receive aggregate net proceeds of at least $4.0 million from new capital transactions after January 1, 2010 and before March 31, 2010 and to keep the proceeds of such transactions at SVB until used. We satisfied this new covenant with the closing, on January 20, 2010, of our sale of 1,239,717 shares of common stock to certain institutional investors in a registered direct offering for gross proceeds of approximately $4.8 million, before deducting estimated offering expenses and placement agent fees.

On July 8, 2010 we entered into a Second Amendment (the Second Amendment) to the Loan Agreement with SVB. The Second Amendment modified the repayment terms of the Term Loan such that from the date of the Second Amendment through December 31, 2010, we are only required to make interest only monthly payments on the Term Loan, thereby reducing our monthly debt payment. Then, beginning on January 1, 2011, the remaining balance due on the Term Loan will amortize over 30 equal payments of principal and interest, which will be payable monthly. In addition, the Second Amendment amended the interest rate due on the remaining principal amount of the Term Loan from 10.0% to a fixed annual rate of 11.0%, payable monthly. The Second Amendment also revised the terms of the financial covenants related to the liquidity ratio and new capital transactions. Pursuant to the Second Amendment, the liquidity ratio equals the ratio of (i) the sum of our unrestricted cash and cash equivalents held with SVB and SVB's affiliates plus eligible accounts, divided by (ii) the outstanding principal amount of the Term Loan and is not permitted to be less than 1.00:1.00. Pursuant to the Second Amendment, we must receive aggregate net proceeds from New Capital Transactions (as defined in the Loan Agreement) of not less than $2.0 million from the date of the Second Amendment through August 31, 2010, $7.0 million from the date of the Second Amendment through October 31, 2010, $15.0 million from the date of the Second Amendment through January 31, 2011 and $35.0 million from the date of the Second Amendment through June 30, 2011. If we meet these financing requirements, we will satisfy the covenant; however, if we do not receive aggregate net proceeds from New Capital Transactions of at least $3.5 million from the date of the Second Amendment through August 31, 2010, $7.5 million from the date of the Second Amendment through October 31, 2010, $15.0 million from the date of the Second Amendment through January 31, 2011 and $35.0 million from the date of the Second Amendment through June 30, 2011, SVB's springing lien on our intellectual property will convert to a full lien on the intellectual property as of the date such "Proposed Capital Raise" was missed. We received approximately $6.3 million from the sale of preferred stock and common stock warrants in a private placement transaction that closed on September 30, 2010, which was less than the amount required by the Second Amendment and resulted in us entering into a Third Amendment to the Loan Agreement (the Third Amendment) with SVB on November 4, 2010. See details of the Third Amendment below. Finally, the Second Amendment revised the definition of "Make-Whole Premium" so that only Term Loan payments of principal made after the date of the Second Amendment will be counted for purposes of determining whether we have made twelve regularly scheduled monthly payments of principal in accordance with Section 2.1.1(d) of the Loan Agreement when the Make-Whole Premium comes due.

The Second Amendment also required the issuance of a new warrant to SVB with an exercise price per share equal to the volume weighted average closing price of our publicly traded common stock for the five trading days prior to the date of the Second Amendment. The warrant gives SVB the right to purchase a number of shares of our common stock equal to $316,350 divided by the exercise price per share. On July 8, 2010, SVB was issued a warrant to purchase 150,642 shares of our common stock with an exercise price of $2.10 per share.

As noted above, we entered into a Third Amendment to the Loan Agreement with SVB on November 4, 2010. The Third Amendment modifies the New Capital Transaction covenant such that it waives the requirements to receive aggregate net proceeds from New Capital Transactions of not less than $3.5 million from the date of the Second Amendment through August 31, 2010 and $7.5 million from the date of the Second Amendment through October 31, 2010. The Third Amendment also modifies the requirement to receive aggregate net proceeds from New Capital Transactions of not less than $15.0 million from the date of the Second Amendment through January 31, 2011 to $12.5 million and eliminates the requirement to receive aggregate net proceeds from New Capital Transactions of not less than $35.0 million from the date of the Second Amendment through June 30, 2011. Lastly, the Third Amendment suspends the liquidity ratio covenant, which was not permitted to be less than 1.00:1.00, until January 31, 2011. We have agreed to maintain a blocked cash collateral account with funds equal to the principal balance outstanding until such time that we have received aggregate net proceeds from New Capital Transactions of not less than $12.5 million from the date of the Second Amendment through January 31, 2011, SVB has received a financial forecast through December 31, 2012 approved by our Board of Directors and we have agreed to new financial covenants or a new financial structure with SVB for our obligations. There were no changes to the repayment terms of the Term Loan as defined in the Second Amendment.

Net Cash Used in Operating Activities

Net cash used in operating activities was $10.1 million and $17.4 million for the nine months ended September 30, 2010 and 2009, respectively. Net cash used in operating activities primarily reflects the net loss for those periods, which was partially offset by depreciation and amortization, change in value of warrant liability, stock-based compensation and changes in operating assets and liabilities.

Net Cash (Used in) Provided by Investing Activities

Net cash used in investing activities was $2,600 for the nine months ended September 30, 2010 compared to net cash provided by investing activities of $5.1 million for the nine months ended September 30, 2009. Net cash used in investing activities for the nine months ended September 30, 2010 is related to purchases of property and equipment. Net cash provided by investing activities for the nine months ended September 30, 2009 is primarily related to proceeds from the maturity of short-term investments slightly offset by the purchase of property and equipment.

Net Cash Provided by Financing Activities

Net cash provided by financing activities was $8.1 million and $18.4 million for the nine months ended September 30, 2010 and 2009, respectively. Net cash provided by financing activities for the nine months ended September 30, 2010 is primarily attributable to

the completion of a private placement transaction that resulted in gross proceeds of $6.3 million for the issuance of preferred stock and common stock warrants, of which $781,000 was received in early October, offset by $43,000 in financing costs incurred through September 30, 2010 and a registered direct offering that resulted in gross proceeds of $4.8 million for the issuance of common stock, offset by $340,000 in financing costs, partially offset by repayments on our long-term debt. Net cash provided by financing activities for the nine months ended September 30, 2009 is primarily attributable to the completion of a private placement transaction that resulted in gross proceeds of $15.9 million for the issuance of common stock and common stock warrants, offset by $806,000 in financing costs incurred through September 30, 2009 and debt funding proceeds of $5.0 million automatically funded on April 28, 2009 per the terms of the $20.0 million debt facility we entered into on November 18, 2008, partially offset by repayments on our long-term debt.

Operating Capital and Capital Expenditure Requirements

To date, we have not commercialized any products and we have not earned any operating revenues. On October 2, 2009, we announced preliminary results from our pivotal clinical study, the EMPOWER trial; indicating that based on an initial analysis, the study did not meet its primary and secondary efficacy endpoints, while meeting its safety endpoint. Following this announcement, management has taken steps to preserve capital by minimizing all commercialization and development activities and focusing on a comprehensive analysis of all clinical, statistical, and engineering data to understand the trial outcome. This resulted in a 40% reduction in force on October 27, 2009. On November 12, 2009 we further announced that the control arm of the trial, which was intended to be inactive, apparently provided a low-intensity blocking signal that introduced VBLOC therapy in human subjects. In January 2010, we met with the FDA to discuss the EMPOWER trial results and the regulatory process going forward. Based on this discussion, in March we submitted an IDE application for a clinical trial using the next-generation Maestro RC System in the treatment of morbid obesity and received unconditional approval from the FDA in October 2010. Assuming we are able to successfully enroll and implant the new clinical trial and achieve favorable results, we do not expect to generate any product revenue in the United States before late 2013. As a result, we anticipate that we will continue to incur substantial net losses for the next several years.

We believe that our cash and cash equivalents balance of $12.6 million as of September 30, 2010, in addition to the remaining $781,000 of funds received in early October from the September 29, 2010 sale of preferred stock and common stock warrants, and any interest income we earn on these balances will be sufficient to meet our anticipated cash requirements into 2011 assuming we do not receive any additional funds, which has raised a substantial doubt about our ability to continue as a going concern. In order to fund on-going operating cash requirements beyond that point or to further accelerate and execute our business plan, including a potential new clinical trial using the next-generation Maestro RC System unconditionally approved by the FDA, we will need to raise significant additional funds and therefore we are exploring various financing options. In view of these matters, the ability for us to continue as a going concern is dependent upon our ability to secure additional financing sufficient to support our research and development activities, approval of developed products for sale by regulatory authorities, including the FDA, and ultimately to generate revenues sufficient to cover all costs. We may seek to raise funds through the sale of additional equity or debt securities, or by entering into an additional credit facility or through collaboration, licensing or other similar arrangements. The sale of additional equity and debt securities may result in dilution to our stockholders. If we raise additional funds through the issuance of debt securities, these securities could have rights senior to those of our common stock and could contain covenants that would restrict our operations. We may be required to raise additional capital on more than one occasion and beyond our currently forecasted amounts. Any such required additional capital may not be available on reasonable terms, if at all. If we are unable to obtain additional financing we may be required to reduce the scope of, delay, or eliminate some or all of, our planned research, development and commercialization activities, which could materially harm our business. In addition, if we raise additional funds through collaboration, licensing or other similar arrangements, it may be necessary to relinquish valuable rights to products or proprietary technologies, or grant licenses on terms that are not favorable.

Our forecast of the period of time through which our financial resources will be adequate to support our operations, the costs to complete development of products and the cost to commercialize our products are forward-looking statements and involve risks and uncertainties, and actual results could vary materially and negatively as a result of a number of factors, including the factors discussed in Part I, Item 1A, *Risk Factors*, of our Annual Report on Form 10-K for the year ended December 31, 2009. We have based these estimates on assumptions that may prove to be wrong, and we could utilize our available capital resources sooner than we currently expect.

Because of the numerous risks and uncertainties associated with the development of medical devices, such as our Maestro System, we are unable to estimate the exact amounts of capital outlays and operating expenditures necessary to complete the development of the products and successfully deliver a commercial product to the market. Our future capital requirements will depend on many factors, including but not limited to the following:

- the scope, rate of progress, results and cost of our clinical trials and other research and development activities;
- the cost and timing of regulatory approvals;
- the cost and timing of establishing sales, marketing and distribution capabilities;
- the cost of establishing clinical and commercial supplies of our Maestro System and any products that we may develop;

- the rate of market acceptance of our Maestro System and VBLOC therapy and any other product candidates;
- the cost of filing and prosecuting patent applications and defending and enforcing our patent and other intellectual property rights;
- the cost of defending, in litigation or otherwise, any claims that we infringe third-party patent or other intellectual property rights;
- the effect of competing products and market developments;
- the cost of explanting clinical devices;
- the terms and timing of any collaborative, licensing or other arrangements that we may establish;
- any revenue generated by sales of our future products; and
- the extent to which we invest in products and technologies, although we currently have no commitments or agreements relating to any of these types of transactions.

Critical Accounting Policies and Estimates

We prepare our consolidated financial statements in accordance with accounting principles generally accepted in the United States. In doing so, we have to make estimates and assumptions that affect our reported amounts of assets, liabilities and expenses, as well as related disclosure of contingent assets and liabilities. In many cases, we could reasonably have used different accounting policies and estimates. In some cases, changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ materially from our estimates. To the extent that there are material differences between these estimates and actual results, our financial condition or results of operations will be affected. We base our estimates on past experiences and other assumptions that we believe are reasonable under the circumstances, and we evaluate these estimates on an ongoing basis.

Our significant accounting policies are fully described in Note 2 to our consolidated financial statements included in our Annual Report on Form 10-K for the year ended December 31, 2009.

Contractual Obligations

During the nine months ended September 30, 2010, there were no material changes to our contractual obligation disclosures as set forth under the caption, “Contractual Obligations” in Part II, Item 7, *Management’s Discussion and Analysis of Financial Condition and Results of Operations*, of our Annual Report on Form 10-K for the year ended December 31, 2009.

The following table summarizes our contractual obligations as of September 30, 2010 and the effect those obligations are expected to have on our financial condition and liquidity position in future periods:

	Payments Due By Period				
Contractual Obligations	Total	Less Than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Operating lease	$1,421,731	$ 273,198	$ 562,896	$585,637	$ —
Long-term debt, including interest	7,955,718	2,359,864	5,595,854	—	—
Other long-term liabilities	100,000	100,000	—	—	—
Total contractual cash obligations	$9,477,449	$2,733,062	$6,158,750	$585,637	$ —

The table above reflects only payment obligations that are fixed and determinable. Our operating lease commitments relate to our corporate headquarters in St. Paul, Minnesota. Other long-term liabilities consist of obligations required under the terms of our license agreements with the Mayo Foundation for Medical Education and Research (Mayo Foundation).

Off-Balance Sheet Arrangements

As of September 30, 2010, we did not have any off-balance sheet arrangements.

Recent Accounting Pronouncements

There were no significant changes in recent accounting pronouncements during the nine months ended September 30, 2010 as compared to the recent accounting pronouncements described in our Annual Report on Form 10-K for the year ended December 31, 2009.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is confined to our cash, cash equivalents and short-term investments. As of September 30, 2010, we had $12.6 million in cash and cash equivalents. The goals of our investment policy are preservation of capital, fulfillment of liquidity needs and fiduciary control of cash and investments. We also seek to maximize income from our investments without assuming significant risk. To achieve our goals, we may maintain a portfolio of cash equivalents and investments in a variety of securities of high credit quality. The securities in our investment portfolio, if any, are not leveraged, are classified as either available for sale or held-to-maturity and are, due to their very short-term nature, subject to minimal interest rate risk. We currently do not hedge interest rate exposure. Because of the short-term maturities of our cash equivalents and investments, we do not believe that an increase in market rates would have any material negative impact on the value of our investment portfolio. We have no investments denominated in foreign currencies and therefore our investments are not subject to foreign currency exchange risk.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), defines the term “disclosure controls and procedures” as those controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission rules and forms and that such information is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. Based on their evaluation as of September 30, 2010, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) were effective.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II – OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

We are not currently a party to any litigation and we are not aware of any pending or threatened litigation against us that could have a material adverse effect on our business, operating results or financial condition. The medical device industry in which we operate is characterized by frequent claims and litigation, including claims regarding patent and other intellectual property rights as well as improper hiring practices. As a result, we may be involved in various legal proceedings from time to time.

ITEM 1A. RISK FACTORS

There have been no material changes during the nine months ended September 30, 2010 to the risk factors set forth in Part I, Item 1A, *Risk Factors*, of our Annual Report on Form 10-K for the year ended December 31, 2009.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Unregistered Sales of Equity Securities

As previously described in our Current Report on Form 8-K filed July 13, 2010, on July 8, 2010, we entered into a second amendment to our loan agreement with Silicon Valley Bank. As required by the second amendment, on July 8, 2010 we issued a warrant to Silicon Valley Bank to purchase 150,642 shares of our common stock with an exercise price of $2.10 per share and a ten year life. See Note 4 to our condensed consolidated financial statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q for more detail about the second amendment. The sale and issuance of this warrant was deemed to be exempt from registration under the Securities Act of 1933, as amended (the Securities Act) by virtue of Section 4(2) of the Securities Act, as a transaction by an issuer not involving any public offering.

As previously described in our Current Report on Form 8-K filed October 5, 2010, on September 30, 2010, we completed the sale of 3,394,309 shares of Series A Non-Voting Convertible Preferred Stock (the Preferred Stock), together with warrants to purchase an aggregate of 3,394,309 shares of common stock (the Up Front Warrants) in a private placement transaction to certain accredited investors for gross proceeds of approximately $6.3 million, less certain expenses (the Private Placement). Each holder of Preferred Stock has the rights, preferences and duties set forth in the Certificate of Designations authorized by our board of directors and filed with the Secretary of State of the State of Delaware on September 29, 2010. The Preferred Stock has a par value of $0.01 per share and the board of directors authorized an amount up to 3,600,000 shares. Each share of Preferred Stock has an original issue price of $1.72. As of the closing of the Private Placement, we had 19 stockholders of record of the Preferred Stock. See Note 6 to our condensed consolidated financial statements included in Part I, Item 1, of this Quarterly Report on Form 10-Q for more detail about the Private Placement. The Preferred Stock and the Up Front Warrants were offered and sold in the Private Placement to accredited investors without registration under the Securities Act, or the securities laws of certain states, in reliance on the exemptions provided by Section 4(2) of the Securities Act and Regulation D promulgated thereunder and in reliance on similar exemptions under applicable state laws.

Uses of Proceeds from Sale of Registered Securities

None.

Purchases of Equity Securities

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. RESERVED

ITEM 5. OTHER INFORMATION

On November 4, 2010, we entered into a third amendment to our loan agreement with Silicon Valley Bank. See Note 7 to our condensed consolidated financial statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for a description of the terms of the third amendment.

ITEM 6. EXHIBITS

The list of exhibits on the accompanying Exhibit Index are filed or incorporated by reference (as stated therein) as part of this Quarterly Report on Form 10-Q.

SIGNATURES

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

ENTEROMEDICS INC.

By: /S/ MARK B. KNUDSON, PH.D.
Mark B. Knudson, Ph.D.
President and Chief Executive Officer
(Principal Executive Officer)

By: /S/ GREG S. LEA
Greg S. Lea
Senior Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

Dated: November 8, 2010

EXHIBIT INDEX

Exhibit Number	Description of Document
3.1	Fifth Amended and Restated Certificate of Incorporation of the Company. (Incorporated herein by reference to Exhibit 3.2 to Amendment No. 6 to the Company's Registration Statement on Form S-1 filed on November 9, 2007 (File No. 333-143265)).
3.2	Certificate of Amendment to the Fifth Amended and Restated Certificate of Incorporation of the Company. (Incorporated herein by reference to Exhibit 3.2 to the Company's Quarterly Report on Form 10-Q filed on August 7, 2009 (File No. 1-33818)).
3.3	Certificate of Amendment to the Fifth Amended and Restated Certificate of Incorporation of the Company. (Incorporated herein by reference to Exhibit 3.1 to the Company's Current Report on Form 8-K filed on July 13, 2010 (File No. 1-33818)).
3.4	Certificate of Designations, dated as of September 29, 2010. (Incorporated herein by reference to Exhibit 10.4 to the Company's Current Report on Form 8-K filed on October 5, 2010 (File No. 1-33818)).
3.5	Amended and Restated Bylaws of the Company, as currently in effect. (Incorporated herein by reference to Exhibit 3.4 to Amendment No. 1 to the Company's Registration Statement on Form S-1 filed on July 6, 2007 (File No. 333-143265)).
4.1	Amended and Restated Investors' Rights Agreement, dated as of July 6, 2006, by and between the Company and the parties named therein. (Incorporated herein by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 filed on May 25, 2007 (File No. 333-143265)).
10.1	Securities Purchase Agreement, dated as of January 14, 2010. (Incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on January 15, 2010 (File No. 1-33818)).
10.2	Second Amendment to Loan and Security Agreement, dated as of July 8, 2010, by and between Silicon Valley Bank and the Company. (Incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on July 13, 2010 (File No. 1-33818)).
10.3	Securities Purchase Agreement, dated as of September 29, 2010. (Incorporated herein by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on October 5, 2010 (File No. 1-33818)).
10.4	Form of Up Front Warrant, dated September 29, 2010, by and between the Company and several accredited investors. (Incorporated herein by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on October 5, 2010 (File No. 1-33818)).
10.5	Form of Conversion Warrant. (Incorporated herein by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on October 5, 2010 (File No. 1-33818)).
10.6*†	2003 Stock Incentive Plan, as amended.
10.7*†	Form of Non-Incentive Stock Option Agreement for new options granted October 29, 2010 pursuant to the option exchange program.
10.8*	Third Amendment to Loan and Security Agreement, dated as of November 4, 2010, by and between Silicon Valley Bank and the Company.
31.1*	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2*	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1*	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith.

† Indicates management contract or compensation plan or agreement.

Exhibit 10.6

ENTEROMEDICS INC.
2003 STOCK INCENTIVE PLAN AS AMENDED

Section 1. Purpose.

The purpose of the EnteroMedics Inc. 2003 Stock Incentive Plan (the "Plan") is to aid in attracting and retaining employees, management personnel and other personnel and members of the Board of Directors who are not also employees ("Non-Employee Directors") of EnteroMedics (the "Company") capable of assuring the future success of the Company, to offer such personnel and Non-Employee Directors incentives to put forth maximum efforts for the success of the Company's business and to afford such personnel and Non-Employee Directors an opportunity to acquire a proprietary interest in the Company.

Section 2. Definitions.

As used in the Plan, the following terms shall have the meanings set forth below:

(a) "Affiliate" shall mean (i) any entity that, directly or indirectly through one or more intermediaries, is controlled by the Company and (ii) any entity in which the Company has a significant equity interest, in each case as determined by the Committee.

(b) "Award" shall mean any Option, Stock Appreciation Right, Restricted Stock, Restricted Stock Unit, Performance Award, Dividend Equivalent, Other Stock Grant or Other Stock-Based Award granted under the Plan.

(c) "Award Agreement" shall mean any written agreement, contract or other instrument or document evidencing any Award granted under the Plan.

(d) "Code" shall mean the Internal Revenue Code of 1986, as amended from time to time, and any regulations promulgated thereunder.

(e) "Committee" shall mean either the Board of Directors of the Company or a committee of the Board of Directors appointed by the Board of Directors to administer the Plan.

(f) "Company" shall mean EnteroMedics Inc., a Delaware corporation, and any successor corporation.

(g) "Dividend Equivalent" shall mean any right granted under Section 6(e) of the Plan.

(h) "Eligible Person" shall mean any employee, officer, consultant, independent contractor or Non-Employee Director providing services to the Company or any Affiliate whom the Committee determines to be an Eligible Person.

(i) "Fair Market Value" shall mean, with respect to any property (including, without limitation, any Shares or other securities), the fair market value of such property determined by such methods or procedures as shall be established from time to time by the Committee. Notwithstanding the foregoing, unless otherwise determined by the Committee, the Fair Market Value of Shares on a given date for purposes of the Plan shall not be less than (i) the closing price as reported for composite transactions, if the Shares are then listed on a national securities exchange, (ii) the last sale price, if the Shares are then quoted on the Nasdaq National Market or (iii) the average of the closing representative bid and asked prices of the Shares in all other cases, on the date as of which fair market value is being determined. If on a given date the Shares are not traded in an established securities market, the Committee shall make a good faith attempt to satisfy the requirements of this clause and in connection therewith shall take such action as it deems necessary or advisable.

(j) "Incentive Stock Option" shall mean an option granted under Section 6(a) of the Plan that is intended to meet the requirements of Section 422 of the Code or any successor provision.

(k) "Non-Qualified Stock Option" shall mean an option granted under Section 6(a) of the Plan that is not intended to be an Incentive Stock Option.

(l) "Option" shall mean an Incentive Stock Option or a Non-Qualified Stock Option.

(m) "Other Stock Grant" shall mean any right granted under Section 6(f) of the Plan.

(n) "Other Stock-Based Award" shall mean any right granted under Section 6(g) of the Plan.

(o) "Participant" shall mean an Eligible Person designated to be granted an Award under the Plan.

(p) "Performance Award" shall mean any right granted under Section 6(d) of the Plan.

(q) "Person" shall mean any individual, corporation, partnership, association or trust.

(r) “Plan” shall mean the EnteroMedics Inc. 2003 Stock Incentive Plan, as amended from time to time.

(s) “Restricted Stock” shall mean any Shares granted under Section 6(c) of the Plan.

(t) “Restricted Stock Unit” shall mean any unit granted under Section 6(c) of the Plan evidencing the right to receive a Share (or a cash payment equal to the Fair Market Value of a Share) at some future date.

(u) “Shares” shall mean shares of Common Stock, $0.01 par value, of the Company or such other securities or property as may become subject to Awards pursuant to an adjustment made under Section 4(c) of the Plan.

(v) “Stock Appreciation Right” shall mean any right granted under Section 6(b) of the Plan.

Section 3. Administration.

(a) Power and Authority of the Committee. The Plan shall be administered by the Committee. Subject to the express provisions of the Plan and to applicable law, the Committee shall have full power and authority to: (i) designate Participants; (ii) determine the type or types of Awards to be granted to each Participant under the Plan; (iii) determine the number of Shares to be covered by (or with respect to which payments, rights or other matters are to be calculated in connection with) each Award; (iv) determine the terms and conditions of any Award or Award Agreement; (v) amend the terms and conditions of any Award or Award Agreement and accelerate the exercisability of Options or the lapse of restrictions relating to Restricted Stock, Restricted Stock Units or other Awards; (vi) determine whether, to what extent and under what circumstances Awards may be exercised in cash, Shares, other securities, other Awards or other property, or canceled, forfeited or suspended; (vii) determine whether, to what extent and under what circumstances cash, Shares, other securities, other Awards, other property and other amounts payable with respect to an Award under the Plan shall be deferred either automatically or at the election of the holder thereof or the Committee; (viii) interpret and administer the Plan and any instrument or agreement relating to, or Award made under, the Plan; (ix) establish, amend, suspend or waive such rules and regulations and appoint such agents as it shall deem appropriate for the proper administration of the Plan; and (x) make any other determination and take any other action that the Committee deems necessary or desirable for the administration of the Plan. Unless otherwise expressly provided in the Plan, all designations, determinations, interpretations and other decisions under or with respect to the Plan or any Award shall be within the sole discretion of the Committee, may be made at any time and shall be final, conclusive and binding upon any Participant, any holder or beneficiary of any Award.

(b) Delegation. The Committee may delegate its powers and duties under the Plan to one or more officers of the Company or any Affiliate or a committee of such officers, subject to such terms, conditions and limitations as the Committee may establish in its sole discretion.

Section 4. Shares Available for Awards.

(a) Shares Available. Subject to adjustment as provided in Section 4(c), the aggregate number of Shares that may be issued under all Awards under the Plan shall be 2,300,000. If any Shares covered by an Award or to which an Award relates are not purchased or are forfeited, or if an Award otherwise terminates without delivery of any Shares, then the number of Shares counted against the aggregate number of Shares available under the Plan with respect to such Award, to the extent of any such forfeiture or termination, shall again be available for granting Awards under the Plan. Notwithstanding the foregoing, the number of Shares available for granting Incentive Stock Options under the Plan shall not exceed 2,300,000, subject to adjustment as provided in the Plan and Section 422 or 424 of the Code or any successor provision.

(b) Accounting for Awards. For purposes of this Section 4, if an Award entitles the holder thereof to receive or purchase Shares, the number of Shares covered by such Award or to which such Award relates shall be counted on the date of grant of such Award against the aggregate number of Shares available for granting Awards under the Plan.

(c) Adjustments. In the event that the Committee shall determine that any dividend or other distribution (whether in the form of cash, Shares, other securities or other property), recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase or exchange of Shares or other securities of the Company, issuance of warrants or other rights to purchase Shares or other securities of the Company or other similar corporate transaction or event affects the Shares such that an adjustment is determined by the Committee to be appropriate in order to prevent dilution or enlargement of the benefits or potential benefits intended to be made available under the Plan, then the Committee shall, in such manner as it may deem equitable, adjust any or all of (i) the number and type of Shares (or other securities or other property) that thereafter may be made the subject of Awards, (ii) the number and type of Shares (or other securities or other property) subject to outstanding Awards and (iii) the purchase or exercise price with respect to any Award; provided, however, that the number of Shares covered by any Award or to which such Award relates shall always be a whole number.

Section 5. Eligibility.

Any Eligible Person of the Company or any Affiliate, shall be eligible to be designated a Participant. In determining which Eligible Persons shall receive an Award and the terms of any Award, the Committee may take into account the nature of the services rendered by the respective Eligible Persons, their present and potential contributions to the success of the Company or such other factors as the Committee, in its discretion, shall deem relevant. Notwithstanding the foregoing, an Incentive Stock Option may only be granted to full or part-time employees (which term as used herein includes, without limitation, officers and directors who are also employees), and an Incentive Stock Option shall not be granted to an employee of an Affiliate unless such Affiliate is also a "subsidiary corporation" of the Company within the meaning of Section 424(f) of the Code or any successor provision.

Section 6. Awards.

(a) Options. The Committee is hereby authorized to grant Options to Participants with the following terms and conditions and with such additional terms and conditions not inconsistent with the provisions of the Plan as the Committee shall determine:

(i) Exercise Price. The purchase price per Share purchasable under an Option shall be determined by the Committee; provided, however, that the purchase price of an Incentive Stock Option shall not be less than 100% of the Fair Market Value of a Share on the date of grant of such Option.

(ii) Option Term. The term of each Option shall be fixed by the Committee; provided, however, that the term of an Incentive Stock Option may not extend more than ten years from the date of grant of such Incentive Stock Option.

(iii) Time and Method of Exercise. The Committee shall determine the time or times at which an Option may be exercised in whole or in part and the method or methods by which, and the form or forms (including, without limitation, cash, Shares, other securities, other Awards or other property, or any combination thereof, having a Fair Market Value on the exercise date equal to the relevant exercise price, which terms shall be set forth in the Award Agreement) in which payment of the exercise price with respect thereto may be made or deemed to have been made.

(iv) Ten Percent Shareholder Rule. Notwithstanding any other provision in the Plan, if at the time an Option is otherwise to be granted pursuant to the Plan to a Participant who owns, directly or indirectly (within the meaning of Section 424(d) of the Code), Common Stock of the Company possessing more than 10% of the total combined voting power of all classes of stock of the Company or its parent or any subsidiary, then any Incentive Stock Option to be granted to such Participant pursuant to the Plan shall satisfy the requirements of Section 422(c)(5) of the Code, and the exercise price of such Option shall be not less than 110% of the Fair Market Value of the Shares covered, and such Option by its terms shall not be exercisable after the expiration of five years from the date such Option is granted.

(b) Stock Appreciation Rights. The Committee is hereby authorized to grant Stock Appreciation Rights to Participants subject to the terms of the Plan and any applicable Award Agreement. A Stock Appreciation Right granted under the Plan shall confer on the holder thereof a right to receive upon exercise thereof the excess of (i) the Fair Market Value of one Share on the date of exercise (or, if the Committee shall so determine, at any time during a specified period before or after the date of exercise) over (ii) the grant price of the Stock Appreciation Right as specified by the Committee, which price shall not be less than 100% of the Fair Market Value of one Share on the date of grant of the Stock Appreciation Right. Subject to the terms of the Plan and any applicable Award Agreement, the grant price, term, methods of exercise, dates of exercise, methods of settlement and any other terms and conditions of any Stock Appreciation Right shall be as determined by the Committee. The Committee may impose such conditions or restrictions on the exercise of any Stock Appreciation Right as it may deem appropriate.

(c) Restricted Stock and Restricted Stock Units. The Committee is hereby authorized to grant Restricted Stock and Restricted Stock Units to Participants with the following terms and conditions and with such additional terms and conditions not inconsistent with the provisions of the Plan as the Committee shall determine:

(i) Restrictions. Shares of Restricted Stock and Restricted Stock Units shall be subject to such restrictions as the Committee may impose (including, without limitation, a waiver by the Participant of the right to vote or to receive any dividend or other right or property with respect thereto), which restrictions may lapse separately or in combination at such time or times, in such installments or otherwise as the Committee may deem appropriate.

(ii) Stock Certificates. Any Restricted Stock shall be registered in the name of the Participant and shall bear an appropriate legend referring to the terms, conditions and restrictions applicable to such Restricted Stock. In the case of Restricted Stock Units, no Shares shall be issued at the time such Awards are granted.

(iii) Forfeiture. Except as otherwise determined by the Committee, upon termination of employment (as determined under criteria established by the Committee) during the applicable restriction period, all Shares of Restricted Stock and all Restricted Stock Units at such time subject to restriction shall be forfeited and reacquired by the Company at the original purchase price; provided, however, that the Committee may, when it finds that a waiver would be in the best interest of the Company, waive in whole or in part any or all remaining restrictions with respect to Shares of Restricted Stock or Restricted Stock Units. Upon the lapse or waiver of restrictions and the restricted period relating to Restricted Stock Units evidencing the right to receive Shares, such Shares shall be issued and delivered to the holders of the Restricted Stock Units.

(d) Performance Awards. The Committee is hereby authorized to grant Performance Awards to Participants subject to the terms of the Plan and any applicable Award Agreement. A Performance Award granted under the Plan (i) may be denominated or payable in cash, Shares (including, without limitation, Restricted Stock and Restricted Stock Units), other securities, other Awards or other property and (ii) shall confer on the holder thereof the right to receive payments, in whole or in part, upon the achievement of such performance goals during such performance periods as the Committee shall establish. Subject to the terms of the Plan and any applicable Award Agreement, the performance goals to be achieved during any performance period, the length of any performance period, the amount of any Performance Award granted, the amount of any payment or transfer to be made pursuant to any Performance Award and any other terms and conditions of any Performance Award shall be determined by the Committee.

(e) Dividend Equivalents. The Committee is hereby authorized to grant Dividend Equivalents to Participants, subject to the terms of the Plan and any applicable Award Agreement, under which such Participants shall be entitled to receive payments (in cash, Shares, other securities, other Awards or other property as determined in the discretion of the Committee) equivalent to the amount of cash dividends paid by the Company to holders of Shares with respect to a number of Shares determined by the Committee.

(f) Other Stock Grants. The Committee is hereby authorized, subject to the terms of the Plan and any applicable Award Agreement, to grant to Participants Shares without restrictions thereon as are deemed by the Committee to be consistent with the purpose of the Plan.

(g) Other Stock-Based Awards. The Committee is hereby authorized to grant to Participants subject to the terms of the Plan and any applicable Award Agreement, such other Awards that are denominated or payable in, valued in whole or in part by reference to, or otherwise based on or related to, Shares (including, without limitation, securities convertible into Shares), as are deemed by the Committee to be consistent with the purpose of the Plan. Shares or other securities delivered pursuant to a purchase right granted under this Section 6(g) shall be purchased for such consideration, which may be paid by such method or methods and in such form or forms (including, without limitation, cash, Shares, other securities, other Awards or other property or any combination thereof), as the Committee shall determine.

(h) General.

(i) No Cash Consideration for Awards. Awards shall be granted for no cash consideration or for such minimal cash consideration as may be required by applicable law.

(ii) Awards May Be Granted Separately or Together. Awards may, in the discretion of the Committee, be granted either alone or in addition to, in tandem with or in substitution for any other Award or any award granted under any plan of the Company or any Affiliate other than the Plan. Awards granted in addition to or in tandem with other Awards or in addition to or in tandem with awards granted under any such other plan of the Company or any Affiliate may be granted either at the same time as or at a different time from the grant of such other Awards or awards.

(iii) Forms of Payment under Awards. Subject to the terms of the Plan and of any applicable Award Agreement, payments or transfers to be made by the Company or an Affiliate upon the grant, exercise or payment of an Award may be made in such form or forms as the Committee shall determine (including, without limitation, cash, Shares, other securities, other Awards or other property or any combination thereof), and may be made in a single payment or transfer, in installments or on a deferred basis, in each case in accordance with rules and procedures established by the Committee. Such rules and procedures may include, without limitation, provisions for the payment or crediting of reasonable interest on installment or deferred payments or the grant or crediting of Dividend Equivalents with respect to installment or deferred payments.

(iv) Limits on Transfer of Awards. No Award (other than Other Stock Grants) and no right under any such Award shall be transferable by a Participant otherwise than by will or by the laws of descent and distribution; provided, however, that, with the approval of the Committee, a Participant may, in the manner established by the Committee, transfer Options (other than Incentive Stock Options) or designate a beneficiary or beneficiaries to exercise the rights of the Participant and receive any property distributable with respect to any Award upon the death of the Participant. Each Award or right under any Award shall be exercisable during the Participant's lifetime only by the Participant or, if permissible under applicable law, by the Participant's guardian or legal representative. No Award or right under any such Award may be pledged, alienated, attached or otherwise encumbered, and any purported pledge, alienation, attachment or encumbrance thereof shall be void and unenforceable against the Company or any Affiliate.

(v) Term of Awards. The term of each Award shall be for such period as may be determined by the Committee.

(vi) Restrictions; Securities Exchange Listing. All Shares or other securities delivered under the Plan pursuant to any Award or the exercise thereof shall be subject to such restrictions as the Committee may deem advisable under the Plan, and to any applicable federal or state securities laws and regulatory requirements. The Committee may cause appropriate entries to be made or legends to be affixed to reflect such restrictions. If the Shares or other securities are listed on a securities exchange, the Company shall not be required to deliver any Shares or other securities covered by an Award until such Shares or other securities have been listed on such securities exchange.

Section 7. Amendment and Termination; Adjustments.

Except to the extent prohibited by applicable law and unless otherwise expressly provided in an Award Agreement or in the Plan:

(a) Amendments to the Plan. The Board of Directors of the Company may amend, alter, suspend, discontinue or terminate the Plan; provided, however, that, notwithstanding any other provision of the Plan or any Award Agreement, without the approval of the shareholders of the Company, no such amendment, alteration, suspension, discontinuation or termination shall be made that, absent such approval:

(i) if a class of the Company's securities is then listed on a securities exchange, would cause Rule 16b-3 or the provisions of Section 162(m)(4)(c) of the Code to become unavailable with respect to the Plan;

(ii) would violate the rules or regulations of the Nasdaq National Market, any other securities exchange or the National Association of Securities Dealers, Inc. that are applicable to the Company; or

(iii) would cause the Company to be unable, under the Code, to grant Incentive Stock Options under the Plan.

(b) Amendments to Awards. The Committee may waive any conditions of or rights of the Company under any outstanding Award, prospectively or retroactively. The Committee may not amend, alter, suspend, discontinue or terminate any outstanding Award, prospectively or retroactively, without the consent of the Participant or holder or beneficiary thereof, except as otherwise herein provided or in the Award Agreement.

(c) Correction of Defects, Omissions and Inconsistencies. The Committee may correct any defect, supply any omission or reconcile any inconsistency in the Plan or any Award in the manner and to the extent it shall deem desirable to carry the Plan into effect.

Section 8. Income Tax Withholding; Tax Bonuses.

(a) Withholding. In order to comply with all applicable federal or state income tax laws or regulations, the Company may take such action as it deems appropriate to ensure that all applicable federal or state payroll, withholding, income or other taxes, which are the sole and absolute responsibility of a Participant are withheld or collected from such Participant. In order to assist a Participant in paying all or a portion of the federal and state taxes to be withheld or collected upon exercise or receipt of (or the lapse of restrictions relating to) an Award, the Committee, in its discretion and subject to such additional terms and conditions as it may adopt, may permit the Participant to satisfy such tax obligation by (i) electing to have the Company withhold a portion of the Shares otherwise to be delivered upon exercise or receipt of (or the lapse of restrictions relating to) such Award with a Fair Market Value equal to the amount of such taxes or (ii) electing to deliver to the Company Shares other than Shares issuable upon exercise or receipt of (or the lapse of restrictions relating to) such Award with a Fair Market Value equal to the amount of such taxes. The election, if any, must be made on or before the date that the amount of tax to be withheld is determined.

(b) Tax Bonuses. The Committee, in its discretion, shall have the authority, at the time of grant of any Award under this Plan or at any time thereafter, to approve cash bonuses to designated Participants to be paid upon their exercise or receipt of (or the lapse of restrictions relating to) Awards in order to provide funds to pay all or a portion of federal and state taxes due as a result of such exercise or receipt (or the lapse of such restrictions). The Committee shall have full authority in its discretion to determine the amount of any such tax bonus.

Section 9. General Provisions.

(a) No Rights to Awards. No Eligible Person, Participant or other Person shall have any claim to be granted any Award under the Plan, and there is no obligation for uniformity of treatment of Eligible Persons, Participants or holders or beneficiaries of Awards under the Plan. The terms and conditions of Awards need not be the same with respect to any Participant or with respect to different Participants.

(b) Award Agreements. No Participant will have rights under an Award granted to such Participant unless and until an Award Agreement shall have been duly executed on behalf of the Company and, if requested by the Company, signed by the Participant.

(c) No Limit on Other Compensation Arrangements. Nothing contained in the Plan shall prevent the Company or any Affiliate from adopting or continuing in effect other or additional compensation arrangements, and such arrangements may be either generally applicable or applicable only in specific cases.

(d) No Right to Employment. The grant of an Award shall not be construed as giving a Participant the right to be retained in the employ of the Company or any Affiliate, nor will it affect in any way the right of the Company or an Affiliate to terminate such employment at any time, with or without cause. In addition, the Company or an Affiliate may at any time dismiss a Participant from employment free from any liability or any claim under the Plan, unless otherwise expressly provided in the Plan or in any Award Agreement.

(e) Governing Law. The validity, construction and effect of the Plan or any Award, and any rules and regulations relating to the Plan or any Award, shall be determined in accordance with the laws of the State of Minnesota.

(f) Severability. If any provision of the Plan or any Award is or becomes or is deemed to be invalid, illegal or unenforceable in any jurisdiction or would disqualify the Plan or any Award under any law deemed applicable by the Committee, such provision shall be construed or deemed amended to conform to applicable laws, or if it cannot be so construed or deemed amended without, in the determination of the Committee, materially altering the purpose or intent of the Plan or the Award, such provision shall be stricken as to such jurisdiction or Award, and the remainder of the Plan or any such Award shall remain in full force and effect.

(g) No Trust or Fund Created. Neither the Plan nor any Award shall create or be construed to create a trust or separate fund of any kind or a fiduciary relationship between the Company or any Affiliate and a Participant or any other Person. To the extent that any Person acquires a right to receive payments from the Company or any Affiliate pursuant to an Award, such right shall be no greater than the right of any unsecured general creditor of the Company or any Affiliate.

(h) No Fractional Shares. No fractional Shares shall be issued or delivered pursuant to the Plan or any Award, and the Committee shall determine whether cash shall be paid in lieu of any fractional Shares or whether such fractional Shares or any rights thereto shall be canceled, terminated or otherwise eliminated.

(i) Headings. Headings are given to the Sections and subsections of the Plan solely as a convenience to facilitate reference. Such headings shall not be deemed in any way material or relevant to the construction or interpretation of the Plan or any provision thereof.

(j) Other Benefits. No compensation or benefit awarded to or realized by any Participant under the Plan shall be included for the purpose of computing such Participant's compensation under any compensation-based retirement, disability, or similar plan of the Company unless required by law or otherwise provided by such other plan.

Section 10. Effective Date of the Plan.

The Plan shall be effective as of the date of its approval and adoption by the Company's shareholders. If the Company's shareholders do not approve the Plan, the Plan shall be null and void.

Section 11. Term of the Plan.

Awards shall only be granted under the Plan during a 10-year period beginning on the effective date of the Plan. However, unless otherwise expressly provided in the Plan or in an applicable Award Agreement, any Award theretofore granted may extend beyond the end of such 10-year period, and the authority of the Committee provided for hereunder with respect to the Plan and any Awards, and the authority of the Board of Directors of the Company to amend the Plan and to waive any conditions or rights of the Company under any Award pursuant to 7(b) hereof, shall extend beyond the termination of the Plan.

Section 12. One-Time Option Exchange Offer.

Notwithstanding any other provision of the Plan to the contrary, upon approval of the Company's stockholders, the Committee may provide for, and the Company may complete, a one-time option exchange offer, pursuant to which certain outstanding options could, at the election of the person holding such option, be tendered to the Company on a grant-by-grant basis for cancellation in exchange for the issuance of a lesser amount of options with a lower exercise price, provided that such one-time option exchange offer is commenced within twelve months of the date of such stockholder approval.

Exhibit 10.7

Grant ID XXXXX

ENTEROMEDICS INC.
NON-INCENTIVE STOCK OPTION AGREEMENT

THIS AGREEMENT, made as of this ____ day of _____, 2010 (the "New Option Grant Date") by and between EnteroMedics Inc., a Delaware corporation (the "Company"), and _____ ("Optionee").

WHEREAS, the Company, pursuant to the Amended and Restated EnteroMedics Inc. 2003 Stock Incentive Plan (the "Plan"), wishes to grant this stock option to Optionee;

WHEREAS, Optionee was a holder of Eligible Options granted under the Plan. Pursuant to the Tender Offer Statement on Schedule TO and exhibits, including the "Offer to Exchange Certain Outstanding Stock Options for New Options, dated September 23, 2010" describing the terms of the Company's stock option exchange offer (collectively, the "Option Exchange Documents"), Optionee as a holder of Eligible Options was offered to exchange his or her Eligible Options for New Options (the "Exchange Offer"), and Optionee tendered all or some of his or her Eligible Options in the Exchange Offer;

WHEREAS, by tendering all or some of his or her Eligible Options in the Exchange Offer, Optionee agreed that his or her tendered Eligible Options would be canceled in exchange for New Options and that the stock option agreements for the New Options would supercede Optionee's existing stock option agreements for the Eligible Options tendered in the Exchange Offer.

WHERERAS, pursuant to the Exchange Offer, Optionee has received the New Options described herein. The grant of New Options is subject to the terms of the Plan, the Option Exchange Documents and this Agreement. Capitalized terms not otherwise defined herein have the meaning set forth in the Plan or Option Exchange Documents. Copies of the Plan and the Option Exchange Documents are available from _____, and are also available on the Company's website.

NOW, THEREFORE, in consideration of the premises and of the mutual covenants herein contained, the parties hereto hereby agree as follows:

1. Grant of New Option. Subject to the terms and conditions set forth herein and in the Plan and the Option Exchange Documents, and pursuant to the Optionee's election to exchange the Eligible Option with Grant ID XXXXX pursuant to the Exchange Offer, the Company hereby cancels Optionee's Eligible Option with Grant ID XXXXX and grants to Optionee in exchange the right and option ("the New Option") to purchase all or any part of an aggregate of _____ shares (the "Shares") of the common stock, par value $0.01 per share (the "Common Stock"), of the Company at the price of $____ per Share. The New Option is not intended to qualify as an incentive stock option within the meaning of Section 422A of the Internal Revenue Code of 1986, as amended (the "Code").

2. Duration and Exerciseability. The New Option may not be exercised by Optionee except as set forth herein, and the New Option shall in all events terminate seven years from the date hereof. Subject to the other terms and conditions set forth herein, the New Option shall vest at one-third (1/3), or approximately ____ shares, immediately on the date hereof, and then __%, or approximately ____ shares, per month thereafter for 24 months, starting _____, 2010 and ending _____, 2012.

During the lifetime of Optionee, the New Option shall be exercisable only by Optionee. The New Option shall not be assignable or transferable by Optionee, other than by will or the laws of descent and distribution. The vesting of the New Option is subject to acceleration under the circumstances described in Section 4.

3. Effect of Termination of Relationship with the Company.

(a) In the event that Optionee's relationship with the Company or its subsidiaries shall terminate, for any reason other than Optionee's gross and willful misconduct or Optionee's death or disability, Optionee shall have the right to exercise the New Option at any time within five years after such termination to the extent of the full number of Shares Optionee was entitled to purchase under the New Option on the date of termination, subject to the condition that the New Option shall not be exercisable after the expiration of its term.

(b) In the event that Optionee's relationship with the Company or its subsidiaries shall terminate by reason of Optionee's gross and willful misconduct during the course of his/her relationship with the Company (as reasonably determined by the Company), the New Option shall terminate as of the date of the misconduct and shall not be exercisable thereafter.

(c) If Optionee shall die during its relationship with the Company or its subsidiaries, or within three months after termination of such relationship with the Company for any reason other than gross and willful misconduct, or if Optionee's relationship with the Company or its subsidiaries is terminated because the Optionee has become disabled within the meaning of Section 22(e)(3) of the Code, and Optionee shall not have fully exercised the New Option, the New Option may be exercised at any time within twelve months after the date of Optionee's death or termination of Optionee's relationship because of disability by the legal representative or, if applicable, guardian of Optionee or by any person to whom the New Option is transferred by will or the applicable laws of descent and distribution to the extent of the full number of Shares Optionee was entitled to purchase under the New Option on the date of death (or termination of Optionee's relationship with the Company, if earlier) or termination of Optionee's relationship because of disability and subject to the condition that the New Option shall not be exercisable after the expiration of its term.

4. Change in Control.

(a) In the event that a "Change in Control" (as hereinafter defined) occurs, (A) all outstanding New Options shall be subject to the agreement pursuant to which such Change in Control is consummated (the "COC Agreement") and (B) the vesting schedule of the New Options held by Optionee shall accelerate such that (y) on the date the Change in Control is completed, 50% of any then-unvested shares subject to the New Options held by Optionee shall immediately vest, irrespective of which of the provisions described in clauses (i) through (v) below are set forth in the COC Agreement is consummated (except in the case of clauses (iv) or (v), in which case 100% of the New Options would become vested), and (z) if Optionee is a Company employee at the time of the Change of Control and, in connection with or within the first two years after a Change in Control, Optionee's employment is terminated "Without Cause" (as hereinafter defined), the vesting schedule of the New Options held by Optionee shall accelerate such that on the termination of employment in connection with such Change in Control, 100% of any then-unvested shares subject to the New Option held by Optionee that remain outstanding shall immediately vest and shall be exercisable during the five-year period following the date of termination of employment (but not after the end of the New Option's original term) irrespective of which of the provisions described in clauses (i) through (v) below are set forth in the COC Agreement (except in the

case of clauses (iv) or (v), in which case 100% of the New Options would become vested). The COC Agreement shall provide for one or more of the following:

(i) The continuation of such outstanding New Options by the Company (if the Company is the surviving corporation).

(ii) The assumption of such outstanding New Options by the surviving corporation or its parent in a manner that complies with Section 424(a) of the Code (whether or not such New Options are ISOs).

(iii) The substitution by the surviving corporation or its parent of new options for such outstanding New Options in a manner that complies with Section 424(a) of the Code (whether or not such New Options are ISOs).

(iv) Full exercisability of such outstanding New Options and full vesting of the Shares subject to such New Options, followed by the cancellation of such New Options. The full exercisability of such New Options and full vesting of the Shares subject to such New Options may be contingent on the closing of such Change in Control. The Optionees shall be able to exercise such New Options during a period of not less than five full business days preceding the closing date of such Change in Control, unless (A) a shorter period is required to permit a timely closing of such Change in Control and (B) such shorter period still offers the Optionee a reasonable opportunity to exercise such New Options. Any exercise of such New Options during such period may be contingent on the closing of such Change in Control.

(v) The cancellation of such outstanding New Options and a payment to the Optionee equal to the excess of (A) the Fair Market Value (as defined in the Plan) of the Shares subject to such New Options (whether or not such New Options are then exercisable or such Shares are then vested) as of the closing date of such Change in Control over (B) their aggregate exercise price. Such payment shall be made in the form of cash, cash equivalents, or securities of the surviving corporation or its parent with a Fair Market Value equal to the required amount. Such payment may be made in installments and may be deferred until the date or dates when such New Options would have become exercisable or such Shares would have vested. Such payment may be subject to vesting based on the Optionee's continuing service to the Company or its affiliates, provided that the vesting schedule shall not be less favorable to the Optionee than the schedule under which such New Options would have become exercisable or such Shares would have vested. If the aggregate exercise price of the Shares subject to such New Options exceeds the Fair Market Value of such Shares by greater than ten percent (10%) of the Fair Market Value of such Shares, then such New Options may be cancelled without making a payment to the Optionee. For purposes of this Section 4(a)(v), the Fair Market Value of any security shall be determined without regard to any vesting conditions that may apply to such security.

(b) A "Change in Control" of the Company shall be deemed to have occurred if:

(i) Any "person" (as such term is used in Sections 13(d) and 14(d)(2) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) who did not own shares of the capital stock of the Company on the date of grant of the New Option shall, together with his, her or its "Affiliates" and "Associates" (as such terms are defined in Rule 12b-2 promulgated under the Exchange Act), become the "Beneficial Owner" (as such term is defined in Rule 13d-3 promulgated under the Exchange Act), directly or indirectly, of securities of the Company

representing 50% or more of the combined voting power of the Company's then outstanding securities (any such person being hereinafter referred to as an "Acquiring Person");

(ii) The "Continuing Directors" (as hereinafter defined) shall cease to constitute a majority of the Company's Board of Directors;

(iii) There should occur (A) any consolidation or merger involving the Company and the Company shall not be the continuing or surviving corporation or the shares of the Company's capital stock shall be converted into cash, securities or other property; provided, however, that this subclause (A) shall not apply to a merger or consolidation in which (i) the Company is the surviving corporation and (ii) the stockholders of the Company immediately prior to the transaction have the same proportionate ownership of the capital stock of the surviving corporation immediately after the transaction; (B) any sale, lease, exchange or other transfer (in one transaction or a series of related transactions) of all or substantially all of the assets of the Company; or (C) any liquidation or dissolution of the Company; or

(iv) The majority of the Continuing Directors determine, in their sole and absolute discretion, that there has been a Change in Control.

(c) "Continuing Director" shall mean any person who is a member of the Board of Directors of the Company, while such person is a member of the Board of Directors, who is not an Acquiring Person, an Affiliate or Associate of an Acquiring Person or a representative of an Acquiring Person or of any such Affiliate or Associate and who (i) was a member of the Company's Board of Directors on the date of grant of the New Option or (ii) subsequently became a member of the Board of Directors, upon the nomination or recommendation, or with the approval of, a majority of the Continuing Directors.

(d) "Without Cause" For purposes of this Agreement, a termination of Optionee Without Cause shall mean a termination (other than termination involving death, disability or mutual agreement of the Company and Optionee) of employment for any reason other than any of the following: (a) willful breach of Optionee's duties to Company; (b) conviction of any felony or any crime involving fraud, dishonesty, or moral turpitude; (c) participation in any fraud against or affecting Company or any subsidiary, affiliate, customer, supplier, client, agent, or employee thereof; or (d) any other act Company determines constitutes gross or willful misconduct detrimental to Company including, but not limited to, unethical practices, dishonesty, disloyalty, or any other acts harmful to Company.

5. Manner of Exercise.

(a) The New Option may only be exercised by Optionee or other proper party within the option period by delivering written notice of exercise to the Company at its principal executive office. The notice shall state the number of Shares as to which the New Option is being exercised and shall be accompanied by payment in full of the option price for all of the Shares designated in the notice.

(b) Optionee may, at the Company's election, pay the option price in cash, by check (bank check, certified check or personal check) or by any other means approved by the Committee (as such term is defined in the Plan) in its discretion, or in accordance with the terms set forth in the Plan.

(c) The exercise of the New Option is contingent upon receipt from Optionee (or other proper person exercising the New Option) of a representation that, at the time of such exercise, it is Optionee's intention to acquire the Shares being purchased for investment and not with a view to the distribution or

sale thereof within the meaning of the Securities Act of 1933, as amended (the "Securities Act"); provided, however, that the receipt of such representation shall not be required upon exercise of the New Option if, at the time of such exercise, the issuance of the Shares subject to the New Option shall have been properly registered under the Securities Act and all applicable state securities laws. Such representation shall be in writing and in such form as the Company may reasonably request. The certificate representing the Shares so issued for investment shall be imprinted with an appropriate legend setting forth all applicable restrictions on their transferability.

6. Right of First Refusal.

(a) **Right of First Refusal**. In the event that the Optionee proposes to sell, pledge or otherwise transfer to a third party any Shares acquired under this Agreement, or any interest in such Shares, the Company shall have the Right of First Refusal with respect to all (and not less than all) of such Shares. If the Optionee desires to transfer Shares acquired under this Agreement, the Optionee shall give a written transfer notice (a "Transfer Notice") to the Company describing fully the proposed transfer, including the number of Shares proposed to be transferred, the proposed transfer price, the name and address of the proposed transferee (the "Transferee") and proof satisfactory to the Company that the proposed sale or transfer will not violate any applicable federal or state securities laws. The Transfer Notice shall be signed both by the Optionee and by the proposed Transferee and must constitute a binding commitment of both parties to the transfer of the Shares. The Company shall have the right to purchase all, and not less than all, of the Shares on the terms of the proposal described in the Transfer Notice (subject, however, to any change in such terms permitted under Subsection (b) below) by delivery of a notice of exercise of the Right of First Refusal within 30 days after the date when the Transfer Notice was received by the Company.

(b) **Transfer of Shares**. If the Company fails to exercise its Right of First Refusal within 30 days after the date when it received the Transfer Notice, the Optionee may, not later than 90 days following receipt of the Transfer Notice by the Company, conclude a transfer of the Shares subject to the Transfer Notice on the terms and conditions described in the Transfer Notice, provided that any such sale is made in compliance with applicable federal and state securities laws and not in violation of any other contractual restrictions to which the Optionee is bound. Any proposed transfer on terms and conditions different from those described in the Transfer Notice, as well as any subsequent proposed transfer by the Optionee, shall again be subject to the Right of First Refusal and shall require compliance with the procedure described in Subsection (a) above. If the Company exercises its Right of First Refusal, the parties shall consummate the sale of the Shares on the terms set forth in the Transfer Notice within 60 days after the date when the Company received the Transfer Notice (or within such longer period as may have been specified in the Transfer Notice); provided, however, that in the event the Transfer Notice provided that payment for the Shares was to be made in a form other than cash or cash equivalents paid at the time of transfer, the Company shall have the option of paying for the Shares with cash or cash equivalents equal to the present value of the consideration described in the Transfer Notice.

(c) **Additional or Exchanged Securities and Property.** In the event of a merger or consolidation of the Company with or into another entity, any other corporate reorganization, a stock split, the declaration of a stock dividend, the declaration of an extraordinary dividend payable in a form other than stock, a spin-off, an adjustment in conversion ratio, a recapitalization or a similar transaction affecting the Company's outstanding securities, any securities or other property (including cash or cash equivalents) that are by reason of such transaction exchanged for, or distributed with respect to, any Shares subject to this Section 6 shall immediately be subject to the Right of First Refusal. Appropriate

adjustments to reflect the exchange or distribution of such securities or property shall be made to the number and/or class of the Shares subject to this Section 6.

(d) **Termination of Right of First Refusal.** Any other provision of this Section 6 notwithstanding, in the event that the Common Stock is readily tradable on an established securities market when the Optionee desires to transfer Shares, the Company shall have no Right of First Refusal, and the Optionee shall have no obligation to comply with the procedures prescribed by Subsections (a) and (b) above.

(e) **Permitted Transfers.** This Section 6 shall not apply to (i) a transfer by beneficiary designation, will or intestate succession or (ii) a transfer to one or more members of the Optionee's Immediate Family or to a trust established by the Optionee for the benefit of the Optionee and/or one or more members of the Optionee's Immediate Family, provided in either case that the Transferee agrees in writing on a form prescribed by the Company to be bound by all provisions of this Agreement. If the Optionee transfers any Shares acquired under this Agreement, either under this Subsection (e) or after the Company has failed to exercise the Right of First Refusal, then this Agreement shall apply to the Transferee to the same extent as to the Optionee. For purposes of this Agreement, "Immediate Family" shall include the ancestors, descendants, siblings and spouse of the Optionee.

(f) **Termination of Rights as Stockholder.** If the Company makes available, at the time and place and in the amount and form provided in this Agreement, the consideration for the Shares to be purchased in accordance with this Section 6, then after such time the person from whom such Shares are to be purchased shall no longer have any rights as a holder of such Shares (other than the right to receive payment of such consideration in accordance with this Agreement). Such Shares shall be deemed to have been purchased in accordance with the applicable provisions hereof, whether or not the certificate(s) therefor have been delivered as required by this Agreement.

(g) **Assignment of Right of First Refusal**. The Board of Directors may freely assign the Company's Right of First Refusal, in whole or in part. Any person who accepts an assignment of the Right of First Refusal from the Company shall assume all of the Company's rights and obligations under this Section 6.

7. Market Stand-Off. In connection with any underwritten public offering by the Company of its equity securities pursuant to an effective registration statement filed under the Securities Act, including the Company's initial public offering, the Optionee or a Transferee shall not directly or indirectly sell, make any short sale of, loan, hypothecate, pledge, offer, grant or sell any option or other contract for the purchase of, purchase any option or other contract for the sale of, or otherwise dispose of or transfer, or agree to engage in any of the foregoing transactions with respect to, any Shares acquired under this Agreement without the prior written consent of the Company or its underwriters. Such restriction (the "Market Stand-Off") shall be in effect for such period of time following the date of the final prospectus for the offering as may be requested by the Company or such underwriters. In no event, however, shall such period exceed 180 days. The Market Stand-Off shall in any event terminate two years after the date of the Company's initial public offering. In the event of the declaration of a stock dividend, a spin-off, a stock split, an adjustment in conversion ratio, a recapitalization or a similar transaction affecting the Company's outstanding securities without receipt of consideration, any new, substituted or additional securities which are by reason of such transaction distributed with respect to any Shares subject to the Market Stand-Off, or into which such Shares thereby become convertible, shall immediately be subject to the Market Stand-Off. In order to enforce the Market Stand-Off, the Company may impose stop-transfer instructions with respect to the Shares acquired under this Agreement until the

end of the applicable stand-off period. The Company's underwriters shall be beneficiaries of the agreement set forth in this Section 7. This Section 7 shall not apply to Shares registered in the public offering under the Securities Act, and the Optionee or a Transferee shall be subject to this Section 7 only if the directors and officers of the Company are subject to similar arrangements.

8. Adjustments. In the event that there is any change in the Common Stock or corporate structure of the Company as a result of any dividend or other distribution (whether in the form of cash, Common Stock, other securities or other property), recapitalization, stock split, reverse stock split, reorganization, merger, consolidation, split-up, spin-off, combination, repurchase or exchange of Common Stock or other securities of the Company, issuance of warrants or other rights to purchase Common Stock or other securities of the Company or other similar corporate transaction or event, and all or any portion of the New Option shall then be unexercised and not yet expired, then appropriate adjustments in the outstanding New Option shall be made as determined by the Committee in accordance with the provisions of Section 4(c) of the Plan in order to prevent dilution or enlargement of New Option rights.

9. Miscellaneous.

(a) The New Option is issued pursuant to the Plan and is subject to the terms of the Plan and the Option Exchange Documents. In the event any of the terms of this New Option conflict or are inconsistent in any respect with terms of the Plan or the Option Exchange Documents, the Plan terms shall control. Optionee hereby acknowledges receipt of a copy of the Plan and the Option Exchange Documents. The Plan and the Option Exchange Documents are also available for inspection during business hours at the principal office of the Company.

(b) This Agreement shall not confer on Optionee any right with respect to continuance of employment by or continuance of the relationship with the Company or any of its subsidiaries, nor will it interfere in any way with the right of the Company to terminate such employment at any time. Optionee shall have none of the rights of a stockholder with respect to the Shares until such Shares shall have been issued to him or her upon exercise of the New Option.

(c) The Company shall at all times during the term of the New Option reserve and keep available such number of Shares as will be sufficient to satisfy the requirements thereof. The exercise of all or any part of the New Option shall only be effective at, and may be deferred until, such time as the sale of the Shares pursuant to such exercise will not violate any federal or state securities laws, it being understood that the Company shall have no obligation to register the issuance or sale of the Shares for such purpose.

[The remainder of this page is intentionally left blank; signature page follows]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed on the day and year first above written.

ENTEROMEDICS, INC.

By _____
Name: Mark B. Knudson, Ph.D.
Title: President and CEO

_____
Optionee

THIRD AMENDMENT TO LOAN AND SECURITY AGREEMENT

THIS **THIRD AMENDMENT TO LOAN AND SECURITY AGREEMENT** (this "Amendment") is entered into as of November 4, 2010 by and between Silicon Valley Bank ("Bank") and Enteromedics Inc., a Delaware corporation ("Borrower"), whose address is 2800 Patton Road, Saint Paul, MN 55113.

RECITALS

A. Borrower, as borrower, and Bank, Compass Horizon Funding Company LLC and Venture Lending & Leasing V, Inc., as lenders, entered into that certain Loan and Security Agreement with an "Effective Date" of November 18, 2008, Subsequently, in accordance with that certain First Amendment to Loan and Security Agreement (the "First Amendment"), dated February 8, 2010, between Borrower and Bank, the Borrower and Bank agreed to the terms of the Amended SVB/Borrower Loan Agreement (as defined in the First Amendment and herein referred to as the "Loan Agreement").

B. Bank has extended credit to Borrower for the purposes permitted in the Loan Agreement.

C. Borrower has requested that Bank amend the Loan Agreement, as herein set forth, and Bank has agreed to the same, but only to the extent, in accordance with the terms, subject to the conditions and in reliance upon the representations and warranties set forth herein.

AGREEMENT

NOW, THEREFORE, in consideration of the foregoing recitals and other good and valuable consideration, the receipt and adequacy of which is hereby acknowledged, and intending to be legally bound, the parties hereto agree as follows:

1. Definitions. Capitalized terms used but not defined in this Amendment shall have the meanings given to them in the Loan Agreement.

2. Amendments and Other Provisions.

2.1 Limited Waiver Regarding New Capital Transactions Covenant Defaults. Borrower has failed to comply with the New Capital Transaction Covenant requirements set forth in Section 6.12 of the Loan Agreement for the compliance periods ending August 31, 2010 and October 31, 2010 (the "New Capital Covenant Defaults"). Bank and Borrower agree that the Borrower's New Capital Covenant Defaults are hereby waived. It is understood by the parties hereto, however, that such waiver does not constitute a waiver of any other provision or term of the Loan Agreement or any related document, nor an agreement to waive in the future this covenant or any other provision or term of the Loan Agreement or any related document.

2.2 Expiration of Forbearance Period. Borrower and Bank acknowledge and agree that the Forbearance Period (as defined in that certain Forbearance to Loan and Security Agreement by and between Borrower and Bank and dated October 5, 2010 (the "Forbearance Agreement")) has expired. Bank further acknowledges and agrees that the Existing Default (as defined in the Forbearance Agreement) is waived in accordance with Section 2.1 hereof.

2.3 Cash Security for Term Loan. Concurrently herewith, Borrower shall provide cash collateral to Bank in an amount equal to at least the outstanding principal amount of the Term Loan. Such cash collateral shall be maintained in a blocked Collateral Account maintained at Bank (the "Cash Security Account") and constitutes part of the Collateral. Borrower grants to Bank a security interest in the Cash Security Account and the funds therein to secure the payment and performance of all Obligations of Borrower to Bank, and Bank's rights with respect to such Collateral are as provided for in the Loan Agreement.

2.4 Release of Cash Security. The funds maintained in the Cash Security Account will remain therein until all of the following have occurred (if ever):

(a) Borrower shall have received aggregate net proceeds from New Capital Transactions of not less than $12,500,000 from the date of the Second Amendment through January 31, 2011, and such proceeds shall be held in Collateral Accounts of Borrower maintained with Bank or Bank's Affiliates until used in the ordinary course of Borrower's business; and

(b) Bank shall have received a financial forecast of Borrower through December 31, 2012 (the "Financial Forecast") which Financial Forecast shall have been approved by Borrower's board of directors and which Financial Forecast must demonstrate, in Bank's good faith business judgment, that Borrower will be able to timely repay the Term Loan and all of its other debts and obligations as they become due; and

(c) Based upon such Financial Forecast, Bank and Borrower shall have agreed upon new financial covenants and/or a new financial structure for Borrower's Obligations and shall have documented the same in form and substance reasonably satisfactory to both Bank and Borrower.

Borrower acknowledges and agrees that if any of the foregoing conditions set forth in this Section 2.4 is not met, the funds maintained in the Cash Security Account shall remain therein until such time as the Obligations are paid in full.

2.5 Suspension of Compliance with Liquidity Ratio Financial Covenant. The requirement that Borrower comply with the Liquidity Ratio Financial Covenant set forth in Section 6.7(a) of the Loan Agreement is hereby suspended through the compliance period ending January 31, 2011.

2.6 Modifications Regarding New Capital Transactions Requirements. Pursuant to Section 6.12 of the Loan Agreement, Borrower is required to have received aggregate net proceeds from New Capital Transactions of not less than $15,000,000 from the date of the Second Amendment through January 31, 2011 (the "January 2011 Requirement") and $35,000,000 from the date of the Second Amendment through June 30, 2011 (the "June 2011 Requirement"). Bank and Borrower hereby agree that (i) the January 2011 Requirement is hereby amended from "$15,000,000" to "$12,500,000" and (ii) the June 30, 2011 Requirement is hereby deleted.

2.7 Addition of Definition. The following definition is hereby added to Section 13.1 of the Loan Agreement in the appropriate alphabetical order:

"**Third Amendment**" is that certain Third Amendment to Loan and Security Agreement dated November 4, 2010, between SVB and Borrower.

3. Limitation of Amendments.

3.1 The amendments set forth above are effective for the purposes set forth herein and shall be limited precisely as written and shall not be deemed to (a) be a consent to any amendment, waiver or modification of any other term or condition of any Loan Document, or (b) otherwise prejudice any right or remedy which Bank may now have or may have in the future under or in connection with any Loan Document.

3.2 This Amendment shall be construed in connection with and as part of the Loan Documents and all terms, conditions, representations, warranties, covenants and agreements set forth in the Loan Documents, except as herein amended, are hereby ratified and confirmed and shall remain in full force and effect.

4. Representations and Warranties. To induce Bank to enter into this Amendment, Borrower hereby represents and warrants to Bank as follows:

4.1 Immediately after giving effect to this Amendment (a) the representations and warranties contained in the Loan Documents are true, accurate and complete in all material respects as of the date hereof (except to the extent such representations and warranties relate to an earlier date, in which case they are true and correct as of such date), and (b) no Event of Default has occurred and is continuing;

4.2 Borrower has the power and authority to execute and deliver this Amendment and to perform its obligations under the Loan Agreement, as amended by this Amendment;

4.3 The organizational documents of Borrower delivered to Bank on the Effective Date (including the Fifth Amended and Restated Certificate of Incorporation filed with the Delaware Secretary of State on November 20, 2007), as amended by the Certificate of Amendment filed with the Delaware Secretary of State on July 2, 2009, remain true, accurate and complete and have not been amended, supplemented or restated and are and continue to be in full force and effect;

4.4 The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Agreement, as amended by this Amendment, have been duly authorized;

4.5 The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Agreement, as amended by this Amendment, do not and will not contravene (a) any law or regulation binding on or affecting Borrower, (b) any contractual restriction with a Person binding on Borrower, (c) any order, judgment or decree of any court or other governmental or public body or authority, or subdivision thereof, binding on Borrower, or (d) the organizational documents of Borrower;

4.6 The execution and delivery by Borrower of this Amendment and the performance by Borrower of its obligations under the Loan Agreement, as amended by this Amendment, do not require any order, consent, approval, license, authorization or validation of, or filing, recording or registration with, or exemption by any governmental or public body or authority, or subdivision thereof, binding on either Borrower, except as already has been obtained or made; and

4.7 This Amendment has been duly executed and delivered by Borrower and is the binding obligation of Borrower, enforceable against Borrower in accordance with its terms, except as such enforceability may be limited by bankruptcy, insolvency, reorganization, liquidation, moratorium or other similar laws of general application and equitable principles relating to or affecting creditors' rights.

5. Counterparts. This Amendment may be executed in any number of counterparts and all of such counterparts taken together shall be deemed to constitute one and the same instrument.

6. Effectiveness. This Amendment shall be deemed effective upon the execution and delivery of this Amendment by each party hereto.

[Signature page follows]

IN WITNESS WHEREOF, the parties hereto have caused this Amendment to be duly executed and delivered as of the date first written above.

BANK

Silicon Valley Bank

By: /s/ Benjaman Johnson
Name: Benjaman Johnson
Title: Deal Team Leader

BORROWER

Enteromedics Inc.

By: /s/ Greg S. Lea
Name: Greg S. Lea
Title: Senior Vice President and Chief Financial Officer

Exhibit 31.1

CERTIFICATION

I, Mark B. Knudson, Ph.D., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of EnteroMedics 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 consolidated financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/S/ MARK B. KNUDSON, PH.D.

Mark B. Knudson, Ph.D.
President and Chief Executive Officer

Date: November 8, 2010

Exhibit 31.2

CERTIFICATION

I, Greg S. Lea, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of EnteroMedics 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 consolidated financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;

c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/S/ GREG S. LEA

Greg S. Lea
Senior Vice President and Chief Financial Officer

Date: November 8, 2010

Exhibit 32.1

CERTIFICATION

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350), Mark B. Knudson, Ph.D., in his capacity as Chief Executive Officer of EnteroMedics Inc., hereby certifies that, to the best of his knowledge:

1. The Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010 to which this Certification is attached as Exhibit 32.1 (the Report) fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act, and
2. That the information contained in the Report fairly presents, in all material respects, the financial condition and the results of operations of EnteroMedics Inc. as of, and for, the periods covered by the Report.

By: /S/ MARK B. KNUDSON, PH.D.

Mark B. Knudson, Ph.D.
President and Chief Executive Officer

Date: November 8, 2010

Exhibit 32.2

CERTIFICATION

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended (the Exchange Act), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350), Greg S. Lea, in his capacity as Chief Financial Officer of EnteroMedics Inc., hereby certifies that, to the best of his knowledge:

1. The Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2010 to which this Certification is attached as Exhibit 32.2 (the Report) fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act, and
2. That the information contained in the Report fairly presents, in all material respects, the financial condition and the results of operations of EnteroMedics Inc. as of, and for, the periods covered by the Report.

By: /S/ GREG S. LEA

Greg S. Lea
Senior Vice President and Chief Financial Officer

Date: November 8, 2010