

VONAGE HOLDINGS CORP  
Form 10-Q  
November 04, 2010  
[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, 2010**

**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**  
**(State or other jurisdiction of**

**incorporation or organization)**

**11-3547680**  
**(IRS Employer**

**Identification No.)**

**23 Main Street, Holmdel, NJ**  
**(Address of principal executive offices)**

**07733**  
**(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**

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

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

\* The registrant has not yet been phased into the interactive data requirements.

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 ☐

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 ☒

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

**Class**  
**Common Stock, par value \$0.001**

**Outstanding at October 31, 2010**  
**212,684,909 shares**

**Table of Contents**

**VONAGE HOLDINGS CORP.**

**INDEX**

|   | <b>Page</b> |
|---|-------------|
| <b><u>Part I. Financial Information</u></b>   |             |
| Item 1. <u>Financial Statements</u>   |             |
| <u>A) Consolidated Balance Sheets as of September 30, 2010 (Unaudited) and December 31, 2009</u>                          | 2           |
| <u>B) Unaudited Consolidated Statements of Operations for the Three and Nine Months Ended September 30, 2010 and 2009</u> | 3           |
| <u>C) Unaudited Consolidated Statements of Cash Flows for the Nine Months Ended September 30, 2010 and 2009</u>           | 4           |
| <u>D) Unaudited Consolidated Statement of Stockholders' Deficit for the Nine Months Ended September 30, 2010</u>          | 5           |
| <u>E) Notes to Unaudited Consolidated Financial Statements for the Nine Months Ended September 30, 2010</u>               | 6           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                      | 20          |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 35          |
| Item 4. <u>Controls and Procedures</u>  | 35          |
| <b><u>Part II. Other Information</u></b>  |             |
| Item 1. <u>Legal Proceedings</u>  | 36          |
| Item 1A. <u>Risk Factors</u>  | 36          |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  | 36          |
| Item 3. <u>Defaults Upon Senior Securities</u>  | 36          |
| Item 5. <u>Other Information</u>  | 36          |
| Item 6. <u>Exhibits</u>   | 37          |
| <u>Signature</u>  | 38          |
| <b>Financial Information Presentation</b>   |             |

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)**

|  | <b>September 30,<br/>2010<br/>(unaudited)</b> | <b>December 31,<br/>2009</b> |
|--|---|------------------------------|
| <b>Assets</b>  |   |                              |
| <b>Assets</b>  |   |                              |
| Current assets:  |   |                              |
| Cash and cash equivalents  | \$ 136,251                                    | \$ 32,213                    |
| Accounts receivable, net of allowance of \$1,004 and \$1,432, respectively | 19,000  | 15,053                       |
| Inventory, net of allowance of \$610 and \$432, respectively               | 4,265   | 7,771                        |
| Deferred customer acquisition costs, current                               | 7,896   | 15,997                       |
| Prepaid expenses and other current assets                                  | 21,340  | 40,425                       |
| Total current assets   | 188,752                                       | 111,459                      |
| Property and equipment, net  | 79,315  | 90,548                       |
| Software, net  | 31,789  | 35,540                       |
| Deferred customer acquisition costs, non-current                           | 1,518   | 7,075                        |
| Debt related costs, net  | 4,819   | 7,412                        |
| Restricted cash  | 48,480  | 43,700                       |
| Intangible assets, net   | 4,473   | 5,331                        |
| Other assets   | 3,250   | 12,319                       |
| Total assets   | \$ 362,396                                    | \$ 313,384                   |
| <b>Liabilities and Stockholders Deficit</b>                                |   |                              |
| <b>Liabilities</b>   |   |                              |
| Current liabilities:   |   |                              |
| Accounts payable   | \$ 35,751                                     | \$ 11,512                    |
| Accrued expenses   | 103,362                                       | 69,171                       |
| Deferred revenue, current portion  | 46,687  | 55,929                       |
| Current maturities of capital lease obligations                            | 1,708   | 1,500                        |
| Current portion of notes payables  | 1,303   | 1,303                        |
| Total current liabilities  | 188,811                                       | 139,415                      |
| Notes payable, net of discount and current maturities                      | 177,185                                       | 200,468                      |
| Embedded features within notes payable, at fair value                      | 79,520  | 25,050                       |
| Deferred revenue, net of current portion                                   | 2,310   | 8,629                        |
| Capital lease obligations, net of current maturities                       | 18,145  | 19,448                       |
| Other liabilities, net of current portion in accrued expenses              | 7,816   | 12,283                       |

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|   |             |             |
|---|-------------|-------------|
| Total liabilities   | 473,787     | 405,293     |
| <b>Commitments and Contingencies</b>  |             |             |
| <b>Stockholders' Deficit</b>  |             |             |
| Common stock, par value \$0.001 per share; 596,950 shares authorized at September 30, 2010 and December 31, 2009; 214,564 and 201,628 shares issued at September 30, 2010 and December 31, 2009, respectively; 212,677 and 199,898 shares outstanding at September 30, 2010 and December 31, 2009, respectively |             |             |
|   | 215         | 202         |
| Additional paid-in capital  | 1,031,200   | 1,008,547   |
| Accumulated deficit   | (1,130,212) | (1,088,236) |
| Treasury stock, at cost, 1,887 shares at September 30, 2010 and 1,730 shares at December 31, 2009   | (13,139)    | (12,878)    |
| Accumulated other comprehensive income  | 545         | 456         |
| Total stockholders' deficit   | (111,391)   | (91,909)    |
| Total liabilities and stockholders' deficit   | \$ 362,396  | \$ 313,384  |

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

**Table of Contents****VONAGE HOLDINGS CORP.****CONSOLIDATED STATEMENTS OF OPERATIONS****(In thousands, except per share amounts)****(Unaudited)**

|  | <b>Three Months Ended<br/>September 30,</b> |             | <b>Nine Months Ended<br/>September 30,</b> |             |
|--|---|-------------|--|-------------|
|  | <b>2010</b>                                 | <b>2009</b> | <b>2010</b>                                | <b>2009</b> |
| <b>Operating Revenues:</b>   |   |             |  |             |
| Telephony services   | \$ 212,135                                  | \$ 216,085  | \$ 658,366                                 | \$ 646,437  |
| Customer equipment and shipping  | 1,991                                       | 5,420       | 9,052                                      | 19,101      |
|  | 214,126                                     | 221,505     | 667,418                                    | 665,538     |
| <b>Operating Expenses:</b>   |   |             |  |             |
| Direct cost of telephony services (excluding depreciation and amortization of \$4,357, \$4,371, \$14,297 and \$14,000, respectively) | 60,263                                      | 52,044      | 185,727                                    | 155,275     |
| Direct cost of goods sold  | 13,214                                      | 17,727      | 43,914                                     | 54,418      |
| Selling, general and administrative  | 58,908                                      | 63,187      | 180,463                                    | 202,565     |
| Marketing  | 49,254                                      | 57,393      | 147,818                                    | 175,232     |
| Depreciation and amortization  | 12,649                                      | 12,881      | 40,346                                     | 39,625      |
|  | 194,288                                     | 203,232     | 598,268                                    | 627,115     |
| Income from operations   | 19,838                                      | 18,273      | 69,150                                     | 38,423      |
| <b>Other Income (Expense):</b>   |   |             |  |             |
| Interest income  | 154   | 58          | 380  | 228         |
| Interest expense   | (11,569)                                    | (13,690)    | (37,203)                                   | (40,911)    |
| Change in fair value of embedded features within notes payable and stock warrant   | (62,150)                                    | (62,998)    | (69,556)                                   | (48,878)    |
| Gain (loss) on extinguishment of notes   | (1,545)                                     | 3,816       | (4,492)                                    | 3,816       |
| Other income (expense), net  | (19)  | 15          | 41   | 821         |
|  | (75,129)                                    | (72,799)    | (110,830)                                  | (84,924)    |
| Loss before income tax expense   | (55,291)                                    | (54,526)    | (41,680)                                   | (46,501)    |
| Income tax expense   | (91)  | (29)        | (296)                                      | (498)       |
| Net loss   | \$ (55,382)                                 | \$ (54,555) | \$ (41,976)                                | \$ (46,999) |
| <b>Net loss per common share:</b>  |   |             |  |             |
| Basic  | \$ (0.26)                                   | \$ (0.33)   | \$ (0.20)                                  | \$ (0.29)   |
| Diluted  | \$ (0.26)                                   | \$ (0.33)   | \$ (0.20)                                  | \$ (0.29)   |

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Weighted-average common shares outstanding:

|         |         |         |         |         |
|---------|---------|---------|---------|---------|
| Basic   | 212,086 | 167,666 | 208,278 | 160,477 |
| Diluted | 212,086 | 167,666 | 208,278 | 160,477 |

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

**Table of Contents****VONAGE HOLDINGS CORP.****CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2010</b>                                | <b>2009</b> |
| <b>Cash flows from operating activities:</b>                                    |  |             |
| Net loss  | \$ (41,976)                                | \$ (46,999) |
| Adjustments to reconcile net loss to net cash provided by operating activities: |  |             |
| Depreciation and amortization and impairment charges                            | 39,487                                     | 38,530      |
| Amortization of intangibles   | 859  | 1,095       |
| Change in fair value of embedded features in notes payable and stock warrant    | 69,556                                     | 48,878      |
| Loss on extinguishment of notes   | 4,492                                      | (3,816)     |
| Amortization of discount on notes   | 3,723                                      | 4,109       |
| Accrued interest paid in-kind   | 13,471                                     | 12,513      |
| Allowance for doubtful accounts   | (438)                                      | 689         |
| Allowance for obsolete inventory  | 1,848                                      | 1,911       |
| Amortization of debt related costs  | 1,080                                      | 2,224       |
| Share-based expense   | 5,831                                      | 6,893       |
| Changes in operating assets and liabilities:                                    |  |             |
| Accounts receivable   | (3,503)                                    | 192         |
| Inventory   | 1,667                                      | (5,515)     |
| Prepaid expenses and other current assets                                       | 18,739                                     | (23,564)    |
| Deferred customer acquisition costs   | 13,660                                     | 16,641      |
| Other assets  | 9,069                                      | 1,663       |
| Accounts payable  | 24,414                                     | (23,604)    |
| Accrued expenses  | 33,950                                     | 3,873       |
| Deferred revenue  | (15,584)                                   | (14,624)    |
| Other liabilities   | (4,991)                                    | (4,429)     |
| Net cash provided by operating activities                                       | 175,354                                    | 16,660      |
| <b>Cash flows from investing activities:</b>                                    |  |             |
| Capital expenditures  | (11,346)                                   | (11,719)    |
| Acquisition and development of software assets                                  | (13,266)                                   | (11,516)    |
| Increase in restricted cash   | (4,809)                                    | (438)       |
| Net cash used in investing activities   | (29,421)                                   | (23,673)    |
| <b>Cash flows from financing activities:</b>                                    |  |             |
| Principal payments on capital lease obligations                                 | (1,095)                                    | (911)       |
| Principal payments on notes   | (41,792)                                   | (1,483)     |
| Debt related costs  |  | (251)       |
| Proceeds from exercise of stock options   | 797  | 57          |
| Net cash used in financing activities   | (42,090)                                   | (2,588)     |



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|  |            |           |
|--|------------|-----------|
| Effect of exchange rate changes on cash        | 195        | 1,286     |
| Net change in cash and cash equivalents        | 104,038    | (8,315)   |
| Cash and cash equivalents, beginning of period | 32,213     | 46,134    |
| Cash and cash equivalents, end of period       | \$ 136,251 | \$ 37,819 |

## **Supplemental disclosures of cash flow information:**

|                                   |           |           |
|-----------------------------------|-----------|-----------|
| Cash paid during the periods for: |           |           |
| Interest                          | \$ 22,677 | \$ 22,050 |
| Income taxes                      | \$ 93     | \$ 1,019  |

## Non-cash financing transactions during the periods for:

|  |           |           |
|--|-----------|-----------|
| Conversion of convertible notes into common stock:                   |           |           |
| Third lien convertible notes, net of discount and debt related costs | \$ 2,562  | \$ 8,846  |
| Embedded conversion option within third lien convertible notes       | \$ 14,563 | \$ 53,480 |

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

Table of Contents

## VONAGE HOLDINGS CORP.

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS DEFICIT

(In thousands)

(Unaudited)

|   | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income | Total        |
|---|-----------------|----------------------------------|------------------------|-------------------|---|--------------|
| Balance at December 31, 2009            | \$ 202          | \$ 1,008,547                     | \$ (1,088,236)         | \$ (12,878)       | \$ 456  | \$ (91,909)  |
| Stock option exercises                  | 2               | 795                              |                        |                   |   | 797          |
| Share-based expense                     |                 | 5,831                            |                        |                   |   | 5,831        |
| Share-based award activity              |                 |                                  |                        | (261)             |   | (261)        |
| Convertible notes conversion            | 11              | 16,027                           |                        |                   |   | 16,038       |
| Comprehensive income (loss):            |                 |                                  |                        |                   |   |              |
| Foreign currency translation adjustment |                 |                                  |                        |                   | 89  | 89           |
| Net loss                                |                 |                                  | (41,976)               |                   |   | (41,976)     |
| Total comprehensive income (loss)       |                 |                                  | (41,976)               |                   | 89  | (41,887)     |
| Balance at September 30, 2010           | \$ 215          | \$ 1,031,200                     | \$ (1,130,212)         | \$ (13,139)       | \$ 545  | \$ (111,391) |

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

**Table of Contents**

**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 leading provider of communications services connecting individuals and social networks through broadband devices worldwide. While customers in the United States represented 94% of our subscriber lines at September 30, 2010, we also serve customers internationally with services in Canada and the United Kingdom.

**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' deficit for the periods presented. The results for the three and nine month periods ended September 30, 2010 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 2009 Annual Report on Form 10-K filed with the Securities and Exchange Commission on February 26, 2010.

**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 life ) used to amortize deferred revenue and deferred customer acquisition costs associated with customer activation;

the useful lives of property and equipment, software costs and intangible assets;

assumptions used for the purpose of determining share-based compensation and the fair value of our stock warrant using the Black-Scholes option pricing model ( Model ), and various other assumptions that we believed to be reasonable. The key inputs for this Model are our stock price at valuation date, exercise price, the dividend yield, risk-free interest rate, life in years, and historical volatility of our common stock;

assumptions used to determine the fair value of the embedded conversion option within our convertible notes using the Monte Carlo simulation model. The key inputs are maturity date, risk-free interest rate, our stock price at valuation date, and historical volatility of our common stock; and

assumptions used to determine the fair value of the embedded make-whole premium feature within our senior secured first lien credit facility (the First Lien Senior Facility ) and our senior secured second lien credit facility (the Second Lien Senior Facility ). 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.

**Table of Contents****VONAGE HOLDINGS CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts)****(Unaudited)***Prepaid Expenses and Other Current Assets*

|   | September 30,<br>2010 | December 31,<br>2009 |
|---|-----------------------|----------------------|
| Nontrade receivables                          | \$ 5,565              | \$ 7,117             |
| Telecommunications                            | 4,906                 | 8,845                |
| Software and hardware maintenance and support | 4,854                 | 6,958                |
| Marketing                                     | 1,913                 | 894                  |
| Insurance                                     | 1,565                 | 1,885                |
| Services                                      | 1,411                 | 2,887                |
| Other prepaids                                | 1,126                 | 2,382                |
| Inventory                                     |                       | 9,457                |
|   | \$ 21,340             | \$ 40,425            |

*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. Based on a review of credit risk exposure, our credit card processors reduced our cash reserves to \$0 as of September 30, 2010, from \$22,423 at December 31, 2009. We also had a cash collateralized letter of credit for \$10,500 as of September 30, 2010 and December 31, 2009, respectively. In addition, we had a cash collateralized letter of credit for \$7,350 as of September 30, 2010 and December 31, 2009, respectively, related to lease deposits for our offices and a cash collateralized letter of credit for \$535 and \$0 as of September 30, 2010 and December 31, 2009, respectively, related to an energy curtailment program for our offices. The total amount of collateralized letters of credit was \$18,385 and \$18,000 at September 30, 2010 and December 31, 2009, respectively. In the aggregate, cash reserves and collateralized letters of credit of \$48,480 and \$43,700 were recorded as long-term restricted cash at September 30, 2010 and December 31, 2009, respectively.

Pursuant to the terms of credit facilities (see Note 3. Notes Payable), commencing October 1, 2009, all specified unrestricted cash above \$30,000, subject to certain adjustments, has been swept into a concentration account (the "Concentration Account"), and until the balance in the Concentration Account was at least equal to \$30,000, we could not access or make any withdrawals from the Concentration Account. As of September 30, 2010, we have funded \$129,679 into the Concentration Account; of this amount, \$30,000 is reflected as restricted cash and \$99,679 is reflected as cash. With limited exceptions, we will have the right to withdraw funds from the Concentration Account in excess of \$30,000. We funded an additional \$765 through October 31, 2010.

*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 Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 350-40, *Internal-Use Software*. Computer software is stated at cost less accumulated amortization and the estimated useful life is two to three years. Total computer software was \$84,950 and \$72,359 at September 30, 2010 and December 31, 2009, respectively, substantially all of which were external costs. Accumulated amortization was \$53,161 and \$36,819 at September 30, 2010 and December 31, 2009, respectively. Amortization

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expense was \$5,493 and \$5,314 for the three months ended September 30, 2010 and 2009, respectively, and \$16,999 and \$14,657, including impairment of \$135 and \$969, for the nine months ended September 30, 2010 and 2009, respectively.

### *Development Expenses*

Costs for research, including predevelopment efforts prior to establishing technological feasibility of software, are expensed as incurred. Development costs are capitalized when technological feasibility has been established and anticipated future revenues support the recoverability of the capitalized amounts. Capitalization stops when the product is available for general release to customers. Due to the short time period between achieving technological feasibility and product release and the insignificant amount of costs incurred during such periods, we have not capitalized any software development costs, and have expensed these costs as incurred. These costs are included in selling, general and administrative expense.

### *Debt Related Costs*

Costs incurred in raising debt are deferred and amortized as interest expense using the effective interest method over the life of the debt. In connection with our financing transaction in November 2008, we recorded debt related costs of \$12,271, which are being amortized over the life of the debt which is five years and seven years. Amortization expense related to these costs is included in interest expense in the consolidated statements of operations and was \$321 and \$1,080 for the three and nine months ended September 30, 2010,

**Table of Contents****VONAGE HOLDINGS CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts)****(Unaudited)**

respectively, and was \$708 and \$2,224 for the three and nine months ended September 30, 2009, respectively. Accumulated amortization of debt related costs was \$7,452 and \$4,859 at September 30, 2010 and December 31, 2009, respectively, including a \$405 and \$1,673 acceleration of unamortized debt related costs associated with the conversion of convertible notes for the nine months ended September 30, 2010 and the year ended December 31, 2009, respectively. At September 30, 2010, accumulated amortization of debt related costs included acceleration of unamortized debt related costs of \$1,107 associated with the prepayment to certain holders of our First Lien Senior Facility and our Second Lien Senior Facility.

*Accrued Expenses*

|  | September 30<br>2010 | December 31,<br>2009 |
|--|----------------------|----------------------|
| Taxes and fees                                     | \$ 24,574            | \$ 14,415            |
| Marketing  | 23,796               | 9,331                |
| Compensation and related taxes and temporary labor | 16,958               | 16,747               |
| Litigation   | 11,518               | 6,689                |
| Telecommunications                                 | 11,483               | 9,873                |
| Other accruals                                     | 6,509                | 3,000                |
| Professional fees                                  | 2,940                | 2,209                |
| Accrued interest                                   | 2,565                | 3,304                |
| Customer credits                                   | 2,205                | 3,384                |
| Inventory  | 497                  | 95                   |
| Credit card fees                                   | 317                  | 124                  |
|  | \$ 103,362           | \$ 69,171            |

*Derivative Instruments*

We do not hold or issue derivative instruments for trading purposes. However, in accordance with FASB ASC 815, *Derivatives and Hedging* ( FASB ASC 815 ), we review our contractual obligations to determine whether there are terms that possess the characteristics of derivative financial instruments that must be accounted for separately from the financial instrument in which they are embedded. Based upon this review, we are required to value the following features separately for accounting purposes:

certain features within our 20% senior secured third lien notes due 2015 ( Convertible Notes ) and a common stock warrant to purchase 514 shares of common stock at an exercise price of \$0.58 because the number of shares to be received by the holder of those instruments upon conversion or exercise could change under certain conditions; and

the make-whole premium provisions within our First Lien Senior Facility and our Second Lien Senior Facility because upon prepayment under certain circumstances we may be required to settle the debt for more than its face amount.

We recognize these features as liabilities in our consolidated balance sheet at fair value each period and recognize any change in the fair value in our statement of operations in the period of change. We estimate the fair value of these liabilities using available market information and

appropriate valuation methodologies.

*Fair Value of Financial Instruments*

Effective January 1, 2008, we adopted FASB ASC 820-10-25, *Fair Value Measurements and Disclosures*. This standard establishes a framework for measuring fair value and expands disclosure about fair value measurements. We did not elect fair value accounting for any assets and liabilities allowed by FASB ASC 825, *Financial Instruments*.

FASB ASC 820-10 defines fair value as the amount that would be received for an asset or paid to transfer a liability (i.e., an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. FASB ASC 820-10 also establishes a fair value hierarchy that requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. FASB ASC 820-10 describes the following three levels of inputs that may be used:

Level 1: Quoted prices (unadjusted) in active markets that are accessible at the measurement date for identical assets and liabilities. The fair value hierarchy gives the highest priority to Level 1 inputs.

Level 2: Observable prices that are based on inputs not quoted on active markets but corroborated by market data.



**Table of Contents****VONAGE HOLDINGS CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts)****(Unaudited)**

Level 3: Unobservable inputs when there is little or no market data available, thereby requiring an entity to develop its own assumptions. The fair value hierarchy gives the lowest priority to Level 3 inputs.

Liabilities measured at fair value on a recurring basis include the following at September 30, 2010:

|                            | Level 1 | Level 2  | Level 3   | Total     |
|----------------------------|---------|----------|-----------|-----------|
| <b>Liabilities:</b>        |         |          |           |           |
| Stock warrant              | \$      | \$ 1,077 | \$        | \$ 1,077  |
| Embedded conversion option |         |          | 19,520    | 19,520    |
| Make-whole premiums        |         |          | 60,000    | 60,000    |
|                            | \$      | \$ 1,077 | \$ 79,520 | \$ 80,597 |

The following tables set forth the inputs as of September 30, 2010 and December 31, 2009 and a summary of changes in the fair value of our embedded conversion option for the nine months ended September 30, 2010 and for the year ended December 31, 2009:

|   | September 30, 2010        | December 31, 2009         |
|---|---------------------------|---------------------------|
|   | October 31, 2015          | October 31, 2015          |
| Maturity date                             | 1.28%                     | 2.95%                     |
| Risk-free interest rate                   | 2.55                      | 1.40                      |
| Price of common stock                     | \$                        | \$                        |
| Volatility                                | 102.5%                    | 109.3%                    |
| <b>Liabilities:</b>                       | <b>Nine Months Ended</b>  | <b>For the Year Ended</b> |
|   | <b>September 30, 2010</b> | <b>December 31, 2009</b>  |
| Beginning balance                         | \$ 25,050                 | \$ 32,720                 |
| Increase in value for notes converted     | 70                        | 34,682                    |
| Fair value adjustment for notes converted | (14,563)                  | (57,050)                  |
| Total unrealized loss in earnings         | 8,963                     | 14,698                    |
| Ending balance                            | \$ 19,520                 | \$ 25,050                 |

The following table sets forth a summary of changes in the fair value of our make-whole premiums for the nine months ended September 30, 2010 and for the year ended December 31, 2009:

|                     | Nine Months Ended | For the Year Ended |
|---------------------|-------------------|--------------------|
|                     | September 30,     | December 31,       |
|                     | 2010              | 2009               |
| <b>Liabilities:</b> |                   |                    |

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|                                   |    |        |    |
|-----------------------------------|----|--------|----|
| Beginning balance                 | \$ |        | \$ |
| Total unrealized loss in earnings |    | 60,000 |    |
| Ending balance                    | \$ | 60,000 | \$ |

We estimate the fair value of the make-whole premiums as the difference between the estimated value of the First Lien Senior Facility and Second Lien Senior Facility with and without the make-whole premiums. Since there is no current observable market for valuing the make-whole premiums, we determine the value using a scenario analysis that incorporates the settlement alternatives available to the debt holders in connection with the make-whole premiums. The scenario analysis valuation model combined expected cash outflows with market-based assumptions and an estimate of the probability of each scenario occurring.

The fair value of the First Lien Senior Facility and Second Lien Senior Facility with the make-whole premiums is estimated by assigning probabilities to the likelihood of completing a repurchase at various settlement amounts as well as not completing a repurchase. Included in this analysis is the acceptance of prepayments without premium in connection with the Consolidated Excess Cash Flow (as defined in the Credit Agreement). The fair value of the First Lien Senior Facility and Second Lien Senior Facility without the make-whole premiums is estimated using a present value model. The present value model combined expected cash outflows with market-based assumptions regarding available interest rates, credit spread relative to our credit rating, and liquidity. As a component of these analyses, we incorporated a market participant consideration as to our capacity to fulfill our contractual obligations including our ability to fulfill any cash settlement obligations, as well as our ability to refinance the First Lien Senior Facility and Second Lien Senior Facility.

Through June 30, 2010, we estimated the fair value of the make-whole premiums to have nominal fair value. During the third quarter of 2010, due to our improved financial condition and favorable credit market conditions, we entered into formal negotiations with the administrative agent, who is also the primary lender, regarding repurchasing the First Lien Senior Facility and Second Lien Senior Facility. In addition, unlike the Consolidated Excess Cash Flow (as defined in the Credit Documentation) offer in April 2010 that was fully accepted and allowed us to prepay, without premium, specified amounts, holders did not fully accept our Consolidated Excess Cash

**Table of Contents****VONAGE HOLDINGS CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts)****(Unaudited)**

Flow offer in July 2010, indicating our ability to continue to repay debt at par was no longer likely. We also determined that we could likely obtain financing at acceptable terms, which along with our existing cash on hand, would be sufficient to repurchase the First Lien Senior Facility and Second Lien Senior Facility including any amounts due pursuant to the make-whole premiums. Based upon these factors and our valuation analysis, the First Lien Senior Facility and the Second Lien Senior Facility make-whole premiums were estimated to have a fair value of \$60,000 as of September 30, 2010. This value may be adjusted upward or downward in subsequent periods reflecting changes in the assumptions outlined above and does not reflect the actual value that might ultimately be paid.

Although management believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different fair value measurement at the reporting date.

*Fair Value of Other Financial Instruments*

The carrying amounts of our financial instruments, including cash and cash equivalents, accounts receivable, and accounts payable, approximate fair value because of their short maturities. The carrying amounts of our capital leases approximate fair value of these obligations based upon management's best estimates of interest rates that would be available for similar debt obligations at September 30, 2010 and December 31, 2009.

Each reporting period we evaluate market conditions, including available interest rates, credit spread relative to our credit rating, and liquidity in estimating the fair value of our debt. After considering such market conditions, we estimate that the fair value of our debt (See Note 3 Notes Payable) at September 30, 2010, using a present value model, was approximately \$121,000 for the First Lien Senior Facility (\$87,003 carrying amount), approximately \$152,000 for the Second Lien Senior Facility (\$88,183 carrying amount) and approximately \$5,000 for the Convertible Notes (\$3,302 carrying amount). The primary assumptions for calculating fair value are market interest rates observed from publicly traded debt with similar credit ratings and maturities as well as assuming our debt is redeemed at maturity.

*Earnings per Share*

Net loss per share has been computed according to FASB ASC 260, *Earnings per Share*, which requires a dual presentation of basic and diluted earnings per share (EPS). Basic EPS represents net income (loss) divided by the weighted average number of common shares outstanding during a reported period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock, including outstanding warrants, stock options, and restricted stock units under our 2001 Stock Incentive Plan and 2006 Incentive Plan, and the Convertible Notes, were exercised or converted into common stock. The dilutive effect of outstanding warrants, stock options, and restricted stock units is reflected in diluted earnings per share by application of the treasury stock method. In applying the treasury stock method for stock-based compensation arrangements, the assumed proceeds are computed as the sum of the amount the employee must pay upon exercise and the amounts of average unrecognized compensation cost attributed to future services. The dilutive effect of the Convertible Notes is reflected in diluted earnings per share using the if-converted method.

For the three and nine months ended September 30, 2010 and 2009, the following were excluded from the calculation of diluted earnings per common share because of their anti-dilutive effects:

|                      | <b>Three Months Ended<br/>September 30,<br/>2010</b> |     | <b>Nine Months Ended<br/>September 30,<br/>2010</b> |     |
|----------------------|--|-----|---|-----|
| Common stock warrant | 514  | 514 | 514   | 514 |

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|                        |        |        |        |        |
|------------------------|--------|--------|--------|--------|
| Convertible Notes      | 8,276  | 21,962 | 8,276  | 21,962 |
| Restricted stock units | 2,385  | 2,983  | 2,385  | 2,983  |
| Employee stock options | 36,121 | 27,717 | 36,121 | 27,717 |
|                        | 47,296 | 53,176 | 47,296 | 53,176 |

### *Facility Exit and Restructuring Costs*

In June 2009, we announced the closing of our office facility in Canada, which was completed by the end of 2009. The final facility and restructuring costs were \$2,529 (including \$340 and \$2,464 for the three and nine months ended September 30, 2009, respectively), of which \$1,090 (including \$89 and \$1,063 for the three and nine months ended September 30, 2009, respectively) was for severance and personnel-related costs, \$670 (including \$153 and \$652 for the three and nine months ended September 30, 2009, respectively) was for lease termination and facilities-related costs, and \$769 (including \$97 and \$749 for the three and nine months ended September 30, 2009, respectively) was for asset impairments.

**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

*Recent Accounting Pronouncements*

In October 2009, the FASB issued Accounting Standards Update No. 2009-13 ( ASU 2009-13 ) *Revenue Recognition (Topic 605), Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force ( EITF )* . This ASU provides amendments to the criteria in FASB ASC 605-25 for separating consideration in multiple-deliverable arrangements. ASU 2009-13 changes existing rules regarding recognition of revenue in multiple deliverable arrangements and expands ongoing disclosures about the significant judgments used in applying its guidance. It will be effective for revenue arrangements entered into or materially modified in the fiscal year beginning on or after June 15, 2010. Early adoption is permitted on a prospective or retrospective basis. We are currently evaluating the impact of ASU 2009-13 on our financial statements.

**Note 2. Commitments and Contingencies**

*Litigation*

*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 and marketing disclosures.

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. On November 6, 2008, the Court entered an Order Granting Consolidation and Appointment of Co-Lead Counsel, and ordered that a consolidated Complaint be filed within 45 days, which Complaint was filed on December 19, 2008. On February 6, 2009, we filed a Motion to Compel Arbitration. On September 1, 2009, the Court denied without prejudice the Motion to Compel Arbitration. On December 2, 2009, we filed a Renewed Motion to Compel Arbitration. Briefing on the motion was completed in February 2010. The parties have engaged in limited discovery. On July 8, 2010, the Court requested that the parties submit supplemental letters to the Court on or before July 30, 2010, addressing the relevance of recent decisions by the U.S. Supreme Court and the U.S. Court of Appeals for the 3rd Circuit regarding arbitration provisions and the parties have filed these submissions.

On September 23, 2010, the parties reached a proposed settlement that includes a release and dismissal with prejudice of all consumer claims against us and will provide a settlement benefit of \$4,750 into a common fund for the benefit of class members. The common fund will include all awarded fees, costs, and expenses (including attorneys' fees and costs), the costs to provide notice of settlement, administrative expenses, and incentive awards, if any, with the remainder of the common fund to be distributed to members of the class pursuant to a plan of allocation among class members. The settlement is subject to negotiation of final documentation and Court approval. On September 28, 2010, the Court entered a Joint Stipulation staying the proceedings and terminating the pending Renewed Motion to Compel Arbitration. We have recorded a reserve of \$4,750 to reflect the proposed settlement. Of this amount, \$2,750 was recorded in the quarter ended September 30, 2010; with \$1,500 and \$750 recorded as a reduction to customer equipment and shipping and telephony services revenue, respectively, and \$500 recorded as selling, general and administrative expense in the consolidated statement of operations. The remaining \$2,000 was recorded as selling, general and

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administrative expense in the consolidated statement of operations in the quarter ended March 31, 2010.

*IPO Underwriter Indemnification.* On December 4, 2009, we received final Court approval for the settlement of litigation arising from our initial public offering ( IPO ), which included a release and dismissal of all stockholder claims against Vonage and its individual directors and officers who were named as defendants. 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, previously 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 previously 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. The settlement of the IPO litigation did not resolve the IPO underwriters' claims for indemnification against the Company.

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**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

*IP Matters*

*Alcatel-Lucent.* On November 4, 2008, Vonage received a letter from Alcatel-Lucent initiating an opportunity for Vonage to obtain a non-exclusive patent license to certain of its patents that may be relevant to Vonage's business. Vonage is currently analyzing the applicability of such patents to its business, as well as additional patents subsequently identified by Alcatel-Lucent. If Vonage determines that these patents are applicable to its business and valid, it may incur expense in licensing them. If Vonage determines that these patents are not applicable to its business or invalid, it may incur expense and damages if there is litigation.

*Ceres Communications Technologies LLC.* On October 6, 2010, Ceres Communications Technologies LLC (Ceres) filed a lawsuit against Vonage Holdings Corp. and its subsidiaries Vonage America, Inc. and Vonage Marketing LLC in the United States District Court for the District of Delaware alleging that Vonage's products and services are covered by a patent held by Ceres, United States Patent No. 5,774,526, entitled Reconfigurable On-Demand Telephone and Data Line System. The suit also named numerous other companies as defendants, including AT&T, Inc., Cablevision Systems Corporation, Comcast Corporation, Cox Communications Inc., Skype Global S.a.r.l, Skype Inc., Time Warner Cable, and Verizon Communications Inc. Vonage is currently reviewing the validity of the Ceres patent and whether any of Vonage's products and services are covered by it. Our response to the Complaint is currently due November 29, 2010.

From time to time, in addition to those identified above, we are 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. From time to time we receive letters from third parties initiating an opportunity for us to obtain patent licenses that might be relevant to our business. In accordance with generally accepted accounting principles, we make 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. Other than as set forth above, no additional reserves were recorded in the three months ended September 30, 2010. Litigation is inherently unpredictable. We believe that we have valid defenses with respect to the legal matters pending against us and are vigorously defending these matters. 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 Voice over Internet Protocol (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 uncertainty over the regulatory classification of VoIP service, 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 CALEA*

On August 5, 2005, the Federal Communications Commission (the FCC) released an Order extending the obligations of the 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.

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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 a 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.



**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

*Federal Local Number Portability*

On May 13, 2009, the FCC adopted an order that reduced to one business day the amount of time that a telecommunications provider such as Vonage has to port a telephone number to another provider. The North American Numbering Council proposed processes to implement the one-day requirement on November 2, 2009. Large telecommunication providers (greater than 2% of the nation's subscriber lines) have nine months to implement the process before the one-day requirement became effective on August 2, 2010. Smaller telecommunication providers, like Vonage, have fifteen months to implement the process before the one-day requirement becomes effective on February 2, 2011. If Vonage, or third parties it relies upon for porting, have difficulty complying with the new one-day porting requirement after the effective date, it could be subject to FCC enforcement action.

*State Telecommunications Regulation*

In general, the focus of interconnected VoIP telecommunications regulation is at the federal level. On November 12, 2004, the FCC issued a declaratory ruling providing that our service is subject to federal regulation and preempted the Minnesota Public Utilities Commission 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 U.S. 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 under this ruling generally 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. Lawsuits by the Nebraska Public Service Commission and New Mexico Public Regulatory Commission that were resolved in 2009 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 sought to apply state universal service funding requirements to Vonage. The Kansas Corporation Commission also has taken the position that it has jurisdiction to seek state universal service funding from nomadic VoIP providers. Similarly, the Public Utility Commission of Ohio has adopted rules that would apply state fees for Telephone Relay Service to nomadic VoIP service.

On July 16, 2009, the Nebraska Public Service Commission and the Kansas Corporation Commission filed a petition with the FCC seeking a declaratory ruling or, alternatively, adoption of a rule declaring that state authorities may apply universal service funding requirements to nomadic VoIP providers. We are participating in the FCC proceedings on the petition. A declaratory ruling could have the effect of overruling a May 1, 2009 decision by the United States Court of Appeals for the 8th Circuit in favor of Vonage. That decision enjoined the Nebraska Public Service Commission from asserting state jurisdiction over Vonage and forcing Vonage to contribute to the Nebraska Universal Service Fund and found the Nebraska Public Service Commission's assertion of state jurisdiction over Vonage is unlawful as preempted by the FCC. A declaratory ruling could also include a finding that the FCC's November 2004 declaratory ruling did not preempt states from assessing services provided by nomadic VoIP providers, such as Vonage, to support state universal service funding. The alternative action requested by the Nebraska Public Service Commission and Kansas Corporation Commission, adoption of a rule, could result in a finding that it is in the public interest to allow states to assess services provided by nomadic VoIP providers, such as Vonage, for state universal service funding on a going forward basis. In addition to this effort, we expect that state public utility commissions and state legislators will continue their attempts to apply state telecommunications regulations to nomadic VoIP service.

*State and Municipal Taxes*

In accordance with generally accepted accounting principles, we make a provision for a liability for taxes 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. For a period of time, we did not collect or remit state or municipal taxes (such as sales, excise, utility, use, and ad valorem taxes), fees or surcharges ( Taxes ) on the charges to our customers for our services, except that we historically complied with the New Jersey sales tax. We have received inquiries or demands from a number of state and municipal

**Table of Contents****VONAGE HOLDINGS CORP.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS****(In thousands, except per share amounts)****(Unaudited)**

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 to expressly include VoIP and we are now collecting and remitting sales taxes in those states. In addition, many states address how VoIP providers should contribute to support public safety agencies, and in those states we remit fees to the appropriate state agencies. We could also be contacted by state or municipal taxing and 911 agencies regarding Taxes that do explicitly apply to VoIP and these agencies could seek retroactive payment of Taxes. As such, we have a reserve of \$5,976 as of September 30, 2010 as our best estimate of the potential tax exposure for any retroactive assessment. We believe the maximum estimated exposure for retroactive assessments is approximately \$11,000 as of September 30, 2010.

*Purchase Obligations*

We have engaged a vendor to provide voicemail to text transcription services. We have committed to pay this vendor approximately \$249 in 2010, \$1,124 in 2011, \$1,524 in 2012, and \$1,197 in 2013. We have also engaged multiple vendors to provide collocation facilities. We have committed to pay these vendors approximately \$817 in 2010, \$4,926 in 2011, \$4,577 in 2012, and \$1,766 in 2013. In addition, we have engaged a vendor to provide local inbound services. We have committed to pay this vendor approximately \$293 in 2010, \$1,759 in 2011, and \$1,466 in 2012.

**Note 3. Notes Payable**

|  | <b>September 30,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|--|-------------------------------|------------------------------|
| 16% First Lien Senior Facility - due 2013, net of discount   | \$ 85,700                     | \$ 107,246                   |
| 20% Second Lien Senior Facility - due 2015, net of discount  | 88,183                        | 86,614                       |
| 20% Third Lien Convertible Notes - due 2015, net of discount | 3,302                         | 6,608                        |
|  | <b>\$ 177,185</b>             | <b>\$ 200,468</b>            |

  

|                                      | <b>First Lien<br/>Senior<br/>Facility</b> | <b>Second Lien<br/>Senior<br/>Facility</b> | <b>Third Lien<br/>Convertible<br/>Notes</b> |
|--------------------------------------|---|--|---|
| 2010                                 | \$ 326                                    | \$   | \$  |
| 2011                                 | 4,235                                     |  |   |
| 2012                                 | 13,030                                    |  |   |
| 2013                                 | 81,910                                    | 1,800                                      |   |
| 2014                                 |   | 7,200                                      |   |
| Thereafter                           |   | 53,540                                     | 2,400                                       |
| Minimum future payments of principal | 99,501                                    | 62,540                                     | 2,400                                       |
| Plus accreted interest               |   | 28,653                                     | 1,110                                       |
| Less unamortized discount            | 12,498                                    | 3,010                                      | 208   |
| Current portion                      | 1,303                                     |  |   |

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|                   |           |           |          |
|-------------------|-----------|-----------|----------|
| Long-term portion | \$ 85,700 | \$ 88,183 | \$ 3,302 |
|-------------------|-----------|-----------|----------|

On October 19, 2008, we entered into definitive agreements (collectively, the Credit Documentation ) for 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 our 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 funding for this transaction was completed on November 3, 2008.

The co-borrowers under the Financing are us and Vonage America Inc., our wholly owned subsidiary. Obligations under the Financing are guaranteed, fully and unconditionally, by our other U.S. subsidiaries (together with the borrowers, the Credit Parties ), and may in the future be guaranteed by Vonage Limited, a United Kingdom subsidiary of us. The lenders under the First Lien Senior Facility and the Second Lien Senior Facility and the purchasers of the Convertible Notes were Silver Point Finance, LLC, certain of its affiliates, other third parties, and affiliates of the Company.

For the First Lien Senior Facility, an aggregate value of \$105,322, or a discount of \$24,978, was recorded. This discount is currently amortized to interest expense over the life of the loan using the effective interest method. The accumulated amortization was \$12,480 and \$5,362 at September 30, 2010 and December 31, 2009, respectively, including the acceleration of unamortized discount on notes related to the prepayment of the First Lien Senior Facility of \$3,917 and \$0 for the nine months ended September 30, 2010

**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

and year ended December 31, 2009, respectively. The amortization for the three and nine months ended September 30, 2010 was \$966 and \$3,202, respectively. The amortization for the three and nine months ended September 30, 2009 was \$1,159 and \$3,425, respectively.

For the Second Lien Senior Facility, an aggregate value of \$67,273, or a discount of \$4,727, was recorded. This discount is currently amortized to interest expense over the life of the loan using the effective interest method. The accumulated amortization was \$1,717 and \$766 at September 30, 2010 and December 31, 2009, respectively, including the acceleration of unamortized discount on notes related to the prepayment of the Second Lien Senior Facility of \$472 and \$0 for the nine months ended September 30, 2010 and year ended December 31, 2009, respectively. The amortization for the three and nine months ended September 30, 2010 was \$149 and \$480, respectively. The amortization for the three and nine months ended September 30, 2009 was \$164 and \$485, respectively.

For the Convertible Notes, an aggregate value of \$55,884, or a premium of \$37,884, was recorded. Given the magnitude of the premium, this amount was recorded as additional paid-in capital as prescribed in FASB ASC 470-20-25 *Debt with Conversions and Other Options-Recognition*.

The following descriptions summarize certain material terms of the Financing as provided in the Credit Documentation.

*First Lien Senior Facility*

The loans under the First Lien Senior Facility will mature in October 2013. Principal amounts under the First Lien Senior Facility are repayable in quarterly installments of \$326 for each quarter ending December 31, 2008 through September 30, 2011 and \$3,258 for each quarter ending December 31, 2011 through September 30, 2013, with the balance due in October 2013. Amounts under the First Lien Senior Facility, at our option, bear interest at:

the greater of 4.00% and LIBOR plus, in either case, 12.00%, payable on the last day of each relevant interest period or, if the interest period is longer than three months, each day that is three months after the first day of the interest period and the last day of such interest period, or

the greater of 6.75% and the higher of (i) the rate quoted in The Wall Street Journal, Money Rates Section as the Prime Rate as in effect from time to time and (ii) the federal funds effective rate from time to time plus 0.50% plus, in either case, 11.00%, payable on the last day of each month in arrears.

*Second Lien Senior Facility*

The loans under the Second Lien Senior Facility will mature in October 2015. Principal amounts under the Second Lien Senior Facility will be repayable in quarterly installments of \$1,800 commencing the later of: (i) the last day of the fiscal quarter after payment-in-full of amounts under the First Lien Senior Facility or (ii) December 31, 2012, with the balance due in October 2015. Amounts under the Second Lien Senior Facility bear interest at 20% payable quarterly in arrears and payable in-kind, or PIK, beginning December 31, 2008 until the third anniversary of the effective date and thereafter 20% payable quarterly in arrears in cash. If the First Lien Senior Facility has not been refinanced in full by the third anniversary of the effective date, then until such refinancing has occurred 70% of the interest due will be payable in cash with the balance payable in PIK. The amount paid in PIK was \$32,321 and \$18,576 as of September 30, 2010 and December 31, 2009, respectively, of which \$3,668 was paid as part of the accepted Consolidated Excess Cash Flow offer on July 16, 2010.

*Consolidated Excess Cash Flow Prepayments*

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Beginning March 31, 2010, because it was the first quarter during which we had more than \$75,000 of specified unrestricted cash in any quarter, we have offered to prepay without premium 50% of the Consolidated Excess Cash Flow (as defined in the Credit Documentation) each quarter.

### *First Lien Senior Facility*

*Consolidated Excess Cash Flow March 31, 2010.* On April 22, 2010, we offered to prepay \$24,032 of loans under the First Lien Senior Facility. While certain holders of loans under the First Lien Senior Facility waived their right to receive the prepayment as permitted under the Credit Documentation, the \$24,032 offered was paid on April 27, 2010 to holders that did not waive the prepayment including certain affiliates or associates of the Company's directors. Of this amount, \$23,187 was applied to the outstanding principal balance, and \$845 was applied to accrued but unpaid interest. A loss on extinguishment of \$4,034, representing acceleration of unamortized debt discount, debt related costs, and administrative agent fees of \$3,312, \$662 and \$60, respectively, was recorded in the three-month period ended June 30, 2010 as a result of the prepayment.

*Consolidated Excess Cash Flow June 30, 2010.* On July 16, 2010, we offered to prepay \$40,776 of loans under the First Lien Senior Facility. While certain holders of loans under the First Lien Senior Facility waived their right to receive the prepayment as permitted under the Credit Documentation, \$4,655 was paid on July 21, 2010 to holders that did not waive the prepayment, who were

**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

affiliates or associates of the Company's directors. Of this amount, \$4,499 was applied to the outstanding principal balance and \$156 was applied to accrued but unpaid interest. A loss on extinguishment of \$731, representing acceleration of unamortized debt discount, debt related costs, and administrative agent fees of \$605, \$120 and \$6, respectively, was recorded in the three-month period ended September 30, 2010 as a result of the prepayment.

*Consolidated Excess Cash Flow – September 30, 2010.* We will offer to prepay loans under the First Lien Senior Facility, and if applicable, the Second Lien Senior Facility in an aggregate amount of \$11,084. We expect holders of the First Lien Senior Facility and Second Lien Senior Facility to waive their right to prepayment as a result of the proposed refinancing (See Note 4. Subsequent Events).

*Second Lien Senior Facility*

*Consolidated Excess Cash Flow – June 30, 2010.* On July 16, 2010, concurrent with the prepayment offer under the First Lien Senior Facility, we offered to prepay \$40,776 of loans under the Second Lien Senior Facility less \$4,655 required to prepay amounts under the First Lien Senior Facility prepayment offer. While certain holders of loans under the Second Lien Senior Facility waived their right to receive the prepayment as permitted under the Credit Documentation, \$13,281 was paid on July 21, 2010 to holders that did not waive the prepayment, who were affiliates or associates of the Company's directors. Of this amount \$13,128 was applied to the outstanding principal balance of which \$3,668 represents payment of PIK interest, which was recorded as a component of cash flows from financing activities, and \$153 was applied to accrued but unpaid interest. A loss on extinguishment of \$813, representing acceleration of unamortized debt discount, debt related costs, and administrative agent fees of \$472, \$325 and \$16, respectively, was recorded in the three-month period ended September 30, 2010 as a result of the prepayment.

*Other Prepayments under First Lien Senior Facility and Second Lien Senior Facility*

Certain events trigger prepayment obligations under the First Lien Senior Facility. To the extent we obtain proceeds from asset sales, insurance/condemnation recoveries or extraordinary receipts, certain prepayments may be required that will be subject to a premium of 7% in year 2, 6% in year 3, 5% in year 4 and 3% in the first 9 months of year 5 and no premium thereafter. In addition, any voluntary prepayments or any mandatory prepayments that may be required from proceeds of debt and equity issuances will be subject to a make-whole provision during the first three years, and thereafter a premium of 5% in year 4 and 3% in the first 9 months of year 5, with the First Lien Senior Facility callable at par thereafter.

Voluntary prepayments for the Second Lien Senior Facility may be made at any time subject to a make-whole provision. After payment-in-full of amounts under the First Lien Senior Facility or in the event mandatory payments are waived by lenders under the First Lien Senior Facility, the Second Lien Senior Facility will be subject to prepayment obligations and premiums consistent with those for the First Lien Senior Facility.

The First Lien Senior Facility and Second Lien Senior Facility include make-whole premiums that must be bifurcated from the underlying debt instrument and valued as a separate financial instrument because the economic and risk characteristics of the make-whole premiums meet the criteria for separate accounting as set forth in FASB ASC 815. The make-whole premiums were estimated to have a fair value of \$60,000 as of September 30, 2010 and a nominal fair value as of December 31, 2009. This value may be adjusted upward or downward in subsequent periods reflecting changes in the assumptions outlined in note 1 and does not reflect the actual value that might ultimately be paid.

*Third Lien Convertible Notes*

Subject to conversion, repayment or repurchase of the Convertible Notes, the Convertible Notes mature in October 2015. Subject to customary anti-dilution adjustments (including triggers upon the issuance of common stock below the market price of the common stock or the conversion price of the Convertible Notes), the Convertible Notes are convertible into shares of our common stock at a rate equal to 3,448.2759 shares for each \$1,000 principal amount of Convertible Notes, or approximately \$0.29 per share. A permanent increase in the conversion rate, resulting in

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the issuance of additional shares, may occur if a fundamental change occurs. During the quarter we did not receive any additional Notices of Conversion from certain note holders indicating their desire to convert their Convertible Notes. In the aggregate in 2010 and 2009, \$15,600 principal amount of Convertible Notes were converted into 53,793 shares of our common stock. As of September 30, 2010, there were \$2,400 principal amount of Convertible Notes outstanding.

Amounts under the Convertible Notes bear interest at 20% that accrues and compounds quarterly until October 30, 2011 at which time such accrued interest may be paid in cash. Any accrued interest not paid in cash on such date will continue to bear interest at 20% that accrues and compounds quarterly and is payable in cash on the maturity date of the Convertible Notes. After October 30, 2011, principal on Convertible Notes will bear interest at 20% payable quarterly in arrears in cash. However, if the First Lien Senior Facility has not been refinanced in full by October 31, 2011, then until such refinancing occurs, the cash interest will be capped at 14% with the balance of 6% accruing and compounding interest quarterly at 20%, to be paid in cash on the maturity date of the Convertible Notes. The amount of accrued and compounding interest as of September 30, 2010 and December 31, 2009 was \$1,110 and \$1,478, respectively. In connection with note conversions for the three and nine months ended September 30, 2010, \$0 and \$1,027, respectively, was paid for accrued interest.



**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

Subject to specific limitations and the right of holders to convert prior to such time, we may cause the automatic conversion of the Convertible Notes into common stock on or after the third anniversary of the issue date if a 30-day volume-weighted average price of our common stock is greater than \$6.00 per share.

In accordance with recent guidance codified in FASB ASC 815, which was effective January 1, 2009, we determined that the Convertible Notes contain an embedded derivative that requires separate valuation from the Convertible Notes because an anti-dilution adjustment is triggered upon the issuance of common stock by us below the conversion price of the Convertible Notes. As explained below, we recognize this embedded derivative as a liability in our consolidated balance sheet at its fair value each period and recognize any change in the fair value in our statement of operations in the period of change. The fair value of the embedded derivative is determined using the Monte Carlo simulation model. The key inputs in the model are maturity date, risk-free interest rate, current share price and historical volatility of our common stock.

In accordance with FASB ASC 815, we determined the fair value of the conversion feature and recorded applicable amounts as follows:

*Issuance.* The fair value of the conversion feature at issuance was \$39,990 which, upon the adoption of FASB ASC 815, was recorded as a liability with a corresponding reduction in additional-paid-in capital of \$37,884, which was the premium originally recorded at issuance. The remaining \$2,106 was recorded as a discount to be amortized to interest expense over the life of the loan using the effective interest method. Accumulated amortization of the discount was \$1,898 and \$1,541 as of September 30, 2010 and December 31, 2009, respectively, including a \$316 and \$1,271 acceleration of unamortized discount on notes related to the conversion of Convertible Notes, for the nine months ended September 30, 2010 and year ended December 31, 2009, respectively. The amortization for the three and nine months ended September 30, 2010 was \$10 and \$42, respectively. Amortization for the three and nine months ended September 30, 2009 was \$57 and \$199, respectively.

*December 31, 2008.* The fair value of the conversion feature at December 31, 2008 was \$32,720. The \$7,270 difference between the fair value of the conversion feature at December 31, 2008 and the issuance date, together with the \$47 amortization of the discount for the period ended December 31, 2008, were recorded as an adjustment to the opening balance of retained earnings that was recognized as a cumulative effect of a change in accounting principle as of January 1, 2009 in accordance with FASB ASC 815.

*Conversion of Convertible Notes in 2009.* At the time of conversions of \$12,305 principal amount of Convertible Notes, which were converted into 42,431 shares of our common stock, we determined that the aggregate fair value of the conversion feature of those Convertible Notes was \$57,050, which was an increase of \$34,682 in the fair value of the conversion feature from December 31, 2008. The changes in fair value were recorded as an expense within other income (expense) for the year ended December 31, 2009. The aggregate fair value of the common stock issued by us in the conversion was \$62,370 at the time of conversion, which was recorded as common stock and additional paid-in capital. In addition, in connection with the extinguishment of the converted Convertible Notes, we recorded a gain on extinguishment of \$4,041 for the three and nine months ended September 30, 2009, respectively, which represented the difference in the carrying value of those Convertible Notes including the fair value of the conversion feature, which was reduced by the discount of \$1,271 and debt related costs of \$1,673 associated with those Convertible Notes, and the fair value of the common stock issued at the time of conversion.

*Conversion of Convertible Notes in 2010.* At the time of conversion of the \$3,295 principal amount of Convertible Notes during the nine months ended September 30, 2010, which converted into 11,362 shares of our common stock, we determined that the aggregate fair value of the conversion feature of those Convertible Notes was \$14,563, which was an increase in value of \$70 from the fair value of the conversion feature as of December 31, 2009. This change in fair value was recorded as income within other income (expense), net for the nine months ended September 30, 2010. The aggregate fair value of the common stock issued by us in the conversion was \$16,038 at the time of conversion, which was recorded as common stock and additional paid-in capital. In addition, in connection with the extinguishment of the converted Convertible Notes, we recorded a gain on extinguishment of \$0 and \$1,087 for the three and nine months ended September 30, 2010, respectively, which represented the difference in the carrying value of those Convertible Notes including the fair value of the conversion feature, which was reduced

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by the discount of \$0 and \$316 and debt related costs of \$0 and \$416 for the three and nine months ended September 30, 2010, respectively, associated with those Convertible Notes, and the fair value of the common stock issued at the time of conversion.

*September 30, 2010.* For the \$2,400 principal amount of Convertible Notes, which are held by certain affiliates or associates of the Company's directors, that were not converted as of September 30, 2010, the fair value of the conversion feature of those Convertible Notes at September 30, 2010 was \$19,520, which was an increase in value of \$8,963 from December 31, 2009.

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**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

**Note 4. Subsequent Events**

On November 2, 2010, we entered into definitive agreements to refinance our existing debt, which are described below in more detail. Consistent with these agreements, we plan to (i) exercise our existing right to retire debt under our First Lien Senior Facility for 100% of the contractual make-whole price, (ii) retire debt under our Second Lien Senior Facility at a discount to the contractual make-whole price, and (iii) cause the conversion of all outstanding Convertible Notes. During the fourth quarter of 2010, we will seek to refinance this existing debt with a new senior secured term loan having significantly lower interest rates and less restrictive covenants. Completion of a refinancing on such terms (as to which there can be no assurance) will provide us greater flexibility to operate and grow our business.

*Master Agreement for Repayment of First Lien Loans and Second Lien Loans*

On November 2, 2010, we and Vonage America Inc. entered into a master agreement (the *Master Agreement*) to repay in full amounts due under our First Lien Senior Facility and Second Lien Senior Facility (the *Repayment Transaction*). The Master Agreement has been executed by lenders holding approximately 71% of the loans outstanding (the *First Lien Lenders*) under our First Lien Senior Facility (the *First Lien Loans*) and lenders holding 100% of the loans outstanding (the *Second Lien Lenders*) under our Second Lien Senior Facility (the *Second Lien Loans*). The holders that signed the Master Agreement held a sufficient amount of First Lien Loans and Second Lien Loans to modify the credit documentation for such loans.

The prepayment in full of the First Lien Loans pursuant to the terms of the senior secured first lien credit facility, including the payment of the make-whole price thereunder, is a condition precedent to the repayment of the Second Lien Loans on the terms described below. As of October 31, 2010, the principal amount of the First Lien Loans was \$99.5 million, accrued but unpaid interest was \$3.9 million, and the required make-whole payment was \$20.6 million. We paid to the First Lien Lenders that executed the Master Agreement (and will pay to any other First Lien Lender that becomes a party to the Master Agreement as provided therein) an amendment fee of 1% of the principal amount of First Lien Loans held by the lender, with such amount to be credited against any payment in full of all First Lien Loans on or before March 2, 2011.

The Second Lien Lenders have agreed to accept from us on any business day through March 2, 2011 as repayment in full of the Second Lien Loans an amount equal to the principal amount of the Second Lien Loans plus accrued but unpaid interest thereon, which was \$89.7 million as of August 30, 2010, plus a payment of \$72.8 million, representing an 81% premium above par and a more than 25% discount to the full make-whole price. We will also pay accrued but unpaid interest on this amount from August 30, 2010 through repayment. The Master Agreement also provides for the payment by us of an option fee to the Second Lien Lenders equal to 6% of the sum of the principal amount of the Second Lien Loans plus accrued but unpaid interest on the Second Lien Loans at August 30, 2010. As a result, we paid an option fee equal to \$5.4 million, of which \$4.5 million may be credited against the amount required to repay the Second Lien Loans. We agreed to make an additional cash payment to the Second Lien Lenders in an aggregate amount of \$9.0 million if we engaged in Qualifying Discussions (as defined in the Master Agreement) prior to June 30, 2011 that result in and M&A Transaction (as defined in the Master Agreement) that is consummated prior to June 30, 2012.

If the Repayment Transaction is consummated, we will repay in full all of the then outstanding First Lien Loans and Second Lien Loans, totaling approximately \$194.0 million.

*Agreement for Conversion of Convertible Notes*

On November 2, 2010, we separately entered into an agreement (the *Third Lien Agreement*) with holders of 100% of our outstanding Convertible Notes. We currently have \$2.4 million aggregate principal amount of Convertible Notes outstanding, which are convertible into

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8.3 million shares of our common stock. Pursuant to the Third Lien Agreement, the holders of the Convertible Notes have agreed to convert their Convertible Notes into shares of our common stock on or before March 2, 2011. We agreed to make a cash payment to the holders of the Convertible Notes in the amount of \$2.2 million plus accrued but unpaid interest on the Convertible Notes to the date of conversion. As of October 31, 2010, accrued but unpaid interest on the Convertible Notes was \$1.1 million.

### *Additional Information*

Certain of our directors (or their affiliates or associates) are parties to the Master Agreement or Third Lien Agreement and because of the interests of these directors, the Master Agreement, the Third Lien Agreement and the transactions contemplated thereby were approved by our board of directors (with these directors abstaining) upon the recommendation of a special committee of disinterested directors.

**Table of Contents**

**VONAGE HOLDINGS CORP.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share amounts)**

**(Unaudited)**

At the time the repurchase is completed, we expect to record a loss on extinguishment of debt of approximately \$35,000, representing acceleration of unamortized debt discount, acceleration of debt related costs, acceleration of administrative agent fees, the call premium on the First Lien Senior Facility, and fees paid to existing lenders. In addition, the balance of the make-whole premium not previously recorded will be recognized.

**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 include but are not limited to: the competition we face; our ability to adapt to rapid changes in the market for voice and messaging services and successfully introduce new products and services; our ability to control customer churn and attract new customers; worsening economic conditions; restrictions in our debt agreements that may limit our operating flexibility; system disruptions or flaws in our technology; results of pending or future litigation or intellectual property matters; results of regulatory inquiries into our business practices; our dependence on third party facilities, equipment and services; our dependence upon key personnel; any failure to meet New York Stock Exchange listing requirements; our history of net operating losses; our ability to obtain additional financing if needed; differences between our service and traditional phone services, including our 911 service; our dependence on our customers' existing broadband connections; uncertainties relating to regulation of VoIP services; our ability to negotiate favorable rates with service providers and increases in termination charges that may be approved by regulators in various countries; our ability to complete the refinancing of our credit facilities and convertible notes; 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 the date this Form 10-Q is filed with the Securities and Exchange Commission.*

**Information Presentation**

For the financial information discussed in this Quarterly Report on Form 10-Q, other than per share, per line amounts, subscriber lines and employees, amounts are presented in thousands, except where noted. All trademarks are the property of their owners.

**Recent Developments**

On October 19, 2008, we entered into definitive agreements (collectively, the Credit Documentation) for 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 our 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 funding for this transaction was completed on November 3, 2008.

On November 2, 2010, we entered into definitive agreements to refinance our existing debt. Consistent with these agreements, we plan to (i) exercise our existing right to retire debt under our First Lien Senior Facility for 100% of the contractual make-whole price, (ii) retire debt under our Second Lien Senior Facility at a discount to the contractual make-whole price, and (iii) cause the conversion of all outstanding Convertible Notes. During the fourth quarter of 2010, we will seek to refinance this existing debt with a new senior secured term loan having significantly lower interest rates and less restrictive covenants. Completion of a refinancing on such terms (as to which there can be no assurance) will provide us greater flexibility to operate and grow our business. As a result of the progress of the negotiations and other facts and circumstances occurring in the third quarter of 2010, we have ascribed \$60,000 of value as of September 30, 2010 to the make-whole premiums, which under FASB ASC 815, *Derivatives and Hedging* (FASB ASC 815) require separate valuation and evaluation each reporting period. This value may be adjusted upward or downward in subsequent periods reflecting changes in our assumptions and does not reflect the actual value that might ultimately be paid. In addition, at the time the repurchase is completed, we expect to record a loss on extinguishment of debt of approximately \$35,000, representing acceleration of unamortized debt discount, acceleration of debt related costs, acceleration of administrative agent fees, the call premium on the First Lien Senior Facility, and fees paid to existing lenders. In addition, the balance of the make-whole premium not previously recorded will be recognized.

**Overview**

We are a leading provider of communications services connecting individuals and social networks through broadband devices worldwide. Our technology serviced approximately 2.4 million subscriber lines as of September 30, 2010. While customers in the United States represented 94% of our subscriber lines at September 30, 2010, we also serve customers internationally with services in Canada and the United Kingdom.

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Our residential and small and home office services are portable and we enable our customers to make and receive phone calls with a telephone almost anywhere a broadband Internet connection is available. We transmit these calls using Voice over Internet Protocol, or VoIP, technology, which converts voice signals into digital data packets for transmission over the Internet. At a cost effective rate, each of our calling plans provides a number of basic features typically offered by traditional telephone service providers, plus a wide range of enhanced features that we believe differentiate our service and offer an attractive value proposition to our customers. We also offer a number of premium services for additional fees.

**Table of Contents**

We rely heavily on our network, which is a flexible, scalable Session Initiation Protocol (SIP) based VoIP network that rides on top of the Internet. This platform enables a user via a single identity to access and utilize services and features regardless of how they are connected to the Internet. As a result, with one identity, either a number or user name, customers have access to Vonage voice, messaging features, and personal profile information regardless of location, device or how they access the Internet, including over 3G, 4G, cable or DSL broadband networks.

Our main offering is Vonage World, a residential plan that includes unlimited calling to more than 60 countries, including India, Mexico and China for a flat monthly rate. In addition, we have two mobile offerings, Vonage World Mobile and Vonage Mobile Pay Per Use, which use our mobile calling application for smart phones. The application can be downloaded for free and provides seamless, low-cost pay-per-use international calling while on Wi-Fi or cellular networks, depending on the device, for the Vonage Mobile plan or unlimited calling to more than 60 countries, including India, Mexico and China for a flat monthly rate for the Vonage World Mobile plan. Bundle discounts are provided for customers who subscribe to both our residential and mobile Vonage World plans. We also recently introduced a Vonage Mobile application for Facebook that allows users to make free mobile calls to all their Facebook friends who have the application around the world, directly from their friends list, with a single touch.

Vonage has developed both a direct sales channel, as represented by web-sites and toll free numbers, and a retail distribution channel through regional and national retailers, including Wal-Mart. The direct and retail distribution channels are supported through integrated advertising campaigns across multiple media such as online, television, direct mail, alternative media, telemarketing, partner marketing, and customer referral programs.

Our primary source of revenue is subscription fees that we charge customers for our service plans, primarily on a monthly basis. We also generate revenue from international calls customers make that are not included in their service plan and for additional features that customers add to their service plans.

**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. The table below includes key operating data that our management uses to measure the growth and operating performance of our business:

|  | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--|-------------------------------------|-----------|------------------------------------|-----------|
|  | 2010                                | 2009      | 2010                               | 2009      |
| Gross subscriber line additions                            | 163,055                             | 190,834   | 472,770                            | 561,089   |
| Change in net subscriber lines                             | (4,846)                             | (50,191)  | (35,861)                           | (145,327) |
| Subscriber lines (at period end)                           | 2,399,035                           | 2,445,027 | 2,399,035                          | 2,445,027 |
| Average monthly customer churn                             | 2.4%                                | 3.4%      | 2.5%                               | 3.2%      |
| Average monthly revenue per line                           | \$ 29.72                            | \$ 29.89  | \$ 30.68                           | \$ 29.37  |
| Average monthly telephony services revenue per line        | \$ 29.45                            | \$ 29.16  | \$ 30.27                           | \$ 28.53  |
| Average monthly direct cost of telephony services per line | \$ 8.36                             | \$ 7.02   | \$ 8.54                            | \$ 6.85   |
| Marketing costs per gross subscriber line addition         | \$ 302.07                           | \$ 300.75 | \$ 312.66                          | \$ 312.31 |
| Employees (excluding temporary help) (at period end)       | 1,145                               | 1,239     | 1,145                              | 1,239     |

*Broadband adoption.* The number of U.S. households with broadband Internet access has grown significantly. On March 16, 2010, the Federal Communications Commission released its National Broadband Plan, which seeks, through supporting broadband deployment and programs, to encourage broadband adoption for the approximately 100 million U.S. residents who do not have broadband at home. We expect the trend of greater broadband adoption 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.

*Competitive landscape.* We face intense competition from traditional telephone companies, wireless companies, cable companies and alternative voice communication providers. Most traditional wire line and wireless telephone service providers and cable companies are substantially larger and better capitalized than we are and have the advantage of a large existing customer base. In addition, because our competitors provide other services, they often choose to offer VoIP services or other voice services as part of a bundle that includes other products, such as video, high speed Internet access, and wireless telephone service, which we do not offer. Further, as wireless providers offer more minutes at lower prices,



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better coverage and companion landline alternative services, their services have become more attractive to households as a replacement for wire line service. We also compete against alternative voice communication providers, such as Skype, Google Voice, magicJack, and independent VoIP service providers. Some of these service providers have chosen to sacrifice telephony revenue in order to gain market share and have offered their services at low prices or for free. As we continue to introduce applications that integrate different forms of voice and messaging services over multiple devices, we are likely to face competition from emerging competitors focused on similar integration, as well as from established alternative voice communication providers. In addition, our competitors have partnered and may in the future partner with other competitors to offer products and services, leveraging their collective competitive positions. We also are subject to the risk of future disruptive technologies.

## **Table of Contents**

*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 soft phones but do not include our virtual phone numbers or toll free numbers, which only allow inbound telephone calls to customers. We believe that the decrease in our subscriber lines was primarily due to increasing wireless substitution, other competition, particularly from cable companies, poor economic conditions in 2009, and reduced marketing spending. Subscriber lines decreased from 2,445,027 as of September 30, 2009 to 2,399,035 as of September 30, 2010.

*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 2.4% and 3.4% for the three months ended September 30, 2010 and 2009, respectively. We believe the reduction in churn is due to initiatives to improve the customer's experience including on-boarding and network quality, an improving economy and credit profile for new customer acquisitions, which has positively impacted non-pay churn, and the value proposition of the Vonage World offer. 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 economic conditions, competitive pressures including wireless substitution, 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 decreased slightly to \$29.72 for the three months ended September 30, 2010 compared to \$29.89 for the three months ended September 30, 2009.

*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 increased slightly to \$29.45 for the three months ended September 30, 2010 from \$29.16 for the three months ended September 30, 2009. This increase was due to an increase in the number of customers signing up for higher priced rate plans, higher service fees, and improved customer quality that reduced bad debt costs.

*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 \$8.36 for the three months ended September 30, 2010 compared to \$7.02 for the three months ended September 30, 2009, due primarily to higher costs from higher international call volume associated with Vonage World, partially offset by more favorable rates negotiated with our service providers. Direct cost of telephony services both overall and on a per line basis is expected to continue to increase for the remainder of the year and into next year. The drivers of this increase are international calling by our growing base of Vonage World customers and, in 2011, potential regulatory termination charges in certain high volume countries.

*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

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customer. Marketing cost per gross subscriber line addition increased to \$302.07 for the three months ended September 30, 2010 compared to \$300.75 for the three months ended September 30, 2009, due to lower gross 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.

## **Table of Contents**

*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. The request by Kansas and Nebraska that the Federal Communications Commission ( FCC ) rule that states can impose state universal service on VoIP service, discussed in Note 2 to our financial statements, is an example of efforts by regulators to determine how VoIP service fits into the telecommunications regulatory landscape. In addition to regulatory matters that directly address VoIP, a number of other regulatory initiatives could impact our business. One such regulatory initiative is net neutrality. In October 2009, the FCC proposed the adoption of net neutrality rules for broadband Internet service providers. If these rules are adopted, it would be more difficult for broadband Internet service providers to block or discriminate against Vonage service. The proposed rules also explicitly apply to wireless broadband Internet service, which could create greater opportunities for VoIP applications that run on wireless broadband Internet service. The D.C. Circuit Court of Appeals in April 2010, however, ruled that the FCC had not provided an adequate justification to exercise regulatory authority over broadband Internet service to enforce its previous attempt at net neutrality regulation, the 2005 Internet Policy Statement, against a major broadband Internet service provider. This D.C. Circuit decision presents a potential obstacle for the FCC in its effort to adopt its proposed net neutrality rules. On May 6, 2010, FCC Chairman Genachowski announced that, in response to the D.C. Circuit decision, the FCC would seek to establish its authority over broadband Internet service by reclassifying the transmission component of broadband Internet service as a telecommunications service. The FCC has extensive regulatory authority over telecommunications services. However, the FCC had classified all broadband Internet services as information services between 2002 and 2007 and the FCC has relatively limited regulatory authority over information services. Reclassifying broadband Internet service as a telecommunications service would allow the FCC to adopt its proposed net neutrality rules for broadband Internet service. The FCC inquiry on its proposal to reclassify broadband Internet service is ongoing. See also the discussion under Regulation in note 2 to our financial statements for a discussion of certain other regulatory issues that impact us.

## **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 have four residential plans, Vonage World , Vonage Lite , Vonage Pro and Basic 500, two mobile plans, Vonage World Mobile and Vonage Mobile P Use and two small office and home office calling plans, Small Business Premium Unlimited Minutes and Small Business Basic 1500 Minutes . 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. We also offer international calling plans that are bundled with our Residential Premium Unlimited plan where a customer can make calls to a chosen international region. We offer similar plans in Canada and the United Kingdom. The Vonage World plan now available in the U.S. and Canada, offers unlimited calling across the U.S. and Puerto Rico, unlimited international calling to over sixty countries including India, Mexico, and Canada, subject to certain restrictions, and free voicemail to text messages with Vonage Visual Voicemail. 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 Puerto Rico, Canada, and certain European countries under our unlimited plans and a variety of countries under international calling plans and Vonage World) are charged on a per minute basis. These per minute fees are not included in our monthly subscription fees. In October 2009, we launched Vonage Mobile, our first mobile calling application for smart phones. Vonage Mobile is a free downloadable application that provides seamless, low-cost pay-per-use international calling while on Wi-Fi or cellular networks, depending on the device. In December 2009, we began offering Vonage World Mobile using this mobile calling application. Bundle discounts are provided for customers who subscribe to both our residential and mobile Vonage World plans.

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, and charge an additional monthly fee for each service. 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 and electronic check payments, 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 (i.e., the current and two subsequent monthly billing cycles), we terminate the account.

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We also generate revenue by charging a fee for activating service but from time to time we may forgo collecting this fee. For example, since May 2009 we have waived activation fees for almost all new customers. In these instances when no activation fee is being collected, no customer acquisition costs are deferred. Customer activation fees when collected, along with the related incremental direct customer acquisition amounts for customer equipment in the direct channel and for rebates and retailer commissions in the retail channel,

## **Table of Contents**

up to but not exceeding the activation fee, are deferred and amortized over the estimated average customer relationship period ( customer life ). The amortization of deferred customer equipment is recorded to direct cost of goods sold. The amortization of deferred rebates is recorded as a reduction of telephony services revenues. The amortization of deferred retailer commissions is recorded as marketing expense. We estimate customer life by analyzing historical trends and applying those trends to future periods. This customer life is solely used to amortize deferred activation fees collected, which we have waived for almost all new customers since May 2009, including those signing up for our Vonage World plan, along with the related incremental customer acquisition costs. Customers signing up for our Vonage World plan currently churn at lower rates than other customers, and therefore appear to have a longer customer life. Because these customers have not paid an activation fee, this does not impact the customer life used in determining the amortization period. The customer life is 38 months for 2010 and was 44 months in 2009. The impact of the change to the customer life in 2010 is 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 recognize revenue on a gross basis for contributions to the Federal Universal Service Fund, or USF, and related fees. All other taxes are recorded on a net basis.

In addition, in some cases we charge a disconnect fee for customers who terminate their service plan within the first twelve months of service. 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 when collected that we charge our customers for shipping any equipment to them. In addition, in some cases we charge an equipment recovery fee for customers who terminate their service plan within the first twelve months of service. Equipment recovery fees are recorded as revenue and are recognized at the time the customer terminates service.

## **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 51% and 41% of our direct cost of telephony services for the three months ended September 30, 2010 and 2009, 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 collocation facility providers.

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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 the 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 when an activation fee is collected. The remaining cost of customer equipment is deferred up to the activation fee collected and amortized over the estimated average customer life.

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 certain 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 and human resources personnel.

Share-based expense related to share-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 and 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, 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 and cash equivalents.

Interest expense on notes payable, patent litigation judgments and settlements and capital leases.

Amortization of debt related costs.

Accretion of notes.

Debt conversion expense relating to the conversion of notes payable to equity.

Gain (loss) on extinguishment of notes.

Change in fair value of embedded features within notes payable and stock warrant.

Life insurance proceeds.

**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<br>September 30, |       | Nine Months Ended<br>September 30, |      |
|--|-------------------------------------|-------|------------------------------------|------|
|  | 2010                                | 2009  | 2010                               | 2009 |
| <b>Operating Revenues:</b>   |                                     |       |                                    |      |
| Telephony services   | 99%                                 | 98%   | 99%                                | 97%  |
| Customer equipment and shipping  | 1                                   | 2     | 1                                  | 3    |
|  | 100                                 | 100   | 100                                | 100  |
| <b>Operating Expenses:</b>   |                                     |       |                                    |      |
| Direct cost of telephony services (excluding depreciation and amortization)      | 28                                  | 23    | 28                                 | 23   |
| Direct cost of goods sold  | 6                                   | 8     | 7                                  | 8    |
| Selling, general and administrative  | 28                                  | 29    | 27                                 | 30   |
| Marketing  | 23                                  | 26    | 22                                 | 26   |
| Depreciation and amortization  | 6                                   | 6     | 6                                  | 6    |
|  | 91                                  | 92    | 90                                 | 93   |
| Income from operations   | 9                                   | 8     | 10                                 | 7    |
| <b>Other Income (Expense):</b>   |                                     |       |                                    |      |
| Interest income  |                                     |       |                                    |      |
| Interest expense   | (5)                                 | (6)   | (5)                                | (6)  |
| Change in fair value of embedded features within notes payable and stock warrant | (29)                                | (28)  | (10)                               | (7)  |
| Gain (loss) on extinguishment of notes   | (1)                                 | 2     | (1)                                | 1    |
| Other income (expense), net  |                                     |       |                                    |      |
|  | (35)                                | (32)  | (16)                               | (12) |
| Loss before income tax expense   | (26)                                | (24)  | (6)                                | (5)  |
| Income tax expense   |                                     |       |                                    |      |
| Net loss   | (26)%                               | (24)% | (6)%                               | (5)% |

***Summary of Results for the Three and Nine Months Ended September 30, 2010 and September 30, 2009*****Telephony Services Revenue and Direct Cost of Telephony Services**

*(in thousands, except percentages)*

| Three Months Ended September 30, |      |                  |                   | Nine Months Ended September 30, |      |                  |                   |
|----------------------------------|------|------------------|-------------------|---------------------------------|------|------------------|-------------------|
| 2010                             | 2009 | Dollar<br>Change | Percent<br>Change | 2010                            | 2009 | Dollar<br>Change | Percent<br>Change |

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|                                       |            |            |            |      |            |            |           |     |
|---------------------------------------|------------|------------|------------|------|------------|------------|-----------|-----|
| Telephony services                    | \$ 212,135 | \$ 216,085 | \$ (3,950) | (2%) | \$ 658,366 | \$ 646,437 | \$ 11,929 | 2%  |
| Direct cost of telephony services (1) | 60,263     | 52,044     | 8,219      | 16%  | 185,727    | 155,275    | 30,452    | 20% |

(1) Excludes depreciation and amortization of \$4,357, \$4,371, \$14,297, and \$14,000, respectively

*Telephony services revenue.* For the three months ended September 30, 2010, telephony services revenue decreased by \$3,950, or 2%, compared to the three months ended September 30, 2009. There was a decrease in the number of subscriber lines from 2,445,027 at September 30, 2009 to 2,399,035 at September 30, 2010. Fewer subscriber lines translated into a decrease in monthly subscription fees of \$6,446 and our discontinuation of collecting activation fees, beginning in most cases in May 2009, contributed to a decrease in activation fees of \$3,032, which included an offset of \$68 for the change in our customer life from 44 months to 38 months in the first quarter of 2010. In addition, we had a decrease in international revenue of \$5,011, primarily due to customers moving, as expected, to our fixed rate Vonage World plan, a decrease in fees that we charged for disconnecting our service of \$3,340 due to fewer disconnections, and a decrease in additional features we provided to customers of \$872. These decreases are offset by an increase in regulatory fees that we collected from subscribers of \$5,627, which included a reduction of USF and related fees of \$1,149, a decrease in credits we issued to subscribers of \$6,908, and a decrease of \$2,463 in bad debt expense.

For the nine months ended September 30, 2010, telephony services revenue increased by \$11,929, or 2%, compared to the nine months ended September 30, 2009. This was primarily driven by an increase in regulatory fees that we collected from subscribers of \$33,148, which included \$8,997 of USF and related fees, with the remaining increase the result of pricing actions, a decrease in credits we issued to subscribers of \$12,385, and a decrease of \$11,721 in bad debt expense. These increases are offset by a decrease in international revenue of \$15,147 primarily due to customers moving, as expected, to our fixed rate Vonage World plan, a decrease in fees that we

**Table of Contents**

charged for disconnecting our service of \$9,184 due to fewer disconnections, and a decrease in additional features we provided to customers of \$2,060. Fewer subscriber lines translated into a decrease in monthly subscription fees of \$9,402 and our discontinuation of collecting activation fees, beginning in most cases in May 2009, contributed to a decrease in activation fees of \$7,812, which included \$3,250 for the change in our customer life from 44 months to 38 months in the first quarter of 2010.

*Direct cost of telephony services.* For the three months ended September 30, 2010 compared to 2009, the increase in direct cost of telephony services of \$8,219, or 16%, was primarily due to increased costs of \$10,752 from higher international call volume associated with Vonage World and an increase in other cost of \$531. These increases were offset by a decrease in USF and related fees imposed by government agencies of \$1,149 and a decrease in domestic termination costs of \$1,140, which are costs that we pay other phone companies for terminating phone calls, a decrease in our network costs of \$376, which includes costs for co-locating equipment in other carriers' facilities, leasing phone numbers, routing calls on the Internet, transferring calls to and from the Internet to the public switched telephone network and E-911 costs, and a decrease in local number portability costs of \$248 due to fewer customer additions.

For the nine months ended September 30, 2010 compared to 2009, the increase in direct cost of telephony services of \$30,452, or 20%, was primarily due to the increased costs of \$28,716 from higher international call volume associated with Vonage World, an increase of USF and related fees imposed by government agencies of \$8,997, and an increase in other cost of \$1,061 primarily related to licensing fees. These increases were offset by a decrease in domestic termination costs of \$6,417, which are costs that we pay other phone companies for terminating phone calls, a decrease in our network costs of \$892, which includes costs for co-locating equipment in other carriers' facilities, leasing phone numbers, routing calls on the Internet, transferring calls to and from the Internet to the public switched telephone network and E-911 costs, and a decrease in local number portability costs of \$879 due to fewer customer additions.

**Customer Equipment and Shipping Revenue and Direct Cost of Goods Sold**

(in thousands, except percentages)

|   | Three Months Ended September 30, |          |               |                | Nine Months Ended September 30, |           |               |                |
|---|----------------------------------|----------|---------------|----------------|---------------------------------|-----------|---------------|----------------|
|   | 2010                             | 2009     | Dollar Change | Percent Change | 2010                            | 2009      | Dollar Change | Percent Change |
| Customer equipment and shipping revenue             | \$ 1,991                         | \$ 5,420 | \$ (3,429)    | (63%)          | \$ 9,052                        | \$ 19,101 | \$ (10,049)   | (53%)          |
| Direct cost of goods sold                           | 13,214                           | 17,727   | (4,513)       | (25%)          | 43,914                          | 54,418    | (10,504)      | (19%)          |
|   | (898,529)                        | 110,407  | (355,686)     |                |                                 |           |               |                |
| Proceeds from sale of property and equipment        | 36,580                           |          | 51,300        |                |                                 |           |               |                |
| Net cash (used in) provided by investing activities | (505,943)                        | 300,760  | (12,705)      |                |                                 |           |               |                |
| Cash flows from financing activities:               |                                  |          |               |                |                                 |           |               |                |
| Issuances of common stock                           | 23,588                           | 22,801   | 15,459        |                |                                 |           |               |                |
| Repurchases of common stock                         | (13,463)                         | (7,076)  | (73,545)      |                |                                 |           |               |                |
| Proceeds from long term debt                        | 415,811                          |          |               |                |                                 |           |               |                |

|   |            |            |            |
|---|------------|------------|------------|
| Repayments of borrowings                                |            |            | (1,308)    |
| Dividend paid to minority interest shareholder          | (40,785)   |            |            |
| Other, net  | 2,787      |            |            |
| Net cash provided by (used in) financing activities     | 387,938    | 15,725     | (59,394)   |
| Effect of exchange rate changes on cash and equivalents | 10,587     | 2,241      | (46)       |
| Net change in cash and equivalents during period        | 58,120     | 232,562    | (207,739)  |
| Cash and equivalents, beginning of period               | 501,097    | 268,535    | 476,274    |
| Cash and equivalents, end of period                     | \$ 559,217 | \$ 501,097 | \$ 268,535 |
| Other cash flow information                             |            |            |            |
| Interest paid   | \$ 5,596   | \$ 212     | \$ 528     |
| Income tax (payments) refunds received, net             | (18,970)   | (2,230)    | 10,402     |
| Inventory transferred to property and equipment         | 8,814      | 16,995     | 7,996      |

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

**Table of Contents**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**Note 1: Description of Business**

We are incorporated in Delaware. A pioneer in the computer networking industry, we provide secure, converged networking solutions, as well as maintenance and support services, for enterprises and public sector organizations of all sizes. Headquartered in Marlborough, Massachusetts, we have worldwide operations, including sales, marketing, research and development, and customer service and support capabilities.

**Note 2: Significant Accounting Policies**

*Fiscal year*

Our fiscal year ends on the Friday closest to May 31. Fiscal 2007 consisted of 52 weeks and ended on June 1, 2007. Fiscal 2006 consisted of the 52 weeks ended on June 2, 2006 and Fiscal 2005 consisted of the 53 weeks ended on June 3, 2005. For convenience, the consolidated financial statements have been shown as ending on the last day of the calendar month.

*Use of estimates in the preparation of consolidated financial statements*

The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make assumptions and estimates that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of sales, costs and expenses during the reporting periods. Such management assumptions and estimates include allowances for doubtful accounts receivable, product returns, rebates and price protection; provisions for inventory to reflect net realizable value; estimates of fair value for investments in privately held companies, goodwill and other intangible assets, estimation of fair value of acquired businesses, and properties held for sale; valuation allowances against deferred income tax assets; and accruals for severance costs, compensation, product warranty, other liabilities, and income taxes, among others. Actual results could materially differ from those estimates and assumptions.

*Basis of presentation*

The consolidated financial statements include the accounts of 3Com and its wholly-owned subsidiaries. All significant intercompany balances and transactions are eliminated in consolidation. As discussed in Notes 3 and 5, we accounted for our investment in the H3C joint venture by the equity method until fiscal 2006, when we exercised our right to purchase an additional 2 percent equity to give us a 51 percent majority ownership in H3C and we entered into an agreement with Huawei, the other shareholder, for an aggregate purchase price of \$28.0 million. We were granted regulatory approval by the Chinese government and subsequently completed this transaction on January 27, 2006 (date of acquisition). Since that time, we have owned a majority interest in the joint venture and have determined that the criteria of Emerging Issues Task Force No. 96-16, *Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights* have been met. Accordingly, we consolidate H3C's financial statements beginning February 1, 2006, a date used under the principle of convenience close. H3C follows a calendar year basis of reporting and therefore, H3C is consolidated on a two-month lag.

*Segment reporting*

As of May 31, 2007, we were organized in two reportable segments: Secured Converged Networking (SCN) and H3C. The SCN reportable segment was comprised of all business activities outside of our wholly-owned subsidiary, H3C, in China. The H3C segment was comprised of operations of our wholly-owned subsidiary in China. Prior to 2006 we had one reportable segment.

*Cash equivalents*

Cash equivalents consist of highly liquid investments in debt securities with maturities of three months or less when purchased.

## **Table of Contents**

### *Short-term investments*

Short-term investments primarily consist of investments in debt securities acquired with maturities exceeding three months but less than one year. Our intent is to hold our investments in debt securities to maturity. However, consistent with Statement of Financial Accounting Standards (SFAS) No. 115, Accounting for Certain Investments in Debt and Equity Securities, all investments in debt securities and all investments in equity securities that have readily determinable fair values have been classified as available-for-sale, since the sale of such investments may be required prior to maturity to implement management strategies. Our short-term investments are reported at fair value, with unrealized gains or losses excluded from earnings and included in other comprehensive income (loss). Short-term investments are evaluated quarterly for other than temporary declines in fair value, which are reported in earnings as identified. The cost of investments sold is based on the specific identification method.

### *Allowance for doubtful accounts*

We monitor payments from our customers on an on-going basis and maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. When we evaluate the adequacy of our allowances for doubtful accounts, we take into account various factors including our accounts receivable aging, customer creditworthiness, historical bad debts, and geographic and political risk. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances might be required.

### *Notes receivable*

Notes receivable represent bills receivable from fourteen Chinese banks to our H3C wholly-owned subsidiary that have maturities of less than six months. These notes originate from customers who settle their commitments to H3C by providing us these bills issued by the Chinese banks. The Chinese banks are responsible to pay H3C. The notes are also referred to as bankers acceptances.

### *Non-marketable equity securities and other investments*

Non-marketable equity securities and other investments consist primarily of direct investments in private companies and investments in limited partnership venture capital funds. Non-marketable equity securities and other investments are accounted for at historical cost or, if we had significant influence over the investee, by the equity method. Cost basis investments are evaluated quarterly for other than temporary declines in fair value, which are reported in earnings as identified. Investments accounted for by the equity method include investments in limited partnership venture capital funds. The net income or loss of limited partnership venture capital funds, and the fair values of the funds, are obtained from the funds' most recently issued financial statements. We record our proportionate share of the net income or loss of the funds, and adjustments reflecting changes in the fair values of the funds, in gain on investments, net. Net investment gains and losses recorded as a result of sales of our investments in the limited partnership venture capital funds are based on the difference between the net sales proceeds and the carrying value of the investment at the time of sale. Generally, in connection with such sales and with the approval of the applicable fund's general partners, we are released from all obligations with respect to future capital calls associated with the investment sold except as otherwise required by applicable law.

### *Concentration of credit risk*

Financial instruments that potentially subject us to concentrations of credit risk consist principally of cash and equivalents, short-term investments, notes receivable and accounts receivable. For our cash and equivalents and notes receivable in China we maintain a minimum BB+ rating and for the period ended March 31, 2007 the average rating was A+.

### *Inventories*

Inventories are stated at the lower of standard cost or market, which approximates actual cost. Cost is determined using the first-in, first-out method.

### *Property and equipment*

Property and equipment is stated at cost, net of accumulated depreciation and amortization. Equipment under capital leases is stated at the lower of fair market value or the present value of the minimum lease payments at the inception of the lease. We capitalize eligible costs related to the application development phase of software developed internally or obtained for internal use. Capitalized costs related to internal-use software are amortized using the straight-line

method over the estimated useful lives of the assets, which range from two to five years; the amounts charged to amortization expense were \$0.4 million in fiscal 2007, \$0.7 million in fiscal 2006, and \$1.0 million in fiscal 2005.

60

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## **Table of Contents**

### *Long-lived assets*

Long-lived assets and certain identifiable intangible assets to be held and used are subject to periodic amortization and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Determination of recoverability of long-lived assets is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss for long-lived assets and certain identifiable intangible assets that management expects to hold and use is based on the fair value of the asset. Long-lived assets and certain identifiable intangible assets to be disposed of are reported at the lower of carrying amount or fair value less costs to sell.

### *Depreciation and amortization*

Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets. Estimated useful lives of property and equipment are generally 2-15 years, except for buildings for which the useful lives are 25-40 years. Depreciation and amortization of leasehold improvements are computed using the shorter of the remaining lease terms or estimated useful life.

### *Goodwill and purchased intangible assets*

SFAS No. 142, *Goodwill and Other Intangible Assets*, requires goodwill to be tested for impairment on an annual basis and between annual tests when events or circumstances indicate a potential impairment. We test our goodwill for impairment annually during our third fiscal quarter. There was no impairment of goodwill in fiscal 2007, 2006, or 2005. Furthermore, SFAS No. 142 requires purchased intangible assets other than goodwill to be amortized over their useful lives unless these lives are determined to be indefinite. Purchased intangible assets are carried at cost less accumulated amortization. Amortization is computed over the estimated useful lives of the respective assets, generally 27 years.

### *Revenue recognition*

We recognize the majority of product revenue in accordance with Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* and Staff Accounting Bulletin No. 104, *Revenue Recognition*. Specifically, product revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred and risk of loss has passed to the customer, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where the customer specifies final acceptance of the product or service, revenue and related costs are deferred until all acceptance criteria have been met. For sales of products that contain software that is marketed separately, we apply the provisions of AICPA Statement of Position 97-2 *Software Revenue Recognition*, as amended.

A significant portion of our sales are made to distributors and resellers through a two-tier distribution channel. Revenue related to such sales is reduced for allowances for product returns, price protection, rebates and other offerings established in our sales agreements. We allow for product return rights that are generally limited to a percentage of sales over a one to three month period.

Sales of services, including professional services, system integration, project management, and training, are recognized upon completion of performance. Other service revenue, such as that related to maintenance and support contracts, is recognized ratably over the contract term, provided that all other revenue recognition criteria have been met. Royalty revenue is generally recognized when we receive payment.

For arrangements that involve multiple elements, such as sales of products that include maintenance or installation services, revenue is allocated to each respective element based on its relative fair value and recognized when the revenue recognition criteria for each element have been met. We use the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and objective and reliable evidence of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue for the delivered elements, provided that all other revenue recognition criteria have been met. If objective and reliable evidence of fair value of one or more undelivered elements does not exist, revenue is deferred and recognized when delivery of those elements occurs or when fair value can be established.

## **Table of Contents**

### *Product warranty*

We provide limited warranty on most of our products for periods ranging from 90 days to the lifetime of the product, depending upon the product. The warranty generally includes parts, labor and service center support. We estimate the costs that may be incurred under our warranty obligations and record a liability in the amount of such costs at the time sales are recognized. Factors that affect our warranty liability include the number of installed units, historical and anticipated rates of warranty claims, and cost per claim. We periodically assess the adequacy of our recorded warranty liabilities and adjust the amounts as necessary.

### *Advertising*

Costs associated with cooperative advertising programs are estimated and recorded as a reduction of revenue at the time the related sales are recognized. All other advertising costs are expensed as incurred in sales and marketing.

### *Restructuring charges*

In recent fiscal years, we have undertaken several initiatives involving significant changes in our business strategy and cost structure. In connection with these initiatives, we have recorded significant restructuring charges, as more fully described in Note 4. Generally, costs associated with an exit or disposal activity are recognized when the liability is incurred. Costs related to employee separation arrangements requiring future service beyond a specified minimum retention period are recognized over the service period.

### *Foreign currency remeasurement and translation*

Our foreign operations are subject to exchange rate fluctuations and foreign currency transaction costs. The majority of our SCN sales transactions are denominated in U.S. dollars. The majority of our H3C sales are denominated in Renminbi. For foreign operations with the local currency as the functional currency, local currency denominated assets and liabilities are translated at the year-end exchange rates, and sales, costs and expenses are translated at the average exchange rates during the year. Gains or losses resulting from foreign currency translation are included as a component of accumulated other comprehensive loss in the consolidated balance sheets. For foreign operations with the U.S. dollar as the functional currency, foreign currency denominated assets and liabilities are remeasured at the year-end exchange rates except for property and equipment which are remeasured at historical exchange rates. Foreign currency denominated sales, costs and expenses are recorded at the average exchange rates during the year. Gains or losses resulting from foreign currency remeasurement are included in other income (expense), net, in the consolidated statements of operations.

Our risk management strategy uses forward contracts to hedge certain foreign currency exposures. The intent is to offset gains and losses that occur on the underlying exposures with gains and losses resulting from the forward contracts that hedge these exposures. In accordance with SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended, these contracts are recorded at fair value, and fair value changes are expensed in the current period in other income (expense), net. In addition, we enter into foreign exchange forward contracts to hedge exposures related to anticipated foreign currency cash flows. Due to the limitations on converting Renmimbi we do not engage in currency hedging activities in China. These contracts, designated as cash flow hedges, also are recorded at fair value. The gain or loss from the effective portion of the hedge is reported in the consolidated statement of operations in the same period or periods and manner as the hedged transaction. The gain or loss from the ineffective portion of the hedge is recognized in other income (expense), net, during the period of change. We do not enter into derivatives for trading or other speculative purposes, nor do we use leveraged financial instruments.

Other income (expense), net included net foreign currency losses of \$1.2 million in fiscal 2007 and \$1.5 million in fiscal 2006 and 2005.

**Table of Contents***Income taxes:*

We are subject to income tax in a number of jurisdictions. A certain degree of estimation is required in recording the assets and liabilities related to income taxes, and it is reasonably possible that such assets may not be recovered and that such liabilities may not be paid or that payments in excess of amounts initially estimated and accrued may be required. We assess the likelihood that our deferred tax assets will be recovered from our future taxable income and, to the extent we believe that recovery is not likely, we establish a valuation allowance. We consider historical taxable income, estimates of future taxable income, and ongoing prudent and feasible tax planning strategies in assessing the amount of the valuation allowance. Based on various factors, including our recent losses, retained deficit, operating performance in fiscal 2007, and estimates of future profitability, we have concluded that future taxable income will, more likely than not, be insufficient to recover our U.S. net deferred tax assets as of May 31, 2007. Accordingly, we have established an appropriate valuation allowance to offset such deferred tax assets. In addition to valuation allowances against deferred tax assets, we maintain reserves for potential tax contingencies arising in jurisdictions in which we do or have done business. Many of these contingencies arise from periods when we were a substantially larger company. Such reserves are based on our assessment of the likelihood of an unfavorable outcome and the expected potential loss from such contingency, and are monitored by management. These reserves are maintained until such time as the matter is settled or the statutory period for adjustment has passed. Adjustments could be required in the future if we determine that the amount to be realized is greater or less than the valuation allowance we have recorded or that our reserves for tax contingencies are inadequate. We have U.S. federal loss carryforwards of approximately \$2.5 billion as of May 31, 2007 expiring between fiscal years 2008 and 2027, substantially all of which expire between fiscal years 2021 and 2027.

*Comprehensive income (loss)*

We account for comprehensive income (loss) in accordance with the provisions of SFAS No.130, Reporting Comprehensive Income. SFAS No. 130 is a financial statement presentation standard that requires us to disclose non-owner changes included in equity but not included in net income or loss. Comprehensive income (loss) presented in the financial statements consists of foreign currency translation and unrealized gains (losses) on available-for-sale securities.

An analysis of accumulated other comprehensive income (loss) follows (in thousands):

|                            | <b>Unrealized<br/>Gain<br/>(Loss)</b> | <b>Accumulated<br/>Translation<br/>Adjustment</b> | <b>Accumulated<br/>Other<br/>Comprehensive<br/>Income<br/>(Loss)</b> |
|----------------------------|---------------------------------------|---|--|
| Balance as of May 31, 2004 | \$ (2,107)                            | \$ (3,181)  | \$ (5,288)   |
| Change in period           | (294)                                 | 99  | (195)  |
| Balance as of May 31, 2005 | (2,401)                               | (3,082)   | (5,483)  |
| Change in period           | 300                                   | 2,226   | 2,526  |
| Balance as of May 31, 2006 | (2,101)                               | (856)   | (2,957)  |
| Change in period           | 2,310                                 | 4,996   | 7,306  |
| Balance as of May 31, 2007 | \$ 209                                | \$ 4,140  | \$ 4,349   |

*Stock-based Compensation*

Prior to fiscal 2007, we accounted for stock-based compensation using the intrinsic value method prescribed by Accounting Principles Board (APB) Opinion No. 25 Accounting for Stock Issued to Employees. As described in Note 14, effective June 3, 2006, we adopted the fair value method of accounting for stock-based compensation under Statement of Financial Accounting Standards (SFAS) 123(R) Share-Based Payment. Under the intrinsic value method,

compensation cost associated with a stock award was measured as the difference between the fair value of the common stock underlying the award and the amount, if any, that an employee was required to pay for the award; measurement generally occurred on the date of grant, which was the date on which the number of shares and price to be paid was apparent. Under the fair value method, compensation cost associated with a stock award is measured based on the estimated fair value of the award itself, determined using established valuation models and principles, and is generally measured as on the date of grant. The amounts measured under either method are generally recognized as expense over the requisite service period, which is typically the vesting period.

Estimates of the fair value of equity awards in future periods will be affected by the market price of our common stock, as well as the actual results of certain assumptions used to value the equity awards. These assumptions include, but are not limited to, the expected volatility of the common stock, the expected term of options granted, the risk free interest rate and dividend yield.

**Table of Contents**

The fair value of stock options and employee stock purchase plan shares is determined by using the Black-Scholes option pricing model and applying the single-option approach to the stock option valuation. The options generally have vesting on an annual basis over a vesting period of four years. We estimate the expected option term by analyzing the historical term period from grant to exercise and also consider the expected term for those options that are outstanding. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period. The volatility of the common stock is estimated using historical volatility. The risk-free interest rate used in the Black-Scholes option pricing model is determined by looking at historical U.S. Treasury zero-coupon bond issues with terms corresponding to the expected terms of the equity awards. In addition, an expected dividend yield of zero is used in the option valuation model, because we do not expect to pay any cash dividends in the foreseeable future. We estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. In order to determine an estimated pre-vesting option forfeiture rate, we used historical forfeiture data, which yields a forfeiture rate of 27 percent. We believe this historical forfeiture rate to be reflective of our anticipated rate on a go-forward basis. This estimated forfeiture rate has been applied to all unvested options and restricted stock outstanding as of June 1, 2006 and to all options and restricted stock granted since June 1, 2006. Therefore, stock-based compensation expense is recorded only for those options and restricted stock that are expected to vest.

*Net loss per share*

Basic earnings per share is computed using the weighted-average number of common shares outstanding. Diluted earnings per share is computed using the weighted-average number of common shares and potentially dilutive common shares outstanding during the period. Potentially dilutive common shares consist of employee stock options and restricted stock, and are excluded from the diluted earnings per share computation in periods where net losses were incurred.

*Recently issued accounting pronouncements*

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, which prescribes a comprehensive model for how a company should recognize, measure, present and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return, including a decision whether or not to file a return in a particular jurisdiction. Under this new guidance, the financial statements will reflect expected future tax consequences including interest and penalties of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts, but without considering time values. This guidance also revises disclosure requirements and introduces a prescriptive, annual, tabular roll-forward of unrecognized tax benefits. We are currently evaluating the impact of adopting FIN 48 and its impact on our financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements ( SFAS No. 157 ). SFAS No. 157 clarifies the principle that fair value should be based on the assumptions market participants would use when pricing an asset or liability and establishes a fair value hierarchy that prioritizes the information used to develop those assumptions. Under the standard, fair value measurements would be separately disclosed by level within the fair value hierarchy. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by 3Com in the first quarter of fiscal 2009. We have not yet determined the impact, if any, that the implementation of SFAS No. 157 will have on our results of operations or financial condition.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115 ( SFAS 159 ). SFAS 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. Under SFAS 159, a company may elect to use fair value to measure accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees and issued debt. Other eligible items include firm commitments for financial instruments that otherwise would not be recognized at inception and non-cash warranty obligations where a warrantor is permitted to pay a third party to provide the warranty goods or services. If the use of fair value is elected, any upfront costs and fees related to the item must be recognized in earnings and cannot be deferred, e.g., debt issue costs. The fair value election is irrevocable and generally made on an

instrument-by-instrument basis, even if a company has similar instruments that it elects not to measure based on fair value. At the adoption date, unrealized gains and losses on existing items for which fair value has been elected are reported as a cumulative adjustment to beginning retained earnings. Subsequent to the adoption of SFAS 159, changes in fair value are recognized in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007 and is required to be adopted by 3Com in the first quarter of fiscal 2009. 3Com currently is determining whether fair value accounting is appropriate for any of its eligible items and cannot estimate the impact, if any, which SFAS 159 will have on its consolidated results of operations and financial condition.

**Table of Contents**

In September 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin 108

Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements , which expresses the staff's views regarding the process of quantifying financial statement misstatements. The Bulletin is effective at our fiscal year end 2008. The Company believes the implementation will have no impact on our results of operations, cash flow or financial position.

**Note 3: Acquisitions****H3C**

On November 17, 2003, we formed H3C, formerly known as the Huawei-3Com joint venture, with a subsidiary of Huawei Technologies, Ltd. (Huawei). H3C is domiciled in Hong Kong, and has its principal operating center in Hangzhou, China.

At the time of formation, we contributed cash of \$160.0 million, assets related to our operations in China and Japan, and licenses related to certain intellectual property in exchange for a 49 percent ownership interest. We recorded our initial investment in H3C at \$160.1 million, reflecting our carrying value for the cash and assets contributed. Huawei contributed its enterprise networking business assets including Local Area Network (LAN) switches and routers; engineering, sales and marketing resources and personnel; and licenses to its related intellectual property in exchange for a 51 percent ownership interest. Huawei's contributed assets were valued at \$178.2 million at the time of formation. Two years after formation of H3C, we had the one-time option to purchase an additional two percent ownership interest from Huawei. On October 28, 2005, we exercised this right and entered into an agreement to purchase an additional 2 percent ownership interest in H3C from Huawei for an aggregate purchase price of \$28.0 million. We were granted regulatory approval by the Chinese government and subsequently completed this transaction on January 27, 2006 (date of acquisition). Since then, we have owned a majority interest in the joint venture and determined that the criteria of Emerging Issues Task Force No. 96-16, Investor's Accounting for an Investee When the Investor Has a Majority of the Voting Interest but the Minority Shareholder or Shareholders Have Certain Approval or Veto Rights were met and, therefore, consolidated H3C's financial statements beginning February 1, 2006, a date used under the principle of a convenience close. As H3C reports on a calendar year basis, we consolidate H3C based on H3C's most recent financial statements, two months in arrears.

Three years after formation of H3C, we and Huawei each had the right to initiate a bid process to purchase the equity interest in H3C held by the other. 3Com initiated the bidding process on November 15, 2006 to buy Huawei's 49 percent stake in H3C and our bid of \$882 million was accepted by Huawei on November 27, 2006. The transaction closed on March 29, 2007, at which time the purchase price was paid in full.

The acquisition transactions were all accounted for as purchases, and accordingly, the purchase price was allocated to the assets purchased and liabilities assumed based on their estimated fair values. Subsequent to obtaining control, the operating results of H3C for the period February 1, 2006 to March 31, 2006 are included in the consolidated financial statements, resulting in the latter two months of H3C's three months ended March 31, 2006 being included in our year ended May 31, 2006 statement of operations.

The purchase prices for our various transactions are shown below (in millions):

|                            | 2003<br>Investment | 2006<br>Purchase | 2007<br>Purchase<br>(Preliminary) |
|----------------------------|--------------------|------------------|-----------------------------------|
| Cash paid for common stock | \$ 160.0           | \$ 28.0          | \$ 882.0                          |
| Assets contributed         | 0.1                |                  |                                   |
| Acquisition direct costs   | 0.0                | 0.2              | 8.7                               |
| Total purchase price       | \$ 160.1           | \$ 28.2          | \$ 890.7                          |

**Table of Contents**

In accordance with SFAS No. 141, Business Combinations, the purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed, including in-process research and development, based on their estimated fair values. The excess purchase price over those values is recorded as goodwill. The fair values assigned to tangible and intangible assets acquired and liabilities assumed are based on management's estimates and assumptions, and other information compiled by management. Goodwill recorded as a result of these acquisition is not deductible for tax purposes. In accordance with SFAS No. 142, goodwill is not amortized but will be reviewed at least annually for impairment. Purchased intangibles with finite lives will be amortized on a straight-line basis over their respective estimated useful lives. The total purchase price has been allocated as follows (in millions):

|   | 2003<br>Investment | 2006<br>Purchase<br>\$ 7.4 | 2007<br>Purchase<br>\$ 148.6 |
|---|--------------------|----------------------------|------------------------------|
| Net tangible assets assumed                 |                    |                            |                              |
| Amortizable intangible assets:              |                    |                            |                              |
| Existing technology                         | \$ 111.7           | 17.8                       | 180.6                        |
| Trade name and trademarks                   |                    |                            | 55.5                         |
| Non-compete agreement with Huawei           |                    |                            | 33.0                         |
| Distributor agreements                      | 2.7                | 0.4                        | 29.1                         |
| Total amortizable intangible assets         | 114.4              | 18.2                       | 298.2                        |
| Amortization prior to the 2006 acquisition  | (65.7)             |                            |                              |
| Net intangible assets                       | 48.7               | 18.2                       | 298.2                        |
| In-process research and development         | 24.7               | 0.7                        | 34.0                         |
| Goodwill                                    | 43.2               | 1.9                        | 409.9                        |
| Total preliminary purchase price allocation |                    | \$ 28.2                    | \$ 890.7                     |

The preliminary allocation of the 2007 purchase price was based upon a preliminary valuation and our estimates and assumptions are subject to change upon the finalization of the valuation.

Intangible assets include amounts recognized for the fair value of existing technology, maintenance agreements, trade name and trademarks, distributor agreements and non-compete agreement. These intangible assets have a weighted-average useful life of approximately five years.

In-process research and development (IPR&D) represents incomplete H3C research and development projects that had not reached technological feasibility and had no alternative future use as of the acquisition dates. Technological feasibility is established when an enterprise has completed all planning, designing, coding, and testing activities that are necessary to establish that a product can be produced to meet its design specifications including functions, features, and technical performance requirements. At the dates of acquisition, H3C had multiple IPR&D efforts under way for certain current and future product lines. Purchased IPR&D relates primarily to projects associated with the H3C routers and switch products, which had not yet reached technological feasibility as of the acquisition date and have no alternative future use.

Of the total estimated purchase price paid to gain full control in 2007, a preliminary estimate of approximately \$148.6 million was allocated to net assets acquired. Net assets were valued at their respective carrying amounts, which management believes approximate fair value, except for adjustments to inventory and deferred revenue. Inventory was adjusted by an increase of \$11.1 million in the consolidated balance sheet as of June 2, 2007, to adjust inventory to the actual fair value less direct selling expense. Deferred revenues were reduced by \$0.5 million in the consolidated balance sheet as of June 2, 2007, to adjust deferred revenue to the estimated cost plus an appropriate profit margin to perform the support and maintenance services.

Approximately \$298.2 million of the 2007 purchase price was allocated to acquired identifiable intangible assets.

Existing core technology is comprised of products that have reached technological feasibility, which includes most of



H3C's technology. The remainder of intangible assets is associated with maintenance agreements, trademarks, and non-compete agreements. One day worth of the amortization expense related to the amortizable intangible assets is reflected in the audited consolidated statements of operations for the year ended June 2, 2007.

Of the total estimated 2007 purchase price, approximately \$409.9 million was allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the net assets acquired. Goodwill amounts are not amortized, but rather are tested for impairment at least annually. In the event that we determine that the value of the goodwill has become impaired, an accounting charge for the amount of the impairment will be incurred in the quarter in which such determination is made.

**Table of Contents***TippingPoint*

On January 31, 2005, we completed our acquisition of 100 percent of the outstanding common shares of TippingPoint Technologies, Inc. for consideration of \$430.0 million. This amount excludes the cost of integration, as well as other costs related to the transaction. TippingPoint is a provider of networked-based intrusion prevention systems. The acquisition enabled us to expand our portfolio of secure, converged voice and data networking solutions.

The TippingPoint acquisition was accounted for as a purchase, and accordingly, the assets purchased and liabilities assumed are included in the consolidated balance sheet as of May 31, 2006 and 2005. The operating results of TippingPoint are included in the consolidated financial statements since the date of acquisition.

The purchase price categories are shown below (in millions):

|   |              |
|---|--------------|
| Cash paid for common stock                      | \$ 389.5     |
| Fair value of outstanding stock options assumed | 36.1         |
| Acquisition direct costs                        | 4.4          |
| <br>Total purchase price                        | <br>\$ 430.0 |

In accordance with SFAS No. 141, Business Combinations, the purchase price was allocated to the tangible and intangible assets acquired and liabilities assumed, including in-process research and development, based on their estimated fair values, while the associated deferred stock compensation was recorded based on intrinsic value. The fair values assigned to tangible and intangible assets acquired and liabilities assumed are based on management's estimates and assumptions, and other information compiled by management, including valuations that utilize established valuation techniques appropriate for the high technology industry. Goodwill recorded as a result of this acquisition is not deductible for tax purposes. In accordance with SFAS No. 142, goodwill is not amortized but will be reviewed at least annually for impairment. Purchased intangibles with finite lives will be amortized on a straight-line basis over their respective estimated useful lives. The total purchase price has been allocated as follows (in millions):

|   |              |
|---|--------------|
| Net tangible assets assumed                     | \$ 37.4      |
| Amortizable intangible assets:                  |              |
| Existing technology                             | 39.1         |
| Maintenance agreements                          | 19.0         |
| Other   | 11.8         |
| <br>Total amortizable intangible assets         | <br>69.9     |
| In-process research and development             | 5.1          |
| Deferred compensation on unvested stock options | 9.4          |
| Goodwill  | 308.2        |
| <br>Total purchase price                        | <br>\$ 430.0 |

During the three months ended August 31, 2005, we revised the purchase price allocation by increasing net tangible assets assumed and reducing goodwill by \$1.3 million. This adjustment related to the revision of an estimate for a contingent liability assumed in the acquisition and has been incorporated into the purchase price allocation above. As of February 28, 2006 the purchase price has been finalized.

Intangible assets include amounts recognized for the fair value of existing technology, maintenance agreements, trade name and trademarks, and non-competition agreements. These intangible assets have a weighted-average useful life of approximately five years.

**Table of Contents**

IPR&D represents incomplete TippingPoint research and development projects that had not reached technological feasibility and had no alternative future use as of the acquisition date. Technological feasibility is established when an enterprise has completed all planning, designing, coding, and testing activities that are necessary to establish that a product can be produced to meet its design specifications including functions, features, and technical performance requirements. At the time of acquisition, TippingPoint had multiple IPR&D efforts under way for certain current and future product lines. The value assigned to IPR&D was determined by considering the importance of each project to our overall development plan, estimating costs to develop the purchased IPR&D into commercially viable products, estimating the resulting net cash flows from the projects when completed and discounting the net cash flows to their present value based on the percentage of completion of the IPR&D projects. Purchased IPR&D relates primarily to projects associated with the TippingPoint UnityOne® products and Software Management System product, which had not yet reached technological feasibility as of the acquisition date and have no alternative future use. We utilized the multi-period excess earnings method to value the IPR&D, using a discount rate of 20 percent. At the time of acquisition, it was estimated that these development efforts would be completed over the next twelve months at an estimated cost of approximately \$10 million. As of February 28, 2006, these projects had been completed.

***Pro forma Results of Operations***

The following unaudited pro forma financial information presents the consolidated results of operations of 3Com and H3C as if the acquisition of full control of H3C had occurred as of the beginning of the periods presented below. Preliminary adjustments, which reflect the amortization of purchased intangible assets, in-process research and development and charges to cost of sales for inventory write-ups, have been made to the consolidated results of operations. We also eliminate the inter-company activity between the parties in the consolidated results. The unaudited proforma financial information is not intended, and should not be taken as representative of our future consolidated results of operations or financial condition or the results that would have occurred had the acquisition occurred as of the beginning of the earliest period.

| (in millions, except per share amounts) | <b>Fiscal Year</b> |             |
|---|--------------------|-------------|
|   | <b>2007</b>        | <b>2006</b> |
| Net sales                               | \$ 1,267.5         | \$ 1,146.8  |
| Net loss                                | (201.3)            | (102.2)     |
| Basic and diluted net loss per share    | \$ (0.51)          | \$ (0.26)   |

Our 2006 consolidated statements of cash flows reflect \$110.4 million of the line item businesses acquired in purchase transactions, net of cash acquired. This reflects acquired cash of \$138.4 million on January 31, 2006 offset by the purchase price payment of \$28.0 million for an additional 2 percent ownership of H3C.

***Roving Planet Acquisition***

On December 5, 2006, the Company acquired certain assets and liabilities of Roving Planet, Inc. ( "Roving Planet" ) to support our strategy of extending our appliance-based intrusion prevention system ( "IPS" ) business to include network access control ( "NAC" ) features. Under the terms of the definitive agreement the Company acquired the Roving Planet assets for \$8.0 million in cash, plus assumption of liabilities of approximately \$0.2 million.

The consolidated financial statements include the operating results of Roving Planet from the date of acquisition, as part of the Company's SCN operating segment. Pro forma results for the Roving Planet acquisition have not been presented because the effects of the acquisitions were not material to the Company's financial results.

The Company's methodology for allocating the purchase price for purchase acquisitions to in-process research and development, purchased intangible assets and goodwill is determined through established valuation techniques.

In-process research and development is expensed upon acquisition because technological feasibility has not been established and no future alternative uses exist.

**Table of Contents**

Based upon these established valuation techniques the Company assigned the purchase price for the acquisition in the following manner (in millions):

|                                     | <b>2007<br/>Preliminary<br/>Purchase<br/>Price Allocation</b> | <b>Useful Life for<br/>Purchased<br/>Intangible Assets</b> |
|-------------------------------------|---|--|
| In-process research and development | \$ 1.7  |  |
| Purchased core technology           | 3.1   | 3 years  |
| Goodwill                            | 3.2   |  |
| Other                               | 0.2   |  |
| Total acquisition value             | \$ 8.2  |  |

The purchase price and related allocation are preliminary and may be revised as a result of adjustments made to the purchase price, additional information regarding liabilities assumed, including revisions of preliminary estimates of fair values made at the date of purchase.

**Note 4: Restructuring Charges**

In recent fiscal years, we have undertaken several initiatives involving significant changes in our business strategy and cost structure.

In fiscal 2001, we began a broad restructuring of our business to enhance the focus and cost effectiveness of our business units in serving their respective markets. These restructuring efforts continued through fiscal 2004. We took the following specific actions in fiscal 2001, 2002, 2003, and 2004 (the Fiscal 2001, 2002, 2003, and 2004 Actions ):

- § announced the integration of the support infrastructure of two of our business units to leverage a common infrastructure in order to drive additional costs out of the business;
- § organized around independent businesses that utilized shared central services;
- § outsourced the manufacturing of certain high volume desktop, mobile and server connectivity products in a contract manufacturing arrangement;
- § entered into an agreement to outsource certain information technology (IT) functions;
- § outsourcing of our remaining manufacturing operations in Dublin, Ireland;
- § reduced our workforce; and
- § continued efforts to consolidate and dispose of excess facilities.

During fiscal 2005 (the Fiscal 2005 Actions ), we took the following additional measures to reduce costs:

- § Reductions in workforce; and

- § continued efforts to consolidate and dispose of excess facilities.

During fiscal 2006 (the Fiscal 2006 Actions ), we took the following additional measures to reduce costs:

- § Reductions in workforce; and

- § continued efforts to consolidate and dispose of excess facilities.

During fiscal 2007 (the Fiscal 2007 Actions ), we took the following additional measures to reduce costs:

- § Further reductions in workforce; and

§ continued efforts to consolidate and dispose of excess facilities.

Restructuring charges related to these various initiatives were \$3.5 million in fiscal 2007, \$14.4 million in fiscal 2006, and \$23.9 million in fiscal 2005. Such charges were net of credits of \$13.3 million in fiscal 2007, \$0.1 million in fiscal 2006, and \$7.6 million in fiscal 2005, related primarily to revisions of previous estimates of employee separation expenses, lease obligation costs and values on held for sale properties.

Accrued liabilities associated with restructuring charges are included in the caption Accrued liabilities and other in the accompanying consolidated balance sheets. These liabilities are classified as current because we expect to satisfy such liabilities in cash within the next 12 months.

**Table of Contents*****Fiscal 2007 Actions***

Activity and liability balances related to the fiscal 2007 restructuring actions are as follows (in thousands):

|                               | <b>Employee<br/>Separation<br/>Expense</b> | <b>Facilities-<br/>related<br/>Charges</b> | <b>Other<br/>Restructuring<br/>Costs</b> | <b>Total</b> |
|-------------------------------|--|--|--|--------------|
| Balance as of June 1, 2006    | \$   | \$   | \$                                       | \$           |
| Provisions                    | 12,134                                     | (7,501)                                    | 247                                      | 4,880        |
| Payments and non-cash charges | (10,804)                                   | 7,765                                      | (247)                                    | (3,286)      |
| Balance as of May 31, 2007    | \$ 1,330                                   | \$ 264                                     | \$                                       | \$ 1,594     |

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce affected employees involved in research and development, sales and marketing, customer support, and general and administrative functions. Through May 31, 2007, the total reduction in workforce associated with actions initiated during fiscal 2007 included approximately 233 employees who had been separated or were currently in the separation process and approximately 15 additional employees who had been notified but had not yet worked their last day.

We believe that the all remaining actions will be completed by the end of fiscal 2008.

***Fiscal 2006 Actions***

Activity and liability balances related to the fiscal 2006 restructuring actions are as follows (in thousands):

|                               | <b>Employee<br/>Separation<br/>Expense</b> | <b>Facilities-<br/>related<br/>Charges</b> | <b>Total</b> |
|-------------------------------|--|--|--------------|
| Balance as of June 1, 2005    | \$   | \$   | \$           |
| Provisions                    | 9,558                                      | 1,635                                      | 11,193       |
| Payments and non-cash charges | (4,681)                                    | (744)                                      | (5,425)      |
| Balance as of May 31, 2006    | 4,877                                      | 891  | 5,768        |
| Provisions                    | (688)                                      | (136)                                      | (824)        |
| Payments and non-cash charges | (4,189)                                    | (619)                                      | (4,808)      |
| Balance as of May 31, 2007    | \$   | \$ 136                                     | \$ 136       |

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce affected employees involved in research and development, sales and marketing, customer support, and general and administrative functions. Through May 31, 2007, the total reduction in workforce associated with actions initiated during fiscal 2006 included approximately 227 employees who had been separated or were currently in the separation process and approximately 41 additional employees who had been notified but had not yet worked their last day.

We believe that the all remaining actions will be completed by the end of fiscal 2008.



**Table of Contents*****Fiscal 2005 Actions***

Activity and liability balances related to the fiscal 2005 restructuring actions are as follows (in thousands):

|                               | <b>Employee<br/>Separation<br/>Expense</b> | <b>Long-term<br/>Asset<br/>Write-downs</b> | <b>Facilities-<br/>related<br/>Charges</b> | <b>Other<br/>Restructuring<br/>Costs</b> | <b>Total</b> |
|-------------------------------|--|--|--|--|--------------|
| Balance as of June 1, 2004    | \$   | \$   | \$   | \$                                       | \$           |
| Provisions                    | 23,391                                     | 1,021                                      | 468  | 768                                      | 25,648       |
| Payments and non-cash charges | (15,186)                                   | (766)                                      | (80)                                       | (755)                                    | (16,787)     |
| Balance as of May 31, 2005    | 8,205                                      | 255  | 388  | 13                                       | 8,861        |
| Provisions                    | 1,873                                      | 221  | 32   | 364                                      | 2,490        |
| Payments and non-cash charges | (8,235)                                    | (221)                                      | (420)                                      | (364)                                    | (9,240)      |
| Balance as of May 31, 2006    | 1,843                                      | 255  |  | 13                                       | 2,111        |
| Provisions                    | (1,395)                                    | (255)                                      | 32   | (13)                                     | (1,631)      |
| Payments and non-cash charges | (145)                                      |  | (32)                                       |  | (177)        |
| Balances as of May 31, 2007   | \$ 303                                     | \$   | \$   | \$                                       | \$ 303       |

Employee separation expenses include severance pay, outplacement services, medical and other related benefits. The reduction in workforce affected employees involved in research and development, sales and marketing, customer support, general and administrative, and manufacturing functions. Through May 31, 2007, the total reduction in workforce associated with actions initiated during fiscal 2005 included approximately 397 employees who had been separated or were currently in the separation process and approximately 3 additional employees who had been notified but had not yet worked their last day. The provision of \$1.9 million recorded in fiscal 2006 relates to employees separation costs for employees that were not notified or had not worked their last day until fiscal 2006. For the year ended May 31, 2007, 2006 and 2005, total separation payments associated with actions initiated during fiscal 2005 were approximately \$0.1 million, \$8.2 million and \$15.2 million, respectively.

Long-term asset write-downs were associated with assets that no longer support our continuing operations. The provision of \$1.0 million was related to capitalized software licenses with no future benefit (\$0.5 million) and leasehold improvements in vacated facilities (\$0.5 million).

Facilities-related charges included write-downs and accelerated depreciation of properties, including properties that were classified as held for sale prior to fiscal 2005, as well as expenses related to lease obligations.

Other restructuring costs of \$0.4 million and \$0.8 million for the years ended May 31, 2006 and 2005, respectively, included payments to suppliers and contract termination fees.

We believe that the all remaining actions will be completed by the end of fiscal 2008.



**Table of Contents*****Fiscal 2001, 2002, 2003 and 2004 Actions***

Activity and liability balances related to the fiscal 2001, 2002, 2003 and 2004 restructuring actions are as follows (in thousands):

|                               | <b>Employee<br/>Separation<br/>Expense</b> | <b>Long-term<br/>Asset<br/>Write-downs</b> | <b>Facilities-<br/>related<br/>Charges</b> | <b>Other<br/>Restructuring<br/>Costs</b> | <b>Total</b> |
|-------------------------------|--|--|--|--|--------------|
| Balance as of May 31, 2004    | \$ 5,529                                   | \$   | \$ 9,819                                   | \$ 82                                    | \$ 15,430    |
| Provisions                    | (2,829)                                    | 12   | 813  | 278                                      | (1,726)      |
| Payments and non-cash charges | (2,700)                                    | (12)                                       | (1,891)                                    | (355)                                    | (4,958)      |
| Balance as of May 31, 2005    |  |  | 8,741                                      | 5  | 8,746        |
| Provisions                    |  | 90   | 609  |  | 699          |
| Payments and non-cash charges |  | (90)                                       | (3,709)                                    |  | (3,799)      |
| Balance as of May 31, 2006    |  |  | 5,641                                      | 5  | 5,646        |
| Provisions                    |  |  | 1,053                                      | 16                                       | 1,069        |
| Payments and non-cash charges |  |  | (5,351)                                    | (21)                                     | (5,372)      |
| Balance as of May 31, 2007    | \$   | \$   | \$ 1,343                                   | \$                                       | \$ 1,343     |

The reductions in workforce affected employees involved in sales, customer support, product development, and general and administrative positions. During fiscal 2005, we recorded a net benefit related to revisions of previous estimates of employee separation expenses.

Facilities-related charges included accelerated depreciation of buildings, write-downs of land and buildings held for sale, losses on sales of facilities, and lease obligations.

Other restructuring costs included payments to suppliers and contract termination fees.

We believe that the all remaining actions will be completed by the end of fiscal 2008.

**Note 5: Investment in Unconsolidated Joint Venture**

As described in Note 3 we formed the Huawei-3Com joint venture (H3C) with a subsidiary of Huawei Technologies, Ltd. (Huawei).

At the time of formation, we contributed cash of \$160.0 million, assets related to our operations in China and Japan, and licenses related to certain intellectual property in exchange for a 49 percent ownership interest. We recorded our initial investment in H3C at \$160.1 million, reflecting our carrying value for the cash and assets contributed. Huawei contributed its enterprise networking business assets - including Local Area Network (LAN) switches and routers; engineering, sales, marketing resources and personnel; and licenses to its related intellectual property - in exchange for a 51 percent ownership interest. Huawei's contributed assets were valued at \$178.2 million at the time of formation. Prior to the acquisition we accounted for our investment by the equity method. Under this method, we recorded our proportionate share of H3C's net income or loss based on the most recently available quarterly financial statements. Since H3C follows a calendar year basis of reporting, we reported our equity in H3C's net loss for H3C's fiscal period from April 1, 2005 through January 31, 2006 for the fiscal year 2006, April 1, 2004 through March 31, 2005 for the fiscal year 2005 in our results of operations for fiscal 2006 and 2005. This represents reporting two months in arrears.



**Table of Contents**

Summarized information from the balance sheet and statement of operations for H3C for the ten month period ended January 31, 2006, and for the year ended March 31, 2005 (in thousands):

|                         | <b>January 31,<br/>2006</b> | <b>March 31,<br/>2005</b> |
|-------------------------|-----------------------------|---------------------------|
| <b>Balance Sheet</b>    |                             |                           |
| Current assets          | \$404,068                   | \$259,369                 |
| Non-current assets      | 132,130                     | 149,571                   |
| Current liabilities     | 210,853                     | 109,097                   |
| Non-current liabilities | 8,866                       | 8,866                     |

**Statement of Operations:**

|                               |           |           |
|-------------------------------|-----------|-----------|
| Sales                         | \$399,612 | \$297,977 |
| Gross profit                  | 181,553   | 120,498   |
| Income (loss) from operations | 10,132    | (17,064)  |
| Net income (loss)             | 22,487    | (14,125)  |

In determining our share of the net loss of H3C certain adjustments are made to H3C's reported results. These adjustments are made primarily to recognize the value and the related amortization expense associated with Huawei's contributed assets, as well as to defer H3C's sales and gross profit on sales of products sold to us that remained in our inventory at the end of the accounting period. We recorded our equity interest in income (loss) of \$11.0 million in fiscal 2006 (prior to the acquisition of majority ownership on January 27, 2006) for the period April 1, 2005 through January 31, 2006 and, (\$6.9) million in fiscal 2005 for the period April 1, 2004 through March 31, 2005 as our share of H3C's net income (loss); this income (loss) is included in our results of operations under the caption Equity interest in income (loss) of unconsolidated joint venture.

3Com and H3C are parties to agreements for the sale of certain products between the two companies. During the ten months ended January 31, 2006 (date of the 2 percent acquisition) we recorded sales to H3C of approximately \$10.6 million and made purchases of approximately \$53.8 million. During fiscal 2005, we recorded sales to H3C of approximately \$13.2 million and made purchases of approximately \$26.9 million.

**Note 6: Investments**

Available-for-sale securities consist of (in thousands):

|   | <b>May 31, 2007</b>       |                                       |  | <b>Estimated<br/>Fair<br/>Value</b> |
|---|---------------------------|---------------------------------------|--|-------------------------------------|
|   | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> |                                     |
|   |                           |                                       |  |                                     |
| Publicly traded corporate equity securities | \$ 257                    | \$ 210                                | \$                                     | \$ 467                              |
| Total                                       | \$ 257                    | \$ 210                                | \$                                     | \$ 467                              |

|                                       | <b>May 31, 2006</b>       |                                       |  | <b>Estimated<br/>Fair Value</b> |
|---------------------------------------|---------------------------|---------------------------------------|--|---------------------------------|
|                                       | <b>Amortized<br/>Cost</b> | <b>Gross<br/>Unrealized<br/>Gains</b> | <b>Gross<br/>Unrealized<br/>Losses</b> |                                 |
|                                       |                           |                                       |  |                                 |
| State and municipal securities        | \$ 22,816                 | \$                                    | \$ (96)                                | \$ 22,720                       |
| U.S. Government and agency securities | 136,317                   | 13                                    | (486)                                  | 135,844                         |
| Corporate debt securities             | 205,793                   | 13                                    | (1,120)                                | 204,686                         |

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|   |            |        |            |            |
|---|------------|--------|------------|------------|
| Short-term investments                      | 364,926    | 26     | (1,702)    | 363,250    |
| Publicly traded corporate equity securities | 309        | 93     |            | 402        |
| Total                                       | \$ 365,235 | \$ 119 | \$ (1,702) | \$ 363,652 |

73

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**Table of Contents**

The total cost and carrying value of corporate equity securities consist of (in thousands):

|   | <b>May 31, 2007<br/>Carrying<br/>Value</b> |
|---|--|
| Publicly traded corporate equity securities | \$ 467                                     |
| Total corporate equity securities           | \$ 467                                     |

|  | <b>Initial<br/>Cost</b> | <b>May 31, 2006<br/>Carrying<br/>Value</b> |
|--|-------------------------|--|
| Investments in limited partnership venture capital funds | \$ 25,498               | \$ 15,794                                  |
| Direct investments in private companies                  | 12,262                  | 91   |
| Total private equity investments                         | \$ 37,760               | 15,885                                     |
| Publicly traded corporate equity securities              |                         | 402  |
| Total corporate equity securities                        |                         | \$ 16,287                                  |

Publicly traded corporate equity securities are included in other current assets. Private equity instruments are included in deposits and other assets.

The following table provides gross realized gains and losses related to our investments (in thousands):

|                       | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|-----------------------|-------------|-------------|-------------|
| Gross realized gains  | \$ 3,560    | \$ 5,499    | \$ 3,594    |
| Gross realized losses | (2,417)     | (1,166)     | (2,014)     |
| Total                 | \$ 1,143    | \$ 4,333    | \$ 1,580    |

**Note 7: Inventories**

Inventories consist of (in thousands):

|                 | <b>2007</b> | <b>2006</b> |
|-----------------|-------------|-------------|
| Finished goods  | \$ 61,857   | \$ 69,386   |
| Work-in-process | 7,143       | 12,777      |
| Raw materials   | 38,988      | 66,656      |
| Total           | \$ 107,988  | \$ 148,819  |

**Table of Contents****Note 8: Property and Equipment**

Property and equipment, net, consists of (in thousands):

|   | <b>May 31,</b> |               |
|---|----------------|---------------|
|   | <b>2006</b>    | <b>2006</b>   |
| Land                                      | \$ 1,724       | \$ 6,999      |
| Buildings and improvements                |                | 11,122        |
| Machinery and equipment                   | 231,886        | 202,407       |
| Software                                  | 31,387         | 63,814        |
| Furniture and fixtures                    | 20,217         | 21,161        |
| Leasehold improvements                    | 17,201         | 13,667        |
| Construction in progress                  | 8,599          | 2,883         |
| <br>Total                                 | <br>311,014    | <br>322,053   |
| Accumulated depreciation and amortization | (234,554)      | (232,944)     |
| <br>Property and equipment, net           | <br>\$ 76,460  | <br>\$ 89,109 |

*Significant property and equipment transactions*

*For the Year Ended May 31, 2007.* We continue to carry the Hemel Hempstead land as held for use, which was damaged in December of 2005, on our balance sheet. Based on the size of the experienced damage, our insurance policy administrator paid us a reimbursement value of approximately \$28 million. Furthermore, with no feasible business necessity to keep this property, we are soliciting offers from prospective buyers to acquire the building and land. Any sale would be contingent on UK government agencies allowing reconstruction of the building. We believe this process will take more than one year and as a result we have kept the land classified as held for use. In the first fiscal quarter we received \$16.0 million of proceeds from the sale of our Santa Clara facility.

*For the Year Ended May 31, 2006.* On December 11, 2005, our Europe, Middle East and Africa headquarters facility in Hemel Hempstead, United Kingdom was damaged by explosions at a third-party oil depot facility which occurred approximately one quarter mile from our facility. Approximately 300 employees and contractors worked at our Hemel campus, primarily in our sales, marketing and product operations groups. The incident occurred during non-business hours and no employee casualties or injuries were reported. We activated our back-up systems and established business operations at alternative facilities to ensure business continuity and minimize disruption to our customers. We believe we have sufficient insurance and recourse against third parties so that any loss incurred by us in connection with these explosions should not have a material adverse effect on our results of operations. The building is currently not being used for operations and the carrying amount of \$16.2 million has been reclassified from property and equipment to other non-current assets and the associated depreciation has been ceased.

*For the Year Ended May 31, 2005.* In February 2005, we completed the sale of certain properties in Hemel Hempstead, U.K. that were classified as held for sale. This property, consisting of approximately 111,000 square feet of office and research and development space, previously had been used for our administrative and research and development activities. Net proceeds from the sale resulted in a gain on the sale of \$0.1 million that was recorded in restructuring charges in the third quarter of fiscal 2005.

**Table of Contents****Note 9: Intangible Assets**

Intangible assets consist of (in thousands):

|                              |              | <b>May 31, 2007</b> |            |              | <b>May 31, 2006</b> |            |
|------------------------------|--------------|---------------------|------------|--------------|---------------------|------------|
|                              | <b>Gross</b> | <b>Accumulated</b>  | <b>Net</b> | <b>Gross</b> | <b>Accumulated</b>  | <b>Net</b> |
|                              |              | <b>Amortization</b> |            |              | <b>Amortization</b> |            |
| Existing technology          | \$ 387,233   | \$ (148,641)        | \$ 238,592 | \$ 203,946   | \$ (114,235)        | \$ 89,711  |
| Trademark                    | 55,500       |                     | 55,500     |              |                     |            |
| Huawei non-compete agreement | 33,000       | (61)                | 32,939     |              |                     |            |
| OEM agreement                | 23,800       | (22)                | 23,778     |              |                     |            |
| Maintenance contracts        | 19,000       | (7,389)             | 11,611     | 19,000       | (4,222)             | 14,778     |
| Other                        | 21,924       | (13,055)            | 8,869      | 15,301       | (7,945)             | 7,356      |
| Total                        | \$ 540,457   | \$ (169,168)        | \$ 371,289 | \$ 238,247   | \$ (126,402)        | \$ 111,845 |

During fiscal 2007, we recorded approximately \$298.2 million and \$3.1 million of intangible assets related to the H3C acquisition and the Roving Planet acquisition, respectively (See Note 3). These amounts were recognized for the fair value of existing technology, maintenance agreements, trade name and trademarks, distributor agreements and non-competition agreements. These intangible assets have a weighted-average useful life of approximately four years. During fiscal 2007, we reclassified \$0.9 million of goodwill that no longer has an indefinite life to intangible assets. During fiscal 2006, we recorded approximately \$132.6 million of intangible assets related to the H3C acquisition and our consolidation of H3C (See Note 3). These amounts were recognized for the fair value of existing technology, maintenance agreements, trade name and trademarks, and non-competition agreements. These intangible assets have a weighted-average useful life of approximately four years.

During fiscal 2005, we recorded approximately \$69.9 million of intangible assets related to the TippingPoint acquisition (See Note 3). These amounts were recognized for the fair value of existing technology, maintenance agreements, trade name and trademarks, and non-competition agreements. These intangible assets have a weighted-average useful life of approximately five years.

Annual amortization expense related to intangible assets is expected to be as follows for each of the following five succeeding fiscal years (in thousands):

|                      | <b>2008</b> | <b>2009</b> | <b>2010</b> | <b>2011</b> | <b>2012</b> |
|----------------------|-------------|-------------|-------------|-------------|-------------|
| Amortization expense | \$ 103,431  | \$ 81,240   | \$ 60,337   | \$ 36,206   | \$ 15,163   |

**Table of Contents****Note 10: Accrued Liabilities and Other**

Accrued liabilities and other consist of (in thousands):

|                                      | May 31,           |                   |
|--------------------------------------|-------------------|-------------------|
|                                      | 2007              | 2006              |
| Accrued payroll and related expenses | \$ 81,791         | \$ 88,305         |
| EARP Accrual                         | 94,563            | 16,960            |
| Accrued rebates and other marketing  | 67,446            | 60,301            |
| Deferred revenue                     | 54,034            | 57,050            |
| Accrued product warranty             | 40,596            | 41,791            |
| Income and other taxes payable       | 36,365            | 25,759            |
| Advance from customers               | 8,300             |                   |
| Restructuring                        | 3,376             | 13,525            |
| Other                                | 49,167            | 14,345            |
| <b>Total</b>                         | <b>\$ 435,638</b> | <b>\$ 318,036</b> |

**Note 11: Accrued Warranty and Other Guarantees**

Most products are sold with varying lengths of warranty ranging from 90 days to limited lifetime. Allowances for estimated warranty obligations are recorded in the period of sale, based on historical experience related to product failure rates and actual warranty costs incurred during the applicable warranty period and are recorded as part of cost of goods sold. Also, on an ongoing basis, we assess the adequacy of our allowances related to warranty obligations recorded in previous periods and may adjust the balances to reflect actual experience or changes in future expectations.

The following table summarizes the activity in the allowance for estimated warranty costs (in thousands):

|  | Years Ended May 31, |                  |                  |
|--|---------------------|------------------|------------------|
|  | 2007                | 2006             | 2005             |
| Accrued warranty, beginning of period                    | \$ 41,791           | \$ 41,782        | \$ 43,825        |
| Cost of warranty claims                                  | (46,950)            | (32,958)         | (32,910)         |
| Accrual for warranties issued during the period          | 46,406              | 28,424           | 30,867           |
| Adjustments to preexisting warranties                    | (651)               |                  |                  |
| Reserves related to H3C at date of 2 percent acquisition |                     | 4,543            |                  |
| <b>Accrued warranty, end of period</b>                   | <b>\$ 40,596</b>    | <b>\$ 41,791</b> | <b>\$ 41,782</b> |

**Note 12: Long-Term Debt**

On March 22, 2007, H3C Holdings Limited (the Borrower), an indirect wholly-owned subsidiary of 3Com Corporation, entered into the Credit and Guaranty Agreement dated as of March 22, 2007 among H3C Holdings Limited, as Borrower, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, as Holdco Guarantors, various Lenders, Goldman Sachs Credit Partners L.P., as Mandated Lead Arranger, Bookrunner, Administrative Agent and Syndication Agent (GSCP), and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent (the Credit Agreement). On March 28, 2007, the Borrower borrowed \$430 million under the Credit Agreement in the form of a senior secured term loan to finance a portion of the purchase price for 3Com's acquisition of 49 percent of H3C Technologies Co., Limited, or H3C.

On May 25, 2007, the parties amended and restated the Credit Agreement in order to, among other things, convert the facility into two tranches with different principal amortization schedules and different interest rates, as further described below (the A&R Loans). The parties closed the A&R Loans on May 31, 2007.





**Table of Contents**

The A&R Loans are subject to the terms and conditions of an Amended and Restated Credit and Guaranty Agreement dated as of May 25, 2007 and effective as of May 31, 2007 among H3C Holdings Limited, as Borrower, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, as Holdco Guarantors, H3C, as a Guarantor, various Lenders, GSCP, as Mandated Lead Arranger, Bookrunner, Administrative Agent and Syndication Agent, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent (the A&R Credit Agreement). As amended, borrowings under the Credit Agreement consist of two tranches with different principal amortization schedules and different interest rates. The first tranche, the Tranche A Term Facility, matures in 2010 and its aggregate principal amount of \$230 million is payable as to 40 percent in year one and then evenly (20 percent per year) over the succeeding three years. The second tranche, the Tranche B Term Facility, matures in 2012 and its \$200 million principal amount is payable primarily in its fourth (10 percent) and fifth (86 percent) years. Moody's Investors Service has assigned a Ba2 rating to the A&R Loans and a Ba2 corporate family rating (stable outlook) to H3C Holdings Limited. Standard & Poor's Ratings Services assigned the A&R Loans a BB rating (with a recovery rating of 1) and assigned a BB- corporate credit rating (stable outlook) to H3C Holdings Limited. We are required to maintain a rating from each of these agencies during the term of the A&R Loans.

Interest on borrowings is payable semi-annually on March 28 and September 28, commencing on September 28, 2007. All amounts outstanding under the Tranche A Term Facility will bear interest, at the Borrower's option, at the (i) LIBOR, or (ii) Base Rate (i.e., prime rate), in each case plus the applicable margin percentage set forth in the table below, which is based on a leverage ratio of consolidated indebtedness of the Borrower and its subsidiaries to EBITDA (as defined in the A&R Credit Agreement, and calculated to exclude certain one-time nonrecurring charges) for the relevant twelve-month period:

| <b>Leverage Ratio</b>   | <b>LIBOR +</b> | <b>Base Rate +</b> |
|-------------------------|----------------|--------------------|
| >3.0:1.0                | 2.25%          | 1.25%              |
| ≤ 3.0:1.0 but > 2.0:1.0 | 2.00%          | 1.00%              |
| ≤ 2.0:1.0 but > 1.0:1.0 | 1.75%          | 0.75%              |
| ≤ 1.0:1.0               | 1.50%          | 0.50%              |

All amounts outstanding under the Tranche B Term Facility will bear interest, at the Borrower's option, at the (i) LIBOR plus 3.00 percent or (ii) Base Rate (i.e., prime rate) plus 2.00 percent. We have elected to use LIBOR as the reference rate for borrowings to date, and expect to do so for the foreseeable future. In addition, the applicable margin for the Tranche A Term Facility is 2.00 percent at May 31, 2007.

A default rate shall apply on all obligations in the event of default under the A&R Loans at a rate per annum of 2 percent above the applicable interest rate.

The Borrower's principal asset is 100 percent of the shares of H3C. Covenants and other restrictions under the A&R Credit Agreement generally apply to the Borrower and its subsidiaries, which we refer to as the H3C Group. 3Com's SCN segment is not generally subject to the terms of the A&R Credit Agreement, other than through parental guarantees. Required payments under the loan are generally expected to be serviced by cash flows from the H3C Group and the loan is secured by assets at the H3C level, as well as the parental guarantees (which are expected to be released after H3C effects a successful capital reduction).

The A&R Loans may be prepaid in whole or in part without premium or penalty. The Borrower will be required to make mandatory prepayments using net proceeds from H3C Group (i) asset sales, (ii) insurance proceeds and (iii) equity offerings or debt incurrence. In addition, the Borrower will be required to make annual prepayments in an amount equal to 75 percent of excess cash flow of the H3C Group. This percentage will decrease to the extent that the Borrower's leverage ratio is lower than specified amounts. Any excess cash flow amounts not required to prepay the loan may be distributed to and used by the Company's SCN segment, provided certain conditions are met.

H3C and all other existing and future subsidiaries of the Borrower (other than PRC subsidiaries or small excluded subsidiaries) will guarantee all obligations under the A&R Loans and are referred to as Guarantors. Additionally, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, will also guarantee all obligations under the A&R Loans until H3C effects a successful capital reduction; these entities are referred to as Parent Guarantors and are

not considered Guarantors. The loan obligations will be secured by (1) first priority security interests in all assets of the Borrower and the Guarantors, including their bank accounts, and (2) a first priority security interest in 100 percent of the capital stock of the Borrower and H3C and the PRC subsidiaries of H3C.

**Table of Contents**

The Borrower must maintain a minimum debt service coverage, minimum interest coverage, maximum capital expenditures and a maximum total leverage ratio. Negative covenants restrict, among other things, (i) the incurrence of indebtedness by the Borrower and its subsidiaries, (ii) the making of dividends and distributions to 3Com's SCN segment, (iii) the ability to make investments including in new subsidiaries, (iv) the ability to undertake mergers and acquisitions and (v) sales of assets. Also, cash dividends from the PRC subsidiaries to H3C, and H3C to the Borrower, will be subject to restricted use pending payment of principal, interest and excess cash flow prepayments. Standard events of default apply.

Payments of principal on the A&R Loans are due as follows on September 28, for fiscal years ending May 31 (in thousands):

|      | <b>Tranche A</b> | <b>Tranche B</b> |
|------|------------------|------------------|
| 2008 | \$92,000         | \$ 2,000         |
| 2009 | 46,000           | 2,000            |
| 2010 | 46,000           | 2,000            |
| 2011 | 46,000           | 2,000            |
| 2012 |                  | 20,000           |
| 2013 |                  | 172,000          |

**Note 13: Borrowing Arrangements and Commitments**

During fiscal 2005, our revolving credit facility was allowed to expire according to its terms in November 2004, and we entered into a new arrangement to facilitate the issuance of standby letters of credit and bank guarantees required in the normal course of business. Since we provide collateral for any standby letters of credit and bank guarantees issued under this agreement, the availability of additional issuances is restricted by the amount of cash and short-term investments that we can provide as collateral. As of May 31, 2007, these facilities were backed by collateral of \$5.9 million provided to the respective banks.

We lease certain of our facilities under operating leases. Leases expire at various dates from 2008 to 2012, and certain leases have renewal options with rentals based upon changes in the Consumer Price Index or the fair market rental value of the property. We also sublet certain of our leased and owned facilities to third party tenants. The sublease agreements expire at various dates from 2008 to 2011.

Future operating lease commitments and future rental income as of May 31, 2007 are as follows (in thousands):

| <b>Fiscal year</b> | <b>Future<br/>Lease<br/>Payments</b> | <b>Future<br/>Rental<br/>Income</b> |
|--------------------|--------------------------------------|-------------------------------------|
| 2008               | \$ 27,671                            | \$ 2,341                            |
| 2009               | 15,486                               | 838                                 |
| 2010               | 3,647                                | 541                                 |
| 2011               | 383                                  | 70                                  |
| 2012               | 42                                   |                                     |
| <b>Total</b>       | <b>\$ 47,229</b>                     | <b>\$ 3,790</b>                     |

Rent expense was approximately \$27.7 million in fiscal 2007, \$16.3 million in fiscal 2006, and \$16.5 million in fiscal 2005. Rental income, which includes rents received for both owned and leased property, was \$5.5 million in fiscal 2007, \$6.8 million in fiscal 2006, and \$6.0 million in fiscal 2005, and is recorded as an offset to operating expenses. In September 2006 we sold all of our remaining venture portfolio and generated cash of approximately \$1.3 million with a loss on sale of investments of \$0.7 million. In August 2006, we sold certain limited partnership interests and generated cash of approximately \$17.0 million with a gain on sale of investment of \$2.4 million and eliminated our future capital call requirements.



**Table of Contents****Note 14: Stock Based Compensation Plans**

In December 2004, the FASB issued SFAS No. 123(R) *Share-Based Payment*, which requires all stock-based compensation expense to employees (as defined in SFAS No. 123(R)), including grants of employee stock options, restricted stock awards, restricted stock units, and employee stock purchase plan shares to be recognized in the financial statements based on their fair values. We adopted SFAS No. 123(R) on June 3, 2006 using the modified prospective transition method and accordingly, prior period amounts have not been restated. In order to determine the fair value of stock options and employee stock purchase plan shares, we use the Black-Scholes option pricing model and apply the single-option valuation approach to the stock option valuation. In order to determine the fair value of restricted stock awards and restricted stock units we use the closing market price of 3Com common stock on the date of grant. We recognize stock-based compensation expense on a straight-line basis over the requisite service period of the awards for options granted following the adoption of SFAS No. 123(R) for time vested awards. We recognize compensation expense for performance based restricted stock in the fiscal quarter when an event makes the probability that performance will more than likely be achieved. For unvested stock options outstanding as of May 31, 2006, we will continue to recognize stock-based compensation expense using the accelerated amortization method prescribed in FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*.

Estimates of the fair value of equity awards in future periods will be affected by the market price of our common stock, as well as the actual results of certain assumptions used to value the equity awards. These assumptions include, but are not limited to, the expected volatility of the common stock price, the expected term of options granted, and the risk free interest rate.

As noted above, the fair value of stock options and employee stock purchase plan shares is determined by using the Black-Scholes option pricing model and applying the single-option approach to the stock option valuation. The options generally vest on an annual basis over a period of four years. We estimate the expected option term by analyzing the historical term period from grant to exercise and also consider the expected term for those options that are still outstanding. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period. For equity awards granted after May 31, 2006, the volatility of the common stock is estimated using the historical volatility. We believe that historical volatility represents the best information currently available for projecting future volatility.

The risk-free interest rate used in the Black-Scholes option pricing model is based on the historical U.S. Treasury zero-coupon bond issues with terms corresponding to the expected terms of the equity awards. In addition, an expected dividend yield of zero is used in the option valuation model because we do not expect to pay any cash dividends in the foreseeable future. In accordance with SFAS No. 123(R), we are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods based upon new information. In order to determine an estimated pre-vesting option forfeiture rate, we used historical forfeiture data, which currently yields an expected forfeiture rate of 27 percent. This estimated forfeiture rate has been applied to all unvested options and restricted stock outstanding as of May 31, 2006 and to all options and restricted stock granted since May 31, 2006. Therefore, stock-based compensation expense is recorded only for those options and restricted stock that are expected to vest. The Company's policy is to issue new shares, or reissue shares from treasury stock, upon settlement of share based payments.

The following table summarizes the incremental effects of the share-based compensation expense resulting from the application of SFAS No. 123(R) to the stock options, restricted stock and employee stock purchase plan:

| (In thousands, except per share data)                                      |  | <b>May 31, 2007</b> |
|--|--|---------------------|
| Cost of sales  |  | \$ 1,576            |
| Sales and marketing  |  | 5,756               |
| Research and development   |  | 4,621               |
| General and administrative   |  | 8,142               |
| Incremental share-based compensation effect of SFAS No. 123(R) on net loss |  | \$ 20,095           |



**Table of Contents**

As of May 31, 2007, total unrecognized stock-based compensation expense relating to unvested employee stock options, restricted stock and employee stock purchase plan, adjusted for estimated forfeitures, was \$20.1 million. This amount is expected to be recognized over a weighted-average period of 2.7 years. If actual forfeitures differ from current estimates, total unrecognized stock-based compensation expense will be adjusted for future changes in estimated forfeitures.

Prior to June 1, 2006, we accounted for stock options using the intrinsic value method, pursuant to the provisions of Accounting Principles Board ( APB ) No. 25. Under this method, stock-based compensation expense was measured as the difference between the option s exercise price and the market price of the Company s common stock on the date of grant.

Pro forma information required under SFAS No. 123 for the prior fiscal years, as if we had applied the fair value recognition provisions of SFAS No. 123 to awards granted under our equity incentive plans, was as follows:

|   | May 31,<br>2006 | May 31,<br>2005 |
|---|-----------------|-----------------|
| (In thousands, except per share amounts)  |                 |                 |
| Net loss as reported  | \$ (100,675)    | \$ (195,686)    |
| Add: Stock-based compensation included in reported net loss   | 9,846           | 2,841           |
| Deduct: Total stock-based compensation determined under the fair value-based method, net of related tax effects | (25,496)        | (16,203)        |
| Adjusted net loss   | \$ (116,325)    | \$ (209,048)    |

Net loss per share-basic and diluted:

|             |           |           |
|-------------|-----------|-----------|
| As reported | \$ (0.26) | \$ (0.51) |
| Adjusted    | \$ (0.30) | \$ (0.55) |

There were 1.4 million shares of common stock issued under the employee stock purchase plan during the year ended May 31, 2007. Employee stock purchases normally occur only in the quarters ended November 30 and May 31.

Share-based compensation recognized in the year ended May 31, 2007 as a result of the adoption of SFAS No. 123(R) as well as pro forma disclosures according to the original provisions of SFAS No. 123 for periods prior to the adoption of SFAS No. 123(R) use the Black-Scholes option pricing model for estimating the fair value of options granted under the company s equity incentive plans. The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. Option valuation models require the input of highly subjective assumptions, including the expected stock price volatility. The underlying weighted-average assumptions used in the Black-Scholes model and the resulting estimates of fair value per share were as follows for options granted during the years ended May 31, 2007, May 31, 2006 and May 31, 2005:

|                                | 2007    | 2006 <sup>1</sup> | 2005 <sup>1</sup> |
|--------------------------------|---------|-------------------|-------------------|
| <b>Employee stock options:</b> |         |                   |                   |
| Volatility                     | 42.7%   | 41.9%             | 53.2%             |
| Risk-free interest rate        | 4.7%    | 4.3%              | 3.5%              |
| Dividend yield                 | 0.0%    | 0.0%              | 0.0%              |
| Expected life (years)          | 4.0     | 4.0               | 4.0               |
| Fair value per option          | \$ 1.67 | \$ 1.52           | \$ 1.89           |

**Employee Stock Purchase Plan:**

|                         |       |       |       |
|-------------------------|-------|-------|-------|
| Volatility              | 39.2% | 38.1% | 39.2% |
| Risk-free interest rate | 5.1%  | 4.4%  | 2.6%  |
| Dividend yield          | 0.0%  | 0.0%  | 0.0%  |



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|                       |        |        |        |
|-----------------------|--------|--------|--------|
| Expected life (years) | 0.5    | 0.5    | 0.5    |
| Fair value per option | \$1.10 | \$1.20 | \$1.04 |

*1 Assumptions used in the calculation of fair value according to the provisions of SFAS No. 123.*

81

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**Table of Contents**

As of May 31, 2007, our outstanding stock options as a percentage of outstanding shares were approximately 13 percent. Stock option detail activity for the period June 1, 2006 to May 31, 2007 was as follows (shares in thousands):

|   | <b>Number<br/>of<br/>shares</b> | <b>Weighted-Average<br/>Exercise<br/>Price</b> |
|---|---------------------------------|--|
| Outstanding, May 31, 2004                                 | 56,885                          | \$ 7.18  |
| Granted   | 10,002                          | 4.22   |
| TippingPoint options assumed                              | 13,886                          | 1.31   |
| Exercised   | (4,273)                         | 2.01   |
| Canceled  | (13,141)                        | 6.90   |
| Outstanding, May 31, 2005                                 | 63,359                          | 5.83   |
| Granted   | 21,974                          | 4.22   |
| Exercised   | (5,467)                         | 2.07   |
| Canceled  | (18,445)                        | 5.83   |
| Outstanding, May 31, 2006                                 | 61,421                          | \$ 5.71  |
| Granted   | 24,285                          | 4.71   |
| Exercised   | (2,527)                         | 3.00   |
| Canceled  | (30,899)                        | 5.94   |
| Outstanding, May 31, 2007                                 | 52,280                          | \$ 5.23  |
| Exercisable   | 22,174                          | \$ 6.20  |
| Weighted-average grant-date fair value of options granted |                                 | \$ 1.67  |

Additional information about employee options outstanding and exercisable at December 31, 2006 is included in the following table:

| <b>Range of<br/>Exercise Prices</b> | <b>Outstanding Options as of May 31, 2007</b>          |  |   | <b>Exercisable as of May 31, 2007</b>       |   |
|-------------------------------------|--|--|---|---|---|
|                                     | <b>Number<br/>of<br/>Shares<br/>(in<br/>thousands)</b> | <b>Weighted-Average<br/>Exercise<br/>Price</b> | <b>Weighted-Average<br/>Remaining<br/>Contractual<br/>Life<br/>(in years)</b> | <b>Number<br/>of<br/>(in<br/>thousands)</b> | <b>Weighted-Average<br/>Shares<br/>Exercise<br/>Price</b> |
| \$0.00 - \$4.00                     | 11,101   | \$ 2.87  | 5.5   | 5,360                                       | \$ 2.33   |

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|              |        |         |     |        |         |
|--------------|--------|---------|-----|--------|---------|
| 4.01 - 5.00  | 21,172 | 4.47    | 5.7 | 4,421  | 4.52    |
| 5.01 - 6.00  | 12,664 | 5.52    | 4.8 | 5,238  | 5.51    |
| 6.01 - 7.00  | 1,363  | 6.21    | 2.4 | 1,242  | 6.21    |
| 7.01 - 8.00  | 403    | 7.35    | 2.6 | 354    | 7.36    |
| 8.01 - 22.00 | 5,577  | 11.84   | 2.6 | 5,559  | 11.85   |
| Total        | 52,280 | \$ 5.23 | 5.0 | 22,174 | \$ 6.20 |

As of May 31, 2007, there were approximately 22.2 million options exercisable with a weighted-average exercise price of \$6.20 per share. By comparison, there were approximately 32.5 million options exercisable as of May 31, 2006 with a weighted-average price of \$6.96 per share.

During the year ended May 31, 2007 approximately 2.5 million options were exercised at an aggregate intrinsic value of \$4.5 million. The intrinsic value above is calculated as the difference between the market value on exercise date and the option price of the shares. The closing market value per share as of June 1, 2007 was \$4.69 as reported by the NASDAQ Global Select Market. The aggregate intrinsic value of options outstanding and options exercisable as of May 31, 2007 was \$25.4 million and \$13.6 million respectively. The aggregate intrinsic value is calculated as the difference between the market value as of June 1, 2007 and the option price of the shares.

**Table of Contents**

Options outstanding that are vested and expected to vest as of May 31, 2007 are as follows:

|  | <b>Number of<br/>Shares</b> | <b>Weighted-<br/>Average<br/>Option<br/>Price</b> | <b>Weighted-<br/>Average<br/>Remaining<br/>Contractual<br/>Life (in<br/>years)</b> | <b>Aggregate<br/>Intrinsic<br/>Value<br/>(in<br/>thousands)</b> |
|--|-----------------------------|---|--|---|
| Vested and expected to vest at May 31, 2007  | 38,248,782                  | \$5.46  | 4.60   | \$ 21,103   |
| Restricted stock awards activity during the year ended May 31, 2007 and restricted stock awards outstanding as of May 31, 2007, were as follows (shares in thousands): |                             |   |  |   |

|                           | <b>Number<br/>of<br/>Shares<br/>(unvested)</b> | <b>Weighted-<br/>Average<br/>Grant-<br/>Date Fair<br/>Value</b> |
|---------------------------|--|---|
| Outstanding, May 31, 2004 | 723  | \$ 4.97   |
| Granted                   | 1,484  | 4.23  |
| Exercised                 | (154)  | 5.31  |
| Canceled                  | (316)  | 4.90  |
| Outstanding, May 31, 2005 | 1,737  | 4.32  |
| Granted                   | 2,419  | 3.84  |
| Exercised                 | (854)  | 4.07  |
| Canceled                  | (1,185)  | 3.96  |
| Outstanding, May 31, 2006 | 2,117  | \$ 4.07   |
| Granted                   | 2,380  | 4.45  |
| Exercised                 | (1,151)  | 4.13  |
| Canceled                  | (943)  | 4.30  |
| Outstanding, May 31, 2007 | 2,403  | \$ 4.33   |

During the year ended May 31, 2007 approximately 1.2 million restricted award shares with an aggregate fair value of \$4.9 million became vested.

Restricted stock unit activity during the year ended May 31, 2007 and restricted stock units outstanding as of May 31, 2007, were as follows (shares in thousands):

| <b>Weighted-<br/>Average</b> | <b>Aggregate</b> |
|------------------------------|------------------|
|------------------------------|------------------|

|                          | <b>Number<br/>of<br/>Shares<br/>(unvested)</b> | <b>Weighted-<br/>Average<br/>Purchase<br/>Price</b> | <b>Remaining<br/>Contractual<br/>Term<br/>(Years)</b> | <b>Intrinsic<br/>Value (in<br/>thousands)<br/>\$</b> |
|--------------------------|--|---|---|--|
| Outstanding June 1, 2006 |  | \$  |   | \$   |
| Granted                  | 4,356  |   |   |  |
| Vested                   | (836)  |   |   | 3,319  |
| Forfeited                | (409)  |   |   |  |
| Outstanding May 31, 2007 | 3,111  | \$  | 1.19  | \$ 14,591  |

During the year ended May 31, 2007 approximately 0.8 million restricted share units with an aggregate fair value of \$3.3 million became vested.

**Table of Contents**

*Employee Stock Purchase Plan.* We have an employee stock purchase plan (ESPP) under which eligible employees may authorize payroll deductions of up to ten percent of their compensation, as defined, to purchase common stock at a price of 85 percent of the lower of the fair market value as of the beginning or the end of the six-month offering period. In September 2003, our stockholders approved an increase of five million shares available for issuance under the ESPP. We recognized \$1.6 million of stock-based compensation expense in the year ended May 31, 2007.

*Preferred Shares Rights Plan.* In September 1989, the Board of Directors approved a common stock purchase rights plan, which was amended and restated in December 1994, and again in March 2001. In November 2002, the Board of Directors approved a Third Amended and Restated Preferred Shares Rights Plan (the Preferred Shares Rights Plan), which replaced the March 2001 Plan. The Preferred Shares Rights Plan provides that the preferred share rights (the Rights) will become exercisable only following the acquisition by a person or a group of 15 percent or more of the outstanding common stock or ten days following the announcement of a tender or exchange offer for 15 percent or more of the outstanding common stock (the Distribution Date). After the Distribution Date, each Right will entitle the holder to purchase for \$55.00 (the Exercise Price), one-one thousandth of a share of our Series A Participating Preferred Stock (or cash, stock or other assets approved by the Board of Directors) with economic terms similar to that of one share of our common stock. Upon a person or a group acquiring 15 percent or more of the outstanding common stock, each Right will allow the holder (other than the acquirer) to purchase common stock or securities of 3Com having a then current market value of two times the Exercise Price of the Right. In the event that following the acquisition of 15 percent of the common stock by an acquirer, we are acquired in a merger or other business combination or 50 percent or more of our assets or earning power is sold, each Right will entitle the holder to purchase for the Exercise Price, common stock or securities of the acquirer having a then current market value of two times the Exercise Price. In certain circumstances, the Rights may be redeemed by us at a redemption price of \$0.001 per Right. If not earlier exchanged or redeemed, the Rights will expire on March 8, 2011.

*Stock Reserved for Issuance.* As of May 31, 2007 we had reserved common stock for issuance as follows (in thousands):

|  |            |
|--|------------|
| Stock option and restricted stock plans for granted shares | 55,391     |
| Stock option and restricted stock plans for future grants  | 14,918     |
| Employee stock purchase plan                               | 3,510      |
| <br>Total shares reserved for issuance                     | <br>73,819 |

In addition, as of May 31, 2007 we had 0.4 million shares of preferred stock reserved for issuance under our Preferred Shares Rights Plan.

*Stock Repurchase and Option Programs.* During the fourth quarter of fiscal 2005, the Board of Directors approved a new stock repurchase program that authorizes expenditures of up to \$100.0 million during a two-year period which expired March 31, 2007, provided that all repurchases are pre-approved by the Audit and Finance Committee of the Board of Directors. Our prior stock repurchase program was announced on March 19, 2003 and permitted expenditures up to \$100.0 million through March 2005.

Pursuant to these authorizations, we did not repurchase any shares during fiscal 2007 or fiscal 2006. We repurchased 15.0 million shares of our common stock during fiscal 2005 at a cost of \$73.5 million.

**Table of Contents****Note 15: Financial Instruments**

The following summary disclosures concerning our financial instruments are made in accordance with the provisions of SFAS No. 107, Disclosures About Fair Value of Financial Instruments, which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate the value. Fair value is defined in SFAS No. 107 as the amount at which an instrument could be exchanged in a current transaction between willing parties, rather than in a forced or liquidation sale.

|                             | May 31, 2007       |                         | May 31, 2006       |                         |
|-----------------------------|--------------------|-------------------------|--------------------|-------------------------|
| (in thousands)              | Carrying<br>Amount | Estimated<br>Fair Value | Carrying<br>Amount | Estimated<br>Fair Value |
| Cash and equivalents        | \$559,217          | \$559,217               | \$501,097          | \$501,097               |
| Short-term investments      |                    |                         | 363,250            | 363,250                 |
| Corporate equity securities | 257                | 467                     | 16,287             | 16,174                  |

The following methods and assumptions were used in estimating the fair values of financial instruments:

*Cash and equivalents.* The carrying amounts reported in the consolidated balance sheets for cash and equivalents approximate their estimated fair values.

*Short-term investments.* The fair values of short-term investments are based on market prices.

*Corporate equity securities.* Fair value of publicly traded corporate equity securities is based on quoted market prices. Fair value of privately held corporate equity securities is based on all available information. For these non-quoted investments, our policy is to regularly review the assumptions underlying the financial performance of the privately held companies in which the investments are maintained. If and when a determination is made that a decline in fair value below the cost basis is other than temporary, the related investment is written down to its estimated fair value.

*Foreign exchange contracts.* We enter into foreign exchange forward contracts to hedge certain balance sheet exposures and intercompany balances against future movements in foreign exchange rates. In addition, we enter into foreign exchange forward contracts to hedge exposures related to anticipated foreign currency cash flows other than in China. We do not use foreign forward exchange contracts for speculative or trading purposes.

Our foreign exchange forward contracts require the exchange of foreign currencies for U.S. Dollars or vice versa, and generally mature in one month or less. We had outstanding foreign exchange forward contracts with aggregate notional amounts of \$42.8 million as of May 31, 2007 and \$39.0 million as of May 31, 2006, that had remaining maturities of one month or less. The fair value of foreign exchange forward contracts is based on prevailing financial market information. The carrying amounts, which were also the estimated fair values, of foreign exchange forward contracts were not significant as of May 31, 2007 and 2006. See Note 2 for information concerning our significant accounting policies for foreign exchange forward contracts.

Because SFAS No. 107 excludes certain financial instruments and all non-financial instruments from its disclosure requirements, any aggregation of the fair value amounts presented in the table above would not necessarily represent the underlying value of all of our financial instruments.

**Table of Contents****Note 16: Interest and Other Income (Expense), Net**

Interest and other income (expense), net, consists of (in thousands):

|                             | <b>Years Ended May 31,</b> |             |             |
|-----------------------------|----------------------------|-------------|-------------|
|                             | <b>2007</b>                | <b>2006</b> | <b>2005</b> |
| Interest income             | \$ 41,310                  | \$ 29,297   | \$ 22,807   |
| Interest expense            | (447)                      | (212)       | (1,401)     |
| Interest income, net        | \$ 40,863                  | \$ 29,085   | \$ 21,406   |
| Other income (expense), net | \$ 38,291                  | \$ 8,235    | \$ (4,785)  |

Other income (expense), net includes \$30.6 million and \$7.3 million in fiscal year 2007 and 2006, respectively, of other income from H3C for an operating subsidy program by the Chinese VAT authorities in the form of a partial refund of VAT taxes collected by H3C from purchasers of software products. Other income also includes a gain from the insurance proceeds from our Hemel facility in fiscal 2007. In 2005, other income (expense), net includes a provision of \$2.4 million for unrecoverable value added tax for prior years that was recorded in fiscal 2005 as a result of an unfavorable tax authority ruling, \$1.5 million loss on foreign exchange, and \$0.9 million of bank charges.

**Note 17: Income Taxes**

The provision (benefit) for income taxes consists of the following (in thousands):

|                | <b>Years Ended May 31,</b> |             |             |
|----------------|----------------------------|-------------|-------------|
|                | <b>2007</b>                | <b>2006</b> | <b>2005</b> |
| Current:       |                            |             |             |
| Federal        | \$                         | \$          | \$          |
| State          | 530                        | 200         | 308         |
| Foreign        | 19,640                     | (14,421)    | 138         |
| Total current  | 20,170                     | (14,221)    | 446         |
| Deferred       |                            |             |             |
| Federal        |                            |             |             |
| State          |                            |             |             |
| Foreign        | (9,997)                    | (612)       | 3,044       |
| Total deferred | (9,997)                    | (612)       | 3,044       |
| Total          | \$ 10,173                  | \$ (14,833) | \$ 3,490    |



**Table of Contents**

The components of net deferred tax assets consist of the following (in thousands):

|   | May 31, 2007 | May 31, 2006 |
|---|--------------|--------------|
| Gross deferred tax assets:                                |              |              |
| Operating loss carryforwards                              | \$ 1,003,569 | \$ 975,506   |
| Amortization and depreciation                             | 33,478       | 42,725       |
| Tax credit carryforwards                                  | 55,618       | 60,075       |
| Capital loss carryforwards                                | 25,828       | 10,979       |
| Unrealized losses on private investments, net             |              | 19,053       |
| Royalty and purchased research and development            | 3,639        | 9,916        |
| Other   | 1,270        | 5,769        |
| Gross deferred tax assets                                 | 1,123,402    | 1,124,023    |
| Gross deferred tax liabilities:                           |              |              |
| Reserves recognized in different periods for tax purposes | (144,486)    | (146,565)    |
| Acquired intangibles                                      | (59,115)     | (25,375)     |
| Other   |              | (1,021)      |
| Gross deferred tax liabilities                            | (203,601)    | (172,961)    |
| Valuation allowance                                       | (937,075)    | (942,758)    |
| Net deferred tax (liabilities) assets                     | \$ (17,274)  | \$ 8,304     |

Deferred tax assets and liabilities as of May 31, 2007, related to the acquisition of H-3C, TippingPoint and Roving Planet, and May 31, 2006, related to the acquisition of H-3C and TippingPoint, include the tax effect of temporary differences and tax attributes related to these acquisitions. A valuation allowance was recorded as the realization of the TippingPoint and Roving Planet deferred tax assets was uncertain so that the impact on the net deferred tax assets was zero.

We have net operating loss carryforwards related to the following income tax jurisdictions and expiration periods: U.S. federal loss carryforwards of approximately \$2.5 billion expiring between fiscal years 2008 and 2027, substantially all of which expire between fiscal years 2021 and 2027; various state loss carryforwards of approximately \$1.2 billion expiring between 2008 and 2027; and various foreign loss carryforwards with \$15.1 million expiring between 2008 and 2014, and \$18.6 million with an unlimited carryforward period. We also have capital loss carryforwards estimated at approximately \$73.8 million expiring between fiscal years 2009 and 2012; a U.S. federal research credit carryforward of \$25.2 million expiring between 2008 and 2027; a U.S. federal foreign tax credit carryforward of \$6.2 million expiring between 2008 and 2012; and a U.S. federal alternative minimum tax credit carryforward of \$10.7 million that has an unlimited carryforward period.

SFAS No. 109, Accounting for Income Taxes, requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion or all of the deferred tax asset will not be realized. The valuation allowance relates to net operating loss and credit carryforwards and temporary differences for which we believe that realization is uncertain. The valuation allowance decreased \$5.7 million in fiscal 2007, and increased \$30.6 million in fiscal 2006, and \$92.5 million in fiscal 2005. The total valuation allowance of \$937.1 million includes \$143.5 million attributable to the tax benefit of stock option deductions, which, if recognized, will be allocated directly to paid-in-capital. In addition, the valuation allowance includes approximately \$59.3 million for acquired net operating

loss carryforwards which, if realized, would result in a decrease in goodwill.

**Table of Contents**

The provision (benefit) for income taxes differs from the amount computed by applying the federal statutory income tax rate to income before taxes as follows:

|  | <b>Years Ended May 31,</b> |             |             |
|--|----------------------------|-------------|-------------|
|  | <b>2007</b>                | <b>2006</b> | <b>2005</b> |
| Tax computed at federal statutory rate   | (35.0)%                    | (35.0)%     | (35.0)%     |
| State income taxes, net of federal effect  | 17.1                       | (2.1)       | (2.5)       |
| Provision for combined foreign and U.S. taxes on certain foreign income at rates greater than U.S. rates | 31.7                       | 15.2        | 10.9        |
| Valuation allowance  | (3.1)                      | 24.1        | 27.5        |
| Income tax benefit arising from settlement of foreign tax audit  |                            | (19.9)      |             |
| Non-deductible purchased in-process technology and merger-related charges                                | 7.0                        | 3.2         | 0.9         |
| Other  | 1.8                        | 1.7         | 0.1         |

|       |       |         |      |
|-------|-------|---------|------|
| Total | 19.5% | (12.8)% | 1.9% |
|-------|-------|---------|------|

Loss before income taxes includes foreign losses of \$20.0 million in fiscal 2007, \$29.9 million in fiscal 2006 and \$47.9 million in fiscal 2005. We have not provided for federal tax on approximately \$293.2 million of undistributed earnings of our foreign subsidiaries because we consider these earnings to be indefinitely reinvested in foreign subsidiary operations.

During fiscal 2006, we settled a tax audit with foreign tax authorities regarding issues covering multiple years. This transaction resulted in the release of \$24.3 million of our tax reserves which were previously reported under the caption "Accrued liabilities and other" on our balance sheet. The release of the reserves resulted in the following amounts being included in the statement of operations; a tax benefit of \$23.0 million included in the caption "Income tax benefit" and a related foreign exchange gain of \$1.3 million included in the caption "Other income (expense), net". We have certain other domestic and foreign income tax audits that are currently in progress. The outcome of these examinations cannot be predicted with certainty and, should unfavorable rulings be made, assessments against us could be significant. Many of these contingencies arise from periods when we were substantially larger. Reserves for contingencies are based on an assessment of the likelihood of an unfavorable outcome and the expected potential loss from such contingency, and are monitored by management. These reserves are maintained until such time as the matter is settled or the statutory period for adjustment has passed. Adjustments could be required in the future if we determine that the reserves for tax contingencies are inadequate. However, we believe that amounts currently provided for such matters are adequate and that the ultimate resolution of the examinations is not expected to have a material adverse effect on our consolidated financial position or results of operations. As of May 31, 2007, our reserves for such income tax contingencies are \$22.5 million.

H3C is located in the Hangzhou High-tech Zone and obtained a preferential tax rate from the Municipal Tax Bureau because we qualified as a high-and-new technology company. H3C was entitled to tax concessions beginning in 2004 whereby it was exempted from the PRC income tax for two consecutive years and is entitled to a 50% reduction in income tax in the following three years. Consequently the H3C statutory tax rate is 7.5% in respect of calendar 2006, 2007 and 2008. Effective calendar 2009, we expect the H3C statutory rate to be 15%. In March 2007 the PRC enacted a Tax Reform Law, the broad objective of which is to standardize the tax treatment of foreign-owned enterprises with that of domestic-owned enterprises. One of the effects of the new law is that there will be a unified PRC corporate income tax rate of 25%. It is proposed that some high-tech enterprises will be exempt from the increased rate, and although much of the detail of the new law is yet to be issued in regulations, we believe that we will continue to qualify as a high-tech enterprise and therefore that these tax concessions will continue to be available for the foreseeable future.



**Table of Contents****Note 18: Net Loss per Share**

The following table presents the calculation of basic and diluted earnings per share (in thousands, except per share data):

|                                      | <b>Years Ended May 31,</b> |              |              |
|--------------------------------------|----------------------------|--------------|--------------|
|                                      | <b>2007</b>                | <b>2006</b>  | <b>2005</b>  |
| Net loss                             | \$ (88,589)                | \$ (100,675) | \$ (195,686) |
| Weighted-average shares Basic        | 393,894                    | 386,801      | 382,309      |
| Effect of dilutive securities:       |                            |              |              |
| Employee stock options               |                            |              |              |
| Restricted stock                     |                            |              |              |
| Weighted-average shares Diluted      | 393,894                    | 386,801      | 382,309      |
| Net loss per share Basic and Diluted |                            |              |              |
| Net loss                             | \$ (0.22)                  | \$ (0.26)    | \$ (0.51)    |

Employee stock options and restricted stock totaling 57.8 million shares in fiscal 2007, 63.5 million shares in fiscal 2006 and 65.1 million shares in fiscal 2005, were not included in the computation of diluted earnings per share as the net loss for these periods would have made their effect anti-dilutive.

**Note 19: Segment Information**

Based on the information provided to our chief operating decision-maker (CODM) for purposes of making decisions about allocating resources and assessing performance, prior to February 1, 2006, we reported one operating segment, 3Com.

Following the acquisition of a majority and controlling interest in H3C, we have two segments that provide information to the CODM. The operating structure is aligned along the SCN business and the acquired H3C business. Each of these segments has designated management teams with direct responsibility over the operations of the respective segments. Accordingly, our CODM now focuses primarily on information and analysis for purposes of making decisions about allocating resources and assessing performance. As a result, we currently report two operating segments, SCN and H3C.

Management evaluates segment performance based on segment net revenue, operating income (loss), net income (loss), and net assets.

Summarized financial information of our continuing operations by segment in 2007 and 2006 is as follows (in thousands).

|   | <b>Year Ended May 31, 2007</b> |            |                     |              |
|---|--------------------------------|------------|---------------------|--------------|
|   | <b>SCN</b>                     | <b>H3C</b> | <b>Eliminations</b> | <b>Total</b> |
| Revenue   | \$ 642,816                     | \$ 731,132 | \$ (106,467)        | \$ 1,267,481 |
| Gross profit  | 239,245                        | 339,209    |                     | 578,454      |
| Sales and marketing, research and development, and general and administrative | 337,523                        | 291,680    |                     | 629,203      |
| Restructuring, amortization, and in-process research and development          | 19,493                         | 62,279     |                     | 81,772       |
| Operating loss  | (117,771)                      | (14,750)   |                     | (132,521)    |
| Net (loss) income   | \$ (81,446)                    | \$ 19,049  | \$ (26,192)         | \$ (88,589)  |

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|   |             |             |             |             |
|---|-------------|-------------|-------------|-------------|
| Total expenditures for additions to property, plant and equipment | \$ 11,686   | \$ 16,645   |             | \$ 28,331   |
| Assets  | \$1,408,214 | \$1,394,199 | \$(651,321) | \$2,151,092 |
| Goodwill  | \$ 311,380  | \$ 455,064  |             | \$ 766,444  |
|   | 89          |             |             |             |

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**Table of Contents**

|   |              | <b>Year Ended May 31, 2006</b> |                     |              |  |
|---|--------------|--------------------------------|---------------------|--------------|--|
|   | <b>SCN</b>   | <b>H3C</b>                     | <b>Eliminations</b> | <b>Total</b> |  |
| Revenue   | \$ 705,339   | \$ 108,290                     | \$ (18,822)         | \$ 794,807   |  |
| Gross profit  | 276,627      | 51,437                         |                     | 328,064      |  |
| Sales and marketing, research and development, and general and administrative | 419,008      | 30,203                         |                     | 449,211      |  |
| Restructuring, amortization, and in-process research and development          | 29,579       | 6,377                          |                     | 35,956       |  |
| Operating (loss) income   | (171,960)    | 14,857                         |                     | (157,103)    |  |
| Net (loss) income   | \$ (114,420) | \$ 21,568                      | \$ (7,823)          | \$ (100,675) |  |
| Total expenditures for additions to property, plant and equipment             | \$ 14,426    | \$ 2,978                       |                     | \$ 17,404    |  |
| Assets  | \$ 1,482,670 | \$ 406,981                     | \$ (28,290)         | \$ 1,861,361 |  |
| Goodwill  | \$ 309,918   | \$ 44,341                      |                     | \$ 354,259   |  |

Certain product groups accounted for a significant portion of our sales. Sales from these product groups as a percentage of total sales for the past three fiscal years were as follows (in thousands):

|                       | <b>Years Ended May 31,</b> |       |             |       |             |       |
|-----------------------|----------------------------|-------|-------------|-------|-------------|-------|
|                       | <b>2007</b>                |       | <b>2006</b> |       | <b>2005</b> |       |
| Networking            | \$ 1,028,090               | 81.1% | \$ 577,038  | 72.6% | \$ 494,492  | 75.9% |
| Security              | 120,053                    | 9.5   | 88,012      | 11.1  | 25,760      | 4.0   |
| Voice                 | 68,033                     | 5.4   | 56,632      | 7.1   | 44,950      | 6.9   |
| Services              | 35,871                     | 2.8   | 33,357      | 4.2   | 32,062      | 4.9   |
| Connectivity Products | 15,434                     | 1.2   | 39,768      | 5.0   | 53,980      | 8.3   |
| Total                 | \$ 1,267,481               |       | \$ 794,807  |       | \$ 651,244  |       |

Sales from significant customers as a percentage of total consolidated sales for the past three fiscal years were as follows:

| <b>Customer</b>         | <b>Years Ended May 31,</b> |             |             |
|-------------------------|----------------------------|-------------|-------------|
|                         | <b>2007</b>                | <b>2006</b> | <b>2005</b> |
| Huawei Technologies Co. | 20%                        | 4%          | %           |
| Ingram Micro, Inc.      | 11%                        | 19%         | 21%         |
| Tech Data (1)           | *                          | 11%         | 13%         |
| Total                   | 31%                        | 34%         | 34%         |

(1) - Customer does not meet the 10 percent threshold in fiscal 2007

Huawei Technologies Co, Ltd. (a customer of our H3C segment and the former minority shareholder of H3C) represented approximately 20 percent of our accounts receivable balance as of May 31, 2007. Ingram Micro, Inc (a

customer of our SCN segment. represented approximately 24 percent of our accounts receivable balance as of May 31, 2007, compared to 16 percent for the previous fiscal year.

**Note 20: Geographical Information**

Sales by geographic region are as follows (in thousands):

| <b>Sales</b>                    | <b>Years Ended May 31,</b> |             |             |
|---------------------------------|----------------------------|-------------|-------------|
|                                 | <b>2007</b>                | <b>2006</b> | <b>2005</b> |
| Americas                        | \$ 233,691                 | \$ 248,532  | \$ 214,051  |
| Latin and South America         | 70,419                     | 72,164      | 57,717      |
| Europe, Middle East, and Africa | 272,826                    | 298,545     | 294,753     |
| Asia Pacific                    | 103,501                    | 91,396      | 84,723      |
| China                           | 587,044                    | 84,170      |             |
| Total                           | \$ 1,267,481               | \$ 794,807  | \$ 651,244  |

Sales information by geography is reported based on the customer's designated delivery point.



**Table of Contents**

The growth in our international operations, which is due primarily to our acquisition of H3C, has increased our exposure to foreign currency fluctuations. Primary currencies of the revenue is U.S. dollars and Chinese Renminbi; expenses include Euros, Singapore Dollars, British Pounds, and Chinese Renminbi. The income statements of our international operations whose functional currencies are the local currencies, are translated into U.S. dollars at the average exchange rates in each applicable period. To the extent the U.S. dollar weakens against foreign currencies, the translation of these foreign currency denominated transactions results in increased revenues and operating expenses. Conversely, our revenues and operating expenses will decrease when the U.S. dollar strengthens against foreign currencies.

Property and equipment by geographic region are as follows (in thousands):

|                         | <b>May 31,<br/>2007</b> | <b>May 31,<br/>2006</b> |
|-------------------------|-------------------------|-------------------------|
| Property and Equipment: |                         |                         |
| United States           | \$ 30,104               | \$ 41,186               |
| United Kingdom          | 7,843                   | 10,325                  |
| China                   | 32,070                  | 32,859                  |
| Other                   | 6,443                   | 4,739                   |
| <br>Total               | <br>\$ 76,460           | <br>\$ 89,109           |

Property and equipment by geography is based on the physical location of the assets at the end of the fiscal year. As of May 31, 2007 and May 31, 2006, property and equipment in the United States, the United Kingdom and China exceeded ten percent of total property and equipment, as shown in the table above.

During fiscal 2006 our Europe, Middle East and Africa headquarters facility in Hemel Hempstead, United Kingdom was damaged by explosions at a third-party oil depot facility which occurred approximately one quarter mile from our facility. Approximately 300 employees and contractors worked at our Hemel campus, primarily in our sales, marketing and product operations groups. The incident occurred during non-business hours and no employee casualties or injuries were reported. We activated our back-up systems and established business operations at alternative facilities to ensure business continuity and minimize disruption to our customers. We believe we have sufficient insurance and recourse against third parties so that any loss incurred by us in connection with these explosions should not have a material adverse effect on our results of operations. During fiscal 2007 we have received approximately \$28 million of insurance proceeds while the net book value of the building has been written off resulting in a gain of \$8.0 million recorded in other income (expense), net. We are in the process of determining the feasibility of selling the Hemel land. We talked with prospective buyers and negotiations are underway. Before any potential sale can be completed the UK government must assess the ability to rebuild on the land. Since it is not believed that this process will be completed within the year we are still categorizing the land as held for use.

**Note 21: Employee Benefit Plan and EARP**

We have adopted a plan known as the 3Com 401(k) Plan (the 401(k) Plan) to provide retirement benefits to domestic employees. As allowed under Section 401(k) of the Internal Revenue Code, the 401(k) Plan provides tax-deferred salary deductions for eligible employees. Participants may elect to contribute from one percent to 22 percent of their annual compensation to the 401(k) Plan each calendar year, limited to a maximum annual amount as set periodically by the Internal Revenue Service. In addition, the 401 (k) Plan provides for contributions as determined by the Board of Directors. We match 50 percent for each dollar on the first six percent of eligible annual compensation contributed by the employee. Employees become vested in our matching contributions according to a three-year vesting schedule based on initial date of hire. Matching contributions to the 401 (k) Plan totaled \$1.8 million in fiscal 2007, \$2.2 million in fiscal 2006, and \$2.2 million in fiscal 2005.

The closing of the acquisition triggered a bonus program for substantially all of H3C's approximately 4,800 employees. This program, which was implemented by Huawei and 3Com in a prior period, is called the Equity

Appreciation Rights Plan, or EARP, and funds a bonus pool based upon a percentage of the appreciation in H3C's value from the initiation of the program to the time of the closing of the acquisition. A portion of the program is based on cumulative earnings of H3C. The total value of the EARP is expected to be approximately \$180 million. Approximately \$37 million was accrued by December 31, 2006. H3C recorded an incremental charge of approximately \$57 million just prior to the closing of the acquisition. At May 31, 2007 the \$57 million of the change-in-control was accrued for on the balance sheet and is expected to be paid in the first quarter of fiscal 2008. H3C expects the unvested portion amounting to \$86 million to be accrued in H3C's operating results over the next three years serving as a continued retention and incentive program for employees.

**Table of Contents****Note 22: Litigation**

We are a party to lawsuits in the normal course of our business. Litigation can be expensive and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. We believe that we have meritorious defenses in the matters set forth below in which we are named as a defendant. An unfavorable resolution of the lawsuits described below could adversely affect our business, financial position, or results of operations. We cannot estimate the loss or range of loss that may be reasonably possible as a result of these litigations and, accordingly, we have not recorded any associated liability in our consolidated balance sheets.

On December 5, 2001, TippingPoint and two of its current and former officers and directors, as well as the managing underwriters in TippingPoint's initial public offering, were named as defendants in a purported class action lawsuit filed in the United States District Court for the Southern District of New York. The lawsuit, which is part of a consolidated action that includes over 300 similar actions, is captioned *In re Initial Public Offering Securities Litigation, Brian Levey vs. TippingPoint Technologies, Inc., et al.* (Civil Action Number 01-CV-10976). The principal allegation in the lawsuit is that the defendants participated in a scheme to manipulate the initial public offering and subsequent market price of TippingPoint's stock (and the stock of other public companies) by knowingly assisting the underwriters' requirement that certain of their customers had to purchase stock in a specific initial public offering as a condition to being allocated shares in the initial public offerings of other companies. In relation to TippingPoint, the purported plaintiff class for the lawsuit is comprised of all persons who purchased TippingPoint stock from March 17, 2000 through December 6, 2000. The suit seeks rescission of the purchase prices paid by purchasers of shares of TippingPoint common stock. On September 10, 2002, TippingPoint's counsel and counsel for the plaintiffs entered into an agreement pursuant to which the plaintiffs dismissed, without prejudice, TippingPoint's former and current officers and directors from the lawsuit. In May 2003, a memorandum of understanding was executed by counsel for the plaintiffs, the issuer-defendants and their insurers setting forth the terms of a settlement that would result in the termination of all claims brought by the plaintiffs against the issuer-defendants and the individual defendants named in the lawsuit. In August 2003, TippingPoint's Board of Directors approved the settlement terms described in the memorandum of understanding. In May 2004, TippingPoint signed a settlement agreement on behalf of itself and its current and former directors and officers with the plaintiffs. This settlement agreement formalizes the previously approved terms of the memorandum of understanding and, subject to certain conditions, provides for the complete dismissal, with prejudice, of all claims against TippingPoint and its current and former directors and officers. Any direct financial impact of the settlement is expected to be borne by TippingPoint's insurers. On August 31, 2005, the District Court issued its preliminary approval of the settlement terms. The settlement remains subject to numerous conditions, including final approval by the District Court. On December 5, 2006, the U.S. Court of Appeals for the Second Circuit held that the District Court erred in granting class-action status to six "focus cases" of the consolidated class action lawsuits that comprise the action. The impact of this decision on the settlement is uncertain. The Plaintiffs petitioned the Second Circuit to hear this case en banc, but the appeals court rejected the petition. The matter is now back before the District Court. If the settlement does not occur for any reason and the litigation against TippingPoint continues, we intend to defend this action vigorously, and to the extent necessary, to seek indemnification and/or contribution from the underwriters in TippingPoint's initial public offering pursuant to its underwriting agreement with the underwriters. However, there can be no assurance that indemnification or contribution will be available to TippingPoint or enforceable against the underwriters.

On December 22, 2006, Australia's Commonwealth Scientific and Research Organization (CSIRO) filed suit in the United States District Court for the Eastern District of Texas (Tyler Division) against several manufacturers and suppliers of wireless products, including 3Com, seeking money damages and injunctive relief. The complaint alleges that the manufacture, use, and sale of wireless products compliant with the IEEE 802.11(a) or 802.11(g) wireless standards infringes on CSIRO's patent, U.S. Patent No. 5,487,069. On March 9, 2007, 3Com filed its Answer, denying infringement and claiming invalidity and unenforceability of the CSIRO patent, among other defenses. The case is in the discovery phase of litigation. The majority of 3Com's wireless products are supplied to the Company under OEM Purchase and Development Agreements that impose substantial intellectual property indemnifications obligations upon 3Com's suppliers. We cannot make any predictions as to the outcome of this litigation and intend to vigorously defend the matter.



**Table of Contents****Note 23: Impairment Charge**

During the closing process for the three months ended February 28, 2006, management decided to discontinue certain development plans utilizing a purchased technology license for which we did not have an alternative use. Management believed this decision indicated that the carrying value of the related asset may have been impaired and that an impairment analysis should be performed. In performing the analysis for recoverability, management estimated the future cash flows expected to result from this license. We recorded a \$4.2 million impairment charge based on this recoverability analysis. The impaired asset was fully written off and recorded in research and development as of February 28, 2006. There were no impairment charges recorded in 2007.

**Note 24: Quarterly Results of Operations (Unaudited)**

|                                  | Fiscal 2007                           |                   |                  |                   | Fiscal 2006      |                   |                  |                   |
|----------------------------------|---------------------------------------|-------------------|------------------|-------------------|------------------|-------------------|------------------|-------------------|
|                                  | First<br>Quarter                      | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter | First<br>Quarter | Second<br>Quarter | Third<br>Quarter | Fourth<br>Quarter |
|                                  | (In thousands, except per share data) |                   |                  |                   |                  |                   |                  |                   |
| Sales                            | \$ 300,144                            | \$ 332,976        | \$ 323,441       | \$ 310,920        | \$ 177,636       | \$ 184,332        | \$ 177,563       | \$ 255,276        |
| Gross profit                     | 136,429                               | 150,151           | 153,437          | 138,437           | 70,066           | 74,315            | 72,406           | 111,277           |
| Gross profit margin %            | 45.5%                                 | 45.1%             | 47.4%            | 44.5%             | 39.4%            | 40.3%             | 40.8%            | 43.6%             |
| Operating loss                   | (20,868)                              | (9,380)           | (8,935)          | (93,338)          | (46,685)         | (42,226)          | (47,272)         | (20,920)          |
| Net loss                         | (14,068)                              | (3,516)           | (4,779)          | (66,226)          | (42,041)         | (10,700)          | (32,760)         | (15,174)          |
| Basic and diluted loss per share | \$ (0.04)                             | \$ (0.01)         | \$ (0.01)        | \$ (0.17)         | \$ (0.11)        | \$ (0.03)         | \$ (0.08)        | \$ (0.04)         |

We acquired majority (51 percent) ownership of Huawei-3Com Co., Ltd. ( H3C ), a China-based joint venture, on January 27, 2006 and determined it was then appropriate to consolidate H3C's results. For convenience of close purposes we consolidated the results of H3C beginning February 1, 2006. H3C follows a calendar year basis of reporting and therefore results are consolidated on a two-month time lag. On November 27, 2006, the shareholders agreed that 3Com buy Shenzhen Huawei's 49 percent shares of the Company for \$882 million. The transaction was approved by the Chinese government. On March 29, 2007, 3Com Technologies completed its purchase at which time the purchase price was paid in full. Huawei-3Com Co., Limited is now known as H3C Technologies Co., Limited, or H3C.

**Table of Contents**

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

None

**ITEM 9A. CONTROLS AND PROCEDURES**

***Evaluation of Disclosure Controls and Procedures***

Our management carried out an evaluation, under the supervision and with the participation of our President and Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Form 10-K pursuant to Exchange Act Rule 13a-15(b). Based upon that evaluation, our President and Chief Executive Officer and our Chief Financial Officer concluded that, as of June 1, 2007, our disclosure controls and procedures were effective.

The term disclosure controls and procedures, as defined under the Exchange Act, means controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

***Changes in Internal Control over Financial Reporting***

There have been no changes in our internal control over financial reporting that occurred during the three months ended June 1, 2007 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

***MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING***

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as such term is defined in Exchange Act Rule 13a-15(f). Our management has assessed the effectiveness of our internal control over financial reporting as of June 1, 2007. Management's evaluation was based on criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework*. Internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

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

Because of its inherent limitations, internal control over financial reporting determined to be effective can provide only reasonable assurance with respect to financial statement preparation and may not prevent or detect all misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Based on the COSO criteria and our management's evaluation, our management has concluded that our internal control over financial reporting was effective as of June 1, 2007.

Our independent registered public accounting firm, Deloitte & Touche LLP, has audited the financial statements included in this Annual Report on Form 10-K and has issued an attestation report on management's assessment of our internal control over financial reporting as well as on the effectiveness of our internal control over financial reporting. This report appears in this Annual Report on Form 10-K.

**Table of Contents**

***Important Considerations***

The effectiveness of our disclosure controls and procedures and our internal control over financial reporting is subject to various inherent limitations, including cost limitations, judgments used in decision making, assumptions about the likelihood of future events, the soundness of our systems, the possibility of human error, and the risk of fraud. Moreover, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions and the risk that the degree of compliance with policies or procedures may deteriorate over time. Because of these limitations, there can be no assurance that any system of disclosure controls and procedures or internal control over financial reporting will be successful in preventing all errors or fraud or in making all material information known in a timely manner to the appropriate levels of management.



**Table of Contents**

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Shareholders of  
3Com Corporation

Marlborough, Massachusetts

We have audited management's assessment, included in the accompanying Management's Annual Report on Internal Control Over Financial Reporting, included in Item 9A of the Annual Report on Form 10-K, that 3Com Corporation and its subsidiaries (3Com or the Company) maintained effective internal control over financial reporting as of June 1, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinions.

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

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

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of June 1, 2007 is fairly stated, in all material respects, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of June 1, 2007, based on the criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements and financial statement schedule as of and for the year ended June 1, 2007 of the Company and our report dated July 31, 2007 expressed an unqualified opinion on those financial statements and financial statement schedule, and includes an explanatory paragraph regarding the Company's adoption of Statement of Financial Accounting Standards No. 123(Revised), *Share-Based Payment*.

/s/ DELOITTE & TOUCHE LLP

Boston, Massachusetts

July 31, 2007



**Table of Contents**

**ITEM 9B. OTHER INFORMATION**

None

**PART III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

**(a) Directors**

Incorporated herein by reference is the information appearing under the caption Nominees and Other Directors in our definitive Proxy Statement for our 2007 Annual Meeting of Stockholders (Proxy Statement).

**(b) Executive Officers**

Incorporated herein by reference is the information appearing under the caption Executive Officers of the Registrant in Part I of Item I of this Annual Report on Form 10-K.

**(c) Section 16(a) Beneficial Ownership Reporting Compliance**

Incorporated herein by reference is the information appearing under the caption Section 16(a) Beneficial Ownership Reporting Compliance in our Proxy Statement.

**(d) Code of Ethics**

We have adopted a Code of Ethics and Business Conduct that applies to all employees, including our principal executive officer, principal financial officer and principal accounting officer and persons performing similar functions. Our Code of Ethics and Business Conduct, which is available on our website at <http://www.3com.com>, complies with the rules of the SEC and the listing standards of the NASDAQ Stock Market. We intend to satisfy the disclosure requirement under Item 10 of Form 8-K, regarding an amendment to or waiver from our code of ethics, by posting the required information on our Internet website at <http://www.3com.com> and will send a paper copy to any shareholder who submits a request in writing to our Secretary.

**(e) Corporate Governance**

Incorporated herein by reference is the information appearing under the caption Corporate Governance in our Proxy Statement.

**ITEM 11. EXECUTIVE COMPENSATION**

The information required by Item 11 of this Annual Report on Form 10-K is incorporated by reference from the information contained in the sections captioned Executive Compensation, Employment, Severance and Change-of-Control Arrangements, Director Compensation, Compensation Discussion and Analysis, Compensation Committee Report and Corporate Governance/Compensation Committee Interlocks and Insider Participation in the Proxy Statement.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

The information required by Item 12 of this Annual Report on Form 10-K is incorporated by reference from the information appearing under the captions Equity Compensation Plan Information and Security Ownership of Certain Beneficial Owners and Management in the Proxy Statement.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

The information required by Item 13 of this Annual Report on Form 10-K is incorporated by reference from the information contained in the sections captioned Related Person Transactions and Corporate Governance in the Proxy Statement.

**Table of Contents****ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

The information required by Item 14 of this Annual Report on Form 10-K is incorporated by reference from the information contained in the section captioned "Ratification of Appointment of Independent Registered Public Accounting Firm" in the Proxy Statement.

**PART IV****ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

- (a) (1) Financial Statements See Index to Consolidated Financial Statements and Financial Statement Schedule at page 53 of this Form 10-K.
- (2) Financial Statement Schedule See Financial Statement Schedule at page 105 of this Form 10-K.
- (3) Exhibits See Exhibit Index at page 98 of this Form 10-K.
- (b) See Exhibit Index at page 98 of this Form 10-K.
- (c) See Index to Consolidated Financial Statements and Financial Statement Schedule at page 53 of this Form 10-K.

**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>   | <b>Incorporated by Reference</b> |                 |                |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|--|----------------------------------|-----------------|----------------|--------------------|---------------------------|
|                           |  | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 2.1                       | Master Separation and Distribution Agreement between the Registrant and Palm, Inc. effective as of December 13, 1999   | 10-Q                             | 002-92053       | 2.1            | 4/4/00             |                           |
| 2.2                       | Indemnification and Insurance Matters Agreement between the Registrant and Palm, Inc.  | 10-Q                             | 002-92053       | 2.11           | 4/4/00             |                           |
| 2.3                       | Agreement and Plan of Merger, dated December 13, 2004, by and among the Registrant, Topaz Acquisition Corporation and TippingPoint Technologies, Inc.  | 8-K                              | 000-12867       | 2.1            | 12/16/04           |                           |
| 2.4                       | Securities Purchase Agreement by and among 3Com Corporation, 3Com Technologies, Huawei Technologies Co., Ltd. and Shenzhen Huawei Investment & Holding Co., Ltd., dated as of October 28, 2005 | 8-K/A                            | 000-12867       | 2.1            | 3/30/06            |                           |
| 2.5                       | Stock Purchase Agreement by and between Shenzhen Huawei Investment & Holding Co., Ltd.   | 8-K                              | 000-12867       | 10.1           | 12/27/06           |                           |

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and 3Com Technologies, dated as  
of December 22, 2006

|     |   |       |           |     |          |
|-----|---|-------|-----------|-----|----------|
| 3.1 | Corrected Certificate of Merger<br>filed to correct an error in the<br>Certificate of Merger                        | 10-Q  | 002-92053 | 3.4 | 10/8/99  |
| 3.2 | Registrant's Bylaws, as amended on<br>March<br>23, 2005   | 8-K   | 000-12867 | 3.1 | 3/28/05  |
| 3.3 | Certificate of Designation of<br>Rights, Preferences and Privileges<br>of Series A Participating Preferred<br>Stock | 10-Q  | 000-12867 | 3.6 | 10/11/01 |
| 4.1 | Third Amended and Restated<br>Preferred Shares Rights<br>Agreement, dated as of<br>November 4, 2002                 | 8-A/A | 000-12867 | 4.1 | 11/27/02 |

**Table of Contents**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>  | <b>Incorporated by Reference</b> |                 |                |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|---|----------------------------------|-----------------|----------------|--------------------|---------------------------|
|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 10.1                      | 3Com Corporation 1983 Stock Option Plan, as amended and restated effective September 30, 2001*                  | 10-Q                             | 000-12867       | 10.1           | 1/11/02            |                           |
| 10.2                      | 3Com Corporation 1984 Employee Stock Purchase Plan, as amended and restated as of July 15, 2003*                | 10-K                             | 000-12867       | 10.3           | 8/1/03             |                           |
| 10.3                      | 3Com Corporation Director Stock Option Plan, as amended*  | 10-Q                             | 000-12867       | 10.4           | 10/10/03           |                           |
| 10.4                      | 3Com Corporation Restricted Stock Plan, as amended July 1, 2001*  | 10-K                             | 000-12867       | 10.6           | 8/2/02             |                           |
| 10.5                      | 3Com Corporation 1994 Stock Option Plan, as amended and restated effective April 30, 2002*                      | 10-K                             | 000-12867       | 10.7           | 8/2/02             |                           |
| 10.6                      | 3Com Corporation 2003 Stock Plan, as amended*   | 8-K                              | 000-12867       | 10.1           | 10/3/05            |                           |
| 10.7                      | Stand Alone Stock Option Agreement dated January 25, 2006 by and between R. Scott Murray and 3Com Corporation * | 10-Q                             | 000-12867       | 10.8           | 4/10/06            |                           |
| 10.8                      | Stand Alone Stock Option Agreement dated September 5, 2006 by and between Edgar Masri and 3Com Corporation *    | 10-Q                             | 000-12867       | 10.2           | 10/10/06           |                           |
| 10.9                      | Stand Alone Stock Option Agreement dated July 3, 2007 by and between Jay Zager and 3Com Corporation *           | S-8                              | 333-144322      | 10.2           | 7/3/07             |                           |
| 10.10                     | Stand Alone Restricted Stock Agreement dated July 3, 2007 by and between Jay Zager and 3Com Corporation *       | S-8                              | 333-144322      | 10.3           | 7/3/07             |                           |

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|       |   |       |           |       |          |
|-------|---|-------|-----------|-------|----------|
| 10.11 | Form of Stock Option Agreement for 2003 Stock Plan (Non-Employee Directors)   | 10-K  | 000-12867 | 10.7  | 8/5/05   |
| 10.12 | Form of Stock Option Agreement for 2003 Stock Plan (Employees)*   | 10-K  | 000-12867 | 10.8  | 8/5/05   |
| 10.13 | Form of Performance Accelerated Vesting Restricted Stock Agreement*   | 10-K  | 000-12867 | 10.9  | 8/5/05   |
| 10.14 | Form of Performance Vesting Restricted Stock Agreement*   | 10-Q  | 000-12867 | 10.6  | 4/10/06  |
| 10.15 | Form of Restricted Stock Grant Agreement Standard 4-Year Vesting*   | 10-K  | 000-12867 | 10.10 | 8/5/05   |
| 10.16 | Form of Restricted Stock Agreement (Time-Based Vesting)*  | 8-K   | 000-12867 | 10.2  | 11/17/05 |
| 10.17 | Form of Restricted Stock Unit Grant Award Agreement*  | 10-Q  | 000-12867 | 10.3  | 10/10/06 |
| 10.18 | R. Scott Murray Employment Agreement, amended and restated as of February 2, 2006, between the registrant and R. Scott Murray * | 8-K/A | 000-12867 | 10.1  | 2/6/06   |
| 10.19 | Performance Vesting Restricted Stock Agreement dated January 25, 2006 by and between R. Scott Murray and 3Com Corporation *     | 10-Q  | 000-12867 | 10.7  | 4/10/06  |
| 10.20 | Edgar Masri Employment Agreement, dated as of August 8, 2007, between the registrant and Edgar Masri *                          | 8-K   | 000-12867 | 10.1  | 8/9/06   |
| 10.21 | Employment Agreement, effective as of March 29, 2007, between H3C and Shusheng Zheng*   |       |           |       | X        |
| 10.22 | Offer Letter dated May 9, 2007 between the Registrant and Jay Zager*  | 8-K   | 000-12867 | 10.1  | 5/10/07  |





**Table of Contents**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>  | <b>Incorporated by Reference</b> |                 |                      |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|---|----------------------------------|-----------------|----------------------|--------------------|---------------------------|
|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b>       | <b>Filing Date</b> |                           |
| 10.23                     | Offer Letter dated June 19, 2004 between the Registrant and Donald M, Halsted III*                        | 10-K                             | 000-12867       | 10.16                | 8/11/06            |                           |
| 10.24                     | Offer Letter dated September 12, 2003 between the Registrant and Neal D. Goldman*                         | 10-K                             | 000-12867       | 10.17                | 8/11/06            |                           |
| 10.25                     | Offer Letter dated November 2, 2005 between the Registrant and Marc Willebeek-LeMair*                     | 10-K                             | 000-12867       | 10.18                | 8/11/06            |                           |
| 10.26                     | Offer Letter dated April 11, 2006 between the Registrant and Robert Dechant*                              | 8-K                              | 000-12867       | 10.1                 | 4/17/06            |                           |
| 10.27                     | Offer Letter dated November 2, 2005 between the Registrant and James Hamilton*                            |                                  |                 |                      |                    | X                         |
| 10.28                     | Severance Benefits Agreement dated February 28, 2007, between the Registrant and James Hamilton*          |                                  |                 |                      |                    | X                         |
| 10.29                     | Robert Y. L. Mao Employment Agreement, dated as of August 7, 2006, between the registrant and Robert Mao* |                                  |                 |                      |                    | X                         |
| 10.30                     | Summary of Executive Officer Fiscal 2008 Compensation   | 8-K                              | 000-12867       | Text of Item 5.02(e) | 7/27/07            |                           |
| 10.31                     | Summary of Equity Appreciation Rights Plan (H3C Technologies)*  |                                  |                 |                      |                    | X                         |
| 10.32                     | 3Com Corporation Section 16 Officer Severance Plan, amended and restated effective September 11, 2006 *   | 10-Q                             | 000-12867       | 10.3                 | 1/09/07            |                           |
| 10.33                     | Above Grade Severance Plan effective September 11, 2006 *   |                                  |                 |                      |                    | X                         |
| 10.34                     |   | 8-K                              | 000-12867       | 10.3                 | 4/4/06             |                           |

Form of Severance Benefits  
Agreement between the Registrant  
and each of the officers or former  
officers named in our proxy  
statement (other than  
Messrs. Masri and Mao)\*

|       |   |       |            |       |         |   |
|-------|---|-------|------------|-------|---------|---|
| 10.35 | Form of Management Retention Agreement between the Registrant and each of the following officers or former officers named in our proxy statement:<br>Messrs. Goldman, Halsted, Hamilton and Willebeek-LeMair* | 10-K  | 000-12867  | 10.15 | 8/5/05  |   |
| 10.36 | Form of Management Retention Agreement between the Registrant and the following officers or former officers named in our proxy statements:<br>Messrs. Dechant, Zheng and Zager and future executive officers* |       |            |       |         | X |
| 10.37 | 3Com Corporation Deferred Compensation Plan*  | 10-K  | 000-12867  | 10.23 | 8/9/04  |   |
| 10.38 | Form of Indemnity Agreement between the Registrant and its officers and directors   | S-3/A | 333-102591 | 10.1  | 4/9/03  |   |
| 10.39 | 3Com Corporation Consultant Services Agreement made as of August 8, 2006 by and between 3Com Corporation and Anik Bose*   | 8-K   | 000-12867  | 10.1  | 8/11/06 |   |
| 10.40 | Office Lease, dated as of November 26, 2002, by and between Marlborough Campus Limited Partnership and the Registrant   | 10-K  | 000-12867  | 10.20 | 8/9/04  |   |
| 10.41 | First Amendment to Lease, dated as of November 26, 2002, by and between Marlborough Campus Limited Partnership and the Registrant   | 10-K  | 000-12867  | 10.17 | 8/5/05  |   |

**Table of Contents**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>  | <b>Incorporated by Reference</b> |                 |                |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|---|----------------------------------|-----------------|----------------|--------------------|---------------------------|
|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 10.42                     | Second Amendment to Lease, dated as of July 18, 2005, by and between 3Com Corporation and Marlborough Campus Limited Partnership  | 10-Q                             | 000-12867       | 10.2           | 4/5/05             |                           |
| 10.43                     | Third Amendment to Lease, dated as of July 18, 2005, by and between 3Com Corporation and Marlborough Campus Limited Partnership   | 8-K                              | 000-12867       | 10.1           | 7/22/05            |                           |
| 10.44                     | Fourth Amendment to Lease dated as of December 12, 2005 by and between Marlborough Campus Limited Partnership and 3Com Corporation  | 10-Q                             | 000-12867       | 10.1           | 1/09/07            |                           |
| 10.45                     | Fifth Amendment to Lease dated as of October 27, 2006 by and between Bel Marlborough I LLC and 3Com Corporation   | 10-Q                             | 000-12867       | 10.2           | 1/09/07            |                           |
| 10.46                     | Agreement for the Lease of Hangzhou Real Property between Huawei Technologies Co. Ltd. and Hangzhou Huawei-3Com Technology Co., Ltd. dated January 1, 2004  | 10-Q                             | 000-12867       | 10.7           | 10/10/06           |                           |
| 10.47                     | Purchase and Sale Agreement made as of July 24, 2006 by and between 3Com Corporation and SSC II, L.P.   | 8-K                              | 000-12867       | 10.1           | 7/26/06            |                           |
| 10.48                     | Shareholders Agreement by and among Shenzhen Huawei Investment & Holding Co. Ltd., 3Com Technologies and Huawei-3Com Co., Ltd. (the Shareholders Agreement ) dated as of November 15, 2003 (Certain Portions Omitted; Confidential Treatment Requested) | 10-K                             | 000-12867       | 10.33          | 8/11/06            |                           |

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|       |   |      |           |       |         |
|-------|---|------|-----------|-------|---------|
| 10.49 | Amendment No. 1 to the Shareholders Agreement dated as of July 31, 2004 (Certain Portions Omitted; Confidential Treatment Requested)  | 10-K | 000-12867 | 10.34 | 8/11/06 |
| 10.50 | Amendment No. 2 to the Shareholders Agreement dated as of January 27, 2006 (Certain Portions Omitted; Confidential Treatment Requested)   | 10-K | 000-12867 | 10.35 | 8/11/06 |
| 10.51 | Credit and Guaranty Agreement dated as of March 22, 2007 among H3C Holdings Limited, as Borrower, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, as Holdco Guarantors, various Lenders, Goldman Sachs Credit Partners L.P., as Mandated Lead Arranger, Bookrunner, Administrative Agent and Syndication Agent, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent  | 8-K  | 000-12867 | 10.1  | 3/23/07 |
| 10.52 | Amended and Restated Credit and Guaranty Agreement dated as of May 25, 2007 and effective as of May 31, 2007 among H3C Holdings Limited, as Borrower, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, as Holdco Guarantors, H3C Technologies Co., Limited, as Guarantor, various Lenders, Goldman Sachs Credit Partners L.P., as Mandated Lead Arranger, Bookrunner, Administrative Agent and Syndication Agent, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent | 8-K  | 000-12867 | 10.1  | 5/25/07 |

**Table of Contents**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>  | <b>Incorporated by Reference</b> |                 |                |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|---|----------------------------------|-----------------|----------------|--------------------|---------------------------|
|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 10.53                     | Borrower Share Charge dated March 22, 2007 among 3Com Technologies, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent                 |                                  |                 |                |                    | X                         |
| 10.54                     | Borrower Fixed and Floating Charge dated March 22, 2007 among H3C Holdings Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent |                                  |                 |                |                    | X                         |
| 10.55                     | Borrower Charge Over Bank Accounts dated March 22, 2007 among H3C Holdings Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent |                                  |                 |                |                    | X                         |
| 10.56                     | H3C Fixed and Floating Charge dated April 3, 2007 among Huawei-3Com Co., Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent   |                                  |                 |                |                    | X                         |
| 10.57                     | H3C Share Mortgage dated March 30, 2007 among H3C Holdings Limited, as Mortgagor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent               |                                  |                 |                |                    | X                         |
| 10.58                     | H3C Equitable Share Charge dated March 29, 2007 among 3Com Technologies, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent            |                                  |                 |                |                    | X                         |
| 10.59                     | Deed of Charge in relation to the 100% equity interests in WFOE dated April 3, 2007 among   |                                  |                 |                |                    | X                         |

Huawei-3Com Co., Limited, as  
Chargor, and Industrial and  
Commercial Bank of China (Asia)  
Limited, as Collateral Agent

|       |  |      |           |      |         |   |
|-------|--|------|-----------|------|---------|---|
| 10.60 | Deed of Charge in relation to the 100% equity interests in Queenhive dated April 3, 2007 among Huawei-3Com Co., Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent |      |           |      |         | X |
| 10.61 | Deed of Release made March 30, 2007 by Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent, in favour of 3Com Technologies   |      |           |      |         | X |
| 10.62 | Commitment Letter, dated as of December 20, 2006, by and between 3Com Technologies and Goldman Sachs Credit Partners L.P.  | 10-Q | 000-12867 | 10.1 | 4/09/07 |   |

**Table of Contents**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>  | <b>Incorporated by Reference</b> |                 |                |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|---|----------------------------------|-----------------|----------------|--------------------|---------------------------|
|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 21.1                      | Subsidiaries of Registrant  |                                  |                 |                |                    | X                         |
| 23.1                      | Consent of Independent Registered<br>Public Accounting Firm Deloitte &<br>Touche LLP  |                                  |                 |                |                    | X                         |
| 31.1                      | Certification of Principal Executive<br>Officer   |                                  |                 |                |                    | X                         |
| 31.2                      | Certification of Principal Financial<br>Officer   |                                  |                 |                |                    | X                         |
| 32.1                      | Certification of Chief Executive<br>Officer and Chief Financial Officer<br>pursuant to 18 U.S.C. Section 1350,<br>as adopted pursuant to Section 906 of<br>the Sarbanes-Oxley Act of 2002 |                                  |                 |                |                    | X                         |
| *                         | Indicates a<br>management<br>contract or<br>compensatory<br>plan or<br>arrangement  |                                  |                 |                |                    |                           |

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on the 31st day of July, 2007.

3COM CORPORATION  
(Registrant)

By: /s/ Edgar Masri  
Edgar Masri  
*President and Chief Executive  
Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated on the 31st day of July, 2007.

**Signature**

**Title**

/s/ Edgar Masri

President, Chief Executive Officer  
and Director  
(Principal Executive Officer)

**(Edgar Masri)**

/s/ Jay Zager

Executive Vice President, Finance  
and Chief Financial Officer  
(Principal Financial and Accounting Officer)

**(Jay Zager)**

/s/ Eric A. Benhamou

Chairman of the Board

**(Eric A. Benhamou)**

/s/ Gary T. DiCamillo

Director

**(Gary T. DiCamillo)**

/s/ James R. Long

Director

**(James R. Long)**

/s/ Robert Mao

Director

**(Robert Mao)**

/s/ Raj Reddy

Director

**(Raj Reddy)**

/s/ Dominique Trempont

Director



**(Dominique Trempont)**

/s/ Paul G. Yovovich

Director

**(Paul G. Yovovich)**

104

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**Table of Contents**

## SCHEDULE II

3Com Corporation

## VALUATION AND QUALIFYING ACCOUNTS AND RESERVES

For the Years Ended May 31, 2005, 2006, and 2007

(In thousands)

| <b>Description</b>              | <b>Balance at<br/>Beginning<br/>of<br/>Period</b> | <b>Additions<br/>Charged to<br/>Costs and<br/>Expenses</b> | <b>Other</b> | <b>Deductions</b> | <b>Balance at<br/>End of<br/>Period</b> |
|---------------------------------|---|--|--------------|-------------------|---|
| <i>Year ended May 31, 2005:</i> |   |  |              |                   |   |
| Allowance for doubtful accounts | \$16,276  | \$ (2,251)   | \$ 793(2)    | \$ (272)(1)       | \$15,090                                |
| Allowance for product returns   | 5,917   | 20,578   |              | 21,443            | 5,052                                   |
| Accrued product warranty        | 43,825  | 30,867   |              | 32,910            | 41,782                                  |
| <i>Year ended May 31, 2006:</i> |   |  |              |                   |   |
| Allowance for doubtful accounts | \$15,090  | \$ 1,000   | \$ 165(3)    | \$ (167)(1)       | \$16,422                                |
| Allowance for product returns   | 5,052   | 15,288   | 6,768(3)     | 18,416            | 8,692                                   |
| Accrued product warranty        | 41,782  | 28,424   | 4,543(3)     | 32,958            | 41,791                                  |
| <i>Year ended May 31, 2007:</i> |   |  |              |                   |   |
| Allowance for doubtful accounts | 16,422  | \$ (586)   | \$           | \$ 544(1)         | \$15,292                                |
| Allowance for product returns   | 8,692   | 13,963   |              | 16,614            | 6,041                                   |
| Accrued product warranty        | 41,791  | 46,406   |              | 47,601            | 40,596                                  |

(1) Accounts  
written off net  
of recoveries

(2) Represents  
reserves related  
to the  
TippingPoint  
acquisition

(3) Represents  
reserves related  
to the H3C  
acquisition

**Table of Contents****EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Exhibit Description</b>   | <b>Incorporated by Reference</b> |                 |                |                    | <b>Filed<br/>Herewith</b> |
|---------------------------|--|----------------------------------|-----------------|----------------|--------------------|---------------------------|
|                           |  | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 2.1                       | Master Separation and Distribution Agreement between the Registrant and Palm, Inc. effective as of December 13, 1999   | 10-Q                             | 002-92053       | 2.1            | 4/4/00             |                           |
| 2.2                       | Indemnification and Insurance Matters Agreement between the Registrant and Palm, Inc.  | 10-Q                             | 002-92053       | 2.11           | 4/4/00             |                           |
| 2.3                       | Agreement and Plan of Merger, dated December 13, 2004, by and among the Registrant, Topaz Acquisition Corporation and TippingPoint Technologies, Inc.  | 8-K                              | 000-12867       | 2.1            | 12/16/04           |                           |
| 2.4                       | Securities Purchase Agreement by and among 3Com Corporation, 3Com Technologies, Huawei Technologies Co., Ltd. and Shenzhen Huawei Investment & Holding Co., Ltd., dated as of October 28, 2005 | 8-K/A                            | 000-12867       | 2.1            | 3/30/06            |                           |
| 2.5                       | Stock Purchase Agreement by and between Shenzhen Huawei Investment & Holding Co., Ltd. and 3Com Technologies, dated as of December 22, 2006  | 8-K                              | 000-12867       | 10.1           | 12/27/06           |                           |
| 3.1                       | Corrected Certificate of Merger filed to correct an error in the Certificate of Merger   | 10-Q                             | 002-92053       | 3.4            | 10/8/99            |                           |
| 3.2                       | Registrant's Bylaws, as amended on March 23, 2005  | 8-K                              | 000-12867       | 3.1            | 3/28/05            |                           |
| 3.3                       | Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock   | 10-Q                             | 000-12867       | 3.6            | 10/11/01           |                           |
| 4.1                       | Third Amended and Restated Preferred Shares Rights   | 8-A/A                            | 000-12867       | 4.1            | 11/27/02           |                           |

Agreement, dated as of  
November 4, 2002

|      |   |      |            |      |          |
|------|---|------|------------|------|----------|
| 10.1 | 3Com Corporation 1983 Stock Option Plan, as amended and restated effective September 30, 2001*                  | 10-Q | 000-12867  | 10.1 | 1/11/02  |
| 10.2 | 3Com Corporation 1984 Employee Stock Purchase Plan, as amended and restated as of July 15, 2003*                | 10-K | 000-12867  | 10.3 | 8/1/03   |
| 10.3 | 3Com Corporation Director Stock Option Plan, as amended*  | 10-Q | 000-12867  | 10.4 | 10/10/03 |
| 10.4 | 3Com Corporation Restricted Stock Plan, as amended July 1, 2001*  | 10-K | 000-12867  | 10.6 | 8/2/02   |
| 10.5 | 3Com Corporation 1994 Stock Option Plan, as amended and restated effective April 30, 2002*                      | 10-K | 000-12867  | 10.7 | 8/2/02   |
| 10.6 | 3Com Corporation 2003 Stock Plan, as amended*   | 8-K  | 000-12867  | 10.1 | 10/3/05  |
| 10.7 | Stand Alone Stock Option Agreement dated January 25, 2006 by and between R. Scott Murray and 3Com Corporation * | 10-Q | 000-12867  | 10.8 | 4/10/06  |
| 10.8 | Stand Alone Stock Option Agreement dated September 5, 2006 by and between Edgar Masri and 3Com Corporation *    | 10-Q | 000-12867  | 10.2 | 10/10/06 |
| 10.9 | Stand Alone Stock Option Agreement dated July 3, 2007 by and between Jay Zager and 3Com Corporation *           | S-8  | 333-144322 | 10.2 | 7/3/07   |

**Table of Contents**

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|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 10.10                     | Stand Alone Restricted Stock Agreement dated July 3, 2007 by and between Jay Zager and 3Com Corporation *                       | S-8                              | 333-144322      | 10.3           | 7/3/07             |                           |
| 10.11                     | Form of Stock Option Agreement for 2003 Stock Plan (Non-Employee Directors)   | 10-K                             | 000-12867       | 10.7           | 8/5/05             |                           |
| 10.12                     | Form of Stock Option Agreement for 2003 Stock Plan (Employees)*   | 10-K                             | 000-12867       | 10.8           | 8/5/05             |                           |
| 10.13                     | Form of Performance Accelerated Vesting Restricted Stock Agreement*   | 10-K                             | 000-12867       | 10.9           | 8/5/05             |                           |
| 10.14                     | Form of Performance Vesting Restricted Stock Agreement*   | 10-Q                             | 000-12867       | 10.6           | 4/10/06            |                           |
| 10.15                     | Form of Restricted Stock Grant Agreement Standard 4-Year Vesting*   | 10-K                             | 000-12867       | 10.10          | 8/5/05             |                           |
| 10.16                     | Form of Restricted Stock Agreement (Time-Based Vesting)*  | 8-K                              | 000-12867       | 10.2           | 11/17/05           |                           |
| 10.17                     | Form of Restricted Stock Unit Grant Award Agreement*  | 10-Q                             | 000-12867       | 10.3           | 10/10/06           |                           |
| 10.18                     | R. Scott Murray Employment Agreement, amended and restated as of February 2, 2006, between the registrant and R. Scott Murray * | 8-K/A                            | 000-12867       | 10.1           | 2/6/06             |                           |
| 10.19                     | Performance Vesting Restricted Stock Agreement dated January 25, 2006 by and between R. Scott Murray and 3Com Corporation *     | 10-Q                             | 000-12867       | 10.7           | 4/10/06            |                           |
| 10.20                     | Edgar Masri Employment Agreement, dated as of August 8, 2007, between the registrant and  | 8-K                              | 000-12867       | 10.1           | 8/9/06             |                           |

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Edgar Masri \*

|       |   |      |           |                      |         |   |
|-------|---|------|-----------|----------------------|---------|---|
| 10.21 | Employment Agreement, effective as of March 29, 2007, between H3C and Shusheng Zheng*                     |      |           |                      |         | X |
| 10.22 | Offer Letter dated May 9, 2007 between the Registrant and Jay Zager*                                      | 8-K  | 000-12867 | 10.1                 | 5/10/07 |   |
| 10.23 | Offer Letter dated June 19, 2004 between the Registrant and Donald M, Halsted III*                        | 10-K | 000-12867 | 10.16                | 8/11/06 |   |
| 10.24 | Offer Letter dated September 12, 2003 between the Registrant and Neal D. Goldman*                         | 10-K | 000-12867 | 10.17                | 8/11/06 |   |
| 10.25 | Offer Letter dated November 2, 2005 between the Registrant and Marc Willebeek-LeMair*                     | 10-K | 000-12867 | 10.18                | 8/11/06 |   |
| 10.26 | Offer Letter dated April 11, 2006 between the Registrant and Robert Dechant*                              | 8-K  | 000-12867 | 10.1                 | 4/17/06 |   |
| 10.27 | Offer Letter dated November 2, 2005 between the Registrant and James Hamilton*                            |      |           |                      |         | X |
| 10.28 | Severance Benefits Agreement dated February 28, 2007, between the Registrant and James Hamilton*          |      |           |                      |         | X |
| 10.29 | Robert Y. L. Mao Employment Agreement, dated as of August 7, 2006, between the registrant and Robert Mao* |      |           |                      |         | X |
| 10.30 | Summary of Executive Officer Fiscal 2008 Compensation   | 8-K  | 000-12867 | Text of Item 5.02(e) | 7/27/07 |   |
| 10.31 | Summary of Equity Appreciation Rights Plan (H3C Technologies)*  |      |           |                      |         | X |

**Table of Contents**

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|                           |   | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 10.32                     | 3Com Corporation Section 16 Officer Severance Plan, amended and restated effective September 11, 2006 *   | 10-Q                             | 000-12867       | 10.3           | 1/09/07            |                           |
| 10.33                     | Above Grade Severance Plan effective September 11, 2006 *   |                                  |                 |                |                    | X                         |
| 10.34                     | Form of Severance Benefits Agreement between the Registrant and each of the officers or former officers named in our proxy statement (other than Messrs. Masri and Mao)*                                      | 8-K                              | 000-12867       | 10.3           | 4/4/06             |                           |
| 10.35                     | Form of Management Retention Agreement between the Registrant and each of the following officers or former officers named in our proxy statement:<br>Messrs. Goldman, Halsted, Hamilton and Willebeek-LeMair* | 10-K                             | 000-12867       | 10.15          | 8/5/05             |                           |
| 10.36                     | Form of Management Retention Agreement between the Registrant and the following officers or former officers named in our proxy statements:<br>Messrs. Dechant, Zheng and Zager and future executive officers* |                                  |                 |                |                    | X                         |
| 10.37                     | 3Com Corporation Deferred Compensation Plan*  | 10-K                             | 000-12867       | 10.23          | 8/9/04             |                           |
| 10.38                     | Form of Indemnity Agreement between the Registrant and its officers and directors   | S-3/A                            | 333-102591      | 10.1           | 4/9/03             |                           |
| 10.39                     | 3Com Corporation Consultant Services Agreement made as of August 8, 2006 by and between 3Com Corporation and Anik Bose*   | 8-K                              | 000-12867       | 10.1           | 8/11/06            |                           |
| 10.40                     |   | 10-K                             | 000-12867       | 10.20          | 8/9/04             |                           |

Office Lease, dated as of  
November 26, 2002, by and  
between Marlborough Campus  
Limited Partnership and the  
Registrant

|       |  |      |           |       |          |
|-------|--|------|-----------|-------|----------|
| 10.41 | First Amendment to Lease, dated as of November 26, 2002, by and between Marlborough Campus Limited Partnership and the Registrant                          | 10-K | 000-12867 | 10.17 | 8/5/05   |
| 10.42 | Second Amendment to Lease, dated as of July 18, 2005, by and between 3Com Corporation and Marlborough Campus Limited Partnership                           | 10-Q | 000-12867 | 10.2  | 4/5/05   |
| 10.43 | Third Amendment to Lease, dated as of July 18, 2005, by and between 3Com Corporation and Marlborough Campus Limited Partnership                            | 8-K  | 000-12867 | 10.1  | 7/22/05  |
| 10.44 | Fourth Amendment to Lease dated as of December 12, 2005 by and between Marlborough Campus Limited Partnership and 3Com Corporation                         | 10-Q | 000-12867 | 10.1  | 1/09/07  |
| 10.45 | Fifth Amendment to Lease dated as of October 27, 2006 by and between Bel Marlborough I LLC and 3Com Corporation  | 10-Q | 000-12867 | 10.2  | 1/09/07  |
| 10.46 | Agreement for the Lease of Hangzhou Real Property between Huawei Technologies Co. Ltd. and Hangzhou Huawei-3Com Technology Co., Ltd. dated January 1, 2004 | 10-Q | 000-12867 | 10.7  | 10/10/06 |
| 10.47 | Purchase and Sale Agreement made as of July 24, 2006 by and between 3Com Corporation and SSC II, L.P.  | 8-K  | 000-12867 | 10.1  | 7/26/06  |



**Table of Contents**

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| 10.48                     | Shareholders Agreement by and among Shenzhen Huawei Investment & Holding Co. Ltd., 3Com Technologies and Huawei-3Com Co., Ltd. (the Shareholders Agreement ) dated as of November 15, 2003 (Certain Portions Omitted; Confidential Treatment Requested)  | 10-K                             | 000-12867       | 10.33          | 8/11/06            |                           |
| 10.49                     | Amendment No. 1 to the Shareholders Agreement dated as of July 31, 2004 (Certain Portions Omitted; Confidential Treatment Requested)   | 10-K                             | 000-12867       | 10.34          | 8/11/06            |                           |
| 10.50                     | Amendment No. 2 to the Shareholders Agreement dated as of January 27, 2006 (Certain Portions Omitted; Confidential Treatment Requested)  | 10-K                             | 000-12867       | 10.35          | 8/11/06            |                           |
| 10.51                     | Credit and Guaranty Agreement dated as of March 22, 2007 among H3C Holdings Limited, as Borrower, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, as Holdco Guarantors, various Lenders, Goldman Sachs Credit Partners L.P., as Mandated Lead Arranger, Bookrunner, Administrative Agent and Syndication Agent, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent | 8-K                              | 000-12867       | 10.1           | 3/23/07            |                           |
| 10.52                     | Amended and Restated Credit and Guaranty Agreement dated as of May 25, 2007 and effective as of May 31, 2007 among H3C Holdings Limited, as Borrower, 3Com Corporation, 3Com Holdings Limited and 3Com Technologies, as Holdco   | 8-K                              | 000-12867       | 10.1           | 5/25/07            |                           |

Guarantors, H3C Technologies Co., Limited, as Guarantor, various Lenders, Goldman Sachs Credit Partners L.P., as Mandated Lead Arranger, Bookrunner, Administrative Agent and Syndication Agent, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent

|       |   |   |
|-------|---|---|
| 10.53 | Borrower Share Charge dated March 22, 2007 among 3Com Technologies, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent                 | X |
| 10.54 | Borrower Fixed and Floating Charge dated March 22, 2007 among H3C Holdings Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent | X |
| 10.55 | Borrower Charge Over Bank Accounts dated March 22, 2007 among H3C Holdings Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent | X |

**Table of Contents**

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|                           |  | <b>Form</b>                      | <b>File No.</b> | <b>Exhibit</b> | <b>Filing Date</b> |                           |
| 10.56                     | H3C Fixed and Floating Charge dated April 3, 2007 among Huawei-3Com Co., Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent  |                                  |                 |                |                    | X                         |
| 10.57                     | H3C Share Mortgage dated March 30, 2007 among H3C Holdings Limited, as Mortgagor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent  |                                  |                 |                |                    | X                         |
| 10.58                     | H3C Equitable Share Charge dated March 29, 2007 among 3Com Technologies, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent   |                                  |                 |                |                    | X                         |
| 10.59                     | Deed of Charge in relation to the 100% equity interests in WFOE dated April 3, 2007 among Huawei-3Com Co., Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent      |                                  |                 |                |                    | X                         |
| 10.60                     | Deed of Charge in relation to the 100% equity interests in Queenhive dated April 3, 2007 among Huawei-3Com Co., Limited, as Chargor, and Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent |                                  |                 |                |                    | X                         |
| 10.61                     | Deed of Release made March 30, 2007 by Industrial and Commercial Bank of China (Asia) Limited, as Collateral Agent, in favour of 3Com Technologies   |                                  |                 |                |                    | X                         |
| 10.62                     | Commitment Letter, dated as of December 20, 2006, by and   | 10-Q                             | 000-12867       | 10.1           | 4/09/07            |                           |

between 3Com Technologies and  
Goldman Sachs Credit Partners  
L.P.

|      |   |   |
|------|---|---|
| 21.1 | Subsidiaries of Registrant  | X |
| 23.1 | Consent of Independent Registered<br>Public Accounting Firm Deloitte &<br>Touche LLP  | X |
| 31.1 | Certification of Principal Executive<br>Officer   | X |
| 31.2 | Certification of Principal Financial<br>Officer   | X |
| 32.1 | Certification of Chief Executive<br>Officer and Chief Financial Officer<br>pursuant to 18 U.S.C. Section 1350,<br>as adopted pursuant to Section 906<br>of the Sarbanes-Oxley Act of 2002 | X |

\* Indicates a  
management  
contract or  
compensatory  
plan or  
arrangement