

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended January 3, 1998
OR
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File No. 0-19621

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.
(Exact name of registrant as specified in its charter)

MINNESOTA
(State or other jurisdiction of
incorporation or organization)

41-1454591
(I.R.S. Employer
Identification No.)

7400 EXCELSIOR BOULEVARD, MINNEAPOLIS, MINNESOTA
(Address of principal executive offices)

55426-4517
(Zip Code)

Registrant's telephone number, including area code: 612-930-9000

Securities registered pursuant to Section 12(b) of the Act: NONE
Securities registered pursuant to Section 12(g) of the Act: COMMON STOCK,
WITHOUT PAR VALUE
(Title of class)

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

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

As of March 26, 1998, the aggregate market value of the voting stock held by nonaffiliates of the registrant, computed by reference to the average of the high and low prices on such date as reported by the Nasdaq SmallCap Market, was \$2,842,000.

As of March 26, 1998, there were outstanding 1,136,744 shares of the registrant's Common Stock, without par value.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Annual Report to Shareholders for the fiscal year ended January 3, 1998 are incorporated by reference into Part II hereof and portions of the definitive proxy statement dated March 24, 1998 are incorporated by reference into Part III hereof.

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PART I

ITEM 1. BUSINESS

GENERAL

Appliance Recycling Centers of America, Inc., together with its operating subsidiaries ("ARCA" or the "Company"), provides a comprehensive range of services for large-scale collection, resale and recycling of major household appliances in an environmentally sound manner. The Company provides its customers with integrated processes and programs addressing the solid waste management, environmental and energy conservation issues involved with appliance disposal and recycling. The Company generates revenues from fees charged for the disposal of appliances, the sale of materials generated from processed appliances (byproduct revenues) and the sale of reconditioned and distressed appliances through a chain of Company-owned retail stores called Encore(R) Recycled Appliances ("Encore").

The Company was incorporated in Minnesota in 1983, although through its predecessors, it commenced the appliance recycling business in 1976. The Company's principal office is located at 7400 Excelsior Boulevard, Minneapolis, Minnesota 55426-4517. References herein to the Company include its operating subsidiaries. (See Exhibit 21.1.)

INDUSTRY BACKGROUND

There are more than 500 million major household appliances, such as refrigerators, freezers, ranges, dishwashers, microwaves, washers, dryers, room air conditioners, water heaters and dehumidifiers, currently in use in the United States. It is estimated by the Steel Recycling Institute that in 1995, 42 million major household appliances were taken out of use in the United States. Industry sources estimate that 50 to 55 million major household appliances will be disposed of each year between the years 1997 and 2000. The disposal of these appliances has become a serious problem as a result of a number of factors including: (i) decreasing landfill capacity in many parts of the country; (ii) the inability of incinerators, composting facilities and other landfill alternatives to process appliances; and (iii) the presence in appliances of certain hazardous and other environmentally harmful materials that require special processing.

Legislation affecting appliance disposal has been adopted in more than 30 states. This legislation includes landfill restrictions, disposal bans, advance disposal fees and other types of restrictions. As a result, appliances must be dealt with outside the ordinary municipal solid waste stream.

Landfill restrictions arise in part because some appliance components contain certain hazardous and other environmentally harmful materials, including polychlorinated biphenyls (PCBs), mercury, refrigerants such as chlorofluorocarbons (CFCs) and sulfur dioxide, and oils. PCBs are suspected as carcinogens, are resistant to degradation when deposited in landfills and can cause groundwater contamination. The production of PCBs was banned by the EPA in 1979, although businesses were allowed to continue using remaining inventories of components that contained PCBs. Mercury is toxic to humans and can enter the body through inhalation, skin absorption or ingestion, and it vaporizes at high temperatures forming extremely toxic fumes. CFCs are believed to cause long-term damage to the earth's stratospheric ozone layer and may contribute to global warming when released into the atmosphere. The 1990

Amendments to the Clean Air Act prohibit the venting of CFCs and since July 1,

1992 have required the recovery of CFC refrigerants during the service, repair and disposal of appliances. See Business - Government Regulation.

In addition to these solid waste management and environmental issues, utility companies, motivated by economic and environmental factors to control energy consumption, sponsor various programs to encourage and assist residential consumers to conserve energy, including programs for turning in surplus, energy-inefficient appliances. Many residential consumers own and operate room air conditioners, freezers or more than one refrigerator, contributing significantly to residential energy use and peak energy demand. In addition, many of the refrigerators manufactured in the 1960s and early 1970s consume up to 1,750 kilowatt-hours of electricity each year. The National Appliance Energy Conservation Act requires that a typical 18-cubic-foot refrigerator manufactured after 1992 have an energy consumption rate not exceeding 700 kilowatt-hours per year. As new, more efficient appliances become available, utility companies have begun to encourage the use of newer models and the disposal of older, less efficient models.

The Federal Energy Policy Act of 1992 gives individual states the option of deregulating their electric utility industry. The potential of deregulation has caused uncertainty about the future and form of energy conservation programs sponsored by electric utilities. Some electric utility companies are delaying new energy conservation programs, including the Company's refrigerator recycling program. The Company believes, however, that energy conservation and efficiency programs will remain a long-term component of the nation's electric utility industry. See Business - Government Regulation.

During 1997, the Company entered into agreements with Whirlpool Corporation, the nation's largest manufacturer of major household appliances, to develop a program for handling distressed appliances for Whirlpool. Under the agreements, the Company will purchase distressed appliances from Whirlpool, recondition suitable units and sell them through ARCA's network of Encore retail stores. Appliances that cannot be reconditioned are recycled in accordance with all applicable environmental regulations. The Company believes that these contracts will provide a large quantity of high quality appliances that can be sold through its Encore stores.

COMPANY BACKGROUND

The Company began business in 1976 as a retailer of reconditioned appliances. Initially, the Company contracted with national and regional retailers of appliances such as Sears, Roebuck & Company, Inc. ("Sears") and Montgomery Ward & Co. ("Montgomery Ward") to collect major appliances in Minneapolis/Saint Paul and two other metropolitan areas. As part of their new appliance sales efforts, these customers arrange for the removal of old appliances from consumers' residences. The Company collects old appliances on behalf of its customers, reconditions and sells suitable used appliances through its own retail stores and sells the remaining appliances to scrap metal processors.

In the late 1980s, in response to stricter environmental protection laws, the Company developed and marketed programs to process and dispose of appliances in an environmentally sound manner. These programs are offered to new appliance manufacturers and retailers, waste management companies and the general public. See Business - Customers and Source of Supply.

In 1989, the Company expanded its appliance recycling concept to the utility industry when it established an appliance processing center in Milwaukee, Wisconsin, pursuant to a contract with a utility company. From 1989 to 1994 the Company focused its resources on the expansion of its business with electric utility companies. During this time period the Company opened nine centers

throughout the U.S. and Canada, primarily serving seventeen electric utility customers. The Company's electric utility business has been negatively impacted by the potential of electric utility industry deregulation. The potential of deregulation has caused electric utilities to decrease their sponsorship of energy conservation programs like the one the Company offers. The Company currently has only one major contract with an electric utility customer.

During fiscal year 1997, that customer, Southern California Edison Company ("Edison"), accounted for approximately 38% of the Company's net revenues. In February 1998, Edison entered into a contract with the Company to extend the refrigerator recycling program through September 1998. The Company has participated in that program through its California subsidiary since 1993. Under the terms of the contract, Edison will provide for a minimum number of refrigerators to be recycled during the contract period. The contract generated revenues of \$4.3 million in 1997 and will generate at least \$3.0 million in revenues in 1998.

In response to the decrease in demand for services from electric utilities, the Company has increased its marketing of services to appliance manufacturers and retailers, waste management companies and property management companies. The Company also has increased its focus on the sale of reconditioned appliances. In 1995, under the name Encore(R) Recycled Appliances, the Company began operating a chain of Company-owned retail stores. These stores offer reconditioned and manufacturers' distressed appliances to value-conscious individuals and property managers.

During 1996 the Company continued to expand its focus on its Encore retail stores and had more than 30 retail stores open at one point during the year. Due to substantial losses in certain markets, the Company closed centers and stores in three markets in the fourth quarter of 1996. Write-offs and other significant expenses related to these closings caused the Company to report a significantly larger than anticipated loss for the year. The Company currently has four recycling centers, located in Columbus, Ohio; Minneapolis, Minnesota; St. Louis, Missouri; and Los Angeles, California. The Company currently has 14 retail stores in these markets.

CUSTOMERS AND SOURCE OF SUPPLY

The Company offers its services to entities that as part of their operations become responsible for disposing of large quantities of used appliances. These entities include new appliance manufacturers and retailers, waste management companies, property management companies and utility companies.

NEW APPLIANCE MANUFACTURERS AND RETAILERS. The Company began its business by offering appliance recycling programs to Sears, Montgomery Ward and other new appliance retailers to collect appliances from either the retailers' facilities or from their consumers. Recently the Company expanded its existing marketing efforts to new appliance manufacturers, a primary source of product that can be reconditioned and sold in the Company's stores.

WASTE MANAGEMENT COMPANIES. The Company provides services to waste management companies and the general public for the collection and recycling of appliances for specified fees.

PROPERTY MANAGEMENT COMPANIES. The Company provides comprehensive appliance exchange and recycling services to property managers of apartment complexes as well as local housing authorities.

UTILITY COMPANIES. The Company contracts with utility companies to provide comprehensive appliance recycling services tailored to the needs of the particular utility. The contracts historically have had terms of one to four years, with provisions for renewal at the option of the utility company. Under some contracts, the utility retains the Company to manage all aspects of its appliance recycling program, while under other contracts, the Company provides only specified services. Pricing for the Company's services is on a per-appliance basis and depends upon several factors, including the total number of appliances processed, the length of the contract term and the specific services selected by the utility. Contracts with electric utility customers require that the Company does not recondition for resale appliances received from utility company energy conservation programs. The Company currently has only one major contract with an electric utility customer.

The Company believes its sources are adequate to supply the current number of retail stores and allow it to increase the number of retail stores.

COMPANY OPERATIONS

The Company provides an integrated range of collection, reuse and recycling services. Appliances are collected from a variety of sources, including new appliance retailers and manufacturers, solid waste management companies, property managers, local government and electric utilities. Some appliances are reconditioned and sold through the Company's retail network of Encore stores. The remaining appliances are disposed of in an environmentally responsible manner at a Company recycling center. Environmentally harmful substances---including CFCs, PCBs and mercury---are removed and properly managed. After all appliance processing is completed, scrap materials are sold for recycling.

The Company believes 10 to 15% of all appliances collected can be reconditioned. Appliances identified for resale are thoroughly inspected for wear-and-tear and broken or damaged parts. Worn parts are replaced and appliances are tested to ensure they are fully operational and function safely under proper conditions. Appliances are professionally cleaned and touched-up or repainted. Reconditioned appliances are then sold in the Company's chain of Encore retail stores. Each appliance has a 90-day warranty, with an additional extended warranty available for purchase. The Company offers a money-back guarantee and provides delivery and repair services on products that it sells.

Appliances that don't meet the Company's standards are processed and

recycled in an environmentally sound manner. Appliances identified to be recycled are processed per federal, state and local environmental regulations. They are inspected and categorized according to the types of hazardous materials they may contain. At the Company's centers, appliances are moved through the processing area on a conveyor system, which eases the handling of heavy and bulky items and promotes employee safety. After the appliances are moved to the processing area, the Company's processing technicians remove electrical capacitors and fluorescent light ballasts that may contain PCB dielectric fluid, and components that may contain mercury. This procedure is conducted at a specially constructed and controlled component removal area. The Company's processing technicians are trained to locate and remove such components from all makes and models of appliances. The technicians place the components in separate, clearly marked containers in the component removal area.

When processing at the Company's centers has been completed and the appliances are free of environmentally hazardous components and materials, they are delivered to qualified metals processing facilities for shredding. Shredded materials from the processed appliances are sold to steel mini-mills or other metal recovery facilities for appropriate reuse.

PLANNED EXPANSION. The Company plans to open three to five additional retail stores in 1998 in its existing markets. Management believes that the uncertainties in the electric utility industry regarding deregulation will persist at least through 1998. The reaction to deregulation among states and utilities has been varied. The Company believes, however, that energy conservation and efficiency programs will remain a long-term component of the nation's electric utility industry.

The Company believes that the growth and expansion of the business in the near future will likely occur primarily through the expansion of revenues from the Company's current retail stores, the development of contracts with solid waste management companies and appliance retailers, and the generation of revenues from the contract with Edison.

PRINCIPAL PRODUCT AND SERVICES

The Company generates revenues from three sources: recycling fees, appliance sales and byproduct sales. The following table reflects the percentage of total revenues from each source.

	1997	1996	1995
	----	----	----
Recycling fees	52.4%	48.4%	75.7%
Appliance sales	34.6%	36.7%	11.0%
Byproduct sales	13.0%	14.9%	13.3%
	-----	-----	-----
	100.0%	100.0%	100.0%
	=====	=====	=====

SALES AND MARKETING

The Company uses various means to promote awareness of its services and the need for environmentally sound recycling of appliances and believes it is recognized as a leader in the appliance recycling industry.

The Company's strategy for its retail stores is to present an upscale image in convenient, high-traffic locations. Store interiors are modern, bright and clean. In every Encore market, the Company actively promotes its stores through various forms of print advertising, including daily classified ads in major newspapers, telephone yellow pages ads and direct mail. In addition, the Company uses radio and television advertisements in some markets, in addition to other types of promotions.

SEASONALITY

The Company experiences seasonal fluctuations in operating results, with revenues generally higher during the second and third calendar quarters than in the first and fourth calendar quarters. The lower levels in the first and fourth quarters reflect consumer purchasing cycles, which result in lower sales of major household appliances during such quarters and corresponding reductions in the demand for appliance recycling services. Furthermore, utility companies that sponsor appliance turn-in programs generally reduce their promotional efforts for such programs during the first and fourth calendar quarters. The Company expects that it will continue to experience lower revenues in the first and fourth quarters of future years as compared to the second and third quarters of such years.

COMPETITION

Many factors, including existing and proposed governmental regulation, may affect competition in the waste management and environmental

services industry. Recycling of appliances in conformity with recent legislative and regulatory requirements is a relatively new industry. The Company generally competes with two or three other companies which are based in the geographic area to be served under the contract and which generally offer only some of the services provided by the Company.

The Company expects its primary competition for contracts with existing or new customers to come from entrepreneurs entering the appliance recycling business, energy management consultants, current recycling companies, major waste hauling companies, scrap metal processors and used appliance dealers. In addition, customers such as utility companies and local governments may operate appliance recycling programs internally rather than contracting with the Company or other third parties. There can be no assurance that the Company will be able to compete profitably in any of its chosen markets.

Competition for the Company's retail stores comes from new appliance retailers and other reconditioned and used appliance retailers. Each Encore location will compete not only with local and national chains of new appliance retailers, many of whom have been in business longer than the Company and who may have significantly greater assets than the Company, but will also be required to compete with numerous independently owned retailers of used and reconditioned appliances.

GOVERNMENT REGULATION

The business of recycling major appliances is subject to certain governmental laws and regulations and is becoming increasingly regulated. These laws and regulations include landfill disposal restrictions, hazardous waste management requirements and air quality standards, as well as special permit and license conditions for the recycling of appliances. In some instances, there are bonding, insurance and other conditions for bidding on appliance recycling contracts.

The Company's appliance recycling centers are subject to various federal, state and local laws, regulations and licensing requirements relating to the collection, processing and recycling of household appliances. Requirements for registrations, permits and licenses vary among the Company's market areas. The Company's centers are registered with the EPA as hazardous waste generators and are licensed, where required, by appropriate state and local authorities. The Company has agreements with approved and licensed hazardous waste companies for transportation and disposal of PCBs from its centers.

The 1990 Amendments to the Clean Air Act provide for the phaseout of the production of CFCs over a period of years. Effective July 1, 1992, the Act prohibited the venting of CFCs in the course of maintaining, servicing, repairing or disposing of an appliance. The Act also requires the recovery of CFC refrigerants from appliances prior to their disposal or delivery for recycling. In 1995, the venting of CFC substitute refrigerants was also prohibited.

In 1992, Congress adopted the Energy Policy Act of 1992 to encourage energy efficiency. Requirements under this act establish, among other things, mandatory energy performance standards that affect the manufacture and sale of major household appliances. Another component of this act allows for deregulation of the nation's energy providers, including the electric utility industry. The ultimate impact of deregulation on the electric utility industry is yet unknown; therefore, there can be

no assurance that the Company will be able to continue certain of its current operations in a deregulated environment.

Company management believes that further government regulation of the appliance recycling industry could have a positive effect on the Company's business; however, there can be no assurance what course future regulation could have. Under some circumstances, further regulation could materially increase the costs of the Company's operations and have an adverse effect on the Company's business. In addition, as is the case with all companies handling hazardous materials, under some circumstances, the Company may be subject to contingent liability.

EMPLOYEES

At March 1, 1998, the Company had 158 full-time employees, of whom approximately 55 percent were involved in the collection, transportation and processing of appliances at the Company's centers and approximately 45 percent were in sales, administration and management. The Company has not experienced any work stoppages and believes its employee relations are good.

ITEM 2. PROPERTIES

The Company's executive offices are located in Minneapolis, Minnesota, in a Company owned facility which includes approximately 11 acres of

land. The building contains approximately 122,000 square feet, including 27,000 square feet of office space and 95,000 square feet of operations and processing space. The Southern California center building, which also is owned by the Company, is located in Compton, California, and consists of 44,000 square feet: 6,000 square feet of office space and 38,000 square feet of warehouse space. In addition, the Company owns a 14,000-square-foot facility in Saint Paul, Minnesota, which contains a retail store at which it sells reconditioned and distressed appliances. All properties owned by the Company currently secure outstanding loans of the Company.

The Company generally leases the other facilities it operates. The Company usually attempts to negotiate lease terms that correspond to the term of the principal contract or contracts in connection with which the center is to be operated. The Company's centers typically range in size from 12,000 to 40,000 square feet. The Company's retail stores are typically 2,500 to 5,000 square feet. The Company is negotiating the settlement of one remaining lease from the locations closed in 1996.

The Company believes that the facilities and equipment at each of its centers are adequate to meet its anticipated needs for the near term and believes that alternate facilities will readily be available to the Company to meet its future needs.

ITEM 3. LEGAL PROCEEDINGS

The Company and its subsidiaries are involved in various legal proceedings arising in the normal course of business, none of which is expected to result in any material loss to the Company or any of its subsidiaries.

Due to legal proceedings brought in August 1997 against the Company, its directors and its subsidiary, Appliance Recycling Centers of America-California, Inc. ("ARCA California"), by the minority shareholder of ARCA California, on October 9, 1997 ARCA California filed a voluntary petition for relief seeking a reorganization of the subsidiary under Chapter 11 of the Federal Bankruptcy Act. On November 5, 1997, a cash settlement agreement between ARCA, Inc., ARCA California, its officers and directors, and the minority shareholder was reached in which all claims between the parties were settled and ARCA, Inc. acquired all of the minority shareholder's stock in ARCA California. The agreement was approved by the United States Bankruptcy Court on November 26, 1997 and the Chapter 11 filing was dismissed. ARCA California accounts for all of the revenues from the Edison contract.

In addition, the Company is involved in certain legal proceedings arising from the cancellation of leases in connection with the closing of certain facilities. The Company has established a reserve for lease settlements and closing costs. See Note 7 in the "Notes to Consolidated Financial Statements" contained in Exhibit 13.0 to this report.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

The Company did not submit any matters to a vote of security holders during the last quarter of the fiscal year covered by this report.

PART II

ITEM 5. MARKET FOR THE COMPANY'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

The Common Stock Data set forth on page 16 of the Company's 1997 Annual Report to Shareholders, presenting certain information regarding the market for the Company's Common Stock, is incorporated herein by reference.

Within the last three years the Company has issued 79,839 (adjusted for 1 for 4 reverse stock split in February 1997) unregistered shares.

In August 1995, the Company acquired Major Appliance Pickup Service of St. Louis, Inc. DBA Gateway Appliance Center, Inc. ("Gateway"), a St. Louis, Missouri-based used appliance retailer and recycler, by exchanging 7,143 shares of its Common Stock for 100% ownership of Gateway.

In January 1996, the Company acquired Universal Appliance Company, Inc. and Universal Appliance Recycling, Inc., Washington, D.C.-based companies, by exchanging a total of 21,000 shares of its Common Stock for 100% ownership of the respective companies, which merged into a subsidiary of the Company, ARCA-Maryland, Inc.

In May 1996, the Company sold, in a privately negotiated transaction, 50,000 shares of its Common Stock at a purchase price of \$14.00 per share to a fund owned by Perkins Capital Management Inc. The proceeds of this sale were used to pay off an equipment loan of \$480,000 and for additional working capital.

In May 1996, the Company agreed to issue 1,696 shares of Common Stock to Tom Harris & Associates, Inc. pursuant to a contract for service with 730 Creative Corporation.

ITEM 6. SELECTED FINANCIAL DATA

The Selected Financial Data set forth on page 16 of the Company's 1997 Annual Report to Shareholders is incorporated herein by reference. Such data should be read in conjunction with the Consolidated Financial Statements and Notes thereto and Management's Discussion and Analysis appearing in the Company's 1997 Annual Report to Shareholders. See Exhibit 13.0 to this report.

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE FISCAL YEARS 1997, 1996 AND 1995

Management's Discussion and Analysis set forth on page 4 of the Company's 1997 Annual Report to Shareholders, representing management's discussion and analysis of financial condition and results of operations, is incorporated herein by reference. See Exhibit 13.0 to this report.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Not applicable.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements, Notes to Consolidated Financial Statements and Independent Auditor's Report set forth in the Company's 1997 Annual Report to Shareholders are incorporated herein by reference. See Index to Financial Statements on page 13 of this report and Exhibit 13.0 to this report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

No changes in or disagreements with accountants have occurred within the two-year period ended January 3, 1998, which required reporting on Form 8-K.

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE COMPANY

Information regarding directors and executive officers of the Company is set forth under "Information Concerning Directors, Nominees and Executive Officers" and under "Beneficial Ownership Reporting Compliance" in the Company's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders to be held April 30, 1998 and is incorporated herein by reference.

ITEM 11. EXECUTIVE COMPENSATION

Information regarding Executive Compensation set forth under "Executive Compensation" in the Company's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders to be held April 30, 1998, other than the subsections captioned "Report of the Compensation and Benefits Committee" and "Performance Graph," is incorporated herein by reference.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information regarding security ownership of certain beneficial owners and management is set forth under "Beneficial Ownership of Common Stock" in the Company's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders to be held April 30, 1998, and is incorporated herein by reference.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions is set forth under "Information Concerning Directors, Nominees and Executive Officers" in the Company's definitive Proxy Statement for its 1998 Annual Meeting of Shareholders to be held April 30, 1998, and is incorporated herein by reference.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) FINANCIAL STATEMENTS, FINANCIAL STATEMENT SCHEDULES AND EXHIBITS

1. FINANCIAL STATEMENTS

The following consolidated financial statements of the Company, included in the Company's 1997 Annual Report to Shareholders, are incorporated herein by reference (See Exhibit 13.0 hereto):

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<CAPTION>

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Consolidated Statements of Operations for the three-year period ended January 3, 1998.....	7
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Consolidated Statements of Shareholders' Equity for the three-year period ended January 3, 1998.....	10
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2. FINANCIAL STATEMENT SCHEDULES

The financial statement schedules of the Company are omitted because of the absence of conditions under which they are required, or the information required is available in the financial statements listed above.

3. EXHIBITS

See Index to Exhibits on page 15 of this report.

(b) REPORTS ON FORM 8-K

No reports on Form 8-K were filed during the last quarter of the fiscal year covered by this report.

SIGNATURES

Pursuant to the requirements of Section 13 or Section 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.

Dated: March 27, 1998

APPLIANCE RECYCLING CENTERS OF
AMERICA, INC.
(Registrant)

By /s/ Edward R. Cameron

Edward R. Cameron
President and Chief Executive Officer

By /s/ Kent S. McCoy

Kent S. McCoy
Chief Financial Officer

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

SIGNATURE -----	TITLE -----	DATE -----
/s/ Edward R. Cameron ----- Edward R. Cameron	Chairman of the Board, President and Chief Executive Officer	March 27, 1998
/s/ Kent S. McCoy ----- Kent S. McCoy	Chief Financial Officer (Principal Accounting Officer)	March 27, 1998
/s/ George B. Bonniwell ----- George B. Bonniwell	Director	March 27, 1998

/s/ Duane S. Carlson Director

Duane S. Carlson

March 27, 1998

/s/ Harry W. Spell Director

Harry W. Spell

March 27, 1998

INDEX TO EXHIBITS

Exhibit No. -----	Description -----
3.1	Restated Articles of Incorporation of Appliance Recycling Centers of America, Inc. [filed as Exhibit 3.1 to the Company's Registration Statement on Form S-18 (Registration No. 33-43182C) and incorporated herein by reference].
3.2	Restated Articles of Incorporation as amended June 3, 1993 [filed as Exhibit 19.2 to the Company's Form 10-Q for the quarter ended June 30, 1993 (File No. 0-19621) and incorporated herein by reference].
3.3	Articles of Amendment of Articles of Incorporation of Appliance Recycling Centers of America, Inc. dated February 7, 1997 [filed as Exhibit 3.3 to the Company's Form 10-K for the year ended December 28, 1996 (File No. 0-19621) and incorporated herein by reference].
+3.4	Articles of Amendment of Articles of Incorporation of Appliance Recycling Centers of America, Inc. dated April 24, 1997.
3.5	Bylaws of Appliance Recycling Centers of America, Inc. [filed as Exhibit 3.2 to the Company's Registration Statement on Form S-18 (Registration No. 33-43182C) and incorporated herein by reference].
*10.1	Restated 1989 Stock Option Plan, as amended [filed as Exhibit 10.7 to the Company's Registration Statement on Form S-1 (Registration No. 33-58338) and incorporated herein by reference].
10.2	Amendment dated May 14, 1992, to lease between Six Brainard Associates Limited Partnership and ARCA Connecticut, Inc. [filed as Exhibit 10.11 to the Company's Registration Statement on Form S-1 (Registration No. 33-58338) and incorporated herein by reference].
*10.3	Amended Appliance Recycling Centers of America, Inc. 1989 Stock Option Plan [filed as Exhibit 19.3 to the Company's Form 10-Q for the quarter ended June 30, 1993 (File No. 0-19621) and incorporated herein by reference].
10.4	Agreement dated December 17, 1992, between Appliance Recycling Centers of America, Inc. and TCF Savings Bank [filed with the Company's Form 8-K, dated December 17, 1992 (File No. 0-19621) and incorporated herein by reference].
10.5	Agreement dated January 19, 1994, between Appliance Recycling Centers of America, Inc. and Standard Insurance Corporation [filed as Exhibit 10.29 to the Company's Form 10-K for the year ended December 31, 1993 (File No.0-19621) and incorporated herein by reference].
10.6	Line of credit dated August 30, 1996, between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc. [filed as exhibit 10.15 to the Company's Form 10-Q for the quarter ended September 28, 1996 (File No. 0-19621) and incorporated herein by reference].
10.7	Amended line of credit dated November 8, 1996, between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc. [filed as exhibit 10.16 to the Company's Form 10-Q for the quarter ended September 28, 1996 (File No. 0-19621) and incorporated herein by reference].
+10.8	Agreement dated February 11, 1998, between Appliance Recycling Centers of America, Inc. and Southern California Edison Company.
*10.9	1997 Stock Option Plan and Amendment [filed as exhibits 28.1 and 28.2 to the Company's Registration Statement on Form S-8

(Registration No. 333-28571) and incorporated herein by reference].

- +10.10 Amended line of credit dated February 12, 1998 between Appliance Recycling Centers of America, Inc. and Spectrum Commercial Services, a division of Lyons Financial Services, Inc., Amended Revolving Note and Amended Guarantor Acknowledgments.
- +10.11 Agreement dated February 13, 1998 between Western Bank and Appliance Recycling Centers of America, Inc.
- *10.12 Amendment, effective April 24, 1997, to 1989 Stock Option Plan [filed as exhibit 28.2 to the Company's Registration Statement on Form S-8 (Registration No. 33-68890) and incorporated herein by reference].
- +13.0 Portions of the Annual Report to Shareholders for the fiscal year ended January 3, 1998: Common Stock Data; Selected Financial Data; Management Discussion and Analysis; Financial Statements.
- +21.1 Subsidiaries of Appliance Recycling Centers of America, Inc.
- +23.1 Consent of McGladrey & Pullen, LLP, Independent Public Accountants.
- +27.0 Financial Data Schedule.

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- * Items that are management contracts or compensatory plans or arrangements required to be filed as an exhibit pursuant to Item 14(c) of this Form 10-K.
- + Filed herewith.

ARTICLES OF AMENDMENT OF
ARTICLES OF INCORPORATION OF
APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

The undersigned, as President and Chief Executive Officer of Appliance Recycling Centers of America, Inc., a corporation subject to the provisions of Chapter 302A of the Minnesota Statutes (the "Corporation"), does hereby certify that the following resolutions were adopted by the Corporation's Board of Directors, by the required vote of said Directors, effective as of March 7, 1997, and does hereby further certify that the following resolutions were adopted by the Corporation's Shareholders, by the required vote of said Shareholders on April 24, 1997:

NOW, THEREFORE, BE IT RESOLVED, that the Board of Directors and Shareholders hereby authorize the amendment of the Corporation's Articles of Incorporation increasing the shares of authorized capital stock from five million (5,000,000) shares, without par value, to ten million (10,000,000) shares, without par value.

FURTHER RESOLVED, that, to effect said amendment, Article 3, paragraph A of the Corporation's Articles of Incorporation hereby is amended to read as follows:

"ARTICLE 3. AUTHORIZED SHARES

The total number of shares of stock which the corporation shall have authority to issue is ten million (10,000,000) shares, all of which shares shall be Common Stock without par value."

FURTHER RESOLVED, that the Corporation's officers are hereby authorized and directed to execute such documents and certificates and to take such other actions and incur such other expenses as they may deem necessary to effectuate the above resolution, including, but not limited to, the execution and filing of Articles of Amendment with the Minnesota Secretary of State.

IN WITNESS WHEREOF, Appliance Recycling Centers of America, Inc. has caused these Articles of Amendment to be signed by its President and Chief Executive Officer this 24th day of April, 1997.

/S/ EDWARD R CAMERON

Edward R. Cameron
President and Chief Executive
Officer

State of Minnesota
Department of State
Filed
May 27, 1997

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING
AND HAZARDOUS MATERIALS DISPOSAL AGREEMENT

1. PARTIES

The parties to the Agreement are Appliance Recycling Centers of America, Inc., the entity responsible for the performance of the work as one Party (hereinafter referred to as "Contractor"), and Southern California Edison Company, a California corporation (hereinafter referred to as "Edison") as the other Party.

2. RECITALS

The Agreement is entered into with reference to the following facts, among others:

- 2.1. The Parties have previously entered into agreements with respect to the recycling of older inefficient refrigerators and freezers and the disposal of hazardous materials ("the Refrigerator Recycling Program").
- 2.2. The Parties desire to continue to implement a Refrigerator Recycling Program ("the 1998 Program") for the removal of older, inefficient second refrigerators and freezers ("Refrigerators and Freezers") from Edison Customer residences thereby reducing the load demand on the electrical system under the terms set forth below.
- 2.3. Edison desires to continue and increase its efforts to reduce the load demand on the electrical system through the further removal of older inefficient second Refrigerators and Freezers.
- 2.4. Edison desires to ensure the safe, lawful recovery and recycling or lawful disposal, as necessary, of CFCs, PCBs, and Hazardous Materials.
- 2.5. In furtherance thereof, Edison desires to contract with Contractor for the continued comprehensive management of the 1998 Program.
- 2.6. Contractor desires to contract with Edison for the continued comprehensive management of the 1998 Program, said management to include collection and dismantling of second Refrigerators and Freezers; removal of CFCs, PCBs and other Hazardous Materials from collected Refrigerators and Freezers; handling storage and legal disposal of compressor oil, PCBs and other Hazardous Materials; recycling of metal, sulfur dioxide, and CFCs; providing incentives to participating Edison Customers who relinquish second Refrigerators and Freezers; and performance of a customer survey.

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- 2.7. Contractor represents (i) that it has knowledge of the Metallic Discard Act, effective January 1, 1994, which prohibits the disposal of Refrigerators and Freezers in landfills and requires that Refrigerators and Freezers be shredded for metal recovery following removal of CFCs, PCBs, and other Hazardous Materials contained in discarded Refrigerators and Freezers, (ii) that it has knowledge of the hazards associated with the removal, handling, storage, recycling, and legal disposal of Hazardous Materials, (iii) that it has experience and expertise in such removal, handling, storage, recycling, and legal disposal, (iv) that it uses only qualified personnel, (including subcontractor's and agent's personnel) who have been instructed and certified in the proper safety procedures to be used in such removal, handling, storage, recycling, or legal disposal, and (v) that it has purchased property and has established and will continue to operate and maintain its recycling center on said purchased property in the City of Compton or other area acceptable to Contractor and Edison.

- 2.8 Pursuant to a 1997 decision of the California Public Utilities Commission ("CPUC"), Edison's rights, duties and obligations under this Agreement may be assigned in the future to the California Board for Energy Efficiency ("Board") or, at the Board's discretion, to the Board's administrator. In the event of such assignment, Edison will have no further obligations under this Agreement except as stated in Section 9.3.3.3.
- 2.9 The Parties hereto desire to set forth terms and conditions under which the aforesaid management services shall be performed and which shall constitute the Parties' agreement.

3. AGREEMENT

- 3.1 In consideration of the aforesaid Recitals, the mutual covenants contained herein, the payments and agreement to be made and performed by Edison as set forth in the pricing schedule attached hereto as Exhibit A and incorporated by reference herein, Contractor shall perform the Work and its associated obligations as an independent contractor.
- 3.2 This Agreement shall be incorporated in a Purchase Order as the terms and conditions for performing the work.

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING
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4. DEFINITIONS

- 4.1 Agreement: This document, the terms and conditions contained in this Agreement as amended from time to time.
- 4.2 CFCs: Chlorofluorocarbons
- 4.3 CFC-11: Chlorofluorocarbons contained in refrigerator and freezer insulating foam.
- 4.4 Change Order: Document issued by Edison to Contractor to change a Purchase Order.
- 4.5 Contract Period: January 1, 1998 to September 30, 1998, or as extended by mutual agreement of the Parties.
- 4.6 Documentation: Specifications, procedures, instructions, reports, test results, analyses, calculations, manuals, and other data specified in the Purchase Order, Change Order, this Agreement, and any amendment to this Agreement, as required by any legal entity having jurisdiction over the Work.
- 4.7 Edison's Specified Volume: The number of units to which Edison commits for the Contract Period.
- 4.8 Eligible Customers: Residential customers in Edison service territory who meet the customer eligibility criteria in Section 7.
- 4.9 Eligible Freezers: Freezers that meet the 1998 Program appliance eligibility criteria as set forth in Section 7.
- 4.10 Eligible Refrigerators: Second refrigerators that meet the 1998 Program appliance eligibility criteria as set forth in Section 7.
- 4.11 Freezer: A freezer which provides supplementary cold storage to a primary freezer or to the freezer section located within the primary refrigerator in a residential household.
- 4.12 Hazardous Materials: Any substance or material which has been designated as hazardous or toxic by the U.S. Environmental Protection Agency, the California Department of Toxic Substances Control and/or any other governmental agency now or hereinafter authorized to regulate materials in the environment, including, but not limited to

"Materials which require special handling" as defined in California Public Resources Code Section 42167, which is contained in or is derived from the Refrigerators or Freezers.

- 4.13 1998 Program: Refrigerator Recycling Program defined by this Agreement.
- 4.14 1998 Program Participants: Eligible customers who turn in qualifying Refrigerators or Freezers.
- 4.15 PCB: Polychlorinated Biphenyl
- 4.16 Purchase Order: Document issued by Edison to Contractor and executed by the Parties, which incorporates by reference this Agreement.
- 4.17 Recycling Center: The site at which Contractor will process Refrigerators and Freezers, remove CFCs, PCBs and other Hazardous Materials, and recycle or legally dispose of Hazardous materials.
- 4.18 Recycling Charge: Per-unit price for services performed by Contractor under scope of work, including CFC-11 recovery services, and excluding bond purchasing, incentive and financing services.
- 4.19 Second refrigerator: Surplus refrigerator utilized by customer concurrently with primary refrigerator.
- 4.20 Specified Volume: The number of units to which Edison commits for the Contract Period.
- 4.21 Subcontractor: Either an entity contracting directly with Contractor to furnish services or materials as part of or directly related to, the Work; or an entity contracting with Subcontractor of any tier to furnish services or materials as a part of, or directly related to, the Work.
- 4.22 Work: Any and all obligations of Contractor to be performed pursuant to this Agreement or a Purchase Order incorporating this Agreement, such as Refrigerator and Freezer collection, Refrigerator and Freezer processing, handling, storing, recycling, and legal disposal, of Hazardous Materials and Documentation preparation.

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5. CONTRACT DOCUMENTS

- 5.1 The contract between the Parties shall consist of the following documents: Change Orders, Purchase Order, this Agreement, and any amendments to this Agreement. In the event of conflicting provisions within the contract, the provisions of the contract shall govern in the following order:
 - 5.1.1 Amendments to the Agreement in chronological order from the most recent to the earliest;
 - 5.1.2 Change Orders incorporating and reflecting any Amendments to the Agreement in chronological order from the most recent to the earliest.
 - 5.1.3 This Agreement.
 - 5.1.4 Purchase Order incorporating this Agreement.
- 5.2 Each party shall notify the other immediately upon the determination of any such conflict or inconsistency.

6. SCOPE OF WORK

- 6.1 Contractor shall be responsible for customer services including provision of inbound 800 telephone numbers for Customers, use and all communication services, scheduling of Refrigerator and Freezer collection appointments, verification of customer and appliance eligibility, and documentation of customer data.
- 6.2 Contractor shall (i) collect all Eligible Refrigerators and

Eligible Freezers from Customers' residences within 10 to 15 working days from the date of initial customer contact (unless otherwise requested by the customer, in remote areas of the service territory, or approved by Edison's 1998 Program Manager because of 1998 Program response in excess of the Edison's Specified Volume for which approval shall not be unnecessarily withheld, and collection shall be no later than 25 working days from the date of the initial customer contact, unless otherwise requested by customer), (ii) ensure Refrigerator or Freezer is an operating unit before removal from residence, (iii) disable the unit prior to leaving pick-up location, and (iv) process unit at its Recycling Center.

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- 6.3 Contractor shall be solely responsible for all methods, techniques, sequences, and procedures for the dismantling of Refrigerators and Freezers, processing of metal panels and components, recycling of recovered scrap metal, removal, recycling, or lawful disposal of Hazardous Materials.
- 6.4 Contractor shall be solely responsible for all methods, techniques, sequences, and procedures for the removal and management of all capacitors found in Refrigerators and Freezers, and the removal and disposal of compressor oil, PCBs, and other Hazardous Materials from the time Contractor collects Refrigerators and Freezers pursuant to this Agreement.
- 6.5 Contractor shall document and maintain records for services under this Agreement, or the Purchase order, incorporating this Agreement, as follows:
- 6.5.1 A Customer Comment Tracking System for recording customer inquiries, complaints, and positive feedback.
- 6.5.2 Appliance Turn-in Order Form to collect data such as customer name, address, home and work phone numbers; utility account number, Refrigerator or Freezer manufacturer's name; Refrigerator or Freezer model and style; defrost type; color, size, and estimated age of unit; location of Refrigerator or Freezer within the residence; amperage, final disposition code (which indicates operating condition of Refrigerator or Freezer), identification of units containing CFC-11; special pick-up instructions (if applicable) and signature of customer following customer certification that the unit is a Second Refrigerator or Freezer in continuous use for a minimum of six months and that in the event refrigerator or freezer is discovered not to be an Eligible Refrigerator or Freezer as certified, customer acknowledges liability to Edison for recycling costs.
- 6.5.3 Compilation of data in paragraphs 6.5.1 and 6.5.2 in electronic mode, employing the Microsoft EXCEL software program.
- 6.6 Contractor shall conduct a customer survey, comparable to Exhibit B, attached and incorporated by reference herein, using a stratified purposeful sample of 5 to 20% of the 1998 Program Participants. The stratification and frequency of the survey may be modified periodically by Edison, provided that an Amendment to this Agreement or a separate agreement shall be entered into if any such modification

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING
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necessitates unreasonable labor, as substantiated by Contractor, requiring the negotiation of a charge separate from the Recycling Charge. The purpose of the survey shall be to elicit information such as appliance use, customer demographics and customer satisfaction. Stratification and frequency of survey shall be modified periodically as

determined by Edison provided modified survey is comparable to Exhibit B.

- 6.7 Contractor and Edison shall establish and implement a financial incentive service as follows:
- 6.7.1 The incentive to each 1998 Program Participant will be a savings bond with a face value of Fifty Dollars (\$50.00) or, a check in the amount of Twenty-Five Dollars (\$25.00) or, an item with a retail value of at least Twenty-Five dollars (\$25.00) or, subject to availability, a 38 quart/36.1 liter Igloo(R)cooler ("Cooler") (the "Cooler Promotion"). The savings bond, the check, the retail item, and the Cooler are each referred to individually as the "Incentive". Each 1998 Program Participant has a right to receive one Incentive, at his or her discretion. The Parties may agree in the future to increase the number of Incentives a 1998 Program Participant may receive.
- The Coolers shall be delivered to Contractor at a location to be mutually agreed upon by the Parties. Edison shall require the cooler manufacturer to deliver the Coolers in either individual boxes or shrink-wrapped with two Coolers to a wrap in order to diminish the possibility of damage to the Coolers. Edison shall use its best efforts to have the manufacturer deliver the Coolers in split lots with a minimum of One Thousand (1,000) Coolers each. Contractor shall provide Edison with a minimum of fifteen (15) business days prior written notice in which to deliver each Cooler lot to Contractor.
- 6.7.2. Contractor shall provide Edison with a weekly listing for approval of Customers qualifying for an Incentive. Customers qualifying for an Incentive are 1998 Program Participants who turn in an

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Eligible Refrigerator or Freezer for which Edison will pay a per-unit price as set forth in Section 10.1 of the Agreement.

- 6.7.3 Upon reimbursement by Edison to Contractor of the Incentives under Section 9.4 of this Agreement, Edison shall be under no further obligation with respect to reimbursement of such amounts and such reimbursement shall constitute full payment to Contractor on behalf of the 1998 Program Participants entitled to Incentives. Moreover, upon Edison's payment to Contractor of the amounts described above, Contractor shall be deemed the holder of such property as far as the interests of the 1998 Program Participants entitled thereto are concerned for any and all purposes, including, but not limited to, complying with the unclaimed property laws of California and any and all other applicable states. At no time after such reimbursement to Contractor is Edison to assume any responsibility for other disposition of such amounts and shall not be entitled to the reversion of any amounts so paid.
- 6.8 Contractor shall provide Edison with reports for the services performed under this Agreement as follows:
- 6.8.1 A monthly report, provided no later than the 15th day of the month, listing the number of Refrigerators and Freezers processed through the Recycling Center during the previous month and containing size in cubic feet, year of manufacture, style, and defrost type.
- 6.8.2 A quarterly report, presented within fifteen (15) days of the new quarter, summarizing the monthly report information from the previous quarter and containing environmental data such as an estimated

breakdown of amount of refrigerants recovered; number of pounds of capacitors removed; number and size of CFC-11 units and amount of CFC-11 recovered; amount of sulfur dioxide recovered, amount of compressor oil recycled, and weight of metals and nonrecyclable materials sold for shredding.

- 6.8.3 A quarterly report presented within fifteen (15) days of the new quarter summarizing the monthly Customer Comment Tracking System information in Section 6.5.1.
- 6.8.4 By the 15th day of each month during the term of this Agreement, Contractor shall provide Edison with monthly aging

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reports indicating the number of Refrigerators and Freezers that were collected during the preceding month and that were scheduled for collection from customers during that month, the date of the initial contact with the Customer, the date or dates the appliance was scheduled for collection, and the actual collection date.

- 6.8.5 Final summary reports covering all activity requested in monthly reports plus information from any incomplete month.
- 6.8.6 A final report by October 31 of all amounts paid by Contractor in compliance with any unclaimed property laws pursuant to Section 6.7.3, hereof.
- 6.8.7 Upon reasonable written request from an authorized representative of Edison, special and nonrecurring reports during course of the 1998 Program. Such report content will be developed by the parties in anticipation of requests from the CPUC, Edison internal audits, or compilation of data relevant to Rebuild LA activities. An amendment to this Agreement or a separate agreement shall be entered into only if any such report necessitates unreasonable labor, as substantiated by Contractor, requiring the negotiation of a charge separate from the Recycling Charge.
- 6.8.8 Contractor shall modify its current computer software program so that the Contractor's Appliance Turn-In Order Form ("ATO") has a disposition code which can be coded for each 1998 Program Participant indicating which Incentive was selected by the 1998 Program Participant. In all cases, when Contractor picks up an Eligible Refrigerator or Eligible Freezer from a 1998 Program Participant, Contractor shall obtain the 1998 Program Participant's signature on the Contractor's ATO. On a weekly basis, Contractor shall prepare an invoice for Edison to evidence the Cooler Fees due for Contractor's delivery of Coolers under the Cooler Promotion and the costs, if any, incurred by Contractor pursuant to Section 10.6 of the First Amendment ("Invoice"). The Invoice shall include an ATO report showing the delivery of Coolers during the billing period. All Invoices will be paid pursuant to Section 10.5.3.

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7. CUSTOMER AND REFRIGERATOR ELIGIBILITY

- 7.1 Customer eligibility for the 1998 Program shall depend on the following:
 - 7.1.1 Customer is a resident in the Edison service territory and occupies a single-family residential

(Domestic Rate) or multi-unit dwelling or mobile home.

7.1.2 Customer owns the Eligible Refrigerator or Freezer or possesses written consent from the Refrigerator or Freezer owner to turn in Eligible Refrigerator or Freezer.

7.1.3 Customer turns in no more than two Eligible Refrigerators and two Eligible Freezers per year unless written Edison approval is obtained for any additional Refrigerator or Freezer.

7.2 Commercial customers do not qualify for the 1998 Program.

7.3 Refrigerator and Freezer eligibility for the 1998 Program shall depend on the following:

7.3.1 Refrigerator or Freezer must be capable of cooling or freezing, or both, as applicable, at time of collection.

7.3.2 Refrigerator or Freezer minimum size is 10 cubic feet and maximum size is 25 cubic feet.

7.3.3 Refrigerator or Freezer is certified by the customer to have been in use for a minimum of six months as a Second Refrigerator or Freezer, as the case may be.

7.4 Commercial refrigerators, ammonia-containing gas refrigerators, commercial freezers, and room air conditioners do not qualify for the 1998 Program.

8. OWNERSHIP AND CONFIDENTIALITY

8.1 All information disclosed by Edison during meetings or negotiations with regard to the 1998 Program, and any information contained in drawings, specifications, technical reports, and data provided by Edison to Contractor during performance of this Agreement shall be

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held in confidence by Contractor and used only for the performance of the Work pursuant to this Agreement.

8.2 Contractor, its employees, and any subcontractors shall not disclose any 1998 Program or customer information to any person other than Edison's personnel either during the term of this Agreement or after its completion, without Contractor having obtained the prior written consent of Edison, except as provided by lawful court order or subpoena and provided Contractor gives Edison advance written notice of such order or subpoena. Prior to any approved disclosure, persons receiving said information, including Contractor, its employees, or third parties, must enter into a nondisclosure agreement with Edison. Contractor agrees to require its employees and subcontractors to execute a nondisclosure agreement prior to performing any services under this Agreement.

8.3 All material provided by Edison to Contractor during the performance of this Agreement shall be returned to Edison after this Agreement is terminated or at the request of Edison. Contractor shall not duplicate any material furnished by Edison without prior written approval from Edison.

8.4 All information, material, and documents prepared or caused to be prepared under this Agreement by Contractor shall become the property of Edison. Such information, or derivative information, materials, and documents, shall be used by Contractor only for work done directly for Edison, shall not be used in Contractor's general course of business, and shall neither be disclosed nor revealed in any way to a third party without the prior express written consent of Edison.

8.5 All information disclosed by Contractor to Edison during meetings or negotiations with regard to the 1998 Program,

and any information contained in drawings, specifications, technical reports, and data provided by contractor to Edison during performance of this Agreement, shall be held in confidence by Edison, and used only in relation to the Work pursuant to this Agreement.

- 8.6 Except as required by the CPUC, Edison, its employees and any subcontractors of Edison shall not disclose any confidential or proprietary information of Contractor ("Contractor's Confidential Information") to any person other than Contractor's personnel, either during the term of the Agreement, or after its completion, without having obtained the prior written consent of Contractor. By way of

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example, Contractor's Confidential Information shall include, without limitation, Contractor's systems for oil degassing, CFC recovery, CFC-11 recovery and Contractor's computer software. Prior to any approved disclosure, persons to receive Contractor's Confidential Information, including Edison, its employees or any third-party, must enter into a nondisclosure agreement with Contractor. Edison agrees to require its employees to execute appropriate nondisclosure agreements prior to any contact with, or evaluation of Contractor's Confidential Information.

- 8.7 Edison agrees that, without the prior written consent of Contractor, it will not, during the term or after termination of this Agreement, directly or indirectly, disclose to any individual, corporation, or other entity, or use for its own or such other's benefit, any of Contractor's Confidential Information, whether reduced to written or other tangible form, which:

- 8.7.1 Is not generally known to the public or in the industry;
- 8.7.2 Has been treated by Contractor or any of its subsidiaries as confidential or proprietary; and
- 8.7.3 Is of a competitive advantage to Contractor or any of its subsidiaries and in the confidentiality of which Contractor or any of its subsidiaries has a legally protectable interest.

- 8.8 Contractor's Confidential Information which becomes generally known to the public or in the industry, or, in the confidentiality of which, Contractor and its subsidiaries cease to have a legally protectable interest, shall cease to be subject to the restrictions of this Paragraph 8.

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9. COMMERCIAL TERMS

9.1 Payment

No payment shall be made under this Agreement until Edison has received a signed "Acceptance Copy" of the Purchase Order from Contractor. Edison shall pay to Contractor, as full compensation for completing the Work, the prices set forth in Exhibit A in accordance with the payment provisions set forth in Sections 9.2 through 9.4.

9.2 Summary of Charges

- 9.2.1 Recycling Charge Edison shall pay to Contractor a per-unit Recycling Charge for the greater of the number of units collected, or specified per Section 9.3.2 below, pursuant to this Agreement at the price or prices set forth in Section 9.3 below. The Recycling Charge covers the scope of work described in Section 6, including CFC-11 Recovery and excluding bond or incentive purchasing and financing services.

- 9.2.2 Other Charges. All other costs for services shall be negotiated between the parties and implemented by an amendment to the Agreement.
- 9.2.3 Pursuant to the terms of Section 10.5.3, Edison shall pay Contractor a fee of Two Dollars (\$2.00) ("Cooler Fee") per Cooler for each Cooler distributed to 1998 Program Participants. The Cooler Fee shall compensate Contractor for the storage, handling and delivery of the Coolers, additional labor, and any and all other costs and expenses in connection with the Cooler Promotion, including any additional documentation and reports that may be necessary or required as a result of the Cooler Promotion. Edison shall not be responsible for any other compensation or reimbursement to Contractor as a result of the Cooler Promotion except for the Cooler Fee.
- 9.2.4 Bond or Incentive Cost and Finance Charges. Edison shall pay to Contractor bond and Incentive costs and finance charges as specified in Section 9.4, below.

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9.3 Pricing Recycling Charge

- 9.3.1 The per-unit Recycling Charge to be paid by Edison for the Contract Period shall be as set forth in Exhibit A.
- 9.3.2 Edison's Specified Volume for the Contract Period shall be 25,000 units.
- 9.3.3 If at the end of the Contract Period the Specified Volume has not been achieved, Edison shall pay to Contractor a per-unit Recycling Charge for each unit in the shortfall.
 - 9.3.3.1 The shortfall shall be determined by subtracting from the Specified Volume all units collected from Edison for the Contract Period.
 - 9.3.3.2 If this Agreement should be assigned to the California Board for Energy Efficiency ("Board") prior to September 1, 1998, the shortfall shall be prorated by month and Edison shall pay 50% of the per unit Recycling Charge for each unit in the shortfall.
 - 9.3.3.3 If this Agreement is assigned to the Board prior to September 1, 1998, Edison shall have no further payment obligations to Contractor as of the effective date of the assignment except for any payments due under Section 9.3.3.2.

9.4 Pricing Bond or Incentive Costs and Finance Charges

- 9.4.1 Edison shall reimburse Contractor for the cost of each bond or incentive payment distributed to 1998 Program Participants.
- 9.4.2 Edison shall pay to Contractor monthly interest at the rate of three-quarter of one percent (0.75%) on the average monthly balance of the outstanding bond or incentive costs.

9.5 Miscellaneous

Contractor agrees that any agreement it has, or in which it may enter with other utilities or agencies for a recycling program, shall not detrimentally affect Contractor's services under this Agreement.

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10. BILLING

- 10.1 Contractor shall submit a weekly invoice reflecting the per-unit charge for the refrigerators and freezers collected, processed, and recycled, and for the purchase and approval of U.S. Savings Bonds and incentives. Contractor shall apply a per-unit charge on units that have been disabled and only for the following transactions:
- 10.1.1 Collection of an Eligible Refrigerator or Freezer.
- 10.1.2 Collection contact made for Eligible Refrigerator or Freezer that cannot be removed due to obstruction because of size or structural barrier provided that Contractor obtains written permission from Customer to permanently disable said unit, and Contractor then permanently disables the unit.
- 10.1.3 Collection of an oversized Eligible Refrigerator or Freezer that requires additional trips, personnel, or equipment to execute removal. Additional services for removal of an oversized Eligible Refrigerator or Freezer shall be charged as a single appointment with no extra charge for said additional services.
- 10.1.4 Collection of an Eligible Refrigerator or Freezer that could not be inspected for eligibility confirmation.
- 10.2 Contractor shall submit a final invoice for the Contract Period in hard copy and in electronic format acceptable to Edison.
- 10.3 Contractor shall apply a 25% per unit discount to the Recycling Charge to any additional units when two or more refrigerators or freezers are removed during a single collection appointment from Customer's residence. Said discount shall be clearly documented and identified in Contractor's invoice.
- 10.4 Contractor shall submit a weekly invoice for the purchase price of the bonds and for other incentive payments and a monthly invoice for the interest charge identified in paragraph 9.5.
- 10.5 Edison shall make payment (less any unsubstantiated or incorrect charge):

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- 10.5.1 For bond and check incentive services, within thirty days of receipt of an Invoice by Edison's Accounts Payable Department.
- 10.5.2 Of Recycling Fee, within thirty days of receipt of an Invoice from Contractor approved by Edison..
- 10.5.3 For Cooler Fees within thirty days of receipt of an Invoice from Contractor approved by Edison.
- 10.6 Upon receipt of each shipment of the Coolers, Contractor shall inspect the shipment for any damaged or defective Coolers. Contractor shall return any damaged and/or defective Cooler directly to the manufacturer for a replacement Cooler. Pursuant to Sections 6.8.8 and 10.5.3, Edison shall reimburse Contractor for all costs associated with the return of any such damaged and/or defective Coolers.
- 10.7 On a weekly basis, Contractor shall provide Edison with an unaudited accounting of Coolers remaining in Contractor's inventory of Coolers. At the end of the Cooler Promotion, Contractor shall complete and provide Edison with a reconciliation to account for the Coolers that were defective, damaged, or stolen. Contractor shall reimburse

Edison for any and all Coolers stolen from Contractor after delivery to Contractor.

10.8 If after a Cooler is delivered by Contractor any 1998 Program Participant alleges that a Cooler is damaged or defective, Edison shall replace such defective and/or damaged Cooler. Edison shall be responsible for the replacement of the such damaged and/or defective Cooler, including, but not limited to, the deliver of a new Cooler to the 1998 Program Participant. If the damage to a Cooler is the result of any action by Contractor, Edison shall be relieved of any obligation to pay Contractor a Cooler Fee for the damaged Cooler.

11. RIGHT TO AUDIT

Edison, or its Authorized Representative, shall have the right and free access, at any reasonable time during normal business hours, to examine,

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING AND HAZARDOUS MATERIALS DISPOSAL AGREEMENT

audit, and copy all Contractor's records and books as related to Contractor's obligations under this Agreement, including, but not limited to, verification of costs to Edison, as claimed by Contractor.

12. CHANGES

Changes to this Agreement shall be made by mutual agreement of the Parties through a written amendment to the Agreement, which shall be incorporated into the Purchase order by Change Order.

13. PERMITS, CODES, AND STATUTES

13.1 Contractor shall perform the Work set forth in this Agreement in accordance with all applicable Federal, state, and local laws, rules, and/or ordinances. Prior to performance of any services, Contractor shall, at its own cost, have obtained, and shall have required all Subcontractors to obtain, all licenses and permits required by law, rule, regulation, and ordinance, or any of them, to engage in the activities required in connection with this transaction. Contractor also represents and warrants that, to the best of its knowledge, based upon reasonable and prudent inquiry, any storage site and any disposal facility to which the Hazardous Materials may be moved are in compliance with any and all federal, state and local laws and regulations pertaining thereto and that such storage sites and disposal facilities are suitable and may lawfully receive and/or dispose of the Hazardous materials.

13.2 Contractor shall comply with all applicable local, state, and federal safety and health laws in effect on the date of this Agreement, including, but not limited to, EPA, California EPA, RCRA, the Occupational Safety and Health Act of 1970 (OSHA), and all standards, rules, regulations, and orders issued pursuant to such local, state, and federal safety and health laws. Should any such law, rule, or regulation be enacted or promulgated subsequent to the date of this Agreement, which renders Contractor's performance impractical, Contractor and Edison shall, in good faith, negotiate an amendment to this Agreement reasonably compensating Contractor for its additional costs.

14. WARRANTY

Contractor warrants to Edison that the Work shall be performed in a competent manner, in accordance with this Agreement, and that the acceptance, handling, storage, recycling, and disposal of the Refrigerators

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING AND HAZARDOUS MATERIALS DISPOSAL AGREEMENT

and Freezers and the Hazardous Materials shall be in accordance with (i) the requirements of this Agreement and (ii) the applicable local, state, and federal laws and regulations in effect at the time of the work performed.

15. TITLE

- 15.1 Title to the Hazardous Materials shall pass to Contractor when Contractor collects refrigerators and freezers from customers.
- 15.2 Title of collected Refrigerators and Freezers shall pass to Contractor.

16. INSURANCE

16.1 Without limiting Contractor's liability to Edison, including the requirements of Section 18.0 Indemnity, Contractor shall maintain For the work, and shall require that each Subcontractor of the first tier maintain, at all times during the work and at its own expense, valid and collectible insurance as described below. This insurance shall not be terminated, expire, not be materially altered, except on thirty days prior written notice to Edison. Contractor shall furnish Edison with certificates of insurance on forms acceptable to Edison and shall require each Subcontractor of the first tier to furnish Contractor with certificates of insurance, as evidence that policies do provide the required coverages and limits of insurance listed below. Such certificates shall be furnished to Edison's 1998 Program Manager by Contractor upon receipt of the Purchase Order, and by Subcontractor for the first tier upon receipt of its subcontract, but in any event prior to start of its portion of the Work. Any other insurance carried by Edison, its officers, agents, and employees, which may be applicable, shall be deemed to be excess insurance, and Contractor's insurance shall be deemed primary for all purposes notwithstanding any conflicting provision in Contractor's policies to the contrary.

- (i) Workers' Compensation Insurance with statutory limits, as required by the state in which the Work is performed, and Employer's Liability Insurance with limits of not less than \$5,000,000. Carriers furnishing such insurance shall be required to waive all rights of subrogation against Edison, its officers, agents, employees, and other contractors and subcontractors.
- (ii) Comprehensive Bodily Injury and Property Damage Liability Insurance, including owners, and contractors' protective liability, product/completed operations liability, contractual

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING AND HAZARDOUS MATERIALS DISPOSAL AGREEMENT

liability, and coverage for liability incurred as a result of sudden and accidental discharge, dispersal, release or escape of polluting materials, (excluding automobile) with a combined single limit of not less than \$3,000,000 for each occurrence. Such insurance shall: (a) acknowledge Edison, its officers, agents, and employees, and additional insureds; (b) be primary for all purposes; and (c) contain standard cross-liability provisions.

- (iii) Automobile Bodily Injury and Property Damage Liability Insurance with a combined single limit of not less than \$3,000,000 for each occurrence. Such insurance shall cover liability arising out of the use by Contractor and Subcontractors of owned, non owned and hired automobiles in the performance of the Work. As used herein, the term "automobile" means vehicles licensed or required to be licensed under the Vehicle Code of the state in which the Work is performed. Such insurance shall acknowledge Edison as an additional insured and be primary for all purposes.
- (iv) Environmental Impairment Expense Insurance with a combined single limit of not less than \$5,000,000 for each occurrence and overall limits of \$10,000,000. Such insurance shall provide coverage

for necessary costs or expense of removing, cleaning-up, transporting, nullifying, and rendering ineffective, or any of them, any substance which has caused environmental impairment and such insurance shall contain no exclusions for non-sudden and/or non-accidental discharge, release or escape of polluting materials. Such insurance shall acknowledge Edison as an additional insured and be primary for all purposes.

Contractor shall report immediately to Edison and confirm in writing any injury, loss, or damage incurred by Contractor or Subcontractors in excess of \$500.00, or its receipt of notice of any claim by a third party in excess of \$500.00, or any occurrence that might give rise to such claim.

If Contractor fails to comply with any of the provisions of this Section 16.0, Contractor shall, at its own cost, defend, indemnify, and hold harmless Edison, its officers, agents, employees, assigns, and successors in interest, from and against any and all liability, damages, losses, claims, demands, actions, causes of action, costs, including attorney's fees and expenses, or any of them, resulting from the death or injury to any person or

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damage to any property to the extent that Edison would have been protected had Contractor complied with all of the provisions of this Section.

17. RESERVED.

18. INDEMNITY

18.1 Contractor shall, at its own cost, indemnify, defend, reimburse, and hold harmless Edison, its officers, directors, employees, agents, assigns, and successors in interest, from and against any and all liability, damages, losses, claims, suits, demands, actions, causes of action, costs, expenses, including attorney's fees and expenses, or any of them resulting from the death or injury to any person or damage to or destruction of any property caused by Contractor, Subcontractors, and employees, officers and agents of either Contractor or Subcontractors, or any of them, and arising out of or attributable to the performance or nonperformance of Contractor's obligations under this Agreement and including, without limitation, failure to comply fully with every federal, state, or local law, statute, regulation, rule, ordinance, or government directive which directly or indirectly regulates or affects the handling, storage, recycling, or disposal of the Hazardous Materials to be managed by Contractor hereunder. In all cases of death or injury to employees, officers or agents of either Contractor or Subcontractors, whether or not caused by Contractor, Edison shall be indemnified by Contractor for any and all liability except to the extent such death or injury results -from the negligence of Edison.

18.2 Contractor shall, at its own cost, indemnify, defend, reimburse, and hold harmless Edison, its officers, directors, employees, and agents, assigns, and successors in interest, from and against any and all liability imposed upon, or to be imposed upon Edison, under any law imposing liability for the environmental clean-up of the Hazardous Materials at any location (other than Edison's property) where the Hazardous Materials have been placed, stored or disposed of in the performance or nonperformance of Contractor's obligations under this Agreement, or any other site to which the Hazardous Materials have migrated.

18.3 The indemnities set forth in this Section 18.0 shall not be limited by the insurance requirements set forth in Section 16.0.

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING
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19. TERM AND TERMINATION

- 19.1 This Agreement shall commence on January 1, 1998 and shall continue in effect until September 30, 1998, or until Contractor has picked up all units called in prior to September 30, 1998, whichever is later. This Agreement may be extended as agreed to in writing by the Parties.
- 19.2 Either Party may terminate the Agreement for cause by 60 days advance written notice, and failure to cure, to the other Party. If the default has not been cured within said time period, the non-defaulting party may declare this Agreement terminated, effective the last day of said notice period. Contractor shall be paid for its services rendered to the date of said termination with all required specified volumes prorated to the date of termination.
- 19.3 Edison shall have the right to terminate this Agreement by 30 days advance written notice to Contractor upon CPUC mandate, or upon depletion of the amount of funding authorized by the CPUC for the Contract Period. In the event the Agreement is terminated upon CPUC mandate, Edison shall pay Contractor all amounts owed under the Agreement as of 30 days after Edison's written notice to Contractor of the CPUC's mandate (the "Termination Date"). In such event, Edison shall only be obligated to pay contractor for such Refrigerators and Freezers actually collected by Contractor for recycling as of the Termination Date, and shall not be obligated to pay contractor for units not collected but which would otherwise be required to be paid for as units comprising Edison's Specified Volume.
- 19.4 In the event of termination pursuant to this Section 19, Contractor and Edison shall work cooperatively to facilitate the termination of the 1998 Program.
- 19.5 Each Party shall immediately provide at no cost to the other any testimony, or any communications with the CPUC, or any board, division, committee or member thereof, which could reasonably be anticipated to effect the 1998 Program or which addresses the 1998 Program in any manner.

20. SUBCONTRACTS

- 20.1 Contractor shall contractually require each Subcontractor of the first tier providing service in connection with the Work to be bound by

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING
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general terms and conditions protecting Edison which are equivalent to the terms and conditions of this Agreement.

- 20.2 Contractor shall, at all times, be responsible for the work, and acts and omissions, of Subcontractors and persons directly or indirectly employed by them for services in connection with the Work. The Purchase Order and this Agreement shall not constitute a contractual relationship between any Subcontractor and Edison nor any obligation for payment to any Subcontractor.

21. CALIFORNIA PUBLIC UTILITIES COMMISSION

This Agreement and the Purchase Order incorporating this Agreement shall at all times be subject to such changes or modifications by the CPUC as it may from time to time direct in the exercise of its jurisdiction.

22. NON-WAIVER

None of the provisions of the Agreement shall be considered waived by either Party unless such waiver is specifically stated in writing.

23. ASSIGNMENT

Edison may be required to assign its rights, duties and obligations under this Agreement to the California Board for Energy Efficiency

("Board") or, at the Board's discretion, to the Board's Administrator. Contractor hereby consents to such assignment. Other than Edison's assignment to the Board or the Board's administrator, neither Party shall delegate or assign this Agreement or any part or interest thereof, without the prior written consent of the other Party, and any assignment without such consent shall be void and of no effect.

24. FORCE MAJEURE

Failure of Contractor to perform any of the provisions of this Agreement by reason of any of the following shall not constitute an event of default or breach of this Agreement: strikes, picket lines, boycott efforts, earthquakes, fires, floods, war (whether or not declared), revolution, riots, insurrections, acts of God, acts of government (including, without limitation, any agency or department of the United States of America), acts of the public enemy, scarcity or rationing of gasoline or other fuel or vital products, inability to obtain materials or labor, or other causes which are reasonably beyond the control of the Contractor.

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25. GOVERNING LAW

The contract shall be interpreted, governed, and construed under the laws of the State of California as if executed and to be performed wholly within the State of California.

26. SECTION HEADINGS

Section headings appearing in this Agreement are for convenience only and shall not be construed as interpretations of text.

27. SURVIVAL

Notwithstanding completion or termination of the Work, of this Agreement, any amendment to the Agreement, or of any Purchase Order or Change Order, the Parties shall continue to be bound by the provisions of this Agreement and any Purchase order incorporating this Agreement, Amendment to this Agreement and Change Orders, which by their nature shall survive such completion or termination. Such provisions shall include, but not be limited to, Contractor's indemnity protecting Edison from any liability for environmental clean up as provided in Section 18 of this Agreement.

28. NONRELIANCE

Neither Party has relied upon any representation, warranty, projection, estimate or other communication from the other not specifically so identified in this Agreement.

29. ATTORNEYS' FEES

In the event of any legal action or other proceeding between the parties arising out of this Agreement or the transactions contemplated herein, the prevailing party in such legal action or proceeding shall be entitled to have and recover from the other party all costs and expenses incurred therein, including reasonable attorneys' fees.

SOUTHERN CALIFORNIA EDISON COMPANY'S 1998 REFRIGERATOR RECYCLING
AND HAZARDOUS MATERIALS DISPOSAL AGREEMENT

30. COOPERATION

Each of the parties agrees to cooperate with the other in whatever manner reasonably required to facilitate such parties' successful completion of the Agreement.

31. ENTIRE AGREEMENT

This Agreement contains the entire agreement and understanding between the Parties and merges and supersedes all prior representations and discussions pertaining to the Agreement, including Contractor's proposal. Any changes, exceptions, or different terms and conditions proposed by Contractor, or contained in Contractor's acknowledgment of the Agreement, or Change Order, are hereby rejected unless expressly stated in the Agreement or incorporated by a Change Order.

CONTRACTOR:

APPLIANCE RECYCLING CENTERS
OF AMERICA. INC.

SOUTHERN CALIFORNIA
EDISON COMPANY

BY: _____
Its: _____

By: _____
Its: _____

Dated as of: _____

Dated as of: _____

SECOND AMENDMENT
TO
GENERAL CREDIT AND SECURITY AGREEMENT AND WAIVER

THIS AGREEMENT, dated as of March 31, 1998, between SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota Corporation, having its mailing address and principal place of business at 7900 International Drive, Suite 890, Bloomington, Minnesota 55425 (herein called "Lender" or "SCS"), and Appliance Recycling Centers of America, Inc., a Minnesota corporation, having the mailing address and principal place of business at 7400 Excelsior Boulevard, Minneapolis, MN 55426, (herein called "Borrower"), amends that certain General Credit and Security Agreement dated August 30, 1996, ("Credit Agreement") as amended. Where the provisions of this Agreement conflict with the Credit Agreement, the intent of this Agreement shall control.

1. The definition of "Maximum Principal Amount" under paragraph 2 of the Credit Agreement is hereby deleted and replaced with the following:

"Maximum Principal Amount" shall mean, at any date, Two Million Seven Hundred Fifty Thousand and No/100ths Dollars (\$2,750,000).

2. The definition of "Borrowing Base" appearing in Paragraph 2 are respectively amended in their entirety to read as follows:

"Borrowing Base" shall mean the sum of (i) Eighty percent (80%) of the net amount of Eligible Receivables or such greater or lesser percentage as Lender, in its sole discretion, shall deem appropriate, plus (ii) the lesser of (x) One Hundred Fifty Thousand and No/100ths Dollars (\$150,000.00) or (y) Twenty Five percent (25%) of the net amount of Eligible Inventory (excluding Eligible Whirlpool Inventory), or such greater or lesser dollars and/or percentage as Lender, in its sole discretion, shall deem appropriate, plus (iii) the lesser of (x) Seven Hundred Fifty Thousand and No/100ths Dollars (\$750,000.00) or (y) Seventy Five percent (75%) of the net amount of Eligible Whirlpool Inventory, or such greater or lesser dollars and/or percentage as Lender, in its sole discretion, shall deem appropriate, plus (iv) One Hundred Sixty Four Thousand and No/100ths Dollars (\$164,000.00) for liquidation value of equipment or such greater or lesser dollars as Lender, in its sole discretion, shall deem appropriate, plus (v) Six Hundred Fifty Thousand and No/100ths (\$650,000.00) for the value of the Mortgaged Premises or such greater or lesser dollars as Lender, In its sole discretion, shall deem appropriate.

3. The following definition is added to paragraph 2:

"Eligible Whirlpool Inventory" shall mean that portion of Eligible Inventory which consists of so called Scratch and Dent, Ding and Dent, and Obsolete inventory, all of which are purchased by Borrower directly from Whirlpool Corporation.

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

LENDER: SPECTRUM COMMERCIAL SERVICES

By _____
Its _____

BORROWER: APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

By _____
Its _____

\$2,750,000.00

March 31, 1998
Bloomington, Minnesota

FOR VALUE RECEIVED, the undersigned, APPLIANCE RECYCLING CENTERS OF AMERICA, INC. promises to pay to the order of SPECTRUM COMMERCIAL SERVICES, a division of Lyon Financial Services, Inc., a Minnesota corporation, (the "Lender") at its office in Bloomington, Minnesota, or at such other place as any present or future holder of this Note may designate from time to time, the principal sum of (i) Two Million Seven Hundred Fifty and 00/100 Dollars (\$2,750,000.00), or (ii) the aggregate unpaid principal amount of all advances and/or extensions of credit made by the Lender to the undersigned pursuant to this Note as shown in the records of any present or future holder of this Note, whichever is less, plus interest thereon from the date of each advance in whole or in part included in such amount until this Note is fully paid. Interest shall be computed on the basis of the actual number of days elapsed and a 360-day year, at an annual rate equal to 5.0% per annum in excess of the Prime Rate of Norwest Bank Minnesota, NA, and that shall change when and as said Prime Rate shall change; provided, however, that (i) in no event shall the interest rate in effect hereunder at any time be less than 10% per annum; and (ii) interest payable hereunder with respect to each calendar month shall not be less than \$10,000 regardless of the amount of loans, advances or other credit extensions that actually may have been outstanding during the month.. Interest is due and payable on the first day of each month and at maturity. The term "Prime Rate" means the rate established by Norwest Bank in its sole discretion from time to time as its Prime or Base Rate, and the undersigned acknowledges that Norwest Bank and/or Lender may lend to its customers at rates that are at, above or below the Prime Rate. Notwithstanding the foregoing, after an Event of Default, this Note shall bear interest until fully paid at 5% per annum in excess of the rate otherwise then in effect, which rate shall continue to vary based on further changes in the Prime Rate; provided, however, that after an Event of Default, (i) in no event shall the interest rate in effect hereunder at any time be less than 15% per annum; and (ii) interest payable hereunder with respect to each calendar month shall not be less than \$10,000 regardless of the amount of loans, advances or other credit extensions that actually may have been outstanding during the month. The undersigned also shall pay the holder of this Note a late fee equal to 10% of any payment under this Note that is more than 10 days past due.

All interest, principal, and any other amounts owing hereunder are due on August 30, 1999 or earlier UPON DEMAND by Lender or any holder hereof, and Lender specifically reserves the absolute right to demand payment of all such amounts at any time, with or without advance notice, for any reason or no reason whatsoever. Lender's right to make such demand is not exclusive and Lender may coincidentally or separately from such demand make further demand for payment pursuant to the terms hereof (including but not limited to upon the occurrence of an Event of Default), and further, amounts may become due hereunder without a demand by Lender.

All or any part of the unpaid balance of this Note may be prepaid at any time, provided however, that if this Note is completely repaid after August 30, 1997 and on or before August 30, 1998, then there shall be a prepayment charge equal to \$40,000.00; provided further, however, that if this Note is completely repaid after August 30, 1998 and on or before August 30, 1999, then there shall be a prepayment charge equal to \$35,000.00; provided further, however, that if Borrower completely repays this Note prior to August 30, 1999 and repays all amounts owing hereunder completely from funds borrowed from Western State Bank (and not from any other source of funds), then no prepayment charge shall be due. At the option of the then holder of this Note, any payment under this Note may be applied first to the payment of other charges, fees and expenses under this Note and any other agreement or writing in

connection with this Note, second to the payment of interest accrued through the date of payment, and third to the payment of principal. Amounts may be advanced and readvanced under this Note at the Lender's sole and absolute discretion, provided the principal balance outstanding shall not exceed the amount first above written. Neither the Lender nor any other person has any obligation to make any advance or readvance under this Note.

The occurrence of any of the following events shall constitute an Event of Default under this Note: (i) any default in the payment of this Note; or (ii) any other default under the terms of any now existing or hereafter arising debt, obligation or liability of any maker, endorser, guarantor or surety of this Note or any other person providing security for this Note or for any guaranty of this Note, including, but not limited to, that certain General Credit and Security Agreement dated August 30, 1996 as amended by the First Amendment dated November 8, 1996, and as amended by the Second Amendment thereto dated even date, the Combination Mortgage, Security Agreement and Fixture Financing Statement dated November 5, 1996, or the Assignment of Leases and Rents dated November 8, 1996; or (iii) the insolvency (other than the insolvency of the undersigned), death dissolution, liquidation, merger or consolidation of any such maker, endorser, guarantor, surety or other person; or (iv) any appointment of a receiver, trustee or similar officer of any property of any such maker, endorser, guarantor, surety or other person; or (v) any assignment for the benefit of

creditors of any such maker, endorser, guarantor, surety or other person; or (vi) any commencement of any proceeding under any bankruptcy, insolvency, dissolution, liquidation or similar law by or against any such maker, endorser, guarantor, surety or other person, provided however, that if such a proceeding is commenced against the maker hereof or any Guarantor on an involuntary basis, then only if such action is not dismissed within 60 days of first being filed; or (vii) the sale, lease or other disposition (whether in one transaction or in a series of transactions) to one or more persons of all or a substantial part of the assets of any such maker, endorser, guarantor, surety or other person; or (viii) any such maker, endorser, guarantor, surety or other person takes any action to revoke or terminate any agreement, liability or security in favor of the Lender; or (ix) the entry of any judgment or other order for the payment of money in the amount of \$10,000.00 or more against any such maker, endorser, guarantor, surety or other person which judgment or order is not discharged or stayed in a manner acceptable to the then holder of this Note within 10 days after such entry; or (x) the issuance or levy of any writ, warrant, attachment, garnishment, execution or other process against any property of any such maker, endorser, guarantor, surety or other person; or (xi) the attachment of any tax lien to any property of any such maker, endorser, guarantor, surety or other person which is other than for taxes or assessments not yet due and payable; or (xii) any statement, representation or warranty made by any such maker, endorser, guarantor, surety or other person (or any representative of any such maker, endorser, guarantor, surety or other person) to any present or future holder of this Note at any time shall be false, incorrect or misleading in any material respect when made; or (xiii) there is a material adverse change in the condition (financial or otherwise), business or property of any such maker, endorser, guarantor, surety or other person. Upon the occurrence of an Event of Default and at any time thereafter while an Event of Default is continuing, the then holder of this Note may, at its option, declare this Note to be immediately due and payable and thereupon this Note shall become due and payable for the entire unpaid principal balance of this Note plus accrued interest and other charges on this Note without any presentment, demand, protest or other notice of any kind.

The undersigned: (i) waives demand, presentment, protest, notice of protest, notice of dishonor and notice of nonpayment of this Note; (ii) agrees to promptly provide all present and future holders of this Note from time to time with financial statements of the undersigned and such other information respecting the financial condition, business and property of the undersigned as any such holder of this Note may reasonably request, in form and substance acceptable to such holder of this Note; (iii) agrees that when or at any time after this Note becomes due the then holder of this note may offset or charge

the full amount owing on this note against any account then maintained by the undersigned with such holder of this Note without notice; (iv) agrees to pay on demand all fees, costs and expenses of all present and future holders of this Note in connection with this Note and any security and guaranties for this Note, including but not limited to audit fees and expenses and reasonable attorneys' fees and legal expenses, plus interest on such amounts at the rate set forth in this Note; and (v) consents to the personal jurisdiction of the state and federal courts located in the State of Minnesota in connection with any controversy related in any way to this Note or any security of guaranty for this Note, waives any argument that venue in such forums is not convenient, and agrees that any litigation initiated by the undersigned against the Lender or any other present or future holder of this Note relating in any way to this Note or any security or guaranty for this Note shall be venued (at the sole option of Lender or the holder hereof) in either the District Court of Dakota or Hennepin County, Minnesota, or the United States District Court, District of Minnesota. Interest on any amount under this Note shall continue to accrue, at the option of any present or future holder of this Note, until such holder receives final payment of such amount in collected funds in form and substance acceptable to such holder. The maker agrees that, if it brings any action or proceeding arising out of or relating to this Agreement, it shall bring such action or proceeding in the District Court of Hennepin County, Minnesota.

No waiver of any right or remedy under this Note shall be valid unless in writing executed by the holder of this Note, and any such waiver shall be effective only in the specific instance and for the specific purpose given. All rights and remedies of all present and future holders of this Note shall be cumulative and may be exercised singly, concurrently or successively. The undersigned, if more than one, shall be jointly and severally liable under this Note, and the term "undersigned," wherever used in this Note, shall mean the undersigned or any one or more of them. This Note shall bind the undersigned and the successors and assigns of the undersigned. This Note shall be governed by and construed in accordance with the laws of the State of Minnesota.

This Note amends and restates, but does not repay, that certain Amended Revolving Note dated as of November 8, 1996 made by the undersigned payable to the order of Lender in the original principal amount of \$2,000,000.00.

THE UNDERSIGNED REPRESENTS, CERTIFIES, WARRANTS AND AGREES THAT THE UNDERSIGNED HAS READ ALL OF THIS NOTE AND UNDERSTANDS ALL OF THE PROVISIONS OF THIS NOTE. THE UNDERSIGNED ALSO AGREES THAT COMPLIANCE BY ANY PRESENT OR FUTURE HOLDER OF

THIS NOTE WITH THE EXPRESS PROVISIONS OF THIS NOTE SHALL CONSTITUTE GOOD FAITH AND SHALL BE CONSIDERED REASONABLE FOR ALL PURPOSES.

APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

By

Edward R. Cameron
President

GUARANTOR ACKNOWLEDGMENT AND AMENDMENT

The undersigned, Edward R. Cameron (the "Guarantor") has entered into a certain Guaranty, dated as of August 30, 1996 (the "Guaranty;" capitalized terms not otherwise defined herein being used herein as therein defined), pursuant to which the Guarantor has guaranteed the payment and performance of certain Indebtedness of Appliance Recycling Centers of America, Inc., a Minnesota corporation ("Borrower") to SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota corporation, ("SCS"), which Indebtedness includes, without limitation, all obligations of Borrower under that certain letter agreement dated as of August 30, 1996 between the Borrower and SCS as amended by a First Amendment dated November 8, 1996, (as so amended the "Original Loan Agreement").

The Guarantor hereby acknowledges that it has received a copy of: (a) the Second Amendment to General Credit and Security Agreement and Waiver dated as of the date hereof (the "Loan Agreement") between the Borrower and SCS amending and restating the Original Loan Agreement;

The Guarantor hereby:

(a) agrees and acknowledges that:

(i) the Guaranty is generally amended so that the guaranty shall be increased to a maximum of \$350,000 plus all of Lender's fees, costs, expenses and attorneys' fees incurred in enforcing the Guarantee; and

(b) confirms that:

(i) by the Guaranty as so amended, the Guarantor continues to guarantee the payment and performance of the Indebtedness owed to SCS, including, without limitation, all obligations of Borrower under the Original Loan Agreement as amended and restated by the Loan Agreement; and

(ii) the Guaranty as so amended remains in full force and effect, enforceable against the Guarantor in accordance with its terms.

Edward R. Cameron
Guarantor

Accepted and Agreed to this 12th day of February, 1998

SPECTRUM COMMERCIAL SERVICES

By:

Its:

GUARANTOR ACKNOWLEDGMENT AND AMENDMENT

Each of the undersigned, collectively (the "Guarantors") has entered into a certain Guaranty, dated as of August 30, 1996 (the "Guaranty;" capitalized terms not otherwise defined herein being used herein as therein defined), pursuant to which the Guarantor has guaranteed the payment and performance of certain Indebtedness of Appliance Recycling Centers of America, Inc., a Minnesota corporation ("Borrower") to SPECTRUM Commercial Services, a division of Lyon Financial Services, Inc., a Minnesota corporation, ("SCS"), which Indebtedness includes, without limitation, all obligations of Borrower under that certain letter agreement dated as of August 30, 1996 between the Borrower and SCS as amended by a First Amendment dated November 8, 1996, (as so

amended the "Original Loan Agreement").

Each of the Guarantors hereby acknowledges that it has received a copy of: (a) the Second Amendment to General Credit and Security Agreement and Waiver dated as of the date hereof (the "Loan Agreement") between the Borrower and SCS amending and restating the Original Loan Agreement;

Each of the Guarantors hereby agrees and acknowledges that the amendment shall in no way impair or limit the right of SCS under Guarantor's Guaranty or any other Loan Document to which such Guarantor is a party and confirms that:

(a) by the Guaranty as so amended, the Guarantor continues to guarantee the payment and performance of the Indebtedness owed to SCS, including, without limitation, all obligations of Borrower under the Original Loan Agreement as amended and restated by the Loan Agreement; and

(b) with respect to each corporate Guarantor, by such Guarantor's Subsidiary Security Agreement, such Guarantor continues to grant a security interest in the "Collateral" described in such Guarantor's Subsidiary Security Agreement to secured the payment and performance of the "obligations" described therein; and

(c) the Guaranty as so amended remains in full force and effect, enforceable against the Guarantor in accordance with its terms.

ARCA of St. Louis, Inc.

ARCA-Maryland, Inc.

By: _____

By: _____

Its: _____

Its: _____

Appliance Recycling Centers of America, California, Inc.

By: _____

Its: _____

Accepted and Agreed to this 12th day of February, 1998

SPECTRUM COMMERCIAL SERVICES

By: _____

Its: _____

TOTAL INDEBTEDNESS SECURED BY THIS MORTGAGE IS \$249,950.00

COMBINATION MORTGAGE AND SECURITY AGREEMENT

This Combination Mortgage and Security Agreement made as of the 13th day of February 1998 (the "Mortgage") by Appliance Recycling Centers of America, Inc., a Minnesota corporation, as mortgagor ("Mortgagor") and Western Bank, 663 University Ave., St. Paul, a Minnesota banking corporation, as mortgagee (the "Mortgagee").

WHEREAS:

a. The Mortgagor holds record fee title to certain land (the "Land") fully described on Exhibit I attached hereto located in the City of St. Paul, County of Ramsey, State of Minnesota;

b. The land is improved with a Commercial building and related facilities (the "Building");

c. On the date hereof Mortgagee has advanced (or is committed to advance) to Mortgagor the sum of \$249,950.00

d. Pursuant to Mortgagor's Note of even date here-with payable to the order of Mortgagee (the "Note") in the principal amount of \$249,950.00, Mortgagor has agreed to repay to Mortgagee the total amount advanced by Mortgagee together with interest thereon at the rate(s) stated in the Note, on or before February 13, 2008 ; and

e. To secure payment of the Note, Mortgagor has executed and delivered to Mortgagee this Mortgage.

NOW, THEREFORE, in consideration of One Dollar (\$1.00) and other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged; and to secure (a) the due and punctual payment of principal of and interest on the Note, and all renewals, extensions and modifications thereof and any agreements or obligations issued in substitution thereof (provided the principal amount of such shall not exceed the original principal amount of the Note); and (b) the performance of all the covenants and agreements of Mortgagor herein and in any other agreement now or hereafter entered into between the Mortgagor and Mortgagee in connection with the Note (the payment and other obligations evidenced by the Note, this Mortgage and all such other agreements are hereinafter collectively referred to as the "Indebtedness"), the Mortgagor does hereby mortgage, grant, bargain, sell, assign, transfer and convey unto the Mortgagee forever, with power of sale, the following:

I.

All of Mortgagor's right, title and interest in and to the Land and the Building, structures, other improvements, fixtures and personal property now standing or at any time hereafter constructed or placed upon the Land (the "Improvements"), including but not limited to (i) all building materials, supplies and equipment now or hereafter located on the Land and suitable or intended to be incorporated in any Improvements located or to be erected on the Land, (ii) all heating, plumbing and lighting apparatus, motors, engines and machinery, electrical equipment, incinerator apparatus, air-conditioning equipment, water and gas apparatus, pipes, faucets, and all other fixtures of every description which are now or may hereafter be placed or used upon the Land or in any of the Improvements now or hereafter located thereon, (iii) all additions, accessions, increases, parts, fittings, accessories, replacements, substitutions, betterments, repairs and proceeds to and of any and all of the foregoing, (iv) all hereditaments, easements, appurtenances, estates, and other rights and interests now or hereafter belonging to or in any way pertaining to the Land or to any of the Improvements now or hereafter located thereon, and (v) all tangible personal owned by the Mortgagor and now or at any time hereafter located on or relating to the Land.

II.

All rents, issues, profits, condemnation awards, revenues and income arising from the ownership, operation or sales of the Land and the Improvements and all proceeds and products thereof (herein collectively called "Revenues and Income").

To Have and To Hold the Land and the Improvements (together the "Mortgaged Property"), and the Revenues and Income unto the Mortgagee forever; provided, nevertheless, that this Mortgage is upon the express condition that if the Mortgagor shall cause to be paid to the Mortgagee as and when due and payable the Indebtedness, and shall also keep and perform each and every covenant and agreement of Mortgagor herein contained, then, this Mortgage and the estate hereby granted shall cease

and be and become void and shall be released of record at the expense of the Mortgagor; otherwise this Mortgage shall be and remain in full force and effect.

The Mortgagor represents, warrants and covenants to and with the Mortgagee that Mortgagor is lawfully seized of the Land in fee simple and has good right and full power and authority to execute this Mortgage and to mortgage and Mortgaged Property; that the Mortgagor owns the Mortgaged Property free from all liens, security interests and encumbrances except as listed in Exhibit 2 attached hereto; that the Mortgagor will warrant and defend the title to the Mortgaged Property and the lien and priority of this Mortgage against all claims and demands of all persons whomsoever, whether now existing or hereafter arising, not listed in Exhibit 2 to this Mortgage. The covenants and warranties of this paragraph shall survive foreclosure of this Mortgage and shall run with the Land.

The Mortgagor further covenants and agrees as follows:

1. Payment of the Indebtedness and Compliance with Other Agreements.

(a) Mortgagor will cause the principal of and interest on the Indebtedness to be duly and punctually paid in accordance with the terms of the Note and this Mortgage when and as due and payable. The provisions of the Note are hereby incorporated by reference into this Mortgage as fully as if set forth at length herein.

(b) Mortgagor will duly and punctually perform each and every obligation under any other agreement now or hereafter entered into by the Mortgagor and Mortgagee in connection with the Note.

2. Application of Payments. All payments received by Mortgagee with respect to the Note of this Mortgage shall be applied by Mortgagee in the following order of priority: (i) interest payable on advances made pursuant to paragraph 11 hereof; (ii) principal of advances made pursuant to paragraph 11 hereof; (iii) interest payable on the Indebtedness; (iv) principal of the Indebtedness; and (v) any other sums secured by this Mortgage, in such order of application as Mortgagee may determine.

3. Payment of Taxes, Assessments and Other Charges; Escrow. Subject to paragraph 7 relating to contest, the Mortgagor shall pay before a penalty might attach for nonpayment thereof, all taxes and assessments and all other charges whatsoever levied upon or assessed or placed against the Mortgaged Property, except that assessments may be paid in installments so long as no fine or penalty is added to any installment for the nonpayment thereof. Mortgagor shall likewise pay all taxes, assessments and other charges, levied upon or assessed, placed or made against, or measured by, this Mortgage, or the recordation hereof, or the Indebtedness secured hereby, provided that the Mortgagor shall not be obliged to pay such tax, assessment or charge if such payment would be contrary to law or would result in the payment of an unlawful rate of interest on the indebtedness secured hereby; and provided further that

nothing herein contained shall be construed as requiring Mortgagor to pay any net income, profits or revenue taxes of the Mortgagee. Mortgagor shall promptly furnish to the Mortgagee all notices received by the Mortgagor of amounts due under this paragraph and shall furnish receipts evidencing such payments within 10 days after such payments are made.

At the request of Mortgagee, Mortgagor shall deposit with the Mortgagee on the first day of each and every month hereafter, an amount equal to one-twelfth (1/12th) of the estimated annual taxes, assessments, and insurance premiums ("Charges") due on the Mortgaged Property. From time to time out of such deposits Mortgagee will, upon the presentation to the Mortgagee by the Mortgagor of the bills thereof, pay the Charges or will upon presentation of receipted bills thereof, reimburse the Mortgagor for such payments made by the Mortgagor. In the event the deposits on hand shall not be sufficient to pay all of the estimated Charges when the same shall become due from time to time, or the prior payments shall be less than the currently estimated monthly amounts, then the Mortgagor shall pay to the Mortgagee on demand any amount necessary make up the deficiency. The excess of any such deposits shall be credited to subsequent payments to be made for such items. If a default or an Event of Default shall occur under the terms of this Mortgage or the Note the Mortgagee may, at its option, without being required so to do, apply any deposits on hand to the Indebtedness. in such order and manner as the Mortgagee may elect. When the Indebtedness has been fully paid any remaining deposits shall be returned to

the Mortgagor as its interest may appear. All deposits are hereby pledged as additional security for the Indebtedness, shall be held for the purposes for which made as herein provided, may be commingled with other funds of the Mortgagee, and shall be held without any allowance of interest thereon.

4. Payment of Utility Charges. Subject to paragraph 7 relating to contest, the Mortgagor shall pay all charges made by utility companies, whether public or private, for electricity, gas, heat, water, or sewer, furnished or used in connection with the Mortgaged Property or any part thereof, and will, upon written request of Mortgagee, furnish proper receipts evidencing such payment.

5. Liens. Subject to paragraph 7 hereof relating to contests, the Mortgagor shall not create, incur or suffer to exist any lien, encumbrance or charge on the Mortgaged Property or Revenues and Income or any part thereof, other than the lien of current real estate taxes and installments of special assessments with respect to which no penalty is yet payable. Mortgagor shall pay, when due, the claims of all persons supplying labor or materials to or in connection with the Mortgaged Property.

6. Compliance with Laws. Subject to paragraph 7 relating to contests, Mortgagor shall comply with all present and future statutes, laws, rules, order, regulations and ordinances affecting the Mortgaged Property, any part thereof or the use thereof. The Mortgagor represents and warrants that no hazardous or toxic substances are buried or otherwise located on the Land.

7. Permitted Contests. The Mortgagor shall not be required to (i) pay any tax, assessment or other charge referred to in paragraph 3 hereof, (ii) pay any charge referred to in paragraph 4 hereof, (iii) discharge or remove any lien encumbrance or charge referred to in paragraph 5 hereof, or (iv) comply with any statute, law, rule, regulation or ordinance referred to in paragraph 6 hereof, so long as Mortgagor shall (a) contest, in good faith, the existence, amount or the validity thereof, the amount of damages caused thereby or the extent of Mortgagor's liability therefor, by appropriate proceedings which shall operate during the pendency thereof to prevent (A) the collection of, or other realization upon the tax, assessment, charge or lien, encumbrance or charge so contested, (B) the sale, forfeiture or loss of the Mortgaged Property or any part thereof, and (C) any interference with the use or occupancy of the Mortgaged Property or any part thereof, and (b) shall give such security to the Mortgagee as may be reasonably demanded by the Mortgagee to insure compliance with the foregoing provisions of this paragraph 7. Mortgagor shall give prompt written notice to Mortgagee of the commencement of any contest referred to in this paragraph 7.

8. Insurance.

(a) Risks to be Insured. Mortgagor, at Mortgagor's sole cost and expense, will maintain insurance of the following character:

(i) "All-Risk" Insurance on the Building and other Improvements now existing or hereafter erected on the Land against loss by fire, lightning, extended coverage perils, collapse, water damage, vandalism, malicious mischief and all other risks and contingencies, subject only to such exceptions as the Mortgagee may approve, in an amount equal to the actual replacement cost thereof (exclusive of foundations and excavations) or the outstanding balance of the Indebtedness, whichever is greater, without deduction for physical depreciation, with coverage for demolition and increased costs of construction, and providing coverage in an "agreed amount" or without provisions for co-insurance. While any Building or other Improvement is in the course of being constructed or rebuilt on the Land, the Mortgagor shall provide the aforesaid hazard insurance in builder's risk completed value form, including coverage available on the so-called 'all risk' non-reporting form of policy.

(ii) Business interruption or loss of rents insurance in an amount not less than the total amount of principal, interest, taxes and insurance premiums payable hereunder for a period of six (6) months.

(iii) If the Land or any part thereof is located in a designated official flood-hazard area, flood insurance insuring the Building and

Improvements now existing or hereafter erected on the Land in an amount equal to the actual replacement cost thereof or to the maximum limit of coverage made

available with respect to such Building and Improvements under the Flood Insurance Act of 1968, as amended, whichever is less.

(iv) Public liability, including personal injury and property damage, insurance applicable to the Mortgaged Property in such amounts as are usually carried by persons operating similar properties in the same general locality but in any event with limits of liability not less than \$1,000,000 combined single limit.

(v) Appropriate worker's compensation insurance with respect to any work on or about the Mortgaged Property.

(b) Policy Provisions. All insurance policies and renewals thereof maintained by Mortgagor pursuant to subparagraph (a) above shall be written by insurance carriers satisfactory to the Mortgagee, contain, except in the case of liability insurance and worker's compensation insurance, a standard mortgagee clause in favor of and in form acceptable to Mortgagee, contain an agreement of the insurer that it will not cancel or materially modify the policy except after 30 days prior written notice to the Mortgagee, include effective waivers by the insurer of all claims for insurance premiums against the Mortgagee, provide, except in the case of liability insurance and worker's compensation insurance, that all sums paid for losses of \$10,000 or more shall be paid solely to the Mortgagee, provide that any losses shall be payable notwithstanding

(1) any act or negligence of the Mortgagor or Mortgagee, (2) any foreclosure or other proceedings or notice of sale relating to the Mortgaged Property, or (3) any change in the title to or ownership of the Mortgaged Property, and be reasonably satisfactory to Mortgagee in all other respects.

(c) Delivery of Policy. Mortgagor will deliver to Mortgagee certificates of insurance or copies of policies satisfactory to Mortgagee evidencing the insurance which is required under subparagraph (a), and Mortgagor shall promptly furnish to Mortgagee all renewal notices and all receipts of paid premiums received by it. At least 30 days prior to the expiration date of a required policy, Mortgagor shall deliver to Mortgagee a renewal policy or certificate of insurance in form satisfactory to Mortgagee.

(d) Assignment of Policy. If the Mortgaged Property is sold at a foreclosure sale or if Mortgagee shall acquire title to the Mortgaged Property, the Mortgagee shall have all of the right, title and interest of Mortgagor in and to any insurance policies required under paragraph 8(a) hereof and the unearned premiums thereon

and in and to the proceeds resulting from any damage to the Mortgaged Property prior to such sale or acquisition.

(e) Notice of Damage or Destruction; Adjusting Loss. If the Mortgaged Property or any part thereof shall be damaged or destroyed by fire or other casualty, Mortgagor will promptly give written notice thereof to the insurance carrier and Mortgagee, and the Mortgagee shall have the right to join the Mortgagor in adjusting any damage or loss which is estimated by Mortgagee in good faith to exceed \$10,000; but if there has been no adjustment of any such damage or loss within 30 days from the date of occurrence thereof and if an Event of Default shall exist at the end of such 30 day period or at any time thereafter, Mortgagee may alone make proof of loss, adjust and compromise any claim under the policies and appear in and prosecute any action arising from such policies. In connection therewith, Mortgagor does hereby irrevocably authorize, empower and appoint Mortgagee as attorney-in-fact for Mortgagor (which appointment is coupled with an interest) to do any and all of the foregoing in the name and on behalf of Mortgagor.

(f) Restoration of Damaged or Destroyed Property. In case of any damage to or destruction of the Mortgaged Property or any part thereof, the Mortgagor, whether or not the insurance proceeds, if any, on account of such damage or destruction shall be sufficient for the purpose, at its expense, shall promptly commence and complete the restoration, repair, replacement or rebuilding of the Mortgaged Property that is damaged or destroyed (the "Restoration") as nearly as possible to its value, condition and character, immediately prior to such damage or destruction, with such alterations and additions as may be made at the Mortgagor's election.

(g) Application of Insurance Proceeds.

(i) All sums paid for losses of \$10,000 or more under any hazard insurance policy and/or flood insurance policy required in paragraph 8(a) shall be paid to Mortgagee. All such sums

recovered by the Mortgagee, less the reasonable cost, if any, to the Mortgagee of such recovery (including attorneys' fees) may, at the sole discretion of the Mortgagee, be applied to the Restoration or to the reduction of the Indebtedness in such order of application as the Mortgagee may determine.

(ii) Mortgagor shall promptly reimburse Mortgagee upon demand for all of Mortgagee's expenses incurred in connection with the collection of the insurance proceeds and all such expenses, together with interest from the date of disbursement at the rate of interest provided in the Note (unless collection of interest from Mortgagor at such rate would be contrary to applicable law, in which event such amounts shall bear interest at the

highest rate which may be collected from Mortgagor under applicable law) shall be additional amounts secured by this Mortgage.

9. Preservation and Maintenance of Mortgaged Property. Mortgagor (i) shall keep the Building and other Improvements now or hereafter erected on the Land in safe and good repair and condition, ordinary wear and tear excepted, (ii) shall constantly maintain the parking and landscaped areas of the Mortgaged Property, (iii) shall not commit waste or permit impairment or deterioration of the Mortgaged Property, (iv) shall not alter or permit the alteration of the design or structural character of any Building now or hereafter erected on the Land or hereafter construct, or permit any tenant to construct, additions to the original Building or additional buildings on the Land without the prior written consent of the Mortgagee and (v) shall not remove from the Land any of the fixtures and personal property included in the Mortgaged Property unless the same is immediately replaced with like property of at least equal value and utility, and this Mortgage becomes a valid first lien on such property.

10. Inspection. The Mortgagee, or its agents, shall have the right at all reasonable times, to enter upon the Mortgaged Property for the purposes of inspecting the Mortgaged Property or any part thereof. The Mortgagees shall, however, have no duty to make such inspection.

11. Protection of Mortgagee's Security. Subject to the rights of the Mortgagor under paragraph 7 hereof, if the Mortgagor fails to perform any of the covenants and agreements contained in this Mortgage or if any action or proceeding is commenced which affects the Mortgaged Property or the interest of the Mortgagee therein, or the title thereto, then the Mortgagee, at Mortgagee's option, may perform such covenants and agreements, defend against and/or investigate such action or proceeding, and take such other action as the Mortgagee deems necessary to protect the Mortgagee's interest. Mortgagee shall be the sole judge of the legality, validity and priority of any claim, lien, encumbrance, tax, assessment, charge and premium paid by it and of the amount necessary to be paid in satisfaction thereof. Mortgagee is hereby given the irrevocable power of attorney (which power is coupled with an interest and is irrevocable) to enter upon the Mortgaged Property as the Mortgagor's agent in the Mortgagor's name to perform any and all covenants and agreements to be performed by the Mortgagor as herein provided. Any amounts disbursed or incurred by the Mortgagee pursuant to this paragraph 11, with interest thereon, shall become additional Indebtedness of the Mortgagor secured by this Mortgage. Unless Mortgagor and Mortgagee agree in writing to other terms of repayment, such amounts shall be immediately due and payable, and shall bear interest from the date of disbursement at the rate of interest provided in the Note, unless collection from Mortgagor of interest at such rate would be contrary to applicable law, in which event such amounts shall bear interest at the highest rate which may be collected from Mortgagor under applicable law. Mortgagee shall, at its option, be subrogated to the lien of any mortgage or other lien discharged in whole or in part by the Indebtedness or by the Mortgagee under the provisions hereof, and any such subrogation rights shall additional and cumulative security for this Mortgage. Nothing contained in

this paragraph 11 shall require the Mortgagee to incur any expense or do any act hereunder, and the Mortgagee shall not be liable to the Mortgagor for any damages or claims arising out of action taken by the Mortgagee pursuant to this paragraph 11.

12. Condemnation.

(a) Mortgagor hereby irrevocably assigns to the Mortgagee any award or payment which becomes payable by reason of any taking of the Mortgaged Property, or any part thereof, whether directly or indirectly or temporarily or permanent, in or by condemnation or other eminent domain proceedings or by reason of sale under threat thereof, or in anticipation of the exercise of the right of condemnation or other eminent domain proceedings (hereinafter called "Taking"). Forthwith upon receipt by Mortgagor of notice of the institution of any proceeding or negotiations for a Taking, Mortgagor shall give notice thereof to Mortgagee. Mortgagee may appear in any such proceedings and participate in

any such negotiations and may be represented by counsel. Mortgagor, notwithstanding that Mortgage may not be a party to any such proceeding, will promptly give to Mortgagee copies of all notices, pleadings, judgements, determinations and other papers received by Mortgagor therein. Mortgagor will not enter into any agreement permitting or consenting to the Taking of the Mortgaged Property, or any part thereof, or providing for the conveyance thereof in lieu of condemnation, with anyone authorized to acquire the same in condemnation or by eminent domain unless Mortgagee shall first have consented thereto in writing, which consent will not be unreasonably withheld. All Taking awards shall be adjusted jointly by Mortgagee. All awards payable as a result of a Taking shall be paid to Mortgagee, which may, at its option, apply them, after first deducting Mortgagee's expenses incurred in the collection thereof, to the payment of the Indebtedness, whether or not due and in such order of application as Mortgagee may determine, or to the repair or restoration of the Mortgaged Property, in such manner as Mortgagee may determine. Any application of Taking awards to principal of the Indebtedness shall not extend or postpone the due dates of the installments payable under the Indebtedness or change the amount of such installments.

(b) If the Taking involves a taking of any Building or other Improvements now or hereafter located on the Land, Mortgagor shall proceed, with reasonable diligence, to demolish and remove any ruins and complete repair or restoration of the Mortgaged Property as nearly as possible to its respective size, type, and character immediately prior to the Taking, whether or not the condemnation awards are available or adequate to complete such repair or restoration.

(c) Mortgagor shall promptly reimburse Mortgagee upon demand for all of Mortgagee's expenses (including reasonable attorney's fees) incurred in the collection of awards and their disbursement in accordance with this paragraph, and all such expenses, together with interest from the date of disbursement at the rate of interest provided in the Note (unless collection of interest from Mortgagor at such rate would be contrary to applicable law, in which event such amounts shall

bear interest at the highest rate which may be collected from Mortgagor under applicable law) shall be additional amounts secured by this Mortgage.

13. Information; Books and Records. Mortgagor will prepare or cause to be prepared at Mortgagor's expense and deliver of any condition or event which constitutes, or which after notice or lapse of time or both would constitute, an Event of Default, written notice specifying the nature and period of existence thereof and what action Mortgagor has taken, is taking or proposes to take with respect thereto. Mortgagor shall keep and maintain at all times at Mortgagor's address stated below or at such other places as Mortgagee may approve in writing, complete and accurate books of accounts and records in sufficient detail and accurate books of accounts and records in sufficient detail to reflect correctly the receipts and expenses in connection with the acquisition, construction, operation and/or sale of the Mortgaged Property and copies of all written contracts, leases and other instruments which affect the Mortgaged Property. Such books, records, contracts, leases and other instruments shall be subject to examination and inspection by the Mortgagee or its representative during ordinary business hours.

14. Indemnification by the Mortgagor. The Mortgagor shall bear all loss, expense (including attorneys' fees) and damage in connection with, and agrees to indemnify and hold harmless the Mortgagee and each of its agents, servants and employees from, all claims, demands and judgements made or recovered against the Mortgagee or any of its agents, servants and employees because of bodily injuries, including death at any time resulting therefrom, and/or because of damages to property of the Mortgagee or others (including loss of use) from any cause whatsoever, arising out of, incidental to, or in connection with the construction and/or operation of the Improvements or arising by reason of the presence of hazardous or toxic substances on the Land or in the Improvements or releases thereof from the Mortgaged Property, whether or not due to any act of omissions or commission, including negligence of the Mortgagor or its employees, servants or agents, and whether or not due to any act of omission or commission of the Mortgagee or its employees, servants or agents. The Mortgagor's liability hereunder shall not be limited to the extent of insurance carried by or provided by the Mortgagor or subject to any exclusions from coverage in any insurance policy. The obligations of the Mortgagor under this paragraph shall survive the payment of the Note.

15. Security Interest. This Mortgage shall constitute a security agreement with respect to (and the Mortgagor hereby grants the Mortgagee a security interest in) the tangible personal property and fixtures included in the Mortgaged Property (as more particularly described in Granting Clause I of this Mortgage) and the Revenues and Income (as more particularly described in Granting Clause II). The Mortgagor will from time to time, at the request of the Mortgagee, execute any and all fixtures (in a form satisfactory to the Mortgagee, execute any and all financing statements covering such personal property and fixtures (in a form satisfactory to the Mortgagee) which the

Mortgagee may reasonably consider necessary or appropriate to perfect its security interest.

16. Events of Default. Each of the following occurrences shall constitute an event of default hereunder (herein called an "Event of Default"):

(a) Mortgagor shall fail to duly and punctually pay any obligation payable under the Note or this Mortgage.

(b) Mortgagor shall fail duly to perform or observe any of the covenants or agreements contained in this Mortgage (other than a default in the performance, or breach, of any covenant of the Mortgagor in paragraph 1(a) hereof) and such failure shall continue for a period of thirty (30) days after the Mortgagee has given written notice to the Mortgagor specifying such default or breach.

(c) Mortgagor shall make an assignment for the benefit of Mortgagor's creditors, or shall admit in writing Mortgagor's inability to pay Mortgagor's debts as they become due, or shall file a petition in bankruptcy, or shall become or be adjudicated a bankrupt or insolvent, however defined, or shall file a petition seeking any reorganization, dissolution, liquidation, arrangement, composition, readjustment or similar relief under any present or future bankruptcy or insolvency statute, law or regulation or shall file an answer admitting to or not consenting the material allegations of petition filed against the Mortgagor in such proceedings, or shall not, within 60 days after the filing of such petition against the Mortgagor, have same dismissed or vacated, or shall seek or consent to or acquiesce in the appointment of any trustee, receiver or liquidator of a material part of the Mortgagor's properties or of the Mortgaged Property or shall not, within 60 days after the appointment (without the Mortgagor's consent or acquiescence) of a trustee, receiver or liquidator of any material part of the Mortgagor's properties or of the Mortgaged Property, have such appointment vacated.

(d) The Land or Building or Revenues and Income, or if any part thereof or any legal or equitable interest therein, shall be sold, conveyed, transferred or further encumbered without the prior written consent of Mortgagee. This provision shall apply to each and every sale, transfer or conveyance, regardless of whether or not the Mortgagee has waived its rights hereunder, whether by action or inaction in connection with any previous sale, transfer or conveyance, whether one or more.

(e) Mortgagor shall default in the payment of any obligation other than the Indebtedness, whether as a principal or as a surety, in favor of the Mortgagee and any periods of grace with respect thereto shall have expired.

17. Acceleration; Foreclosure. Whenever any Event of Default shall have occurred and be subsisting, the Mortgagee may, at its option, exercise one or more of the following rights and remedies (and/or any other rights and remedies available to it):

(a) Mortgagee may, by written notice to the Mortgagor, declare immediately due and payable all Indebtedness secured by this Mortgage, and the same shall thereupon be immediately due and payable, without further notice or demand.

(b) Mortgagee shall have and may exercise with respect to all personal property and fixtures which are part of the Mortgaged Property and with respect to the Revenues and Income, all the rights and remedies accorded upon default to a secured party under the Uniform Commercial Code, as in effect in the State of Minnesota. If notice to the Mortgagor of intended disposition of such property is required by law in a particular instance, such notice shall be deemed commercially reasonable if given to Mortgagor (in the manner specified in paragraph 21) at least 10 calendar days prior to the date of intended disposition. Mortgagor shall pay on demand all costs and expenses incurred by Mortgagee in exercising such rights and remedies, including without limitation, reasonable attorneys' fees and legal expenses.

(c) Mortgagee may (and is hereby authorized and empowered to) foreclose this Mortgage by action or advertisement, pursuant to chapters 580 through 582 of the statutes of the State of Minnesota in such case made and provided, power being expressly granted to sell the Mortgaged Property (including, without limitation, and at the option of the Mortgagee, any goods constituting a part thereof) at public auction and convey the same to the purchaser in fee simple and out of the proceeds arising from such sale, to pay all or any part of the Indebtedness secured hereby with interest, and all legal costs and charges of such foreclosure and the maximum attorneys' fees permitted by law, which

costs, charges and fees the Mortgagor agrees to pay.

(d) The Mortgagor shall be entitled, without notice and without any showing of waste of the Mortgaged Property, inadequacy of the Mortgaged Property as security for the Indebtedness, or insolvency of the Mortgagor, to the appointment of a receiver of the rents and profits of the Mortgaged Property, including those past due.

(e) Mortgagee may pursue one or more of the remedies provided for herein, in the Note, or in any other agreement now or hereafter entered into between the Mortgagor and Mortgagee in connection with the Note.

18. Estoppel Certificates. Mortgagor agrees at any time and from time to time, upon not less than 15 days' prior notice by Mortgagee, to execute, acknowledge and deliver, without charge, to Mortgagee or to any person designated by Mortgagee, a statement in writing certifying that this Mortgage is unmodified (or if there have been modifications, identifying the same by the date thereof and specifying the nature thereof), the principal amount then secured hereby, that Mortgagor has not received any notice of default or notice acceleration or foreclosure of this notice of this Mortgage (or if Mortgagor has received such a notice, that it has been revoked, if such be the case), that

to the knowledge of Mortgagor no Event of Default exists hereunder (or if any such Event of Default does exist, specifying the same and stating that the same has been cured, if such be the case), the Mortgagor to Mortgagor's knowledge has no claims or offsets against Mortgagee (or if Mortgagor has any such claims, specifying the same), and the dates to which the principal and interest and the other sums and charges payable by Mortgagor pursuant to the Note and this Mortgage have been paid. In the event Mortgagor fails to execute, acknowledge and deliver such statement within the time above required, Mortgagor hereby appoints and constitutes Mortgagee as Mortgagor's attorney-in-fact to do so (which power of attorney is coupled with an interest and is irrevocable), and Mortgagor shall be fully bound by any such statement executed by Mortgagee on Mortgagor's behalf to the same extent as if Mortgagor had executed, acknowledged and delivered the same.

19. Forbearance Not a Waiver, Rights and Remedies Cumulative. No delay by the Mortgagee in exercising any right shall be deemed a waiver of or preclude the exercise of such right or remedy, and no waiver by the Mortgagee of any particular provision of this Mortgage shall be deemed effective unless in writing signed by the Mortgagee. All such rights and remedies provided for herein or which the Mortgagee may have otherwise, at law or in equity, shall be distinct, separate and cumulative and may be exercised concurrently, independently or successively in any order whatsoever, and as often as the occasion therefor arises. The Mortgagee's taking action pursuant to paragraph 11 or receiving proceeds, awards or damage pursuant to paragraphs 8 or 12 shall not impair any right or remedy available to the Mortgagee under paragraph 17 hereof. Acceleration of maturity of the Indebtedness, once claimed hereunder by the Mortgagee, may, at the option of Mortgagee, be rescinded by written acknowledgement to that effect by Mortgagee, but the tender and acceptance of partial payments alone shall not in any way affect or rescind such acceleration of maturity of the Indebtedness or constitute a waiver of any proceedings commenced to foreclose this Mortgage.

20. Successors and Assigns Bound; Number; Gender; Agents, Captions. The covenants and agreements herein contained shall bind, and the rights hereunder shall inure to, the respective heirs, legal representatives, successors and assigns of the Mortgagee and the Mortgagor, subject to paragraph 16(d). Wherever used, the singular number shall include the plural, and the plural the singular, and the use of any gender shall apply to all genders. In exercising any rights hereunder or taking any actions provided for herein, Mortgagee may act through its employees, agents or independent contractors as authorized by Mortgagee. The captions are headings of the paragraphs of this Mortgage are for convenience only and are not to be used to interpret or define the provisions hereof.

21. Notice. Any notice from the Mortgagee to the Mortgagor under this Mortgage shall be deemed to have been given by the Mortgagee and received by the Mortgagor when mailed by certified mail by the Mortgagee or its agents to the Mortgagor at the address set forth in paragraph 25(a) below or at such other address as the Mortgagor may designate in writing to the Mortgagee.

22. Governing Law; Severability. This mortgage shall be governed by the laws of the State of Minnesota. In the event that any provision or clause of this Mortgage conflicts with applicable law, such conflict shall not affect other provisions of this Mortgage which can be given effect without the conflicting provisions and to this end the provisions of the Mortgage are declared to be severable.

23. Counterparts. This Mortgage may be executed in any number of counterparts, each of which shall be an original, but all of which together

shall constitute one instrument.

24. Waiver of Marshalling. Mortgagor, any party who consents to this mortgage and any party who now or hereafter acquires a lien on the Mortgaged Property and who has actual or constructive notice of this Mortgage hereby waives any and all right to require the marshalling of assets in connection with the exercise of any of the remedies permitted by applicable law or provided herein and waives any right to have the Mortgaged Property sold in separate tracts pursuant to section 580.08, Minnesota Statutes.

25. Fixture Filing. From the date of its recording, this Mortgage shall be effective as a financing statement filed as a fixture filing with respect to all goods constituting part of the Mortgaged Property (as more particularly described in Granting Clause I of this Mortgage) which are or are to become fixtures related to the real estate described herein. For this purpose, the following information is set forth:

(a) Name and Address of Debtor and Record Owner of Real Estate:

Appliance Recycling Centers of America, Inc.
7400 Excelsior Blvd.
St. Louis Park, MN 55426

(b) Name and Address of Secured Party:

Western Bank
663 University Avenue West
St. Paul, MN 55104
Attention: Loan Servicing Dept.

(c) This document covers goods which are or are to become fixtures.

IN WITNESS WHEREOF, the Mortgagor has caused this Mortgage to be duly executed as of the day and year first above written.

THE TOTAL INDEBTEDNESS SECURED BY THIS DOCUMENT IS \$249,950.00.

Appliance Recycling Centers of America, Inc.

By: Kent S. McCoy, Chief Financial Officer

STATE OF Minnesota)
) SS.
COUNTY OF Ramsey)

The foregoing instrument was acknowledged before me this _____ day of February, 1998 by Kent S. McCoy, Chief Financial Officer of Appliance Recycling Centers of America, Inc., a Minnesota Corporation, on behalf of the corporation. .

Notary Public

This instrument was drafted by: Western Bank, 663 University Ave., St. Paul, MN 55104

EXHIBIT 1
TO
COMBINATION MORTGAGE AND SECURITY AGREEMENT
(DESCRIPTION OF THE "LAND")

Legal:

Lots 6, 7, 8, 9, 10 and 11, in Chute Brothers Division No. 1 Addition to the
City of St. Paul, Minnesota

Address: 654 University Avenue, St. Paul, MN 55104

EXHIBIT 2
TO
COMBINATION MORTGAGE AND SECURITY AGREEMENT
(PERMITTED ENCUMBRANCES)

- 1) Taxes not yet due and payable.

PORTIONS OF
1997 ANNUAL REPORT
OF
APPLIANCE RECYCLING CENTERS
OF AMERICA, INC.

MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

The 1997 fiscal year (1997) ended January 3, 1998.

The Company generates revenues from three major areas: recycling fees, sales of reconditioned and distressed appliances, and sales of byproducts. The Company experiences seasonal fluctuations in operating results, with revenues generally higher during the second and third calendar quarters than in the first and fourth quarters. The lower levels in the first and fourth quarters reflect consumer purchasing cycles, which result in lower demand for appliances and recycling services.

In 1997 the Company focused on stabilizing its operations and developing a stronger foundation for its appliance reuse business. The Company made significant progress towards these objectives. The Company reduced its loss to \$748,000 in 1997 from \$7,269,000 in 1996. Though the Company had lower revenues in 1997, same-store sales for its reconditioned and distressed appliance business increased 19%. Overall, gross profit as a percentage of sales increased to 41.7% in 1997 compared to 19.6% in the previous year. In addition, selling, general and administrative expenses decreased by \$4,164,000 from the previous year.

REVENUES

The Company's total revenues for 1997 were \$11,979,000 compared to \$14,030,000 in 1996. Recycling revenues decreased to \$6,274,000 in 1997 from \$6,785,000 in 1996. The decrease was primarily due to the Company's closing four recycling centers in late 1996 and early 1997, partially offset by increased recycling revenues from the Company's Southern California Edison Company ("Edison") contract. Edison has renewed its contract through September 30, 1998. This contract is expected to generate minimum revenues of \$3,000,000. The Company believes its 1998 recycling revenues level is dependent on the volume of appliances processed from the Edison program and whether the Edison program is extended for the last three months of 1998.

Appliance sales decreased to \$4,149,000 in 1997 from \$5,148,000 in 1996. The decrease was primarily due to the Company's reducing its number of retail stores to 13 in 1997 from 26 in the fourth quarter 1996. Due to substantial losses in 1996, the Company withdrew from three markets during the fourth quarter of 1996, closing 12 retail locations and three recycling centers. The Company operated 13 stores throughout 1997. Same-store sales (for stores open for the full years 1997 and 1996) increased 19% in 1997.

In 1997, the Company entered into agreements with Whirlpool Corporation to purchase Whirlpool's distressed, discontinued and returned products. The Company believes the availability of these products along with its traditional products will increase retail sales significantly in 1998.

Byproduct revenues decreased to \$1,556,000 in 1997 from \$2,097,000 in 1996. The decrease was primarily due to fewer appliances recycled in 1997 compared to 1996, which resulted from the closing of three recycling centers in the fourth quarter of 1996.

The Company's total revenues for 1996 were \$14,030,000 compared to \$16,241,000 in 1995. Recycling revenues decreased to \$6,785,000 in 1996 from \$12,300,000 in 1995, primarily due to decreased revenues from electric utility programs that ended during 1996.

Appliance sales increased to \$5,148,000 in 1996 from \$1,793,000 in 1995. The increase was due to the Company's expansion of its retail business through a new chain of stores under the name "Encore Recycled Appliances." During 1996, the Company opened 22 retail locations in seven markets. Due to substantial losses, the Company closed 12 retail locations in the fourth quarter of 1996.

Byproduct revenues decreased slightly to \$2,097,000 in 1996 from \$2,148,000 in 1995. The decrease was primarily due to lower sales of reclaimed CFCs offset by a small increase in scrap metal income.

GROSS PROFIT

The Company's overall gross profit rate increased to 41.7% in 1997 from 19.6% in 1996. The increase was primarily due to the closing of the under-performing recycling centers and Encore stores in the fourth quarter of 1996 and increased operating efficiencies in the remaining centers. The Company believes the gross profit rate will continue to improve in 1998 due to continued operating efficiencies and higher sales volumes at the existing centers. The Company believes the gross profit will be dependent on the volume of appliances processed from the Edison program and the gross profit margin the Company can achieve on Whirlpool product sales.

The overall gross profit rate decreased to 19.6% for 1996 from 34.7% for 1995. The decrease was primarily due to costs related to a decrease in units recycled from utility customers, start-up inefficiencies related to the expansion of the reconditioned appliance business, lower than planned retail sales and write-offs and other

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significant expenses related to the closing of retail stores and recycling centers. The gross profit rate in the closed markets was a negative 12.7% in 1996.

SELLING, GENERAL AND ADMINISTRATIVE EXPENSES

Selling, general and administrative expenses were 45.7% of sales in 1997 compared to 68.7% and 36.0% in 1996 and 1995, respectively. Selling, general and administrative expenses decreased to \$5,479,000 in 1997 from \$9,643,000 in 1996, a 43.2% decrease. Selling expenses decreased to \$1,498,000 in 1997 from \$3,275,000 in 1996. The decrease in selling expenses was primarily due to operating fewer retail stores in 1997 compared to 1996. General and administrative expenses decreased to \$3,981,000 from \$6,368,000 in 1996. The decrease was primarily due to operating fewer centers in 1997 compared to 1996 and incurring lower costs associated with the closed markets.

Selling, general and administrative expenses increased to \$9,643,000 in 1996 from \$5,852,000 in 1995. The increase was primarily due to opening and operating additional centers and retail operations in 1996 compared to 1995. The increase was also due to costs incurred related to closing three recycling centers and 12 retail locations.

In 1995, the Company took a one-time charge of \$1,316,000 related to a loss on impaired assets and non-recurring charges associated with the Company's utility business.

INTEREST EXPENSE

Interest expense increased slightly in 1997 compared to 1996 due to a higher average borrowed amount in 1997 than 1996. Interest expense in 1996 was approximately the same as in 1995.

INCOME TAXES AND NET OPERATING LOSSES

As of its 1997 and 1996 year-ends, the Company recorded a valuation allowance of \$2,952,000 and \$2,795,000, respectively, against its net deferred tax assets due to the uncertainty of their realization. In addition, in conjunction with the fourth quarter business restructuring, the Company wrote-off \$235,000 of deferred tax assets recorded in prior years due to the uncertainty of their realization. The realization of deferred tax assets is dependent upon sufficient future taxable income during the period when deductible temporary differences and carryforwards are expected to be available to reduce taxable income.

The Company has net operating losses of approximately \$5,630,000 at January 3, 1998 which are available to reduce income taxes payable in future years. Future utilization of these loss carryforwards is dependent upon the Company's attaining profitable operations.

To the extent the Company is able to generate taxable income in a period in which this net operating loss carryforward is available, the Company's cash requirements for the payment of income taxes would be reduced.

MINORITY INTEREST IN NET INCOME OF SUBSIDIARY

The Company was an 80% shareholder in its California subsidiary, and accordingly, recorded the minority shareholder's interest in the subsidiary's net income during 1997. No minority interest was recorded in 1996 and 1995 since the subsidiary had an accumulated net loss. During the fourth quarter of 1997, the Company purchased all the minority shareholder's stock in the California subsidiary.

LIQUIDITY AND CAPITAL RESOURCES

At January 3, 1998, the Company had a working capital deficit of \$1,959,000 compared to a working capital deficit of \$1,671,000 at December 28, 1996. Cash and cash equivalents decreased to \$13,000 at January 3, 1998 from \$280,000 at December 28, 1996. Net cash provided by operating activities was \$308,000 in 1997 compared to net cash used in operating activities of \$4,142,000 in 1996. The increase in cash provided by operating activities was primarily due to a decrease in the Company's net loss of \$6,521,000 offset by a decrease in depreciation expense of \$1,450,000.

Net cash used in investing activities was \$467,000 in 1997 compared to \$954,000 in 1996. The decrease in net cash used in investing activities in 1997 from 1996 was due to a decrease in capital expenditures offset by lower proceeds for selling excess equipment and the purchase of the minority interest in the California subsidiary. In November 1997, the Company purchased all outstanding shares held by the minority shareholder of its California subsidiary for \$275,000.

Net cash used in financing activities was \$108,000 compared to net cash provided by financing activities of \$750,000 in 1996. The increase in cash used in financing activities was primarily due to the nonissuance of Common Stock in 1997.

The Company's capital expenditures were approximately \$299,000 in 1997 and \$1,285,000 in 1996. The 1997 capital expenditures were primarily related to building improvements. The 1996 capital expenditures were primarily related to leasehold improvements to the Company's recycling centers and additional retail stores. The Company did not have any material purchase commitments for assets as of January 3, 1998.

As of January 3, 1998, the Company had a \$2.0 million line of credit with a lender. In February 1998, the line

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of credit was increased to \$2.75 million. The amount of borrowings available under the line of credit is based on a formula using receivables, inventories, and property and equipment. The line of credit has a stated maturity date of August 30, 1999, and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The loan provides for a rate of interest equal to 5 percentage points over the prime lending rate per annum, but never less than 10% per annum (the interest rate as of January 3, 1998 was 13.5%), and minimum monthly interest payments of \$10,000 regardless of the outstanding principal balance. Upon an event of default, the interest rate may increase by 5 percentage points per annum. The line of credit is secured by receivables, inventories, equipment, real estate and other assets of the Company and a portion is guaranteed by the President of the Company. The loan also requires that the Company meet certain financial covenants, provides payment penalties for noncompliance, limits the amount of other debt the Company can incur, limits the amount of spending on fixed assets and limits payments of dividends. At January 3, 1998, the Company's borrowing capacity was fully utilized.

In May 1996, \$700,000 was raised in a private placement of Common Stock to an institutional investor that currently holds approximately 11% of the outstanding shares. These proceeds were used to pay off an equipment loan of \$480,000 and for additional working capital. The proceeds were raised from selling 50,000 shares at \$14.00 per share after giving effect to the Company's 1997 reverse stock split.

The Company believes, based on anticipated revenues from the Edison contract, the anticipated growth in retail sales and the anticipated improvement in gross profit, that funds generated from operations and the current line of credit will be sufficient to finance its operations and capital expenditures through December 1998. The Company's total capital requirements will depend, among other things as discussed below, on the number of recycling centers operating and the number and size of retail stores operating during the fiscal year. Currently, the Company has four centers and 13 stores in operation. If revenues are lower than anticipated or expenses are higher than anticipated or the line of credit cannot be maintained, the Company may require additional capital to finance operations. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity (including the issuance of Preferred Stock if authorized by the shareholders at the 1998 Annual Meeting of Shareholders) or other securities. There can be no assurance that such additional sources of financing will be available or available on terms satisfactory to the Company or permitted by the Company's current lender.

YEAR 2000

Based on a recent assessment of the Year 2000 Issue, the Company determined that it will be required to modify or replace significant portions of its software so that its computer systems will properly utilize dates beyond December 31, 1999. The Company believes that with modifications to existing software and conversions to new software, the Year 2000 Issue can be mitigated. However, if such modifications and conversions are not made, or are not completed in a timely manner, the Year 2000 Issue could have a material impact on the operations of the Company.

The Company will utilize both internal and external resources to replace and test the software for Year 2000 modifications. The Company plans to complete the Year 2000 project no later than December 31, 1998. The costs of the project are expected to be funded through operating cash flows. A portion of the costs will be used to purchase new software, which will be capitalized. The remaining portion of the costs will be expensed as incurred over the course of the project. The overall cost of the project is not expected to have a material effect on the results of operations.

PROVISION FOR (BENEFIT OF) INCOME TAXES (Note 8) (590,000)	(31,000)	235,000
---	----------	---------

Net income (loss) before minority interest (943,000)	\$ (663,000)	\$ (7,269,000)	\$
---	--------------	----------------	----

MINORITY INTEREST IN NET INCOME OF SUBSIDIARY	85,000	--	
---	--------	----	--

Net income (loss) (943,000)	\$ (748,000)	\$ (7,269,000)	\$
--------------------------------	--------------	----------------	----

BASIC AND DILUTED LOSS PER COMMON SHARE (0.90)	\$ (0.66)	\$ (6.53)	\$
---	-----------	-----------	----

WEIGHTED AVERAGE NUMBER OF COMMON SHARES 1,052,000	1,137,000	1,114,000
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</TABLE>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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CONSOLIDATED BALANCE SHEETS
Appliance Recycling Centers of America, Inc. and Subsidiaries

<TABLE>
<CAPTION>

	JANUARY 3, 1998	December 28, 1996
<S>	<C>	<C>
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	\$ 13,000	\$ 280,000
Accounts receivable, net of allowance of \$35,000 in 1997 and \$84,000 in 1996 (Notes 4 and 10)	736,000	1,127,000
Inventories (Note 4)	694,000	444,000
Refundable income taxes	29,000	400,000
Other current assets	140,000	246,000
Total current assets	\$ 1,612,000	\$ 2,497,000
PROPERTY AND EQUIPMENT, AT COST (Notes 4, 5 and 11)		
Land	\$ 2,103,000	\$ 2,103,000
Buildings and improvements	3,955,000	3,798,000
Equipment	5,461,000	5,604,000
Less accumulated depreciation	\$ 11,519,000	\$ 11,505,000
Net property and equipment	\$ 6,712,000	\$ 7,419,000
OTHER ASSETS	\$ 55,000	\$ 76,000
GOODWILL, NET	190,000	--
Total assets	\$ 8,569,000	\$ 9,992,000

LIABILITIES AND SHAREHOLDERS' EQUITY

CURRENT LIABILITIES		
Line of credit (Note 4)	\$ 1,513,000	\$ 1,390,000
Current maturities of long-term obligations (Note 5)	101,000	227,000
Accounts payable	1,136,000	1,391,000
Accrued expenses (Note 6)	821,000	1,160,000
Total current liabilities	\$ 3,571,000	\$ 4,168,000
LONG-TERM OBLIGATIONS, LESS CURRENT MATURITIES (Note 5)	1,633,000	1,711,000
Total liabilities	\$ 5,204,000	\$ 5,879,000

COMMITMENTS (Note 7)

SHAREHOLDERS' EQUITY (Notes 3, 4 and 9)		
Common Stock, no par value; authorized 10,000,000 shares; issued and outstanding 1,137,000 shares	\$ 10,350,000	\$ 10,350,000

Accumulated deficit	(6,985,000)	(6,237,000)

Total shareholders' equity	\$ 3,365,000	\$ 4,113,000

Total liabilities and shareholders' equity	\$ 8,569,000	\$ 9,992,000
=====		

</TABLE>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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CONSOLIDATED STATEMENTS OF CASH FLOWS
Appliance Recycling Centers of America, Inc. and Subsidiaries

<TABLE>
<CAPTION>

	For the fiscal year	
ended		
	JANUARY 3,	December 28,
	1998	1996
	<C>	<C>

December 30,		
1995		

CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	\$ (748,000)	\$ (7,269,000)
(943,000)		
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	1,027,000	2,477,000
1,452,000		
Minority interest in net income of subsidiary	85,000	--
--		
Common Stock issued for services	--	30,000
--		
(Gain) loss on sale of equipment	(80,000)	(118,000)
15,000		
Deferred income taxes	--	650,000
(586,000)		
Loss on impaired assets and non-recurring charges	--	--
1,316,000		
Change in assets and liabilities, net of effects from acquisition of Universal Appliance Company, Inc., and Universal Appliance Recycling, Inc. in 1996:		
Accounts receivable	391,000	510,000
2,850,000		
Inventories	(250,000)	37,000
(247,000)		
Other current assets	106,000	88,000
(17,000)		
Refundable income taxes	371,000	(294,000)
(106,000)		
Accounts payable	(255,000)	(327,000)
834,000		
Accrued expenses	(339,000)	87,000
(433,000)		
Income taxes payable	--	(13,000)
(429,000)		

Net cash provided by (used in) operating activities	\$ 308,000	\$ (4,142,000)
3,706,000		

CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of property and equipment	\$ (299,000)	\$ (1,285,000)
\$(1,549,000)		
Purchase of minority interest in California subsidiary	(275,000)	--
--		
Cash acquired in 1996 business acquisition	--	26,000
--		
Proceeds from disposal of property and equipment	107,000	415,000
177,000		
Payments for non-compete agreements	--	(110,000)
--		

Net cash used in investing activities	\$ (467,000)	\$ (954,000)
\$(1,372,000)		

CASH FLOWS FROM FINANCING ACTIVITIES				
Net borrowings under line of credit	\$	123,000	\$ 1,390,000	\$
--				
Payments on long-term obligations (788,000)		(231,000)	(1,412,000)	
Proceeds and tax benefits from stock option exercises 181,000		--	55,000	
Proceeds from long-term obligations		--	17,000	
--				
Proceeds from issuance of Common Stock		--	700,000	
--				

Net cash provided by (used in) financing activities \$ (108,000) \$ 750,000 \$
(607,000)

Effect of foreign currency exchange rate
changes on cash and cash equivalents \$ -- \$ 21,000 \$
18,000

Increase (decrease) in cash and cash equivalents \$ (267,000) \$ (4,325,000) \$
1,745,000

CASH AND CASH EQUIVALENTS

Beginning 280,000 4,605,000
2,860,000

Ending \$ 13,000 \$ 280,000 \$
4,605,000

=====

SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION

Cash payments (receipts) for:

Interest	\$	346,000	\$ 285,000	\$
288,000				
Income taxes	\$	(399,000)	\$ (103,000)	\$
413,000				

=====

SUPPLEMENTAL SCHEDULE OF NON-CASH INVESTING AND FINANCING ACTIVITIES

Long-term obligations incurred for purchase of equipment	\$	27,000	\$ --	\$
712,000				

=====

Acquisition of Universal Appliance Company, Inc. and
Universal Appliance Recycling, Inc.
Working capital acquired, including cash and
cash equivalents of \$26,000 \$ -- \$ 118,000 \$

-- Fair value of other assets acquired, principally
property and equipment and a non-compete agreement -- 176,000

-- Purchase price assigned to goodwill -- 301,000

-- Long-term debt assumed -- (207,000)

-- Total consideration, 21,000 shares of Common Stock \$ -- \$ 388,000 \$

</TABLE>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
Appliance Recycling Centers of America, Inc. and Subsidiaries

<TABLE>
<CAPTION>

Total	Common Stock		Retained Earnings (Accumulated Deficit)	Foreign Currency Translation Adjustment
	Shares	Amount		
<S>	<C>	<C>	<C>	<C>
BALANCE, DECEMBER 31, 1994	1,045,000	\$ 8,996,000	\$ 1,975,000	\$ (39,000)
10,932,000				
Exercise of Common Stock				

options and warrants and related tax benefits (Note 9)	12,000	181,000	--	--	
181,000					
Foreign currency translation adjustment	--	--	--	18,000	
18,000					
Net income (loss)	--	--	(943,000)	--	
(943,000)					

BALANCE, DECEMBER 30, 1995	1,057,000	\$ 9,177,000	\$ 1,032,000	\$ (21,000)	\$
10,188,000					
Issuance of Common Stock (Notes 3 and 9)	73,000	1,118,000	--	--	
1,118,000					
Exercise of Common Stock options and warrants (Note 9)	7,000	55,000	--	--	
55,000					
Foreign currency translation adjustment	--	--	--	21,000	
21,000					
Net income (loss)	--	--	(7,269,000)	--	
(7,269,000)					

BALANCE, DECEMBER 28, 1996	1,137,000	\$ 10,350,000	\$ (6,237,000)	\$ --	\$
4,113,000					
Net income (loss)	--	--	(748,000)	--	
(748,000)					

BALANCE, JANUARY 3, 1998	1,137,000	\$ 10,350,000	\$ (6,985,000)	\$ --	\$
3,365,000					
=====					

</TABLE>

SEE NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Appliance Recycling Centers of America, Inc. and Subsidiaries

NOTE 1. NATURE OF BUSINESS AND SIGNIFICANT ACCOUNTING POLICIES

NATURE OF BUSINESS: Appliance Recycling Centers of America, Inc. and subsidiaries (the "Company") is in the business of selling reconditioned and distressed appliances and providing recycling services in an environmentally sound manner for major household appliances throughout the United States. The Company sells appliances through a chain of Company-owned stores under the name "Encore(R) Recycled Appliances." The Company provides recycling services on a credit basis to utilities, local governments, appliance retailers and waste management companies.

A SUMMARY OF THE COMPANY'S SIGNIFICANT ACCOUNTING POLICIES IS AS FOLLOWS:

PRINCIPLES OF CONSOLIDATION: The consolidated financial statements include the accounts of Appliance Recycling Centers of America, Inc. and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

FAIR VALUE OF FINANCIAL INSTRUMENTS: The following methods and assumptions are used to estimate the fair value of each class of financial instruments:

CASH EQUIVALENTS: Due to their short-term maturities, the carrying amount approximates fair value.

SHORT- AND LONG-TERM DEBT: The fair value of short- and long-term debt is estimated based on interest rates for the same or similar debt offered to the Company having the same or similar remaining maturities and collateral requirements. At January 3, 1998, and December 28, 1996, the carrying value of the Company's short- and long-term debt approximated its fair value.

FISCAL YEAR: The fiscal year ended January 3, 1998 includes 53 weeks. The fiscal years ended December 28, 1996 and December 30, 1995 include 52 weeks.

REVENUE RECOGNITION: The Company recognizes revenue from appliance sales in the period the appliance is sold. Recycling revenue is recognized when a unit is collected and processed. Byproduct revenue is recognized upon shipment.

The Company provides allowances for uncollectable revenues receivable based on management's periodic assessment of the need for such allowances.

The Company defers revenue under extended warranty arrangements and recognizes it over the term of the warranty contract.

CASH AND CASH EQUIVALENTS: For purposes of reporting cash flows, the Company considers all cash and any treasury bills, commercial paper and money-market funds with an initial maturity of three months or less to be cash equivalents. The Company maintains its cash in bank deposits and money-market accounts which, at times, exceed federally insured limits. The Company has not experienced any losses in such accounts.

INVENTORIES: Inventories, consisting primarily of reconditioned and distressed appliances, are stated at the lower of cost, first-in, first-out (FIFO) basis, or market.

GOODWILL: The Company was an 80% shareholder in its California subsidiary, and accordingly, recorded the minority shareholder's interest in the subsidiary's net income. During the fourth quarter of 1997, the Company purchased all the minority shareholder's stock in the California subsidiary. This transaction resulted in the Company's recording goodwill of \$190,000. Goodwill is being amortized by the straight-line method over a period of five years.

PROPERTY AND EQUIPMENT: Depreciation is computed using straight-line and accelerated methods over the following estimated useful lives:

	YEARS
Buildings and improvements	18 - 30
Equipment	3 - 8

The Company reviews its long-lived assets periodically to determine potential impairment by comparing the carrying value of the long-lived assets with the estimated future net undiscounted cash flows expected to result from the use of the assets, including cash flows from disposition. Should the sum of the expected future net cash flows be less than the carrying value, the Company would recognize an impairment loss at the date. An impairment loss would be measured by comparing the amount by which the carrying value exceeds the fair value (estimated discounted future cash flows or appraisal of assets) of the long-lived assets. In 1995, the Company recorded a charge for impairment of certain assets. (See Note 11.)

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INCOME TAXES: Deferred taxes are provided on an asset and liability method whereby deferred tax assets are recognized for deductible temporary differences and operating loss and tax credit carryforwards, and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

NET LOSS PER SHARE: The Company adopted Statement of Financial Accounting Standards No. 128 (SFAS No. 128), Earnings per Share, which supersedes APB Opinion No. 15. SFAS No. 128 requires the presentation of earnings per share by all entities that have common stock or potential common stock, such as options, warrants and convertible securities, outstanding that trade in a public market. Those entities that have only common stock outstanding are required to present basic earnings per-share amounts. Basic per-share amounts are computed, generally, by dividing net income or loss by the weighted-average number of common shares outstanding. All other entities are required to present basic and diluted per-share amounts. Diluted per-share amounts assume the conversion, exercise or issuance of all potential common stock instruments unless the effect is anti-dilutive, thereby reducing the loss or increasing the income per common share.

The Company initially applied SFAS No. 128 for the year ended January 3, 1998 and, as required by the Statement, has retroactively applied it to all periods presented. As described in Note 9, at January 3, 1998 and December 28, 1996, the Company had stock options outstanding. However, because the Company has incurred a loss in all periods presented, the inclusion of those potential common shares in the calculation of diluted loss per-share would have an antidilutive effect. Therefore, basic and diluted loss per-share amounts are the same in each period presented.

ESTIMATES: The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

NOTE 2. MARKET CLOSINGS AND CORPORATE LIQUIDITY

The Company withdrew from three under-performing markets in the fourth quarter of 1996. The Company closed three recycling centers and nine retail stores in Hartford, Connecticut; Washington D.C./Baltimore, Maryland; and Oakland, California. In addition, the Company closed its three retail stores in Los Angeles, California. In connection therewith, the Company incurred charges of approximately \$2.0 million which included the write-off of leasehold

improvements, deferred tax assets, goodwill and certain non-compete agreements, receivables, and inventories, and the accrual of potential lease contingencies and other costs.

The Company believes, based on anticipated revenues from the Southern California Edison Company ("Edison") contract, the anticipated growth in retail sales and the anticipated improvement in gross profit, that funds generated from operations and the current line of credit will be sufficient to finance its operations and capital expenditures through December 1998. The Company's total capital requirements will depend, among other things, on the number of recycling centers operating and the number and size of retail stores operating during the fiscal year. If revenues are lower than anticipated, expenses are higher than anticipated or the line of credit cannot be maintained, the Company may require additional capital to finance operations. Sources of additional financing, if needed in the future, may include further debt financing or the sale of equity or other securities. There can be no assurance that such additional sources of financing will be available or available at terms satisfactory to the Company or permitted by the Company's current lender.

NOTE 3. BUSINESS COMBINATIONS

On January 2, 1996, the Company acquired Universal Appliance Company, Inc. and Universal Appliance Recycling, Inc., Washington, D.C.-based companies, by exchanging a total of 21,000 shares of its Common Stock for 100% ownership of the respective companies. The acquisitions were accounted for under the Purchase Method of accounting. Also, the selling shareholders received \$110,000 under non-compete agreements. In December 1996, the Company withdrew from the Baltimore, Maryland/Washington, D.C. market and closed the center and three retail locations. Accordingly, the goodwill and non-compete agreements were written off in the fourth quarter of 1996. Pro forma income statement information for 1995 has not been presented due to immateriality.

On August 23, 1995, the Company acquired Major Appliance Pickup Service of St. Louis, Inc., a St. Louis, Missouri-based used appliance retailer and recycler, by

issuing 7,143 shares of its Common Stock. The acquisition has been accounted for as a pooling of interests.

NOTE 4. LINE OF CREDIT

At January 3, 1998, the Company had a bank line of credit of \$2.0 million. In February 1998, the line was increased to \$2.75 million. The amount of borrowings available under the line of credit is based on a formula using receivables, inventories, and property and equipment. The line of credit has a stated maturity date of August 30, 1999, and provides that the lender may demand payment in full of the entire outstanding balance of the loan at any time. The loan provides for a rate of interest equal to 5 percentage points over the prime lending rate per annum, but never less than 10% per annum (the interest rate as of January 3, 1998 was 13.5%), and minimum monthly interest payments of \$10,000 regardless of the outstanding principal balance. Upon an event of default, the interest rate may increase by 5 percentage points per annum. The line of credit is secured by receivables, inventories, equipment, real estate and other assets of the Company and a portion is guaranteed by the President of the Company. The loan also requires that the Company meet certain financial covenants, provides payment penalties for noncompliance, limits the amount of other debt the Company can incur, limits the amount of spending on fixed assets and limits payments of dividends.

NOTE 5. LONG-TERM OBLIGATIONS

Long-term obligations consisted of the following:

	1997	1996
9.00% mortgage, due in monthly installments of \$11,411, including interest, balance due February 2004, secured by land and building	\$ 962,000	\$ 1,010,000
8.75% mortgage, due in monthly installments of \$6,981, including interest, balance due January 2003, secured by land and building	700,000	722,000
8.25% note payable, paid December 1997	-	127,000
Other	72,000	79,000
	\$ 1,734,000	\$ 1,938,000
Less current maturities	101,000	227,000
	\$ 1,633,000	\$ 1,711,000

The annual maturities of long-term debt as of January 3, 1998 were as follows:

1998	\$ 101,000
1999	102,000
2000	110,000
2001	102,000
2002	110,000
Thereafter	1,209,000

	\$ 1,734,000

NOTE 6. ACCRUED EXPENSES

Accrued expenses were as follows:

	1997	1996

Compensation	\$ 167,000	\$ 218,000
Lease contingencies and closing costs	289,000	466,000
Other	365,000	476,000

	\$ 821,000	\$ 1,160,000

NOTE 7. COMMITMENTS

OPERATING LEASES: The Company leases certain of its recycling center facilities and retail stores under noncancelable operating leases. The leases require the payment of taxes, maintenance, utilities and insurance. In the fourth quarter of 1996, the Company withdrew from three under-performing markets and closed its retail locations in the Los Angeles, California, market. The Company is currently negotiating the cancellation of leases in these markets. At January 3, 1998, the Company had accrued \$269,000 for estimated settlements of these leases.

Minimum rental commitments under noncancelable operating leases excluding the aforementioned leases subject to settlement as of January 3, 1998 were as follows:

1998	\$ 373,000
1999	\$ 157,000
2000	\$ 108,000
2001	\$ 4,000

Rent expense for the fiscal years ended January 3, 1998, December 28, 1996 and December 30, 1995 was \$433,000, \$1,585,000 and \$1,010,000, respectively.

NOTE 8. INCOME TAXES

The provision for (benefit of) income taxes consisted of the following:

	1997	1996	1995

Current:			
Federal	\$ -	\$ (415,000)	\$ (4,000)
State	(31,000)	-	-
Deferred	-	650,000	(586,000)

	\$ (31,000)	\$ 235,000	\$ (590,000)

A reconciliation of the effective tax rates with the federal statutory tax rate is shown below:

	1997	1996	1995

Income taxes at statutory rate	\$ (236,000)	\$ (2,462,000)	\$ (566,000)
State taxes, net of federal tax effect	(26,000)	(208,000)	(24,000)
Permanent differences	74,000	110,000	-
Change in valuation allowance	(289,000)	235,000	-
Effect of NOL with no current tax benefit	446,000	2,560,000	-

	\$ (31,000)	\$ 235,000	\$ (590,000)

The tax effects of principal temporary differences are as follows:

	1997	1996

Deferred tax assets:		
Net operating loss carryforwards	\$ 2,319,000	\$ 1,873,000

Loss on asset impairment	429,000	478,000
Federal and state tax credits	250,000	250,000
Accrued expenses	246,000	397,000

Gross deferred tax assets	\$ 3,244,000	\$ 2,998,000
Deferred tax liability:		
Accelerated tax depreciation	(292,000)	(203,000)
Valuation allowance	(2,952,000)	(2,795,000)

Net deferred tax assets	\$ -	\$ -
=====		

At January 3, 1998, the Company recorded a valuation allowance of \$2,952,000 on deferred tax assets to reduce the total to an amount management believes will ultimately be realized. Realization of deferred tax assets is dependent upon sufficient future taxable income during the period that deductible temporary differences and carryforwards are expected to be available to reduce taxable income.

At January 3, 1998, the Company had net operating loss carryforwards consisting of the following:

Expiration	Amount

2011	\$ 4,515,000
2012	\$ 1,115,000

NOTE 9. SHAREHOLDERS' EQUITY

STOCK OPTION PLANS: The Company has two Stock Option Plans (the "Plans") that permit the granting of "incentive stock options" meeting the requirements of Section 422 of the Internal Revenue Code of 1986, as amended, and nonqualified options which do not meet the requirements of Section 422. The Plans have 150,000 and 100,000 shares, respectively, available for grant. The options that have been granted under the Plans are exercisable for a period of five or seven years from the date of grant and vest over a period of two or three years from the date of grant.

The Company has adopted the disclosure-only provisions of Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation." Accordingly, no compensation cost has been recognized for the Plans. Had compensation cost for the Plans been determined based on the fair value at the grant date consistent with the provisions of SFAS No. 123, the Company's net loss and basic and diluted loss per share would have been increased to the pro forma amounts indicated below:

	1997	1996

Net loss - as reported	\$ (748,000)	\$ (7,269,000)
Net loss - pro forma	\$ (847,000)	\$ (7,348,000)
Basic and diluted loss per share		
- as reported	\$ (0.66)	\$ (6.53)
Basic and diluted loss per share		
- pro forma	\$ (0.75)	\$ (6.60)
=====		

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	1997	1996

Expected dividend yield	-	-
Expected stock price volatility	50.43%	51.02%
Risk-free interest rate	6.00%	6.00%
Expected life of options (years)	3	3
=====		

Additional information relating to all outstanding options is as follows:

	Shares	Weighted Average Exercise Price

Outstanding at		
December 31, 1994	71,000	\$ 25.92
Exercised	(6,000)	\$ 9.44
Cancelled	(1,000)	\$ 28.20

Outstanding at		
December 30, 1995	64,000	\$ 27.08
Granted	37,000	\$ 12.72
Exercised	(9,000)	\$ 9.60
Cancelled	(12,000)	\$ 20.72

Outstanding at		
December 28, 1996	80,000	\$ 23.36
Granted	44,000	\$ 2.54
Cancelled	(31,000)	\$ 31.31

Outstanding at		
January 3, 1998	93,000	\$ 10.93

The weighted average fair value per option of options granted during 1997 and 1996 was \$0.96 and \$4.92, respectively.

The following tables summarize information about stock options outstanding as of January 3, 1998:

OPTIONS OUTSTANDING

Range of Exercise Prices	Number Options Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$35.50 to \$45.52	6,000	1.6	\$ 39.64
\$17.50	27,000	3.7	\$ 17.50
\$10.52 to \$12.76	18,000	5.5	\$ 10.58
\$2.38 to \$3.00	42,000	6.7	\$ 2.55
	93,000		

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OPTIONS EXERCISABLE

Range of Exercise Prices	Number Options Exercisable	Weighted Average Exercise Price
\$35.50 to \$45.52	6,000	\$ 39.64
\$17.50	25,000	\$ 17.50
\$10.52 to \$12.76	9,000	\$ 10.58
\$2.38 to \$3.00	-	-
	40,000	

PRIVATE PLACEMENT: In May 1996, \$700,000 was raised in a private placement of Common Stock to an institutional investor by selling 50,000 shares at \$14.00 per share.

REVERSE SPLIT: In February 1997, the Company had a 1-for-4 reverse stock split and decreased the number of authorized shares to five million. The effect of the reverse stock split has been retroactively reflected in these financial statements and notes for all periods presented.

In April 1997, the shareholders approved an increase in the number of authorized shares to 10 million.

NOTE 10. MAJOR CUSTOMERS

Net revenues include sales to major customers as follows:

	1997	1996	1995
REVENUE PERCENTAGE:			
Customer A	37.8%	22.1%	23.5%
Customer B	-	1.9%	14.0%
Totals	37.8%	24.0%	37.5%

As of January 3, 1998, the receivable amount from Customer A on the Company's balance sheet was \$350,000.

NOTE 11. LOSS ON IMPAIRED ASSETS AND NON-RECURRING CHARGES

As of December 30, 1995, the Company recorded a charge of \$1,316,000 consisting of a loss on impaired assets and accruals associated with the Company's business with utility customers. The loss on impaired assets was \$1,194,000 with related charges of \$122,000.

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Shareholders
Appliance Recycling Centers of America, Inc.
Minneapolis, Minnesota

We have audited the accompanying consolidated balance sheets of Appliance Recycling Centers of America, Inc. and Subsidiaries as of January 3, 1998 and December 28, 1996, and the related consolidated statements of operations, shareholders' equity, and cash flows for each of the years in the three year period ended January 3, 1998. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on

these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Appliance Recycling Centers of America, Inc. and Subsidiaries as of January 3, 1998 and December 28, 1996, and the results of their operations and their cash flows for each of the years in the three year period ended January 3, 1998, in conformity with generally accepted accounting principles.

/s/ McGladrey & Pullen, LLP

Minneapolis, Minnesota
February 17, 1998

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FIVE-YEAR FINANCIAL SUMMARY

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Fiscal Years Ended	1997	1996	1995	1994	1993
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STATEMENT OF OPERATIONS					
Total revenues	\$ 11,979,000	\$ 14,030,000	\$ 16,241,000	\$ 20,327,000	\$ 14,943,000
Gross profit	\$ 4,990,000	\$ 2,744,000	\$ 5,630,000	\$ 8,360,000	\$ 4,996,000
Operating income (loss)	\$ (489,000)	\$ (6,899,000)	\$ (1,538,000)	\$ 1,753,000	\$ (645,000)
Net income (loss)	\$ (748,000)	\$ (7,269,000)	\$ (943,000)	\$ 877,000	\$ (455,000)
Basic and diluted earnings (loss) per share	\$ (0.66)	\$ (6.53)	\$ (0.90)	\$ 0.82	\$ (0.47)
Weighted average number of common shares outstanding	1,137,000	1,114,000	1,052,000	1,071,000	975,000

BALANCE SHEET

Working capital (deficit)	\$ (1,959,000)	\$ (1,671,000)	\$ 3,503,000	\$ 4,700,000	\$ 2,046,000
Total assets	\$ 8,569,000	\$ 9,992,000	\$ 15,890,000	\$ 16,912,000	\$ 14,481,000
Long-term liabilities	\$ 1,633,000	\$ 1,711,000	\$ 2,084,000	\$ 2,741,000	\$ 2,474,000
Shareholders' equity	\$ 3,365,000	\$ 4,113,000	\$ 10,188,000	\$ 10,932,000	\$ 9,840,000

</TABLE>

COMMON STOCK DATA*

The Company's Common Stock trades on the Nasdaq SmallCap Market under the symbol ARCI.

The Company has never paid or declared any cash dividends and the line of credit agreement entered into in 1996 prohibits the payment of cash dividends. The Company does not intend to pay dividends on its Common Stock in the foreseeable future.

The following table sets forth the range of low and high prices for the Company's Common Stock for each of the four quarters of 1997 and 1996:

	1997		1996	
	Low	High	Low	High
First Quarter	\$ 2	\$ 4	\$ 12	\$ 19 1/2
Second Quarter	2 3/8	3 3/8	14 1/2	20
Third Quarter	2 1/2	3 1/4	8 1/2	17 1/2
Fourth Quarter	2 1/8	4 1/4	2 1/3	11 1/2

*In February 1997, the Company had a 1-for-4 reverse stock split. These numbers reflect that split.

The Company had approximately 1,815 shareholders of record as of March 20, 1998.

APPLIANCE RECYCLING CENTERS OF AMERICA, INC.

SUBSIDIARIES AS OF JANUARY 3, 1998

NAME OF SUBSIDIARY -----	JURISDICTION OF INCORPORATION -----	PERCENT VOTING SECURITIES OWNED -----
Appliance Recycling Centers of America-California, Inc.	California	100%
ARCA of St. Louis, Inc.	Missouri	100%
ARCA-Maryland, Inc.	Maryland	100%

CONSENT OF INDEPENDENT ACCOUNTANTS

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (commission file No. 33-51584), on Form S-8 (commission file No. 33-68890), on Form S-8 (commission file No. 333-28571), and on Form S-3 (commission file No. 333-15463) of our report dated February 17, 1998, with respect to the consolidated financial statements of Appliance Recycling Centers of America, Inc., incorporated by reference from the Annual Report to the Shareholders in the Company's Annual Report on Form 10-K for the year ended January 3, 1998.

McGLADREY & PULLEN, LLP

Minneapolis, Minnesota
April 2, 1998

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