

DIGITAL RIVER INC /DE
Form 10-K
February 29, 2008

Table of Contents

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

Form 10-K

(Mark One)

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2007.
- OR**
- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.**

Commission File Number: 000-24643

DIGITAL RIVER, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

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

41-1901640

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

**9625 WEST 76TH STREET
EDEN PRAIRIE, MINNESOTA 55344**

(Address of principal executive offices)

(952) 253-1234

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
Name of each Exchange on which registered:
Common Stock \$0.01 par value Nasdaq Global Select Market

Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by checkmark if the registrant is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes No

Indicated by checkmark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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 filing requirements for the past 90 days. Yes No

Edgar Filing: DIGITAL RIVER INC /DE - Form 10-K

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

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 Smaller reporting company
(Do not check if a smaller reporting company)

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

As of June 30, 2007, there were 41,489,018 shares of Digital River, Inc. common stock, issued and outstanding. As of such date, based on the closing sales price as quoted by The NASDAQ Stock Market, 40,191,937 shares of common stock, having an aggregate market value of approximately \$1,818,685,000 were held by non-affiliates. For purposes of the above statement only, all directors and executive officers of the registrant are assumed to be affiliates.

The number of shares of common stock outstanding at February 1, 2008 was 40,580,644 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Certain sections of the Registrant's definitive Proxy Statement for the 2008 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K to the extent stated herein.

TABLE OF CONTENTS

PART I

<u>Item 1.</u>	Business	3
<u>Item 1A.</u>	<u>Risk Factors</u>	13
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	27
<u>Item 2.</u>	<u>Properties</u>	27
<u>Item 3.</u>	<u>Legal Proceedings</u>	27
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	28

PART II

<u>Item 5.</u>	Market for Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities	29
<u>Item 6.</u>	<u>Selected Financial Data</u>	31
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	32
<u>Item 7A.</u>	<u>Qualitative and Quantitative Disclosures about Market Risk</u>	41
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	43
<u>Item 9.</u>	<u>Changes In and Disagreements With Accountants on Accounting and Financial Disclosure</u>	43
<u>Item 9A.</u>	<u>Controls and Procedures</u>	43
<u>Item 9B.</u>	<u>Other Information</u>	45

PART III

<u>Item 10.</u>	Directors, Executive Officers and Corporate Governance	46
<u>Item 11.</u>	<u>Executive Compensation</u>	46
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	46
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u>	46
<u>Item 14.</u>	<u>Principal Accountant Fees and Services</u>	46

PART IV

<u>Item 15.</u>	Exhibits and Financial Statement Schedules	47
	<u>2007 Equity Incentive Plan</u>	
	<u>Computation of Ratio of Earnings to Fixed Charges</u>	
	<u>Subsidiaries</u>	
	<u>Consent of Independent Registered Public Accounting Firm</u>	
	<u>Certification of CEO Pursuant to Section 302</u>	
	<u>Certification of CFO Pursuant to Section 302</u>	
	<u>Certification of CEO and CFO Pursuant to Section 906</u>	

Table of Contents**CAUTIONARY STATEMENT PURSUANT TO THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995**

This Annual Report on Form 10-K contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. All statements, other than statements of historical fact, regarding our strategy, future operations, financial position, estimated revenue, projected costs, projected savings, prospects, plans, opportunities and objectives constitute forward-looking statements. The words may, will, expect, plan, anticipate, believe, estimate, potential, similar types of expressions identify forward-looking statements, although not all such statements contain these identifying words. These forward-looking statements are based upon information that is currently available to us and/or management's current expectations, speak only as of the date hereof, and are subject to risks and uncertainties. We expressly disclaim any obligation, except as required by law, or undertaking to update or revise any forward-looking statements contained or incorporated by reference herein to reflect any change or expectations with regard thereto or to reflect any change in events, conditions, or circumstances on which any such forward-looking statement is based, in whole or in part. Our actual results may differ materially from the results discussed in or implied by such forward-looking statements. We are subject to a number of risks, some of which may be similar to those of other companies of similar size in our industry, including pre-tax losses, rapid technological changes, competition, limited number of suppliers, customer concentration, failure to successfully integrate acquisitions, adverse government regulations, failure to manage international activities, and loss of key individuals. Risks that may affect our operating results include, but are not limited to, those discussed in Part I Item 1A, titled Risk Factors. Readers should carefully review the risk factors described in this document and in other documents that we file from time to time with the Securities and Exchange Commission.

PART I**ITEM 1. BUSINESS.****Overview**

We provide end-to-end global e-commerce solutions to a wide variety of companies in software, consumer electronics, computer and video games, and other markets. We were incorporated in 1994 and began building and operating online stores for our clients in 1996. We offer our clients a broad range of services that enable them to quickly and cost effectively establish an online sales channel capability and to subsequently manage and grow online sales on a global basis. Our offerings help our clients mitigate risk and grow their online revenues. Our services include design, development and hosting of online stores, store merchandising and optimization, order management, denied parties screening, export controls and management, tax compliance and management, digital product delivery via download, physical product fulfillment, subscription management, multi-lingual customer service, online marketing including e-mail marketing, management of paid search programs, website optimization, web analytics and reporting.

Our products and services allow our clients to focus on promoting and marketing their brands while leveraging our investments in technology and infrastructure to facilitate the purchase of products from their online stores. When shoppers visit the store on one of our clients' websites, they are transferred to our e-commerce platform. Once on our system, shoppers can browse for products and make purchases online. After a purchase is made, we either deliver the product digitally via download over the Internet or transmit instructions to a third party for physical fulfillment of the order. We also process the buyer's payment, including collection and remittance of applicable taxes, and can provide customer service in multiple languages to handle order-related questions. We believe we are an example of an emerging trend known as Software as a Service (SaaS). We have invested substantial resources to develop our e-commerce software platform and we provide access and use of it to our clients as a service as opposed to selling the

software to be operated on their own in-house computer hardware.

In addition to the services we provide that facilitate the completion of an online transaction, we also offer services designed to increase traffic to our clients' online stores and improve the sales productivity of those

Table of Contents

stores. Our services include paid search advertising, search engine optimization, affiliate marketing, store optimization, and e-mail optimization. All of our services are designed to help our clients acquire customers more effectively, sell to those customers more often and more efficiently, and increase the lifetime value of each customer.

Our clients include many of the largest software, consumer electronics, and computer and video game companies and major retailers of these products, including Allume Systems, Inc., Autodesk, Inc., CompUSA, Inc., Computer Associates, Canon Inc., Electronic Arts, Inc., Hewlett Packard Company, Lexmark, Inc., Microsoft Corporation, Nuance Communications Inc, Symantec Corporation, and Trend Micro, Inc.

General information about us can be found at www.digitalriver.com under the Company/Investor Relations link. Our annual report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, as well as any amendments or exhibits to those reports, are available free of charge through our website as soon as reasonably practicable after we file them with the Securities and Exchange Commission.

Industry Background

Growth of the Internet and E-Commerce. E-Commerce sales continue to grow at a rapid rate. The U.S. Commerce Department reported that e-commerce sales in the fourth quarter of 2007 rose 18.0% compared to the fourth quarter of 2006, continuing a series of strong quarterly growth reports. We believe there are a number of factors that are contributing to the continued growth of e-commerce: (i) adoption of the Internet continues to increase globally; (ii) broadband technology is increasingly being used to deliver Internet service enabling the delivery of richer content as well as larger files to consumers; (iii) Internet users are becoming increasingly comfortable with the process of buying products online; (iv) the functionality of online stores continues to improve, offering a broader assortment of payment options with more promotion alternatives; (v) businesses are placing more emphasis on their online channel, reaching a larger audience at comparatively lower costs than the methods used to drive traffic to traditional bricks-and-mortar retail stores; and (vi) concerns about conflicts between online and traditional sales channels continue to subside.

Growing Interest in Direct Sales of Products to Consumers. Increasingly, companies are selling their products directly to consumers via online sales channels. This is due to increased competition for shelf space in the traditional retail channels as well as recognition that direct sales channels can co-exist with traditional sales channels.

Opportunities for Outsourced E-Commerce. We believe the market for outsourced e-commerce will continue to grow as there are advantages to outsourced e-commerce that will continue to make it an attractive alternative to building and maintaining this capability in-house. These advantages include: (i) eliminating the substantial up-front and ongoing costs of computer hardware, network infrastructure, specialized application software and training and support costs; (ii) reducing the time it takes to get online stores live and productive; (iii) shifting the ongoing technology, financial, regulatory and compliance risks to a proven service provider; (iv) leveraging the direct marketing expertise of an e-commerce service provider to accelerate growth of an online business; and (v) allowing businesses to focus on their specific core competencies.

Once an online store is established, it is immediately accessible to Internet users around the world. Web pages must be presented and customer service inquiries handled in multiple languages, and a variety of currencies and payment options must be accepted. The appropriate taxes must be collected and paid, payment fraud risk mitigated, fulfillment provided, and assurances made that products are not shipped to banned locations. These and other requirements of a global e-commerce system make it an expensive and potentially risky undertaking for any business. These factors also make a comprehensive outsourced offering, such as that provided by Digital River, an attractive alternative.

Shift from Physical to Electronic Delivery of Software. Consumers have grown increasingly comfortable with the electronic delivery of digital products, such as software, computer and video games, music, and video. This shift from physical to electronic delivery is being driven by benefits to both buyers and sellers of these products. For buyers, downloaded products are immediately available for use and a wider variety of products are available than can be found in most retail stores. For sellers, electronic delivery eliminates

Table of Contents

inventory-stocking requirements, shipping, handling, storage and inventory-carrying costs as well as the risk of product obsolescence.

The Digital River Solution

Our solution combines a robust e-commerce technology platform and a suite of services to help businesses worldwide grow their online revenues and avoid the costs and risks of running a global e-commerce operation in-house. We offer a comprehensive e-commerce solution that operates seamlessly as part of a client's website. We provide services that facilitate e-commerce transactions and drive traffic to our clients' online stores. Our services include design, development and hosting of online stores, store merchandising, order management, fraud prevention, popular online payment methods, export controls, tax compliance and management, digital product delivery via download, physical product fulfillment, multi-lingual customer service, subscription management, online marketing services including e-mail marketing, management of paid search programs, web analytics and reporting. We also provide our clients with increased product visibility and sales opportunities through our large network of online channel partners, including retailers and affiliates. We generate a substantial majority of our revenue on a revenue-share basis, meaning that we are paid a percentage of the selling price of each product sold at a client's online store that is being managed by Digital River. We believe this revenue share model aligns our interests with those of our clients.

Benefits to Clients

Reduced Total Cost of Ownership and Risk

Utilizing the Digital River solution, businesses can dramatically reduce or eliminate upfront and ongoing hardware, software, maintenance and support costs associated with developing, customizing, deploying, maintaining and upgrading an in-house global e-commerce solution. They can have a global e-commerce presence without assuming the costs and risks of internal development and leverage the investments we make in our e-commerce system. In addition, we help mitigate the risks of global e-commerce, including risks associated with payment fraud, tax compliance, and regulatory compliance. Our ongoing investments in the latest technologies and e-commerce functionality help ensure our clients maintain pace with industry advances.

Revenue Growth

We can assist our clients in growing their online businesses by (i) facilitating the acquisition of new customers, improving the retention of existing customers, and increasing the lifetime value of each customer; (ii) extending their businesses into international markets; and (iii) expanding the visibility and sales of their products through new online sales channels. We have developed substantial expertise in online marketing and merchandising which we apply to help our clients increase traffic to their online stores, and improve order close ratios, average order sizes and repeat purchases, all of which result in higher revenues for our clients and Digital River.

We provide the technology and services required to establish, grow and support international sales, both for U.S.-based clients seeking to reach customers overseas, and non-U.S.-based clients looking to access the U.S. and other markets. Our technology platform enables transactions to be completed in numerous currencies using a variety of payment methods. In addition, we provide localized online content and offer customer service in a variety of languages, extending our clients' reach beyond their home markets.

Through our large online marketplace, which we call Digital River oneNetwork™ (described in more detail in the section titled *Strategy*), we provide our clients access to new online sales channels which can help grow their online businesses. Clients can offer any part of their product catalogs to our network of online channel partners, including online retailers and affiliates. This increases the exposure these products receive and can result in higher sales

volumes. Our channel partners benefit because we eliminate the need for each of them to manage hundreds of relationships with product developers while increasing the depth and breadth of products they can sell, all without requiring the management of physical product inventory.

Table of Contents

Deployment Speed

Businesses can reduce the time required to develop an e-commerce presence by utilizing our outsourced business model. Typically, a new client can have an online store live in a matter of weeks compared with months or longer if they decide to build, test and deploy the e-commerce capability in-house. Once they are operational on our platform, most clients can utilize our remote control toolset to make real-time changes to their online store, allowing them to address issues and take advantage of opportunities without technical assistance from Digital River.

Focus on Core Competency

By utilizing our outsourced e-commerce services, clients can focus on developing, marketing and selling their products rather than devoting time and resources to building and maintaining an e-commerce infrastructure. This allows client management time to focus on what they know best while ensuring they have access to the latest technologies, tools and expertise for running a successful e-commerce operation.

Benefits to Buyers

Our solution emphasizes convenience as it enables products to be purchased online at anytime from anywhere in the world via a connection to the Internet. In the case of software, PC games and other digital products, buyers can immediately download their purchase and, depending on file size, begin using it in a matter of minutes. Search technology allows shoppers to browse our entire catalog to find the products they are looking for quickly and easily. Our extended download service, which guarantees replacement of products accidentally destroyed through computer error or malfunction, and our 24/7 customer service provided on behalf of our clients, offer shoppers additional assurance that their e-commerce experience will be a positive one. Our CD2Go service gives buyers the ability to obtain, for a fee, a copy on CD of the product they have purchased and downloaded, providing additional assurances to buyers.

Strategy

Our objective is to be the global leader in outsourced e-commerce services for software and digital products developers, high-tech product manufacturers, computer and video games, and related online retailers. Our strategy for achieving this objective includes the following key components:

Attract New Clients and Expand Relationships with Existing Clients. We have focused our efforts on securing new clients and expanding our relationships with existing clients primarily in the software, digital products, high-tech products, consumer electronics, and computer and video game markets. Our clients include software publishers, other digital content providers, high-tech product manufacturers, and online channel partners such as retailers. In 2007, we entered into more than 100 new contracts with new and existing clients.

We believe we can attract new clients and gain additional business with existing clients by expanding the range of services we offer. This includes services to enhance the e-commerce transaction as well as additional online marketing services. We believe that by expanding the size and breadth of the catalog of products we offer, we will attract additional online retailers and affiliates seeking to offer their customers a wide range of quality products. As of February 1, 2008, we were providing e-commerce services for thousands of software and digital products publishers, high-tech products manufacturers, online retailers and affiliates.

We believe we have amassed the largest catalog of digital software titles available anywhere online, which we offer to online retailers and affiliates. We generate revenue when web traffic is directed to a site for which we provide e-commerce services and a purchase transaction occurs. We will continue to expand the content available in our

catalog, which we believe will make that catalog increasingly attractive to online retailers, affiliates and other online channel partners. We believe the Digital River oneNetwork is a unique marketplace and provides opportunities to grow our revenues and strengthen our relationships with clients and partners.

Table of Contents

Expand International Sales. We believe there is a substantial opportunity to grow our business by enabling our clients to expand their sales through international online stores. Internet adoption and broadband deployment continue to increase rapidly, especially in the European and Asia Pacific regions. We have seen significant growth in sales for clients that have created international online stores. We intend to continue to enhance our technology platform, payment options and localized service offerings to increase sales in international markets.

Provide Clients with Strategic Marketing Services. We proactively develop and deliver new products and services, called strategic marketing services that are designed to help our clients improve customer acquisition and retention and maximize the lifetime value of customers. These services currently include paid search advertising, search engine optimization, affiliate marketing, store optimization, and e-mail marketing and optimization. In general, we manage these programs for our clients and have achieved significant increases in client revenue, return-on-investment or both, compared to what clients experienced when running these programs and supporting technologies in-house. We intend to continue to develop and/or acquire new value-added strategic marketing services and technologies to create additional sources of revenue for our clients and for Digital River.

Maintain Technology Leadership. We believe our technology platform and infrastructure afford us a competitive advantage in the market for outsourced e-commerce solutions. We intend to continue to invest in and enhance our platform to improve scalability, efficiency, reliability, security and performance as well as reduce costs. By leveraging our fixed cost structure, we can improve our ability to provide low-cost, high-value services while continuing to deploy the latest technologies. Additionally, we plan to continue investing in our infrastructure to enable our clients to further penetrate international markets, enhance their relationships with their customers, better manage the return-on-investment across all their online marketing activities, successfully adopt new selling models such as subscriptions, software-as-a-service, try-before-you-buy and volume licensing.

Continue to Seek Strategic Acquisitions. Historically, we have been an active acquirer of businesses, and we expect to continue actively pursuing acquisitions that further our business strategy. Some of the strategic factors we consider when evaluating an acquisition opportunity include: expanding our base of clients, improving the breadth and depth of our product offering, improving the catalog of content, extending our strategic marketing and other services offerings, expanding our geographic reach and diversifying our revenue stream into complementary or adjacent market segments.

Expand the Digital River oneNetwork Marketplace. We have developed a global marketplace we call Digital River oneNetwork which enables our clients to efficiently offer their products to a broad range of online retailers and affiliates. Affiliates are entities (individuals, organizations, companies, etc.) that generate online traffic to specific websites. On those websites, there are links, advertisements and other offers to sell various products and services. If a visitor clicks one of the links or advertisements and subsequently makes a purchase, the affiliate receives a commission in the form of a fixed fee or a percentage of the selling price of the product(s) purchased. Affiliates are an increasingly important source of website traffic as they can target specific types of Internet users.

Services

We provide a broad range of services to our clients, including design, development and hosting of online stores, merchandising, order management, fraud prevention screening, popular online payment methods, denied parties screening, tax compliance and management, digital and physical product fulfillment, multi-lingual customer service, subscription management, online marketing services including email marketing and paid search program management, and analytics and reporting. Most of these offerings can be managed through client-facing, remote control self-service tools that are easily used by business users without specialized training. Since clients utilize our centralized system and processes, we can consistently offer best practices across our entire client base.

Store Design, Development and Hosting. We offer our clients website design services utilizing our experience and expertise to create efficient and effective online stores. Our e-commerce solutions can be

Table of Contents

deployed quickly and implemented in a variety of ways from fully-functioning shopping carts through completely merchandised online stores. The online stores we operate for our clients match their branding and website design to provide a seamless experience for shoppers. When a shopper navigates from a client's website (operated by them) to their store (operated by us), the transition is seamless and the customer is unaware they are then being served by our technology platform. We manage the order process through payment processing, fraud screening, and fulfillment (either digital or physical) and notify the buyer via e-mail once the transaction is completed. Transaction information is captured and stored in our database systems, an increasingly valuable source of information used to create highly targeted merchandising programs, e-mail marketing campaigns, product offers and test marketing programs.

For many of our clients, the solution we provide is critical to their businesses and therefore we operate global data centers that perform and scale for continuous e-commerce operation in a high-demand environment. We operate multiple data centers globally, which feature fully redundant high-speed connections to the Internet, server capacity to handle unpredictable spikes in traffic and transactions, 24/7 security and monitoring, back-up electric generators and dedicated power supplies.

Store Merchandising. Our technology platforms support a wide range of merchandising activities. This enables our clients to effectively execute promotions, up-sell, and cross-sell activities and to feature specific products and services during any phase of the shopping process. From the home page of our clients' online stores through the checkout and thank you pages, our solution allows clients to deliver targeted offers designed to increase order close ratios and average order sizes.

Order Management and Fraud Screening. We manage all phases of a shopper's order on our clients' e-commerce stores. We process payment transactions for orders placed through our technology platform and support a wide variety of payment types, including credit cards, wire transfers, purchase orders, money orders, direct debit cards and many other payment methods popular both in the United States and around the world. As part of the payment process, we ensure that the correct taxes are displayed, collected, remitted and reported.

The fraud screening component of our platform uses both rules-based and heuristic scoring methods which use observations of known fraudulent activities to make a determination regarding the validity of the order, buyer and payment information. As the order is entered, hundreds of data reviews can be processed in real time. We also provide denied-parties screening and export controls, which are designed to ensure that persons and/or organizations appearing on government denied-parties lists are blocked from making purchases through our system. Once a transaction is approved and the digital product has been delivered via download or the physical product(s) has been shipped, we submit the transaction for payment.

Digital and Physical Fulfillment Services. We provide both digital and physical fulfillment services to our clients. We offer our clients a broad array of electronic delivery capabilities that enable delivery of digital products directly to customers' computers via the Internet. Delivery is completed when a copy of the purchased digital product is made from a master generally stored on our technology platform and then securely downloaded to the purchaser. Optionally, buyers can, for an additional fee, request that a CD be created and shipped as a backup for their order.

In addition to electronic fulfillment via download, we offer physical distribution services to our clients as well. We have contracted with third-party fulfillment agents that maintain inventories of physical products for shipment to buyers. These products are held by the fulfillment agent on consignment from our clients. We provide notification of product shipment to the buyer as well as shipment tracking, order status, and inventory information. We also provide a service called Physical on Demand (POD), which utilizes robotic systems to create a client-branded product CD and packaging materials after a POD order has been placed. This eliminates the requirement for inventory to be stored in a warehouse as physical product is created only when needed. We provide extended download services for digital products for an additional fee, which enables buyers to download the products they have purchased more than once in

the event of a computer failure or other unexpected problem. We believe physical fulfillment services are important to providing a complete e-commerce solution to our clients, particularly for non-digital products market where digital fulfillment is not possible.

Table of Contents

Customer Service. At our client's option and for an additional fee, we provide telephone and e-mail customer support for products sold through our platforms. We provide assistance to buyers regarding ordering and delivery questions on a 24/7 basis in multiple languages. We continue to invest in technology and infrastructure to provide fast and efficient responses to customer inquiries as well as provide online self-help options.

Advanced Reporting and Analytics. We capture and store detailed information about visitor traffic, for sales in the online stores we manage for our clients. This information is stored in our database systems where it is available for analysis and reporting. We provide clients access to a large collection of standard and customizable reports as well as our web analytics technology. This enables our clients to track and analyze sales, products, transactions, customer behavior and the results of marketing campaigns so they can optimize their marketing efforts to increase traffic, order close ratios and average order values.

Strategic Marketing Services. We offer a range of strategic marketing services designed to increase customer acquisition, improve customer retention and enhance the lifetime value of each customer. Through a combination of web analytics, analytics-based statistical testing, optimization and proven direct marketing practices, our team of strategic marketing experts develops, delivers and manages programs such as paid search advertising, search engine optimization, affiliate marketing, store optimization and e-mail optimization on behalf of our clients. We generally charge an incremental percentage of the selling price of merchandise for sales driven by our strategic marketing services activities. We believe our ability to capture and analyze integrated traffic and e-commerce sales data enhances the value of our strategic marketing services as we can precisely determine the effectiveness of specific marketing activities, website changes, and other actions taken by our clients.

Clients

We serve distinct groups of clients: (1) software, consumer electronics, and computer and video game product manufacturers; and (2) online channel partners including retailers and affiliates. We believe that the breadth of our catalog of products is a competitive advantage in selling e-commerce services to online channel partners as they can access a huge volume of products to sell without negotiating contract terms with every product provider. At the same time, we believe the breadth of our channel partner group is attractive to product developers and manufacturers as it gives them access to broad distribution through a single source.

Sales and Marketing

We sell products and services primarily to consumers through the Internet. We sell and market our services for clients through a direct sales force located in offices in the United States, Europe and Asia Pacific. These offices include staff dedicated to pre-sales, sales and sales support activities. Our client sales organization sells to executives within software companies, consumer electronics and high-tech product manufacturers, game manufacturers and online channel partners who are looking to create or expand their e-commerce businesses. During the sales process, our sales staff delivers demonstrations, presentations, collateral material, return-on-investment analyses, proposals and contracts.

We also design, implement and manage marketing and merchandising programs to help our clients drive traffic to their online stores and increase order close ratios, average order values and repeat purchases at those stores. Our strategic e-marketing team delivers a range of marketing and merchandising programs such as paid search advertising, search engine optimization, affiliate marketing, site and store optimization, e-mail marketing and optimization and site merchandising, which includes promotions, cross-sells and up-sells. This team combines their marketing domain expertise with our suite of technology, including reporting, analytics, optimization and e-mail to drive increased sales for our clients.

We market our products and services directly to clients and prospective clients. We focus our efforts on generating awareness of our brand and capabilities, establishing our position as a global leader in e-commerce outsourcing, generating leads in our target markets, and providing sales tools for our direct sales force. We conduct a variety of highly integrated marketing programs to achieve these objectives in an efficient and effective manner. We currently market our products and services to clients and prospects via direct marketing,

Table of Contents

print and electronic advertising, trade shows and events, public relations, media events and speaking engagements.

Technology

We deliver our outsourced e-commerce solutions on several platforms, each of which has been architected to solve our clients multi-faceted e-commerce needs. The following is a brief description of the technology standards utilized by the family of Digital River commerce platforms:

Architecture. Our platforms are highly scalable and designed to handle tens of thousands of individual e-commerce stores and millions of products available for sale within those stores. These platforms consist of Digital River developed proprietary software applications running on multiple pods of Sun Microsystems and Dell servers that serve dynamic web pages using Oracle, SQL server and MySQL databases, .net Microsoft IIS and Oracle 9iAS application servers. We use Akamai, Limelight and Mirror Image s worldwide caching technology to enable our platform engines to serve web pages with consistent load times around the world. Our platforms are designed to support growth by adding servers, CPUs, memory and bandwidth without substantial changes to the software applications. We believe this level of scalability is a competitive advantage. The application software is written in modular layers, enabling us to quickly respond to industry changes, payment processing changes, changes to international requirements for taxes and export screening, banking procedures, encryption technologies, and new and emerging web technologies, including AJAX, Web Services, DHTML, and web Caches.

The platforms include search capabilities that allow shoppers to search for items across millions of products and thousands of categories based on specific product characteristics or specifications while maintaining page response times acceptable to the user. We use database indexing combined with a dynamic cache system to provide flexibility and speed. The platforms have been designed to index, retrieve and manipulate all transaction data that flows through the system, including detailed commerce transactions and end-user interaction data. This enables us to create proprietary market profiles of each shopper and groups of shoppers that can then be used to create merchandising campaigns that are better targeted and more successful. We also use our platforms internally for fraud detection and prevention, management of physical shipping, return authorizations, backorder processing, transaction auditing and reporting.

E-Commerce System Maintenance. Our platforms have a centralized maintenance management system that we use to build and manage our clients e-commerce systems. Changes that affect all of our clients e-commerce sites or groups of e-commerce sites can be made centrally, dramatically reducing maintenance time and complexity. Most of our clients e-commerce sites include a central store and many have additional web pages where highly targeted traffic is routed. Clients also may choose to link specific locations on their e-commerce stores to detailed product or category information within their stores to more effectively address a shopper s specific areas of interest.

Security. We have security systems in place to control access to our internal systems and commerce data. Log-ins and passwords are required for all systems with additional levels of log-in, password and Internet Protocol security in place to control access on an individual basis. Access only is granted to commerce areas for which an individual is responsible. Multiple levels of firewalls prevent unauthorized access from the outside or access to confidential data from the inside. Our security system does not allow direct access to any client or customer data. We license certain encryption and authentication technology from third parties to provide secure transmission of confidential information such as credit card data. The security system is designed not to interfere with the end-user s experience on our clients e-commerce sites.

Data Center Operations. Continuous data center operations are crucial to our success. We currently maintain major data center operations in eight facilities: California and Minnesota, USA; and Germany, Ireland and Sweden. All major data center locations are currently processing transactions and serving downloads.

Table of Contents

All data centers currently utilize multiple levels of redundant systems, including load balancers managing traffic volumes across web and application server farms, database servers, and enterprise disk storage arrays. For the majority of these systems, we have automatic failover procedures in place such that when a fault is detected, a process automatically takes that portion of the system offline and processing continues on the remaining redundant portions of the system, or in an alternate datacenter. In the event of an electrical power failure, we have redundant power generators and uninterruptible power supplies that protect our facilities. Fire suppression systems are present in each data center.

Our network software constantly monitors our clients' e-commerce sites and internal system functions, and notifies systems engineers if any unexpected conditions arise. We lease multiple lines from diverse Internet service providers and maintain a policy of adding additional capacity if more than 40 percent of our capacity is consistently utilized. Accordingly, if one line fails, the other lines are able to assume the traffic load of the failed line. We also utilize content distribution networks operated by our vendors to serve appropriate types of traffic; currently, the majority of our image traffic and a substantial portion of our download traffic is served via the Akamai, Limelight and Mirror Image networks.

Product Research and Development

Our primary product research and development strategy is to continually enhance the technology and feature set of our commerce platforms and related technologies. To this end, we continually have numerous development projects in process, including ongoing enhancement of our commerce platforms, improvements in our remote control capabilities, enhanced international support, advanced product distribution capabilities, sophisticated reporting functionality and new marketing technologies. Product research and development expenses were \$39.2 million, \$32.3 million, and \$20.7 million, in 2007, 2006, and 2005 respectively.

We believe that the functionality and capabilities of our commerce platforms are a competitive advantage and that we must continue to invest in them to maintain our competitive position. The Internet and e-commerce, in particular, are subject to rapid technological change, changes in user and client requirements and expectations, new technologies and evolving industry standards. To remain successful, we must continually adapt to these and other changes. We rely on internally developed, acquired and licensed technologies to maintain the technological sufficiency of our e-commerce platforms.

Competition

The market for e-commerce solutions is highly competitive. We compete with e-commerce solutions that our customers develop internally or contract with third parties to develop on their behalf. We also compete with other outsourced e-commerce providers. The competition we encounter includes:

In-house development of e-commerce capabilities using tools or applications from companies such as Art Technology Group, Inc. and IBM Corporation;

E-Commerce capabilities custom-developed by companies such as IBM Global Services and Accenture, Inc.;

Other providers of outsourced e-commerce solutions, such as GSI Commerce, Inc. and asknet Inc.;

Providers of technologies, services or products that support a portion of the e-commerce process, such as payment processing, including CyberSource Corporation and PayPal Corp.;

Companies that offer various online marketing services, technologies and products, including ValueClick, Inc. and a Quantive, Inc.;

High-traffic branded websites that generate a substantial portion of their revenue from e-commerce and may offer or provide to others the means to offer products for sale, such as Amazon.com, Inc.; and

Web hosting, web services and infrastructure companies that offer portions of our solution and are seeking to expand the range of their offerings, such as Network Solutions, LLC, Akamai Technologies, Inc., Yahoo! Inc., eBay Inc. and Hostopia.com, Inc.

Table of Contents

We believe that the principal competitive factors in our market are the breadth of consumer products and services offered, the number of clients and online channel partnerships, brand recognition, system reliability and scalability, price, customer service, ease of use, speed to market, convenience, and quality of delivery. Some of the companies described above are clients or potential clients, but they may choose to compete with us by adopting a similar business model.

Intellectual Property

We believe the protection of our trademarks, copyrights, trade secrets and other intellectual property is critical to our success. We rely on patent, copyright and trademark enforcement, contractual restrictions, service mark and trade secret laws to protect our proprietary rights. We have entered into confidentiality and invention assignment agreements with our employees and contractors, and nondisclosure agreements with certain parties with whom we conduct business in order to limit access to and disclosure of our proprietary information. We also seek to protect our proprietary position by filing U.S. and foreign patent applications related to our proprietary technology, inventions and improvements that are important to our business. We currently have sixteen U.S patents issued with seven to sixteen years remaining prior to expiration. We also have over seventy U.S. and foreign patent applications pending. We pursue the registration of our trademarks and service marks in the U.S. and internationally. We have a number of registered trademarks in the U.S., European Union and other countries.

Employees

As of February 1, 2008, we employed 1265 associates. We also employ independent contractors and other temporary employees. None of our employees are represented by a labor union, and we consider our employee relations to be good. Competition for qualified personnel in our industry is intense. We believe that our future success will continue to depend, in part, on our continued ability to attract, hire and retain qualified personnel.

Executive Officers

The following table sets forth information regarding our executive officers at February 1, 2008:

Name	Age	Position
Joel A. Ronning	51	Chief Executive Officer
Thomas M. Donnelly	43	Chief Financial Officer
Kevin L. Crudden	52	VP/General Counsel

Mr. Ronning founded Digital River in February 1994 and has been our Chief Executive Officer and a director since that time. From February 2001 through February 2004, Mr. Ronning also was a member of the Office of the President. From February 1994 to July 1998, Mr. Ronning served as President of Digital River. From May 1995 to December 1999, Mr. Ronning served as Chairman of the Board of Directors of Tech Squared, Inc., a direct catalog marketer of software and hardware products. From May 1995 to July 1998, Mr. Ronning served as Chief Executive Officer, Chief Financial Officer and Secretary of Tech Squared. From May 1995 to August 1996, Mr. Ronning also served as President of Tech Squared. Mr. Ronning founded MacUSA, Inc., formerly a wholly-owned subsidiary of Tech Squared, and served as a director of MacUSA, Inc. from April 1990 to December 1999. From April 1990 to July 1998, Mr. Ronning also served as the Chief Executive Officer of MacUSA, Inc.

Mr. Donnelly joined Digital River in February 2005 as Vice President of Finance and Treasurer and was named Chief Financial Officer and Secretary in July 2005. From March 1997 to May 2004, he held various positions, including President, Chief Operating Officer and Chief Financial Officer with Net Perceptions, Inc., a developer of software systems used to improve the effectiveness of various customer interaction systems. From March 1995 to March 1997, Mr. Donnelly served as a financial and management consultant in the capacity of chief financial officer or corporate controller for various public and private companies and partnerships. Prior to 1995, Mr. Donnelly served as an investment analyst for Marshall Financial Group, a merchant banking company, Chief Financial Officer of Medical Documentation Systems, Inc., a medical software company, and Controller of Staats International, Inc., a defense subcontractor.

Table of Contents

Mr. Crudden joined Digital River in January 2006 as Vice President and General Counsel. For more than five years prior to joining Digital River, Mr. Crudden was a partner in the law firm of Robins, Kaplan, Miller & Ciresi L.L.P., Minneapolis, Minnesota, practicing in the areas of corporate finance, mergers and acquisitions, and corporate governance.

ITEM 1A. RISK FACTORS

The risks described below are not the only ones facing our company. Additional risks not presently known to us or that we currently deem immaterial also may impair our business operations. Our business, financial condition or results of operations could be materially adversely affected by any of these risks and the value of our common stock could decline due to any of these risks. This annual report also contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of certain factors, including the risks faced by us described below and elsewhere in this report.

A loss of any client that accounts for a large portion of our revenue would cause our revenue to decline.

Sales of products for one software publisher client, Symantec Corporation, accounted for approximately 26.2% of our revenue in 2007. In addition, revenues derived from proprietary Digital River services sold to Symantec end-users and sales of Symantec products through our oneNetwork retail and affiliate channel together accounted for approximately 13.2% of total Digital River revenue. In addition, a limited number of other software and physical goods clients contribute a large portion of our annual revenue. Contracts with our clients are generally one or two years in length. If any one of these key contracts is not renewed or otherwise terminates, or if revenues from these clients decline for any other reason (such as competitive developments), our revenue would decline and our ability to sustain profitability would be impaired. If our contract with Symantec is not renewed or otherwise terminated, or if revenues from Symantec and Symantec-related services decline for any other reason, our revenue and our ability to sustain profitability could be materially adversely impaired. It is important to our ongoing success that we maintain our key client relationships and, at the same time, develop new client relationships.

Our future success cannot be predicted based upon our limited operating history.

Compared to certain of our current and potential competitors, we have a relatively short operating history. In addition, the nature of our business and the e-commerce industry in which we operate has undergone rapid development and change. Accordingly, it is difficult to predict whether we will be successful. Thus, our chances of financial and operational success should be evaluated in light of the risks, uncertainties, expenses, delays and difficulties associated with operating a business with limited history in a relatively rapidly changing industry. If we are unable to address these issues, we may not be financially or operationally successful.

Failure to properly manage and sustain our expansion efforts could strain our management and other resources.

Through acquisitions and organic growth, we are rapidly and significantly expanding our operations, both domestically and internationally. We will continue to expand further to pursue growth of our service offerings and customer base. This expansion increases the complexity of our business and places a significant strain on our management, operations, technical performance, financial resources, and internal financial control and reporting functions, and there can be no assurance that we will be able to manage it effectively. Our personnel, systems, procedures and controls may not be adequate to effectively manage our future operations, especially as we employ personnel in multiple domestic and international locations. We may not be able to hire, train, retain and manage the personnel required to address our growth. Failure to effectively manage our growth opportunities could damage our reputation, limit our future growth, negatively affect our operating results and harm our business.

Table of Contents

We intend to continue to expand our international operations and these efforts may not be successful in generating additional revenue.

We sell products and services to end-users outside the United States and we intend to continue expanding our international presence. In 2007, our sales to international consumers represented approximately 43.2% of our total sales. Expansion into international markets, particularly the European and Asia-Pacific regions, requires significant resources that we may fail to recover by generating additional revenue. Conducting business outside of the United States is subject to risks, including:

Changes in regulatory requirements and tariffs;

Uncertainty of application of local commercial, tax, privacy and other laws and regulations;

Reduced protection of intellectual property rights;

Difficulties in physical distribution for international sales;

Higher incidences of credit card fraud and difficulties in accounts receivable collection;

The burden and cost of complying with a variety of foreign laws, rules and regulations;

The possibility of unionization of our workforce outside the United States, particularly in Europe;

Political, social and economic instability;

Import and export license requirements and restrictions of the United States and every other country in which we operate; and

Political or economic constraints on international trade or instability.

Any of the factors described above may have a material adverse effect on our ability to increase or maintain foreign sales. These risks have grown with the acquisitions of Digital River GmbH, which has substantial operations outside the U.S. and with our expansion into the Asia-Pacific region. More recently, we acquired NetGiro Systems which is based in Stockholm, Sweden.

We may be unable to successfully and cost-effectively market, sell and distribute our services in foreign markets. This may be more difficult or take longer than anticipated especially due to international challenges, such as language barriers, currency exchange issues and the fact that the Internet infrastructure in foreign countries may be less advanced than the U.S. Internet infrastructure. If we are unable to successfully expand our international operations, or manage this expansion, our operating results and financial condition could be harmed. In addition, a significant portion of our cash and marketable securities are held in non-U.S. domiciled countries.

Our operating results are subject to fluctuations in demand for products and services offered by us or our clients.

Our quarterly and annual operating results are subject to fluctuations in demand for the products or services offered by us or our clients, such as anti-virus software and anti-spyware software. In particular, sales of anti-virus software represented a significant portion of our revenues in recent years, and continue to be very important to our business. Demand for anti-virus software is subject to the unpredictable introduction of significant computer viruses. To the extent that software publishers successfully introduce products or services not sold through our platform that are

competitive with products and services sold by current Digital River clients (including anti-virus products and services), our revenues could be materially adversely affected.

New obligations to collect or pay transaction taxes could substantially increase the cost to us of doing business.

Currently, we collect sales, use, value added tax (VAT) or other similar transaction taxes with respect to electronic software download and physical delivery of products in tax jurisdictions where we believe we have taxable presences. The application of transaction taxes to interstate and international sales over the Internet is

Table of Contents

complex and evolving. We already are required to collect and remit VAT in the European Union, for example. Local, state or international jurisdictions may seek to impose transaction tax collection obligations on companies like ours that engage in e-commerce, and they may seek to impose taxes retroactively on past transactions that we believed were exempt from transaction tax liability. A successful assertion by one or more tax jurisdictions that we should collect or were obligated to collect transaction taxes on the products we sell could harm our results of operations.

We could be liable for fraudulent, improper or illegal uses of our platforms.

In recent years revenues from our remote control platforms have grown as a percentage of our overall business, and we plan to continue to emphasize our self service e-commerce solutions. These platforms typically have an automated structure that allows customers to use our e-commerce services without significant participation from Digital River personnel. Despite our efforts to detect and contractually prohibit the sale of inappropriate and illegal goods and services, the remote control nature of these platforms makes it more likely that transactions involving the sale of unlawful goods or services or the violation of the proprietary rights of others may occur before we become aware of them. Furthermore, unscrupulous individuals may offer illegal products for sale via such platforms under innocuous names, further frustrating attempts to prevent inappropriate use of our services. Failure to detect inappropriate or illegal uses of our platforms by third parties could expose us to a number of risks, including fines, increased fees or termination of services by payment processors or credit card associations, risks of lawsuits, and civil and criminal penalties.

Loss of our credit card acceptance privileges would seriously hamper our ability to process the sale of merchandise.

The payment by end-users for the purchase of digital goods that we process is typically made by credit card or similar payment method. As a result, we must rely on banks or payment processors to process transactions, and must pay a fee for this service. From time to time, credit card associations may increase the interchange fees that they charge for each transaction using one of their cards. Any such increased fees will increase our operating costs and reduce our profit margins. We also are required by our processors to comply with credit card association operating rules, and we have agreed to reimburse our processors for any fines they are assessed by credit card associations as a result of processing payments for us. The credit card associations and their member banks set and interpret the credit card rules. Visa, MasterCard, American Express, Discover, or other card associations could adopt new operating rules or re-interpret existing rules that we or our processors might find difficult to follow. We have had payment processing agreements with certain of our payment processors terminated due to violations of their rules, and although we have been able to successfully migrate to new processors, such migrations require significant attention from our personnel, and often result in higher fees and customer dissatisfaction. Any disputes or problems associated with our payment processors could impair our ability to give customers the option of using credit cards to fund their payments. If we were unable to accept credit cards, our business would be seriously damaged. We also could be subject to fines or increased fees from MasterCard and Visa if we fail to detect that merchants are engaging in activities that are illegal or activities that are considered high risk, primarily the sale of certain types of digital content. We may be required to expend significant capital and other resources to monitor these activities.

Our failure to attract and retain software and digital products publishers, manufacturers, online retailers and online channel partners as clients would cause our revenue and operating profits to decline.

We generate revenue by providing outsourced services to a wide variety of companies, primarily in the software and high-tech products markets. If we cannot develop and maintain satisfactory relationships with software and digital products publishers, manufacturers, online retailers and online channel partners on acceptable commercial terms, we will likely experience a decline in revenue and operating profit. We also depend on our software and digital publisher clients creating and supporting software and digital products that end-users will purchase. If we are unable to obtain sufficient quantities of software and digital products for any reason, or if the quality of service provided by these

software and digital products publishers falls below a satisfactory level, we could also experience a decline in revenue, operating profit and end-user satisfaction,

Table of Contents

and our reputation could be harmed. Our contracts with our software and digital products publisher clients are generally one to two years in duration, with an automatic renewal provision for additional one-year periods, unless we are provided with a written notice before the end of the contract. As is common in our industry, we have no material long-term or exclusive contracts or arrangements with any software or digital products publishers that guarantee the availability of software or digital products. Software and digital products publishers that currently supply software or digital products to us may not continue to do so and we may be unable to establish new relationships with software or digital product publishers to supplement or replace existing relationships.

The matters relating to the investigation by the Special Committee of the Board of Directors and the restatement of our consolidated financial statements may result in additional litigation and governmental enforcement actions.

In February 2007, we announced that an internal review had discovered irregularities related to the issuance of certain stock option grants primarily made between 1998 and 2002. As a result of the internal review, the Special Committee concluded, and the Audit Committee and Board of Directors agreed, that we used incorrect measurement dates for financial accounting purposes for certain stock option grants in prior periods. Therefore, we have recorded additional non-cash stock-based compensation expense and related tax effect with regard to certain past stock option grants, and we have restated previously filed financial statements in our Form 10-K for the year ended December 31, 2006. The full year adjustment to 2006 was recorded in the fourth quarter of 2006 due to its insignificance.

Activities related to our internal review of historical stock option practices have required us to incur substantial expenses for legal, accounting, tax and other professional services, have diverted management's attention from our business, and could, in the future, harm our business, financial condition, results of operations and cash flows.

While we believe we have made appropriate judgments in determining the correct measurement dates for our stock option grants, the SEC may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact. Accordingly, there is a risk we may have to further restate our prior financial statements, amend prior filings with the SEC, or take other actions not currently contemplated.

Our past stock option granting practices and the restatement of prior financial statements have exposed us to greater risks associated with litigation, regulatory proceedings and government enforcement actions. In December 2006, the SEC initiated an informal inquiry into our historical stock option practices. We have provided the results of our internal review together with supporting documentation to the SEC. We intend to continue to fully cooperate with the SEC's inquiry. No assurance can be given regarding the outcomes from litigation, regulatory proceedings or government enforcement actions relating to our past stock option practices. The resolution of these matters could be time consuming, expensive, and may distract management from the conduct of our business. Furthermore, if we are subject to adverse findings in litigation, regulatory proceedings or government enforcement actions, we could be required to pay damages or penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows.

We may incur additional expenses in order to assist our employees with potential income tax liabilities which may arise under Section 409A of the Internal Revenue Code.

As a result of our investigation into our historical stock option granting practices, we have determined that a number of our outstanding stock option awards were granted at exercise prices below the fair market value of our stock on the appropriate accounting measurement date. The primary adverse tax consequence is that the re-measured options vesting after December 31, 2005 are potentially subject to option holder excise tax under Section 409A of the Internal Revenue Code (and, as applicable, similar excise taxes under state law or foreign law). Our employees who have exercised or will exercise options which are determined to have been granted with exercise prices below the fair market value of the underlying shares of common stock on

Table of Contents

the appropriate measurement date and do not meet one of the exceptions under 409A may be subject to an increase in taxes imposed by 409A, penalties and interest.

Implementing our acquisition strategy could result in dilution and operating difficulties leading to a decline in revenue and operating profit.

A key element of our business strategy involves expansion through the acquisitions of businesses, assets, products or technologies that allow us to complement our existing product offerings, expand our market coverage, increase our engineering workforce or enhance our technological capabilities. Between January 1, 1999 and December 31, 2007, we acquired 27 companies. We continually evaluate and explore strategic opportunities as they arise, including business combination transactions, strategic partnerships, and the purchase or sale of assets, including tangible and intangible assets such as intellectual property. We have acquired, and intend to continue engaging in strategic acquisitions of businesses, technologies, services and products. Since December 2006, we have acquired three businesses, NetGiro Systems AB, DigitalSwift Corporation and CustomCD, Inc.

Acquisitions may require significant capital infusions, typically entail many risks, and could result in difficulties in assimilating and integrating the operations, personnel, technologies, products and information systems of acquired companies or businesses. We have in the past and may in the future experience delays in the timing and successful integration of an acquired company's technologies and product development, unanticipated costs and expenditures, changing relationships with customers, suppliers and strategic partners, or contractual, intellectual property or employment issues. In addition, key personnel of an acquired company may decide not to work for us. The acquisition of another company or its products and technologies may also require us to enter into a geographic or business market in which we have little or no prior experience.

The process of integrating an acquired business, technology, service or product into our business and operations may result in unforeseen operating difficulties and expenditures. Integration of an acquired business also may disrupt our ongoing business, distract management and make it difficult to maintain standards, controls and procedures. These challenges are magnified as the size of the acquisition increases. Furthermore, these challenges would be even greater if we acquired a business or entered into a business combination transaction with a company that was larger and more difficult to integrate than the companies we have historically acquired. Moreover, the anticipated benefits of any acquisition may not be realized. If a significant number of clients of the acquired businesses cease doing business with us, we would experience lost revenue and operating profit, and any synergies from the acquisition may be lost. Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of debt, contingent liabilities, amortization of intangible assets or impairment of goodwill.

We may need to raise additional capital to achieve our business objectives, which could result in dilution to existing investors or increase our debt obligations.

We require substantial working capital to fund our business. In January 2005, we filed a registration statement to increase our available shelf registration amount and we have \$82 million available for future use. In addition, we filed an acquisition shelf for up to approximately 1.5 million shares. In February 2006, we filed a shelf registration that would allow us to sell an undetermined amount of equity or debt securities in accordance with the recently approved rules applying to well-known seasoned issuers. If additional funds are raised through the issuance of equity securities, the percentage ownership of our stockholders will be reduced and these equity securities may have rights, preferences or privileges senior to those of our common stock. In June 2004, we issued 1.25% convertible notes which require us to make interest payments and will require us to pay principal when the notes become due in 2024 or in the event of acceleration under certain circumstances, unless the notes are converted into our common stock prior to that. For a thirty day period ending January 1, 2009, the note holders have the right to have the debt redeemed at 100.25% of principal face amount. In light of current market conditions for interest rates and our stock price relative to the

conversion price for the notes, it is likely that some of the note holders will seek repayment on January 1, 2009. We may not have sufficient capital to service this or any future debt securities that we may issue, further, the conversion of the notes into our common stock would result in further dilution to our stockholders.

Table of Contents

Our capital requirements depend on several factors, including the rate of market acceptance of our products, the ability to expand our client base, the growth of sales and marketing, and opportunities for acquisitions of other businesses. We have had significant operating losses and negative cash flow from operations since inception. Additional financing may not be available when needed, on terms favorable to us or at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop or enhance our services, take advantage of future opportunities or respond to competitive pressures, which would harm our operating results and adversely affect our ability to sustain profitability.

Our operating results have fluctuated in the past and are likely to continue to do so, which could cause the price of our common stock to be volatile.

Our quarterly and annual operating results have fluctuated significantly in the past and are likely to continue to do so in the future due to a variety of factors, some of which are outside our control. As a result, we believe that quarter-to-quarter and year-to-year comparisons of our revenue and operating results are not necessarily meaningful, and that these comparisons may not be accurate indicators of future performance. If our annual or quarterly operating results fail to meet the guidance we provide to securities analysts and investors or otherwise fail to meet their expectations, the trading price of our common stock may be impacted. Some of the factors that have contributed or may contribute to fluctuations in our quarterly and annual operating results include:

The addition of new clients or loss of current clients;

The introduction by us of new websites, web stores or services that may require a substantial investment of our resources;

The introduction by others of competitive websites, web stores or services or products;

Our ability to continue to upgrade and develop our systems and infrastructure to meet emerging market needs and remain competitive in our service offerings;

Economic conditions, particularly those affecting e-commerce;

Client decisions to delay new product launches or to invest in e-commerce initiatives;

The performance of our newly acquired assets or companies;

Slower than anticipated growth of the online market as a vehicle for the purchase of software products;

The cost of compliance with U.S. and foreign regulations relating to our business;

Our ability to retain and attract personnel commensurate with our business needs; and

Acquisitions.

In addition, revenue generated by our software and digital commerce services is likely to fluctuate on a seasonal basis that is typical for the software publishing market, consumer electronics, and computer and video games markets.

Our operating expenses are based on our expectations of future revenue. These expenses are relatively fixed in the short-term. If our revenue for a quarter falls below our expectations and we are unable to quickly reduce spending in response, our operating results for that quarter would be harmed. In addition, the operating results of companies in the

electronic commerce industry have, in the past, experienced significant quarter-to-quarter fluctuations that may adversely affect our stock price.

Security breaches could hinder our ability to securely transmit confidential information.

A significant barrier to e-commerce and communications is the secure transmission of confidential information over public networks. Any compromise or elimination of our security could be costly to remedy, damage our reputation and expose us to liability, and dissuade existing and new clients from using our services. We rely on encryption and authentication technology licensed from third parties to provide the

Table of Contents

security and authentication necessary for secure transmission of confidential information, such as end-user credit card numbers. A party who circumvents our security measures could misappropriate proprietary information or interrupt our operations.

We may be required to expend significant capital and other resources to protect against security breaches or address problems caused by breaches. Concerns over the security of the Internet and other online transactions and the privacy of users could deter people from using the Internet to conduct transactions that involve transmitting confidential information, thereby inhibiting the growth of our business. To the extent that our activities or those of third-party contractors involve the storage and transmission of proprietary information, such as credit card numbers, security breaches could damage our reputation and expose us to a risk of loss, fines or litigation and possible liability. Our security measures may not prevent security breaches, and failure to prevent security breaches could lead to a loss of existing clients and also deter potential clients away from our services.

Claims of infringement of other parties' intellectual property rights could require us to expend significant resources, enter into unfavorable licenses or require us to change our business plans.

From time to time, we are named as a defendant in lawsuits claiming that we have, in some way, violated the intellectual property rights of others. We have been notified of several potential patent disputes, and expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity. Any assertions or prosecutions of claims like these could require us to expend significant financial and managerial resources. The defense of any claims, with or without merit, could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product enhancement delays or require that we develop non-infringing technology or enter into royalty or licensing agreements. Royalty or licensing agreements, if required, may be unavailable on terms acceptable to us or at all. In the event of a successful claim of infringement against us and our failure or inability to develop non-infringing technology or license the infringed or similar technology on a timely basis, we may be unable to pursue our current business plan. We expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity, and our results of operations and financial condition could be materially adversely affected.

Claims against us related to the software products that we deliver electronically and the tangible goods that we deliver physically could require us to expend significant resources.

We may become more vulnerable to third party claims as laws such as the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are interpreted by the courts. Claims may be made against us for negligence, copyright or trademark infringement, products liability or other theories based on the nature and content of software products or tangible goods that we deliver electronically and physically. Because we did not create these products, we are generally not in a position to know the quality or nature of the content of these products. Although we carry general liability insurance and require that our customers indemnify us against end-user claims, our insurance and indemnification measures may not cover potential claims of this type, may not adequately cover all costs incurred in defense of potential claims, or may not reimburse us for all liability that may be imposed. Any costs or imposition of liability that are not covered by insurance or indemnification measures could be expensive and time-consuming to address, distract management and delay product deliveries, even if we are ultimately successful in the defense of these claims.

If our internal control over financial reporting or disclosure controls and procedures are not effective, there may be errors in our financial statements that could require a restatement or our filings may not be timely and investors may lose confidence in our reported financial information, which could lead to a decline in our stock price.

Section 404 of the Sarbanes-Oxley Act of 2002 requires us to evaluate the effectiveness of our internal control over financial reporting as of the end of each year, and to include a management report assessing the effectiveness of our internal control over financial reporting in each Annual Report on Form 10-K. Section 404

Table of Contents

also requires our independent registered public accounting firm to attest to, and report on, management's assessment of our internal control over financial reporting.

Our management, including our Chief Executive Officer and Chief Financial Officer, does not expect that our internal control over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. Over time, controls may become inadequate because changes in conditions or deterioration in the degree of compliance with policies or procedures may occur. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

As a result, we cannot assure you that significant deficiencies or material weaknesses in our internal control over financial reporting will not be identified in the future. Any failure to maintain or implement required new or improved controls, or any difficulties we encounter in their implementation, could result in significant deficiencies or material weaknesses, cause us to fail to timely meet our periodic reporting obligations, or result in material misstatements in our financial statements. Any such failure could also adversely affect the results of periodic management evaluations and annual auditor attestation reports regarding disclosure controls and the effectiveness of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and the rules proclaimed after that. The existence of a material weakness could result in errors in our financial statements that could result in a restatement of financial statements, cause us to fail to timely meet our reporting obligations and cause investors to lose confidence in our reported financial information, leading to a decline in our stock price.

Because the e-commerce industry is highly competitive and has low barriers to entry, we may be unable to compete effectively.

The market for e-commerce solutions is extremely competitive and we may find ourselves unable to compete effectively. Because there are relatively low barriers to entry in the e-commerce market, we expect continued intense competition as current competitors expand their product offerings and new competitors enter the market. In addition, our clients may become competitors in the future. Increased competition is likely to result in price reductions, reduced margins, longer sales cycles and a decrease or loss of our market share, any of which could negatively impact our revenue and earnings. We face competition from the following sources:

In-house development of e-commerce capabilities using tools or applications from companies, such as Art Technology Group, Inc. and IBM Corporation;

E-Commerce capabilities custom-developed by companies, such as IBM Global Services and Accenture, Inc.;

Other providers of outsourced e-commerce solutions, such as GSI Commerce, Inc., and asknet Inc.;

Companies that provide technologies, services or products that support a portion of the e-commerce process, such as payment processing, including CyberSource Corporation and PayPal Corp.;

Companies that offer various online marketing services, technologies and products, including ValueClick, Inc. and aQuantive, Inc.;

High-traffic, branded websites that generate a substantial portion of their revenue from e-commerce and may offer or provide to others the means to offer their products for sale, such as Amazon.com, Inc.; and

Web hosting, web services and infrastructure companies that offer portions of our solution and are seeking to expand the range of their offering, such as Network Solutions, LLC, Akamai Technologies, Inc., Yahoo!, Inc., eBay, Inc. and Hostopia.com, Inc.

Table of Contents

We believe that the principal competitive factors for a participant in our market are the breadth of products and services offered, proven global platforms, the number of clients and online channel partnerships a participant has, brand recognition, system reliability and scalability, price, customer service, ease of use, speed to market, convenience and quality of delivery. The online channel partners and the other companies described above may compete directly with us by adopting a similar business model. Moreover, while some of these companies also are clients or potential clients of ours, they may compete with our e-commerce outsourcing solution to the extent that they develop e-commerce systems or acquire such systems from other software vendors or service providers.

Many of our competitors have, and new potential competitors may have, more experience developing Internet-based software and e-commerce solutions, larger technical staffs, larger customer bases, more established distribution channels and customer relationships, greater brand recognition and greater financial, marketing and other resources than we have. In addition, competitors may be able to develop services that are superior to our services, achieve greater customer acceptance or have significantly improved functionality as compared to our existing and future products and services. Our competitors may be able to respond more quickly to technological developments and changes in customers' needs. Our inability to compete successfully against current and future competitors could cause our revenue and earnings to decline.

Changes in government regulation could limit our Internet activities or result in additional costs of doing business over the Internet.

We are subject to the same international, federal, state and local laws as other companies conducting business over the Internet. Today, there are relatively few laws specifically directed towards conducting business over the Internet. The adoption or modification of laws related to the Internet could harm our business, operating results and financial condition by increasing our costs and administrative burdens. Due to the increasing popularity and use of the Internet, many laws and regulations relating to the Internet are being debated at the international, federal and state levels. These laws and regulations could cover issues such as:

User privacy with respect to adults and minors;

Our ability to collect and/or share necessary information that allows us to conduct business on the Internet;

Export compliance;

Pricing, taxation, and regulatory fees;

Fraud;

Advertising;

Intellectual property rights;

Information security;

Quality of products and services;

Taxes; and

Recycling of consumer products.

Applicability to the Internet of existing laws governing issues, such as property ownership, copyrights and other intellectual property issues, taxation, libel, obscenity and personal privacy also could harm our operating results and substantially increase the cost to us of doing business. For example, numerous state legislatures have proposed that tax rules for Internet retailing and catalog sales correspond to enacted tax rules for sales from physical stores. Any requirement that we collect sales tax for each online purchase and remit the tax to the appropriate state authority would be a significant administrative burden to us, and would likely depress online sales. This and any other change in laws applicable to the Internet also might require significant management resources to respond appropriately. The vast majority of these laws was adopted prior to the advent of the Internet, and do not contemplate or address the unique issues raised thereby. Those laws that do

Table of Contents

reference the Internet, such as the Digital Millennium Copyright Act, are only beginning to be interpreted by the courts, and their applicability and reach are therefore uncertain.

Failure to develop our technology to accommodate increased traffic could reduce demand for our services and impair the growth of our business.

We periodically enhance and expand our technology and transaction-processing systems, network infrastructure and other technologies to accommodate increases in the volume of traffic on our technology platforms. Any inability to add software and hardware or to develop and upgrade existing technology, transaction-processing systems or network infrastructure to manage increased traffic on this platform may cause unanticipated systems disruptions, slower response times and degradation in client services, including impaired quality and speed of order fulfillment. Failure to manage increased traffic could harm our reputation and significantly reduce demand for our services, which would impair the growth of our business. We may be unable to improve and increase the capacity of our network infrastructure sufficiently or anticipate and react to expected increases in the use of the platform to handle increased volume. Further, additional network capacity may not be available from third-party suppliers when we need it. Our network and our suppliers' networks may be unable to maintain an acceptable data transmission capability, especially if demands on the platform increase.

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our e-commerce platforms and the underlying network infrastructure. If we incur significant costs without adequate results, or are unable to adapt rapidly to technological changes, we may fail to achieve our business plan. The Internet and the e-commerce industry are characterized by rapid technological changes, changes in user and client requirements and preferences, frequent new product and service introductions embodying new technologies and the emergence of new industry standards and practices that could render our technology and systems obsolete. To be successful, we must adapt to rapid technological changes by licensing and internally developing leading technologies to enhance our existing services, developing new products, services and technologies that address the increasingly sophisticated and varied needs of our clients, and responding to technological advances and emerging industry standards and practices on a cost-effective and timely basis. The development of our proprietary technologies involves significant technical and business risks. We may fail to use new technologies effectively or fail to adapt our proprietary technology and systems to client requirements or emerging industry standards.

System failures could reduce the attractiveness of our service offerings.

We provide commerce, marketing and delivery services to our clients and end-users through our proprietary technology transaction processing and client management systems. These systems also maintain an electronic inventory of products and gather consumer marketing information. The satisfactory performance, reliability and availability of the technology and the underlying network infrastructure are critical to our operations, level of client service, reputation and ability to attract and retain clients. We have experienced periodic interruptions, affecting all or a portion of our systems, which we believe will continue to occur from time-to-time. Any systems damage or interruption that impairs our ability to accept and fill client orders could result in an immediate loss of revenue to us, and could cause some clients to purchase services offered by our competitors. In addition, frequent systems failures could harm our reputation.

Although we maintain system redundancies in multiple physical locations, our systems and operations are vulnerable to damage or interruption from:

Fire, flood and other natural disasters;

Operator negligence, improper operation by, or supervision of, employees, physical and electronic break-ins, misappropriation, computer viruses and similar events; and

Power loss, computer systems failures, and Internet and telecommunications failure.

We may not carry sufficient business interruption insurance to fully compensate us for losses that may occur.

Table of Contents

We may become liable to clients who are dissatisfied with our services.

We design, develop, implement and manage e-commerce solutions that are crucial to the operation of our clients businesses. Defects in the solutions we develop could result in delayed or lost revenue, adverse end-user reaction, and/or negative publicity, which could require expensive corrections. As a result, clients who experience these adverse consequences either directly or indirectly by using our services could bring claims against us for substantial damages. Any claims asserted could exceed the level of any insurance coverage that may be available to us. The successful assertion of one or more large claims that are uninsured, that exceed insurance coverage or that result in changes to insurance policies, including future premium increases, could adversely affect our operating results or financial condition.

We depend on key personnel.

Our future success significantly depends on the continued services and performance of our senior management. Our performance also depends on our ability to retain and motivate our key technical employees who are skilled in maintaining our proprietary technology platforms. The loss of the services of any of our executive officers or key employees could harm our business if we are unable to effectively replace that officer or employee, or if that person should decide to join a competitor or otherwise directly or indirectly compete with us. Further, we may need to incur additional operating expenses and divert other management time in order to search for a replacement.

Our future success depends on our ability to continue to identify, attract, hire, train, retain and motivate highly skilled personnel. Competition for these personnel is intense, particularly in the Internet industry. We may be unable to successfully attract, assimilate or retain sufficiently qualified personnel. In making employment decisions, particularly in the Internet and high-technology industries, job candidates often consider the value of stock option grants they are to receive in connection with their employment.

Protecting our intellectual property is critical to our success.

We regard the protection of our trademarks, copyrights, trade secrets and other intellectual property as critical to our success. We rely on a combination of patent, copyright, trademark, service mark and trade secret laws and contractual restrictions to protect our proprietary rights. We have entered into confidentiality and invention assignment agreements with our employees and contractors, and nondisclosure agreements with parties with whom we conduct business, in order to limit access to and disclosure of our proprietary information. These contractual arrangements and the other steps taken by us to protect our intellectual property may not prevent misappropriation of our technology or deter independent third-party development of similar technologies. We also seek to protect our proprietary position by filing U.S. patent applications related to our proprietary technology, inventions and improvements that are important to the development of our business. Proprietary rights relating to our technologies will be protected from unauthorized use by third parties only to the extent they are covered by valid and enforceable patents or are effectively maintained as trade secrets. We pursue the registration of our trademarks and service marks in the U.S. and internationally. Effective trademark, service mark, copyright and trade secret protection may not be available in every country in which our services are made available online.

The steps we have taken to protect our proprietary rights may be inadequate and third parties may infringe or misappropriate our trade secrets, trademarks and similar proprietary rights. Any significant failure on our part to protect our intellectual property could make it easier for our competitors to offer similar services and thereby adversely affect our market opportunities. In addition, litigation may be necessary in the future to enforce our intellectual property rights, to protect our trade secrets or to determine the validity and scope of the proprietary rights of others. Litigation could result in substantial costs and diversion of management and technical resources.

Table of Contents

Our clients' sales cycles are lengthy, which may cause us to incur substantial expenses and expend management time without generating corresponding consumer revenue, which would impair our cash flow.

We market our services directly to software publishers, online retailers and other prospective customers outside of the software industry. These relationships are typically complex and take time to finalize. Due to operating procedures in many organizations, a significant amount of time may pass between selection of our products and services by key decision-makers and the signing of a contract. The period between the initial client sales call and the signing of a contract with significant sales potential is difficult to predict and typically ranges from six to twelve months. If at the end of a sales effort a prospective client does not purchase our products or services, we may have incurred substantial expenses and expended management time that cannot be recovered and that will not generate corresponding revenue. As a result, our cash flow and our ability to fund expenditures incurred during the sales cycle may be impaired. We can incur substantial front-end cost to launch client sites and it may require a substantial time before those costs are recouped by us.

The listing of our network addresses on anti-spam lists could harm our ability to service our clients and deliver goods over the Internet.

Certain privacy and anti-email proponents have engaged in a practice of gathering, and publicly listing, network addresses that they believe have been involved in sending unwanted, unsolicited emails commonly known as spam. In response to user complaints about spam, Internet service providers have, from time to time, blocked such network addresses from sending emails to their users. If our network addresses mistakenly end up on these spam lists, our ability to provide services for our clients and consummate the sales of digital and physical goods over the Internet could be harmed.

We are subject to regulations relating to consumer privacy.

We collect and maintain end-user data for our clients, which subjects us to increasing international, federal and state regulations related to online privacy and the use of personal user information. Congress has enacted anti-SPAM legislation with which we must comply when providing email campaigns for our clients. Legislation and regulations are pending in various domestic and international governmental bodies that address online privacy protections. Several governments have proposed, and some have enacted, legislation that would limit the use of personal user information or require online services to establish privacy policies. In addition, the U.S. Federal Trade Commission, or FTC, has urged Congress to adopt legislation regarding the collection and use of personal identifying information obtained from individuals when accessing websites. In the past, the emphasis has been on information obtained from minors. Focus has now shifted to include online privacy protection for minors and adults.

Even in the absence of laws requiring companies to establish these procedures, the FTC has settled several proceedings resulting in consent decrees in which Internet companies have been required to establish programs regarding the manner in which personal information is collected from users and provided to third parties. We could become a party to a similar enforcement proceeding. These regulatory and enforcement efforts could limit our collection of and/or ability to share with our clients demographic and personal information from end-users, which could adversely affect our ability to comprehensively serve our clients.

The European Union has adopted a privacy directive that regulates the collection and use of information that identifies an individual person. These regulations may inhibit or prohibit the collection and sharing of personal information in ways that could harm our clients or us. The globalization of Internet commerce may be harmed by these and similar regulations because the European Union privacy directive prohibits transmission of personal information outside the European Union. The United States and the European Union have negotiated an agreement providing a safe harbor for those companies who agree to comply with the principles set forth by the U.S. Department of Commerce and agreed

to by the European Union. Failure to comply with these principles may result in fines, private lawsuits and enforcement actions. These enforcement actions can include interruption or shutdown of operations relating to the collection and sharing of information pertaining to citizens of the European Union.

Table of Contents

Compliance with future laws imposed on e-commerce may substantially increase our costs of doing business or otherwise adversely affect our ability to offer our services.

Because our services are accessible worldwide, and we facilitate sales of products to end-users worldwide, international jurisdictions may claim that we are required to comply with their laws. Laws regulating Internet companies outside of the United States may be less favorable than those in the United States, giving greater rights to consumers, content owners and users. Compliance may be more costly or may require us to change our business practices or restrict our service offerings relative to those provided in the United States. Any failure to comply with foreign laws could subject us to penalties ranging from fines to bans on our ability to offer our services.

As our services are available over the Internet in multiple states and foreign countries, these jurisdictions may claim that we are required to qualify to do business as a foreign corporation in each state or foreign country. We and/or our subsidiaries are qualified to do business only in certain states. Failure to qualify as a foreign corporation in a required jurisdiction could subject us to taxes and penalties and could result in our inability to enforce contracts in these jurisdictions.

In addition, we are subject to United States laws governing the conduct of business with other countries, such as export control laws, which prohibit or restrict the export of goods, services and technology to designated countries, denied persons or denied entities from the United States. Violation of these laws could result in fines or other actions by regulatory agencies and result in increased costs of doing business and reduced profits. In addition, any significant changes in these laws, particularly an expansion in export control laws, will increase our costs of compliance and may further restrict our overseas client base.

We are exposed to foreign currency exchange risk.

Sales outside the United States accounted for approximately 43.2% of our total sales in 2007. The results of operations of, and certain of our intercompany balances associated with, our internationally focused websites are exposed to foreign exchange rate fluctuations. Upon translation, net sales and other operating results from our international operations may differ materially from expectations, and we may record significant gains or losses on the remeasurement of intercompany balances. If the U.S. dollar weakens against foreign currencies, the translation of these foreign-currency-denominated transactions will result in increased net revenues and operating expenses. Similarly, our net revenues and operating expenses will decrease if the U.S. dollar strengthens against foreign currencies. As we have expanded our international operations, our exposure to exchange rate fluctuations has become more pronounced. We may enter into short-term currency forward contracts to offset the foreign exchange gains and losses generated by the re-measurement of certain assets and liabilities recorded in non-functional currencies. The use of such hedging activities may not offset more than a portion of the adverse financial impact resulting from unfavorable movements in foreign exchange rates. See Item 7A of Part II, for information demonstrating the effect on our consolidated statements of income from changes in exchange rates versus the U.S. dollar.

Changes in our tax rates could affect our future results.

Our future effective tax rates could be favorably or unfavorably affected by changes in the mix of earnings in countries with differing statutory tax rates, changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws or their interpretation. In addition, we are subject to the continuous examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these continuous examinations will not have an adverse effect on our results of operations and financial condition.

Developments in accounting standards may cause us to increase our recorded expenses, which in turn would jeopardize our ability to demonstrate sustained profitability.

In January 2002, we adopted Statement of Financial Accounting Standard No. 142, Goodwill and Other Intangible Assets (SFAS No. 142). The statement generally establishes that goodwill and intangible assets

Table of Contents

with indefinite lives are not amortized, but are to be tested on an annual basis for impairment and, if impaired, are recorded as an impairment charge in income from operations. As of December 31, 2007, we had goodwill with an indefinite life of \$261.9 million from our acquisitions. If our goodwill is determined for any reason to be impaired, the subsequent accounting of the impaired portion as an expense would lower our earnings and jeopardize our ability to demonstrate sustained profitability. On January 1, 2006, we adopted SFAS 123(R) which requires the measurement and recognition of compensation expense for all stock-based compensation based on estimated fair values. Our operating results for 2007 contain, and our operating results for future periods will contain, a charge for stock-based compensation related to stock options, restricted stock grants and employee stock purchases.

Internet-related stock prices are especially volatile and this volatility may cause our stock price to fluctuate significantly.

The stock market and the trading prices of Internet-related companies in particular, have been notably volatile. This volatility is likely to continue and is not necessarily related to the operating performance of affected companies. This broad market and industry volatility could significantly reduce the price of our common stock at any time, without regard to our operating performance. Factors that could cause our stock price in particular to fluctuate include, but are not limited to:

Actual or anticipated variations in quarterly operating results;

Announcements of technological innovations;

The ability to sign new clients and the retention of existing clients;

Loss of key clients;

New products or services that we offer;

Competitive developments, including new products or services, or new relationships by our competitors;

Changes that affect our clients or the viability of their product lines;

Changes in financial estimates by securities analysts;

Conditions or trends in the Internet and online commerce industries;

Global unrest and terrorist activities;

Changes in the economic performance and/or market valuations of other Internet or online e-commerce companies;

Required changes in generally accepted accounting principles and disclosures;

Our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments or results of operations or other developments related to those acquisitions;

Additions or departures of key personnel; and

Sales or other transactions involving our common stock or our convertible notes.

In addition, our stock price may be impacted by the short sales and actions of other parties who may disseminate misleading information about us in an effort to profit from fluctuations in our stock price.

Provisions of our charter documents, other agreements and Delaware law may inhibit potential acquisition bids for us.

Certain provisions of our amended and restated certificate of incorporation, bylaws, other agreements and Delaware law could make it more difficult for a third party to acquire us, even if a change in control would be beneficial to our stockholders.

Table of Contents

The investment of our substantial cash balance and our investments in marketable debt securities are subject to risks which may cause losses and affect the liquidity of these investments.

At January 31, 2008, we held approximately \$117.5 million of municipal debt, classified as current assets, with an auction reset feature (auction rate securities) whose underlying assets are generally student loans which are FFELP (Federal Family Education Loan Program) back, over-collateralized, insured and backed by the Department of Education. In February 2008 auctions failed for \$40.0 million of our auction rate securities and there is no assurance that currently successful auctions on the other auction rate securities in our investment portfolio will continue to succeed and as a result our ability to liquidate our investment and fully recover the carrying value of our investment in the near term may be limited or not exist. A failed auction will occur if there is more selling than buying in a given auction. All of our auction rate securities, including those subject to the failure, are currently rated AAA, the highest rating, by a rating agency. If the issuers are unable to successfully close future auctions and their credit ratings deteriorate, we may in the future be required to record an impairment charge on these investments. We believe we will be able to liquidate our investment without significant loss within the next year, and we currently believe these securities are not significantly impaired, primarily due to the government guarantee of the underlying securities; however, it could take until the final maturity of the underlying notes (up to 30 years) to realize our investments recorded value. Based on our expected operating cash flows, and our other sources of cash, we do not anticipate the potential lack of liquidity on these investments will affect our ability to execute our current business plan.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The following table summarizes the various facilities that we lease for our business operations:

Description of Use	Primary Locations	Square Footage(1)	Lease Expirations
Corporate Office Facilities	Minnesota	162,500	From 2008 to 2011
Other U.S. Office Facilities	California, Colorado, Illinois, Nebraska, Ohio, Pennsylvania, Utah	57,117	From 2008 to 2011
Non-U.S. Office Facilities	China, Germany, Ireland, Japan, Korea, Luxembourg, Sweden, Taiwan, United Kingdom	68,363	From 2008 to 2026
Off Site U.S. Data Centers	California, Minnesota	693	2008
Off Site non U.S. Data Centers	Germany, Ireland, Sweden	378	2008

(1) Includes sub-leased space.

We believe our properties are suitable and adequate for our present needs. We periodically evaluate whether additional facilities are necessary.

ITEM 3. LEGAL PROCEEDINGS

DDR Holdings, LLC has brought a claim against us and several other defendants regarding US Patents No. 6,629,135 and 6,993,572, which are owned by DDR Holdings. These patents claim e-commerce outsourcing systems and methods relating to the provision of outsourced e-commerce support pages having a common look and feel with a host's website. The case was filed in the U.S. District Court for the Eastern District of Texas on January 31, 2006. The complaint seeks injunctive relief, declaratory relief, damages and attorneys' fees. We have denied infringement of any valid claim of the patents-in-suit, and have asserted counter-claims which seek a judicial declaration that the patents are invalid and not infringed. In September 2006, DDR Holdings filed an application for reexamination of its patents based upon the prior art produced by us and the other defendants in the case. As part of that application, DDR Holdings asserted that this prior art raised a substantial question as to the patentability of the inventions claimed in the patents. In December 2006,

Table of Contents

the Court stayed the litigation pending a decision on the reexamination application. In February 2007, the US Patent and Trademark Office ordered reexamination of DDR's patents. We intend to vigorously defend ourselves in this matter.

NetRatings, Inc. has brought a claim against us regarding US Patents Nos. 5,675,510, 6,115,680, 6,108,637, 6,138,155 and 6,763,386, which are owned by NetRatings. These patents claim web analytic and reporting systems. The case was filed in the U.S. District Court for the District of Minnesota on October 5, 2006. The complaint seeks injunctive relief, declaratory relief, damages and attorney's fees. We have denied the allegations of infringement. Discovery in this matter is ongoing. In December 2007, the parties submitted briefs to the Court in connection with the Markman claim construction. No trial date is currently set for this case. We intend to continue our vigorous defense of this matter.

In December 2006, we announced that we had received an informal inquiry from the SEC relating to our historical stock option grant practices. We have cooperated with the SEC regarding this matter and intend to continue to do so.

We are subject to legal proceedings, claims and litigation arising in the ordinary course of business. While the final outcome of these matters is currently not determinable, we believe there is no litigation pending against us that is likely to have, individually or in the aggregate, a material adverse effect on our consolidated financial position, results of operations or cash flows. Because of the uncertainty inherent in litigation, it is possible that unfavorable resolutions of these lawsuits, proceedings and claims could exceed the amount we have currently reserved for these matters.

Third parties have from time-to-time claimed, and others may claim in the future, that we have infringed their intellectual property rights. We have been notified of several potential patent disputes, and expect that we will increasingly be subject to patent infringement claims as our services expand in scope and complexity. We have in the past been forced to litigate such claims. We also may become more vulnerable to third-party claims as laws, such as the Digital Millennium Copyright Act, the Lanham Act and the Communications Decency Act are interpreted by the courts and as we expand geographically into jurisdictions where the underlying laws with respect to the potential liability of online intermediaries like ourselves are either unclear or less favorable. These claims, whether meritorious or not, could be time-consuming and costly to resolve, cause service upgrade delays, require expensive changes in our methods of doing business, or could require us to enter into costly royalty or licensing agreements.

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

None.

Table of Contents**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES****Price Range of Common Stock**

Our common stock is traded on NASDAQ Global Select Market under the symbol DRIV. The following table sets forth, for the periods indicated, the high and low sale price per share of our common stock on that market. These over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, markdown or commission, and may not necessarily represent actual transactions.

	High	Low
2006		
First Quarter	\$ 46.08	\$ 29.27
Second Quarter	\$ 48.00	\$ 37.00
Third Quarter	\$ 53.21	\$ 37.90
Fourth Quarter	\$ 60.99	\$ 48.20
2007		
First Quarter	\$ 58.67	\$ 47.80
Second Quarter	\$ 60.30	\$ 43.70
Third Quarter	\$ 49.71	\$ 41.71
Fourth Quarter	\$ 53.52	\$ 32.38

 Holders

As of February 1, 2008, there were approximately 350 holders of record of our common stock. On February 1, 2008, the last sale price reported on The NASDAQ Stock Market for our common stock was \$30.68 per share.

Dividend Policy

We have never declared or paid any cash dividends on our capital stock. We intend to retain any future earnings to support operations and to finance the growth and development of our business and do not anticipate paying cash dividends for the foreseeable future.

Issuer Purchases of Equity Securities

In June 2007, the Board of Directors authorized a new share repurchase program of up to \$200.0 million of our outstanding shares of common stock. This new program supersedes and replaces the \$50.0 million share repurchase program adopted in 2005. Under the new program, the shares may be repurchased in the open market or in privately negotiated transactions. Repurchases are at our discretion based on ongoing assessments of the capital needs of the business, the market price of our common stock and general market conditions. No time limit was set for the completion of the repurchase program. We did not repurchase any of our common stock during the three months ended December 31, 2007. During 2007, we repurchased 1,372,185 shares for \$63.0 million. None of the repurchased shares have been retired.

Securities Authorized for Issuance under Equity Compensation Plans

The information required in the table of Securities Authorized for Issuance under Equity Compensation Plans is incorporated by reference to our Proxy Statement in connection with our 2008 Annual Meeting to be filed in accordance with Regulation 14A under the Securities Exchange Act of 1934, as amended.

Table of Contents

Securities Performance Measurement Comparison¹

The SEC requires a comparison on an indexed basis of cumulative total stockholder return for the Company, a relevant broad equity market index and a published industry line-of-business index. The following graph shows a total stockholder return of an investment of \$100 in cash on December 31, 2002 for (i) the Company's Common Stock; (ii) the CRSP Total Return Index for the Nasdaq Stock Market (U.S. companies) (the Nasdaq Composite Index); and (iii) the RDG Technology Composite Index. The RDG Technology Composite Index is composed of approximately 500 technology companies in the semiconductor, electronics, medical and related technology industries. Historic stock price performance is not necessarily indicative of future stock price performance. All values assume reinvestment of the full amount of all dividends.

**COMPARISON OF 5 YEAR CUMULATIVE TOTAL RETURN*
Among Digital River, Inc., The NASDAQ Composite Index
And The RDG Technology Composite Index**

* \$100 invested on 12/31/02 in stock or index-including reinvestment of dividends.
Fiscal year ending December 31.