VONAGE HOLDINGS CORP
Form 10-Q
November 10, 2008
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

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

For the Quarterly Period Ended September 30, 2008

or

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

For the Transition Period From _____ to _____

Commission File Number 001-32887

VONAGE HOLDINGS CORP.

(Exact name of registrant as specified in its charter)

Delaware	**11-3547680**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
23 Main Street, Holmdel, NJ	**07733**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (732) 528-2600

(Former name, former address and former fiscal year, if changed since last report): Not Applicable

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 x No ¨

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

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

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

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

Class	**Outstanding at October 31, 2008**
Common Stock, par value $0.001	156,565,277 shares

Table of Contents

VONAGE HOLDINGS CORP.

INDEX

Financial Information Presentation

For the financial information discussed in this Quarterly Report on Form 10-Q, other than per share and per line amounts, dollar amounts are presented in thousands, except where noted.

Table of Contents

Part I Financial Information

Item 1. Financial Statements

VONAGE HOLDINGS CORP.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

	September 30, 2008 (unaudited)	December 31, 2007
Assets		
Assets		
Current assets:		
Cash and cash equivalents	$ 112,267	$ 71,542
Marketable securities		79,942
Accounts receivable, net of allowance of $1,940 and $1,924, respectively	24,957	20,105
Inventory, net of allowance of $1,377 and $3,080, respectively	10,683	19,604
Deferred customer acquisition costs, current	25,958	18,992
Prepaid expenses and other current assets	28,681	21,498
Restricted cash	2,185	
Total current assets	204,731	231,683
Property and equipment, net of accumulated depreciation	103,465	118,666
Deferred customer acquisition costs, non-current	23,392	39,159
Deferred financing costs, net	690	3,172
Restricted cash	39,799	38,928
Due from related parties		2
Intangible assets, net	6,109	7,656
Other assets	51,450	23,031
Total assets	$ 429,636	$ 462,297
Liabilities and Stockholders Equity (Deficit)		
Liabilities		
Current liabilities:		
Accounts payable	$ 47,775	$ 56,235
Accrued expenses	82,621	84,360
Deferred revenue, current portion	67,844	53,653
Current maturities of capital lease obligations	1,195	1,035
Convertible notes, net	253,413	253,320
Total current liabilities	452,848	448,603
Deferred revenue, net of current portion	26,382	43,575
Capital lease obligations, net of current maturities	21,288	22,200
Other liability, net of current portion in accrued expenses	19,116	23,046
Total liabilities	519,634	537,424
Commitments and Contingencies		
Stockholders Equity (Deficit)		

Common stock, par value $0.001 per share; 596,950 shares authorized at September 30, 2008 and December 31, 2007;		
158,027 and 157,414 shares issued at September 30, 2008 and December 31, 2007, respectively;		
156,500 and 156,014 shares outstanding at September 30, 2008 and December 31, 2007, respectively	158	157
Additional paid-in capital	939,850	930,600
Stock subscription receivable	(5,195)	(5,266)
Accumulated deficit	(1,011,945)	(988,285)
Treasury stock, at cost, 1,527 shares at September 30, 2008 and 1,400 shares at December 31, 2007	(12,676)	(12,499)
Accumulated other comprehensive income (loss)	(190)	166
Total stockholders Equity (Deficit)	(89,998)	(75,127)
Total liabilities and stockholders Equity (Deficit)	$ 429,636	$ 462,297

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

1

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts)

(Unaudited)

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Operating Revenues:				
Telephony services	$ 216,092	$ 203,724	$ 651,810	$ 593,561
Customer equipment and shipping	9,678	6,810	26,101	18,815
	225,770	210,534	677,911	612,376
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization of $4,908, $4,312, $14,337 and $12,616, respectively)	56,502	54,463	169,586	162,364
Royalty		11,139		32,606
Total direct cost of telephony services	56,502	65,602	169,586	194,970
Direct cost of goods sold	20,835	17,057	61,440	41,633
Selling, general and administrative	73,035	214,139	230,358	382,933
Marketing	64,911	61,885	191,110	220,641
Depreciation and amortization	13,347	8,563	34,670	24,613
	228,630	367,246	687,164	864,790
Loss from operations	(2,860)	(156,712)	(9,253)	(252,414)
Other Income (Expense):				
Interest income	544	4,238	2,965	15,066
Interest expense	(5,504)	(5,424)	(16,610)	(15,700)
Other, net	46	(36)	(66)	(69)
	(4,914)	(1,222)	(13,711)	(703)
Loss before income tax benefit (expense)	(7,774)	(157,934)	(22,964)	(253,117)
Income tax benefit (expense)	(43)	(94)	(696)	(471)
Net loss	$ (7,817)	$ (158,028)	$ (23,660)	$ (253,588)
Net loss per common share:				
Basic and diluted	$ (0.05)	$ (1.01)	$ (0.15)	$ (1.63)
Weighted-average common shares outstanding:				
Basic and diluted	156,299	155,784	156,146	155,482

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

2

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Cash flows from operating activities:		
Net loss	$ (23,660)	$ (253,588)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization and impairment charges	32,563	23,159
Amortization of intangibles	2,107	1,454
Beneficial conversion on interest in kind on convertible notes	93	32
Accrued interest	804	597
Allowance for doubtful accounts	(63)	1,087
Allowance for obsolete inventory	1,116	1,443
Amortization of deferred financing costs	2,482	1,490
Loss on disposal of fixed assets	12	118
Share-based expense	9,203	5,879
Changes in operating assets and liabilities:		
Accounts receivable	(4,847)	(6,220)
Inventory	7,747	3,350
Prepaid expenses and other current assets	(10,591)	(8,047)
Deferred customer acquisition costs	8,661	(8,284)
Due from related parties	2	74
Other assets	633	185
Accounts payable	(11,244)	(1,108)
Accrued expenses	(2,188)	106,147
Deferred revenue	(2,729)	17,243
Other liability	(3,930)	26,000
Net cash provided by (used in) operating activities	6,171	(88,989)
Cash flows from investing activities:		
Capital expenditures	(8,417)	(19,981)
Purchase of intangible assets	(560)	
Purchase of marketable securities	(21,375)	(210,325)
Maturities and sales of marketable securities	101,316	351,032
Acquisition and development of software assets	(23,589)	(12,737)
Increase in restricted cash	(3,162)	(101,160)
Net cash provided by (used in) investing activities	44,213	6,829
Cash flows from financing activities:		
Principal payments on capital lease obligations	(752)	(754)
Debt related costs	(8,601)	
Proceeds from subscription receivable, net	9	279
Proceeds from directed share program, net	62	169
Proceeds from exercise of stock options	48	780

Net cash provided by (used in) financing activities	(9,234)	474
Effect of exchange rate changes on cash	(425)	443
Net change in cash and cash equivalents	40,725	(81,243)
Cash and cash equivalents, beginning of period	71,542	210,253
Cash and cash equivalents, end of period	$ 112,267	$ 129,010
Supplemental disclosures of cash flow information:		
Cash paid during the periods for:		
Interest	$ 14,033	$ 15,167
Income taxes	$ 696	$ 471

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

Table of Contents

VONAGE HOLDINGS CORP.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY (DEFICIT)

(In thousands)

(Unaudited)

	Common Stock	Additional Paid-in Capital	Stock Subscription Receivable	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income (loss)	Total
Balance at December 31, 2007	$ 157	$ 930,600	$ (5,266)	$ (988,285)	$ (12,499)	$ 166	$ (75,127)
Stock option exercises	1	47					48
Share-based expense		9,203					9,203
Share-based award activity					(177)		(177)
Directed share program transactions, net			62				62
Stock subscription receivable payments			9				9
Comprehensive loss:							
Change in unrealized gain (loss) on available-for-sale investments						(1)	(1)
Foreign currency translation adjustment						(355)	(355)
Net loss				(23,660)			(23,660)
Total comprehensive income (loss)				(23,660)		(356)	(24,016)
Balance at September 30, 2008	$ 158	$ 939,850	$ (5,195)	$ (1,011,945)	$ (12,676)	$ (190)	$ (89,998)

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

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 1. Basis of Presentation and Significant Accounting Policies

Nature of Operations

Vonage Holdings Corp. (Vonage , Company , we , our , us) is incorporated as a Delaware corporation. We are a provider of broadband Voice o Internet Protocol (VoIP) services to residential and small business and home office customers. We launched service in the United States in October 2002, in Canada in November 2004 and in the United Kingdom in May 2005.

We have incurred operating losses since our inception and have an accumulated deficit at September 30, 2008 of $1,011,945. For the nine months ended September 30, 2008, we had cash flows from operating activities of $6,171. Our primary source of funds to date has been through the issuance of equity and debt securities, including net proceeds from our initial public offering (IPO) in May 2006.

Going Concern

Our consolidated financial statements as of September 30, 2008 and December 31, 2007 have been prepared under the assumption that we will continue as a going concern for the twelve months ending December 31, 2008. Our independent registered public accounting firm s report dated March 17, 2008 on our 2007 financial statements included an explanatory paragraph referring to our $217,000 working capital deficit caused primarily by $253,460 of convertible notes (Notes) due December 1, 2010 classified as a current liability since they could have been put to us on December 16, 2008 and expressing substantial doubt as to our ability to continue as a going concern without refinancing them or obtaining additional debt or equity capital.

As of September 30, 2008, we had a working capital deficit of $248,117 caused primarily by $253,460 of Notes being classified as a current liability since they could have been put by the holders on December 16, 2008. On October 19, 2008, we entered into definitive agreements for a financing consisting of (i) a $130,300 senior secured first lien credit facility (the First Lien Senior Facility), including an original issuance discount of $7,200, (ii) a $72,000 senior secured second lien credit facility (the Second Lien Senior Facility) and (iii) the sale of $18,000 of the Company s 20% senior secured third lien notes due 2015 (the Convertible Notes and, together with the First Lien Senior Facility and the Second Lien Senior Facility, the Financing). The Financing was consummated on November 3, 2008. We used the net proceeds of the Financing, plus cash on hand, to repurchase $253,460 of Notes in a tender offer.

Unaudited Interim Financial Information

The accompanying unaudited interim consolidated financial statements and information have been prepared in accordance with accounting principles generally accepted in the United States and in accordance with the instructions for Form 10-Q. Accordingly, they do not include all of the information and disclosures required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, these financial statements contain all normal and recurring adjustments considered necessary to present fairly the financial position, results of operations, cash flows and statement of stockholders equity (deficit) for the periods presented. The results for the three and nine month periods ended September 30, 2008 are not necessarily indicative of the results to be expected for the full year.

These unaudited interim consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in our 2007 Annual Report on Form 10-K filed with the Securities and Exchange Commission on March 17, 2008.

Significant Accounting Policies

Basis of Consolidation

The consolidated financial statements include the accounts of Vonage and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported and disclosed in the consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

On an ongoing basis, we evaluate our estimates, including the following:

- those related to the average period of service to a customer (the customer relationship period) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation. For 2007, the estimated customer relationship period was 60 months. For 2008, due to the increase in churn, the customer relationship period was reduced to 48 months;

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

- the useful lives of property and equipment and intangible assets; and
- assumptions used for the purpose of determining stock-based compensation using the Black-Scholes option model (Model). The key inputs for this Model are stock price at valuation date, strike price for the option, the dividend yield, risk-free interest rate, life of an option in years and volatility.

We base our estimates on historical experience, available market information, appropriate valuation methodologies, and on various other assumptions that we believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Restricted Cash and Letters of Credit

Our credit card processors have established reserves to cover any exposure that they may have as we collect revenue in advance of providing services to our customers, which is a customary practice for companies that bill their customers in advance of providing services. As such, we provided our credit card processors with cash reserves of $22,237 and a cash collateralized letter of credit for $10,413 as of September 30, 2008. We also had a cash collateralized letter of credit for $7,000 as of September 30, 2008 and December 31, 2007 related to lease deposits for our offices. The total amount of collateralized letters of credit was $17,562 and $17,254 at September 30, 2008 and December 31, 2007, respectively. In the aggregate, cash reserves and collateralized letters of credit of $39,799 and $38,928 were recorded as long-term restricted cash at September 30, 2008 and December 31, 2007, respectively. In addition, we had outstanding a cash collateralized letter of credit for $2,185 for our appeal of state taxes due which was classified as short-term restricted cash at September 30, 2008 as it was released in October 2008.

Software Costs

We capitalize certain costs, such as purchased software and internally developed software that we use for customer acquisition and customer care automation tools, in accordance with Statement of Position 98-1, *Accounting for Costs of Computer Software Development or Obtained for Internal Use.* These costs are classified as Other Assets in the consolidated balance sheets. Computer software is stated at cost less accumulated amortization and the estimated useful life is three years. Total computer software was $51,650 and $29,277 at September 30, 2008 and December 31, 2007, substantially all of which were external costs respectively. Accumulated amortization was $15,514 and $7,678 at September 30, 2008 and December 31, 2007. Amortization expense was $4,322 and $1,023 for the three months ended September 30, 2008 and 2007, respectively, and $9,052 and $2,547 for the nine months ended September 30, 2008 and 2007, respectively.

Long-Lived Assets

We review the carrying values of our property and equipment for possible impairment whenever circumstances indicate the carrying amount of an asset may not be recoverable. An impairment loss is recognized to the extent the sum of the undiscounted estimated future cash flow expected to result from the use of the asset is less than the carrying value. For the three and nine months ended September 30, 2008, we incurred an impairment loss of $1,447 and $1,847, respectively, for certain network equipment, computer hardware costs and capitalized software that no longer had future benefit. This impairment loss was recorded in the statement of operations as part of depreciation expense.

Intangible Assets

Intangible assets acquired in the settlement of litigation or by direct purchase are accounted for based upon the fair value of assets received.

Patents

In June 2006, we purchased three patents related to the compression of packetized digital signals commonly used in Voice over Internet Protocol (VoIP) technology at a cost of $5,268. In July 2006, we began amortizing the cost of these patents over their estimated useful lives of 2.7 years. Amortization expense was $484 for the three months ended September 30, 2008 and 2007, and $1,453 for the nine months ended September 30, 2008 and 2007, respectively. Annual amortization will be approximately $1,940.

In October 2007, in connection with the settlement of our patent litigation with Sprint, we acquired a license to use Sprint s portfolio of Voice over Packet patents. The fair value assigned to these patents was $5,500. We began amortizing the cost of these patents in October 2007 over their patent lives of 6.6 years. Amortization expense was $206 and $619 for the three and nine months ended September 30, 2008, respectively. Annual amortization will be approximately $825.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Trademark

In April 2008, in connection with the settlement of a trademark dispute, we acquired the right to use the trademark in question. The fair value assigned to the trademark was $560. This trademark is being amortized over its remaining life of 8 years. Amortization expense was $17 and $35 for the three and nine months ended September 30, 2008. Annual amortization will be approximately $70.

Convertible Notes

As of September 30, 2008, the carrying amount of our convertible notes approximate fair value since a tender offer was outstanding to purchase the convertible notes at par value. The convertible notes were repurchased at par value on November 3, 2008.

Loss per Share

Basic and diluted loss per common share is calculated by dividing loss to common stockholders by the weighted average number of common shares outstanding during the period. The effects of potentially dilutive common shares, including shares issued under outstanding warrants and for restricted stock units and stock options issued under our 2001 Stock Incentive Plan and 2006 Incentive Plan using the treasury stock method, have been excluded from the calculation of diluted loss per common share because of their anti-dilutive effects.

The following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

	Three and Nine Months Ended September 30, 2008	2007
Common stock warrants	514	3,085
Convertible notes	17,824	17,824
Restricted stock units	3,306	3,797
Employee stock options	29,593	19,116
	51,237	43,822

Recent Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB), affirmed the consensus of FASB Staff Position (FSP) Accounting Principles Board Opinion No. 14-1 (APB 14-1), *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*, which applies to all convertible debt instruments that have a net settlement feature; which means that such convertible debt instruments, by their terms, may be settled either wholly or partially in cash upon conversion. FSP APB 14-1 requires issuers of convertible debt instruments that may be settled wholly or partially in cash upon conversion to separately account for the liability and equity components in a manner reflective of the issuer s nonconvertible debt borrowing rate. Previous guidance provided for accounting for this type of convertible debt instrument entirely as debt. FSP APB 14-1 is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We are evaluating if the adoption of FSP APB 14-1 will have a material impact on our financial statements.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162 (SFAS No. 162), *The Hierarchy of Generally Accepted Accounting Principles.* SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles. SFAS No. 162 becomes effective 60 days following the Securities and Exchange Commission s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles.* We do not expect that the adoption of SFAS No. 162 will have a material impact on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS No. 159), *The Fair Value Option for Financial Assets and Financial Liabilities*. Under SFAS No. 159, companies may elect to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 was effective for us beginning in the first quarter of 2008. We currently do not have any instruments eligible for election of the fair value option. Therefore, the adoption of SFAS No. 159 in the first quarter of 2008 did not impact our consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS No. 157), *Fair Value Measurements* , which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements and is effective for fiscal years beginning after November 15, 2007. In February 2008, the

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

FASB issued FASB FSP 157-2, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. These nonfinancial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. Effective January 1, 2008, we adopted SFAS No. 157 for financial assets and liabilities recognized at fair value on a recurring basis. The partial adoption of SFAS No. 157 for financial assets and liabilities did not have a material impact on our consolidated financial position, results of operations or cash flows.

Note 2. Commitments and Contingencies

Litigation

State Attorney General Proceedings. On June 19, 2008, Vonage learned that a group of approximately twenty-six states attorney generals had begun an investigation into certain of our business practices. By October 15, 2008, we received 19 document requests, and expect to receive additional requests, from most, if not all, of the participating states. The requests seek information that Vonage previously produced to the Wisconsin Attorney General as part of an investigation commenced in November 2007, which consisted of, among other things, sales and retention marketing scripting, advertising disclosures, and information related to our money back guarantee. The most recent requests also seek information related to marketing and billing practices, as well as early termination fees. To date, none of the attorney generals have filed a complaint against us or taken other formal action. We are unable to predict whether a formal action will be filed against us. We intend to fully cooperate in the investigation.

IPO Litigation. During June and July 2006, Vonage, several of our officers and directors, and the firms who served as the underwriters in our IPO were named as defendants in several purported class action lawsuits arising out of our IPO. On January 9, 2007, the Judicial Panel on Multidistrict Litigation transferred all complaints to the District of New Jersey. On September 7, 2007, the Court appointed Zyssman Group as the lead plaintiff, and the law firm of Zwerling, Schachter and Zwerling, LLP as lead counsel. On November 19, 2007, the plaintiffs filed the Amended Complaint, which generally alleges: (i) defendants made misstatements regarding subscriber line growth and average monthly churn rate; (ii) defendants failed to disclose problems with facsimile transmissions and a pending fax litigation case; (iii) defendants failed to disclose all patent infringement claims and issues; and (iv) that the Directed Share Program suffered from various infirmities. On January 18, 2008, defendants filed their motions to dismiss the Amended Complaint, and briefing on the matter was completed by April 2, 2008, and the Court heard oral argument on October 10, 2008. The Court has not yet ruled on the motion. The firms who served as underwriters to the IPO, pursuant to an indemnification agreement entered into between us and those firms prior to the IPO, have demanded that Vonage reimburse them for the costs and fees incurred by them in defense of the IPO litigation. In addition, three of the firms have demanded that Vonage reimburse them for the costs and fees incurred by them in response to various regulatory inquiries by the Financial Industry Regulatory Authority (formerly the NASD) and the New York Stock Exchange, among other things. Vonage has declined to reimburse these three firms any fees or expenses.

Consumer Class Action Litigations. We have been named in several purported class actions venued in California, New Jersey, and Washington alleging a wide variety of deficiencies with respect to our business practices, marketing disclosures, email marketing and quality issues for both phone and fax service.

For example, there are various class actions, on behalf of both nationwide and state classes, pending in New Jersey, Washington and California generally alleging that we delayed and/or refused to allow consumers to cancel their Vonage service; failed to disclose procedural impediments to cancellation; failed to adequately disclose that their 30-day money back guarantee does not give consumers 30 days to try out our services; suppressed and concealed the true nature of our services and disseminated false advertising about the quality, nature and terms of our services; imposed an unlawful early termination fee; and invoked unconscionable provisions of our Terms of Service to the detriment of customers. On May 11, 2007, plaintiffs in one action petitioned the Judicial Panel on Multidistrict Litigation (the Panel), seeking transfer and consolidation of the pending actions to a single court for coordinated pretrial proceedings. In an Order dated August 15, 2007, the Panel transferred the pending actions to the United States Court for the District of New Jersey, captioned *In re Vonage Marketing and Sales Practices Litigation*, MDL No. 1862, Master Docket No. 07-CV-3906 (USDC, D.N.J.). On October 1, 2007, counsel for one group of plaintiffs moved before the Court for

Consolidation and Appointment of Co-Lead Counsel of the actions, and requested time to file an Amended Consolidated Complaint. The Court has not yet ruled on the motion.

Nebraska Public Service Commission. On November 15, 2007, the Director of the Nebraska Telecommunications Infrastructure and Public Safety Department of the Nebraska Public Service Commission filed a complaint (the PSC Complaint) before the Nebraska Public Service Commission (the NPSC) alleging that Vonage is required to contribute to the Nebraska Universal Service Fund (NUSF) and has failed to do so. The PSC Complaint seeks an order compelling Vonage to contribute to the NUSF, as well as administrative penalties. Vonage is vigorously defending itself against the PSC Complaint. On December 6, 2007,

8

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Vonage filed its answer. On or about December 20, 2007, Vonage also brought a complaint for declaratory and injunctive relief against the NPSC in the United States District Court for the District of Nebraska. On March 3, 2008, the United States District Court for the District of Nebraska issued a Memorandum and Order granting Vonage s Motion for a Preliminary Injunction and Declaratory Relief. Specifically, the Court enjoined the NPSC from asserting state jurisdiction over Vonage to force Vonage to contribute to the NUSF and found the NPSC s assertion of state jurisdiction over Vonage to force Vonage to pay into the NUSF is unlawful as preempted by the Federal Communications Commission (FCC). On April 1, Nebraska filed a Notice of Appeal to the 8th Circuit Court of Appeals. On April 2, Vonage filed a motion for summary judgment in the district court, arguing the court should grant our permanent injunction. The district court, in a May 9, 2008 order, denied Vonage s request for summary judgment without prejudice. Briefing before the 8th Circuit Court of Appeals has been completed. It is unknown whether the Court of Appeals for the 8th Circuit will grant oral argument or when the parties can expect a decision.

New Mexico Public Service Commission. On June 27, 2008, the New Mexico Public Regulation Commission (NMPRC) filed a complaint for Declaratory Judgment (NMPRC Complaint) in the United States District Court for the District of New Mexico, alleging that Vonage is required to contribute to the New Mexico Universal Service Fund (NMUSF) and failed to do so. The NMPRC Complaint seeks an order compelling Vonage to contribute to the NMUSF. Vonage is vigorously defending itself against the NMPRC Complaint. On or about July 21, 2008, Vonage filed a Motion to Dismiss the NMPRC Complaint. The NMPRC filed a response to the Motion to Dismiss. It is not known when the parties can expect a decision on the Motion to Dismiss.

City of New York vs. Verizon and Vonage. On April 21, 2008, the City of New York and the Sheriff of the City of New York filed a complaint (NYC Complaint) in New York State Court against Verizon and Vonage, arising out of collection efforts on the $58,000 judgment entered against Vonage in the *Verizon vs. Vonage* patent litigation. The City alleges that either Verizon or Vonage is liable for $2,900, which represents a poundage fee of 5% of the value of the property sought to be levied upon. On May 13, 2008, Vonage filed a motion to dismiss one count of the NYC Complaint. On May 16, 2008, Verizon filed a motion to dismiss the NYC Complaint in its entirety. The Court denied both motions and the parties are currently engaged in discovery.

From time to time, in addition to those identified above, Vonage is subject to legal proceedings, claims, investigations and proceedings in the ordinary course of business, including claims of alleged infringement of third-party patents and other intellectual property rights, commercial, employment and other matters. In accordance with generally accepted accounting principles, Vonage makes a provision for a liability when it is both probable that a liability has been incurred and the amount of the loss or range of loss can be reasonably estimated. These provisions are reviewed at least quarterly and adjusted to reflect the impacts of negotiations, settlements, rulings, advice of legal counsel, and other information and events pertaining to a particular case. Litigation is inherently unpredictable. We believe that we have valid defenses with respect to the legal matters pending against Vonage. Given the uncertainty surrounding litigation and our inability to assess the likelihood of a favorable or unfavorable outcome in the above noted matters, it is possible that the resolution of one or more of these matters could have a material adverse effect on our consolidated financial position, cash flows or results of operations.

Regulation

Telephony services are subject to a broad spectrum of state and federal regulations. Because of the uncertainty over whether VoIP should be treated as a telecommunications or information service, we have been involved in a substantial amount of state and federal regulatory activity. Implementation and interpretation of the existing laws and regulations is ongoing and is subject to litigation by various federal and state agencies and courts. Due to the nature of the technology in use, there can be no assurance that we will not be subject to new regulations or existing regulations under new interpretations, and that such change would not introduce material additional costs to our business.

Federal - Local Number Portability

On November 8, 2007, the FCC released its Order extending Local Number Portability (LNP) obligations to interconnected VoIP providers. The Order was published in the Federal Register on February 21, 2008, and the LNP requirement for interconnected VoIP providers became effective on March 24, 2008.

In addition, the FCC held that validation of LNP requests should be based on no more than four fields for simple ports and those fields should be: (1) 10-digit telephone number; (2) customer account number; (3) 5-digit zip code; and (4) pass code (if applicable). This part of the Order was to become effective on February 6, 2008. On January 11, 2008, Embarq, a local telecommunications carrier, filed a petition asking that the FCC waive the effective date of the four field validation requirement until it implements a new billing system. On February 5, 2008, the FCC waived the requirement for Embarq to comply with the four field validation requirement until September 30, 2008. The FCC also, on its own motion, waived the February 6, 2008 deadline for all other affected companies until July 31, 2008.

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Vonage currently provides LNP. Vonage occasionally faces difficulties in executing port requests in a timely manner. If Vonage is not able to implement port requests in a timely manner after the effective date of the LNP requirement for interconnected VoIP providers, Vonage could be subject to complaints at the FCC and/or an enforcement action by the FCC.

Federal - Disability Access

On September 15, 2007, the FCC released its Order extending the disability access requirements of Section 255 and 225 to interconnected VoIP services and to manufacturers of specially designed equipment used to provide VoIP services. The Order also required interconnected VoIP providers to contribute to the TRS Fund and offer 711 dialing for access to relay services. Vonage has complied effective October 5, 2007.

On October 9, 2007, the FCC s Consumer and Governmental Affairs Bureau issued an Order granting in part several waiver requests related to VoIP 711 dialing. The Order waives for six months the requirement that interconnected VoIP service providers transmit 711 calls to an appropriate relay provider. On April 4, 2008, the Consumer and Governmental Affairs Bureau extended the waiver until June 30, 2009 for nomadic VoIP providers like Vonage. Under the direction of the FCC waiver, Vonage, as an interconnected VoIP service, is providing reminders to subscribers to dial 911 directly in the event of an emergency.

Federal - E-911

On September 3, 2005, the FCC released its VoIP E-911 Order. Pursuant to the Order, we were required (i) to notify our customers of the differences between the emergency services available through us and those available through traditional telephony providers and to receive affirmative acknowledgment from all of our customers that they understand the nature of the emergency services available through our service and (ii) to provide E-911 services to 100% of our subscribers by November 28, 2005. We have received affirmative acknowledgment from substantially all of our customers that they understand our emergency services and therefore we are substantially in compliance with both aspects of the Order. On November 28, 2005, we filed a petition for extension of time and limited waiver of certain of the enhanced emergency service requirements. To the extent the waiver is necessary and remains ungranted, we are at risk of an enforcement action including fines, penalties and/or an order to cease and desist selling and marketing our services in certain areas where E-911 service is unavailable. We regularly update the FCC on our E-911 deployment efforts. As of September 30, 2008, we have deployed E-911 service to approximately 99% of our U.S. customer base.

On July 23, 2008, the President signed the New and Emerging Technologies 911 Improvement Act of 2008 (NET 911 Act) into law. The Act codifies the requirements adopted by the FCC in the VoIP E-911 Order. In addition, the Act provides that IP-enabled voice service providers shall have the same protection from liability for the provision of 911 service as wireless providers and local exchange carriers. Previously, Vonage did not have this protection. Further, the Act provides that IP-enabled voice service providers shall have access to the elements necessary to provide 911 service at the same rates, terms, and conditions as wireless providers. Previously, incumbent local exchange carriers, public service answering points, and others that control these elements were not required to provide access to IP-enabled voice service providers. Under the Act, the FCC must adopt rules to implement the access provisions of the Act within ninety days of July 23, 2008. On October 21, 2008, the FCC released its order implementing the NET 911 Act.

Federal - CALEA

On August 5, 2005, the FCC released an Order extending the obligations of Communications Assistance for Law Enforcement Act (CALEA) to interconnected VoIP providers. Under CALEA, telecommunications carriers must assist law enforcement in executing electronic surveillance, which include the capability of providing call content and call-identifying information to a local enforcement agency, or LEA, pursuant to a court order or other lawful authorization.

The FCC required all interconnected VoIP providers to become fully CALEA compliant by May 14, 2007. To date, we have taken significant steps towards CALEA compliance, which include testing the CALEA solution with the FBI and delivering lawful CALEA requests. We have also implemented alternative solutions that allow CALEA access to call content and call-identifying information. The FCC and law enforcement officials have been advised as to our CALEA progress and our efforts at implementing alternative solutions. We could be subject to an enforcement action by the FCC if our CALEA solution is deemed not fully operational.

Federal - CPNI

On April 2, 2007, the FCC released its Order extending the application of the customer proprietary network information (CPNI) rules to interconnected VoIP providers. The FCC s CPNI rules were published with an effective date of December 8, 2007. CPNI includes information such as the phone numbers called by a consumer; the frequency, duration, and timing of such calls; and any services/features purchased by the consumer, such as call waiting, call forwarding, and caller ID.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Under the FCC s existing rules, carriers may not use CPNI without customer approval except in circumstances related to their provision of existing services, and must comply with detailed customer approval processes when using CPNI outside of these circumstances. The new CPNI requirements are aimed at establishing more stringent security measures for access to a customer s CPNI data in the form of enhanced passwords for on-line access and call-in access to account information as well as customer notification of account or password changes.

At the present time we do not utilize our customer s CPNI in a manner which would require us to obtain consent from our customers, but in the event that we do in the future, we will be required to adhere to specific CPNI rules aimed at marketing such services. Vonage has implemented additional security measures for CPNI designed to address the new requirements.

State Telecommunications Regulation

In general, the focus of interconnected VoIP telecommunications regulation is at the federal level. On November 12, 2004, the FCC declared that our service is subject to federal regulation and preempted the Minnesota Public Utilities Commission, or MPUC, from imposing certain of its regulations on us. The FCC s decision was based on its conclusion that our service is interstate in nature and cannot be separated into interstate and intrastate components. On March 21, 2007, the United States Court of Appeals for the 8th Circuit affirmed the FCC s declaratory ruling preempting state regulation of Vonage s service. The 8th Circuit found that it is impossible for Vonage to separate its interstate traffic from its intrastate traffic because of the nomadic nature of the service. As a result, the 8th Circuit held that it was reasonable for the FCC to preempt state regulation of Vonage s service. The 8th Circuit was clear, however, that the preemptive effect of the FCC s declaratory ruling may be reexamined if technological advances allow for the separation of interstate and intrastate components of the nomadic VoIP service. Therefore, the preemption of state authority over Vonage s service hinges on the inability to separate the interstate and intrastate components of the service.

While this ruling does not exempt us from all state oversight of our service, it effectively prevents state telecommunications regulators from imposing certain burdensome and inconsistent market entry requirements and certain other state utility rules and regulations on our service. State regulators continue to probe the limits of federal preemption in their attempts to apply state telecommunications regulation to interconnected VoIP service. The Nebraska Public Service Commission and New Mexico Public Regulatory Commission cases, discussed above under the Litigation section to this note, are examples of state public utility commission attempts to extend traditional state telecommunications regulation to our service. In these cases, the state public utility commissions are seeking to apply state universal service funding requirements to Vonage. Kansas has also asserted that they have jurisdiction to seek state universal service funding from interconnected VoIP providers. Similarly, the Public Utility Commission of Ohio has proposed rules that would apply state fees for Telephone Relay Service to interconnected VoIP service. We expect that state public utility commissions will continue their attempts to apply state telecommunications regulations to interconnected VoIP service.

State and Municipal Taxes

Vonage vs. Commonwealth of Pennsylvania. On January 8, 2008, Vonage filed a Petition for Review with the Pennsylvania Commonwealth Court, arising out of the Pennsylvania Department of Revenue s assessment of Sales and Use Tax (Assessment) against Vonage. The total amount of the tax at issue, including interest, is $2,003. On March 6, 2008, in order to stay enforcement of the Assessment and proceed with the litigation, Vonage filed with the Court a letter of credit for 120% of the Assessment ($2,185). On September 18, 2008, the parties filed a Stipulation of Judgment, reflecting that the matter has been resolved for $680.

For a period of time, we did not collect or remit state or municipal taxes (such as sales, excise, and ad valorem taxes), fees or surcharges (Taxes) on the charges to our customers for our services, except that we have historically complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal taxing and 911 agencies seeking payment of Taxes that are applied to or collected from customers of providers of traditional public switched telephone network services. Although we have consistently maintained that these Taxes do not apply to our service for a variety of reasons depending on the statute or rule that establishes such obligations, a number of states have changed their statutes as part of the streamlined sales tax initiatives and we are now collecting and remitting sales taxes in those states. In addition, a few states address how VoIP providers should contribute to support public safety agencies, and in those states we began to remit fees to the appropriate state agencies. We have also contacted authorities in each of the other states to discuss how we can financially contribute to the 911 system. We do not know how all these discussions will be resolved, but there is a possibility that we will be required to pay or collect and remit some or all of these Taxes in the future. Additionally, some of these Taxes could apply to us retroactively. As such, we have a reserve of $3,062 at September 30, 2008 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is $11,683 as of September 30, 2008.

Table of Contents

VONAGE HOLDINGS CORP.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(In thousands, except per share amounts)

(Unaudited)

Note 3. Subsequent Events

Convertible Notes Refinancing

On October 19, 2008, we entered into definitive agreements for a financing consisting of (i) a $130,300 senior secured first lien credit facility (the First Lien Senior Facility), including an original issuance discount of $7,200, (ii) a $72,000 senior secured second lien credit facility (the Second Lien Senior Facility) and (iii) the sale of $18,000 of the Company s 20% senior secured third lien notes due 2015 (the Convertible Notes and, together with the First Lien Senior Facility and the Second Lien Senior Facility, the Financing). The Financing was consummated on November 3, 2008.

The First Lien Senior Facility, the Second Lien Senior Facility and the Note Purchase Agreement governing the Convertible Notes contain various covenants and other restrictions that limit our ability and/or the ability of certain of our subsidiaries to engage in specified types of transactions. These covenants and other restrictions may under certain circumstances limit, but not necessarily preclude, our and certain of our subsidiaries ability to, among other things: incur, prepay, refinance or modify indebtedness; create liens; pay dividends on or repurchase our capital stock or make other restricted payments; make investments; enter into acquisitions, sales and mergers; enter into sale and leaseback transactions; amend our organizational documents, or amend, modify or waive litigation settlements, key employment agreements or other material contracts; incur marketing expenses in excess of specified thresholds; change the nature of our business or enter into additional lines of business; and enter into transactions with our stockholders and affiliates.

Under the Financing agreements, we are required to maintain a specified minimum fixed charge coverage ratio, maximum leverage ratio and senior secured debt leverage ratio. Additionally, these agreements require us to maintain minimum levels of consolidated adjusted EBIDTA, liquidity and pre-marketing operating income and limit our capital expenditures. Upon the repayment of our obligations under the First Lien Senior Facility and the Second Lien Senior Facility, the covenants will fall-away, but the Note Purchase Agreement for the Convertible Notes will continue to limit our ability to incur indebtedness and make restricted payments. Our ability to comply with such financial and other covenants can be affected by events beyond our control, so we may not be able to comply with these covenants. A breach of any financial or other covenants could result in a default under these agreements. In that case, the lenders and the noteholders could elect to declare due and payable immediately all amounts due under the Financing agreements, including principal, accrued interest, a make-whole premium and, in the case of the Convertible Notes, liquidated damages, and may take action to foreclose upon the collateral securing the indebtedness.

We used the net proceeds of the Financing, plus cash on hand, to repurchase $253,460 of our pre-existing convertible notes in a tender offer. We estimate that we have incurred and will incur aggregate costs in connection with the Financing, including all fees and expenses, of between $28,000 and $31,000 of which $12,305 was incurred through September 30, 2008 and included in Other Assets in the consolidated balance sheet. We are in the process of determining the accounting impact of the Financing and subsequent extinguishment of the pre-existing convertible notes. Depending on the fair market value of the Financing and mutual lenders in the Financing and pre-existing convertible notes, there may be a material debt extinguishment charge in the fourth quarter. Except for certain fees paid directly to lenders in the Financing which will be included in the debt extinguishment charge, the balance of the fees and expenses are expected to be amortized over the term of the Financing, using the effective interest method.

Table of Contents

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

You should read the following discussion together with our consolidated financial statements and the related notes included elsewhere in this Form 10-Q and our audited financial statements included in our Annual Report on Form 10-K. This discussion contains forward-looking statements. These forward-looking statements are based on information available at the time the statements are made and/or management s belief as of that time with respect to future events and involve risks and uncertainties that could cause actual results and outcomes to be materially different. Important factors that could cause such differences including but not limited to the Company s history of net operating losses and the Company s need for cash to finance the Company s growth; worsening economic conditions; restrictions in our debt agreements that may limit our operating flexibility; results of pending litigation and intellectual property and other litigation that may be brought against us; the competition we face; our dependence on our customers existing broadband connections; differences between our service and traditional phone services, including our 911 service; uncertainties relating to regulation of VoIP services; system disruptions or flaws in our technology; the risk that VoIP does not gain broader acceptance; and other factors that are set forth in the Risk Factors in our Annual Report on Form 10-K, in our Quarterly Reports on Form 10-Q and in our Current Reports on Form 8-K. While we may elect to update forward-looking statements at some point in the future, we specifically disclaim any obligation to do so, and therefore, you should not rely on these forward-looking statements as representing our views as of any date subsequent to today.

Overview

We are a leading provider of broadband telephone services with over 2.6 million subscriber lines as of September 30, 2008. Our services use Voice over Internet Protocol, or VoIP, technology, which enables voice communications over the Internet through the conversion and compression of voice signals into data packets. In order to use our service offerings, customers must have access to a broadband Internet connection with sufficient bandwidth (generally 60 kilobits per second or more) for transmitting those data packets.

We earn revenue and generate cash primarily through our broadband telephone service plans, each of which offers a different pricing structure based on a fixed monthly or annual fee. We generate most of our revenue from those fees, substantially all of which we bill to our customers credit cards, debit cards or electronic check payments, or ECP, one month in advance.

We have invested heavily in an integrated marketing strategy to build brand awareness and drive response rates that supports our sales and distribution efforts. We acquire customers through a number of sales channels, including our websites, toll free numbers, kiosks in shopping malls and a presence in major retailers located in the United States, Canada and the United Kingdom. We also acquire new customers through Refer-a-Friend, our online customer referral program.

We launched our service in the United States in October 2002, in Canada in November 2004 and in the United Kingdom in May 2005. Since our U.S. launch, we initially experienced rapid revenue and subscriber line growth, which has slowed in recent quarters. While our revenue has grown, we have incurred an accumulated deficit of $1,011,945 from our inception through September 30, 2008. Although our net losses initially were driven primarily by start-up costs and the cost of developing our technology, more recently our net losses have been driven by patent litigation settlements and investments in marketing. In addition, we plan to continue to invest in research and development and customer care. In 2007, we announced we are seeking to balance growth with profitability. We intend to continue to pursue investments in growth marketing because we believe it will position us as a strong competitor in the long term. Although we believe we will achieve net income in the future, we ultimately may not be successful and we may never achieve net income.

Recent Developments Related to Our Convertible Notes Refinancing

As of September 30, 2008, we had a working capital deficit of $248,117, caused primarily by $253,460 of Notes due December 1, 2010 (Notes) being classified as a current liability since they could have been put to us by the holders on December 16, 2008. On October 19, 2008, we entered into definitive agreements for a financing consisting of (i) a $130,300 senior secured first lien credit facility (the First Lien Senior Facility), including an original issuance discount of $7,200, (ii) a $72,000 senior secured second lien credit facility (the Second Lien Senior Facility) and (iii) the sale of $18,000 of the Company s 20% senior secured third lien notes due 2015 (the Convertible Notes and, together with the First Lien Senior Facility and the Second Lien Senior Facility, the Financing). The Financing was consummated on November 3, 2008.

We used the net proceeds of the Financing, plus cash on hand, to repurchase $253,460 of our existing convertible notes in a tender offer. We estimate that we have incurred and will incur aggregate costs in connection with the Financing, including all fees and expenses, of between $28,000 and $31,000.

13

Table of Contents

Trends in Our Industry and Key Operating Data

A number of trends in our industry have a significant effect on our results of operations and are important to an understanding of our financial statements. Also, the table below includes key operating data that our management uses to measure the growth and operating performance of our business:

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Gross subscriber line additions	238,430	299,978	750,591	869,311
Net subscriber line additions	9,460	77,763	41,673	300,100
Subscriber lines (at period end)	2,621,900	2,524,211	2,621,900	2,524,211
Average monthly customer churn	3.0%	3.0%	3.1%	2.7%
Average monthly revenue per line	$ 28.75	$ 28.24	$ 28.96	$ 28.66
Average monthly telephony services revenue per line	$ 27.52	$ 27.32	$ 27.84	$ 27.78
Average monthly direct cost of telephony services per line	$ 7.20	$ 7.30	$ 7.24	$ 7.60
Marketing costs per gross subscriber line addition	$ 272.24	$ 206.30	$ 254.61	$ 253.81
Employees (excluding temporary help) (at period end)	1,573	1,559	1,573	1,559

Broadband adoption. The number of U.S. households with broadband Internet access has grown significantly. We expect this trend to continue. We benefit from this trend because our service requires a broadband Internet connection and our potential addressable market increases as broadband adoption increases.

Changing competitive landscape. We continue to see increasing competition from other companies that offer multiple services such as cable television, video services, voice service and broadband Internet service. These competitors are offering VoIP or other voice services as part of a bundle, in which they offer voice services at a lower price than we do to new subscribers. In addition, we believe several of these competitors are working to develop new integrated offerings that we cannot provide and that could make their services more attractive to customers. We also compete against established alternative voice communication providers and independent VoIP service providers. Some of these service providers may choose to sacrifice revenue in order to gain market share and have offered their services at lower prices or for free.

Gross subscriber line additions. Gross subscriber line additions for a particular period are calculated by taking the net subscriber line additions during that particular period and adding to that the number of subscriber lines that terminated during that period. This number does not include subscriber lines both added and terminated during the period, where termination occurred within the first 30 days after activation. The number does include, however, subscriber lines added during the period that are terminated within 30 days of activation but after the end of the period.

Net subscriber line additions. Net subscriber line additions for a particular period reflect the number of subscriber lines at the end of the period, less the number of subscriber lines at the beginning of the period.

Subscriber lines. Our subscriber lines include, as of a particular date, all subscriber lines from which a customer can make an outbound telephone call on that date. Our subscriber lines include fax lines and SoftPhones but do not include our virtual phone numbers or toll free numbers, which only allow inbound telephone calls to customers. Subscriber lines increased from 2,524,211 as of September 30, 2007 to 2,621,900 as of September 30, 2008. We believe that the increase in our subscriber lines was related to our advertising which includes television, online, direct mail and telemarketing. Although our subscriber lines increased compared to last year, we have not sustained our historical subscriber line growth rate on a percentage basis we believe due to a combination of increased competition, a larger customer base, our decrease in marketing costs and increasing saturation among our initial target customer base, which included many early adopters.

Average monthly customer churn. Average monthly customer churn for a particular period is calculated by dividing the number of customers that terminated during that period by the simple average number of customers during the period, and dividing the result by the number of months in the period. The simple average number of customers during the period is the number of customers on the first day of the period, plus the number of customers on the last day of the period, divided by two. Terminations, as used in the calculation of churn statistics, do not include customers terminated during the period if termination occurred within the first 30 days after activation. Our average monthly customer churn was 3.0% for the three months ended September 30, 2008 and September 30, 2007, respectively. We are working to address network quality and improve the quality of our customer service in order to decrease churn. We monitor churn on a daily basis and use it as an indicator of the level of customer satisfaction. Other companies may calculate churn differently, and their churn data may not be directly comparable to ours. Customers who have been with us for a year or more tend to have a lower churn rate than customers who have not. Our churn will fluctuate over time due to increased competitive pressures, market place perception of our services and our ability to provide high quality customer care and network quality and add future innovative products and services.

Average monthly revenue per line. Average monthly revenue per line for a particular period is calculated by dividing our total revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. The simple average number of subscriber lines for the period is the number of subscriber lines on the first day of the period, plus the number of subscriber lines on the last day of the period, divided by two. Our average monthly revenue per line increased slightly to $28.75 for the three months ended September 30, 2008 compared to $28.24 for the three months ended September 30, 2007, reflecting a benefit from the reduction in the period over which activation fees are amortized. We continue to expect stability in our pricing environment.

Table of Contents

Average monthly telephony services revenue per line. Average monthly telephony services revenue per line for a particular period is calculated by dividing our total telephony services revenue for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. Our average monthly telephony services revenue per line was $27.52 for the three months ended September 30, 2008 compared with $27.32 for the three months ended September 30, 2007, reflecting a benefit from the reduction in the period over which activation fees are amortized.

Average monthly direct cost of telephony services per line. Average monthly direct cost of telephony services per line for a particular period is calculated by dividing our direct cost of telephony services for that period by the simple average number of subscriber lines for the period, and dividing the result by the number of months in the period. We use the average monthly direct cost of telephony services per line to evaluate how effective we are at managing our costs of providing service. Our average monthly direct cost of telephony services per line was $7.20 for the three months ended September 30, 2008 compared to $7.30 for the three months ended September 30, 2007 due primarily to the increase in customer base.

Marketing cost per gross subscriber line addition. Marketing cost per gross subscriber line addition is calculated by dividing our marketing expense for a particular period by the number of gross subscriber line additions during the period. Marketing expense does not include the cost of certain customer acquisition activities, such as rebates and promotions, which are accounted for as an offset to revenues, or customer equipment subsidies, which are accounted for as direct cost of goods sold. As a result, it does not represent the full cost to us of obtaining a new customer. Marketing cost per gross subscriber line addition increased to $272.24 for the three months ended September 30, 2008 compared to $206.30 for the three months ended September 30, 2007 due primarily to lower net subscriber line additions compared to the prior year.

Employees. Employees represent the number of personnel that are on our payroll and exclude temporary or outsourced labor.

Regulation. Our business has developed in an environment largely free from regulation. The United States and other countries, however, are examining how VoIP services should be regulated, and a number of initiatives could have an impact on our business. For example, the FCC has concluded that wireline broadband Internet access, such as DSL and Internet access provided by cable companies, is an information service and is subject to lighter regulation than telecommunications services. This order may give providers of wireline broadband Internet access the right to discriminate against our services, charge their customers an extra fee to use our service or block our service. More recently, however, the FCC found that a major cable operator s network management practices, which had the effect of degrading certain applications, were not allowed under the FCC s network neutrality policy statement. We believe it is unlikely that such blocking or discrimination will occur on a widespread basis, but if it does it would have a material adverse effect on us. Other regulatory developments including state efforts to impose state telecommunications regulation on us and the FCC s proposed reforms for the intercarrier compensation and universal service funding systems may affect our business by increasing the taxes and regulatory fees we pay and our operating expenses, including legal and consulting fees, or requiring us to make significant capital expenditures.

Operating Revenues

Operating revenues consists of telephony services revenue and customer equipment and shipping revenue.

Telephony services revenue. Substantially all of our operating revenues are telephony services revenue. In the United States, we offer two residential plans, Residential Premium Unlimited and Residential Basic 500, and two small business and home office plans, Small Business Unlimited and Small Business Basic. Each of our unlimited plans offers unlimited domestic calling as well as unlimited calling to Puerto Rico, Canada and selected European countries, subject to certain restrictions, and each of our basic plans offers a limited number of domestic calling minutes per month. Also, we currently offer international calling plans that are bundled with our Residential Premium Unlimited plan where a customer can make calls to a chosen international region. Under our basic plans, we charge on a per minute basis when the number of domestic calling minutes included in the plan is exceeded for a particular month. International calls (except for calls to certain European countries under our unlimited plans and a variety of countries under international calling plans) are charged on a per minute basis. These per minute fees are not included in our monthly subscription fees. We offer similar plans in Canada and the United Kingdom.

We derive most of our telephony services revenue from monthly subscription fees that we charge our customers under our service plans. We also offer residential fax service, virtual phone numbers, toll free numbers and other services, for each of which we charge an additional monthly fee. One business fax line is included with each of our two small office and home office plans, but we charge monthly fees for additional business fax lines. We automatically charge these fees to our customers credit cards, debit cards or ECP monthly in advance. We also automatically charge the per minute fees not included in our monthly subscription fees to our customers credit cards, debit cards or ECP monthly in arrears unless they exceed a certain dollar threshold, in which case they are charged immediately.

By collecting monthly subscription fees in advance and certain other charges immediately after they are incurred, we are able to reduce the amount of accounts receivable that we have outstanding, thus allowing us to have lower working capital requirements. Collecting in this manner also helps us mitigate bad debt losses, which are recorded as a reduction to revenue. If a customer s credit card, debit card or ECP is declined, we generally suspend international calling capabilities as well as the customer s ability to incur domestic usage charges in excess of their plan minutes. Historically, in most cases, we are able to correct the problem with the customer within the current monthly billing cycle. If the customer s credit card, debit card or ECP could not be successfully processed during three billing cycles, we terminate the account.

We also generate revenue by charging a fee for activating service. We charge an activation fee to our direct channel customers, or those customers who purchase equipment directly from us and to our retail channel customers, or customers who purchase equipment from retail stores. For our direct channel customers, activation fees, together with the related customer acquisition amounts for equipment, were deferred and amortized over the estimated average customer relationship period of 60 months. For our retail channel customers, rebates and retailer commissions up to but not exceeding the activation fee, were also deferred and amortized over the estimated average customer relationship period of 60 months. Starting January 1, 2008, due to the increase in churn, the customer relationship period was reduced to 48 months for both the direct and retail channel. The amortization of deferred customer equipment expense is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction to telephony services revenue. The amortization of deferred retailer commissions is recorded as marketing expense. The impact of this change was not material to the consolidated results of operations.

In the United States, we charge regulatory recovery fees on a monthly basis to defray the costs associated with regulatory consulting and compliance as well as related litigation, E-911 compliance and to cover taxes that we are charged by the suppliers of telecommunications services. In addition, we charge customers Federal USF and related fees, which fees we record as revenue.

Prior to August 15, 2007, we accepted returns of customer equipment up to 30 days. From August 15, 2007 through January 31, 2008, customers had up to 60 days to return equipment. Starting February 1, 2008, returns of customer equipment was reduced back to 30 days. For all subscribers who became our customers from July 1, 2005 to February 1, 2007, we charged a disconnect fee to customers who terminated their service within one year of activation. For subscribers who became customers after February 1, 2007, we charge a disconnect fee to those customers who terminate their service within two years of activation. Disconnect fees are recorded as revenue and are recognized at the time the customer terminates service.

Telephony services revenue is offset by the cost of certain customer acquisition activities, such as rebates and promotions.

Customer equipment and shipping revenue. Customer equipment and shipping revenue consists of revenue from sales of customer equipment to our wholesalers or directly to customers and retailers. In addition, customer equipment and shipping revenue includes the fees that we charge our customers for shipping any equipment to them.

Operating Expenses

Operating expenses consist of direct cost of telephony services, royalties, direct cost of goods sold, selling, general and administrative expense, marketing expense and depreciation and amortization.

Total direct cost of telephony services. Total direct cost of telephony services primarily consists of fees that we pay to third parties on an ongoing basis in order to provide our services. These fees include:

- Access charges that we pay to other telephone companies to terminate domestic and international calls on the public switched telephone network. These costs represented approximately 42% and 43% of our direct cost of telephony services for the three months ended September 30, 2008 and 2007, respectively, with a portion of these payments ultimately being made to incumbent telephone companies. When a Vonage subscriber calls another Vonage subscriber, we do not pay an access charge.

- The cost of leasing internet transit services from multiple internet service providers. This internet connectivity is used to carry VoIP session initiation signaling and packetized audio media between our subscribers and our regional data centers.

- The cost of leasing from other telephone companies the telephone numbers that we provide to our customers. We lease these telephone numbers on a monthly basis.

The cost of co-locating our regional data connection point equipment in third-party facilities owned by other telephone companies, Internet service providers, or co-location facility providers.

The cost of providing local number portability, which allows customers to move their existing telephone numbers from another provider to our service. Only regulated telecommunications providers have access to the centralized number databases that facilitate this process. Because we are not a regulated telecommunications provider, we must pay other telecommunications providers to process our local number portability requests.

The cost of complying with FCC regulations regarding VoIP emergency services, which require us to provide enhanced emergency dialing capabilities to transmit 911 calls for all of our customers.

Taxes that we pay on our purchase of telecommunications services from our suppliers or imposed by government agencies such as Federal USF and related fees.

Royalties for use of third-party intellectual property.

Table of Contents

Direct cost of goods sold. Direct cost of goods sold primarily consists of costs that we incur when a customer first subscribes to our service. These costs include:

- The cost of the equipment that we provide to customers who subscribe to our service through our direct sales channel in excess of activation fees. The remaining cost of customer equipment is deferred and amortized over the estimated average customer relationship period.
- The cost of the equipment that we sell directly to retailers.
- The cost of shipping and handling for customer equipment, together with the installation manual, that we ship to customers.
- The cost of products or services that we give customers as promotions.

Selling, general and administrative expense. Selling, general and administrative expense includes:

- Compensation and benefit costs for all employees, which is the largest component of selling, general and administrative expense and includes customer care, research and development, network engineering and operations, sales and marketing, executive, legal, finance, human resources and business development personnel.
- Share-based expense related to stock-based awards to employees, directors and consultants.
- Outsourced labor related to customer care and retail in-store support activities.
- Transaction fees paid to credit card, debit card or ECP companies, which include a per transaction charge in addition to a percent of billings charge.
- Rent and related expenses.
- Professional fees for legal, accounting, tax, public relations, lobbying and development activities.
- Litigation settlements.

Marketing expense. Marketing expense consists of:

- Advertising costs, which comprise a majority of our marketing expense and include online, television, print and radio advertising, direct mail, alternative media, promotions, sponsorships and inbound and outbound telemarketing.
- Creative and production costs.

- The costs to serve and track our online advertising.
- Certain amounts we pay to retailers for newspaper insert advertising, product placement and activation commissions.
- The cost associated with our customer referral program.

Depreciation and amortization expenses. Depreciation and amortization expenses include:

- Depreciation of our network equipment, furniture and fixtures, and employee computer equipment.
- Amortization of leasehold improvements and purchased and developed software.
- Amortization of intangible assets (patents and trademarks).
- Loss on disposal or impairment of property and equipment.

Other Income (Expense)

Other Income (Expense) consists of:

- Interest income on cash, cash equivalents and marketable securities.
- Interest expense on notes payable, patent litigation judgements and settlements and capital leases.
- Amortization of deferred financing costs.
- Accretion of convertible notes.
- Debt conversion expense relating to the conversion of notes payable to equity.

Table of Contents

Results of Operations

The following table sets forth, as a percentage of consolidated operating revenues, our consolidated statement of operations for the periods indicated:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Operating Revenues:				
Telephony services	96%	97%	96%	97%
Customer equipment and shipping	4	3	4	3
	100	100	100	100
Operating Expenses:				
Direct cost of telephony services (excluding depreciation and amortization)	25	27	25	27
Royalty		5		5
Total direct cost of telephony services	25	32	25	32
Direct cost of goods sold	9	8	9	7
Selling, general and administrative	32	102	34	63
Marketing	29	29	28	36
Depreciation and amortization	6	4	5	4
	101	175	101	142
Loss from operations	(1)	(75)	(1)	(42)
Other Income (Expense):				
Interest income		2		2
Interest expense	(2)	(3)	(2)	(3)
	(2)	(1)	(2)	(1)
Loss before income tax benefit (expense)	(3)	(76)	(3)	(43)
Income tax benefit (expense)				
Net loss	(3)%	(76)%	(3)%	(43)%

Summary of Results for the Three and Nine Months Ended September 30, 2008 and September 30, 2007

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008	2007	Dollar Change	Percent Change	2008	2007	Dollar Change	Percent Change
Telephony services	$ 216,092	$ 203,724	$ 12,368	6%	$ 651,810	$ 593,561	$ 58,249	10%
Direct cost of telephony services (1)	56,502	54,463	2,039	4%	169,586	162,364	7,222	4%
Royalty		11,139	(11,139)	(100)%		32,606	(32,606)	(100)%

(1) Excludes depreciation and amortization of $4,908, $4,312, $14,337 and $12,616, respectively

Telephony services revenue. For the quarter ended September 30, 2008, telephony services revenue increased by $12,368, or 6%, compared to the quarter ended September 30, 2007. This was primarily driven by an increase in the number of subscriber lines, which grew from 2,524,211 at September 30, 2007 to 2,621,900 at September 30, 2008. The increase in subscriber lines translated into an increase in monthly subscription fees of $5,247, regulatory fees that we collect from subscribers of $2,928, which included $2,225 of USF and related fees, and activation fees of $3,354. The increase in activation fees included $1,875 for the change in our customer life from 60 months to 48 months in the first quarter of 2008. Additionally, we experienced a higher volume of international calling by subscribers that generated an increase of $6,037. We also had an $841 increase in the fees we charge for disconnecting our service. This was offset by a $2,917 increase in bad debt expense as we had a high number of customers terminate service with a balance due and a $3,395 increase in credits we issued to subscribers in an effort to reduce churn.

For the nine months ended September 30, 2008, telephony services revenue increased by $58,249, or 10%, compared to the nine months ended September 30, 2007. This was primarily driven by an increase in the number of subscriber lines, which grew from

Table of Contents

2,524,211 at September 30, 2007 to 2,621,900 at September 30, 2008. The increase in subscriber lines translated into an increase in monthly subscription fees of $32,914, regulatory fees that we collect from subscribers of $12,347, which included $8,876 of USF and related fees, and activation fees of $10,759. The increase in activation fees included $6,794 for the change in our customer life from 60 months to 48 months in the first quarter of 2008. Additionally, we experienced a higher volume of international calling by subscribers that generated an increase of $16,079. We also had a $2,341 increase in the fees we charge for disconnecting our service. This was offset by a $10,973 increase in bad debt expense and a $6,732 increase in credits we issued to subscribers.

Direct cost of telephony services. For the quarter ended September 30, 2008 compared to 2007, the increase in direct cost of telephony services of $2,039, or 4%, was primarily due to the USF and related fees imposed by government agencies of $2,225. There was also an increase in other cost of $234 mainly for implementing new features and termination costs of $140, which are costs to transfer calls to and from the Internet to the public switched telephone network. This was offset by a decrease in our network costs of $292, which includes costs for co-locating in other carriers facilities, for leasing phone numbers, routing calls on the Internet, and transferring calls to and from the Internet to the public switched telephone network and E-911 costs and a decrease of taxes that we pay on our purchase of telecommunications services from our suppliers of $270.

For the nine months ended September 30, 2008 compared to 2007, the increase in direct cost of telephony services of $7,222, or 4%, was primarily due to the USF and related fees imposed by government agencies of $8,876. Also, there was an increase in our network costs of $2,945, which includes costs for co-locating in other carriers facilities, for leasing phone numbers, routing calls on the Internet, and transferring calls to and from the Internet to the public switched telephone network and E-911 costs. There is also an increase of $1,019 in other cost mainly for implementing new features. This was offset by a decrease in termination costs of $5,385, which are costs to transfer calls to and from the Internet to the public switched telephone network and a decrease of taxes that we pay on our purchase of telecommunications services from our suppliers of $235.

Royalty. The royalty expense of $11,139 and $32,606 for the three and nine months ended September 30, 2007, respectively, was for the judgment entered against us in our patent litigation with Verizon. No royalty is required subsequent to our October 2007 IP-litigation settlement with Verizon.

(in thousands, except percentages)	Three Months Ended September 30,				Nine Months Ended September 30,			
	2008	**2007**	**Dollar Change**	**Percent Change**	**2008**	**2007**	**Dollar Change**	**Percent Change**
Customer equipment and shipping	$ 9,678	$ 6,810	$ 2,868	42%	$ 26,101	$ 18,815	$ 7,286	39%
Direct cost of goods sold	20,835	17,057	3,778	22%	61,440	41,633	19,807	48%
Customer equipment and shipping gross loss	$ (11,157)	$ (10,247)	$ (910)	(9)%	$ (35,339)	$ (22,818)	$ (12,521)	(55)%

Customer equipment and shipping revenue. For the quarter ended September 30, 2008 compared to 2007, our customer equipment and shipping revenue increased by $2,868, or 42%, primarily due to an increase in customer equipment sales of $2,918, which was offset by the decrease in customer shipping revenue and rebates of $49 due to less period over period customer additions.

For the nine months ended September 30, 2008 compared to 2007, our customer equipment and shipping revenue increased by $7,286, or 39%, primarily due to an increase in customer equipment sales of $11,064 from more expensive devices and more retail devices sold, which was offset by the decrease in customer shipping revenue and rebates of $3,777 due to less period over period customer additions.

Direct cost of goods sold. For the quarter ended September 30, 2008 compared to 2007, the increase in direct cost of goods sold of $3,778, or 22%, was due to an increase in the cost of customer equipment of $4,128 including $1,688 of amortization costs on customer equipment, which were higher for the three months ended September 30, 2008 compared to the three months ended September 30, 2007 due to the increase in subscriber base and the change of our customer life from 60 months to 48 months in the first quarter of 2008. In addition, there was an increase in waived activation fees for new customers. This was offset by a decrease in our shipping costs of $350 due to fewer periods over period customer additions.

For the nine months ended September 30, 2008 compared to 2007, the increase in direct cost of goods sold of $19,807, or 48%, was due to an increase in the cost of customer equipment of $18,427 including $6,162 of amortization costs on customer equipment, which were higher for the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007 due to the increase in subscriber base and the change of our customer life from 60 months to 48 months in the first quarter of 2008. In addition, there was an increase in waived activation fees for new customers. Our shipping costs increased by $1,380 due to higher shipping rates offset by fewer devices shipped for the nine months ended September 30, 2008.

Table of Contents

(in thousands, except percentages)	Three Months Ended September 30, 2008	2007	Dollar Change	Percent Change	Nine Months Ended September 30, 2008	2007	Dollar Change	Percent Change
Selling, general and administrative	$ 73,035	$ 214,139	$ (141,104)	(66)%	$ 230,358	$ 382,933	$ (152,575)	(40)%

Selling, general and administrative. For the quarter ended September 30, 2008 compared to 2007, the decrease in selling, general and administrative expenses of $141,104, or 66%, was primarily due to the settlement expenses of $132,951 related to our patent litigation with Sprint, AT&T, Verizon and others recorded in the quarter ended September 30, 2007. There was also a decrease in professional fees of $9,782, primarily related to our past IP-litigation, in costs related to our retail kiosks of $611 and in severance costs of $442 related to our reduction-in-force in 2007. This was offset by increases in share-based expense of $1,739, which was primarily related to the separation and consulting agreements with our former interim chief executive officer, salaries, recruiting and outsourced temporary labor of $1,621, and tax expense of $905 as we had an expense reduction in the third quarter of 2007 that was not repeated in the third quarter of 2008.

For the nine months ended September 30, 2008 compared to 2007, there was a decrease in selling, general and administrative expenses of $152,575, or 40%. This decrease was primarily due to the settlement expenses of $132,951 related to our patent litigation with Sprint, AT&T, Verizon and others in 2007 and in professional fees of $21,267, primarily related to our IP-litigation in 2007. There were also decreases in severance costs of $3,601 related to our reduction-in-force in 2007, in salaries, recruiting and outsourced temporary labor of $2,256 and in tax expense of $910 as we had expense reductions in 2008 that were higher than 2007. The decreases were offset by increases in costs related to our retail kiosks of $3,008 and share-based expense of $3,324, which was related to the separation and consulting agreements with our former interim chief executive officer and the reduction in share-based expense in 2007 for actual forfeitures exceeding previous estimates due to the departure of our former chief executive officer, certain senior executives and other personnel primarily as a result of the reduction in force during the second and third quarters of 2007.

(in thousands, except percentages)	Three Months Ended September 30, 2008	2007	Dollar Change	Percent Change	Nine Months Ended September 30, 2008	2007	Dollar Change	Percent Change
Marketing	$ 64,911	$ 61,885	$ 3,026	5%	$ 191,110	$ 220,641	$ (29,531)	(13)%

Marketing. For the quarter ended September 30, 2008 compared to 2007, there was a slight increase in marketing expense of $3,026, or 5%. We had reductions in television advertising of $5,725, in retail advertising of $1,771 and in alternative media of $315, offset by an increase in online advertising of $4,144, direct mail marketing of $4,041 and other miscellaneous marketing costs of $2,652.

For the nine months ended September 30, 2008 compared to 2007, marketing expense decreased by $29,531, or 13%, primarily related to managements decision in the second quarter of 2007 to balance growth and profitability. This translated into reductions in alternative media of $13,447, online advertising of $3,710, in television advertising of $9,300 and in retail advertising of $4,786, which was offset by an increase in direct mail other miscellaneous marketing costs of $1,712.

(in thousands, except percentages)	Three Months Ended September 30, 2008	2007	Dollar Change	Percent Change	Nine Months Ended September 30, 2008	2007	Dollar Change	Percent Change
Depreciation and amortization	$ 13,347	$ 8,563	$ 4,784	56%	$ 34,670	$ 24,613	$ 10,057	41%

Depreciation and amortization. The increase in depreciation and amortization of $4,784, or 56%, and $10,057, or 41%, for the three and nine months ended September 30, 2008 and 2007, respectively, was primarily due to an increase in depreciation of network equipment, computer equipment and amortization related to patents and software. We also recorded an impairment charge of $1,447 and $1,847 for the three and nine months ended September 30, 2008, respectively, for assets that no longer had future benefit.

Table of Contents

(in thousands, except percentages)	Three Months Ended September 30, 2008	2007	Dollar Change	Percent Change	Nine Months Ended September 30, 2008	2007	Dollar Change	Percent Change
Interest income	$ 544	$ 4,238	$ (3,694)	(87)%	$ 2,965	$ 15,066	(12,101)	(80)%
Interest expense	(5,504)	(5,424)	(80)	(1)%	(16,610)	(15,700)	(910)	(6)%
Other, net	46	(36)	82	228%	(66)	(69)	3	4%
	$ (4,914)	$ (1,222)	$ (3,692)		$ (13,711)	$ (703)	$ (13,008)	

Interest income. For the three and nine months ended September 30, 2008 compared to 2007, the decrease in interest income of $3,694, or 87%, and $12,101, or 80%, respectively, was due to the decrease in cash, cash equivalents and marketable securities and lower interest rates.

Interest expense. Interest expense remained flat for the three months ended September 30, 2008 compared to 2007. For the nine months ended September 30, 2008, interest expense increased by $910, or 6%, primarily due to additional amortization for deferred financing costs of $993.

(in thousands, except percentages)	Three Months Ended September 30, 2008	2007	Dollar Change	Percent Change	Nine Months Ended September 30, 2008	2007	Dollar Change	Percent Change
Income tax benefit (expense)	$ (43)	$ (94)	$ 51	54%	$ (696)	$ (471)	$ (225)	(48)%

Provision for Income Taxes

Although we have net losses for financial reporting purposes, in certain jurisdictions we are not able to file a consolidated income tax return, which prevents us from offsetting taxable losses from some subsidiaries against taxable income of other subsidiaries. As such, we have incurred income tax expense which has decreased for the three ended September 30, 2008 and increased for the nine months ended September 30, 2008 compared to the three and nine months ended September 30, 2007.

As of September 30, 2008, we had net operating loss carryforwards for U.S. federal and state tax purposes of $749,940 and $720,763, respectively, expiring at various times from years ending 2020 through 2028. In addition, we had net operating loss carryforwards for Canadian tax purposes of $57,465 expiring through 2027. We also had net operating loss carryforwards for United Kingdom tax purposes of $31,823 with no expiration date. Recognition of deferred tax assets will require generation of future taxable income. There can be no assurance that we will generate sufficient taxable income in future years. Therefore, we established a valuation allowance on net deferred tax assets of $391,050 as of September 30, 2008.

(in thousands, except percentages)	Three Months Ended September 30, 2008	2007	Dollar Change	Percent Change	Nine Months Ended September 30, 2008	2007	Dollar Change	Percent Change
Net loss	$ (7,817)	$ (158,028)	$ 150,211	95%	$ (23,660)	$ (253,588)	$ 229,928	91%

Net Loss. Based on the explanations described above, our net loss decreased for both the three and nine months ended September 30, 2008 compared to 2007.

Table of Contents

Liquidity and Capital Resources

Overview

The following table sets forth a summary of our cash flows for the periods indicated:

	Nine Months Ended September 30,	
	2008	2007
	(dollars in thousands)	
Net cash provided by (used in) operating activities	$ 6,171	$ (88,989)
Net cash provided by (used in) investing activities	44,213	6,829
Net cash provided by (used in) financing activities	(9,234)	474

Historically, we have incurred operating losses since our inception. As a result, we have generated negative cash flows from operations. Our primary sources of funds have been proceeds from private placements of our preferred stock, private placements of convertible notes, an initial public offering of our common stock, operating revenues and borrowings under notes payable from our principal stockholder and Chairman, which were subsequently converted into shares of our preferred stock. We have used these proceeds for working capital, funding operating losses, IP litigation settlements and other general corporate purposes.

Although our net losses initially were driven primarily by start-up costs and the cost of developing our technology, more recently our net losses have been driven by investments in marketing and settlement of our IP litigation. In addition, we plan to continue to invest in research and development and customer care. In 2007, we announced a plan seeking to balance growth with profitability. We intend to continue to pursue investments in growth marketing because we believe it will position us as a strong competitor in the long term. Although we believe we will achieve profitability in the future, we ultimately may not be successful and we may never achieve profitability. We believe that cash flow from operations and cash on hand will fund our operations for at least the next twelve months.

Our consolidated financial statements as of September 30, 2008 and December 31, 2007 have been prepared under the assumption that we will continue as a going concern for the twelve months ending December 31, 2008. Our independent registered public accounting firm s report dated March 17, 2008 on our 2007 financial statements included an explanatory paragraph referring to our $217,000 working capital deficit caused primarily by $253,460 of Notes due December 1, 2010 classified as a current liability since they could have been put to us by the holders on December 16, 2008 and expressing substantial doubt as to our ability to continue as a going concern without refinancing them or obtaining additional debt or equity capital.

As of September 30, 2008, we had a working capital deficit of $248,117 caused primarily by $253,460 of Notes being classified as a current liability since they could have been put to us by the holders on December 16, 2008. On October 19, 2008, we entered into definitive agreements for the Financing consisting of (i) a $130,300 First Lien Senior Facility, including an original issuance discount of $7,200, (ii) a $72,000 Second Lien Senior Facility and (iii) the sale of $18,000 of the Company s Convertible Notes. The Financing was consummated on November 3, 2008.

We used the net proceeds of the Financing, plus cash on hand, to repurchase $253,460 of Notes in a tender offer. We estimate that we have incurred and will incur aggregate costs in connection with the Financing, including all fees and expenses, of between $28,000 and $31,000.

The annual cash interest expense for 2009 on the Financing will be $20,848 assuming no change in the initial interest rate for the First Lien Senior Facility of 16%.

We also have contingent liabilities for state and local sales taxes. As of September 30, 2008, we had a reserve of $3,062. If our ultimate liability exceeds this amount, it could affect our liquidity unfavorably. However, we do not believe it would significantly impair our liquidity.

To the extent we change our plans, or if our expectations are wrong, we may need to seek additional funding by accessing the equity or debt capital markets. In addition, although we do not currently anticipate any acquisitions, we may need to seek additional funding if an attractive acquisition opportunity is presented to us. However, our significant losses to date may prevent us from obtaining additional funds on favorable terms or at all. Because of our historical net losses and our limited tangible assets, we do not fit traditional credit lending criteria, which, in particular, could make it difficult for us to obtain loans or to access the debt capital markets. In addition, the documentation for the Financing contains affirmative and negative covenants that affect, and in many respects significantly limit or prohibit, among other things, our ability to incur, prepay, refinance or modify indebtedness and enter into acquisitions, investments, sales, mergers and consolidations. Further, the ability to raise additional capital through the issuance of equity securities may be impeded due to the litigation surrounding our IPO and our current stock price.

Capital expenditures

For 2008, capital expenditures have been primarily for the implementation of software solutions. We also have purchased network equipment and computer hardware as we continue to expand our network. Our capital expenditures for the nine months ended September 30, 2008 were $32,566, of which $23,589 was for software acquisition and development. For 2008, we believe our capital expenditures will be approximately $45,000.

Table of Contents

Operating Activities

Cash provided by operating activities for the nine months ended September 30, 2008 was $6,171 and consisted of a net loss of $23,660, $18,486 used in working capital and other activities and $48,317 provided by adjustments for non-cash items. Adjustments for non-cash items consisted primarily of depreciation and amortization of $34,670 and $9,203 for share-based expense. Working capital and other activities primarily consisted of a net decrease in cash for prepaid expenses of $10,591 for advance payments to procure materials for production of devices, a decrease of $13,432 for accounts payable and accrued expenses, which are primarily related to marketing, a decrease in cash in accounts receivable of $4,847 and $3,930 for a reduction in other liability related to AT&T patent litigation. This was offset by an increase in cash of $5,932 for deferred revenue and deferred product costs and $7,747 in inventory.

Cash used in operating activities for the nine months ended September 30, 2007 was $88,989 and consisted of a net loss of $253,588 and $129,340 provided by working capital and other activities, offset by adjustments for non-cash items of $35,259. Adjustments for non-cash items consisted primarily of depreciation and amortization of $24,613 and $5,879 for share-based expense. Working capital and other activities primarily consisted of a net increase in cash of $131,039 for accounts payable, accrued expenses and other liability primarily related to our patent litigation settlements and marketing, an increase of $8,959 for deferred revenue net of deferred product cost and a $3,350 increase in inventory offset by a decrease in accounts receivable of $6,220 and a decrease in cash of $8,047 for prepaid expenses.

Investing Activities

Cash provided by investing activities for the nine months ended September 30, 2008 of $44,213 was attributable to net sales and purchases of marketable securities of $79,941 offset by capital expenditures, purchase of intangible assets and development of software assets of $32,566 and $3,162 for the increase in restricted cash.

Cash provided by investing activities for the nine months ended September 30, 2007 of $6,829 was attributable to net sales and purchases of marketable securities of $140,707 offset by capital expenditures and development of software assets of $32,718 and $101,160 for the increase in restricted cash.

Financing Activities

Cash used in financing activities for the nine months ended September 30, 2008 of $9,234 was primarily for debt related costs of $8,601 and capital lease payments of $752.

Cash provided by financing activities for the nine months ended September 30, 2007 of $474 was attributable to $1,228 in net proceeds received from the exercise of stock options, stock subscription receivable and monies received from customers that owed money through our Directed Share Program related to our initial public offering in May 2006, which was offset by $754 in capital lease payments.

Summary of Critical Accounting Policies and Estimates

Our significant accounting policies are summarized in Note 1 to our consolidated financial statements. The following describes our critical accounting policies and estimates:

Use of Estimates

Our consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States, which require management to make estimates and assumptions that affect the amounts reported and disclosed in the consolidated financial statements and the accompanying notes. Actual results could differ materially from these estimates.

On an ongoing basis, we evaluate our estimates, including the following:

- those related to the average period of service to a customer used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation;

the useful lives of property and equipment; and

assumptions used for the purpose of determining stock-based compensation using the Black-Scholes option model (Model). The key inputs for this Model are stock price at valuation date, strike price for the option, the dividend yield, risk-free interest rate, life of option in years and volatility.

We base our estimates on historical experience, available market information, appropriate valuation methodologies, and on various other assumptions that we believe to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

Revenue Recognition

Operating revenues consist of telephony services revenues and customer equipment (which enables our telephony services) and shipping revenues. The point in time at which revenues are recognized is determined in accordance with Staff Accounting Bulletin No. 104, Revenue Recognition, and Emerging Issues Task Force Consensus No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products).*

Table of Contents

Substantially all of our operating revenues are telephony services revenues, which are derived primarily from monthly subscription fees that customers are charged under our service plans. We also derive telephony services revenues from per minute fees for international calls and for any calling minutes in excess of a customer s monthly plan limits. Monthly subscription fees are automatically charged to customers credit cards, debit cards or ECP in advance and are recognized over the following month when services are provided. Revenues generated from international calls and from customers exceeding allocated call minutes under limited minute plans are recognized as services are provided, that is, as minutes are used, and are billed to a customer s credit cards, debit cards or ECP in arrears. As a result of our multiple billing cycles each month, we estimate the amount of revenues earned from international calls and from customers exceeding allocated call minutes under limited minute plans but not billed from the end of each billing cycle to the end of each reporting period. These estimates are based primarily upon historical minutes and have been consistent with our actual results.

We also generate revenues by charging a fee for activating service. Customer activation fees, along with the related customer acquisition amounts for customer equipment in the direct channel and for rebates and retailer commissions in the retail channel up to but not exceeding the activation fee, are deferred and amortized over the estimated average customer relationship period. The amortization of deferred customer equipment is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction to telephony services revenues. The amortization of deferred retailer commissions is recorded as marketing expense. For 2006 and 2007, the estimated customer relationship period was 60 months. For 2008, due to the increase in churn, the customer relationship period was reduced to 48 months.

We also provide rebates to customers who purchase their customer equipment from retailers and satisfy minimum service period requirements. These rebates in excess of activation fees are recorded as a reduction of revenues over the service period based upon the estimated number of customers that will ultimately earn and claim the rebates.

Inventory

Inventory consists of the cost of customer equipment and is stated at the lower of cost or market, with cost determined using the average cost method. We provide an inventory allowance for customer equipment that has been returned by customers but may not be able to be re-issued to new customers or returned to the manufacturer for credit.

Income Taxes

We recognize deferred tax assets and liabilities for the expected tax consequences of temporary differences between the tax bases of assets and liabilities and their reported amounts using tax rates in effect for the year the differences are expected to reverse. We have recorded a valuation allowance on the assumption that we will not generate taxable income.

Net Operating Loss Carryforwards

As of September 30, 2008, we had net operating loss carryforwards for U.S. federal and state tax purposes of $749,940 and $720,763, respectively, expiring at various times from years ending 2020 through 2028. In addition, we had net operating loss carryforwards for Canadian tax purposes of $57,465 expiring through 2027. We also had net operating loss carryforwards for United Kingdom tax purposes of $31,823 with no expiration date.

Under Section 382 of the Internal Revenue Code, if a corporation undergoes an ownership change (generally defined as a greater than 50% change (by value) in its equity ownership over a three-year period), the corporation s ability to use its pre-change of control net operating loss carry forward and other pre-change tax attributes against its post-change income may be limited. The Section 382 limitation is applied annually so as to limit the use of our pre-change net operating loss carryforwards to an amount that generally equals the value of our stock immediately before the ownership change multiplied by a designated federal long-term tax-exempt rate. In addition, we may be able to increase the base Section 382 limitation amount during the first five years following the ownership change to the extent it realizes built-in gains during that time period. A built-in gain generally is gain or income attributable to an asset that was held at the date of the ownership change and that had a fair market value in excess of the tax basis at the date of the ownership change. Section 382 provides that any unused Section 382 limitation amount can be carried forward and aggregated with the following year s available net operating losses. Due to the cumulative impact of our equity issuances for the period ended April 2005, a change of ownership occurred upon the issuance of our previously outstanding Series E Preferred Stock at the end of April 2005. As a result, $171,147 of the total U.S. net operating losses will be subject to an annual base limitation of $39,374. As noted above, we believe we may be able to increase the base Section 382 limitation for built-in gains during the first five years following the ownership change.

Recent Accounting Pronouncements

In March 2008, the Financial Accounting Standards Board (FASB), affirmed the consensus of FASB Staff Position (FSP) Accounting Principles Board Opinion No. 14-1 (APB 14-1), *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*, which applies to all convertible debt instruments that have a net settlement feature; which means that such convertible debt instruments, by their terms, may be settled either wholly or partially in cash upon conversion. FSP APB 14-1 requires issuers of convertible debt instruments that may be settled wholly or partially in cash upon conversion to separately account for the liability and equity components in a manner reflective of the issuer s nonconvertible debt borrowing rate. Previous guidance provided for accounting for this type of convertible debt instrument entirely as debt. FSP APB 14-1

Table of Contents

is effective for financial statements issued for fiscal years beginning after December 15, 2008 and interim periods within those fiscal years. We are evaluating if the adoption of FSP APB 14-1 will have a material impact on our financial statements.

In May 2008, the FASB issued Statement of Financial Accounting Standards No. 162 (SFAS No. 162), *The Hierarchy of Generally Accepted Accounting Principles.* SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with generally accepted accounting principles. SFAS No. 162 becomes effective 60 days following the Securities and Exchange Commission s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. We do not expect that the adoption of SFAS No. 162 will have a material impact on our consolidated financial statements.

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159 (SFAS No. 159), *The Fair Value Option for Financial Assets and Financial Liabilities* . Under SFAS No. 159, companies may elect to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS No. 159 was effective for us beginning in the first quarter of 2008. We currently do not have any instruments eligible for election of the fair value option. Therefore, the adoption of SFAS No. 159 in the first quarter of 2008 did not impact our consolidated financial position, results of operations or cash flows.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157 (SFAS No. 157), *Fair Value Measurements* which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements and is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued FASB FSP 157-2, which delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. These nonfinancial items include assets and liabilities such as reporting units measured at fair value in a goodwill impairment test and nonfinancial assets acquired and liabilities assumed in a business combination. Effective January 1, 2008, we adopted SFAS No. 157 for financial assets and liabilities recognized at fair value on a recurring basis. The partial adoption of SFAS No. 157 for financial assets and liabilities did not have a material impact on our consolidated financial position, results of operations or cash flows.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are exposed to financial market risks, including changes in currency exchange rates and interest rates.

Foreign Exchange Risk

Our exposure to foreign currency transaction gains and losses is the result of certain net receivables due from our foreign subsidiaries and customers being denominated in currencies other than the U.S. dollar, primarily the British Pound, the Euro, and the Canadian Dollar. Our foreign subsidiaries conduct their businesses in local currency.

Interest Rate Risk

We invest in a variety of securities, consisting primarily of investments in interest-bearing demand deposit accounts with financial institutions, money market funds and highly liquid debt securities of corporations and municipalities. By policy, we limit the amount of credit exposure to any one issuer.

Investments in both fixed rate and floating rate interest earning products carry a degree of interest rate risk. Fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates, while floating rate securities may produce less income than predicted if interest rates fall. Due in part to these factors, our income from investments may decrease in the future.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures. Based on the evaluation of our disclosure controls and procedures (as defined in Securities Exchange Act of 1934 Rules 13a-15(e) and 15d-15(e)) required by Securities Exchange Act Rules 13a-15(b) or 15d-15(b), our Chief Executive Officer and our Chief Financial Officer have concluded that as of the end of the period covered by this report, our disclosure controls and procedures were effective.

Changes in Internal Controls. There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

Part II Other Information

Item 1. Legal Proceedings

We are subject to a number of lawsuits, government investigations and claims arising out of the conduct of our business. See a discussion of our litigation matters in Note 2 of Notes to our Consolidated Financial Statements, which is incorporated herein by reference.

Item 1A. Risk Factors

Except as provided hereafter, there have been no material changes from the risk factors previously disclosed in Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 31, 2007. This information should be read in conjunction with the risk factors in such Annual Report.

RISK FACTORS

Current economic conditions may adversely affect our industry, business and results of operations.

The United States economy is currently undergoing a period of slowdown and very high volatility and the future economic environment may continue to be less favorable than that of recent years. A substantial portion of our revenues comes from residential and small business customers whose spending patterns may be affected by prevailing economic conditions. While we believe that the weakening economy had a modest effect on our net subscriber additions during recent months, if these economic conditions continue to deteriorate, the growth of our business and results of operations may be affected. Reduced consumer spending may drive us and our competitors to offer certain services at promotional prices, which could have a negative impact on our operating results.

The debt agreements governing our recent financing contain restrictions that may limit our flexibility in operating our business.

On November 3, 2008, we consummated a financing consisting of (i) a $130,300 senior secured first lien credit facility (the First Lien Senior Facility), (ii) a $72,000 senior secured second lien credit facility (the Second Lien Senior Facility) and (iii) the sale of $18,000 of the Company s 20% senior secured third lien notes due 2015 (the Convertible Notes and collectively, the Financing). The First Lien Senior Facility, the Second Lien Senior Facility and the Note Purchase Agreement governing the Convertible Notes contain various covenants and other restrictions that limit our ability and/or the ability of certain of our subsidiaries to engage in specified types of transactions. These covenants and other restrictions may under certain circumstances limit, but not necessarily preclude, our and certain of our subsidiaries ability to, among other things:

- incur, prepay, refinance or modify indebtedness;
- create liens;
- pay dividends on or repurchase our capital stock or make other restricted payments;
- make investments;
- enter into acquisitions, sales and mergers;
- enter into sale and leaseback transactions;

amend our organizational documents, or amend, modify or waive litigation settlements, key employment agreements or other material contracts;

incur marketing expenses in excess of specified thresholds;

change the nature of our business or enter into additional lines of business; and

enter into transactions with our stockholders and affiliates.

Table of Contents

Under the Financing agreements, we are required to maintain a specified minimum fixed charge coverage ratio, maximum leverage ratio and senior secured debt leverage ratio. Additionally, these agreements require us to maintain minimum levels of consolidated adjusted EBIDTA, liquidity and pre-marketing operating income and limit our capital expenditures. Upon the repayment of our obligations under the First Lien Senior Facility and the Second Lien Senior Facility, the covenants will fall-away, but the Note Purchase Agreement for the Convertible Notes will continue to limit our ability to incur indebtedness and make restricted payments. Our ability to comply with such financial and other covenants can be affected by events beyond our control, so we may not be able to comply with these covenants. A breach of any such covenant could result in a default under these agreements. In that case, the lenders and the noteholders could elect to declare due and payable immediately all amounts due under the Financing agreements, including principal, accrued interest, a make-whole premium and, in the case of the Convertible Notes, liquidated damages, and may take action to foreclose upon the collateral securing the indebtedness.

Our certificate of incorporation and bylaws, the agreements governing our indebtedness and the terms of certain settlement agreements to which we are a party contain provisions that could delay or discourage a takeover attempt, which could prevent the completion of a transaction in which our stockholders could receive a substantial premium over the then-current market price for their shares.

Certain provisions of our restated certificate of incorporation and our second amended and restated bylaws may make it more difficult for, or have the effect of discouraging, a third party from acquiring control of us or changing our board of directors and management. These provisions:

- permit our board of directors to issue additional shares of common stock and preferred stock and to establish the number of shares, series designation, voting powers (if any), preferences, other special rights, qualifications, limitations or restrictions of any series of preferred stock;
- limit the ability of stockholders to amend our restated certificate of incorporation and second amended and restated bylaws, including supermajority requirements;
- allow only our board of directors, Chairman of the board of directors or Chief Executive Officer to call special meetings of our stockholders;
- eliminate the ability of stockholders to act by written consent;
- require advance notice for stockholder proposals and director nominations;
- limit the removal of directors and the filling of director vacancies; and
- establish a classified board of directors with staggered three-year terms.

Table of Contents

In addition, a change of control would constitute an event of default under our Financing agreements. Upon the occurrence of an event of default, the lenders and the noteholders could elect to declare due and payable immediately all amounts due under the Financing agreements, including principal, accrued interest, a make-whole premium and, in the case of the Convertible Notes, liquidated damages, and may take action to foreclose upon the collateral securing the indebtedness.

Under our Financing agreements, a change of control would result from the occurrence of, among other things:

- the disposition by Jeffrey A. Citron or certain of his affiliates of shares of common stock in excess of certain specified amounts;
- the acquisition by any person or group (other than Mr. Citron and his majority-controlled affiliates or certain investment funds related to New Enterprise Associates) of at least 30% of the voting and/or economic interest of our outstanding common stock on a fully-diluted basis or of the power to elect a majority of our board of directors, if such acquiror also has a greater voting and/or economic interest in our company than Mr. Citron and his majority-owned affiliates;
- a change in our Chief Executive Officer, unless an interim successor and permanent successor reasonably acceptable to the administrative agent and note agent is appointed within specified time periods; or
- the acquisition by Silver Point Finance, LLC and its affiliates and related funds of at least 50% of the voting and/or economic interest of our outstanding common stock on a fully-diluted basis or those entities obtaining the power to elect a majority of our board of directors.

We encourage you to read the agreements in full, including the definition of change of control therein. These Financing agreements have been previously filed with the Securities and Exchange Commission as exhibits to Amendment No. 8 to our Schedule TO, which was filed on October 22, 2008.

Further, we were named as a defendant in several suits that related to patent infringement and entered into agreements to settle certain of the suits. See Item 3. - Legal Proceedings - Patent Litigation, in our Annual Report on Form 10-K for the year ended December 31, 2007. Certain terms of those agreements, including licenses and covenants not to sue, will be restricted upon a change of control, which may discourage certain potential purchasers from acquiring us.

Such provisions could have the effect of depriving stockholders of an opportunity to sell their shares at a premium over prevailing market prices. Any delay or prevention of, or significant payments required to be made upon, a change of control transaction or changes in our board of directors or management could deter potential acquirers or prevent the completion of a transaction in which our stockholders could receive a substantial premium over the then-current market price for their shares.

Table of Contents

Jeffrey A. Citron, our founder, Chairman and a significant stockholder, exerts significant influence over us.

After giving effect to the Financing and the purchase by us of then outstanding convertible notes tendered in our recently completed tender offer, Mr. Citron beneficially owned approximately 36.4% of our outstanding common stock, including outstanding securities convertible into or exercisable for common stock prior to December 31, 2008 held by Mr. Citron. As a result, Mr. Citron is able to exert significant influence over all matters presented to our stockholders for approval, including election and removal of our directors and change of control transactions. In addition, as our Chairman, Mr. Citron has and will continue to have significant influence over our strategy, technology and other matters. Mr. Citron s interests may not always coincide with the interests of other holders of our common stock.

Our common stockholders may suffer dilution in the future upon exercise of our Convertible Notes.

In connection with the Financing, we issued $18,000 aggregate principal amount of Convertible Notes to Silver Point Finance, LLC, certain of its affiliates, other third parties and affiliates of the Company. If the conversion rights in the Convertible Notes are exercised, the exercising noteholders may obtain a significant equity interest in us and other stockholders may experience significant and immediate dilution. Conversion of the entire $18,000 aggregate principal amount of Convertible Notes at the initial conversion rate would have resulted in an increase of our outstanding common stock from 156,565,277 shares (as of October 31, 2008) to 218,634,243 shares, an approximate 39.6% increase.

If we do not meet the New York Stock Exchange continued listing requirements, our common stock may be delisted.

The New York Stock Exchange (NYSE) listing standards require us, among other things, to maintain an average closing price of at least $1.00 per share of common stock and a market capitalization of at least $100,000 during any consecutive 30-trading-day period. On October 24, 2008, we were notified by the NYSE that we were not in compliance with the NYSE listing standard relating to minimum average share price. We have notified the NYSE of our intent to cure the deficiency. We must bring our share price and average share price back above $1.00 within six months from the receipt of the NYSE notice, subject to possible extension, to regain compliance with the NYSE s price condition, or our common stock will be subject to suspension and delisting procedures. During the cure period and subject to compliance with NYSE s other continued listing standards, our common stock will continue to be listed on the NYSE.

A delisting of our common stock could negatively impact us by: (i) reducing the liquidity and market price of our common stock; (ii) reducing the number of investors willing to hold or acquire our common stock, which could negatively impact our ability to raise equity financing; (iii) limiting our ability to use a registration statement to offer and sell freely tradable securities, thereby preventing us from accessing the public capital markets, (iv) impairing our ability to provide equity incentives to our employees and (v) causing an increase in the conversion rate under the Convertible Notes, resulting in the issuance of additional shares upon conversion. A delisting of

Table of Contents

our common stock is not an event of default under the documents governing our senior credit facilities and Convertible Notes.

Our business may be harmed if we are unable to meet Payment Card Industry data security standards.

We are currently in the process of upgrading our systems and procedures to meet Payment Card Industry (PCI) data security standards, which requires periodic audits, including an audit prior to the end of 2008, by independent third parties to assess compliance. PCI data security standards are a comprehensive set of requirements for enhancing payment account data security that was developed by the PCI Security Standards Council including American Express, Discover Financial Services, JCB International, MasterCard Worldwide and VISA Inc., to help facilitate the broad adoption of consistent data security measures. Failure to comply with the security requirements or rectify a security issue may result in fines. While we believe it is unusual, restrictions on accepting payment cards, including a complete restriction, may be imposed on companies that are not compliant. While there can be no assurance, we currently expect to be compliant with PCI security standards by the end of 2008, although it is likely that the audit to confirm compliance will have started but will not be completed at that time.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Use of Proceeds from Initial Public Offering

On May 23, 2006, the Securities and Exchange Commission declared effective our Registration Statement on Form S-1 (File No. 333-131659) relating to our IPO. After deducting underwriting discounts and commissions and other offering expenses, our net proceeds from the offering equaled approximately $491,144, which includes $1,896 of costs incurred in 2005. We have invested the net proceeds of the offering in short-term, interest bearing securities pending their use to fund our expansion, including funding marketing expenses and operating losses. Except for payments made in 2007 in connection with IP litigation settlements, there has been no material change in our planned use of proceeds from our IPO as described in our final prospectus filed with the Securities and Exchange

Table of Contents

Commission pursuant to Rule 424(b). We did not use any of the net proceeds from the IPO until the year ended December 31, 2007. Since January 2007, we used $292,617 of the net proceeds from the IPO to fund operating activities including $210,275 for IP litigation settlements and $79,798 for capital expenditures, software development and purchase of intangible assets.

Item 3. Defaults Upon Senior Securities

None

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

On August 20, 2008, a special meeting of stockholders was held to ask stockholders of Vonage Holdings Corp. to approve the issuance of all shares of Vonage common stock that may be issued upon conversion of $90 million of convertible secured second lien notes that Vonage and Vonage America Inc. (Vonage America) had expected to issue as co-issuers in a private placement, including shares of Vonage common stock that may be issued to our directors, officers and substantial security holders upon conversion of such notes. The number of votes which the shares of the Company s stock represented at the special meeting in person or by proxy was 115,671,688, constituting more than a majority of the votes which the outstanding shares of the Company s common stock were entitled to vote at the special meeting. There were 115,236,579 votes cast in favor, 331,342 votes against and 103,767 votes abstained.

Subsequent to the August 20, 2008 approval, our management and Board of Directors, along with Silver Point Finance, LLC, determined that it was in the best interest of all parties to further negotiate the terms of the contemplated financing, including the terms of the notes referenced in the immediately preceding paragraph. On November 3, 2008, a special meeting of stockholders was held to ask stockholders of Vonage Holdings Corp. to approve the issuance of all shares of Vonage common stock that may be issued upon conversion of $18,000 of convertible secured third lien notes that Vonage and Vonage America issued following the special meeting as co-issuers in a private placement, including shares of Vonage common stock that may be issued to our directors, officers and substantial security holders upon conversion of such notes. The number of votes which the shares of the Company s stock represented at the special meeting in person or by proxy was 113,800,341, constituting more than a majority of the votes which the outstanding shares of the Company s common stock were entitled to vote at the special meeting. There were 113,540,680 votes cast in favor, 235,553 votes against and 24,108 votes abstained.

Item 5. Other Information

On November 6, 2008, Vonage Holdings Corp. (the Company) announced its financial results for the quarter ended September 30, 2008. The full text of a press release issued in connection with the announcement was furnished as Exhibit 99.1 to a Current Report on Form 8-K filed with the Securities and Exchange Commission on November 6, 2008. This information was released after the Company s management and independent registered public accountants participated in a discussion of the Company s quarter-end financial statements with the audit committee of its board of directors. As explained in more detail below, after the release of preliminary financial information and based upon discussions with its independent registered public accountants in connection with finalizing this Form 10-Q, the Company has subsequently made a determination that causes certain amounts reported in the November 6, 2008 press release to be different from amounts reported in the Form 10-Q.

Since November 6, 2008, the Company determined to categorize $8,601 of debt related costs paid in connection with the Company s recently completed refinancing as cash used in financing operations rather than cash used in operations. These adjustments had the effect of changing the Company s net cash provided by (used in) operating activities from $(26,524) to $(17,923) for the three months ended September 30, 2008 and from $(2,430) to $6,171 for the nine months ended September 30, 2008. Net cash provided by (used in) financing activities changed from $(245) to $(8,846) for the three months ended September 30, 2008 and from $(633) to $(9,234) for the nine months ended September 30, 2008.

Item 6. Exhibits

Exhibit Number	Description of Exhibit
3.1	Second Amended and Restated By-laws of Vonage Holdings Corp.(2)
10.1	First Lien Credit and Guaranty Agreement, dated as of October 19, 2008 among Vonage Holdings Corp., Vonage America Inc., as borrowers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various lenders, and Silver Point Finance, LLC, as Administrative Agent, Collateral Agent and Lead Arranger(3)

10.2	First Lien Pledge and Security Agreement, dated as of October 19, 2008 among Vonage Holdings Corp., Vonage America Inc. and certain subsidiaries of Vonage Holdings Corp., as grantors, and Silver Point Finance, LLC, as Collateral Agent(3)
10.3	Second Lien Credit and Guaranty Agreement, dated as of October 19, 2008 among Vonage Holdings Corp., Vonage America Inc., as borrowers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various lenders, and Silver Point Finance, LLC, as Administrative Agent, Collateral Agent and Lead Arranger(3)
10.4	Second Lien Pledge and Security Agreement, dated as of October 19, 2008 among Vonage Holdings Corp., Vonage America Inc. and certain subsidiaries of Vonage Holdings Corp., as grantors, and Silver Point Finance, LLC, as Collateral Agent(3)
10.5	Third Lien Note Purchase Agreement dated as of October 19, 2008 among Vonage Holdings Corp., Vonage America Inc., as co-issuers, certain subsidiaries of Vonage Holdings Corp., as guarantors, various purchasers, and Silver Point Finance, LLC, as Note Agent and Collateral Agent(3)
10.6	Third Lien Pledge and Security Agreement, dated as of October 19, 2008 among Vonage Holdings Corp., Vonage America Inc. and certain subsidiaries of Vonage Holdings Corp., as grantors, and Silver Point Finance, LLC, as Collateral Agent(3)

10.7	Form of 20.00% Senior Secured Third Lien Notes due 2015 issued by Vonage Holdings Corp. and Vonage America Inc.(3)
10.8	Registration Rights Agreement, dated as of October 19, 2008, among Vonage Holdings Corp., Vonage America Inc. and purchasers of 20.00% Senior Secured Third Lien Notes due 2015(3)
10.9	Amended and Restated Non-Compete Agreement dated as of October 17, 2008 by and between Vonage Holdings Corp. and Jeffrey A. Citron(1)
10.10*	Employment Agreement dated as of July 29, 2008 by and between Vonage Holdings Corp. and Marc P. Lefar(2)
10.11*	Indemnification Agreement dated as of July 29, 2008 by and between Vonage Holdings Corp. and Marc. P. Lefar(2)
10.12*	Form of Nonqualified Stock Option Agreement for Marc P. Lefar under the Vonage Holdings Corp. 2006 Incentive Plan(2)
10.13*	Separation Agreement and General Release dated as of July 29, 2008 by and between Vonage Holdings Corp. and Jeffrey A. Citron(2)
10.14*	Consulting Agreement dated as of July 29, 2008 by and between Vonage Holdings Corp. and KEC Holdings LLC(2)
10.15*	Form of Nonqualified Stock Option Agreement for Jeffrey A. Citron under the Vonage Holdings Corp. 2006 Incentive Plan(2)
31.1	Certification of the Company s Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
31.2	Certification of the Company s Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
32.1	Certification of the Company s Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002(1)

(1) Filed herewith.

(2) Incorporated by reference to Vonage Holding Corp. s Current Report on Form 8-K filed on August 4, 2008.

(3) Incorporated by reference to Vonage Holding Corp. s Amendment No. 8 to Schedule TO filed on October 22, 2008.

* Management contract or compensatory plan or arrangement.

Table of Contents

SIGNATURE

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

VONAGE HOLDINGS CORP.

Dated: November 10, 2008

By: /s/ JOHN S. REGO
John S. Rego
Executive Vice President, Chief Financial Officer
and Treasurer
(Principal Financial and Accounting Officer and Duly Authorized Officer)

Table of Contents

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31.1	Certification of the Company s Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
31.2	Certification of the Company s Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-14(a) and 15d-14(a), as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002(1)
32.1	Certification of the Company s Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002(1)

(1) Filed herewith.

(2) Incorporated by reference to Vonage Holding Corp. s Current Report on Form 8-K (File No. 001-32887) filed on August 4, 2008.

(3) Incorporated by reference to Vonage Holding Corp. s Amendment No. 8 to Schedule TO filed on October 22, 2008.

* Management contract or compensatory plan or arrangement.

34