

DIGITAL RIVER INC /DE  
Form 10-K405/A  
November 26, 2001

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**FORM 10-K/A**

(Mark one)

☒ **Amendment to Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal year ended December 31, 2000.**

**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, SUITE 150  
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: None

Securities registered pursuant to Section 12(g) of the Act:

**Common Stock \$0.01 par value**

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 ☐

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

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Form 10-K or any amendment to this Form 10-K. /x/

The aggregate market value of the Common Stock of the registrant held by non-affiliates as of March 21, 2001 was approximately \$100,862,204.

The number of shares of Common Stock outstanding at March 21, 2001 was approximately 24,650,472 shares.

## DOCUMENTS INCORPORATED BY REFERENCE

Certain sections of the Registrant's definitive Proxy Statement for the 2001 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K to the extent stated herein.

## EXPLANATORY NOTE TO AMENDMENT TO ANNUAL REPORT

All information contained in this Report on Form 10-K/A was current as of the date of filing of the Registrant's initial Annual Report on March 27, 2001 and the Company has not undertaken to update the same in this amendment.

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## PART I

### ITEM 1. BUSINESS.

#### CAUTIONARY STATEMENT PURSUANT TO THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

Certain statements set forth or incorporated by reference in this Form 10-K/A, as well as in our Annual Report to Stockholders for the year ended December 31, 2000, constitute "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "believes," "anticipates," "expects," "intends," "estimates" and similar expressions are intended to identify forward-looking statements, but are not the exclusive means of identifying such statements. These statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, performance or achievements, or industry results, to be materially different from any future results, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: our limited operating history and variability of operating results, the expectation of future losses, risks associated with electronic software delivery, our dependence on the Internet and the growth in electronic commerce and Internet infrastructure development, our dependence on software publishers, our dependence on online retailers, system development and electronic commerce security risks, rapid technological changes, competition in the electronic commerce industry, the importance of attracting and retaining personnel, management of the our growth, the integration of acquired companies, our dependence on key employees, and other risk factors set forth under "Risk Factors" and elsewhere in this Form 10-K/A. We expressly disclaim any obligation to update or publicly release any revision to these forward-looking statements after the date of this Form 10-K/A.

#### Overview

We are a provider of comprehensive electronic commerce outsourcing solutions. We were incorporated in February 1994 and commenced offering products for sale through our clients' Web stores in August 1996. As an application service provider, we enable our clients to access our proprietary electronic commerce system over the Internet. We have developed a technology platform that allows us to provide a suite of electronic commerce services, including Web commerce development and hosting, transaction processing, fraud screening, digital delivery, integration to physical fulfillment and customer service. We also provide analytical marketing and merchandising services to assist clients in increasing Web page view traffic to, and sales through, their Web commerce systems. We provide an outsourcing solution that allows our clients to promote their own brands while leveraging our investment in infrastructure and technology. Our Software and Digital Commerce Services Division serves the software and digital products market, and our E-Business Services Division serves manufacturers, distributors and retailers outside the software industry. Our clients include 3M Company, Autodesk, Inc., Egghead.com, Inc., Fujitsu Ltd., MicroWarehouse, Inc., ScanSoft, Inc., Symantec Corporation and Xircom Inc.

Our proprietary commerce network server, or CNS, technology serves as the platform for our solutions. The CNS incorporates custom software applications that enable Web store authoring, electronic software delivery, fraud prevention, export control, merchandising programs and online registration, and features a database of more than 100,000 software and digital products. Using our CNS platform, we create Web commerce systems for our clients that replicate the look and feel of each client's Web site. End-users enter the client site and are then seamlessly

transferred to our CNS. End-users can then browse for products and make purchases online, and once purchases are made, we either deliver the products digitally to the end-user through the Internet or communicate the order through its integration into a number of third-party fulfillment agencies for physical fulfillment. We also provide transaction processing services and collect and maintain critical information about end-users.

This information can later be used by our clients to facilitate add-on or upgrade sales and for other direct marketing purposes. We actively manage direct marketing campaigns for our clients, and also deliver purchase information and Web store traffic statistics to our clients through online reporting.

### **Recent Acquisitions**

On August 24, 2000, pursuant to an Asset Purchase Agreement dated as of August 24, 2000 by and between Digital River and NetSales, Inc., in exchange for 1,000,000 shares of our Common Stock, we purchased those assets and assumed those liabilities of NetSales related to NetSales' software services business. The Purchase Agreement includes a contingent earnout whereby NetSales can receive up to an additional 350,000 shares of Common Stock based on performance over the 180 day period following August 24, 2000. Of the 1,000,000 shares of Common Stock issued at closing, 100,000 shares were placed in escrow to secure certain indemnification obligations contained in the Purchase Agreement. Subject to outstanding claims, the escrow will terminate nine months following the closing. See Note 2 of "Notes to Consolidated Financial Statements" for more detailed information.

On March 20, 2001, pursuant to an Asset Purchase Agreement dated as of March 20, 2001 by and between Digital River, Calico Commerce, Inc., a Delaware corporation, and ConnectInc.com, Co., a Delaware corporation and a wholly owned subsidiary of Calico, we purchased those assets and assumed those liabilities of ConnectInc related to ConnectInc's Market Maker business, in exchange for approximately 1.63 million shares of our Common Stock. The Purchase Agreement includes a contingent earnout whereby ConnectInc can receive additional shares of Common Stock based upon the revenue generated by the Market Maker business, from sales by Digital River and Calico, over the 13 months following the closing.

### **Industry Background**

*Growth Of The Internet And Electronic Commerce.* The Internet has emerged as a significant global communications medium, enabling millions of people to share information and conduct business electronically. A number of factors have contributed to the growth of the Internet and its commercial use, including: (i) the large and growing installed base of personal computers in homes and businesses; (ii) improvements in network infrastructure and bandwidth; (iii) easier and cheaper access to the Internet; (iv) increased awareness of the Internet among consumer and business users; and (v) the rapidly expanding availability of online content and commerce that increases the value to users of being connected to the Internet.

The increasing functionality, accessibility and overall usage of the Internet have made it an attractive commercial medium. Online businesses can interact directly with end-users, both businesses and consumers, and can frequently adjust their featured selections, shopping interfaces and pricing. The ability to reach and serve a large and global group of end-users electronically from a central location and the potential for personalized low-cost customer interaction provide additional economic benefits for online businesses. Unlike traditional retail channels, online businesses do not have the burdensome costs of managing and maintaining a significant physical retail store infrastructure or the continuous printing and mailing costs of catalog marketing. Because of these advantages, online businesses have the potential to build large, global customer bases quickly and to achieve superior economic returns over the long term. An increasingly broad base of products is being sold successfully online, including computers, travel services, brokerage services, automobiles and music, as well as software products.

*Advantages Of Outsourcing Electronic Commerce.* According to a Gartner Group study, the initial investment in an electronic commerce site that is functionally equivalent to most industry participants is \$1.0 million to \$5.0 million and requires an average of five months to implement. A market differentiating electronic commerce solution requires an expenditure of \$5.0 to \$20.0 million.

Additionally, to maintain a scaleable, best-of-breed commerce solution, businesses must continue to invest in technology, infrastructure and personnel related to electronic commerce management.

There are a number of advantages to outsourcing electronic commerce, including: (i) avoiding the large, upfront investment required to purchase and implement software applications and computer hardware; (ii) a shorter time to market with an electronic commerce solution; (iii) the opportunity to shift the ongoing financial and technology risk to a proven service provider; and (iv) allowing businesses to focus on their

specific core competency. Because of these advantages, we believe that an increasing number of businesses will outsource their electronic commerce needs.

*Opportunity For Electronic Commerce Outsourcing.* We believe that the market for electronic commerce outsourcing in the software and digital products market as well as among manufacturers, distributors and retailers will continue to grow rapidly. However, unlike established physical distribution channels, there is currently no established, comprehensive electronic distribution source for businesses. We believe that providing an integrated service offering of Web commerce development and hosting, transaction processing, fraud screening, digital delivery, integration to physical fulfillment and customer service is complex and requires upfront and ongoing investments in secure, reliable and scaleable systems. Accordingly, we believe that a substantial market opportunity exists for a comprehensive, cost-effective, outsourced electronic commerce solution for software publishers and online retailers as well as for manufacturers, distributors and retailers.

### **The Digital River Solution**

We have developed a technology platform that enables us to provide a comprehensive suite of electronic commerce services to our clients. We also leverage our merchandising expertise to increase traffic and sales for our clients. Rather than maintaining our own branded Web store, we provide an outsourcing solution for Web commerce development and hosting, transaction processing, digital delivery and merchandising services that enables our clients to promote their own brands while leveraging our investment in infrastructure. In addition, this approach enables us to leverage our clients' brand investments and the traffic at our clients' sites to maximize the number of transactions completed through Digital River.

*Benefits To Clients.* Our electronic commerce solution enables our clients to leverage our investment in technology, personnel and infrastructure to provide a business-to-business or business-to-consumer electronic commerce solution. This provides the client with a cost-effective, proven solution that allows the clients to focus on their core competency. Clients have the ability to offer the complete library of their products directly to end-users from their Web commerce systems, and for software publishers, through our network of online retailers. This benefit is particularly significant for smaller software publishers who have limited market access through traditional distribution methods. Our solution also provides a channel for underdistributed products permitting clients to offer online their complete product catalog. In addition, through our 100% end-user registration and data warehousing, we provide clients with valuable end-user information that can facilitate targeted marketing, upgrade notification and sophisticated merchandising strategies. Finally, by exploiting the distribution relationships we have developed with a large network of online retailers, software publishers can reduce or eliminate the need for multiple retailer relationships, thereby lowering administrative costs and reducing the number of master copies of their software in existence for distribution.

Additionally, online retailers can use our robust CNS technology to sell software products online without having to build and maintain their own electronic commerce infrastructure. We enable online retailers to offer their end-users access to virtually all of our inventory of software products without the burden of developing and maintaining relationships with hundreds of software publishers. Like software publishers, online retailers enjoy the cost savings from online fulfillment and the database marketing

benefits we offer. Online retailers can effectively outsource electronic commerce functionality while building their own brands online. Online retailers also eliminate the cost and risk associated with carrying inventory and the risk of inventory obsolescence. In addition, niche market and high traffic Web sites can become online retailers at minimal cost using our solution.

*Benefits To End-Users.* Our solution emphasizes convenience by allowing end-users, both business and consumer, to purchase products online twenty-four hours a day, seven days a week, or 24x7, from their home or office. End-users are not required to make a trip to the store, can act immediately on a purchase impulse and can locate products that are difficult to find. Because we have a global reach, we can deliver an extremely broad selection to end-users in rural, international or other locations that cannot support retail stores. Software and digital products purchased online can either be quickly and conveniently downloaded and installed through digital delivery or delivered physically. Using our sophisticated search engine technology, end-users visiting retailers' online Web stores can access virtually all of our inventory of products. End-users also benefit from the protection of our archiving service, through which we guarantee replacement of software in the event of accidental destruction through computer error or malfunction, and from our 24x7 customer service provided on behalf of our clients.

### **Strategy**

Our objective is to become a global leader in comprehensive electronic commerce outsourcing solutions to software publishers and online retailers through our Software and Digital Commerce Services Division as well as to manufacturers, distributors and retailers through our E-Business Services Division. We intend to achieve our objective through the following key strategies:

*Software And Digital Commerce Services Division: Develop And Expand Relationships With Software Publishers And Online Retailers.* We plan to continue to build our inventory of software products through additional contractual relationships with software publishers. As of March 1, 2001, we had contracts with approximately 8,000 software publishers and online retailers, representing more than 100,000 software products. We believe that our ability to develop Web hosting relationships with our software publisher clients increases our reach to end-users and provides the basis for a long-term relationship with our software publisher clients. We further believe that the large number of software products that we offer from our software publisher clients will be critical to our ability to deliver a compelling inventory of products to online retailer clients.

Additionally, we believe that by increasing the number of points of entry to the CNS, we will increase the number of transactions over our network. Accordingly, in addition to expanding and developing relationships with software publishers, we seek to expand aggressively our network of online retailer clients. Online retailer clients include traditional store-based and mail-order retailers with a Web presence, online retailers dedicated to online commerce, as well as high traffic or niche Web site operators desiring to add electronic commerce functionality. Our model enables us to leverage our clients' marketing resources to direct traffic to our software trade network.

*E-Business Services Division: Develop And Expand Relationships With Manufacturers, Distributors And Retailers.* In late 1998, we began exploring electronic commerce outsourcing opportunities outside of the software industry. During 1999, sales and marketing personnel were hired to develop contractual relationships to sell our electronic commerce outsourcing services to manufacturers, distributors and retailers. As of December 31, 2000, we had 51 contracts to provide commerce services, such as Web commerce development and hosting, transaction processing and fraud screening, customer service, integration into third-party physical fulfillment, and merchandising and analytical marketing services. We believe that our ability to provide a proven, cost efficient electronic commerce solution, which can typically be implemented in a one to eight week time frame, provides the basis for a long-term

relationship with these clients. We further believe that additional electronic commerce outsourcing opportunities may develop as relationships with existing clients expand.

*Provide Clients Value-Added Services.* We believe that our growing data warehouse of end-user purchasing information provides us with a powerful tool to assist clients with value-added services, such as targeted advertising, promotions and direct response merchandising. We offer merchandising and analytical marketing programs, customer support and communications programs, advertising placement services, Web commerce system design services, a returns management module and fraud screening services. We intend to continue to expand our programs and believe that these programs help build stronger partnerships with our clients, while enabling them to increase their Web site sales.

*Maintain Technology Leadership.* We believe that our CNS technology has given us a competitive advantage in the market for outsourcing solutions. We will continue to invest in and enhance our CNS technology in order to increase redundancy, reliability and bandwidth, and to expand services and reduce costs. By leveraging our fixed-cost infrastructure, we will improve our ability to provide low cost, high value services to our clients while utilizing the latest technology.

## Services

We provide a broad range of services to our clients, including Web commerce hosting, digital delivery and physical fulfillment services, transaction processing and fraud screening, customer service and merchandising and analytical marketing services.

*Web Commerce Hosting.* We host Web commerce activities for all of our online retailer clients, our E-Business clients and for those software publisher clients that choose this option. Our outsourcing solution is mission-critical for many of our clients. Therefore, we have a data center that is designed to provide our clients with the performance they require for continuous Web commerce operations. The data center features redundant, high speed connections to the Internet, 24x7 security and monitoring, back-up generators and dedicated power.

We can quickly and efficiently create a Web commerce system for our clients, which can be accessed easily by clicking on a "buy button" on a client's existing Web site. The end-user is then transferred to a Web commerce system hosted on our CNS, which replicates the look and feel of the client Web site. The end-user can then shop for products and make purchases online. By replicating the look and feel of our clients' Web sites, we support clients in conducting electronic commerce under their own brands. Our solution allows clients to choose either digital or, when available, physical delivery. The transaction information is captured and added to our data warehouse. Our ability to retrieve and manipulate this information creates a powerful data mining tool, which can be used for targeted merchandising to end-users through emails, banner presentations and special offers.

*Digital And Physical Fulfillment Services.* We offer clients access to our electronic software delivery capabilities to permit delivery of digital products to an end-user's computer via the Internet. Digital delivery eliminates many of the costs that exist in the physical distribution chain,

such as manufacturing, packaging, shipping, warehousing and inventory carrying and handling costs. Delivery is fulfilled when a copy is made from the master on our CNS and is then securely downloaded to the end-user via the Internet. Our digital distribution model not only reduces costs, thereby increasing margins available to software publishers and online retailers, but also solves the shelf space problem constraining product availability and sales. While most software publishers use our Web hosting services, certain software publishers use only our digital delivery services, which provide them with online distribution through our extensive network of online retailers.

In addition to fulfillment through electronic software delivery, we offer clients physical distribution services. We have contracted with a third-party fulfillment agency that maintains an inventory of physical software products, generally on consignment from our clients that select this option, for

shipment to end-users. We also communicate orders through integration into many third-party fulfillment agencies for physical fulfillment for our clients. We believe physical fulfillment services are important to our ability to provide a comprehensive electronic commerce outsourcing solution.

*Transaction Processing And Fraud Screening.* We process transactions, primarily via credit card, generated by end-users ordering products through our CNS. We obtain customer and payment information required to process transactions. The fraud screening component of the CNS uses both rules-based and heuristic scoring methods to make a determination regarding the validity of the order, end-user and payment information. As the end-user is entering the order, over 580 data reviews are processed real-time. Depending on the contractual agreement, we either offer the use of our proprietary fraud screening to clients to either significantly reduce the number of fraudulent transactions or to completely shift the risk of fraud to us. When a credit card transaction is completed and approved, and the ordered product has been delivered, we process the order for payment.

*Customer Service.* We offer both telephone and email customer support for products sold through our CNS on behalf of our clients. We will provide end-user assistance on order and delivery questions on a 24x7 basis. We have invested and continue to invest in technology and infrastructure to provide fast, efficient responses to customer inquiries. We also provide archiving service to the end-users that purchase digital products.

*Merchandising And Analytical Marketing Services.* We offer a range of merchandising and analytical marketing services to our clients to help them drive additional traffic to their Web stores. Clients are provided with detailed reports of transactions on their Web stores, as well as marketing information related to end-user visits to their Web stores. The CNS captures Web page visits, banner and pricing information and other data that can be used by the software publishers and online retailers to analyze their Web stores' performance.

We also offer advanced merchandising services to assist clients in increasing response rates for their marketing efforts. These services include email campaigns for special promotions, upgrade notification programs and the presentation of complementary products, bundled products or other programs designed to increase average order size based on a targeted end-user profile. We participate in co-op dollar and market development fund programs with our clients and buy selected banner placements in bulk to support clients' promotional campaigns. In addition, we test and analyze merchandising techniques, such as promotional pricing and banner advertising, based on information gathered in the CNS data warehouse.

## Clients

Within the Software and Digital Commerce Services Division, we distribute software products through a network of software publishers and online retailers. Online retailer clients include traditional store-based and direct mail retailers with a Web presence, online retailers dedicated to online commerce, as well as high traffic or niche Web site operators desiring to add electronic commerce functionality. In a typical online retailer contract, we are responsible for: (i) a payment to the online retailer based on a percentage of net sales of software products that we distribute through the online retailer's Web site; (ii) the processing of payments made by end-users; (iii) the delivery of the software products to end-users; (iv) the payment of applicable credit card transaction fees; (v) the collection, payment and returns filing of applicable sales taxes; and (vi) the distribution of a report to the online retailer detailing related sales activity that we have processed. We also expect to support traditional physical retailers in developing their online stores for the sale of software products online. While most software publishers use our Web hosting services, certain software publishers use only our "channel services" whereby the software publishers are provided with digital and physical fulfillment capability through our extensive network of online retailers. In a typical software publisher contract, we are responsible for: (i) the maintenance of master copies of software products in a secure format for

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distribution to end-users; (ii) a payment to the software publisher for the cost of software products that we distribute through either a retailers' Web site or through the publisher's host Web site; (iii) the processing of payments made by end-users; (iv) the delivery of software products to end-users; (v) the payment of applicable credit card transaction fees; (vi) the collection, payment and returns filing of applicable sales taxes; and (vii) the distribution of a report to the software publisher detailing related sales activity that we have processed.

As of March 1, 2001, we had approximately 8,000 contracts with software publishers and online retailers. Our Software and Digital Commerce Services Division clients include:

### **Software Publishers**

*Web Hosting And Channel Services*  
Adaptec, Inc  
Aladdin Knowledge Systems Ltd.  
Autodesk, Inc  
Scansoft, Inc.  
Symantec Corporation

### **Online Retailers**

Cyberian Outpost, Inc.  
Egghead.com, Inc.  
Micro Warehouse, Inc  
Staples.com  
Vioneer, Inc.

### *Channel Services Only*

DataViz  
IBM Corp.  
Lotus Development Corporation  
McAfee.com  
PowerQuest Corp.

Within the E-Business Services Group, we provide a variety of electronic commerce services to clients outside of the software industry, primarily manufacturers, distributors and retailers. These services allow the client to perform electronic commerce on a business-to-business or business-to-consumer basis. In a typical E-Business Services contract, we are responsible for: (i) Web commerce system design, hosting and integration into the client's management system; (ii) the processing of payments made by end-users; (iii) the communication of orders to the client or the clients third-party fulfillment agency for delivery of the product to end-users; (iv) the fraud screening and processing of the applicable credit card transaction to the client's credit card processor; (v) customer service; and (vi) the distribution of a report to the client detailing related sales activity that we have processed.

As of December 31, 2000, we had 51 contracts with clients in the E-Business Services Group, including:

### **E-Business Services**

3M Company  
Fujitsu Ltd.  
Xircom Inc.  
Polaris Industries Inc.  
Nabisco

## **Sales And Marketing**

We market our services directly to clients and prospective clients. We do not operate our own Web store because of our strategy to serve as a neutral provider of electronic commerce outsourcing solutions. Generally, our direct marketing to end-users focuses on supporting the marketing and promotional efforts of our clients in driving traffic to their Web stores. This direct marketing effort leverages our extensive data warehouse, which enables us to create and quickly implement marketing

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programs targeted at specific end-user segments. By providing consistent quality service, branding client order pages with our name and logo, billing credit card transactions under our name and engaging in brand positioning, advertising and promotion, we believe we have established our brand as a trusted name for electronic software delivery and electronic commerce outsourcing solutions among current and prospective clients and end-users.

Our sales and marketing organization is divided into two divisions: the Software and Digital Commerce Services Division and the E-Business Services Division. The Software and Digital Commerce Services Division focuses on software and digital content publishers and online retailers of all sizes, including traditional physical retailers, with significant online revenue potential. These sales are typically complex in nature and

involve a lengthy sales cycle. Contracts with larger clients often involve certain incentives, principally pricing concessions. We make decisions with respect to contract incentives on a case-by-case basis. The E-Business Services Division focuses on manufacturers, distributors and retailers, generally with total annual revenues of \$100.0 million or more. These sales are complex in nature and involve a lengthy sales cycle. Both the Software and Digital Commerce Services Division and the E-Business Services Division serve existing clients and provide them with merchandising and database marketing assistance designed to increase revenues. As of March 1, 2001, we had 138 employees engaged in sales and marketing.

We currently market our services to clients via direct marketing, print advertising, trade show participation and other media events. We plan to increase our expenditures on direct marketing, seminars and print advertising, primarily directed at potential E-Business Services clients. In addition, we operate a sales office in the United Kingdom.

### **Technology**

We deliver our electronic commerce outsourcing solution using our proprietary CNS technology, is described below:

*Architecture.* Our scaleable CNS is designed to handle tens of thousands of individual Web commerce stores and millions of products. The CNS consists of a pool of network servers and a proprietary software application that serves dynamic Web pages using an Oracle technology. Our CNS was designed to scale to support growth by adding CPUs, memory, disk drives and bandwidth without substantial changes to the application. The CNS software code is written in modular layers, enabling us to quickly adapt in response to industry changes, including bandwidth opportunities, payment processing changes, international requirements for taxes and export screening, new technologies such as Web Caches, Java, ML, DHTML, VRML, SET, banking procedures and encryption technologies. The CNS product search system, based on Verity, allows end-users to search for items across millions of potential products and thousands of categories specific to various product specifications, while maintaining a fast page response that is acceptable to the end-user. We use sophisticated database indexing coupled with a dynamic cache system to provide flexibility and speed. These caches help increase the overall speed of each page and facilitate complex searches across our entire inventory of software products. The CNS has also been designed to index, retrieve and manipulate all transactions that flow through the system, including detailed commerce transaction and end-user interaction data. This enables us to create proprietary market profiles of each end-user and groups of end-users that can then be used to create merchandising campaigns. Our CNS is also used for internal purposes, including reporting and maintenance for fraud detection and prevention, physical shipping, return authorizations, back order processing and full transaction auditing and reporting capabilities for all commerce functions.

*Web Commerce System Maintenance.* Clients' Web commerce systems are built and maintained using the CNS centralized management system. Global changes that affect all Web commerce systems or groups of Web commerce systems can be made as easily as changes to an individual Web commerce

system. Client Web commerce systems typically include a main store and may optionally include several "focus stores" and "channel sites" to which highly targeted traffic may be routed. Clients may also link specific locations on their Web stores to detailed product or category areas of the stores in order to better target their end-users' interests.

*Security.* Our security systems address access to internal systems and illegal access to commerce data via the Internet. Internally, log-ins and passwords are maintained for all systems, with additional log-ins, passwords and IP access control granted on an individual basis to only the required commerce areas for which the recipient is responsible. Firewalls prevent unauthorized access from outside. We rely on certain encryption and authentication technology licensed from third parties to provide secure transmission of confidential information, such as end-user credit card numbers. Unix, Oracle and Web server security additionally restrict access from the outside to the appropriate transaction data. The CNS security system is designed not to interfere with the end-user experience. Product wrappers, clearing-house processing and additional password mechanisms that negatively impact digital delivery performance are not needed. The CNS security system does not allow direct access to the clients' products and ensures that an end-user requests digital delivery through a valid page and has purchased the product.

*Data Center Operations.* Continuous data center operations are crucial to our success. All transaction data is backed up periodically and all inventory data is archived and kept in fireproof storage facilities. Our network software constantly monitors clients' Web commerce systems and internal system functions and notifies systems engineers if any unexpected conditions arise. We currently lease seven T1 lines and 4 DS3 lines from multiple vendors and maintain a policy of adding additional lines if more than 50% of our bandwidth capacity is utilized. Accordingly, if one line fails the other lines are able to assume the capacity of the failed line. Our data center is located in a single location at our main facilities in Eden Prairie, Minnesota. In the event of electrical power failure, we have a back-up power supply system. We have also installed a FM-200 automatic fire suppression system in the data center. The data center currently incorporates redundant systems consisting of additional servers and arrays. We currently have no automatic switchover in the case of equipment or software failure, although we have plans to implement further redundancy in the future.



## Product Research and Development

Our product research and development strategy is to enhance the technology and features of our CNS. To this end, we have numerous development projects in process, including Internet optimization tools, personalization, business-to-business related technologies and online interactive customer service. Product research and development expenses were \$3.1 million, \$10.3 million and \$13.1 million in 1998, 1999 and 2000, respectively. As of March 1, 2001, we employed 38 persons in product research and development.

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of the CNS 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 electronic commerce industry are characterized by rapid technological change, 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 change 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 CNS technology and other proprietary technology involves significant technical and business risks. We may

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fail to use new technologies effectively or adapt our proprietary technology and systems to client requirements or emerging industry standards.

## Competition

The market for Internet-based, 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 competition to intensify as current competitors expand their product offerings and new competitors enter the market. In addition, our clients and partners may become competitors in the future. Increased competition is likely to result in price reductions, lower average sales prices, reduced margins, longer sales cycles and a decrease or loss of our market share, any of which reduce our revenues. We face competition from the following sources:

other providers of outsourced electronic commerce solutions, such as Beyond.com Corporation and ReleaseNow Corporation;

software publishers and online retailers who have or may choose to make substantial initial and ongoing investments in order to develop and manage their own e-commerce sites, and who may decide to market this capability to other companies;

system integrators and application service providers that offer tools and services for electronic commerce, including companies that provide a broad range of Internet and server solutions, such as Corio, Inc. and US Internetworking;

companies that provide tools and services enabling one or more of the transaction processing functions of electronic commerce, such as transaction control, data security, customer interaction and database marketing, including BroadVision Corporation, CyberSource Corporation and Preview Systems, Inc.;

in-house development of e-commerce capabilities;

companies that sell, distribute or rent software products over the Internet;

high-traffic, branded Web sites that derive a substantial portion of their revenues from e-commerce and may themselves offer, or provide means for others to offer, software products, such as Amazon.com, Inc.; and

traditional channels and methods of retail and corporate software sales, such as mail order catalogs and retail superstores.

We believe that the principal competitive factors in our market are breadth of services and software product offerings, software publisher and online retailer relationships, brand recognition, system reliability and capacity, price, customer service, speed and accessibility and ease of use, speed to market, scalability, convenience and speed of fulfillment. The online retailers and the other companies listed above may compete directly with us by adopting a similar business model. Moreover, while some of these companies are also clients or potential clients of ours, they may compete with our electronic commerce outsourcing solution to the extent that they develop electronic 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, services 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, that achieve greater customer acceptance or that 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 revenues to decline.

### Intellectual Property

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 United States and foreign 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 currently have six U.S. patents issued with between 13 and 14.5 years remaining prior to expiration, and five U.S. patent applications pending related to our e-commerce services, including fraud screening, distribution of files over the Internet, cache management and global web site management. We pursue the registration of our trademarks and service marks in the United States and internationally. We currently have nine U.S. registered trademarks and nine trademark applications pending in the United States and other countries. 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.

### Employees

As of March 1, 2001, we employed 417 people. We also employ independent contractors and other temporary employees. None of our employees is represented by a labor union, and we consider our employee relations to be good. Competition for qualified personnel in our industry is intense, particularly among software development and other technical staff. We believe that our future success will 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 as of December 31, 2000:

Name	Age	Position
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Name	Age	Position
Joel A. Ronning	44	Chief Executive Officer
Perry W. Steiner	35	President
Robert E. Strawman	41	Chief Financial Officer and Treasurer
Jay A. Kerutis	41	President, Software and Digital Commerce Services Division
Gregory R.L. Smith	34	Vice President of Finance and Secretary

Mr. Ronning founded the Company in February 1994 and has been Chief Executive Officer and a director of the Company since that time. In February 2001, Mr. Ronning was elected to the Office of the President. From February 1994 to July 1998, Mr. Ronning was also President of the Company. 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. Ronning also serves as a director of the Software Publishers Association and JASC, Inc.

Mr. Steiner has served as a director of the Company since April 1998 and served as President of the Company from July 1998 to February 2001. Since February 2001, Mr. Steiner has served as a Managing Partner of Arlington Capital Partners, a private equity fund. From January 1997 to July 1998, Mr. Steiner served as Vice President of Wasserstein Perella & Co., Inc., an investment banking firm, and as Vice President of Wasserstein Perella Ventures, Inc., the general partner of Wasserstein Adelson Ventures, L.P., a venture capital fund. From June 1993 to December 1996, Mr. Steiner was a principal of TCW Capital, a group of leveraged buyout funds managed by Trust Company of the West. Mr. Steiner serves as a director of Laplink, Inc. and was a director of Tech Squared from December 1998 to June 1999.

Mr. Strawman joined the Company in April 1998 as Chief Financial Officer and Treasurer. In February 2001, Mr. Strawman was elected to the Office of the President. From September 1995 to April 1998, Mr. Strawman served as Director of Finance and Vice President of Finance for Caribou Coffee Company, Inc., a gourmet coffee retailer. From 1989 to 1995, Mr. Strawman held various financial positions at Software Etc. Stores, Inc., a specialty retailer of software, most recently as Chief Financial Officer.

Mr. Kerutis joined the Company in February 1999 as Vice President of Sales, served as Executive Vice President, Software and Digital Commerce Services Division from January 2000 to December 2000 and has been President, Software and Digital Commerce Services Division since December 2000. In February 2001, Mr. Kerutis was elected to the Office of the President. From March 1997 to

February 1999, Mr. Kerutis was Vice President Retail Channel for Merisel Americas, Inc. From April 1995 to March 1997, Mr. Kerutis was Vice President Sales and Marketing for New Media Corporation. From October 1993 to April 1995, Mr. Kerutis served as Director Sales for Merisel Americas, Inc.

Mr. Smith joined the Company as Controller in June 1997 and has served as Vice President of Finance since June 1999. Since December 1997, Mr. Smith has also served as Secretary. From November 1995 to June 1997, Mr. Smith was Manager, External Reporting and Investor Relations at Secure Computing Corporation, a developer of network and Internet security products. From June 1988 to November 1995, Mr. Smith held various positions with Ernst & Young LLP.

### RISK FACTORS

In addition to the other information provided in this report, stockholders or prospective investors should carefully consider the following risk factors:

#### **We have a limited operating history, a history of losses and we have yet to achieve profitability.**

We were incorporated in February 1994 and conducted our first online sale through a client's Web store in August 1996. We have not yet achieved profitability and have incurred significant losses since we were formed. As of December 31, 2000, we had an accumulated deficit of approximately \$83.9 million. Our limited operating history makes it difficult for you to evaluate our ability to achieve profitability in the future.

The success of our business model depends upon our success in generating sufficient transaction and service fees from the use of our e-commerce solutions by existing and future clients. Accordingly, we must maintain existing and develop new relationships with software publishers, online retailers and E-business clients. To achieve this goal, we intend to continue to expend significant financial and management resources on the development of additional services, sales and marketing, improved technology and expanded operations. As a result of these

expenditures, we expect operating losses and negative cash flows to continue for the near future and may increase from current levels. If we are unable to maintain existing and develop new client relationships, we will not generate a profitable return on our investments and we will be unable to gain meaningful market share to justify these investments. Further, we may be unable to achieve profitability if our revenues increase slower than expected, or if operating expenses exceed our expectations and cannot be adjusted to compensate for lower than expected revenues. Even if we are able to achieve profitability, we may be unable to sustain or increase profitability on a quarterly or annual basis.

**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 revenues 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 expectations of securities analysts and investors, the trading price of our common stock will likely decline. Some of the factors that have or may contributed to fluctuations in our quarterly and annual operating results include:

our ability to attract and retain software publishers and online retailers as clients;

our ability to attract and retain E-Business clients;

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the introduction of new Web sites, Web stores, services by us that may require a substantial investment of our resources;

the introduction of competitive Web sites, Web stores, services by others;

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

technical difficulties or system downtime leading to termination of client contracts and harm to our reputation;

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

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

In addition, revenues generated by our Software and Digital Commerce Services Division is likely to fluctuate on a seasonal basis that is typical for the software publishing market in general. We believe that our first and fourth quarters are seasonally stronger than our second and third quarters due to the timing of demand of tax preparation software and the Christmas selling period. We also believe that software publishers avoid new product releases in the summer months.

Our operating expenses, which include sales and marketing, product research and development, general and administrative expenses and amortization of intangible assets, are based on our expectations of future revenues and are relatively fixed in the short term. If our revenues for a quarter fall 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 e-commerce industry have in the past experienced significant quarter-to-quarter fluctuations that may adversely affect our stock price.

**A loss of any client that accounts for a large portion of our revenues could cause our revenues to decline.**

Revenues related to three software publisher clients collectively accounted for approximately 20% of our revenues in 1999 and approximately 15% of our revenues in the Software and Digital Commerce Services Division in 2000. Contracts with these clients are generally short term in nature. If any one of these contracts is not renewed or otherwise terminates, and if we are unable to replace it with other client agreements, our revenues would decline and our losses would likely increase. It is important to our success that we maintain these client relationships and at the same time develop new client relationships.

**The success of our business strategy and our future revenue growth depends on increasing consumer acceptance of the internet as a medium of commerce.**

The failure of the Internet to continue developing into a significant commercial medium will harm our ability to increase our revenues and execute our business strategy. We depend on the growing use and acceptance of the Internet as an effective medium of commerce by end-users. Rapid growth in the use of and interest in the Internet and other online services is a recent development. The acceptance and use of the Internet and other online services may not continue to develop and a sufficiently broad base of consumers may not adopt, and continue to use, the Internet and other online services as a medium of commerce. We rely on purchasers who have historically used traditional means of commerce to purchase goods or transact business. If we are to be successful, these purchasers must accept and use the Internet as a means of purchasing goods and services and exchanging information and we cannot predict the rate at which these purchasers will do so.

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**Our sales cycle is lengthy, which may cause us to incur substantial expenses and expend management time without generating corresponding revenues, which would impair our cash flow.**

We market our services directly to software publishers, online retailers and E-Business prospects. These relationships are typically complex and take time to finalize. Due to operating procedures in many large 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 sales call and the signing of a contract with significant sales potential is difficult to predict and typically ranges from six to 12 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 revenues. As a result, our cash flow and our ability to fund expenditures incurred during the sales cycle may be impaired.

**General economic uncertainty may reduce our revenues.**

The revenue growth and profitability of our business depends significantly on the overall demand for Internet-based e-commerce solutions. We believe that the market for these solutions may be adversely affected by a number of factors, including reductions in capital expenditures by clients and overall weakening of the U.S. and foreign economies. These factors may, in turn, give rise to a number of market trends that may slow our revenue growth, including:

longer sales cycles;

deferral or delay of e-commerce projects and generally reduced expenditures for e-commerce solutions and related services and;

increased price competition.

If the current economic slowdown continues, the effects of the slowdown for e-commerce solutions could reduce our revenues and limit our ability to meet our profitability goals.

**Electronic Software Delivery, or ESD, is still an evolving and unproven technology and the industry may ultimately fail to accept ESD.**

Our success will depend in large part on the growth in end-user acceptance of ESD as a method of distributing software products. ESD is a relatively new method of distributing software products to end-users, and unless ESD gains widespread market acceptance, we will be unable to achieve our business plan. Factors that will influence the market acceptance of ESD include:

the availability of sufficient bandwidth, both presently and in the future, to enable purchasers to rapidly download software products;

the cost of time-based Internet access;

the number and adequacy of software products that are available for purchase through ESD as compared to those available through physical delivery; and

the level of end-user comfort with the process of downloading software via the Internet, including the ease of use and lack of concern about transaction security.

Even if ESD achieves widespread acceptance, we may be unable to overcome the substantial existing and future technical challenges associated with electronically delivering software reliably and consistently on a long-term basis. Our failure to do so would also impair our ability to execute our business plan.

**The growth of the market for our services depends on the development and maintenance of the internet infrastructure.**

Our business is based on delivering services over the Internet, and the success of our business therefore depends on the development and maintenance of a sound Internet infrastructure. This includes maintenance of a reliable network backbone with the necessary speed, data capacity and security, as well as timely development of complementary products such as high speed modems, for providing reliable Internet access and services. Our ability to increase the speed and scope of our services is limited by and depends upon the speed and reliability of both the Internet and our clients' internal networks. Consequently, as Internet usage increases, the growth of the market for our services depends upon improvements being made to the Internet as well as to individual client's networking infrastructures to alleviate overloading and congestion. In addition, any delays in the adoption of new standards and protocols required to govern increased levels of Internet activity or increased governmental regulation may have a detrimental effect on the Internet infrastructure.

**Our failure to attract and retain software publishers as clients would cause our revenues to decline.**

Our Software and Digital Commerce Services Division generates revenues by providing outsourced services to software publishers. If we cannot develop and maintain satisfactory relationships with software publishers on acceptable commercial terms, we would likely experience a decline in revenues. We also depend on our software publisher clients creating and supporting software products that end-users will purchase. If we are unable to obtain sufficient quantities of software for any reason or if the quality of service provided by these software publishers falls below a satisfactory level, we could also experience a decline in revenues and client satisfaction, and our reputation could be harmed. Our contracts with our software publisher clients are generally one year in duration, with an automatic renewal provision for additional one-year periods, unless we are provided with a written notice at least 90 days before the end of the contract. As is common in our industry, we have no long-term or exclusive contracts or arrangements with any software publishers that guarantee the availability of software products. Software publishers that currently supply software to us may not continue to do and we may be unable to establish new relationships with software publishers to supplement or replace existing relationships.

**Our business plans depend on increasing revenues from E-Business clients.**

The success of our business strategy depends upon increasing fee and service revenues from E-Business clients. Since initiating sales of electronic commerce outsourcing services in 1999, our E-Business Services Division has incurred only net losses. We have made substantial investments in technology and infrastructure and we may not succeed in establishing and maintaining sufficient relationships with E-Business clients to offset these expenses. If we are unable to develop and expand our relationships with E-Business services clients, we will fail to grow revenues as projected.

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

The market for Internet-based, 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 competition to intensify as current competitors expand their product offerings and new competitors enter the market. In addition, our clients and partners may become competitors in the future. Increased competition is likely to result in price reductions, lower average

sales prices, reduced margins, longer sales cycles and a decrease or loss of our market share, any of which reduce our revenues. We face competition from the following sources:

other providers of outsourced electronic commerce solutions, such as Beyond.com Corporation and ReleaseNow Corporation;

software publishers and online retailers who have or may choose to make substantial initial and ongoing investments in order to develop and manage their own e-commerce sites, and who may decide to market this capability to other companies;

system integrators and application service providers that offer tools and services for electronic commerce, including companies that provide a broad range of Internet and server solutions, such as Corio, Inc. and US Internetworking;

companies that provide tools and services enabling one or more of the transaction processing functions of electronic commerce, such as transaction control, data security, customer interaction and database marketing, including BroadVision Corporation, CyberSource Corporation and Preview Systems, Inc.;

in-house development of e-commerce capabilities;

companies that sell, distribute or rent software products over the Internet;

high-traffic, branded Web sites that derive a substantial portion of their revenues from e-commerce and may themselves offer, or provide means for others to offer, software products, such as Amazon.com, Inc.; and

traditional channels and methods of retail and corporate software sales, such as mail order catalogs and retail superstores.

Many of our competitors have, and new potential competitors may have, more experience developing Internet-based software, services, 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, that achieve greater customer acceptance or that 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 revenues to decline.

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

A significant barrier to electronic 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 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 to 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 the Internet. 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 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 a deter potential clients away from our services.

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

The payment by end-users for the purchase of digital goods that we process is typically made by credit card. If we incur significant instances of credit card fraud over an extended period of time it may result in penalties and termination of our credit card acceptance privileges. Loss of our credit card acceptance privileges would severely impact our ability to process the sale of digital goods where the payment method is by credit card. We may be required to expend significant capital and other resources to protect against these fraudulent transactions.

**Implementing our acquisition strategy could result in dilution and operating difficulties.**

We have acquired, and intend to continue acquiring, businesses, technologies, services or products that we believe are strategic, such as businesses that provide outsourcing services to software publishers. For example, in March 2001, we acquired the Market Maker business of Calico Commerce, Inc., which we believe will improve our e-commerce services offerings. Although the integration of the Market Maker business is largely complete, 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. Moreover, the anticipated benefits of any acquisition, including that of the Market Maker business, may not be realized. If a significant number of clients of the acquired businesses cease doing business with us, we would experience lost revenues, 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 or amortization expenses related to goodwill and other intangible assets.

**We have experienced rapid growth and failure to properly manage and sustain our expansion efforts could strain our management and other resources.**

Our ability to successfully offer services and implement our business plan in a rapidly evolving market requires an effective planning and management process. We have rapidly and significantly expanded our operations. In 2000, we increased our number of employees from 278 to 381 and we anticipate that further significant expansion will be required to address potential growth in our client base and market opportunities. Failure to properly manage this expansion could place a significant strain on our managerial, operational and financial resources. Our new employees include a number of key managerial, technical and operations personnel whom we have not yet fully integrated. We expect to add additional key personnel in the near future, including direct sales, marketing and technical personnel. To manage the expected growth of our operations and personnel, we will be required to:

improve existing and implement new operational, financial and management controls, reporting systems and procedures;

install new management information systems; and

train, motivate, retain and manage our employees.

We may be unable to install management information and control systems in an efficient and timely manner, and our current or planned personnel, systems, procedures and controls may be inadequate to support our future operations. In addition, we may be unable to hire, train, retain,

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motivate and manage required personnel or to successfully identify, manage and exploit existing and potential market opportunities.

**Failure to develop our technology to accommodate increased cns 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, and network infrastructure and other technologies to accommodate increases in the volume of traffic on the CNS. Our inability to add software and hardware or to develop and upgrade existing technology, transaction-processing systems or network infrastructure to manage increased traffic on the CNS 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 CNS to handle increased volume. In addition, 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 CNS increase.

**Our industry is characterized by rapid technological change that may make our technology and systems obsolete or cause us to incur substantial costs to adapt to these changes.**

To remain competitive, we must continue to enhance and improve the responsiveness, functionality and features of our CNS 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 electronic commerce industry are characterized by rapid technological change, changes in user 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 change by licensing and internally developing 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 CNS technology and other proprietary technology involves significant technical and business risks. We may fail to use new technologies effectively or 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 CNS 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 CNS 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 damage to, or systems interruption that impairs our ability to accept and fill client orders could result in an immediate loss of revenues to us, and could cause some clients to purchase services offered by our competitors. In addition, frequent systems failures could harm our reputation.

Our systems and operations are vulnerable to damage or interruption from:

fire, flood and other natural disasters;

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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 presently have no offsite back-up facilities and do not carry sufficient business interruption insurance to fully compensate us for losses that may occur.

**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 revenues, adverse end-user reaction and negative publicity or require expensive corrections. As a result, clients who experience these adverse consequences either directly or indirectly as a result of our services could bring claims against us for substantial damages. Any claims asserted could exceed the level of our insurance. The insurance we carry may not continue to be available on economically reasonable terms, or at all. The successful assertion of one or more large claims that are uninsured, exceed insurance coverage or result in changes to insurance policies, including premium increases, could adversely affect our operating results or financial condition.

**Our chief executive officer and key technical employees are critical to our business and if they do not remain with us in the future, we may be unable to effectively replace them.**

Our future success significantly depends on the continued services and performance of our senior management, particularly Joel A. Ronning, our chief executive officer and member of the office of the president. Our performance also depends on our ability to retain and motivate our key technical employees who are skilled in maintaining the CNS. The loss of the services of any of our executive officers or key technical 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. We have a long-term employment agreement only with Mr. Ronning and we do not maintain any key person life insurance policies.

**We must continually attract and retain technical and other key personnel in order to be able to successfully execute our business strategy**

Our future success depends on our ability to continue to identify, attract, hire, train, retain and motivate highly skilled technical, managerial, operations, merchandising, sales and marketing and client service personnel. Competition for this personnel is intense, particularly in the Internet industry, and we may be unable to successfully attract, assimilate or retain sufficiently qualified personnel. Failure to do so could harm our business growth and ability to achieve profitability. In addition, the market price of our common stock has fluctuated substantially since our initial public offering in August 1998. Consequently, potential employees may perceive our equity incentives such as stock options as less attractive and current employees whose options are no longer attractively priced may choose not to remain with our organization. In that case, our ability to attract employees will be adversely affected. Finally, should our stock price substantially decline, the retention value of stock options granted since our initial public offering will decline and our employees may choose not to remain with our organization.

**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 United States and foreign 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 United States 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.

**Claims of infringement of other parties' intellectual property rights could require us to expend significant resources.**

From time to time, we may receive notice of claims of infringement of other parties' proprietary rights. Any future assertions or prosecutions of claims like these could require us to expend significant financial and managerial resources. The defense of any claims, whether these claims are with or without merit, could be time-consuming, result in costly litigation and diversion of technical and management personnel, cause product shipment 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.

**Claims against us related to the software products that we deliver electronically could also require us to expend significant resources.**

Claims may be made against us for negligence, copyright or trademark infringement or other theories based on the nature and content of software products that we deliver electronically and are subsequently distributed to others. Because we did not create these software products, we are generally not in a position to know the quality of or nature of the content of these products. Although we carry general liability insurance, our insurance may not cover potential claims of this type, adequately cover all costs incurred in defense of potential claims or indemnify us for all liability that may be imposed. Any costs or imposition of liability that are not covered by insurance or in excess of insurance coverage could be expensive and time-consuming to address, distract management and delay product deliveries even if we were ultimately successful in the defense of these claims.

**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 federal, state and local laws as other companies conducting business on the Internet. Today there are relatively few laws specifically directed towards conducting business on 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 state and federal levels. These laws and regulations could cover issues such as:

user privacy with respect to adults and minors;

pricing and taxation;

fraud;

quality of products and services;

advertising;

intellectual property rights; and

information security.

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 could also harm our operating results and substantially increase the cost to us of doing business. It may also require significant management resources to respond to any changes in these laws. The vast majority of these laws were adopted prior to the advent of the Internet, and do not contemplate or address the unique issues raised thereby. Those laws that do 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.

**Laws relating to user information and online privacy may limit the collection of end-user data for our clients.**

We collect and maintain end-user data for our clients, which subjects us to increasing federal and state regulation related to online privacy and the use of personal user information. Several states have proposed legislation that would limit the uses of personal user information gathered online or require online services to establish privacy policies. In addition, the U.S. Federal Trade Commission, or the FTC, is considering adopting regulations regarding the collection and use of personal identifying information obtained from individuals when accessing Web sites, with particular emphasis on information obtained from minors. These regulations may include requirements that companies establish procedures to, among other things:

give adequate notice to users regarding information collection and disclosure practices;

provide users with the ability to have personal information deleted from a company's database;

provide users with access to their collected personal information and the ability to correct inaccuracies;

clearly identify affiliations with third parties that may collect information or sponsor activities on another company's Web site; and

obtain express parental consent prior to collecting and using personal information from children under 13 years of age.

Bills are also pending in Congress that would improve online privacy protections for adults. Laws of this kind require that we establish procedures to disclose and notify users of privacy and security policies, obtain consent from users for collection and use of information, or provide users with the ability to access, correct and delete personal information stored by us. Even in the absence of these regulations, the Federal Trade Commission 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 demographic and personal information from end-users, which could adversely affect our ability to comprehensively serve our clients.

**The adoption and implementation of international laws and regulations applicable to e-commerce may impair our efforts to expand revenues from international transactions.**

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 unless the receiving country has enacted individual privacy protection laws at least as strong as those enacted by the European Union privacy directive. The United States and the European Union have not yet resolved this matter, and they may not ever do so, in a manner favorable to our clients or us.

**Future Laws imposed on e-commerce may substantially increase the 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, foreign 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.

In addition, 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 are qualified to do business only in California, Connecticut, Minnesota and Washington. 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.

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

We sell software products and services to end-users outside the United States and we intend to continue to expand our international presence. Expansion into international markets, particularly Europe, requires significant resources that we may fail to recover by generating additional revenues. Conducting business outside of the United States is subject to risks, including:

changes in regulatory requirements and tariffs;

uncertainty of application or governing of local laws;

reduced protection of intellectual property rights;

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difficulties in distribution for international sales;

higher incidences of credit card fraud and difficulties in accounts receivables collection;

the burden and cost of complying with a variety of foreign laws; and

political or economic constraints on international trade or instability.

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.

**New obligations to collect or pay sales tax could substantially increase the cost to us of doing business.**

We do not currently collect sales, use or other similar taxes with respect to ESD or shipments of software products into states other than California, Connecticut, Minnesota and Washington. The application of sales tax to interstate and international sales over the Internet is unclear and evolving. Local, state or foreign jurisdictions may seek to impose sales or use tax collection obligations on out-of-state companies like ours that engage in electronic commerce. A successful assertion by one or more states or any foreign country that we should collect sales, use or other taxes on the sale of merchandise through our E-Business Service Division or on shipments of software could harm our results of operations. In addition, any failure by an E-Business client to collect obligatory sales or use taxes could cause the relevant jurisdiction to attempt imposing that obligation on us.

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

The stock market, and the trading prices of Internet-related companies in particular, have recently been notably volatile. This volatility is likely to continue in the short-term 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. In the past, following periods of volatility in the market price of a company's securities, securities class-action litigation has often been instituted against that company. Litigation, if instituted, could result in substantial costs and a diversion of management's attention and resources. Factors that could cause our stock price in particular to fluctuate include:

actual or anticipated variations in quarterly operating results;

announcements of technological innovations;

new products or services that we or our competitors offer;

changes in financial estimates by securities analysts;

conditions or trends in the Internet and online commerce industries;

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

our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments;

additions or departures of key personnel; and

sales of our common stock.

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

We require substantial working capital to fund our business. If capital requirements vary materially from those currently planned, we may require additional financing sooner than anticipated. If additional funds are raised through the issuance of equity securities, the percentage ownership of our stockholders will be reduced, stockholders may experience additional dilution or these equity securities may have rights, preferences or privileges senior to those of our common stock. We have had significant operating losses and negative cash flow from operations since inception and expect to continue to do so for the near future. We believe that our existing capital resources will be sufficient to meet our capital requirements for at least the next 24 months. However, our capital requirements depend on several factors, including the rate of market acceptance of our products, the ability to expand our client base and the growth of sales and marketing. 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 achieve profitability.

**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.

**ITEM 2. PROPERTIES.**

We currently lease approximately 70,000 square feet of office and warehouse space in two facilities in Eden Prairie, Minnesota. Both agreements expire on July 31, 2003. We also lease on a month-to-month basis approximately 900 square feet of office space in suburban London that houses our European sales office. In addition, we lease on a short-term basis offices in Cheshire, Connecticut and Issaquah, Washington, with space of 1,700 and 800 square feet, respectively. We are currently seeking to expand our office space in Minnesota by approximately 20,000 square feet, which we believe we will be able to lease at competitive market rates.

**ITEM 3. LEGAL PROCEEDINGS.**

From time to time, we may be involved in litigation relating to claims arising out of the ordinary course of business. We presently are not subject to any material legal proceedings.

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

None.

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**PART II**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.**

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Our Common Stock is traded on the Nasdaq National Market under the symbol "DRIV." Public trading of the Common Stock commenced on August 11, 1998. Prior to that, there was no public market for the Common Stock. The following table sets forth, for the periods indicated, the high and low sale price per share of the Common Stock on the Nasdaq National Market. These over-the-counter market quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	<u>HIGH</u>	<u>LOW</u>
<b>1999</b>		
First Quarter	\$ 61.38	\$ 27.44
Second Quarter	\$ 51.38	\$ 19.56
Third Quarter	\$ 36.13	\$ 18.25
Fourth Quarter	\$ 43.63	\$ 19.63
<b>2000</b>		
First Quarter	\$ 37.38	\$ 21.00
Second Quarter	\$ 22.13	\$ 7.00
Third Quarter	\$ 9.13	\$ 5.38
Fourth Quarter	\$ 7.38	\$ 2.19

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## Trustee, Principal Paying Agent and Transfer Agent

HSBC Bank USA, National Association is the trustee under the indenture and the principal corporate trust office of the trustee in The City of New York is also designated as the principal paying agent, registrar, transfer agent and calculation agent for the notes. We may at any time designate additional agents or rescind the designation of any agents or approve a change in the office through which any agent acts.

## Book-Entry System

We will issue the notes of each series in the form of one or more fully registered global securities. We will deposit these global securities with, or on behalf of, DTC and register these securities in the name of DTC's nominee. Direct and indirect participants in DTC will record beneficial ownership of the notes by individual investors. The transfer of ownership of beneficial interests in a global security will be effected only through records maintained by DTC or its nominee, or by participants or persons that hold through participants.

Investors may elect to hold beneficial interests in the global securities through either DTC, Clearstream or Euroclear if they are participants in these systems, or indirectly through organizations which are participants in these systems. Beneficial interests in the global securities will be held in minimum denominations of \$2,000 and integral multiples of \$1,000 in excess thereof.

Upon receipt of any payment in respect of a global security, DTC or its nominee will immediately credit participants' accounts with amounts proportionate to their respective beneficial interests in the principal amount of the global security as shown in the records of DTC or its nominee. Payments by participants to owners of beneficial interests in a global security held through participants will be governed by standing instructions and customary practices and will be the responsibility of those participants.

DTC holds securities of institutions that have accounts with it or its participants. Through its maintenance of an electronic book-entry system, DTC facilitates the clearance and settlement of securities transactions among its participants and eliminates the need to deliver securities certificates physically. DTC's participants include securities brokers and dealers, including the underwriters of this offering, banks, trust companies, clearing corporations and other organizations. DTC is owned by a number of its participants and by the New York Stock Exchange, Inc., the American Stock Exchange, Inc. and the Financial Industry Regulatory Authority, Inc. Access to DTC's book-entry system is also available to others such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a participant, either directly or indirectly. DTC agrees with and represents to its participants that it will administer its book-entry system in accordance with its rules and bylaws and requirements of law. The rules applicable to DTC and its participants are on file with the SEC.

Clearstream and Euroclear will hold interests on behalf of their participants through customers' securities accounts in Clearstream's and Euroclear's names on the books of their respective depositaries, which in turn will hold interests in customers' securities accounts in the depositaries' names on the books of DTC. At the present time, Citibank, N.A. acts as U.S. depositary for Clearstream and JPMorgan Chase Bank, N.A. acts as U.S. depositary for Euroclear, or, collectively, the "U.S. Depositaries."

Clearstream holds securities for its participating organizations, or "Clearstream Participants," and facilitates the clearance and settlement of securities transactions between Clearstream Participants





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through electronic book-entry changes in accounts of Clearstream Participants, thereby eliminating the need for physical movement of certificates. Clearstream provides to Clearstream Participants, among other things, services for safekeeping, administration, clearance and settlement of internationally traded securities and securities lending and borrowing. Clearstream interfaces with domestic markets in several countries.

Clearstream is registered as a bank in Luxembourg and as such is subject to regulation by the *Commission de Surveillance du Secteur Financier* and the *Banque Centrale du Luxembourg*, which supervise and oversee the activities of Luxembourg banks. Clearstream Participants are worldwide financial institutions, including underwriters, securities brokers and dealers, banks, trust companies and clearing corporations, and may include the underwriters or their affiliates. Indirect access to Clearstream is available to other institutions that clear through or maintain a custodial relationship with a Clearstream Participant. Clearstream has established an electronic bridge with Euroclear as the operator of the Euroclear System, or the "Euroclear Operator," in Brussels to facilitate settlement of trades between Clearstream and the Euroclear Operator.

Distributions with respect to the notes of a series held beneficially through Clearstream will be credited to cash accounts of Clearstream Participants in accordance with its rules and procedures, to the extent received by the U.S. Depositary for Clearstream.

Euroclear holds securities and book-entry interests in securities for participating organizations, or "Euroclear Participants" and facilitates the clearance and settlement of securities transactions between Euroclear Participants, and between Euroclear Participants and participants of certain other securities intermediaries through electronic book-entry changes in accounts of such participants or other securities intermediaries. Euroclear provides Euroclear Participants with, among other things, safekeeping, administration, clearance and settlement, securities lending and borrowing, and related services.

Euroclear Participants are investment banks, securities brokers and dealers, banks, central banks, supranationals, custodians, investment managers, corporations, trust companies and certain other organizations and may include the underwriters or their affiliates. Non-participants in Euroclear may hold and transfer beneficial interests in a global security through accounts with a Euroclear Participant or any other securities intermediary that holds a book-entry interest in a global security through one or more securities intermediaries standing between such other securities intermediary and Euroclear.

Distributions with respect to notes of a series held beneficially through Euroclear will be credited to the cash accounts of Euroclear Participants in accordance with the Terms and Conditions, to the extent received by the U.S. Depositary for Euroclear.

Transfers between Euroclear Participants and Clearstream Participants will be effected in the ordinary way in accordance with their respective rules and operating procedures.

Cross-market transfers between DTC's participating organizations, or the "DTC Participants," on the one hand, and Euroclear Participants or Clearstream Participants, on the other hand, will be effected through DTC in accordance with DTC's rules on behalf of Euroclear or Clearstream, as the case may be, by its U.S. Depositary; however, such cross-market transactions will require delivery of instructions to Euroclear or Clearstream, as the case may be, by the counterparty in such system in accordance with the rules and procedures and within the established deadlines (European time) of such system. Euroclear or Clearstream, as the case may be, will, if the transaction meets its settlement requirements, deliver instructions to its U.S. Depositary to take action to effect final settlement on its behalf by delivering or receiving interests in the global security in DTC, and making or receiving

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payment in accordance with normal procedures for same-day fund settlement applicable to DTC. Euroclear Participants and Clearstream Participants may not deliver instructions directly to their respective U.S. Depositories.

Due to time zone differences, the securities accounts of a Euroclear Participant or Clearstream Participant purchasing an interest in a global security from a DTC Participant in DTC will be credited, and any such crediting will be reported to the relevant Euroclear Participant or Clearstream Participant during the securities settlement processing day (which must be a business day for Euroclear or Clearstream) immediately following the settlement date of DTC. Cash received in Euroclear or Clearstream as a result of sales of interests in a global security by or through a Euroclear Participant or Clearstream Participant to a DTC Participant will be received with value on the settlement date of DTC but will be available in the relevant Euroclear or Clearstream cash account only as of the business day for Euroclear or Clearstream following DTC's settlement date.

The information in this section concerning DTC, Euroclear and Clearstream and their book-entry systems has been obtained from sources that we believe to be reliable, but we take no responsibility for the accuracy of that information.

None of us, any of the underwriters and the trustee will have any responsibility for the performance by Euroclear or Clearstream or their respective participants of their respective obligations under the rules and procedures governing their operations.

Although DTC, Clearstream and Euroclear have agreed to the foregoing procedures in order to facilitate transfers of securities among participants of DTC, Clearstream and Euroclear, they are under no obligation to perform or continue to perform such procedures and they may discontinue the procedures at any time.

### **Same-Day Settlement and Payment**

Initial settlement for the notes will be made in immediately available funds. Secondary market trading between DTC participants will occur in the ordinary way in accordance with DTC rules and will be settled in immediately available funds using DTC's Same-Day Funds Settlement System.

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**TAX CONSIDERATIONS**

The following summary of material considerations relating to U.S. federal income tax, Bermuda tax and Swiss tax and the European Union Savings Tax Directive is based upon laws, regulations, decrees, rulings, administrative practice and judicial decisions in effect at the date of this prospectus supplement. Legislative, judicial or administrative changes or interpretations may, however, be forthcoming. Any such changes or interpretations could affect the tax consequences to holders of the notes, possibly on a retroactive basis, and could alter or modify the statements and conclusions set forth herein. This summary does not purport to be a legal opinion or to address all tax aspects that may be relevant to a holder of the notes. Prospective purchasers of the notes are advised to consult their own tax advisers as to the tax consequences, under the tax laws of the country of which they are resident, of a purchase of notes including, without limitation, the consequences of the receipt of interest and (if applicable) any premium on, and of the sale or redemption of, the notes or any interest therein.

The summary in respect of Swiss tax considerations does not deal with the position of certain classes of noteholders, such as dealers, and relates only to those persons who are the absolute beneficial owners of the notes and who hold the notes as an investment.

**United States Taxation**

**U.S. Holders**

The following discussion summarizes certain U.S. federal income tax considerations that may be relevant to you if you purchase notes in the initial offering at the original issue price and are a "U.S. holder." You will be a "U.S. holder" if you are an individual who is a citizen or resident of the United States, a U.S. domestic corporation, or any other person that is subject to U.S. federal income tax on a net income basis in respect of an investment in the notes. This summary deals only with U.S. holders that hold notes as capital assets. It does not address considerations that may be relevant to you if you are an investor that is subject to special tax rules, such as a bank, thrift, real estate investment trust, regulated investment company, insurance company, pass-through entity, dealer in securities or currencies, trader in securities or commodities that elects mark-to-market treatment, person that will hold notes as a hedge against currency risk or as a position in a "straddle" or conversion transaction, tax-exempt organization or a person whose "functional currency" is not the U.S. dollar.

You should consult your tax adviser about the tax consequences of holding notes, including the relevance to your particular situation of the considerations discussed below, as well as the relevance to your particular situation of state, local, non-U.S., or other tax laws.

*Payments or Accruals of Interest*

Payments or accruals of interest on a note will be taxable to you as ordinary interest income at the time that you receive or accrue such amounts (in accordance with your regular method of tax accounting). Interest income on the 2014 notes will be treated as U.S. source income and interest income on the 2019 notes will be treated as foreign source income for U.S. federal income tax purposes, which may be relevant in calculating a U.S. holder's foreign tax credit limitation.

*Sale or Exchange of Notes*

Upon the sale, exchange or other taxable disposition of a note, you generally will recognize gain or loss equal to the difference between the amount realized on the disposition (less any accrued interest,

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which will be taxable as such) and your tax basis in such note (generally, its cost less any principal payments previously received). Any such gain or loss generally will be U.S.-source capital gain or loss and will be long-term capital gain or loss (which long-term capital gain is currently subject to taxation at reduced rates for non-corporate taxpayers) if you have held the note for more than one year. The deductibility of capital losses is subject to limitations.

*Information Reporting and Backup Withholding*

A paying agent must file information returns with the U.S. Internal Revenue Service ("IRS") in connection with payments on the notes made within the United States, or through certain U.S.-relevant financial intermediaries, to certain United States persons. If you are a United States person, you generally will not be subject to U.S. backup withholding tax on such payments if you provide your taxpayer identification number to the paying agent. The amount of any backup withholding from a payment to a U.S. holder will be allowed as a credit against the U.S. holder's U.S. federal income tax liability and may entitle the U.S. holder to a refund, provided that the required information is timely furnished to the IRS. You also may be subject to information reporting and backup withholding tax requirements with respect to the proceeds from a sale of the notes. If you are not a United States person, you may have to comply with certification procedures to establish that you are not a United States person in order to avoid information reporting and backup withholding tax requirements.

**Non-U.S. Holders**

Under current U.S. federal income tax law,

- (a) payment on a 2014 note by us or any paying agent to a holder that is a non-U.S. holder (as defined below) will not be subject to withholding of U.S. federal income tax, provided that, with respect to payments of interest, (i) the holder does not actually or constructively own 10% or more of the combined voting power of all classes of our stock and is not a controlled foreign corporation related to us through stock ownership, (ii) the holder is not a bank extending credit to us in the ordinary course of its trade or business, and (iii) the beneficial owner provides a statement signed under penalty of perjury that includes its name and address and certifies that it is a non-U.S. holder in compliance with applicable requirements (or satisfies certain documentary evidence requirements for establishing that it is a non-U.S. holder); and
- (b) a holder of a note that is a non-U.S. holder will not be subject to U.S. federal income tax on gain realized on the sale, exchange or redemption of the note, unless (i) such gain is effectively connected with the conduct by the holder of a trade or business in the United States or (ii) in the case of gain realized by an individual holder, the holder is present in the United States for 183 days or more in the taxable year of the sale and either (A) such gain or income is attributable to an office or other fixed place of business maintained in the United States by such holder or (B) such holder has a tax home in the United States.

Payments on a 2014 note owned by a non-U.S. holder will not be subject to information reporting requirements or backup withholding tax if the statement described in clause (a) of the preceding paragraph is duly provided to the paying agent.

Payment on a note by the U.S. office of a custodian, nominee or other agent of the beneficial owner of such note will be subject to information reporting requirements and backup withholding tax unless the beneficial owner timely certifies its non-U.S. status under penalties of perjury or otherwise establishes an exemption.

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Information reporting requirements and backup withholding tax will not apply to any payment of the proceeds of the sale of a note effected outside the United States by a foreign office of a foreign "broker" (as defined in applicable U.S. Treasury regulations), provided that such broker (i) derives less than 50% of its gross income for certain periods from the conduct of a trade or business in the United States, (ii) is not a controlled foreign corporation for U.S. federal income tax purposes and (iii) is not a foreign partnership that, at any time during its taxable year, is more than 50% (by income or capital interest) owned by U.S. persons or is engaged in the conduct of a U.S. trade or business. Payment of the proceeds of the sale of a note effected outside the United States by a foreign office of any other broker will not be subject to backup withholding tax, but will be subject to information reporting requirements unless such broker has documentary evidence in its records that the beneficial owner is a non-U.S. holder and certain other conditions are met, or the beneficial owner otherwise establishes an exemption. Payment of the proceeds of a sale of a note by the U.S. office of a broker will be subject to information reporting requirements and backup withholding tax unless the beneficial owner certifies its non-U.S. status under penalties of perjury or otherwise establishes an exemption.

For purposes of applying the rules set forth under the heading "non-U.S. holders" to an entity that is treated as fiscally transparent (e.g., a partnership) for U.S. federal income tax purposes, the beneficial owner means each of the ultimate beneficial owners of the entity.

For purposes of the discussion under this heading "non-U.S. holders" a "non-U.S. holder" is a holder of a note or coupon that is not a U.S. holder (as defined above).

## **Bermuda Taxation**

Under current law, no income, withholding or other taxes or stamp, registration or other duties are imposed in Bermuda upon the issue, transfer or sale of the 2019 notes, or payments made in respect of the 2019 notes. As of the date hereof, there is no Bermuda income, company or profits tax, withholding tax, capital gains tax, capital transfer tax, estate duty or inheritance tax payable in respect of capital gains realized on a disposition of securities issued by Novartis Securities Investment Ltd. or in respect of distributions by Novartis Securities Investment Ltd. with respect to its securities. Furthermore, Novartis Securities Investment Ltd. has received from the Minister of Finance of Bermuda under the Exempted Undertakings Tax Protection Act of 1966 an undertaking that, in the event of there being enacted in Bermuda any legislation imposing any tax computed on profits or income, including any dividend or capital gains withholding tax, or computed on any capital assets, gain or appreciation or any tax in the nature of an estate or inheritance tax or duty, the imposition of such tax shall not be applicable to Novartis Securities Investment Ltd. or any of its operations or obligations until March 28, 2016. This undertaking applies to securities issued by Novartis Securities Investment Ltd. It does not, however, prevent the application of Bermuda taxes to persons ordinarily resident in Bermuda. As an exempted company, Novartis Securities Investment Ltd. is liable to pay, in Bermuda, an annual registration fee which is currently U.S.\$4,070.

## **Swiss Taxation**

### **Swiss Withholding Tax**

According to the present practice of the Swiss Federal Tax Administration, payments of principal and interest (and discount or premium, if any) or gains in respect of the notes by the relevant Issuer or the Guarantor are not subject to Swiss Withholding Tax (*Verrechnungssteuer*), if the proceeds from the notes are neither directly nor indirectly used in Switzerland.

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**EU Savings Tax for Swiss Paying Agents**

The payment of interest (and discount or premium, if any) in respect of the notes by the relevant Issuer or the Guarantor or the payment of accrued interest upon a sale of the notes by the purchaser may be subject to a deduction of 20% until July 1, 2011 or 35% thereafter, if such payment is made to an EU resident individual (or certain entities or vehicles) via a Swiss paying agent. The deduction is not applied if the recipient of the payment voluntarily elects to have details on the payment transmitted to the tax authorities of his state of residence.

**Issue or Transfer Stamp Taxes**

The issue of notes is not subject to Issue or Transfer Stamp Taxes, provided that proceeds from the notes are neither directly nor indirectly used in Switzerland.

Secondary market transactions in notes may be subject to Transfer Stamp Tax of up to 0.3% of the consideration paid, if a Swiss or Liechtenstein securities dealer (as defined in the Swiss Stamp Tax Act) is involved in the transaction as party or as intermediary.

Redemption of notes is not subject Issue or Transfer Stamp Taxes.

**Personal Income Tax**

Under present Swiss tax law, an individual noteholder who is not Swiss tax resident and who, during the tax year, has not engaged in trade or business through a permanent establishment, sole proprietorship or partnership in Switzerland and who is not subject to Swiss taxation for any other reason, will not become subject to Swiss personal income tax on the interest (and discount or premium, if any) or gains from the notes because of the mere acquisition, ownership or disposal of notes.

A Swiss tax resident individual who holds notes as part of his private assets is subject to income tax on the interest (and discount or premium, if any) derived from the notes as part of his overall net income. A gain realized upon a sale of notes by such individual is not subject to income tax.

A Swiss tax resident individual holding notes as part of his Swiss business assets (including a professional securities dealer) is subject to income tax on any interest (and discount or premium, if any) and gain derived from the notes as part of the overall income. Losses incurred on notes by such investors are tax deductible, if certain conditions are met. Similar rules apply to foreign resident individuals, which have a permanent establishment or business in Switzerland with which the notes are effectively connected.

**Profit Tax**

Under present Swiss tax law, a corporate noteholder who is not Swiss tax resident and who, during the tax year, has not engaged in trade or business through a permanent establishment or partnership in Switzerland and who is not subject to Swiss taxation for any other reason, will not become subject to Swiss profit tax on the interest (and discount or premium, if any) or gain from the notes because of the mere acquisition, ownership or disposal of notes.

A Swiss tax resident corporate entity holding notes is subject to profit tax on any profit (interest, discount, premium and gains) derived from the notes as part of the overall profit. Losses incurred on notes by such investors are tax deductible, if certain conditions are met. Similar rules apply to foreign

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resident corporate entities, which have a permanent establishment or business in Switzerland with which the notes are effectively connected.

**European Union Savings Tax Directive**

On June 3, 2003, the Council of the European Union adopted a directive (Directive 2003/48/EC) on the taxation of savings income (the "EU Savings Tax Directive"). Pursuant to the directive, a member state of the European Union (the "EU") will be required to provide to the tax authorities of other EU member states information regarding payments of interest (or other similar income) paid by a person within its jurisdiction to individual residents of such other EU member states, except that Belgium, Luxembourg and Austria will instead operate a withholding tax system for a transitional period in relation to such payments. EU member states were required to put the EU Savings Tax Directive into effect by July 1, 2005.

On October 26, 2004, the European Community and Switzerland entered into an agreement on the taxation of savings income by way of a withholding tax system and voluntary declaration in the case of transactions between parties in the EU member states and Switzerland. On the basis of such agreement, Switzerland has introduced a withholding tax on interest payments or other similar income paid by a paying agent within Switzerland to EU resident individuals as of July 1, 2005. The withholding tax is to be withheld at a rate of 20% until July 1, 2011 and at a rate of 35% thereafter. The beneficial owner of the interest payments may be entitled to a tax credit or refund of the withholding if certain conditions are met.

Prospective purchasers of the notes should consult their advisors concerning the impact of the EU Savings Tax Directive. If any of Novartis Capital Corporation, Novartis Securities Investment Ltd., Novartis AG, any paying agent or any institution where the notes are deposited are required to withhold any amount as a direct or indirect consequence of the EU Savings Tax Directive, we will not be required to pay any additional amounts relating to such withholding. See "Description of Debt Securities Covenants Payment of Additional Amounts" in the accompanying prospectus.

Table of Contents**UNDERWRITING**

Under the terms and subject to the conditions contained in an underwriting agreement dated \_\_\_\_\_, 2009, we have agreed to sell to the underwriters named below, for whom J.P. Morgan Securities Inc., Banc of America Securities LLC, Citigroup Global Markets Inc. and Goldman, Sachs & Co. are acting as representatives, the following respective principal amounts of the notes:

<b>Underwriter</b>	<b>Principal amount of 2014 notes</b>	<b>Principal amount of 2019 notes</b>
J.P. Morgan Securities Inc.	\$	\$
Banc of America Securities LLC		
Citigroup Global Markets Inc.		
Goldman, Sachs & Co.		
<b>Total</b>	<b>\$</b>	<b>\$</b>

The underwriting agreement provides that the underwriters are obligated to purchase all of the notes if any are purchased. The underwriting agreement also provides that if an underwriter defaults, the purchase commitments of non-defaulting underwriters may be increased or the offering of notes may be terminated.

The underwriters propose to offer each series of notes initially at the respective price to public listed on the cover page of this prospectus supplement and to other broker-dealers at the applicable price to public less a selling concession of % of the principal amount per 2014 note and % of the principal amount per 2019 note. The underwriters and the other broker-dealers may allow a discount of % of the principal amount per 2014 note and % of the principal amount per 2019 note on sales to other broker-dealers. After the initial public offering, the underwriters may change the price to public and concession and discount to broker-dealers.

We estimate that our expenses (which consist of, among other fees, SEC registration fees, legal fees and expenses, accounting fees and expenses and printing expenses) for this offering, excluding underwriting discounts, will be approximately \$ \_\_\_\_\_. The underwriters have agreed to reimburse us for a portion of our expenses in connection with this offering.

The notes are a new issue of securities with no established trading market. The notes will not be listed on any securities exchange or interdealer market quotation system. One or more of the underwriters intends to make a secondary market for the notes. However, they are not obligated to do so and may discontinue making a secondary market for the notes at any time without notice. No assurance can be given as to how liquid the trading market for the notes will be.

Each underwriter has agreed that it will not offer or sell, directly or indirectly, any of the notes in any jurisdiction where such offer or sale is not permitted.

We have agreed to indemnify the underwriters against liabilities under the Securities Act of 1933, as amended (the "Securities Act"), or contribute to payments that the underwriters may be required to make in that respect.

In the ordinary course of their respective businesses, the underwriters and their affiliates have engaged, and in the future may engage, in commercial banking and/or investment banking transactions with us and our affiliates.



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In connection with the offering, the underwriters may engage in stabilizing transactions, over-allotment transactions, syndicate covering transactions and penalty bids in accordance with Regulation M under the Exchange Act.

Stabilizing transactions permit bids to purchase the underlying security so long as the stabilizing bids do not exceed a specified maximum.

Over-allotment involves sales by the underwriters of notes in excess of the principal amount of notes the underwriters are obligated to purchase, which creates a syndicate short position.

Syndicate covering transactions involve purchases of notes in the open market after the distribution has been completed in order to cover syndicate short positions.

Penalty bids permit the underwriters to reclaim a selling concession from a syndicate member when the notes originally sold by such syndicate member are purchased in a stabilizing or a syndicate covering transaction to cover syndicate short positions.

These stabilizing transactions, syndicate covering transactions and penalty bids may have the effect of raising or maintaining the market price of the notes or preventing or retarding a decline in the market price of the notes. As a result, the price of the notes may be higher than the price that might otherwise exist in the open market.

There is no assurance that the underwriters will undertake stabilization action. Such stabilizing, if commenced, may be discontinued at any time and, if begun, must be brought to an end after a limited period. Any stabilization action or over-allotment must be conducted by the underwriters in accordance with all applicable laws and rules.

We expect that delivery of the notes will be made against payment therefor on or about \_\_\_\_\_, 2009, which is the fifth business day after the date hereof. Under Rule 15c6-1 of the Exchange Act, trades in the secondary market generally are required to settle in three business days, unless the parties to any such trade expressly agree otherwise. Accordingly, purchasers who wish to trade the notes on the date hereof or the next following business day will be required, by virtue of the fact that the notes initially will not settle in T+3, to specify an alternative settlement cycle at the time of such trade to prevent a failed settlement and should consult their own adviser.

## SELLING RESTRICTIONS

### European Economic Area

In relation to each Member State of the European Economic Area which has implemented the Prospectus Directive (each a "Relevant Member State"), each underwriter has represented and agreed that, with effect from and including the date on which the Prospectus Directive is implemented in that Relevant Member State, or (the "Relevant Implementation Date"), it has not made and will not make an offer of notes which are the subject of the offering contemplated by this prospectus supplement to the public in that Relevant Member State other than:

- (a) at any time to legal entities that are authorized or regulated to operate in the financial markets or, if not so authorized or regulated, whose corporate purpose is solely to invest in securities;

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- (b) at any time to any legal entity that has two or more of (i) an average of at least 250 employees during the last financial year; (ii) a total balance sheet of more than €43,000,000 and (iii) an annual net turnover of more than €50,000,000, as shown in its last annual or consolidated accounts;
- (c) at any time to fewer than 100 natural or legal persons (other than qualified investors as defined in the Prospectus Directive) subject to obtaining the prior consent of the representatives of the underwriters; or
- (d) in any other circumstances falling within Article 3(2) of the Prospectus Directive, provided that no such offer of notes shall require us or any underwriter to publish a prospectus pursuant to Article 3 of the Prospectus Directive or supplement a prospectus pursuant to Article 16 of the Prospectus Directive.

For the purposes of this provision, the expression an "offer of notes to the public" in relation to any notes in any Relevant Member State means the communication in any form and by any means of sufficient information on the terms of the offer and notes to be offered so as to enable an investor to decide to purchase or subscribe the notes, as the same may be varied in that Member State by any measure implementing the Prospectus Directive in that Member State and the expression "Prospectus Directive" means Directive 2003/71/EC and includes any relevant implementing measure in each Relevant Member State.

**United Kingdom**

Each underwriter has represented and agreed, and each further underwriter appointed under the notes will be required to represent and agree, that:

- (a) it has only communicated or caused to be communicated and will only communicate or cause to be communicated an invitation or inducement to engage in investment activity (within the meaning of Section 21 of the Financial Services and Markets Act of 2000 (the "FSMA")) received by it in connection with the issue or sale of any securities in circumstances in which section 21(1) of the FSMA does not apply to Novartis Capital Corporation, Novartis Securities Investment Ltd. or Novartis AG.
- (b) it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the securities in, from or otherwise involving the United Kingdom.

**The Grand Duchy of Luxembourg**

In addition to the cases described in the European Economic Area selling restriction in which the underwriters can make an offer of notes to the public in an EEA member state (including the Grand Duchy of Luxembourg) ("Luxembourg"), the underwriters can also make an offer of notes to the public in Luxembourg:

- (a) at any time, to national and regional governments, central banks, international and supranational institutions (such as the International Monetary Fund, the European Central Bank, the European Investment Bank) and other similar international organizations;
- (b) at any time, to legal entities which are authorized or regulated to operate in the financial markets (including credit institutions, investment firms, other authorized or regulated financial

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institutions, undertakings for collective investment and their management companies, pension and investment funds and their management companies, insurance undertakings and commodity dealers) as well as entities not so authorized or regulated whose corporate purpose is solely to invest in securities; and

(c)

at any time, to certain natural persons or small and medium-sized enterprises (as defined in the Luxembourg act dated 10 July 2005 on prospectuses for securities implementing the Directive 2003/71/EC (the "Prospectus Directive") into Luxembourg law) recorded in the register of natural persons or small and medium-sized enterprises considered as qualified investors as held by the *Commission de surveillance du secteur financier* as competent authority in Luxembourg in accordance with the Prospectus Directive.

**Switzerland**

This prospectus supplement and the accompanying prospectus do not constitute an issue prospectus pursuant to Article 652a or Article 1156 of the Swiss Code of Obligations. The notes will not be listed on the SIX Swiss Exchange and, therefore, this prospectus supplement and the accompanying prospectus may not comply with the disclosure standards of the listing rules (including any additional listing rules or prospectus schemes) of the SIX Swiss Exchange. Accordingly, the notes may not be offered to the public in or from Switzerland, but only to a selected and limited circle of investors, which do not subscribe to the notes with a view to distribution. The investors will be individually approached by any underwriter from time to time.

**Hong Kong**

The notes may not be offered or sold by means of any document other than (i) in circumstances which do not constitute an offer to the public within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), or (ii) to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap.571, Laws of Hong Kong) and any rules made thereunder, or (iii) in other circumstances which do not result in this prospectus supplement and the accompanying prospectus being a "prospectus" within the meaning of the Companies Ordinance (Cap.32, Laws of Hong Kong), and no advertisement, invitation or document relating to the notes may be issued or may be in the possession of any person for the purpose of issue (in each case whether in Hong Kong or elsewhere), which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the laws of Hong Kong) other than with respect to notes which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap. 571, Laws of Hong Kong) and any rules made thereunder.

**Japan**

The notes have not been and will not be registered under the Securities and Exchange Law of Japan (the Securities and Exchange Law) and each underwriter has agreed that it will not offer or sell any notes, directly or indirectly, in Japan or to, or for the benefit of, any resident of Japan (which term as used herein means any person resident in Japan, including any corporation or other entity organized under the laws of Japan), or to others for re-offering or resale, directly or indirectly, in Japan or to a resident of Japan, except pursuant to an exemption from the registration requirements of, and otherwise in compliance with, the Securities and Exchange Law and any other applicable laws, regulations and ministerial guidelines of Japan.

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**Singapore**

This prospectus supplement and the accompanying prospectus have not been registered as a prospectus with the Monetary Authority of Singapore. Accordingly, this prospectus supplement and the accompanying prospectus and any other document or material in connection with the offer or sale, or invitation for subscription or purchase, of the notes may not be circulated or distributed, nor may the notes be offered or sold, or be made the subject of an invitation for subscription or purchase, whether directly or indirectly, to persons in Singapore other than (i) to an institutional investor under Section 274 of the Securities and Futures Act, Chapter 289 of Singapore (the "SFA"), (ii) to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA or (iii) otherwise pursuant to, and in accordance with the conditions of, any other applicable provision of the SFA.

Where the notes are subscribed or purchased under Section 275 by a relevant person which is: (a) a corporation (which is not an accredited investor) the sole business of which is to hold investments and the entire share capital of which is owned by one or more individuals, each of whom is an accredited investor; or (b) a trust (where the trustee is not an accredited investor) whose sole purpose is to hold investments and each beneficiary is an accredited investor, shares, debentures and units of shares and debentures of that corporation or the beneficiaries' rights and interest in that trust shall not be transferable for 6 months after that corporation or that trust has acquired the notes under Section 275 except: (1) to an institutional investor under Section 274 of the SFA or to a relevant person, or any person pursuant to Section 275(1A), and in accordance with the conditions, specified in Section 275 of the SFA; (2) where no consideration is given for the transfer; or (3) by operation of law.

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**LEGAL MATTERS**

Certain matters of U.S. law will be passed upon for us by Allen & Overy LLP and for the underwriters by Shearman & Sterling LLP. Shearman & Sterling LLP has performed legal services for us and our subsidiaries and affiliates.

**EXPERTS**

The consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting (which is included in management's report on internal control over financial reporting) incorporated in this prospectus supplement and the accompanying prospectus by reference to the Annual Report on Form 20-F for the year ended December 31, 2008 have been so incorporated in reliance on the report of PricewaterhouseCoopers AG, Switzerland, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

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**PROSPECTUS**

**Novartis Capital Corporation**

**Debt Securities**

Fully and Unconditionally Guaranteed by

**Novartis AG**

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**Novartis Securities Investment Ltd.**

**Debt Securities**

Fully and Unconditionally Guaranteed by

**Novartis AG**

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**Novartis Finance S.A.**

**Debt Securities**

Fully and Unconditionally Guaranteed by

**Novartis AG**

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We may offer debt securities from time to time in one or more series through this prospectus. The debt securities will be issued by one of Novartis AG's finance subsidiaries, Novartis Capital Corporation, Novartis Securities Investment Ltd. or Novartis Finance S.A., and will be fully and unconditionally guaranteed by Novartis AG.

We will provide the specific terms of the debt securities we offer in one or more supplements to this prospectus. You should read this prospectus and any related prospectus supplement carefully before you invest. Our debt securities may be denominated in U.S. dollars or in any other currencies, currency units or composite currencies as we may designate.

We may offer these debt securities through underwriters, agents or dealers or directly to institutional purchasers. The accompanying prospectus supplement will set forth the names of any underwriters or agents and any applicable commissions or discounts. The prospectus supplement will also set forth the proceeds we will receive from any sale of debt securities.

**Neither the Securities and Exchange Commission nor any state securities commission nor any other regulatory body has approved or disapproved of these securities or determined if this prospectus or any accompanying prospectus supplement is truthful or complete.**

**Any representation to the contrary is a criminal offense.**

The date of this prospectus is September 26, 2008.

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You should rely only on the information incorporated by reference or provided in this prospectus or any prospectus supplement. We have not authorized anyone else to provide you with different information. You should not assume that the information in this prospectus or any prospectus supplement is accurate as of any date other than the date on the front of these documents. We are not making an offer of these securities in any state or jurisdiction where the offer is not permitted.



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**ABOUT THIS PROSPECTUS**

This prospectus is part of a registration statement that we filed with the Securities and Exchange Commission, or the "SEC," using a "shelf" registration process. Under this shelf process, we may sell any combination of the debt securities described in this prospectus in one or more offerings.

This prospectus provides you with a general description of the debt securities we may offer. Each time we sell securities, we will provide a prospectus supplement, attached to the front of this prospectus, that will contain specific information about the terms of that offering. Those terms may vary from the terms described in this prospectus. As a result, the summary description of the debt securities in this prospectus is subject to, and qualified by reference to, the descriptions of the particular terms of any debt securities contained in any related prospectus supplement. The prospectus supplement may also add, update or change information contained in this prospectus. You should read both this prospectus and any related prospectus supplement together with the additional information described under the headings "Where You Can Find More Information" and "Incorporation of Certain Documents by Reference."

This prospectus does not include all of the information contained in the registration statement of which it is a part. We refer you to the registration statement and the related exhibits for a more complete understanding of our debt securities and the shelf registration process.

As used in this prospectus, the term "finance subsidiaries" refers to Novartis Capital Corporation, a Delaware corporation, Novartis Securities Investment Ltd., a limited liability company incorporated under the laws of Bermuda and Novartis Finance S.A., a public limited liability company (*société anonyme*) incorporated under the laws of Luxembourg. Any debt securities issued by one of the finance subsidiaries will be fully and unconditionally guaranteed by Novartis AG, a stock corporation (*Aktiengesellschaft*) incorporated under the laws of Switzerland. The term "guarantor" refers to Novartis AG. Unless the context requires otherwise, the terms "we," "our" and "us" refer to Novartis AG and its consolidated subsidiaries.

**WHERE YOU CAN FIND MORE INFORMATION**

We file annual reports with and furnish other reports and information to the SEC. You may read and copy any document we file with or furnish to the SEC at the SEC's public reference room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may also obtain documents we file with or furnish to the SEC on the SEC website at [www.sec.gov](http://www.sec.gov). The address of the SEC's internet site is provided solely for the information of prospective investors and is not intended to be an active link. Please visit this website or call the SEC at 1-800-732-0330 for further information about its public reference room. Reports and other information concerning our business may also be inspected at the offices of the New York Stock Exchange at 20 Broad Street, New York, New York 10005.

**INCORPORATION OF CERTAIN DOCUMENTS BY REFERENCE**

The SEC allows us to "incorporate by reference" the information we file with or furnish to the SEC, which means that we can disclose important information to you by referring you to those documents. The information incorporated by reference is an important part of this prospectus, and information that we later file with or furnish to the SEC and that is incorporated by reference will automatically update and supersede information in this prospectus and information previously incorporated by reference herein.

Each document incorporated by reference is current only as of the date of such document, and the incorporation by reference of such documents is not intended to create any implication that there has been no change in our affairs since the date of the relevant document or that the information contained in such document is current as of any time subsequent to its date. Any statement contained

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in such incorporated documents is deemed to be modified or superseded for the purpose of this prospectus to the extent that a subsequent statement contained in another document we incorporate by reference at a later date modifies or supersedes that statement. Any such statement so modified or superseded will not be deemed, except as so modified or superseded, to constitute a part of this prospectus.

We hereby incorporate by reference into this prospectus the documents listed below. Unless otherwise noted, all of the documents listed below have the SEC file number 001-15024:

Annual Report on Form 20-F for the year ended December 31, 2007;

Report on Form 6-K furnished to the SEC on May 30, 2008 with the amended and restated articles of incorporation of Novartis AG; and

Each of the following documents that we file with or furnish to the SEC after the date of this prospectus from now until we terminate the offering of securities under this prospectus and the registration statement:

Reports filed under Section 13(a), 13(c) or 15(d) of the Securities Exchange Act of 1934, as amended, and

Reports filed or furnished on Form 6-K that indicate that they are incorporated by reference in this prospectus.

You may obtain copies of these documents in the manner described above. You may also request copies of these documents (excluding exhibits) at no cost by contacting us as follows:

Novartis International AG  
Investor Relations  
P.O. Box  
CH - 4002 Basel  
Switzerland  
Tel: +41 61 324 79 44  
Fax: +41 61 324 84 44  
E-mail:  
investor.relations@novartis.com

Novartis Finance Corporation  
Investor Relations  
608 Fifth Avenue  
New York, NY 10020  
USA  
Tel: +1 212 307 1122  
Fax: +1 212 830 2405  
E-mail:  
investor.relations@novartis.com  
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**PRESENTATION OF FINANCIAL INFORMATION**

We present our consolidated financial statements in U.S. dollars and in accordance with International Financial Reporting Standards ("IFRS") as issued by the International Accounting Standards Board. When we refer to "\$," we mean U.S. dollars. Except where noted, all financial information is presented in accordance with IFRS.

**FORWARD-LOOKING STATEMENTS**

This prospectus and the information incorporated by reference in this prospectus include 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. You should not place undue reliance on these statements. In addition, in the future we, and others on our behalf, may make statements that constitute forward-looking statements. Such forward-looking statements can be identified by the use of forward-looking terminology such as "will," "believes," "intends," "plans," or "expects," or similar expressions, or by express or implied discussions regarding potential new products, potential new indications for existing products, or regarding potential future revenues from any such products, or potential future sales or earnings of Novartis AG, its subsidiaries or any of our divisions or business units; or by discussions of strategy, plans, expectations or intentions. Such forward-looking statements reflect our current views regarding future events, and involve known and unknown risks, uncertainties and other factors that may cause actual results to be materially different from any future results, performance or achievements expressed or implied by such statements. There can be no guarantee that any new products will be approved for sale in any market, or that any new indications will be approved for existing products in any market, or that such products will achieve any particular revenue levels. Nor can there be any guarantee that the Novartis Group, or any of its divisions or business units, will achieve any particular financial results. In particular, management's expectations could be affected by, among other things, uncertainties involved in the development of new pharmaceutical products; unexpected clinical trial results, including additional analysis of existing clinical data or unexpected new clinical data; unexpected regulatory actions or delays or government regulation generally; our ability to obtain or maintain patent or other proprietary intellectual property protection, including the uncertainties involved in the US litigation process; competition in general; government, industry, and general public pricing and other political pressures; and the impact that the foregoing factors could have on the values attributed to the assets and liabilities of Novartis AG and its subsidiaries as recorded on our consolidated balance sheet. Some of these factors are discussed in more detail in our Annual Report on Form 20-F for the year ended December 31, 2007, including under "Item 3.D. Risk Factors," "Item 4. Information on the Company," and "Item 5. Operating and Financial Review and Prospects." Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this prospectus or in the documents incorporated herein by reference as anticipated, believed, estimated or expected. The information in this prospectus, any applicable prospectus supplement and any document incorporated herein by reference is current only as of the date of such and we do not intend, and do not assume any obligation, to update any information or forward-looking statements included in any such documents.

Table of Contents**USE OF PROCEEDS**

Unless we tell you otherwise in a prospectus supplement, we will use the net proceeds from the sale of the debt securities described in this prospectus for general corporate purposes outside of Switzerland.

**RATIOS OF EARNINGS TO FIXED CHARGES**

The following table sets forth our consolidated ratio of earnings to fixed charges for each of the periods indicated using financial information extracted, where applicable, from our IFRS consolidated financial statements.

<b>Six Months Ended</b>							
<b>June 30,</b>							
<b>2008</b>	<b>2007</b>	<b>2007</b>	<b>Year Ended December 31,</b>				
			<b>2006</b>	<b>2005</b>	<b>2004<sup>1</sup></b>	<b>2003<sup>1</sup></b>	
31.5	29.0	21.4	21.7	17.7	18.2	18.9	

(1)

We adopted a number of new International Financial Reporting Standards from January 1, 2005, not all of which required retrospective application. Data for 2004 and 2003 is therefore not comparable with 2007, 2006 and 2005.

For purposes of determining the ratio of earnings to fixed charges, earnings have been calculated by adding (i) income from continuing operations before taxes (after eliminating our share of results from associated companies), (ii) fixed charges and (iii) dividends from associated companies. Fixed charges are defined as the total of (i) interest expense and (ii) an estimate of the interest within rental expense.

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**NOVARTIS AG**

Novartis AG was incorporated on February 29, 1996 under the laws of Switzerland as a stock corporation (*Aktiengesellschaft*). On December 20, 1996, our predecessor companies, Ciba-Geigy AG and Sandoz AG, merged into this new entity, creating the Novartis Group. Novartis AG is domiciled in and governed by the laws of Switzerland. Its registered office is located at Novartis AG, Lichtstrasse 35, CH-4056 Basel, Switzerland, and its telephone number is +41 61 324 1111.

Novartis AG is organized as a holding company which owns, directly or indirectly, 100% of all significant operating companies of the Novartis Group. The Novartis Group is a multinational group of companies specializing in the research, development, manufacturing and marketing of innovative healthcare products and provides healthcare solutions that address the evolving needs of patients and societies worldwide with a broad portfolio that includes innovative medicines, preventive vaccines and diagnostic tools, generic pharmaceuticals and consumer health products.

Our businesses are divided on a worldwide basis into the following four operating divisions:

Pharmaceuticals (brand-name patented pharmaceuticals)

Vaccines and Diagnostics (human vaccines and molecular diagnostics)

Sandoz (generic pharmaceuticals)

Consumer Health (over-the-counter medicines, animal health medicines, and contact lenses and lens-care products)

Our shares are listed in Switzerland on the SWX Swiss Exchange under the symbol "NOVN" and our American Depositary Shares are listed on the New York Stock Exchange under the symbol "NVS." We employed approximately 98,200 full-time equivalent associates as of December 31, 2007 and have operations in approximately 140 countries around the world.

**NOVARTIS CAPITAL CORPORATION**

Novartis Capital Corporation is a finance subsidiary indirectly owned 100% by Novartis AG and was incorporated as a corporation under the laws of Delaware on July 23, 2008. It exists for the purpose of issuing debt securities, the proceeds of which will be invested by it in marketable securities or advanced to, or otherwise invested in, subsidiaries or affiliates of Novartis AG. The principal office of Novartis Capital Corporation is located at 608 Fifth Avenue, New York, New York 10020, USA, and its telephone number is +1 212 307 1122.

**NOVARTIS SECURITIES INVESTMENT LTD.**

Novartis Securities Investment Ltd. is a finance subsidiary indirectly owned 100% by Novartis AG and was incorporated as a limited liability company under the laws of Bermuda on September 25, 2001 for an indefinite duration. It exists for the purpose of issuing debt securities, the proceeds of which will be invested by it in marketable securities or advanced to, or otherwise invested in, subsidiaries or affiliates of Novartis AG. The principal office of Novartis Securities Investment Ltd. is located at 131 Front Street, Hamilton, HM12, Bermuda, and its telephone number is +1 441 296 8025.

**NOVARTIS FINANCE S.A.**

Novartis Finance S.A. is a finance subsidiary indirectly owned 100% by Novartis AG and was incorporated as a public limited liability company (*société anonyme*) under the laws of Luxembourg on July 25, 2008. It exists for the purpose of issuing debt securities, the proceeds of which will be invested by it in marketable securities or advanced to, or otherwise invested in, subsidiaries or affiliates of Novartis AG. The registered office of Novartis Finance S.A. is located at 20, rue Eugène Ruppert, L-2453 Luxembourg, Luxembourg, and its telephone number is

+352 26 29 42 01. It is registered with the Luxembourg trade and companies register under number B. 141.096.

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**LEGAL OWNERSHIP OF DEBT SECURITIES**

**"Street Name" and Other Indirect Holders**

We generally will not recognize investors who hold debt securities in accounts at banks or brokers as legal holders of those debt securities. Holding securities in accounts at banks or brokers is called holding in "street name." If an investor holds debt securities in street name, we recognize only the bank or broker or the financial institution the bank or broker uses to hold the debt securities. These intermediary banks, brokers and other financial institutions pass along principal, interest and other payments on the debt securities, either because they agree to do so in their customer agreements or because they are legally required to do so. If you hold debt securities in street name, you should check with your own institution to find out:

how it handles payments and notices with respect to securities;

whether it imposes fees or charges;

how it would handle voting if ever required;

how and when you should notify it to exercise on your behalf any rights or options that may exist under the debt securities;

whether and how you can instruct it to send you securities registered in your own name so you can be a direct holder as described below; and

how it would pursue rights under the debt securities if there were a default or other event triggering the need for holders to act to protect their interests.

**Registered Holders**

Our obligations, as well as the obligations of the trustee and those of any third parties employed by us or the trustee, extend only to persons who are registered as holders of debt securities. As noted above, we do not have obligations to you if you hold in street name or through other indirect means, either because you choose to hold debt securities in that manner or because the debt securities are issued in the form of global securities as described below. For example, once we make payment to the registered holder, we have no further responsibility for the payment even if that holder is legally required to pass the payment along to you as a street name customer but does not do so.

**Global Securities**

A global security is a special type of indirectly held security. If we choose to issue debt securities in the form of global securities, the ultimate beneficial owners of the debt securities will be indirect holders. We do this by requiring that the global security be registered in the name of a financial institution we select and by requiring that the debt securities represented by the global security not be registered in the name of any other holder except in the special situations described below. The financial institution that acts as the sole registered holder of the global security is called the depositary. Any person wishing to own a debt security may do so indirectly through an account with a broker, bank or other financial institution that in turn has an account with the depositary. The prospectus supplement will indicate whether your series of debt securities will be issued only as global securities.

Transfers of debt securities represented by the global security will be made only on the records of the depositary or its nominee by transferring such debt securities from the account of one broker, bank or financial institution to the account of another broker, bank or financial institution. These transfers are made electronically only and are also known as book-entry transfers. Securities in global form are sometimes also referred to as being in book-entry form.





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As an indirect holder, your rights relating to a global security will be governed by the account rules of your broker, bank or financial institution and of the depository, as well as general laws relating to securities transfers. We will not recognize you as a holder of debt securities and instead will deal only with the depository that holds the global security.

You should be aware that if debt securities are issued only in the form of a global security:

you cannot have debt securities registered in your own name;

you cannot receive physical certificates for your interest in the debt securities, subject to certain exceptions;

you will be a street name holder and must look to your own broker, bank or financial institution for payments on the debt securities and protection of your legal rights relating to the debt securities;

you may not be able to sell interests in the debt securities to some insurance companies and other institutions that are required by law to own securities in the form of physical certificates;

the depository's policies will govern payments, transfers, exchanges and other matters relating to your indirect interest in the global security. We and the trustee will have no responsibility for any aspect of the depository's actions or for its records of ownership interests in the global security. We and the trustee also will not supervise the depository in any way; and

the depository will require that indirect interests in the global security be purchased or sold within its system using same-day funds for settlement.

**Special Situations**

In a few special situations described below, the global security will terminate and the indirect interests in it will be exchanged for registered debt securities represented by physical certificates. After that exchange, the choice of whether to hold debt securities in registered form or in street name will be up to you. You must consult your broker, bank or financial institution to find out how to have your interests in debt securities transferred to your name, so that you will be a registered holder.

Unless we specify otherwise in the prospectus supplement, the special situations for termination of a global security are:

when the depository notifies us that it is unwilling or unable to continue as depository and we do not or cannot appoint a successor depository within 90 days;

the depository ceases to be a clearing agency registered under the Exchange Act and we do not appoint a successor depository within 90 days;

an event of default has occurred and is continuing and beneficial owners representing a majority in principal amount of the applicable series of debt securities have advised the depository to cease acting as the depository; or

we decide we do not want to have the debt securities of that series represented by a global security.

The prospectus supplement may also list additional situations for terminating a global security that would apply only to the particular series of debt securities covered by the prospectus supplement. When a global security terminates, the depository (and not us or the trustee) is responsible for deciding the names of the institutions that will be the initial registered holders.



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**The Term "Holder" as Used in this Prospectus and Elsewhere**

In the descriptions of the debt securities included in this prospectus and any prospectus supplement, when we refer to the "holder" of a given debt security as being entitled to certain rights or payments, or being permitted to take certain actions, we are in all cases referring to the registered holder of the debt security.

While you would be the registered holder if you held a certificated security registered in your name, it is likely that the holder will actually be either the broker, bank or other financial institution where you have your street name account, or, in the case of a global security, the depository. If you are an indirect holder, you will need to coordinate with the institution through which you hold your interest in a debt security in order to determine how the provisions involving holders described in this prospectus and any prospectus supplement will actually apply to you. For example, if the debt security in which you hold a beneficial interest in street name can be repaid at the option of the holder, you cannot exercise the option yourself by following the procedures described in the prospectus supplement. Instead, you would need to cause the institution through which you hold your interest to take those actions on your behalf. Your institution may have procedures and deadlines different from or additional to those described in the prospectus supplement relating to the debt security.

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**DESCRIPTION OF DEBT SECURITIES**

This section describes the general terms that will apply to any debt securities that we may offer pursuant to this prospectus. The specific terms of any offered debt securities, and the extent to which the general terms described in this section apply to those debt securities, will be described in the related prospectus supplement at the time of the offer.

**General**

As used in this prospectus, "debt securities" means the debentures, notes, bonds, guarantees and other evidences of indebtedness that one of our finance subsidiaries issues, Novartis AG fully and unconditionally guarantees and the trustee authenticates and delivers under the indenture. The debt securities will be direct unsecured obligations of the relevant finance subsidiary and will rank equally and ratably without preference among themselves and at least equally with all of the other unsecured and unsubordinated indebtedness of the relevant finance subsidiary. The guarantees will be direct unsecured obligations of Novartis AG and will rank equally and ratably without preference among Novartis AG and at least equally with all other unsecured and unsubordinated guarantees and indebtedness of Novartis AG.

The debt securities will be issued in one or more series under an indenture to be entered into among the Novartis finance subsidiaries, HSBC Bank USA, National Association, as trustee, and Novartis AG, as guarantor. The indenture will be qualified under the Trust Indenture Act of 1939, as amended.

This prospectus briefly outlines the provisions of the indenture. The terms of the indenture will include both those stated in the indenture and those made part of the indenture by the Trust Indenture Act. The indenture has been filed as an exhibit to the registration statement of which this prospectus forms a part, and you should read the indenture for provisions that may be important to you.

The indenture does not contain any covenants or other provisions designed to protect holders of the debt securities against a reduction in the creditworthiness of Novartis AG or the finance subsidiaries in the event of a highly leveraged transaction or that would prohibit other transactions that might adversely affect holders of the debt securities.

**Issuances in Series**

The indenture does not limit the amount of debt securities that may be issued. The debt securities may be issued in one or more series with the same or various maturities, at a price of 100% of their principal amount or at a premium or a discount. Not all debt securities of any one series need be issued at the same time, and, unless otherwise provided, any series may be reopened, without the consents of the holders of debt securities of that series, for issuances of additional debt securities of that series. Except in the limited circumstances described below under "Covenants Limitation on Liens," the debt securities will not be secured by any property or assets of Novartis AG or the finance subsidiaries.

The terms of any authorized series of debt securities will be described in a prospectus supplement. These terms will include some or all of the following:

the title, aggregate principal amount and denominations of the debt securities;

the date or dates on which principal will be payable;

the percentage of the principal amount at which the debt securities will be issued and whether the debt securities will be "original issue discount" securities for U.S. federal income tax purposes. If original issue discount debt securities are issued (generally, securities that are issued

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at a substantial discount below their principal amount), the special U.S. federal income tax and other considerations of a purchase of original issue discount debt securities will be described;

the rate or rates, which may be fixed or variable, at which the debt securities will bear interest;

the interest payment dates;

any optional or mandatory redemption terms;

whether any sinking fund is required;

the currency in which the debt securities will be denominated or principal, premium or interest will be payable, if other than U.S. dollars;

whether the debt securities are to be issued as individual certificates to each holder or in the form of global certificates held by a depositary on behalf of beneficial owners;

information describing any book-entry features;

the names and duties of any co-trustees, depositaries, authenticating agents, paying agents, transfer agents or registrars for any series;

the applicability of the defeasance and covenant defeasance provisions described in this prospectus, or any modifications of those provisions;

any deletions from, modifications of or additions to the events of default or covenants with respect to the debt securities; and

any other terms, conditions, rights or preferences of the debt securities.

The prospectus supplement relating to any series of debt securities may add to or change statements contained in this prospectus. The prospectus supplement may also include, if applicable, a discussion of certain U.S. federal income tax, Swiss income tax, Bermuda tax and Luxembourg withholding tax considerations.

**Novartis Guarantees**

Debt securities issued by the finance subsidiaries will be fully and unconditionally guaranteed by Novartis AG. If for any reason the applicable finance subsidiary does not make any required payment in respect of its debt securities when due, whether on the normal due date, on acceleration, redemption or otherwise, Novartis AG will cause the payment to be made to or to the order of the trustee. The holder of a guaranteed debt security will be entitled to payment under the applicable guarantee of Novartis AG without taking any action whatsoever against the relevant finance subsidiary.

**Payment and Transfer**

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The debt securities will be issued only as registered securities, which means that the name of the holder will be entered in a register that will be kept by the trustee or another agent appointed by us. Unless stated otherwise in a prospectus supplement, and except as described under "Book-Entry System" below, payments of principal, interest and additional amounts, if any, will be made at the office of the paying agent or agents named in the prospectus supplement or by check mailed to registered holders at the address appearing in the register.

Unless other procedures are described in a prospectus supplement and except as described under "Book-Entry System" below, you will be able to transfer registered debt securities at the office of the transfer agent or agents named in the prospectus supplement. You may also exchange registered debt securities at the office of the transfer agent for an equal aggregate principal amount of registered

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debt securities of the same series having the same maturity date, interest rate and other terms as long as the debt securities are issued in authorized denominations.

Neither we nor the trustee will impose any service charge for any transfer or exchange of a debt security; however, we may ask you to pay any taxes or other governmental charges in connection with a transfer or exchange of debt securities.

**Consolidation, Merger or Sale**

Novartis AG and the finance subsidiaries have agreed in the indenture not to consolidate with or merge with or into any other person or convey or transfer all or substantially all of their respective properties and assets to any person (except that the finance subsidiaries may merge with or into Novartis AG and Novartis AG may merge with or into the finance subsidiaries), unless:

Novartis AG or the applicable finance subsidiary, as the case may be, is the continuing person, or the successor expressly assumes by supplemental indenture their respective obligations under the indenture;

the continuing person is organized and validly existing under the laws of (i) if the continuing person is a successor to the relevant finance subsidiary, the jurisdiction of organization of such finance subsidiary or Switzerland, (ii) if the continuing person is a successor to Novartis AG, the United States or Switzerland or (iii) in any case, a jurisdiction that is a member country of the Organization for Economic Cooperation and Development (or any successor) and, if it is not organized and validly existing under the laws of (x) in the case of the applicable finance subsidiary, the jurisdiction of organization of such finance subsidiary, (y) in the case of Novartis AG, the United States or (z) in any case, Switzerland, the continuing person agrees by supplemental indenture to be bound by a covenant comparable to that described below under "Covenants Payment of Additional Amounts" with respect to taxes imposed in the continuing person's jurisdiction of organization (in which case the continuing person will benefit from a redemption option comparable to that described below under "Optional Redemption for Tax Reasons" in the event of changes in taxes in that jurisdiction after the date of the consolidation, merger or sale);

immediately after the transaction, no default under the debt securities has occurred and is continuing; and

Novartis AG or the relevant finance subsidiary, as applicable, delivers to the trustee an officer's certificate and, if neither Novartis AG nor the relevant finance subsidiary, as applicable, is the continuing person, an opinion of counsel, in each case stating, among other things, that the transaction and the supplemental indenture, if required, comply with these provisions and the indenture.

**Covenants**

*Payment of Additional Amounts*

Payments made by us under or with respect to the debt securities will be free and clear of and without withholding or deduction for or on account of any and all present or future taxes, duties, assessments or governmental charges of any nature imposed, levied, collected, withheld or assessed by or on behalf of (i) the government of Switzerland or of any political subdivision of Switzerland or by any authority or agency therein or thereof having the power to tax, (ii) the government of the jurisdiction of organization of the applicable finance subsidiary or any political subdivision or territory or possession of such jurisdiction or by any authority or agency therein or thereof having the power to tax or (iii) the government of any jurisdiction from or through which a payment on the debt securities or the guarantee is made or any political subdivision or territory or possession of such jurisdiction or by

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any authority or agency therein or thereof having power to tax (each of clauses (i), (ii) and (iii), a "Relevant Taxing Jurisdiction"), which we refer to collectively as "Taxes," unless we are required to withhold or deduct Taxes by law.

If we are required to withhold or deduct any amount for or on account of Taxes from any payment made with respect to the debt securities, we will pay such additional amounts as may be necessary so that the net amount received by each holder (including additional amounts) after such withholding or deduction will not be less than the amount the holder would have received if the Taxes had not been withheld or deducted; *provided* that no additional amounts will be payable with respect to Taxes:

that would not have been imposed but for the existence of any present or former connection between such holder or beneficial owner of the debt securities (or between a fiduciary, settlor, beneficiary, member or shareholder of, or possessor of a power over, such holder or beneficial owner, if such holder or beneficial owner is an estate, trust, partnership or corporation) and a Relevant Taxing Jurisdiction, including, without limitation, such holder or beneficial owner (or such fiduciary, settlor, beneficiary, member, shareholder or possessor) being or having been a citizen or resident thereof or treated as a resident thereof or domiciled thereof or a national thereof or being or having been present or engaged in trade or business therein or having or having had a permanent establishment therein;

that are estate, inheritance, gift, sales, transfer, personal property, wealth or similar taxes, duties, assessments or other governmental charges;

payable other than by withholding from payments of principal of or interest on the debt securities;

that would not have been imposed but for the failure of the applicable recipient of such payment to make a declaration of non-residence or other similar claim for exemption to the relevant tax authority or comply with any certification, identification, information, documentation or other reporting requirement to the extent such compliance is required by applicable law or administrative practice or an applicable treaty as a precondition to exemption from, or reduction in, the rate of deduction or withholding of such Taxes;

that are imposed on a payment to an individual on a residual entity and are required to be made pursuant to European Council Directive 2003/48/EC or any other Directive implementing the conclusions of the ECOFIN Council meeting of November 26-27, 2000 on the taxation of savings income, or any law implementing or complying with, or introduced in order to conform to, such Directive;

that would not have been imposed but for the presentation of a debt security (where presentation is required) for payment on a date more than 30 days after the date on which such payment first became due and payable or the date on which payment thereof was duly provided for, whichever occurred later;

to the extent the amount of Tax could have been reduced by presentation for payment of the relevant debt securities to a paying agent other than the paying agent to which the presentation was made; or

any combination of the foregoing items;

nor shall additional amounts be paid with respect to any payment of the principal of or interest on any debt security to any such holder who is a fiduciary or a partnership or a beneficial owner who is other than the sole beneficial owner of such payment to the extent a beneficiary or settlor with respect to such fiduciary or a member of such partnership or a beneficial owner would not have been entitled to such additional amounts had it been the holder of the debt security.



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*Limitation on Liens*

In the indenture we have agreed, for so long as any debt securities are outstanding, that neither the relevant finance subsidiary nor Novartis AG will create or have outstanding any lien upon the whole or any part of its assets, present or future (including any uncalled capital), in order to secure any existing or future relevant indebtedness (as this term is defined below) or to secure any guarantee or indemnity in respect thereof without in any such case at the same time securing the debt securities equally and ratably with such relevant indebtedness (or any guarantee or indemnity in respect thereof) or creating such other security approved by the relevant finance subsidiary and/or Novartis AG (as the case may be) and the holders of a majority in principal amount of all affected series of debt securities, voting as one class.

The restrictions on liens will not apply to:

liens arising by operation of law; and

liens on the assets of any person existing at the time such person is merged with or into or consolidated with Novartis AG.

For purposes of the limitation on liens covenant, the term "relevant indebtedness" means any loan or other indebtedness in the form of, or represented or evidenced by, bonds, debentures, notes or other securities that are or are capable of being quoted, listed or traded on any stock exchange or in any securities market or over-the-counter market. For purposes of the limitation on liens covenant, "assets" refers to assets of the relevant finance subsidiary and Novartis AG, respectively, and does not include the assets of their respective subsidiaries.

*Additional Covenants*

We may be subject to additional covenants, including restrictive covenants in respect of a particular series of debt securities. Such additional covenants will be set forth in the applicable prospectus supplement and, to the extent necessary, in the supplemental indenture or board resolution relating to that series of debt securities.

**Optional Redemption for Tax Reasons**

The relevant finance subsidiary may redeem any series of debt securities in whole but not in part at any time, on giving not less than 30 nor more than 60 days' notice of such redemption, at a redemption price equal to the principal amount plus accrued interest, if any, to the date fixed for redemption (except in the case of discounted debt securities, which may be redeemed at the redemption price specified by the terms of each series of such debt securities), if:

the relevant finance subsidiary determines that, as a result of any change in or amendment to the laws or any regulations or rulings promulgated thereunder of a Relevant Taxing Jurisdiction, or any change in the application or official interpretation of such laws, regulations or rulings, or any change in the application or official interpretation of, or any execution of or amendment to, any treaty or treaties affecting taxation to which any such jurisdiction is a party, which change, execution or amendment becomes effective on or after the issue date or such other date specified in the debt securities of that series:

the relevant finance subsidiary would be required to pay additional amounts (as described under "Covenants Payment of Additional Amounts" above) with respect to that series of debt securities on the next succeeding interest payment date and the payment of such additional amounts cannot be avoided by the use of reasonable measures available to us; or

withholding tax has been or would be required to be withheld with respect to interest income received or receivable by the applicable finance subsidiary directly from the guarantor (or any

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affiliate) and such withholding tax obligation cannot be avoided by the use of reasonable measures available to the applicable finance subsidiary or the guarantor (or any affiliate); or

the relevant finance subsidiary determines, based upon an opinion of independent counsel selected by the relevant finance subsidiary that, as a result of any action taken by any legislative body of, taxing authority of, or any action brought in a court of competent jurisdiction in, a Relevant Taxing Jurisdiction (whether or not such action was taken or brought with respect to Novartis AG or the applicable finance subsidiary, as the case may be), which action is taken or brought on or after the issue date or such other date specified in the debt securities of that series, there is a substantial probability that the circumstances described above would exist; *provided, however*, that no such notice of redemption may be given earlier than 90 days prior to the earliest date on which the relevant finance subsidiary would be obligated to pay such additional amounts.

We will also pay to each holder, or make available for payment to each such holder, on the redemption date any additional amounts resulting from the payment of such redemption price. Prior to the publication of any notice of redemption, we will deliver to the trustee:

an officer's certificate stating that the relevant finance subsidiary is entitled to effect a redemption and setting forth a statement of facts showing that the conditions precedent of the right so to redeem have occurred; or

an opinion of counsel to the effect that the conditions specified above have been satisfied.

Any notice of redemption will be irrevocable once the relevant finance subsidiary delivers the officer's certificate to the trustee.

**Events of Default**

Unless otherwise specified in a prospectus supplement, an event of default with respect to a series of debt securities means any one of the following events:

default in payment of the principal (or premium, if any) of any debt security of that series when due (including as a sinking fund installment), and the continuance of that default for more than two business days;

default in payment of interest on, or any additional amounts payable in respect of, any debt security of that series when due and payable, and the continuance of that default for 30 days;

default in performing any other covenant in the indenture with regard to that series for 90 days after the receipt of written notice from the trustee or from the holders of 25% in principal amount of the debt securities of that series;

(i) any indebtedness of, or guaranteed by, the relevant finance subsidiary or Novartis AG is not paid at its stated maturity or (as the case may be) within any originally applicable grace period; or (ii) any such indebtedness, or guarantee, of the relevant finance subsidiary or Novartis AG (as the case may be) becomes due and payable prior to its stated maturity by reason of an event of default; *provided* that (x) the amount of indebtedness referred to in clauses (i) and/or (ii) above individually or in the aggregate exceeds \$150,000,000 (or its equivalent in any other currency or currencies); and (y) there shall not be deemed to be a default (i) where the relevant finance subsidiary or Novartis AG in good faith claims a right of set-off or otherwise contests its obligations to pay or (ii) if such acceleration is annulled or such payment or repayment is made within 10 days after the receipt of written notice from the trustee or from the holders of 25% in principal amount of the debt securities of that series;

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an encumbrancer or a receiver or a person with similar functions appointed for execution (in Switzerland a *Sachwalter* or *Konkursverwalter* and in Luxembourg, a *commissaire, juge-commissaire, liquidateur* or *curateur*) taking possession of the whole or any substantial part of the assets or undertaking of the relevant finance subsidiary or Novartis AG or a distress, execution or other process being levied or enforced upon or sued out against a substantial part of the property or assets of the relevant finance subsidiary or Novartis AG and not being paid, discharged, removed or stayed within 30 days;

the relevant finance subsidiary or Novartis AG stopping payment or ceasing business (except in each case in circumstances previously approved by the holders of a majority in principal (or, if any debt securities are original issue discount securities, such portion of the principal of such debt securities of such series as may then be accelerated pursuant to the terms of such debt securities) of the outstanding debt securities of all series affected (all such series voting as one class));

the relevant finance subsidiary becoming bankrupt or insolvent or entering into a moratorium or making a general assignment for the benefit of its creditors including, in relation to Novartis Finance S.A., bankruptcy (*faillite*), insolvency, its voluntary or judicial liquidation (*liquidation volontaire ou judiciaire*), reprieve from payment (*sursis de paiement*), controlled management (*gestion contrôlée*), and composition with creditors (*concordat préventif de faillite*);

Novartis AG becoming bankrupt or insolvent (or is obliged to notify the court of its financial situation in accordance with Article 725 (2) of the Swiss Code of Obligations) or entering into a moratorium (*Stundung*) or making arrangements with its creditors (*Nachlassvertrag*);

an order being made or a resolution passed for the winding-up or dissolution of the relevant finance subsidiary or Novartis AG except a winding-up or dissolution, the terms of such winding-up or dissolution having previously been approved by the holders of a majority in principal (or, if any debt securities are original issue discount securities, such portion of the principal of such debt securities of such series as may then be accelerated pursuant to the terms of such debt securities) of the outstanding debt securities of all series affected (all such series voting as one class);

if the guarantee with respect to the relevant series of debt securities ceases to be, or is claimed by Novartis AG not to be, in full force and effect; or

any other event of default provided with respect to that particular series of debt securities.

For purposes of the definition of "event of default," the term "indebtedness" means any indebtedness for monies borrowed or raised including, without limitation, any debenture, note, bond or like security.

Any additional or different events of default applicable to a particular series of debt securities will be described in the prospectus supplement relating to such series.

An event of default with respect to a particular series of debt securities will not necessarily constitute an event of default with respect to any other series of debt securities.

The trustee may withhold notice to the holders of debt securities of any default (except in the payment of principal, premium or interest) if it, in good faith, considers such withholding of notice to be in the best interests of the holders. A default is any event which is an event of default described above or would be an event of default but for the giving of notice or the passage of time.

If an event of default occurs and continues, the trustee or the holders of the aggregate principal amount of the debt securities specified below may require us to repay immediately, or accelerate:

the entire principal of the debt securities of such series; or



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if the debt securities are original issue discount securities, such portion of the principal as may be described in the applicable prospectus supplement.

If the event of default occurs because of a default in a payment of principal or interest on the debt securities of any series, then the trustee or the holders of at least 25% of the aggregate principal amount of debt securities of that series can accelerate that series of debt securities. If the event of default occurs because of a failure to perform any other covenant in the indenture or any covenant for the benefit of one or more, but not all, of the series of debt securities, then the trustee or the holders of at least 25% of the aggregate principal amount of debt securities of all series affected, voting as one class, can accelerate all of the affected series of debt securities. If the event of default occurs because of bankruptcy proceedings, then all of the debt securities under the indenture will be accelerated automatically. Therefore, except in the case of a default on a payment of principal or interest on the debt securities of your series or a default due to our bankruptcy or insolvency, it is possible that you may not be able to accelerate the debt securities of your series because of the failure of holders of other series to take action.

The holders of a majority of the aggregate principal amount of the debt securities of all affected series, voting as one class, can rescind this accelerated payment requirement or waive any past default or event of default or allow noncompliance with any provision of the indenture. However, they cannot waive a default in payment of principal of, premium, if any, or interest on any of the debt securities when due otherwise than as a result of acceleration.

After an event of default, the trustee must exercise the same degree of care a prudent person would exercise under the circumstances in the conduct of her or his own affairs. Subject to these requirements, the trustee is not obligated to exercise any of its rights or powers under the indenture at the request, order or direction of any holders, unless the holders offer the trustee reasonable indemnity. If they provide this reasonable indemnity, the holders of a majority in principal amount of all affected series of debt securities, voting as one class, may direct the time, method and place of conducting any proceeding for any remedy available to the trustee, or exercising any power conferred upon the trustee, for any series of debt securities. However, the trustee may refuse to follow any direction that conflicts with law or the indenture or is unduly prejudicial to the rights of other holders.

No holder will be entitled to pursue any remedy with respect to the indenture unless the trustee fails to act for 60 days after it is given:

notice of default by that holder;

a written request to enforce the indenture by the holders of not less than 25% in principal amount of all outstanding debt securities of any affected series; and

an indemnity to the trustee, satisfactory to the trustee;

and during this 60-day period the holders of a majority in principal amount of all outstanding debt securities of such affected series do not give a direction to the trustee that is inconsistent with the enforcement request. These provisions will not prevent any holder of debt securities from enforcing payment of the principal of (and premium, if any) and interest on the debt securities at the relevant due dates.

If an event of default with respect to a series of debt securities occurs and is continuing, the trustee will mail to the holders of those debt securities a notice of the event of default within 90 days after it occurs. However, except in the case of a default in any payment in respect of a series of debt securities, the trustee shall be protected in withholding notice of an event of default if it determines in good faith that this is in the interests of the holders of the relevant debt securities.

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**Modification of the Indenture**

In general, our rights and obligations and those of the holders under the indenture may be modified if the holders of a majority in aggregate principal amount of the outstanding debt securities of each series affected by the modification consent to such modification. However, the indenture provides that, unless each affected holder agrees, an amendment cannot:

make any adverse change to any payment term of a debt security such as extending the maturity date, extending the date on which we have to pay interest or make a sinking fund payment, reducing the interest rate, reducing the amount of principal or additional amounts payable, changing the currency in which we have to make any payment of principal, premium or interest, modifying any redemption or repurchase right, or right to convert or exchange any debt security, to the detriment of the holder and impairing any right of a holder to bring suit for payment;

waive any payment default;

reduce the percentage of the aggregate principal amount of debt securities needed to make any amendment to the indenture or to waive any covenant or default; or

make any other change to the amendment provisions of the indenture.

However, if we and the trustee agree, the indenture may be amended without notifying any holders or seeking their consent if the amendment does not materially and adversely affect any holder. We and the trustee are permitted to make modifications and amendments to the indenture without the consent of any holder of debt securities for any of the following purposes:

to cure any ambiguity, defect or inconsistency in the indenture;

to comply with sections of the indenture governing when Novartis AG or the relevant finance subsidiary may merge;

to comply with any requirements of the SEC in connection with the qualification of the indenture under the Trust Indenture Act;

to evidence and provide for the acceptance by a successor trustee of appointment under the indenture with respect to the debt securities of any or all series;

to establish the form or forms or terms of the debt securities of any series or of the coupons appertaining to such debt securities as permitted under the indenture;

to provide for uncertificated debt securities and to make all appropriate changes for such purpose;

to provide for a further guarantee from a third party on outstanding debt securities of any series and the debt securities of any series that may be issued under the indenture;

to change or eliminate any provision of the indenture; *provided* that any such change or elimination will become effective only when there are no outstanding debt securities of any series created prior to the execution of such supplemental indenture that is entitled to the benefit of such provision;

to supplement any of the provisions of the indenture to such extent as will be necessary to permit or facilitate the defeasance and discharge of any series of debt securities pursuant to the indenture; *provided* that any such action will not adversely affect the interests of the holders of such or any other series of debt securities in any material respect; or

to make any change that does not materially and adversely affect the rights of any holder of the debt securities.

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The provisions of articles 86 to 94-8 of the Luxembourg act dated August 10, 1915 on commercial companies, as amended, will not apply to any debt securities issued by Novartis Finance S.A.

**Defeasance**

The term defeasance means discharge from some or all of the obligations under the indenture. If we deposit with the trustee sufficient cash or government securities to pay the principal, interest, any premium and any other sums due to the stated maturity date or a redemption date of the debt securities of a particular series, then at our option:

we will be discharged from our respective obligations with respect to the debt Securities of such series; or

we will no longer be under any obligation to comply with the restrictive covenants, if any, contained in the indenture and any supplemental indenture or board resolution with respect to the debt securities of such series, and the events of default relating to failures to comply with covenants will no longer apply to us.

If this happens, the holders of the debt securities of the affected series will not be entitled to the benefits of the indenture except for registration of transfer and exchange of debt securities and replacement of lost, stolen or mutilated debt securities. Instead, the holders will only be able to rely on the deposited funds or obligations for payment.

The relevant finance subsidiary must deliver to the trustee an opinion of counsel to the effect that the deposit and related defeasance would not cause the holders of the debt securities to recognize income, gain or loss for U.S. federal income tax purposes. The relevant finance subsidiary may, in lieu of an opinion of counsel, deliver a ruling to such effect received from or published by the U.S. Internal Revenue Service.

**Book-Entry System**

Debt securities may be issued under a book-entry system in the form of one or more global securities. The global securities will be registered in the name of a depository or its nominee and deposited with that depository or its custodian. Unless stated otherwise in the prospectus supplement, The Depository Trust Company, New York, New York, or DTC, will be the depository if a depository is used.

DTC has advised us as follows:

DTC is a limited-purpose trust company organized under the New York Banking Law, a "banking organization" within the meaning of the New York Banking Law, a member of the Federal Reserve System, a "clearing corporation" within the meaning of the New York Uniform Commercial Code and a "clearing agency" registered pursuant to the provisions of Section 17A of the Exchange Act;

DTC was created to hold securities of its participants and to facilitate the clearance and settlement of securities transactions, such as through transfers and pledges, among its participants in such securities through electronic book-entry changes to accounts of its participants, thereby eliminating the need for physical movement of securities certificates;

DTC's participants include securities brokers and dealers, banks, trust companies, clearing corporations and certain other organizations, some of whom (and/or their representatives) own DTC; and



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access to DTC's book-entry system is also available to others, such as banks, brokers, dealers and trust companies that clear through or maintain a custodial relationship with a participant, either directly or indirectly.

According to DTC, the foregoing information with respect to DTC has been provided to the financial community for informational purposes only and is not intended to serve as a representation, warranty or contract modification of any kind.

Following the issuance of a global security in registered form, the depositary will credit the accounts of its participants with the debt securities upon our instructions. Only persons who hold directly or indirectly through financial institutions that are participants in the depositary can hold beneficial interests in the global securities. Since the laws of some jurisdictions require certain types of purchasers to take physical delivery of such securities in definitive form, you may encounter difficulties in your ability to own, transfer or pledge beneficial interests in a global security.

So long as the depositary or its nominee is the registered owner of a global security, we and the trustee will treat the depositary as the sole owner or holder of the debt securities for purposes of the indenture. Therefore, except as set forth below, you will not be entitled to have debt securities registered in your name or to receive physical delivery of certificates representing the debt securities. Accordingly, you will have to rely on the procedures of the depositary and the participant in the depositary through whom you hold your beneficial interest in order to exercise any rights of a holder under the indenture. We understand that under existing practices, the depositary would act upon the instructions of a participant or authorize that participant to take any action that a holder is entitled to take.

We will make all payments of principal, interest and additional amounts, if any, on the debt securities to the depositary. It is expected that the depositary will then credit participants' accounts proportionately with these payments on the payment date and that the participants will in turn credit their customers' accounts in accordance with their customary practices. Neither we nor the trustee will be responsible for making any payments to participants or customers of participants or for maintaining any records relating to the holdings of participants and their customers, and you will have to rely on the procedures of the depositary and its participants.

Global securities are generally not transferable. Physical certificates will be issued to beneficial owners in lieu of a global security only in the special situations described under the heading "Legal Ownership of Debt Securities Global Securities Special Situations."

**Information Concerning the Trustee**

HSBC Bank USA, National Association will be the trustee. The trustee will be required to perform only those duties that are specifically set forth in the indenture, except when a default has occurred and is continuing with respect to the debt securities. After a default, the trustee must exercise the same degree of care that a prudent person would exercise under the circumstances in the conduct of her or his own affairs. Subject to these requirements, the trustee will be under no obligation to exercise any of the powers vested in it by the indenture at the request of any holder of debt securities unless the holder offers the trustee reasonable indemnity against the costs, expenses and liabilities that might be incurred by exercising those powers.

**Governing Law**

The debt securities, the related guarantees and the indenture will be governed by and construed in accordance with the laws of the State of New York.

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## **TAX CONSIDERATIONS**

The applicable prospectus supplement will describe certain tax considerations in connection with the acquisition, ownership and disposal of debt securities.

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**PLAN OF DISTRIBUTION**

We may sell our securities through agents, underwriters, dealers or directly to purchasers.

Our agents may solicit offers to purchase our securities.

We will name any agent involved in offering or selling our securities, and any commissions that we will pay to the agent, in our prospectus supplement.

Unless we indicate otherwise in our prospectus supplement, our agents will act on a best efforts basis for the period of their appointment.

Our agents may be deemed to be underwriters under the Securities Act of any of our securities that they offer or sell.

We may use an underwriter or underwriters in the offer or sale of our securities.

If we use an underwriter or underwriters, we will execute an underwriting agreement with the underwriter or underwriters at the time that we reach an agreement for the sale of our securities.

We will include the names of the specific managing underwriter or underwriters, as well as any other underwriters, and the terms of the transactions, including the compensation the underwriters and dealers will receive, in our prospectus supplement.

The underwriters will use our prospectus supplement to sell our securities.

If we use an underwriter or underwriters, the underwriter or underwriters will acquire our securities for their own account and may resell our securities in one or more transactions, including negotiated transactions. These sales will be made at a fixed price or at varying prices determined at the time of the sale.

We may use one or more dealers to sell our securities.

If we use a dealer, we, as principal, will sell our securities to the dealer.

The dealer will then sell our securities to the public at varying prices that the dealer will determine at the time it sells our securities.

We will include the name of the dealer and the terms of our transactions with the dealer in our prospectus supplement.

We may solicit directly offers to purchase our securities, and we may directly sell our securities to institutional or other investors. We will describe the terms of our direct sales in our prospectus supplement.

We may indemnify agents, underwriters and dealers against certain liabilities, including liabilities under the Securities Act. Our agents, underwriters and dealers, or their affiliates, may be customers of, engage in transactions with or perform services for, us or our subsidiaries and affiliates in the ordinary course of business.

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We may authorize our agents and underwriters to solicit offers by certain institutions to purchase our securities at the public offering price under delayed delivery contracts.

If we use delayed delivery contracts, we will disclose that we are using them in the prospectus supplement and will tell you when we will demand payment and delivery of the securities under the delayed delivery contracts.

These delayed delivery contracts will be subject only to the conditions that we set forth in the prospectus supplement.

We will indicate in our prospectus supplements the commission that underwriters and agents soliciting purchases of our securities under delayed delivery contracts will be entitled to receive.

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**LEGAL MATTERS**

Certain matters of U.S. law will be passed upon for us by Allen & Overy LLP and for the underwriters by Shearman & Sterling LLP. Shearman & Sterling LLP has performed legal services for us and our subsidiaries and affiliates.

**EXPERTS**

The consolidated financial statements and management's assessment of the effectiveness of internal control over financial reporting (which is included in management's report on internal control over financial reporting) incorporated in this prospectus by reference to the Annual Report on Form 20-F for the year ended December 31, 2007 have been so incorporated in reliance on the report of PricewaterhouseCoopers AG, Switzerland, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

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**LIMITATIONS ON ENFORCEMENT OF U.S. LAWS**

Because Novartis AG is a Swiss company headquartered in Switzerland, many of our directors and executive officers (as well as certain directors, managers and executive officers of the finance subsidiaries), and certain experts named in this prospectus, reside outside the United States. As a result, it may be difficult for you to serve legal process on us or our directors and executive officers (as well as certain directors, managers and executive officers of the finance subsidiaries) or have any of them appear in a U.S. court. In addition, U.S. investors may find it difficult in a lawsuit based on the civil liability provisions of the U.S. federal securities laws to enforce in U.S. courts or outside the U.S. judgments obtained against those persons in U.S. courts, to enforce in U.S. courts judgments obtained against those persons in courts in jurisdictions outside the U.S., or to enforce against those persons in Switzerland, whether in original actions or in actions for the enforcement of judgments of U.S. courts, civil liabilities based solely upon the U.S. federal securities laws.

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