

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 20-F

REGISTRATION STATEMENT PURSUANT TO SECTION 12(b) OR 12(g) OF THE SECURITIES EXCHANGE ACT OF 1934

OR

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

For the fiscal year ended December 31, 2011

OR

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

OR

SHELL COMPANY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Date of event requiring this shell company report.....

For the transition period from \_\_\_\_ to \_\_\_\_

Commission File No. 000-51694

**Perion Network Ltd.**

(Exact Name of Registrant as specified in its charter)

N/A

(Translation of Registrant's name into English)

**Israel**

(Jurisdiction of incorporation or organization)

**4 HaNechoshet Street**

**Tel Aviv, Israel 69710**

(Address of principal executive offices)

Securities registered or to be registered pursuant to Section 12(b) of the Act.

Title of Each Class  
Ordinary shares, par value NIS 0.01 per share

Name of Each Exchange on which Registered  
NASDAQ Global Market

Securities registered or to be registered pursuant to Section 12(g) of the Act.

None  
(Title of Class)

Securities for which there is a reporting obligation pursuant to Section 15(d) of the Act.

None  
(Title of Class)

Indicate the number of outstanding shares of each of the issuer's classes of capital or common stock as of the close of the period covered by the Annual Report.

As of December 31, 2011, the Registrant had outstanding 9,916,194 ordinary shares, par value NIS 0.01 per share.

---

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark which basis of accounting the registrant has used to prepare the financial statements included in this filing:

U.S. GAAP

International Financial Reporting Standards as issued by  
the International Accounting Standards Board

Other

If "Other" has been checked in response to the previous question, indicate by check mark which financial statement item the registrant has elected to follow.

Item 17

Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):

Yes  No

---

## PRELIMINARY NOTES

### Terms

In November 2011, the Company changed its name from Incredimail Ltd. to Perion Network Ltd.

As used herein, and unless the context suggest otherwise, the terms "Perion", "Company", "we", "us" or "ours" refer to Perion Network Ltd. References to "U.S. dollars," "U.S.\$" and "\$" are to the lawful currency of the United States of America, and references to "NIS" are to New Israeli Shekels, the lawful currency of the State of Israel.

### Forward-Looking Statements

This annual report on Form 20-F contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements relate to future events or our future financial performance and involve known and unknown risks, uncertainties and other factors that may cause our, or our industry's, actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed, implied or inferred by these forward-looking statements. In some cases, you can identify forward-looking statements by terminology such as "may", "will", "should", "could", "would", "expects", "plans", "intends", "anticipates", "believes", "estimates", "predicts", "projects", "potential" or "continue" or the negative of such terms and other comparable terminology.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we do not know whether we can achieve positive future results, levels of activity, performance, or goals. Actual events or results may differ materially from our current expectations. All forward-looking statements included in this report are based on information available to us on the date of this report. Except as required by applicable law, we undertake no obligation to update or revise any of the forward-looking statements after the date of this annual report to conform those statements to reflect the occurrence of unanticipated events, new information or otherwise.

You should read this annual report and the documents that we reference in this report completely and with the understanding that our actual future results, levels of activity, performance and achievements may be materially different from what we currently expect.

Factors that could cause actual results to differ materially from those expressed or implied by the forward-looking statements contained in this annual report include:

- our ability to establish and increase market acceptance of our products;
  - our dependence on a limited number of possible customers in general and one dominant customer in particular for search generated revenues;
  - our dependence on the availability and openness of other PC and Internet platforms;
  - our ability to adopt to new and increasingly popular mobile platforms in a timely fashion;
  - our dependence on the web browsing environment and ability to adapt to its continuing evolution;
  - our ability to manage our growth, including the integration of acquired companies;
  - our dependence on a small number of products and our ability to continually enhance these products and to develop new products that achieve widespread market acceptance;
  - our dependence on search related revenues and our ability to maintain substantial revenues from "search" activities and further increase these revenues;
  - our ability to cause continued and increasing installation of our products;
  - our ability to offer and subsequently continue to direct search activity from substantial number of consumers;
  - our ability to establish a trusted brand name, particularly in light of our recent name change;
  - our ability to develop additional ways to distribute and sell our products;
  - our ability to hire and retain key personnel;
  - our ability to protect our intellectual property rights;
-

- the development and future nature of the Internet;
- the volatility and liquidity of the financial markets;
- the dynamic nature of the commercial and legal aspects of the Internet;
- restrictions imposed in connection with our international operations;
- political, economic and military conditions in the Middle East; and
- our ability to maintain substantial revenues from advertisers and further increase these revenues.

Assumptions relating to the foregoing involve judgment with respect to, among other things, future economic, competitive and market conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. In light of the significant uncertainties, inherent in the forward-looking information included herein, the inclusion of such information should not be regarded as a representation by us or any other person that our objectives or plans will be achieved. Factors that could cause actual results to differ from our expectations or projections include the risks and uncertainties relating to our business described in this annual report at "Item 3.D Risk Factors." Moreover, we operate in a very competitive and rapidly changing environment. New risks emerge from time to time and it is not possible for our management to predict all risks, nor can we assess the impact of all risks on our business or the extent to which any risk, or combination of risks, may cause actual results to differ from those contained in any forward-looking statements.

We obtained statistical data, market data and other industry data and forecasts used in preparing this annual report from market research, publicly available information and industry publications. Industry publications generally state that they obtain their information from sources that they believe to be reliable, but they do not guarantee the accuracy and completeness of the information. Similarly, while we believe that the statistical data, industry data and forecasts and market research are reliable, we have not independently verified the data, and we do not make any representation as to the accuracy of the information.

## TABLE OF CONTENTS

|                                  | <b><u>Page</u></b>   |    |
|----------------------------------|--|----|
| <b>PART I</b>                    |  |    |
| <a href="#"><u>Item 1.</u></a>   | <a href="#"><u>Identity of Directors, Senior Management and Advisers.</u></a>                        | 4  |
| <a href="#"><u>Item 2.</u></a>   | <a href="#"><u>Offer Statistics and Expected Timetable.</u></a>                                      | 4  |
| <a href="#"><u>Item 3.</u></a>   | <a href="#"><u>Key Information.</u></a>  | 4  |
| <a href="#"><u>Item 4.</u></a>   | <a href="#"><u>Information on the Company.</u></a>   | 18 |
| <a href="#"><u>Item 4.A</u></a>  | <a href="#"><u>Unresolved Staff Comments.</u></a>  | 30 |
| <a href="#"><u>Item 5.</u></a>   | <a href="#"><u>Operating and Financial Review and Prospects.</u></a>                                 | 30 |
| <a href="#"><u>Item 6.</u></a>   | <a href="#"><u>Directors, Senior Management and Employees.</u></a>                                   | 44 |
| <a href="#"><u>Item 7.</u></a>   | <a href="#"><u>Major Shareholders and Related Party Transactions.</u></a>                            | 56 |
| <a href="#"><u>Item 8.</u></a>   | <a href="#"><u>Financial Information.</u></a>  | 58 |
| <a href="#"><u>Item 9.</u></a>   | <a href="#"><u>The Offer and Listing.</u></a>  | 59 |
| <a href="#"><u>Item 10.</u></a>  | <a href="#"><u>Additional Information.</u></a>   | 60 |
| <a href="#"><u>Item 11.</u></a>  | <a href="#"><u>Quantitative and Qualitative Disclosures about Market Risk.</u></a>                   | 78 |
| <a href="#"><u>Item 12.</u></a>  | <a href="#"><u>Description of Securities Other than Equity Securities.</u></a>                       | 79 |
| <b>PART II</b>                   |  |    |
| <a href="#"><u>Item 13.</u></a>  | <a href="#"><u>Defaults, Dividend Arrearages and Delinquencies.</u></a>                              | 80 |
| <a href="#"><u>Item 14.</u></a>  | <a href="#"><u>Material Modifications to the Rights of Security Holders and Use of Proceeds.</u></a> | 80 |
| <a href="#"><u>Item 15.</u></a>  | <a href="#"><u>Controls and Procedures.</u></a>  | 80 |
| <a href="#"><u>Item 16.</u></a>  | <a href="#"><u>[Reserved].</u></a>   | 81 |
| <a href="#"><u>Item 16A.</u></a> | <a href="#"><u>Audit Committee Financial Expert.</u></a>   | 81 |
| <a href="#"><u>Item 16B.</u></a> | <a href="#"><u>Code of Ethics.</u></a>   | 81 |
| <a href="#"><u>Item 16C.</u></a> | <a href="#"><u>Principal Accountant Fees and Services.</u></a>                                       | 81 |
| <a href="#"><u>Item 16D.</u></a> | <a href="#"><u>Exemptions from the Listing Standards for Audit Committees.</u></a>                   | 81 |
| <a href="#"><u>Item 16E.</u></a> | <a href="#"><u>Purchases of Equity Securities by the Issuer and Affiliated Purchasers.</u></a>       | 82 |
| <a href="#"><u>Item 16F.</u></a> | <a href="#"><u>Changes in Registrant's Certifying Accountant.</u></a>                                | 82 |
| <a href="#"><u>Item 16G.</u></a> | <a href="#"><u>Corporate Governance.</u></a>   | 82 |
| <b>PART III</b>                  |  |    |
| <a href="#"><u>Item 17.</u></a>  | <a href="#"><u>Financial Statements.</u></a>   | 83 |
| <a href="#"><u>Item 18.</u></a>  | <a href="#"><u>Financial Statements.</u></a>   | 83 |
| <a href="#"><u>Item 19.</u></a>  | <a href="#"><u>Exhibits.</u></a>   | 84 |



**PART I**

**ITEM 1. IDENTITY OF DIRECTORS, SENIOR MANAGEMENT AND ADVISERS**

Not applicable.

**ITEM 2. OFFER STATISTICS AND EXPECTED TIMETABLE**

Not applicable.

**ITEM 3. KEY INFORMATION**

**A. SELECTED FINANCIAL DATA**

The following tables present selected financial data and should be read in conjunction with "Item 5 - Operating and Financial Review and Prospects" and our consolidated financial statements and related notes appearing elsewhere in this annual report. We derived the selected operations data below for the years ended December 31, 2009, 2010 and 2011 and the selected balance sheet data as of December 31, 2010 and 2011 from our audited consolidated financial statements included elsewhere in this report. We derived the selected operations data below for the years ended December 31, 2007 and 2008 and the selected balance sheet data as of December 31, 2007, 2008 and 2009 from our audited consolidated financial statements not included in this report. Our consolidated financial statements are prepared and presented in U.S. dollars and in accordance with United States Generally Accepted Accounting Principles ("U.S. GAAP").

| Statement of Operations Data:  | Year ended December 31,                                     |                  |                  |                  |                  |
|--|---|------------------|------------------|------------------|------------------|
|  | 2007  | 2008             | 2009             | 2010             | 2011             |
|  | U.S. dollars in thousands (except share and per share data) |                  |                  |                  |                  |
| Revenues   |   |                  |                  |                  |                  |
| Search   | \$ 7,783  | \$ 11,747        | \$ 20,011        | \$ 22,792        | \$ 25,466        |
| Products   | 9,078   | 9,158            | 6,717            | 5,404            | 7,191            |
| Other  | 1,814   | 1,001            | 467              | 1,301            | 2,816            |
|  | <u>\$ 18,675</u>  | <u>\$ 21,906</u> | <u>\$ 27,195</u> | <u>\$ 29,497</u> | <u>\$ 35,473</u> |
| Cost of revenues   | 1,740   | 1,795            | 1,505            | 1,606            | 2,840            |
| Gross profit   | <u>16,935</u>   | <u>20,111</u>    | <u>25,690</u>    | <u>27,891</u>    | <u>32,633</u>    |
| Operating expenses:  |   |                  |                  |                  |                  |
| Research and development costs, net                                      | 6,125   | 7,589            | 6,254            | 6,607            | 7,453            |
| Selling and marketing expenses   | 4,682   | 7,343            | 4,616            | 5,244            | 12,984           |
| General and administrative expenses                                      | 3,693   | 3,806            | 3,334            | 4,741            | 7,649            |
| Goodwill impairment and other charges                                    | 163   | 1,153            | -                | -                | -                |
| Total operating expenses   | <u>14,663</u>   | <u>19,891</u>    | <u>14,204</u>    | <u>16,592</u>    | <u>28,086</u>    |
| Operating income   | 2,272   | 220              | 11,486           | 11,299           | 4,547            |
| Financial income (expenses), net   | (3,641)   | 4,494            | 72               | 322              | 1,293            |
| Income (loss), before taxes on income                                    | (1,369)   | 4,714            | 11,558           | 11,621           | 5,840            |
| Taxes on income  | 1,393   | 289              | 3,545            | 3,232            | 172              |
| Net income (Loss)  | <u>\$ (2,762)</u>   | <u>\$ 4,425</u>  | <u>\$ 8,013</u>  | <u>\$ 8,389</u>  | <u>\$ 5,668</u>  |
| Net earnings (loss) per share:   |   |                  |                  |                  |                  |
| Basic  | <u>\$ (0.29)</u>  | <u>\$ 0.47</u>   | <u>\$ 0.86</u>   | <u>\$ 0.87</u>   | <u>\$ 0.58</u>   |
| Diluted  | <u>\$ (0.29)</u>  | <u>\$ 0.46</u>   | <u>\$ 0.84</u>   | <u>\$ 0.85</u>   | <u>\$ 0.57</u>   |
| Weighted average number of shares used in net earnings (loss) per share: |   |                  |                  |                  |                  |
| Basic  | 9,442,658   | 9,427,424        | 9,347,915        | 9,622,181        | 9,796,380        |
| Diluted  | 9,442,658   | 9,516,477        | 9,562,721        | 9,831,628        | 10,002,171       |

|                            | <b>As of December 31,</b> |          |           |           |           |
|----------------------------|---------------------------|----------|-----------|-----------|-----------|
|                            | 2007                      | 2008     | 2009      | 2010      | 2011      |
|                            | (in thousands)            |          |           |           |           |
| <b>Balance Sheet Data:</b> |                           |          |           |           |           |
| Cash and cash equivalents  | \$ 4,611                  | \$ 7,835 | \$ 24,368 | \$ 16,055 | \$ 11,260 |
| Working capital            | 19,756                    | 25,143   | 26,846    | 28,067    | (39)      |
| Total assets               | 31,766                    | 37,651   | 39,894    | 41,348    | 54,892    |
| Total liabilities          | 10,995                    | 12,107   | 12,892    | 13,196    | 23,077    |
| Shareholders' equity       | 20,771                    | 25,544   | 27,002    | 28,152    | 31,815    |

**B. CAPITALIZATION AND INDEBTEDNESS**

Not applicable.

**C. REASONS FOR OFFER AND USE OF PROCEEDS**

Not applicable.

**D. RISK FACTORS**

*Investing in our ordinary shares involves a high degree of risk. You should consider carefully the following risk factors, as well as the other information in this annual report before deciding to invest in our ordinary shares. Our business, financial condition or results of operations could be affected adversely by any of these risks. The trading price of our ordinary shares could decline due to any of these risks and you might lose all or part of your investment in our ordinary shares.*

***Risks Related to Our Business***

**If the Google AdSense for Search program is terminated or significantly changed by Google, we would be forced to immediately seek an alternative search provider, in which case we would be susceptible to a certain transition period during which we may experience a material reduction in our search generated revenues and, possibly a long-term decrease in search generated revenues and, in turn, an adverse effect on our financial condition.**

Our business is currently very dependent on search based revenues, currently utilizing primarily the Google AdSense program, pursuant to which we receive a portion of the amount paid by advertisers to Google for the activity performed by those downloading the Company's applications. This dependence continues to grow and we obtained approximately 67% of our revenues for the year ended December 31, 2011 from this partnership. While this percentage has been decreasing recently, we expect this venue to continue to generate a major portion of our revenues in the foreseeable future.

In December 2010 we signed an agreement with Google effective January 1, 2011 and expiring January 1, 2013. As in past agreements, this too enables termination by either side after one year with 90 days notice (to date, neither party has exercised such right), and in addition, Google is able to amend the agreement, change its policies and guidelines, and has other limited termination rights. If this agreement is terminated, substantially amended, or not renewed on favorable terms, we would be forced to seek an alternative search provider. There are very few companies in the market that provide Internet search services similar to those provided by Google. Google is the most dominant player in this market, particularly on a global scale and competitors do not offer as much coverage through sponsored links. If we fail to quickly locate, negotiate and finalize alternative arrangements, or if the alternatives do not provide for terms that are as favorable as those provided for by the AdSense program, or if the alternative arrangement will not attract the same traffic as the traffic attracted by the Google AdSense program, or if the termination by Google affects our ability to contract other providers, we would experience a material reduction in our revenues and, in turn, our business, financial condition and results of operations would be adversely affected. Our failure to retain existing users, or attract new users, as well as generate traffic to our search properties, could adversely affect our business, financial condition and results of operations.

**We rely heavily on the ability to offer our search properties to users of our software products and subsequently retain them. Should this offering be blocked, constrained or made redundant, by the providers of the underlying platform, our ability to generate revenues from search could be significantly reduced.**

Approximately 72% of our revenues for the year ended December 31, 2011 were generated from the acceptance and subsequent retention of our search properties by the users of our software products. The market for offering and retaining these search properties is very competitive. In addition, some companies offer a browser without a homepage, while others may cause difficulties in resetting the homepage, which is one of our main search properties. The guidelines imposed pursuant to our agreement with Google, with respect to homepage resets and default search resets to Google services when providing downloadable applications have changed as compared to the previous agreement, this had negative revenue implications, offset by some positive changes made in the agreement. Should Google, or the other companies providing the internet browsers, effectively further restrict, discourage, or otherwise hamper other companies from offering or changing the search properties, or those providing browsers without a homepage increase their market share, there would be a material adverse affect on our search generating revenue model and our financial results.

**The generation of revenues from searches has become subject to fierce competition. We obtain a significant portion of our revenues from searches made through our homepage and other search properties. If we cannot compete effectively in this market, our revenues are likely to decline.**

We obtain a significant portion of our revenues from searches made through the Company's home page (*MyStart*), as well as offering other search properties. We therefore are constantly looking for ways to convince our users to make *MyStart* their homepage and accept the other search properties offered. There are a growing number of companies that generate an increasing amount of their revenues from searches, some of them with a more significant presence than ours and with greater capability to offer substantially more content. In addition, with competition growing, even the larger and in the past more conservative companies, (such as Google, Microsoft and others), have become increasingly aggressive in their search service offering. Therefore, our ability to attract new users to install Perion's home page, and retaining existing users, could suffer, preventing or delaying us in increasing our revenues, or even cause them to decrease.

**Social related software and Facebook in particular, is becoming an increasingly dominant method of communication over the internet. If Facebook increases its dominance over other forms of communication, or changes the way people share content and we are not able to adapt our products to this new environment, the users of our products could decrease and negatively affect our revenues.**

A significant portion of our revenues stems from the usage of our Incredimail email client. If the usage of Facebook or other social related software as a method of communication replaces email, this would decrease the usage of our email client and subsequently have a negative effect on our revenues.

In addition, our Incredimail email client and other products, interface with Facebook, which we believe contributes to the usage by our users of our products. If Facebook were to change the guidelines and policies governing their cooperation with companies, these changes could negatively impact the use of our products.

Finally, a significant portion of the users of our Smilebox photo-sharing product uses Facebook to share their creations. We could be impacted by changes that Facebook makes in how our users are able to post content into Facebook. These changes could negatively impact the use of Smilebox to post to Facebook which would adversely affect our service usage and revenues.



**If we are unable to continually enhance our existing products and develop new products that achieve widespread market acceptance, our ability to attract and retain customers could be impaired, our competitive position may be harmed and we may be unable to generate additional revenues.**

We believe that the number of downloads of our free products indicates that many consumers are interested in having a customized and entertaining email or creative photo sharing experience. Our future revenue and profit growth will depend, in part, on the percentage of registered or active users of our free product who become actual purchasers of our products and services, and increasing the number of downloads and acceptance of the search properties offered with them, as well as making our products and services attractive to new users. In order to induce those consumers to use our products, accept the search properties offered, and purchase or license our products, we must continually enhance our existing products by offering additional features and content that appeal to our unique user base. Maintaining the usability and relevance of existing products and the development and commercialization of new products can be very complex. Software product development and commercialization depends upon a number of factors, including:

- accurate prediction of market requirements, market preferences and trends and evolving standards;
- development of advanced technologies and capabilities;
- timely completion and introduction of new product designs and features that incorporate market requirements and preferences;
- our ability to recruit and retain highly qualified personnel;
- our ability to market our new products; and
- market acceptance of the enhanced and new products.

We may be unable to maintain the usability and relevance of our existing products or to develop new products. Furthermore, we may not develop or introduce new products or product enhancements in time to take advantage of market opportunities or achieve a significant or substantial level of acceptance in new or existing markets. If we fail to do so, our ability to attract and retain customers could be impaired, our competitive position may be harmed and we may be unable to generate substantial revenues.

**If we are unable to establish and increase market acceptance of our products, we will not expand our business and our revenues could decline.**

Our basic software products are currently supplied to our customers free of charge. We will be able to increase product revenues only if we can create and maintain a substantial market demand for our products, including acceptance of the search properties offered with them, and to a certain extent our enhanced software products, for which we currently charge a one-time license, annual license, or subscription fee.

Our ability to execute our business strategy depends on market demand for software programs that are simple, safe and useful, and our ability to maintain these characteristics in our email client, our photo sharing product and offering it in other existing products or those that will be bought or internally developed in the future. For instance, the fact that many email users have multiple email clients and accounts, many of which are likely provided to them free of charge by large Internet and software companies, positively affects the potential market demand for our enhanced email software products. The growing popularity of web based mail and its increased functionality and mobility negatively affect the potential market demand for our primarily PC based email client. Our photo sharing product has benefited from the social trend of sharing digital photos, while the increasing popularity for taking and viewing photos on mobile devices are a challenge for our primarily desktop oriented user experience. The rate of adoption and acceptance of our products may be affected adversely by changing consumer preferences, product obsolescence, technological change, market competition and our products' quality and novelty.

**Our results of operations and financial condition may be adversely impacted by worldwide economic conditions.**

Our primary user base is composed of individual consumers and for the most part their discretionary purchase habits. The current overall lack of growth in the U.S. and European economies following on a few years of weak performance have resulted in continued negative pressure on consumer spending in general, and discretionary spending in particular, and have impacted consumers in our market territories in ways that could negatively affect our business. In the event that the United States or Europe experiences an economic downturn, or the current economic climate worsens, our current and potential software license subscribers may be unable or unwilling to purchase our products or use our service. This would also have a negative impact on consumer internet spending and search generated revenues. A reduction in the purchasing of our products or use our services, consumer internet spending and search generated revenues have had a negative impact in the past, and may possibly have a greater negative impact in the future, on our sales and revenue generation, margins and operating expenses, and consequently have a material adverse effect on our business, results of operations and financial condition.

**Our continuing "viral growth" could be adversely affected if we do not increase the number of our registered users or if users stop using our software.**

To date, we have relied to a great extent on "viral growth" to increase our user base, and although the pace of viral growth has declined, it is of relatively low cost and remains an important part of our growth strategy going forward. Other marketing methods, while effective, are far more costly. As users of our products stop, reduce, or limit their usage, our viral growth will diminish because these users will no longer forward links to our site via their emails, and as a result our market share and revenues decrease. Our historical experience with usage of our products indicates that usage of products declines rapidly, although some continue to use them for as long as six years. Therefore, in order to induce our existing users to continue to use our products, we must continuously enhance our existing products and periodically develop new ones. If we cannot offer such products, because of lack of resources, competition or other reasons described elsewhere in these Risk Factors, our distribution, revenues and results of operations will be adversely affected.

**The market for email software products and services is declining, as web based solutions are gaining in their popularity.**

One of our major products competes in the market for email software products and services that aim to offer a customized personal, productive and entertaining email experience for consumers. Our main competitors are those providing a web-based email solution, which does not require the user to download software, and thus provides a very mobile and accessible email tool. Some of these competitors provide (or will provide) a downloadable email client as well. While there are advantages and disadvantages to each method and system and the markets for each of them remain large, the market for web based systems is growing at the expense of downloadable email clients. In addition, many of our competitors providing a web-based solution have more established brands, products and customer relationships than we do, which could inhibit our market penetration efforts even if they may not offer features similar to *IncrediMail*<sup>®</sup>. For example, consumers may choose to receive an extensive package of Internet and email services from a more dominant and recognized company, such as Google (Gmail), Microsoft Corporation (HotMail), Facebook, or Yahoo! (Yahoo Mail).

Should this trend accelerate faster than the company's ability to provide differentiating advantages to its downloadable solution, this could result in fewer downloads of our product and our ability to offer search services, less use of our product, fewer purchases of our products and services and loss of market share. See "Item 4.B Business Overview — Competition" for additional discussion of our competitive market.

**We rely significantly on our ability to advertise through the Google Adwords network for marketing and acquiring new users for our products. Should Google make substantial changes to this network or if it becomes substantially more expensive, it would be more difficult and expensive to acquire new customers and would negatively affect our revenues.**

As the ability to market our products via "viral growth" methods declines, we are becoming increasingly reliant on advertising for acquiring new customers. One of the main venues for advertising our products is Google's Adwords network. Google sets the standards for using this network as well as being the market-maker for establishing the pricing in its network. Although there are alternative networks and markets for advertising, none are currently as popular as Google. Should Google change the rules for using this network and the way distributors of downloadable software products interact with it, or the cost of advertising our products increases dramatically, our ability to distribute our products would be limited which would negatively affect our revenues.

**We have and intend to continue and use a substantial portion of our invested resources to acquire unspecified businesses. These acquisitions divert a substantial part of our resources and management attention, could cause dilution to our shareholders and adversely affect our financial results.**

We recently used a substantial portion of our invested resources to acquire Smilebox Inc. and intend to continue to acquire complementary products, technologies or businesses. Prior to this acquisition our management had no experience together as a team in making acquisitions or integrating acquired businesses. Although we believe we have been successful in this acquisition so far, the continued integration of this newly-acquired business, as well as negotiating potential additional acquisitions to a certain extent diverts our management's attention from other business concerns, is expensive and time-consuming. New acquisitions could expose our business to unforeseen liabilities or risks associated with the business or assets acquired or with entering new markets. In addition, while this has not been the case so far with Smilebox, we might lose key employees while integrating new organizations and we might not effectively integrate any other acquired products, technologies or businesses. With regard to the Smilebox acquisition, less than a year has passed since the acquisition, and we might yet lose key employees and not effectively complete full integration, nor achieve anticipated revenues or cost benefits, from this acquisition and similar risks exist for other acquisitions which may occur in the future. Future acquisitions could result in customer dissatisfaction, performance problems with an acquired product, technology or company, the incurrence of debt or issuances of equity securities that cause dilution to our existing shareholders. Furthermore, a substantial portion of the cost of these acquisitions is for intangible assets. We may incur contingent liabilities, amortization expenses related to intangible assets, or possible impairment charges related to goodwill or other intangible assets or other unanticipated events or circumstances relating to the acquisition, and we may not have, or may not be able to enforce, adequate remedies in order to protect our Company. If any of these or similar risks relating to acquiring products, technologies or businesses should occur in the future on a scale that is larger than the effect of the acquisition described above, our business could be materially harmed.

**If we are deemed to be not in compliance with applicable data protection laws, our operating results could be materially affected.**

We collect and maintain certain information about our customers in our database. Such collection and maintenance of customer information is subject to data protection laws and regulations in Israel and may be subject to laws and regulations in, the United States, the European Union and other countries as well. A failure to comply with applicable regulations could result in class actions, governmental investigations and orders, and criminal and civil liabilities, which could materially affect our operating results.

Although we strive to comply with the applicable laws and regulations and use our best efforts to comply with the evolving global standards regarding privacy, and inform our customers of our business practices prior to any installations of our product and use of our services, it is possible that these laws may be interpreted and applied in a manner that is inconsistent with our data collection and preservation practices, or that it may be argued that our practices do not comply with other countries' privacy and data protection laws and regulations. In addition to the possibility of fines, such a situation could result in the issuance of an order requiring that we change our data collection or retention practices, which in turn could have a material effect on our business. See "Item 4.B Business Overview — Government Regulation" for additional discussion of applicable regulations.

**If users or third parties express privacy or security concerns regarding our collection, use and handling of personal information, we could incur substantial expenses.**

Although we strive to comply with strict privacy data security requirements and take all reasonable steps to ensure the security of personal information, concerns may be expressed, from time to time, about whether our products compromise the privacy or confidentiality of the information of users and others. Concerns about our collection, use, sharing or handling of personal information or other privacy related matters, even if unfounded, could damage our reputation and operating results. See "Item 4.B Business Overview — Government Regulation" for additional discussion of applicable regulations.

**We depend on a third party Internet and telecommunication provider to operate our websites. Temporary failure of these services would reduce our revenues and damage our reputation, and securing alternate sources for these services could significantly increase our expenses.**

We depend on Bezeq International Ltd., a third party provider of Internet and related telecommunication services, including hosting and location facilities, to operate our websites. This company may not continue to provide services to us without disruptions in services at the current cost or at all. Such a disruption in services, even temporary, would reduce our revenues from product sales, and possibly even from search, depending on the extent of disruption. While we believe that there are many alternative providers of hosting and other communication services available to us, and the company has a plan for adjusting and adapting in such an event, the costs associated with any transition to a new service provider could be substantial and require us to reengineer our computer systems and telecommunications infrastructure to accommodate a new service provider. This process could be both expensive and time consuming and could result in lost business both during the transition period and after.

Our servers and communications systems could be damaged or interrupted by fire, flood, power loss, telecommunications failure, earthquakes, acts of war or terrorism, acts of God, computer viruses, physical or electronic break-ins and similar events or disruptions. Although we maintain back-up systems for our servers, any of these events could cause system interruption, delays, loss of critical data and lost registered users and revenues.

We currently rely solely on the Internet as a means to sell our products. Accordingly, if we, or our customers, are unable to utilize the Internet due to a failure of technology or infrastructure, terrorist activity or other reasons, we could lose current or potential customers and revenues. While we have backup systems for most aspects of our operations, our systems are not fully redundant and our disaster recovery planning may not be sufficient for all eventualities. In addition, we may have inadequate insurance coverage or insurance limits to compensate us for losses from a major interruption. Furthermore, interruptions in our website could materially impede our ability to attract new companies to advertise on our website and to maintain relationships with current advertisers. Difficulties of this kind could damage our reputation, be expensive to remedy and curtail our growth.

**Our products operate in a variety of computer configurations and could contain undetected errors or defects that could result in product failures, lost revenues and loss of market share.**

Our software may contain undetected errors, failures or defects, especially when the products are first introduced or when new versions are released. Our customers' computer environments are often characterized by a wide variety of standard and non-standard configurations that make pre-release testing for programming or compatibility errors very difficult and time-consuming. Therefore, there could be errors or failures in our products. In addition, despite testing by us and beta testing by some of our registered users, errors, failures or bugs may not be found in new products or releases until after commencement of commercial sales. In the past, we have discovered software errors, failures and defects in certain of our product offerings after their full introduction and have likely experienced delayed or lost revenues during the period required to correct these errors.

Errors, failures or defects in products released by us could result in negative publicity, product returns, loss of or delay in market acceptance of our products, loss of competitive position or claims by customers. Alleviating any of these problems could require significant expense and could cause interruptions.

**Due to our evolving business model and rapid changes in the Internet, we may not be able to accurately predict our future performance or continue our revenue growth or profitability.**

Since beginning operations in 2000, we have introduced many new products and initiatives, some of which have been unsuccessful. Consequently, we have a limited history of ongoing operations from which to predict our future performance and making such predictions is very complex and challenging, particularly with regard to new products and initiatives and scaling existing business. The future viability of our business will depend on our ability to increase product sales, introduce new products appealing to the Internet market, increase search generated, affiliate and advertising revenues, exploit our brand name and control our costs, which we may be unable to do. As a result, we may not be able to continue our revenue growth or profitability.

**We may have difficulty managing our growth, which could limit our ability to increase our sales and control our costs.**

The organic growth of our operations has slowed in recent years. To accelerate growth we have invested heavily in advertising and the acquisition of new businesses and products. This strategy for emphasizing accelerated growth is required in order to achieve our business objectives, and is placing increased demands on our management and on our operational resources. This growth has, and continues to increase the challenges involved in:

- implementing appropriate operational and financial systems and controls;
- expanding our sales and marketing infrastructure and capabilities; and
- maintaining the commitment of our employees.

If we cannot scale and manage our business appropriately, we will not experience our projected growth and our financial results will suffer.

**A decline in market acceptance for Microsoft technologies on which our products rely could have a material adverse effect on us.**

Most of our products and virtually all of our revenues currently run or are based on Microsoft Windows operating systems. Recently the Linux and Apple operating systems have gained popularity and market share, although still accounting for only a small part of the market. A decline in market acceptance of Microsoft technologies or the increased acceptance of other operating systems could cause us to incur significant development costs and could have a material adverse effect on our ability to market our current products. Although we believe that Microsoft technologies will continue to be widely used by consumers, we cannot assure you that consumers will adopt these technologies as anticipated or will not in the future migrate to other computing technologies that we do not currently support. In addition, our products and technologies must continue to be compatible with new developments in Microsoft technologies. We cannot assure you that we can maintain such compatibility or that we will not incur significant expenses in connection therewith.

**More individuals are using non-PC devices to access the Internet, and most of our products and services are currently not usable on these competing platforms.**

The number of individuals who access the Internet through devices other than personal computers, such as mobile phones, tablets, etc., has increased dramatically. Our products for the most part are not yet compatible with these alternative platforms and devices. If this trend accelerates and an increasing number of consumers find our products difficult to access through such devices, we may fail to capture a sufficient share of an increasingly important portion of the market for online services, our products will become less relevant and may fail to attract advertisers and web traffic.

**If the ubiquity of Adobe's flash technology decreases, the use of our Smilebox photo sharing product could be negatively affected and as a result our revenues could decline.**

Our Smilebox photo sharing product for the desktop uses Adobe Flash technology as part of its core underlying file format and relies on the fact that recipients in general have Flash and are able to playback Smilebox creations without requiring an additional file download. We could be adversely impacted by a reduction in the marketing of Flash by Adobe and a related decline in the ubiquity of Flash as a platform.

**Exchange rate fluctuations may decrease our earnings if we are not able to hedge our currency exchange risks effectively.**

A majority of our revenues are denominated in U.S. dollars. However, a significant portion of our sales is in currencies other than the U.S. dollar, of which a large portion is in, or originates in, Euros. In 2011, approximately 16% of our revenue was received directly in these currencies and approximately an additional 69% indirectly originated in these currencies. To the extent such sales are not immediately exchanged for U.S. dollars, we bear a foreign currency fluctuation risk. In addition, a substantial part of our costs, mainly personnel expenses, are incurred in NIS. Inflation in Israel may have the effect of increasing the U.S. dollar cost of our operations in Israel. Whenever the U.S. dollar declines in value in relation to the New Israeli Shekel, it will become more expensive for us to fund our operations in Israel. A revaluation of one percent of the NIS as compared to the U.S. dollar could reduce our income before taxes by approximately \$0.1 million. The exchange rate of the U.S. dollar to the New Israeli Shekel has been very volatile in the past years, increasing on average through the year, by approximately 10% in 2009, decreasing by 5% in 2010 and decreasing by approximately 4% in 2011. As of December 31, 2011, we had a foreign currency net asset of approximately \$6 million and our total foreign exchange income was approximately \$102 thousand for the year ended December 31, 2011. In addition, in market territories where our prices are based on local currencies, fluctuations in the dollar exchange rate could affect our gross profit margin. To assist us in hedging the risks associated with fluctuations in currency exchange rates, we have contracted a consulting firm proficient in this area, and are generally implementing their proposals. Based on the advice received from this firm, we are advised that we are unable to hedge exchange risks associated with revenues indirectly originating in non-U.S. dollar currencies, but received in US dollars. We do not hedge the exchange risk from revenues received directly in non-US currencies, as the amounts of these revenues are not material. However, due to the market conditions, volatility and other factors, we do not always implement our consultant's proposals in full, our consultant's proposals do not always prove to be effective and may even prove harmful. We may incur losses from unfavorable fluctuations in foreign currency exchange rates. See "Item 11 Quantitative and Qualitative Disclosure of Market Risks" for further discussion of the effects of exchange rate fluctuations on earnings.

**A loss of the services of our senior management and other key personnel could adversely affect execution of our business strategy.**

We depend on the continued services of our senior management, particularly Josef Mandelbaum, our Chief Executive Officer. Our current strategy is to a great extent a function of his capabilities and experience, together with the experience and knowledge of our other senior management. The loss of the services of these personnel could create a gap in management and could result in the loss of management and technical expertise necessary for us to execute our business strategy and thereby adversely affect execution of our business strategy. We do not currently have "key person" life insurance with respect to any of our senior management.

Further, our ability to execute our business strategy also depends on our ability to continue to attract, retain and motivate qualified and skilled technical and creative personnel and skilled management, marketing and sales personnel. If we cannot attract and retain additional key employees or lose one or more of our current key employees, our ability to develop or market our products and attract or acquire new users could be adversely affected. See "Item 6 Directors, Senior Management and Employees."

**Under current Israeli law, we may not be able to enforce non-competition covenants and, therefore, may be unable to prevent our competitors from benefiting from the expertise of some of our former employees.**

We have entered into non-competition agreements with most of our professional employees. These agreements prohibit our employees, if they cease working for us, from competing directly with us or working for our competitors for a limited period. Under current Israeli law, we may be unable to enforce these agreements, in whole or in part, and it may be difficult for us to restrict our competitors from gaining the expertise that our former employees gained while working for us. For example, Israeli courts have required employers seeking to enforce non-compete undertakings of a former employee to demonstrate that the competitive activities of the former employee will harm one of a limited number of material interests of the employer which have been recognized by the courts, such as the secrecy of a company's confidential commercial information or its intellectual property. If we cannot demonstrate that harm would be caused to us, we may be unable to prevent our competitors from benefiting from the expertise of our former employees.

**Our international operations involve special risks that could increase our expenses, adversely affect our operating results and require increased time and attention of our management.**

We derive and expect to continue to derive a substantial portion of our revenues from users outside United States. Our international sales and related operations are subject to a number of inherent risks, including risks with respect to:

- potential loss of proprietary information due to piracy, misappropriation or laws that may be less protective of our intellectual property rights than those of the United States;
- costs and delays associated with translating and supporting our products in multiple languages;
- foreign exchange rate fluctuations and economic instability, such as higher interest rates and inflation, which could make our products more expensive in those countries;
- costs of compliance with a variety of laws and regulations;
- restrictive governmental actions such as trade restrictions;
- limitations on the transfer and repatriation of funds and foreign currency exchange restrictions;
- compliance with different consumer and data protection laws and restrictions on pricing or discounts;
- lower levels of adoption or use of the Internet and other technologies vital to our business and the lack of appropriate infrastructure to support widespread Internet usage;
- lower levels of consumer spending on a per capita basis and fewer opportunities for growth in certain foreign market segments compared to the United States;
- lower levels of credit card usage and increased payment risk;
- changes in domestic and international tax regulations; and
- geopolitical events, including war and terrorism.

***Risks Related to Our Intellectual Property***

**Unlawful copying of our products or other third party violations of existing legal protections or reductions in the legal protection for intellectual property rights of software developers or use of open source software could adversely affect our distribution and revenue.**

The software products that we sell incorporate a technology that reduces the ability of third parties to copy the software without having paid for it. Unlicensed copying and use of software and intellectual property rights represents a loss of users and potential revenue to us, which could be more significant in countries where laws are less protective of intellectual property rights. Continued educational and enforcement efforts may not affect revenue positively and further deterioration in compliance with existing legal protections or reductions in the legal protection for intellectual property rights of software developers could adversely affect our revenue.

In addition, certain of our products or services may now or in the future incorporate open source software, which are typically distributed "as-is" without warranties, such as warranties of performance or ownership or indemnities against intellectual property infringement claims. Moreover, to the extent that we incorporate open source software into our products or services, (although we do not currently intend to do so), the license for such open source software may obligate us, among other things, to pass on to our licensees without charge the rights to use, copy, modify and redistribute the underlying software source code, both with respect to the original open source code and any modifications to such code created by us.

**If we fail to detect and stop misrepresentations of our site and products, or for some reason are perceived as promoting malware or "spamming", we could lose the confidence of the users of our products and services, or software could be blocked by software or utilities designed to detect such practices, thereby causing our business to suffer.**

We are exposed to the risk of domains using our brand names (such as "IncrediMail", "Smilebox", etc.) in various ways, and attracting in this manner our potential or existing users. Many times these domains are engaged with fraudulent or spam activities and using our brand names can result in damage to our reputation and loss of our clients' confidence in our products. In addition, if we or our products were for some reason perceived as promoting "malware or "spamming", our software could be blocked by software or utilities designed to detect such practices. If we are unable to effectively detect and terminate this misrepresentation activity of others or the way that we and our products are perceived, we may lose users and our ability to produce revenues will be harmed.

**Third party claims of infringement or other claims against us could require us to redesign our products, seek licenses, or engage in future costly intellectual property litigation, which could adversely affect our financial position and our ability to execute our business strategy.**

The appeal of our products is largely the result of the graphics, sound and multimedia content that we incorporate into our products. We enter into licensing arrangements with third parties for these uses. However, other third parties may from time to time claim that our current or future use of content, sound and graphics infringe their intellectual property rights, and seek to prevent, limit or interfere with our ability to make, use or sell our products. We have experienced such claims in the past although ultimately with no material consequence.

If it appears necessary or desirable, we may seek to obtain licenses for intellectual property rights that we are allegedly infringing, may infringe or desire to use. Although holders of these types of intellectual property rights often offer these licenses, we cannot assure you that licenses will be offered or that the terms of any offered licenses will be acceptable to us. Our failure to obtain a license for key intellectual property rights from a third party for technology or content, sound or graphic used by us could cause us to incur substantial liabilities and to suspend the development and sale of our products. Alternatively, we could be required to expend significant resources to re-design our products or develop non-infringing technology. If we are unable to re-design our products or develop non-infringing technology, our revenues could decrease and we may not be able to execute our business strategy.

We may become involved in litigation not only as a result of alleged infringement of a third-party's intellectual property rights, but also to protect our own intellectual property rights. If we do not prevail in any third-party action for infringement, we may be required to pay substantial damages and be prohibited from using intellectual property essential to our products.

We may also become involved in litigation in connection with the brand name rights associated with our Company name or the names of our products. We do not know whether others will assert that our Company name or brand name infringes their trademark rights. In addition, names we choose for our products may be claimed to infringe names held by others. If we have to change the name of our Company or products, we may experience a loss in goodwill associated with our brand name, customer confusion and a loss of sales. Any lawsuit, regardless of its merit, would likely be time-consuming, expensive to resolve and require additional management time and attention.

#### ***Risks Related to Our Industry***

**The Internet as a medium for commerce and communication is subject to uncertainty and there could be a shift in communication platforms away from email.**

The Internet and electronic communication industry is rapidly evolving, as new means for electronic communication are offered to the public. Our ability to execute our business strategy is currently dependent upon the continued predominance of email as a means of electronic communication and upon the continued use of the Internet.

Although we are in the process of diversifying our product portfolio, currently our email product, IncrediMail, generates approximately 88% of our revenues. In addition, although email software programs and services currently enjoy a large market, the development and consumer acceptance of other means of electronic communication, such as text messaging over phone networks, chat-boards, blogs and web-based social networks, have slowed the growth of the email market and could result in a substantial decrease in the size of this market, in which case our revenues could decrease and our products could become obsolete.

**There is direct competition between web-based software and downloaded software.**

There are different advantages and disadvantages to web-based software as compared to downloaded software. Currently, web-based software seems to be growing at a faster rate than downloaded software. Our business is currently reliant on the continued prevalence of downloaded software. If there were to be a more dramatic shift to web-based software this could cause a decrease in the distribution of our software and subsequently in our revenues.

**The Internet and Internet companies are providing an increasing number of services for free.**

Internet based companies are providing an increasing number of services for free, including email clients and anti-spam software and services. A substantial part of our revenues comes from selling software products and services, currently accounting for approximately 20% of our revenues. We attribute part of the decline in our revenues from the sale of products and services to this trend. Should this trend accelerate or even continue for a prolonged period, our revenues from product sales and services would decrease further.

**Our financial performance may be adversely affected by information technology, insufficient cyber-security and Other Business Disruptions**

Our business may be impacted by disruptions, including information technology attacks or failures. Cybersecurity attacks, in particular, are evolving and include, but are not limited to, malicious software, attempts to gain unauthorized access to data, and other electronic security breaches that could lead to disruptions in systems, unauthorized release of confidential or otherwise protected information and corruption of data. Unidentified groups recently hacked numerous Israel-based internet websites in what many have perceived as politically motivated attacks and as an Israeli Corporation we could similarly be at risk for attacks targeting Israeli entities in particular. We are not aware of material cybersecurity attacks directed at us in the past, but may experience them in the future, potentially with more frequency. We believe that we have adopted appropriate measures to mitigate potential risks to our technology and our operations from these information technology-related and other potential disruptions, and are also seeking to obtain appropriate levels of insurance coverage with respect to such incidents. However, given the unpredictability of the timing, nature and scope of such disruptions, we could potentially be subject to system downtimes, operational delays, other detrimental impacts on our operations or ability to provide products and services to our customers, the compromising of confidential or otherwise protected information, destruction or corruption of data, security breaches, other manipulation or improper use of our systems and networks, financial losses from remedial actions, loss of business or potential liability, and/or damage to our reputation, any of which could have a material adverse effect on our cash flows, competitive position, financial condition or results of operations.

**New laws and regulations applicable to e-commerce, Internet advertising, privacy and data collection and protection, and uncertainties regarding the application or interpretation of existing laws and regulations, could harm our business.**

Our business is conducted through the Internet and therefore, among other things, we are also subject to the laws and regulations that apply to e-commerce. These laws and regulations are becoming more prevalent in the United States, Europe, Israel and elsewhere and may impede the growth of the Internet or other online services. These regulations and laws may cover taxation, user privacy, data collection and protection, pricing, content, copyrights, electronic contracts and other communications, Internet advertising (including monitoring and tracking consumer behavior), consumer protection, the provision of online payment services, broadband residential Internet access, and the characteristics and quality of products and services.

Many areas of the law affecting the Internet remain largely unsettled, even in areas where there has been some legislative action. For example, there is a degree of uncertainty regarding the level of enforceability of different laws of countries in which the Company's products are being used. Therefore it is difficult to determine whether and how existing laws, such as those governing intellectual property, privacy and data collection and protection, libel, data security and taxation, apply to the Internet and our business. The US administration recently called for the creation of a Privacy Policy Office that would help develop an Internet "privacy bill of rights" for US citizens and coordinate privacy issues globally. The US Commerce Department's prepared a report recommending a "framework" to protect people from a burgeoning personal data-gathering industry and fragmented US privacy laws that cover certain types of data but not others. New laws and regulations may seek to impose additional burdens or restrictions on companies conducting business over the Internet. In Europe particularly, there is a major overhaul of the European Data Privacy framework which appears more proscriptive and ambitious and, over the course of the next 12 months, we will begin to understand the impact of this new proposed regulation which may demand further change in the way we conduct business and interact with our customers. With other national governments also taking steps to enshrine consumer rights (e.g., the UK government has proposals to consolidate all consumer protections into a single new "Consumer Bill of Rights") the level of consumer protections we face as a business is set to increase. We are unable to accurately predict the nature of the limitations that may be imposed.



There is currently also uncertainty in relation to the passing of relatively recent online laws. For example, legislation has been enacted to regulate the use of "cookie" technology. In Europe there is a patchwork of implementation and limit guidance as to what good practice looks like. Further, some Member States are yet to implement the relevant Directive and bring their laws into compliance. Upon installation of our software, certain cookies generated by us and our advertisers are placed on our customers' computers. It has been argued that Internet protocol addresses and cookies are intrinsically personally identifiable information that is subject to privacy standards. We cannot assure you that our current policies and procedures would meet these restrictive standards.

In addition, technology is changing constantly and data security regulations and standards are in a state of flux. Changes in law or regulations may require that we materially change the way we do business. For example, we may be required to implement physical, administrative and technological security measures different from those we have now, such as different data access controls or encryption technology. We may incur substantial expenses in implementing such security measures.

Although current decisions of the U.S. Supreme Court restrict the imposition of obligations to collect state and local sales and use taxes with respect to sales made over the Internet, the U.S. Congress and a number of states have been considering or have adopted various initiatives that could limit or supersede these decisions. If any of these initiatives result in a reversal of the Court's current position, we could be required to collect sales and use taxes on our U.S. sales. The imposition by state and local governments of various taxes upon Internet commerce could create administrative burdens for us and could decrease our future sales.

The EU has already enacted legislation regarding Value Added Tax imposed on certain software sold by companies outside the EU to consumers in the EU over the Internet. This legislation could be interpreted to include other parts of the Company's business not yet accrued for by the Company, causing additional significant tax exposure, or alternatively, reduce the competitiveness of the Company's pricing of its products.

The cost of compliance with the world taxation, consumer data protection and privacy related laws and regulations could be material and we may not be able to comply with the applicable regulations in a timely or cost-effective manner. In response to evolving legal requirements, we may be compelled to change our business model and practices, which could reduce our sales, and we may not be able to replace the revenues lost as a consequence of the change. These changes could also require us to incur significant expenses, subject us to liability and require increased time and attention of our management. See "Item 4.B Business Overview — Government Regulation" for additional discussion of applicable regulations affecting our Company.

#### ***Risks Related to Our Operations in Israel***

##### **Political, economic and military instability in the Middle East may impede our ability to operate and harm our financial results.**

Our principal executive offices are located in Israel. Accordingly, political, economic and military conditions in the Middle East may affect our business directly. Since the establishment of the State of Israel in 1948, a number of armed conflicts have occurred between Israel and its Arab neighbors. During the winter of 2008, Israel was engaged in an armed conflict with Hamas, a militia group and political party operating in the Gaza Strip, and during the summer of 2006, Israel was engaged in an armed conflict with Hezbollah, a Lebanese Islamist Shiite militia group and political party. Since February 2011, Egypt has experienced political turbulence, following the resignation of Hosni Mubarak as president, including protests throughout Egypt, and the appointment of a military regime in his stead followed by the election to the Egyptian parliament of certain political parties which advocate breaking ties with Israel, which may damage the current peaceful and diplomatic relations between Israel and Egypt, and which could affect the region as a whole. Similar civil unrest and political turbulence has occurred in other countries in the region and is affecting the political stability of those countries. Syria, which borders Israel, has experienced months of violence and some have expressed concern that the unrest could spill into Israel or lead to incidents on what has been a relatively quiet border in recent years. This instability may lead to deterioration of the political and economic relationships that exist between the State of Israel and some of these countries. In addition, Iran has threatened to attack Israel and is widely believed to be developing nuclear weapons. Iran is also believed to have a strong influence among extremist groups in the region, such as Hamas in Gaza and Hezbollah in Lebanon. These situations may potentially escalate in the future to more violent events which may affect Israel and us. These situations, including conflicts which involved missile strikes against civilian targets in various parts of Israel, negatively affected business conditions in Israel. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could have a material adverse effect on our business, operating results and financial condition. While such hostilities did not in the past have a material adverse impact on our business, we cannot guarantee that hostilities will not be renewed and have such an effect in the future. Ongoing and revived hostilities and the attempts to resolve the conflict between Israel and its Arab neighbors often results in political instability that affects the Israeli capital markets and can cause volatility in interest rates, exchange rates and stock market quotes. The political and security situation in Israel may result in parties with whom we have contracts claiming that they are not obligated to perform their commitments under those agreements pursuant to force majeure provisions. These or other Israeli political or economic factors could harm our operations and product development and cause our sales to decrease. Any hostilities involving Israel or the interruption or curtailment of trade between Israel and its present trading partners could adversely affect our operations and could make it more difficult for us to raise capital. Furthermore, several countries, principally those in the Middle East, still restrict business with Israel and Israeli companies and, although the impact of these restrictions is not as important for a company such as ours that sells its products through the Internet, it may nevertheless have an adverse effect on our results of operations. Since many of our facilities are located in Israel, we could experience serious disruptions if acts associated with this conflict result in any serious damage to our facilities. Our business interruption insurance may not adequately compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business. Any future armed conflicts or political instability in the region would likely negatively affect business conditions and harm our results of operations.

**Our operations may be disrupted by the obligations of our personnel to perform military service.**

All non-exempt male adult citizens and permanent residents of Israel under the age of 40, or older for reserves officers or citizens with certain occupations, as well as certain female adult citizens and permanent residents of Israel, are obligated to perform military reserve duty and may be called to active duty under emergency circumstances. In recent years, there have been significant call-ups of military reservists, and it is possible that there will be additional call-ups in the future. Many of our male employees in Israel, including members of senior management, are obligated to perform up to 36 days of military reserve duty annually until they reach the relevant age of discharge from army service and, in the event of a military conflict, could be called to active duty. While we have operated effectively despite these conditions in the past, we cannot assess what impact these conditions may have in the future, particularly if emergency circumstances arise. Our operations could be disrupted by the absence of a significant number of our employees related to military service or the absence for extended periods of military service of one or more of our executive officers or key employees. Any disruption in our operations would harm our business.

**Investors and our shareholders generally may have difficulties enforcing a U.S. judgment against us, our executive officers and our directors or asserting U.S. securities laws claims in Israel.**

We are incorporated in Israel and most of our executive officers and most of our directors reside outside the United States. Service of process upon them may be difficult to effect within the United States. Furthermore, most of our assets and most of the assets of our executive officers and directors are located outside the United States. Therefore, a judgment obtained against us or any of them in the United States, including one based on the civil liability provisions of the U.S. federal securities laws may not be collectible in the United States and may not be enforced by an Israeli court. It also may be difficult for you to assert U.S. securities law claims in original actions instituted in Israel. However, subject to certain time limitations, Israeli courts may enforce U.S. final executory judgments for liquidated amounts in civil matters obtained after due trial before a court of competent jurisdiction (according to the rules of private international law currently prevailing in Israel) which enforces similar Israeli judgments, provided that the requisite procedural and legal requirements are adhered to. If a foreign judgment is enforced by an Israeli court, it generally will be payable in NIS, which can then be converted into foreign currency at the rate of exchange of such foreign currency on the date of payment. Pending collection, the amount of the judgment of an Israeli court stated in NIS (without any linkage to a foreign currency) ordinarily will be linked to the Israeli consumer price index plus interest at the annual statutory rate prevailing at such time. Judgment creditors bear the risk of unfavorable exchange rates.

**The tax benefits available to us require us to meet several conditions and may be terminated or reduced in the future, which would increase our costs and taxes.**

We have generated income and therefore, are able to take advantage of tax exemptions and reductions resulting from the "Approved Enterprise" and "Beneficiary Enterprise" status of our facilities in Israel, albeit, during the period in the past when we distributed dividends, to a limited extent. To remain eligible for these tax benefits, we must continue to meet certain conditions stipulated in the Law for the Encouragement of Capital Investments, 1959 (the "Investment Law"), and its regulations and the criteria set forth in the specific certificate of approval. This pertains in particular to establishing that revenues are generated and based on technology developed in Israel. If we fail to meet the required conditions in the future, the tax benefits would be canceled and we could be required to refund any tax benefits we have received with interest and adjustment for change in Israeli consumer price index. These tax benefits may not be continued in the future at their current levels or at any level.

Effective April 1, 2005, the Investment Law was amended. As a result, the criteria for investments qualified to receive tax benefits as an Approved Enterprise were revised (the "First Amendment"). As will be elaborated below, the Israeli Parliament approved recently an additional amendment to the Investment Law, which revises again the criteria for investments qualified to receive tax benefits as a "Preferred Enterprise" for new tax benefits programs from January 1, 2011 (the "Second Amendment"). No assurance can be given that we will, in the future, be eligible to receive additional tax benefits under this law and its amendments. The termination or reduction of these tax benefits would increase our tax liability in the future, which would reduce our profits or increase our losses. Additionally, if as we are contemplating, we increase our activities outside of Israel, for example, by additional future acquisitions or otherwise not based on technology based in Israel, our increased activities might not be eligible for inclusion in Israeli tax benefit programs. If and when we were to discontinue our policy for not distributing dividends, with respect to earnings from 2011 and beyond, tax-exempt income generated under the provisions of the law will subject us to taxes upon distribution or liquidation and we may be required to record deferred tax liability with respect to such tax-exempt income, possibly affecting our results in the future. See "Item 10.E Taxation — Israeli Taxation — Law for the Encouragement of Capital Investments, 1959" for more information about these programs, the Investment Law and the abovementioned amendments.

***Risks Related to our Ordinary Shares and their Listing on a Stock Exchange***

**Although we have paid dividends in the past, our policy since the beginning of 2011 is not to distribute dividends. Therefore, the return on investment in our ordinary shares will be limited to the value of our stock.**

We have paid dividends in the past, however as we announced, our current policy is not to distribute dividends, starting with the profits of 2011 and beyond. If we do not pay dividends, our stock may be less valuable because a return on your investment will only occur if our stock price appreciates. See "Item 8.A Consolidated Statements and Other Financial Information — Policy on Dividend Distribution" for additional information regarding the payment of dividends.

**We incur significant costs as a result of being a public company.**

As a public company, we incur significant legal, accounting and other expenses. We incur costs associated with our public company reporting requirements as well as costs associated with corporate governance requirements, including requirements under the Sarbanes-Oxley Act of 2002, the rules of the Nasdaq Stock Market, the provisions of the Israeli Securities Law that apply to dual listed companies (companies that are listed on the Tel Aviv Stock Exchange ("TASE") and another recognized stock exchange located outside of Israel) and the provisions of the Israeli Companies Law that apply to public companies. For example, as a public company, we have created additional board committees and are required to have two external directors, pursuant to the Israeli Companies Law. We have also contracted an internal auditor and a consultant for implementation of and compliance with the requirements under the Sarbanes-Oxley Act. See "Item 5 Operating and Financial Review and Prospects — Overview — General and Administrative Expenses" for a discussion of our increased expenses as a result of being a public company.

**If we were to lose our foreign private issuer status under US federal securities laws, we would incur additional expenses associated with compliance with the US securities laws applicable to US domestic issuers.**

We are a foreign private issuer, as such term is defined under US federal securities laws, and, therefore, we are not required to comply with all of the periodic disclosure and current reporting requirements applicable to US domestic issuers. If we lost this status, we would be required to comply with the reporting and other requirements applicable to US domestic issuers, which are more detailed and extensive than the requirements for foreign private issuers. The regulatory and compliance costs to us under US securities laws, if we are required to comply with the reporting requirements applicable to a US domestic issuer, may be significantly higher than the cost we currently incur as a foreign private issuer.

**The rights and responsibilities of our shareholders are governed by Israeli law and differ in some respects from the rights and responsibilities of shareholders under U.S. law.**

We are incorporated under Israeli law. The rights and responsibilities of holders of our ordinary shares are governed by our memorandum of association, our articles of association and by Israeli law. These rights and responsibilities differ in some respects from the rights and responsibilities of shareholders in typical U.S. corporations. In addition, as a foreign private issuer, we are permitted by the listing requirements of the NASDAQ to rely on home country governance requirements and certain exemptions thereunder rather than relying on the corporate governance requirements of the NASDAQ. See "Item 16.G Corporate Governance." In particular, a shareholder of an Israeli company has a duty to act in good faith toward the company and other shareholders and to refrain from abusing his power in the company, including, among other things, in voting at the general meeting of shareholders on certain matters. Israeli law does not currently describe the substance of this duty of fairness, but provides that laws applicable to a breach of contract, adjusted according to the circumstances shall apply to a breach of such duties. See "Item 10.B Memorandum and Articles of Association — Approval of Related Party Transactions" for additional information concerning this and other duties of a shareholder under Israeli law. Because Israeli corporate law has undergone extensive revision in recent years, there is relatively little case law available to assist in understanding the implications of these provisions that govern shareholder behavior.

**Provisions of our articles of association and Israeli law may delay, prevent or make difficult an acquisition of our Company, which could prevent a change of control and, therefore, depress the price of our shares.**

Israeli corporate law regulates mergers, requires tender offers for acquisitions of shares above specified thresholds, requires special approvals for transactions involving directors, officers or significant shareholders and regulates other matters that may be relevant to these types of transactions. In addition, our articles of association contain provisions that may make it more difficult to acquire our Company, such as provisions establishing a classified board. Furthermore, Israeli tax considerations may make potential transactions unappealing to us or to some of our shareholders. See "Item 10.B Memorandum and Articles of Association — Approval of Related Party Transactions" and "Item 10.E – Taxation — Israeli Taxation" for additional discussion about some anti-takeover effects of Israeli law.

These provisions of Israeli law may delay, prevent or make difficult an acquisition of our Company, which could prevent a change of control and therefore depress the price of our shares.

**Future sales of our ordinary shares could reduce our stock price.**

Sales by shareholders of substantial amounts of our ordinary shares, or the perception that these sales may occur in the future, could materially and adversely affect the market price of our ordinary shares. In addition, although our executive officers and directors have certain limitations regarding how and when they may trade our securities, neither they or relatively large shareholders are subject to contractual restrictions on the sale by them of shares, resulting in a substantial number of shares held by them in the public market. Furthermore, the market price of our ordinary shares could drop significantly if our executive officers, directors, or certain large shareholders sell their shares, or are perceived by the market as intending to sell them.

#### **ITEM 4. INFORMATION ON THE COMPANY**

##### **A. HISTORY AND DEVELOPMENT OF THE COMPANY**

###### **Our History**

We were incorporated in the State of Israel in November 1999 under the name Verticon Ltd. We changed our name to Incredimail Ltd. in November 2000, and in November 2011 to Perion Network Ltd., to better reflect the diverse nature of our business. We operate under the laws of the State of Israel. Our headquarters are located at 4 HaNechoshet Street, Tel-Aviv 69710, Israel. Our phone number is (972-3) 769-6100. Our website address is [www.perion.com](http://www.perion.com). The information on our websites does not constitute a part of this annual report.

We completed the initial public offering of our ordinary shares in the United States on February 3, 2006, whereby we became a "limited liability public company" under the Israeli Companies Law. The registration statement on Form F-1 relating to our initial public offering became effective on January 30, 2006.

Since November 20, 2007 the Company's ordinary shares are also traded on the Tel Aviv Stock Exchange.

On August 31, 2011 we completed the purchase of Smilebox Inc., a Washington corporation, through our Delaware subsidiary. See "Recent Developments" below.

### **Principal Capital Expenditures**

We had capital expenditures of \$31.8 million in 2011, \$0.7 million in 2010 and \$0.5 million in 2009. We currently expect that outside of possible acquisition of products and companies, our capital expenditures will be approximately \$1.5 million in 2012. To date, we have financed our general capital expenditures with cash generated from operations.

Our capital expenditures during 2009 and 2010 consisted primarily of; leasehold improvements and furnishings, as well as investments in computer hardware and software, in Israel. In 2011, capital expenditures consisted of \$31.5 million for the acquisition of Smilebox, including approximately \$7 million to be paid in 2012, and \$0.3 million for investment in computer hardware and software, leasehold improvements and furnishings.

In 2012, we expect to continue our growth strategy for acquiring products and businesses, in addition to organic capital investments. Our organic investments are expected to consist primarily of acquiring computer hardware, software, peripheral equipment and installation, all which are expected to be financed by the Company's resources. To the extent we acquire new products and businesses these acquisitions may be financed by any of, or a combination of, cash generated from operations, the credit facility currently available to the Company from Israeli banks, in an amount up to \$20 million, and/or issuances of securities or debt.

### **Recent Developments**

On August 1, 2011 we signed a definitive agreement to acquire (via our Delaware Subsidiary) Smilebox Inc., a U.S. consumer focused photo sharing and social expression company.

Smilebox is an Internet photo sharing service available for the desktop and smart-phone, with an easy-to-use, downloadable desktop application that allows consumers to use personal photos and videos to construct unique creations, including: greeting cards, invitations, slideshows, scrapbooks and photo albums. On the desktop, Smilebox can be used both on the PC and the Mac, in order to create digital creations from personal photos using a range of digital designs including Invitations, Greetings, Collages, Scrapbooks, Photo Albums and slideshows. These creations can then be shared free of charge via email, Facebook, Twitter, Print, DVD or Photo Frames. Revenues are generated from subscriptions for premium content and features, advertising from creations that are shared for free, printing revenues from creations that are printed to store or printed and shipped to home and search revenues for consumers that elect to have Smilebox provide their default search results.

Smilebox is also available for the iPhone making easy to personalize and share photos in the moment directly from the device. Personalization options include captions, stickers and frames and sharing options include email, Facebook or SMS. Revenues are generated via subscriptions for premium content

The acquisition added another major product to the Perion portfolio of products, significantly diversifying its revenue mix. Under the terms of the agreement, Perion paid \$25 million substantially in cash at closing which occurred on August 31, 2011, with additional payments of up to \$15 million, if certain milestones and performance based conditions are met, payable in two installments on the seven and fourteen months anniversary from closing. Approximately 10% of the acquisition consideration is being held in escrow until 18 months after closing.

Smilebox continues to operate from its Redmond, Washington, based offices, which employs approximately 50 people, as of the date of this annual report.

## B. BUSINESS OVERVIEW

### Overview

We are a digital media company that provides products and services to consumers to help make their everyday life simpler and more enjoyable. Focusing on an underserved market of second wave adopters who value their time online, Perion offers a growing portfolio of easy-to-use products. The Company's products include:

- IncrediMail Premium, an award winning e-mail product sold in over 100 countries in 10 different languages;
- Smilebox, a leading photo sharing and social expression product and service that lets customers quickly turn life's moments into digital creations to share and connect with friends and family in a fun and personal way;
- PhotoJoy, a photo discovery and sharing screensaver & wallpaper product; and
- Fixie, a PC optimization product.

Since we began operations in 2000, our products have been downloaded in more than 100 countries, and in the last quarter of 2011 we recorded an average of approximately 2.1 million registered downloads each month. As of December 31, 2011, we had an installed base of approximately 12.3 million, and in the last quarter of 2011 more than 369 million IncrediMail® emails and our Smilebox users shared 2.3 million photo creations. Our users typically use our products for as long as six years. However, the length of use varies dramatically based on the product, whether it's the free version or paid for, when the product was downloaded and other factors.

In 2011 we sold 402,000 products and content licenses worldwide to our registered users. We believe that our historical track record of converting registered users to purchasing customers represents a convincing validation of our business strategy.

We generate revenue primarily by:

- generating searches and sharing in the revenues with the provider of the search engine;
- selling our premium software products; and
- other revenues from advertising and collaborations.

For a breakdown of total revenues by category of activity, see "Item 5.A Operating Results — Revenues."

In the past we relied primarily on "viral growth" to grow our user base. Since the middle of 2011, while viral growth still contributes a substantial portion of our growth, we are investing increasing sums in advertising to accelerate our growth as the effectiveness of our viral growth declines. Our "viral growth" has resulted from recipients of our users' emails clicking on the link at the bottom of emails sent with *IncrediMail® Xe*, or receiving digital photo creations from friends and relatives, created by our Smilebox software, and then downloading our products and also from word of mouth. Our revenues were \$27.2 million in 2009, \$29.5 million in 2010 and \$35.5 million in 2011. Our operations have been profitable since 2002, with a gross profit margin of at least 90%.

When we use the term "registered user" in this annual report, we mean a user who has downloaded at least one of our products and completed the registration process. Registrations are not necessarily indicative of the number of individuals using our products or services, as a user may register more than one time and a particular product or service may be resident on their computer but not actually being used. In addition, the term "active user" as used in this annual report means a registered user whose computer the Company can communicate with in order to verify if any of its products are resident on such computer, in the 30 days prior to the applicable measurement date.

### Our Markets

In the past we emphasized the graphic content provided in our products and looked to develop and market products rich in graphic content. This perception was created by the success of our email client *IncrediMail Xe*, which was rich in graphic content and provided the ability to personalize users' email experience. Consistent with this strategy, we developed our Magentic and HiYo products, both of which are also rich in graphic content. However, neither of these products has been successful in generating substantial revenues.

Based on our recent consumer research, we have learned that while the graphic content was critical in attracting the user to the product, the use of the product was based on our ability to provide our consumer segment of “second wave adopters”, software that is simple, safe and useful, assisting them in better utilizing their time.

*Our user.* Our products ideally service “second wave adopters”, characterized by typically being above 40 years in age, looking for computer applications that assist them in effectively utilizing their time and that are simple, safe and useful. Based on our internal statistics and in-depth consumer research contracted by the Company, we have learned that, approximately 94% of our users are 35 years or older and approximately 79% are 45 or older. In addition, our users do tend to adopt technology later in its life cycle, rather than earlier.

*Our Opportunity.* We believe we are one of the few hi-tech companies that target this unique demographic segment, rather than offering the latest technology to younger audiences. Our opportunity is to offer this demographic software that is simple safe and useful, enabling them to better utilize their time, as we have done successfully with our email client, photo sharing software and recently begun with our PC optimization software. We believe this is a substantial and underserved market.

*Productivity tools.* We are actively seeking to enrich our product suite to include other consumer products that bear similar characteristics appealing to our unique demographic segment. We believe our digital photo products Smilebox and PhotoJoy have these characteristics and will appeal similarly to our user base. Based on our consumer research, we will seek to offer our users, in addition to these products, other tools in the areas, safety and security in the POC environment, personal productivity, wellness, and other areas.

## **Our Strategy**

Our objective is to become the market leader and a reliable provider of consumer software for second wave adopters seeking computer products that are simple, safe and easy to use. To achieve this we intend to enhance our existing business and extend it beyond that by way of acquisitions.

To enhance the existing business we intend to;

- invest in consumer insight enabling us to identify the specific needs of our targeted demographic;
- continue and further increase our customer acquisition costs; and,
- develop a more robust product line.

By investing in consumer research, we will be able to better identify the specific needs of our targeted demographic. In addition, until recently, the Company had predominantly relied on the viral nature of its applications, investing in customer acquisition only as a tool of initial market penetration for its products. The growth of our user base has been tapering off as a result of us relying on this method of marketing. Based on the back-end systems recently developed and still being improved, the Company has increased significantly the amount invested in customer acquisition, in order to accelerate the growth in its user base. Finally, in order to reduce the Company’s dependency on a limited number of products and to better serve our users and their needs, we intend to continue to enrich and expand our product suite.

However, in order to grow our business beyond organic growth, the Company intends to invest in acquiring other products and extend the business as we have done with the acquisition of Smilebox Inc. in 2011. This will enable us to further diversify our revenue base, better serve the needs of our users and reduce the time required to bring these new products to market.

By focusing on our consumer, enhancing and extending our business, we believe we will be able to further grow the basic metrics that support our growth, by;

- *Maintaining and growing our user base.* Our effective viral marketing has resulted in millions of registered users who spread the word about our products and services at relatively low marketing costs to us. Our product remains viral and thereby provides high profit margins. We intend to layer on top a strategy for acquiring new customers, who will also be viral to a certain extent, in order to accelerate our growth.
- *Increasing the use of our products by our users and the searches performed by them through our products.* By focusing on our consumers and their needs, we believe we can increase the use of our products and subsequently the searching capabilities offered to them.

- *Enhancing product offerings and increasing user sales.* Over recent years our premium product sales have declined. We believe that another result of our consumer research will be to identify the premium products and services sought by our users and better identifying their value. Although we believe that a majority of our revenues will continue to be generated by advertising in general, and search generated revenues in particular, we believe that there remains a real opportunity to grow our premium product sales significantly.
- *Enhancing the consumer experience.* We have always attempted to provide a positive experience to our users. As we further emphasize this aspect, we will continue to design our products and services and market them to address users' aversion to spam, spyware and other perceived offensive Internet marketing tools, which we believe encourages more use of them and increases user loyalty.
- *Continuing to focus on the online consumer market.* Email remains a prominent communication medium and sharing digital photo creations has become a popular way of expression. We intend to enhance our email client so that it embraces other methods of communication; instant messaging, social networks, etc. and incorporate new platforms for sharing photos such as smart-phones and tablets. The Internet allows us to reach potential users throughout the world quickly and easily as well as reduces the costs associated with sales and distribution of our products and services.

#### **Search generated revenues**

We offer our users the ability to search by collaborating with premium search companies, currently almost exclusively Google Inc., and to receive a portion of the revenues generated by these companies through the search process.

On December 27, 2010 we signed a new search distribution agreement with Google, effective January 1, 2011 and expiring January 31, 2013, which replaced the previous agreement we had with Google. We are unable to disclose many of the terms of this contract. However, while there are several changes in this new agreement when compared to the one previously in place, the results produced by this new agreement are materially similar to those of the prior agreement. Google's coverage and service offering is the one most suited to our global distribution and provides the best monetization opportunity for our products. Nonetheless, we will continue to explore opportunities to work with the other search providers.

#### **Other advertising and other revenues**

Finally, we utilize the distribution of our products and their presence in the user's desktop to generate other advertising revenues from methods such as display ads and banners, as well for generating revenues by collaborating with other companies to offer their products to those that download our products.

For a breakdown of total revenues by category of activity, see "Item 5.A Operating Results — Revenues."

#### **Our Products**

Our products are currently available in ten languages in addition to English. Prices and license fees for our premium products range between \$5 and \$60, varying based on market, length of license period and whether the products are offered together. We offer the following products, all of which may be downloaded over the Internet through a personal computer running on a Microsoft Windows operating system:

Communication vertical:

- *IncrediMail® Xe* is our communication client, available over the Internet free of charge, which is used for managing email messages and Facebook feeds, and which has the following main features:
  - o pre-prepared backgrounds and letterheads;
  - o animated notifiers;
  - o emoticons (animations that are intended to convey emotions);
  - o 3D effects;
  - o handwritten signatures;
  - o a web gallery with additional animations, notifiers and email backgrounds;
  - o sound effects;



- o virtual e-cards; and
- o advanced search and sorting capabilities within the email client.
- *IncrediMail® Premium* is an enhanced version of *IncrediMail® Xe*. Users who upgrade through the purchase of *IncrediMail® Premium* benefit from the following features:
  - o no advertising banners displayed in the product;
  - o the ability to change the appearance of the product through the use of software skins;
  - o voice message recorder;
  - o no promotional link at the bottom of outgoing emails;
  - o enhanced notifiers;
  - o a web gallery with additional animations, notifiers and email backgrounds;
  - o advanced account access; and
  - o email-based user support.
- *The Gold Gallery* is a license-based premium content in the form of email backgrounds, animations, sounds, graphics and email notifiers.
- *JunkFilter Plus / Protection Center* is an advanced anti-spam product, based on the Recurrent Pattern Detection Technology (RPD™) that we license from Commtouch Ltd.
- *IncrediMail® Letter Creator* is an application that enables *IncrediMail®* users to design and create their own personalized email letters and ecards.

Digital photo vertical:

- *Smilebox* is an Internet photo sharing service available for the desktop and smart-phone.
  - o On the desktop, Smilebox can be used both on the PC and the Mac, making it easy to create digital creations from personal photos using a range of digital designs including Invitations, Greetings, Collages, Scrapbooks, Photo Albums and slideshows. These creations can then be shared free of charge via email, Facebook, Twitter, Print, DVD or Photo Frames. Revenues are generated from subscriptions for premium content and features, advertising from creations that are shared for free, printing revenues from creations that are printed to store or printed and shipped to home and search revenues for consumers that elect to have Smilebox provide their default search results.
  - o Smilebox is also available for the iPhone making easy to personalize and share photos in the moment directly from the device. Personalization options include captions, stickers and frames and sharing options include email, Facebook or SMS. Revenues are generated via subscriptions for premium content.
- *PhotoJoy* is a photo discovery tool for the PC, accessing and revealing personal photos saved on a user's PC. In addition, the software allows users to take photos from photo hosting web sites (such as Flickr and Picasa) and continue viewing new photos once uploaded to these sites directly in *PhotoJoy* as well, thereby enabling the user to enjoy photos on the computer desktop. Recently the Company released a version of PhotoJoy for the iPhone and iPad.

Security and Safety vertical:

- *Fixie* helps users optimize the speed and performance of their PC, with the following main features:
  - o Conducts error check & quickly fixing PC errors;
  - o Cleans registry, providing more stable computer environment;
  - o Assists in preventing blue screen and other common PC problems;
  - o Scans PC for out of date drivers and updates them;
  - o Minimizes freezes caused by conflicting hardware;
  - o Protects PC with real-time system optimizer;

- o Reduces malware, spyware and Trojan viruses that can infect the computer;
- o Safeguards personal information with built-in privacy monitor; and
- o Cleans system by removing junk files that take up space on the PC.

### Products under Development

Our research and development activities are conducted internally by our Chief Technology Officer and a 69 person research and development staff. Our research and development efforts are focused on the development of upgraded software, new features and the enhancement, and enabling new platforms for our existing product suite.

In 2011 we increased our development investment effort, and refocused this effort so as to enhance our product pipeline. The initial results of this effort are apparent by the products and features released during the past year. We intend to continue this effort in 2012 by introducing additional products and focusing on adapting our existing products for use on mobile platforms, including the iPhone, iPad and possibly Android based platforms as well.

### Sales, Marketing and Distribution

Our products are distributed and sold throughout the world in more than 100 countries. The following table shows the estimated distribution of our registered users, search generated revenues and products sold by territory in 2011: (\*)

|        | Search Generated |          | Product  |
|--------|------------------|----------|----------|
|        | Registrations    | Revenues | Revenues |
| Tier 1 | 32%              | 42%      | 66%      |
| Tier 2 | 24%              | 43%      | 23%      |
| Tier 3 | 44%              | 15%      | 11%      |

(\*) Tier 1: United States, Canada, United Kingdom & Australia; Tier 2: France, Germany, Netherlands, Italy, Belgium, Switzerland; Tier 3: Other

To date, we have relied mainly on "viral growth," arising from recipients of our users' emails clicking on the link at the bottom of emails sent with *IncrediMail® Xe* and then downloading our products and from word-of-mouth. In addition, during 2008 we employed traditional marketing strategies, consisting primarily of online advertising, which efforts were met to our satisfaction. These efforts were employed to assist in the initial market penetration of our HiYo product in the latter part of 2008. Having achieved the objectives originally set out, and in light of the new market conditions and our focus on profitability in 2009, we scaled back our marketing efforts and remained at a similar level in 2010. In 2011 we supplemented the viral marketing with customer acquisition efforts aimed at accelerating our growth, increasing the number of registered users, and as a result increasing revenues. We plan to continue this effort, and increase it somewhat, in 2012

We have typically experienced stronger product sales in the first and fourth quarters, principally because our products are purchased in holiday sales in December or in the after-holiday sales in January. This is especially so regarding our Smilebox photo-sharing software. This is in addition to the general seasonality of the Internet as well as e-commerce being more active in the winter months. Since 2007 and up until the first half of 2011, as search generated revenues accounted for a growing and more dominant portion of our revenues, the seasonality of our revenues has decreased; however, with the acquisition of Smilebox and the increased growth in product sales, we can again expect higher seasonality towards those months.

As of December 31, 2011 we had 32 employees in our sales and marketing department.

### Intellectual Property

We rely on a combination of patent, copyright, trademark and trade secret laws and confidentiality and invention assignment agreements to protect our intellectual property rights. However, we do not currently believe that they provide a significant competitive advantage.

Most of the components of our software products were developed solely by us. We have licensed certain components of our software from third parties. Except for our agreements regarding anti-spam software and some of our content licenses, most of these licenses entailed a one-time fee or are freeware. We believe that these components are not material to the overall performance of our software and may be replaced without significant difficulty.

In July 2006 a patent was awarded to the Company in the in the United States entitled “System and Method for visual feedback of command execution in electronic mail systems”.

In 2011 the Israeli Patent office concluded the examination and has notified the Company that it is willing to allow a patent of said application in Israel. A correspondent application is still pending in the EPO.

In 2007 an international application was filed for an invention entitled "Interactive Message Editing System and Method". This application was filed as part of the National Phase in the USA, Europe and China.

We enter into licensing arrangements with third parties for the use of graphic, sound and multimedia content integrated into our products.

We have registered: (i) IncrediMail, and PhotoJoy as trademarks in the United States, the European Community (a community Trademark) and China; (ii) “Smilebox Teeth Design” in the United States; and (iii) “Smilebox” in Australia, Canada, China, France, Germany, Japan, Korea, United Kingdom and the United States.

We have pending trademark applications of “Perion” in Israel, United States the European Community (a community Trademark).

All professional employees and technical consultants are required to execute confidentiality covenants in connection with their employment and consulting relationships with us. We also require them to agree to disclose and assign to us all inventions conceived in connection with their services to us. However, there can be no assurance that these arrangements will be enforceable or that they will provide us with adequate protection.

### **Competition**

The vertical markets we are active in are subject to intense competition. Our products compete in the specialized market for email software products, digital photo services and PC safety and security, aiming to offer simple, safe and useful applications.

Perion was among the first companies to offer to the consumer email market a solution that combines an easy to use and intuitive email product with a gallery of creative content. Providing this kind of solution and compiling content is a lengthy process and based on a prolonged relationship with our users, and we have been doing it since 2000. We believe we have established ourselves with our unique demographic segment, as a provider of solutions answering to these needs, and we believe that we have as such an advantage over many of our competitors.

In the digital photo sharing space, our Smilebox product is unique in that it is the only service that enables consumers to create a complete range of digital creations that can be shared electronically via email, Facebook or Twitter complete with music, interactivity and animation or physically via print, DVD or photo frame. Smilebox is unique in personalizing the photo sharing experience on smart-phones, by easily enabling the user to personalize their photos with content, and which can then be shared in a way that is personal via email, SMS or Facebook.

Our ability to compete effectively depends upon our ability to distinguish our Company and our products from our competitors and their products, and includes the following factors:

- the simplicity of use
- product quality;
- product pricing;
- the creativity, variety and volume of content accessible through our software;
- success and timing of new product development and introductions;
- maintaining our reputation for safe and reliable products; and
- development of successful marketing channels.

With respect to our communication products, our main competition is with web-based email software products, such as Google's Gmail™, Yahoo! Mail™ and Microsoft's Hotmail™. The web based email market is characterized with significant competition, changing technologies and evolving products and services enhancements.

Google, Yahoo! and Microsoft each offer a web-based e-mail service in addition to the many other services they provide, such as desktop search, local search, instant messaging, photos, maps, video sharing, mobile applications, and so on. We expect these competitors to increasingly use their financial and engineering resources to compete with our client-based e-mail service, and if we are unable to successfully compete with them, our results of operations may be adversely affected.

In addition, there is some competition in the area of downloadable email clients, such as: WikMail, Arcsoft Multimedia Email™ 3 and Mind Spark Products™. In addition, our products also face competition from general email software programs offered to the private market by large Internet and software companies, such as AOL9 by America Online, Inc., Eudora® by QUALCOMM Incorporated (Nasdaq: QCOM), Thunderbird® by Mozilla Corporation and Outlook Express by Microsoft Corporation (Nasdaq: MSFT), some of which may also incorporate certain special features that provide a personalized email experience, some of them offering creative graphic backgrounds, such as Yahoo! Mail™. Many of the large Internet and software companies offer their email software programs free of charge. Our PhotoJoy products' main competitors, in area of providers of wallpapers, screensaver and digital photo management offer the following products: Picasa, webshots.com and screensavers.com, which offer wallpapers and screensavers both free and premium products for a fee. Competition with these products, reliance on viral marketing and technical difficulties have resulted in a reduction of the number of downloads, market share, prices and margins.

Many of our competitors have more established brands, products and customer relationships than we do, which could inhibit our market penetration efforts even if they may not offer a solution that is as simple to use, or that provides a customized and entertaining email experience similar to *IncrediMail*®. For example, consumers may choose to receive an extensive package of Internet and email services from a more dominant and recognized company, such as Microsoft Corporation (Outlook Express) or America Online, Inc. (AOL®). If we are unable to achieve continued market penetration, we will be unable to compete effectively.

With respect to our Smilebox photo sharing product, Smilebox competes broadly within the photo services category. Competition includes America Greetings and Hallmark from the greetings category, Shutterfly, Kodak and Snapfish from the photo products category and services like Flickr, Facebook and Instagram in the social photo sharing category.

In addition, as a major part of our revenues stem from our offering search properties by means of offering consumer downloadable software, other companies with consumer downloadable software, albeit with totally different software, are competing by utilizing the same strategy, to offer their search properties.

Finally, many of our other current and potential competitors have significantly greater financial, research and development, manufacturing, and sales and marketing resources than we have. These competitors could use their greater financial resources to acquire other companies to gain enhanced name recognition and market share, as well as to develop new technologies, products or features that could effectively compete with our existing product lines. Demand for our products could be diminished by products and technologies offered by competitors, whether or not their products and technologies are equivalent or superior.

#### **Government Regulation**

U.S., U.K., the European Union, Israeli and other jurisdictions have adopted laws that could have an impact on our business, including the ones described in this section.

There are still relatively few laws or regulations specifically addressing the Internet. In some instances, in the EU particularly, those that have been implemented are dating rapidly as online practice (and particular social commerce and extent of online interaction and communication) evolves. As a result, the manner in which existing laws and regulations should be applied to the Internet in general, and how they relate to our business in particular, is unclear in many cases and varies from county to country. Such uncertainty arises under existing laws regulating matters, including user privacy, defamation, access changes, "net-neutrality" pricing, advertising, taxation, gambling, sweepstakes, promotions, content regulation, quality of products and services, and intellectual property ownership and infringement.

To resolve some of the current legal uncertainty, it is possible that new laws and regulations (and associated guidance) will be adopted that will be directly applicable to our activities. Any existing or new laws, regulations or legislation applicable to us could expose us to potential liability, including significant expenses necessary to comply with such laws and regulations, and could dampen the growth in use of the Internet in general. In connection with this, some of the countries in which we operate have increased their enforcement of local laws and therefore the potential impact of failing to comply with local and international legislative requirements has increased significantly.

When users visit our website or install and use our software, certain "cookies" (pieces of information sent by a web server to a user's browser) may be generated by us and third parties we cooperate with, including our advertisers and may be placed on our customers' computers. While we believe that our use of cookies does not result in personal identification, it has been argued that Internet protocol addresses and cookies are intrinsically personally identifiable information that is subject to privacy standards. In addition, the impact of new regulation in the EU means that, regardless of personal identification via cookies (or any similar devices), there are now obligations to inform consumers how cookies are used and provide information about cookies. Unless limited exceptions apply we will now only be able to place a cookie on terminal equipment where the user or subscriber has given their consent. We cannot assure you that our current policies and procedures will meet these restrictive standards but we will continue to assess our use of cookies, and where necessary, work with third parties serving cookies via our websites and take steps to provide transparency, as well as assess which solution for obtaining user consent will be most appropriate. The compliance situation is compounded as not all of EU legislation is currently in force and there are likely to be a number of variations in the approach and regulations. Today we have limited technical or operational capability to vary our website or practices on a country to country basis. There are no specific laws restricting the use of such cookies in the United States. While some courts there previously questioned whether placement of cookies on a user's hard drive is permissible without the user's consent, to the best of our knowledge no liability has been found.

Our approach to privacy and data protection compliance includes both technological solutions and a focus on employee awareness and behavior. We post our privacy policy and practices concerning cookies and the use and disclosure of user data on our websites. Our websites inform users through our privacy policy what information we collect about them and about their use of our services as mentioned above, in the EU at least, it is likely that further transparency and consent will be required in connection with some of our activities which use cookies and similar technologies. We also provide users with the opportunity to opt out of receiving certain communications from us.

Any failure by us to comply with our posted privacy policy, U.S. Federal Trade Commission requirements or other domestic or international privacy-related laws and regulations could result in proceedings by governmental or regulatory bodies that could potentially harm our business, results of operations and financial condition, or result in private civil actions for damages and equitable relief. In addition, abuse by third parties of the data we collect could potentially subject us to liability. In addition, the negative public perception, potential reputational damage and associated public concern over privacy practice may equally impact our business in the event of any adverse publicity around failure to comply or any regulatory investigation into our practices.

In this regard, there are still a large number of legislative proposals before the European Union, as well as before the United States Congress and various state legislative bodies, regarding privacy and other issues related to our business. Other jurisdictions could also adopt laws and regulations that could adversely impact our company and business. It is not possible to predict whether or when such laws, regulations and legislation may be adopted, and certain proposals, if adopted, could harm our business through a decrease in user registrations and revenues. These decreases could be caused by, among other possible provisions, the required use of disclaimers, mandatory consents or affirmations or other requirements before users can utilize our services.

### *Israel*

Our database, which includes a database of registered users, falls within the definition of a database that requires registration under the Israeli Protection of Privacy Law 1981 (the "Privacy Law"). Maintaining a database other than in compliance with the Privacy Law, may subject the owner, holder, manager and operator to criminal liability and civil liability. We registered our database with the Data Base Registrar on June 21, 2004.

In addition to the registration obligations under the Privacy Law, the Privacy Law also determines that any request for information should be accompanied by a notice that indicates: whether a person is legally required to expose such information, or that such exposure is subject to such person's own will and consent; the purpose for which the information is requested; and to whom the information is to be delivered and for what purpose. The law also determines that any person is entitled to inspect any information about him which is kept in a certain data base. It should be stated that violating such requirements can result in imprisonment. The Privacy Law stipulates that an infringement of privacy is a civil wrong action, and authorizes the court to set compensation of NIS 50,000 (approximately US\$14,000) without proof of injury. The database registrar has been granted with wide authorities in event of violation of the provisions of the law, such as canceling the registration of a certain database.

The Copyrights Law of 2007 (the "Copyrights Law") protects, among others, artistic works, as well as sound recordings and computer programs, foreign work and moral rights (the right of paternity and the right of integrity). The Copyrights Law set forth the amount for compensation that a court may award to a claimant without proof of injury, for each copyright or moral right infringement to NIS 100,000, (approximately USD 27,000).

On December 1, 2008, Amendment No. 40 to the Israeli Communications Law (Transmissions and Broadcasting) 5742-1982 (the "Israeli Anti-Spam Law") came into effect. The Israeli Anti-Spam Law prohibits dissemination of commercial e-mail advertisements, as well as other forms of electronic advertisements, without the recipient's prior express consent. The Israeli Anti-Spam Law applies equally to entities themselves offering goods or services, and entities distributing electronic advertisements on their behalf. Consent may be obtained in writing, by electronic message or recorded conversation. Advertisers may make a single contact with business recipients in order to solicit such consent; such initial contact will not be considered a violation of the Israeli Anti-Spam Law. Recipients may revoke their consent at any time, either in writing or in the same medium used to transmit the advertisement. It is permitted to distribute commercial promotional electronic advertisements without prior recipient consent where all of the following conditions are met: (i) the recipient provided his contact information to the advertiser in the course of purchasing goods or services or negotiations for the purchase of goods or services, and the advertiser provided notice that the details so provided would be used for purposes of disseminating such advertisements; (ii) the advertiser provided the recipient the opportunity to refuse to receive such advertisements, either generally or of a particular type, and the recipient did not do so; and (iii) the advertisement relates to goods or services similar to those described in (i) above. In addition to the consent requirements described above, the Israeli Anti-Spam Law requires that all electronic advertisements include a clear, conspicuous notice containing (i) identification of the message as an advertisement (for email communications, the word "advertisement" must appear in the email subject line; in all other electronic advertisements, such identification must appear in the beginning of the advertisement; (ii) the advertiser's identity and contact information; and (iii) notification of the recipient's right to opt out of receiving such advertisements and means for opting out (including an email address for email advertisements). Violations of the Israeli Anti-Spam Law may carry criminal and civil penalties. Advertisers who disseminate advertisements in violation of the law are subject to a fine of approximately NIS 202,000 (approximately US \$54,000). Failure to comply with the mandatory notice provisions carries a fine of approximately NIS 67,300 (approximately US \$18,000). Managers and individuals working for the advertiser who are responsible for marketing or promotions and who do not take sufficient measures to ensure compliance with the law may be personally liable for violations of the law and may be subject to a fine of approximately NIS 67,300 (approximately US \$18,000). There is a statutory presumption that any illegal spam that was sent, was sent knowingly, unless proven otherwise. This statutory presumption of knowingly delivering illegal spam cannot even be challenged under certain instances (such as repeat offenses or distribution to a randomly selected list of addresses). The Israeli Anti-Spam Law also creates a private right of action for violations; in addition to other compensation to which recipients may be entitled, the court is authorized to award recipients statutory damages of approximately NIS 1,000 (approximately US \$ 300) per email received in knowing violation of the law. There are also provisions for punitive damages as well as civil tort liabilities. In addition, the Israeli Anti-Spam Law provides for certifying claims against advertisers who violate the Israeli Anti-Spam Law as class-action lawsuits. In light of the fact that we are headquartered out of Israel and have Israeli customers, we are challenged by these rules with respect to our email campaigns, and non-compliance would expose us to potential fines and sanction, civil tort claims, as well as potential reputational damage.

#### *United States*

The CAN-SPAM Act of 2003 is intended to regulate spam and create criminal penalties for unmarked and unsolicited email advertisements, sexually-oriented material and emails containing fraudulent headers. The USA Patriot Act is intended to give the government greater ability to conduct surveillance on the Internet by allowing it in certain cases to intercept communications regarding terrorism and compromises to national security. The Digital Millennium Copyright Act ("DMCA") is intended to reduce or shield the liability of online service providers for displaying content posted and created by third parties that contain copyright infringing materials, if the provider complies with certain policies, registers a DMCA agent with the U.S Copyright Office and adopts a "take-down" policy that is enforced. We do not presently offer such online provider services. The Children's Online Protection Act, the Children's Online Privacy Protection Act, and the Prosecutorial Remedies and Other Tools to End Exploitation of Children Today Act of 2003 ("COPPA"), are intended to restrict the distribution of certain materials deemed harmful to children and impose additional restrictions on the ability of online services to collect user information from minors without verifiable parental or guardianship consent. In September of 2011, the Federal Trade Commission proposed significant regulations under COPPA. Among other changes, the proposal provided for updated requirements for parental notice, expanded definitions of "personal information" and "collection". The rules could regulate tracking cookies, device serial numbers and IP addresses of children under 13. Because of the nature of our business includes, among other things, the placement of cartoon "emoticons" in emails, we anticipate that our services could attract a significant number of users who would fall into the regulated class. Accordingly, depending on the exact regulations adopted, our business could be affected by the new rules. In addition, the Protection of Children from Sexual Predators Act of 1998 requires electronic communication service and remote computing service providers to report to law enforcement agencies any knowledge of facts or circumstances from which a violation of specified offenses involving child pornography is apparent. Because our services enable users to upload photographs to the internet and share them with others, we could be subject to liability unless our procedures adequately identify and report such violations of the law. Almost all the states in the United States have data security breach laws that impose various requirements on service providers to report to state attorneys general and send notices to affected consumers in the event of a breach of security of network and computer systems that compromise a user's personal financial and other information, such as social security numbers and financial information. A national data breach notification bill is pending before the U.S. Congress, which if enacted into law, would likely supersede the numerous state notification laws.

In addition, some state laws govern internet activity generally. For example, the California Online Privacy Protection Act which applies to any Internet website which can be accessed by California residents and regulates information collected about users. The Massachusetts Office of Consumer Affairs and Business Regulation established data security regulations (201 CMR 17.00 et seq.) which became effective on March 1, 2010. They require any company which possesses the personal information of a Massachusetts resident to adopt and implement a comprehensive written information security program. The program must include technical, physical, and administrative safeguards for the protection of personal information owned, licensed, received, stored, maintained, processed, or otherwise accessed by the company. State legislation could require us to modify our business practices and could potentially subject us to liability.

### ***United Kingdom and European Union***

The U.K. Data Protection Act and similar European Member State implementations of the European Union Data Protection Directive establish a core framework of rights and duties which are designed to safeguard personal data processed within the EU. There are other ancillary and related laws and regulations across the EU which combine to create an extensive regulatory regime. The core data privacy framework is underpinned by a set of eight straightforward principles which we must apply to safeguard personal data. Any failure to ensure that personal information is processed in accordance with these principles could result in criminal or civil penalties as well as potentially damage our customers. EU data protection legislation further prohibits the transfer of personal data to non-EEA countries that do not meet the European "adequacy" standard for privacy protection. The European Union privacy legislation requires, among other things, the creation of government data protection agencies, registration of processing with those agencies, and in some instances prior approval before personal data processing may begin. Such legislation and the associated compliance practices implemented under such legislation may impose significant additional costs or restrictions on our business or subject us to additional liabilities.

On November 25, 2009, EU Directive 2009/136/EC was enacted, which amended certain prior directives affecting online service providers respecting the processing of personal data and the protection of privacy in the electronic communications sector. As mentioned above, this amendment tightened the restrictions around the use of cookies with EU consumers and this amended "ePrivacy Directive" now requires that:

*"the storing of information or the gaining of access to information already stored in the terminal equipment of a subscriber or user is only allowed on condition that the subscriber or user concerned has given his or her consent."*

Some local legislation is now implemented by Member States but others, missing the prescribed deadline for such implementation of May 2011, have not resolved and published their approach to the required changes to legislation. Much about how this new directive may affect our operations in the European Union remains unknown until member states pass their own implementing legislation. Valuable associated regulatory guidance on best practice in those Member States that have implemented the rules is only slowly being issued leaving additional uncertainty around the changes which may be required of our business. As others in the online market, we are observing the changes in online practice made by our peers and recognize a likely need to amend our practices.

Notably, and as mentioned above, Article 66 of the ePrivacy Directive requires both transparency about cookie use and that a provider obtain a user's consent before a cookie is placed on the user's computer. While a user's choice in browser settings to allow cookies has been deemed to suffice in several European jurisdictions these technologies have not yet emerged and as a consequence it is likely that some form of affirmative step is to be necessary to enable a user to opt in before or at the time the cookie is placed. As clarity around these new rules and associated guidance emerges we might be required to incur costs to ensure compliance and consider solutions or limitation of access to our services, and we might become subject to additional liability. Inevitably the solution required may also have a negative impact on consumer adoption and the types of services and revenue we can drive from cookie use and the information such use can derive.

In the UK at least, the government is taking a phased approach to the implementation of the ePrivacy Directive and, until May 2012, the regulator (ICO) are therefore taking the approach that if they receive a complaint about a website then they will expect to receive a response from an organization setting out how they have considered the new requirements and to demonstrate that the organization has a realistic plan to achieve compliance.

Similar to CAN-SPAM Act of 2003, the EU has equally tough legal regime as a result of the Privacy and Electronic Communications Directive (2002/58/EC), which specifically applies to the sending of unsolicited commercial email. All EU Member States now have implementations within their own national legislation which implement these rules (though not always on the same basis which complicates our compliance). As a consequence direct marketing email messages may be sent only to subscribers who have given their prior consent ("opt-in") although certain exemptions apply where there has been a prior course of dealing with the consumer in question and these can provide our business with more flexibility. We are challenged by these (and associated rules) when mounting EU email campaigns and non-compliance would expose us to potential fines and regulatory investigation and sanction on a country to country basis as well as potentially reputational damage.

#### **C. ORGANIZATIONAL STRUCTURE**

During 2006, we formed a wholly-owned subsidiary in Delaware, for marketing and other activities (the "Delaware Subsidiary"), and formed another wholly owned subsidiary in Israel to acquire the business of our transaction processing provider, operating primarily out of Israel (the "Israeli Subsidiary"). In 2009 we refocused the transaction processing activity to deal exclusively with internally generated activity and currently the Israeli Subsidiary is inactive. In August 2011 we acquired, through our Delaware Subsidiary, all the outstanding shares of Smilebox Inc., a Washington corporation operating out of Redmond Washington. See "Recent Developments". Except for such subsidiaries, we do not currently have other subsidiaries.

#### **D. PROPERTY, PLANTS AND EQUIPMENT**

We lease two facilities, one located in Tel Aviv, Israel and the second in Redmond Washington. The lease in Tel Aviv for a total area of 18,300 square feet was extended in 2011 to expire in 2015, with annual rent of approximately \$18 per square foot. The lease in Redmond for a total area of 8,300 square feet was extended in 2010 to expire in 2015, with an option to extend for another 2-5 years, with annual rent of approximately \$19 per square foot.

Perion owns servers that are located in Israel and Smilebox owns additional servers located in Seattle Washington for a total of 60 servers. We also rent the services of approximately 100 additional servers located around the world. Our servers include mainly web servers, application servers, ad servers, mail servers and database servers. Bezeq International Ltd. which we refer herein as "Bezeq", provides our Internet and related telecommunications services in Israel, including hosting and location facilities, needed to operate our websites. Bezeq is Israel's largest provider of such services and is a member of Bezeq Group, Israel's national telecommunications provider. Bezeq provides these services through standard purchase orders and invoices. We add servers and expand our systems located at their facilities as our operations require. We believe there are many alternative providers of these services both within and outside of Israel.

#### **ITEM 4.A UNRESOLVED STAFF COMMENTS**

Not applicable.

#### **ITEM 5. OPERATING AND FINANCIAL REVIEW AND PROSPECTS**

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes to the financial statements included elsewhere in this annual report. In addition to historical financial information, the following discussion and analysis contains forward looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including, without limitation, statements regarding the Company's expectations, beliefs, intentions, or future strategies that are signified by the words "expects," "anticipates," "intends," "believes," or similar language. These forward looking statements involve risks, uncertainties and assumptions. Our actual results and timing of selected events may differ materially from those anticipated in these forward looking statements as a result of many factors, including those discussed under "Item 3.D Risk Factors" and elsewhere in this annual report.*



## A. OPERATING RESULTS

### Overview

We design and market a suite of downloadable consumer products that are simple safe and useful. These include, customized and entertaining email software products, software for sharing digital photo creations, a photo discovery tool and PC optimization software. We believe we are unique in addressing our demographic market of second wave adopters. We believe that the user experience we have created has been successful in attracting a unique underserved demographic, seeking software application that make their life a little simpler and more enjoyable.

In the last quarter of 2011, we recorded an average of approximately 2.1 million registered downloads each month. As of December 31, 2011, we had an installed base of approximately 12.3 million, and 402,000 users of our premium products. In the last quarter of 2011, our email users sent over 369 million IncrediMail® emails and our Smilebox users shared 2.3 million creations each month. Included in our “installed base” are users who have our software installed on their computer on the measurement date. Our users use our products for as long as six years, based on current statistics (this estimate has been adjusted upwards over the past three years). However, the length of use varies dramatically based on the product, whether it’s the free version or paid for, when the product was downloaded and other factors. We believe our historical track record of our users accepting and utilizing the search properties we offer, as well as converting registered users to purchasing customers, represents a convincing validation of our business strategy.

Prices and license fees for our products vary based on market, length of license period and whether the products are offered together. Our prices and fees range from less than \$5 to about \$60. These prices are subject to market conditions and can vary in currencies, other than the US dollar. Because a significant portion of our revenues come through other aggregators, it is difficult for us to know whether and to what extent inflation or a fluctuation in foreign currency exchange rates have had a material effect on our revenues and therefore there is little we can do to address these issues.

### Revenues

We generate our revenues primarily from three major sources: (i) search generated revenues and other services, (ii) sale of premium software products and solutions, and (iii) advertising and other. The following table shows our revenues by category (in thousands of US Dollars):

|                       | Year Ended December 31, |                  |                  |
|-----------------------|-------------------------|------------------|------------------|
|                       | 2009                    | 2010             | 2011             |
| Search                | \$ 20,011               | \$ 22,792        | \$ 25,466        |
| Products              | 6,717                   | 5,404            | 7,191            |
| Other                 | 467                     | 1,301            | 2,816            |
| <b>Total revenues</b> | <b>\$ 27,195</b>        | <b>\$ 29,497</b> | <b>\$ 35,473</b> |

### Cost of Revenues

Cost of revenues consists primarily of salaries and related expenses, license fees, amortization of acquired technology, amortization of capitalized research and development costs and payments for content and server maintenance, all related to our product revenues and communicating with our users. The direct cost relating to search and advertising revenues are immaterial.

### Research and Development Expenses, net

Our research and development expenses consist primarily of salaries and other personnel-related expenses for employees primarily engaged in research and development activities. We expect our research and development expenditures, which in 2011 increased compared to last year, primarily due to the acquisition of Smilebox Inc. and its product development effort, although decreasing as percentage of sales, to continue and increase at a moderate rate, while decreasing as a percentage of sales. The nominal increase will enable us to continue to enrich our product pipeline going forward.

### ***Selling and Marketing Expenses***

Our selling and marketing expenses consist of customer acquisition cost, salaries and other personnel-related expenses for employees primarily engaged in marketing activities, credit card commissions and fees to our payment gateway providers that provide secure Internet payment processes. As part of our strategy to accelerate growth, in 2011 we increased customer acquisition costs dramatically, particularly in the second half of the year, and expect to increase the pace of investment even further in 2012. This investment is in order to increase the number of product downloads, users and subsequently revenue generated. Customer acquisition costs were; \$1.9 million, \$1.8 million and \$8.1 million in 2009, 2010 and 2011, respectively. Credit card commissions include nominal transaction costs and percentage commission costs, both of which vary based on the service provider, currency, geographic location and other variables.

### ***General and Administrative Expenses ("G&A")***

Our general and administrative expenses consist primarily of salaries and other personnel-related expenses for executive, accounting and administrative personnel, professional fees and other general corporate expenses. In order to facilitate our strategy for accelerated organic and non-organic growth in 2011 and beyond, the Company has enhanced its management team with experienced professionals, capable of taking the Company to the next level. In the latter half of 2010, the Company engaged a new experienced CEO, created a Corporate Development department and hired a VP of Corporate Development and enhanced the other administrative functions with experienced personnel. These investments had their full impact and started showing their results in 2011. As a result, G&A expenses increased in 2010 and continued to increase in 2011. Having completed most of the ramping up needed in this area, we currently expect that absent of acquisitions, G&A expenses to increase nominally to accommodate the Company's growth, while decreasing as a percentage of sales in 2012.

### ***Income Tax Expense***

In 2001 and 2003, we were granted the status of "Approved Enterprise" and in 2008 we received approval for continued "Beneficiary Enterprise" status, all with respect to three separate investment programs, entitling us to a tax exemption for a period of two years and to a reduced tax rate of 10%-25% for an additional period of five to eight years (depending on the level of foreign investment in our Company). The "Approved Enterprise" status and the "Beneficiary Enterprise" status under these tax benefits programs allow for 0% corporate tax for a limited period of time on undistributed profits generated from operations, and preferential taxation of the distributed portion, requiring regular Israeli corporate tax on income generated from other sources. To the extent the Company distributes dividends from profits generated under this program, as it did in 2009 and 2010, the distributed sum would benefit only partially from this program. The Company has elected to implement the recent tax reform to its 2011 preferred income. According to which, reduced tax rate of 15% is applied to the Company's preferred income. A distribution from a Preferred Enterprise out of the "Preferred Income" would be subject to 15% withholding tax for Israeli-resident individuals and non-Israeli residents (subject to applicable treaty rates).

See "Item 10.E Taxation - Israeli Taxation-Law for the Encouragement of Capital Investments, 1959" and Item 8. Financial Information A. Consolidated Statements and Other Financial Information - Policy on Dividend Distribution, for more information about these programs and the Company's dividend policy.

### ***Critical Accounting Policies and Estimates***

The discussion and analysis of our financial condition and results of operation are based on our financial statements, which have been prepared in conformity with U.S. GAAP. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We evaluate these estimates on an on-going basis. We base our estimates on our historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying amount values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Under U.S. GAAP, when more than one accounting method or policy or its application is generally accepted, our management selects the accounting method or policy that it believes to be most appropriate in the specific circumstances. Our management considers some of these accounting policies to be critical.

A critical accounting policy is an accounting policy that management believes is both most important to the portrayal of our financial condition and results and requires management's most difficult subjective or complex judgment, often as a result of the need to make accounting estimates about the effect of matters that are inherently uncertain. While our significant accounting policies are discussed in Note 3 to our financial statements, we believe the following accounting policies to be critical:

#### ***Revenue recognition***

Search generated and other revenues from advertising, whether from keyword search, advertising on our website or in our email client, are recognized when we are entitled to receive the fee. Advertisers are charged and pay monthly, based on the number of clicks generated by users clicking on these ads.

In accordance with ASC 605-50, "Customer Payments and Incentives" the Company accounts for cash consideration given to customers, for which it does not receive a separately identifiable benefit or cannot reasonably estimate fair value, as a reduction of revenue rather than as an expense.

Revenues from email software license sales are recognized when all criteria outlined in ASC 985-605, "Software – Revenue Recognition" are met. Revenues from software license are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable and collectability is probable.

For substantially all of our software arrangements, we evaluate each of these criteria as follows:

*Evidence of an arrangement:* We consider a clicking on "acceptance" of the agreement terms to be evidence of an arrangement.

*Delivery:* Delivery is considered to occur when the license key is sent via email to the customer or alternatively the customer is given access to download the licensed key.

*Fixed or determinable fee:* Fees are determinable at the time of sale. Customers are charged immediately through credit cards. In addition, the fees are subject to a refund policy period, currently up to 30 days.

*Collection is probable:* We are subject to a minimal amount of collection risk related to software sold to our customers as these are obtained through credit card sales.

Revenues from licensing *The Gold Gallery* content database are recognized over the term of the licensing period. We currently offer one year licenses for *The Gold Gallery* content database for a one-time, upfront payment. These licenses constituted less than 5% of our revenues in 2011. In the past we offered lifetime licenses as well. Our estimation of the lifetime usage of *The Gold Gallery* is six years and is based on historical data collected. We continually track usage patterns, and as we gather more user information, we may update this estimated useful life. If the lifetime usage of *The Gold Gallery* is demonstrated to be shorter or longer than the current estimate, we would recognize revenues earlier or later. Based on our current revenue streams, such an adjustment would not have a significant effect on our revenues. We intend in the future to turn this service into a product which expires after one year, without providing ongoing service or updates during the license period and as a result, recognize revenues upon purchase of the license.

Revenues from our *JunkFilter Plus / Protection Center* solution and Smilebox service are recognized over the term of the license.

Our deferred revenue consists of the unamortized balance of the license fees, which totaled \$5.4 million as of December 31, 2011, of which \$4.3 million was classified as short-term deferred revenues and the balance as long-term deferred revenue on our balance sheets.

### ***Stock-Based Compensation***

The Company accounts for share-based payment awards made to employees and directors in accordance with ASC 718, "Compensation – Stock Compensation", which requires the measurement and recognition of compensation expense based on estimated fair values. Determining the fair value of stock-based awards at the grant date requires the exercise of judgment, as well as the determination of the amount of stock-based awards that are expected to be forfeited. If actual forfeitures differ from our estimates, equity-based compensation expense and our results of operations would be impacted.

Total equity-based compensation expense recorded during 2011 was \$1.2 million, of which \$1.0 million was included in general and administrative expenses and the rest in research and development costs and selling and marketing expenses.

As of December 31, 2011, the maximum total compensation cost, related to options granted to employees, not yet recognized, amounted to \$1.5 million. This cost is expected to be recognized over a weighted average period of 2 years.

The Company estimates the fair value of standard stock options granted using the Binomial method option-pricing model and options with exercise that is subject to a stock price target, using the Monte Carlo simulations. The option-pricing models require a number of assumptions, of which the most significant are; expected stock price volatility and the expected option term. In 2009 and 2010, expected volatility was calculated based upon an average between historical volatilities of the Company, similar entities and industry sector index similar to the Company's characteristics, since it did not have sufficient company specific data. In 2011, expected volatility was calculated based upon actual historical stock price movements. The expected option term was calculated based on the Company's assumptions of early exercise multiples which were calculated based on comparable companies and termination exit rate which was calculated based on actual historical data. The expected option term represents the period that the Company's stock options are expected to be outstanding. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term.

In November 2010 the Company's Board decided to change its dividend policy so that beginning with earnings of 2011 and beyond, the Company does not intend to distribute any dividends to the holders of its ordinary shares, as result the Company has no foreseeable plans to pay dividends.

### ***Taxes on Income***

We are subject to income taxes in Israel and the U.S. Significant judgment is required in evaluating our uncertain tax positions and determining our provision for income taxes. Based on the guidance in ASC 740 "Income Taxes", we use a two-step approach to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount that is more than 50% likely of being realized upon settlement.

Although we believe we have adequately reserved for our uncertain tax positions, no assurance can be given that the final tax outcome of these matters will not be different. We adjust these reserves in light of changing facts and circumstances, such as the closing of a tax audit, the refinement of an estimate or changes in tax laws. To the extent that the final tax outcome of these matters is different than the amounts recorded, such differences will impact the provision for income taxes in the period in which such determination is made. The provision for income taxes includes the impact of reserve provisions and changes to reserves that are considered appropriate, as well as the related interest. Starting 2011, interest is recorded within finance income, net.

Accounting for tax positions requires judgments, including estimating reserves for potential uncertainties. We also assess our ability to utilize tax attributes, including those in the form of carry forwards for which the benefits have already been reflected in the financial statements. We record valuation allowances for deferred tax assets that we believe are not more likely than not to be realized in future periods. While we believe the resulting tax balances as of December 31, 2011 and 2010 are appropriately accounted for, the ultimate outcome of such matters could result in favorable or unfavorable adjustments to our consolidated financial statements and such adjustments could be material. See Note 10 to our Consolidated Financial Statements for further information regarding income taxes. We have filed or are in the process of filing local and foreign tax returns that are subject to audit by the respective tax authorities. The amount of income tax we pay is subject to ongoing audits by the tax authorities, which often result in proposed assessments. We believe that we adequately provided for any reasonably foreseeable outcomes related to tax audits and settlement. However, our future results may include favorable or unfavorable adjustments to our estimated tax liabilities in the period the assessments are made or resolved, audits are closed or when statutes of limitation on potential assessments expire.

### ***Business combinations***

We account for business combinations following ASC 805 “Business Combinations”, which requires that we allocate the purchase price of acquired companies to the tangible and intangible assets acquired and liabilities assumed, based on their estimated fair values. In addition, we expense acquisition-related expenses as they are incurred. We engage third-party appraisal firm to assist management in determining the fair values of certain assets acquired and liabilities assumed. Such valuations require management to make significant estimates and assumptions, especially with respect to intangible assets.

Management makes estimates of fair value based upon assumptions it believes to be reasonable. These estimates are based on historical experience and information obtained from the management of the acquired companies and relevant market and industry data and are, inherently, uncertain. Critical estimates made in valuing certain of the intangible assets include, but are not limited to, the following: (i) future expected cash flows from license sales, maintenance agreements, customer contracts and acquired developed technologies and patents; (ii) the acquired company’s brand and market position as well as assumptions about the period of time the acquired brand will continue to be used in the combined company’s product portfolio; and (iii) discount rates. Unanticipated events and circumstances may occur which may affect the accuracy or validity of such assumptions, estimates or actual results. Changes to these estimates, relating to circumstances that existed at the acquisition date, are recorded as an adjustment to goodwill during the purchase price allocation period (generally within one year of the acquisition date) and as operating expenses, if otherwise.

In connection with purchase price allocations, we estimate the fair value of the support obligations assumed in connection with acquisitions. The estimated fair value of the support obligations is determined utilizing a cost build-up approach. The cost build-up approach determines fair value by estimating the costs related to fulfilling the obligations plus a normal profit margin. The sum of the costs and operating profit approximates, in theory, the amount that we would be required to pay a third party to assume the support obligation. See Note 2 to our consolidated financial statements for additional information on accounting for our recent acquisition.

### ***Goodwill***

Goodwill is measured as the excess of the cost of acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets acquired less liabilities assumed. We review goodwill for impairment annually in October each year, and whenever events or changes in circumstances indicate its carrying value may not be recoverable in accordance with ASC 350 “Intangibles – Goodwill and other”. Goodwill impairment is deemed to exist if the carrying value of a reporting unit exceeds its fair value. If the carrying value of a reporting unit’s goodwill exceeds its implied fair value, then we would record an impairment loss equal to the difference.

We operate in one operating segment, and this segment comprises our only reporting unit. In calculating the fair value of the reporting unit, we used our market equity capitalization.

If the carrying value of a reporting unit exceeds its fair value, we then calculate the goodwill's implied fair value by performing a hypothetical allocation of the reporting unit's fair value to the underlying assets and liabilities, with the residual being the implied fair value of goodwill. This allocation process involves using significant estimates; include estimates of future cash flows, future short-term and long-term growth rates, weighted average cost of capital and assumptions about the future deployment of the long-lived assets of the reporting unit. Other factors we consider are the brand awareness and the market position of the reporting unit and assumptions about the period of time we will continue to use the brand in our product portfolio. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for our goodwill.

Our most recent annual goodwill impairment analysis, which was performed during in 2011, did not result in impairment. As of December 31, 2011, the market capitalization of the Company was significantly higher than the equity book value.

***Impairment of Long-Lived Assets.***

We are required to assess the impairment of tangible and intangible long-lived assets subject to amortization, under ASC 360 "Property, Plant and Equipment", on a periodic basis, when events or changes in circumstances indicate that the carrying value may not be recoverable. Impairment indicators include any significant changes in the manner of our use of the assets or the strategy of our overall business, significant negative industry or economic trends and significant decline in our share price for a sustained period.

Upon determination that the carrying value of a long-lived asset may not be recoverable based upon a comparison of aggregate undiscounted projected future cash flows from the use of the asset or asset group to the carrying amount of the asset, an impairment charge is recorded for the excess of carrying amount over the fair value. We measure fair value using discounted projected future cash flows. We base our fair value estimates on assumptions we believe to be reasonable but that are unpredictable and inherently uncertain. If these estimates or their related assumptions change in the future, we may be required to record impairment charges for our tangible and intangible long-lived assets subject to amortization. No impairment charges were recognized during 2009, 2010 and 2011.

***Research and Development Expenses, Net.***

Research and development costs incurred in the process of software development before establishment of technological feasibility are charged to expenses as incurred. Costs of the production of a detailed program design, incurred subsequent to the establishment of technological feasibility are capitalized. Based on our product development process, technological feasibility is established upon completion of a detailed program design.

Capitalized software development costs are amortized commencing with general product release by the straight-line method over the estimated useful life of the software product.

At each balance sheet date, we assess the recoverability of this intangible asset by comparing the unamortized capitalized software costs to the net realizable value on a product by product basis. Should the amount of the unamortized capitalized costs of a computer software product exceed the net realizable value, these products will be written down by the excess amount.

**Recently issued accounting pronouncements.**

See Item 18. Financial Statements. Note 3(w).

The following table sets forth, for the periods indicated, our statements of operations expressed as a percentage of total revenues (the percentages may not equal 100% because of the effects of rounding):

|                                      | Year Ended December 31, |            |            |
|--------------------------------------|-------------------------|------------|------------|
|                                      | 2009                    | 2010       | 2011       |
| Revenues:                            |                         |            |            |
| Search                               | 74%                     | 77%        | 72%        |
| Products                             | 24                      | 19         | 20         |
| Other                                | 2                       | 4          | 8          |
| Total revenues                       | 100%                    | 100%       | 100%       |
| Cost of revenues                     | 6                       | 5          | 8          |
| <b>Gross profit</b>                  | <b>94</b>               | <b>95</b>  | <b>92</b>  |
| Operating expenses                   |                         |            |            |
| Research and development, net        | 23                      | 23         | 21         |
| Selling and marketing                | 17                      | 18         | 37         |
| General and administrative           | 12                      | 16         | 22         |
| Total operating expenses             | 52                      | 57         | 80         |
| <b>Operating income</b>              | <b>42</b>               | <b>38</b>  | <b>12</b>  |
| Financial income, net                | -                       | 1          | 4          |
| <b>Income before taxes on income</b> | <b>42</b>               | <b>39</b>  | <b>16</b>  |
| Income tax expense                   | 13                      | 11         | -          |
| <b>Net income</b>                    | <b>29%</b>              | <b>28%</b> | <b>16%</b> |

As shown in the above table, our operations are generally characterized by high margins, which are attributable mainly to two factors: (i) we do not have manufacturing costs for our products, and (ii) we sell our products online and until the second half of 2011 relied primarily on viral marketing. Starting the second half of 2011, we increased our investment in customer acquisition costs dramatically to fuel future growth. These expenses increased from \$1.8 million in 2010 to \$8.1 million in 2011. This was the primary reason for selling and marketing expenses increasing in 2011, both nominally and as a percentage of sales, resulting in lower operating and net income margins in 2011. We expect to further increase our customer acquisition costs in 2012, increasing our sales and marketing expenses, and having a negative effect on the operating margin in 2012. However, as a result of the increased expenditure in 2011 and the subsequent increase in revenues in 2012, we expect operating margins to improve in 2012.

**Year Ended December 31, 2011 Compared to Year Ended December 31, 2010**

*Search revenues.* These revenues increased by 12%, from \$22.8 million in 2010, to \$25.5 million in 2011. This increase was due to an increase in the number of downloads and subsequently the number of users using our search service. As the number of downloads of our Incredimail products increased, while the number of downloads of our Magentic and HiYo products decreased, search generated revenues through our partnership with Google accounted for more than 94% of these revenues, with the remaining revenues coming from other search providers. Our current agreement with Google continues until January 31, 2013 and we therefore expect them to continue to account for virtually all the search generated revenues. We have begun to implement our search generating revenue model with our PhotoJoy and Smilebox products. While these products did not contribute significantly to search revenues in 2011, we expect them, particularly Smilebox, to generate growing search revenues in 2012, through our partnership with Google and our ability to apply this technology and the back systems required to support and track these revenues.

*Products revenues.* These revenues grew by over 33% in 2011, from \$5.4 million in 2010 to \$7.2 million in 2011. This increase was primarily attributable to our recent acquisition of Smilebox Inc. whose products sales were \$2.2 million, partially offset by a \$0.4 million decrease of organic products sales. We believe that in 2012 we will see increasing revenues from the Smilebox product as a result of: (i) consolidating these product sales for a full year, as compared to only 4 months in 2011, (ii) a result of the accounting rules regarding acquired deferred revenues, deferred revenues from Smilebox product prior to the closing are adjusted downward to their fair value as of the acquisition and the resulting reduction in revenues will decrease as we complete a year post acquisition, and (iii) continued organic growth in sales of this product. In addition, we expect to record increasing sales of our Incredimail products and recently introduced Fixie product in 2012.

*Other revenues.* These revenues more than doubled in 2011, from \$1.3 million in 2010 to \$2.8 million in 2011. This increase is attributable to collaboration with other vendors for the sale of their product to our users and an increase in other advertising revenues through a toolbar, on our homepage and other. We believe we will be able to maintain a similar nominal level of these sales in 2012. However, we currently have no plans for increasing our investment to grow these sales beyond that.

*Cost of revenues.* Cost of revenues in 2011 was \$2.8 million, as compared to \$1.6 million in 2010. This increase was primarily due to the acquisition of Smilebox who's associated direct costs of approximately \$0.6 million, included amortization of intangible assets and direct content costs. Smilebox content costs were based on usage, and as a result included in the cost of revenues. Since the acquisition, the Company has been working to transition these relationships to a model where the Company acquires the full rights to the content regardless of usage, paying for what is expected to be a much lower sum in advance. However, this positive effect will be more than offset by the fact that the Company will be consolidating a full year of Smilebox's activity in 2012 as compared to only 4 months in 2011. As a result, we expect that although gross profits will increase, the gross profit margin will decline somewhat in 2012. In addition, direct cost in 2011 also included approximately \$0.3 million payments to third-party search partners.

*Research and development expenses, net ("R&D").* R&D increased by \$0.9 million, from \$6.6 million in 2010 to \$7.5 million in 2011, decreasing as a percentage from sales from 23% in 2010 to 21% in 2011. The increase was as a result of our investing in enriching our product pipeline in 2011, with the Fixie product already selling in the fourth quarter of 2011, the mobile version of our Smilebox product announced shortly after the acquisition, and the recently announced PhotoJoy product for iPad and iPhone platforms. In 2012, we expect this expenditure to further increase nominally, although generally remain stable as a percentage of sales as we continue to organically enrich our product pipeline.

*Selling and marketing expenses.* Selling and marketing expenses more than doubled from \$5.2 million in 2010 to \$13.0 million in 2011. This increase was primarily attributable to the increased investment in customer acquisition costs, which increased from \$1.8 million in 2010 to \$8.1 million in 2011. In addition, marketing expenses increased due to personnel costs incurred by our increasing the size of our marketing department to enable us to make these investments and subsequently track the return generated. Finally, the increase was also due to the marketing expenses incurred by the acquisition of Smilebox and the marketing expenses needed to support that product. As we look to 2012, we expect to continue to increase customer acquisition costs significantly, possibly even double, in order to further accelerate the growth in revenues. That being said, we continue to condition this investment on a positive return on investment ("RoI") within one year, and to the extent we cannot ramp up and maintain a positive RoI, we may draw back on this expenditure.

*General and administrative expenses ("G&A").* G&A increased from \$4.7 million in 2010 to \$7.6 in 2011. This increase was primarily due to our building a management team, primarily in the latter part of 2010, capable of scaling the business model and taking the Company to the next level, both organically and through acquisitions. As a result, in 2011 G&A on average was at a level similar to that off the last quarter of 2010. In addition, the Company recorded over \$1.0 million in expenses related to the acquisition of Smilebox Inc., which in according to US GAAP is accounted for as an expense when incurred. . With exception to costs that could be incurred by future acquisitions, we expect G&A to increase nominally, primarily as a result of consolidating Smilebox for a full year, as compared to only four months in 2011, although decrease as a percentage of sales.

*Taxes on Income.* Income tax in 2011 was \$0.2 million, compared to \$3.2 million in 2010. The decrease in income tax was a result of a number of tax credits received with respect to past years, tax refund due to settlement of tax audit with the Israeli tax authorities and the discontinuation of our dividend distribution policy. Assuming a similar tax environment in 2012, we expect an effective tax rate less than 20% for our activity in Israel and the effective tax rate for our activity in Washington will be dependent on our ability to utilize accumulated losses from prior periods.

*Net Income.* Net income in 2011 was \$5.7 million, compared to \$8.4 million, in 2010. As described above, this decrease was primarily a result of the \$6.2 million increase in customer acquisition costs, amortization of intangibles resulting from Smilebox acquisition, partially offset by increased profits from the increase in revenues and capitalization of research and development costs.



## *Year Ended December 31, 2010 Compared to Year Ended December 31, 2009*

*Search generated revenues.* These revenues increased by 14%, from \$20.0 million in 2009, to \$22.8 million in 2010. In 2010 we continued to collaborate with two search providers; with approximately 90% of search generated revenues being provided by our partnership with Google and the remaining 10% coming from other search providers, primarily InfoSpace. The continued increase in search generated revenues reflects the success of our strategy to leverage our large user base, primarily those using our free products. In 2011, as we implement our strategy for growth and invest in customer acquisition, we expect to accelerate the growth coming from these revenues. In 2010, we were not successful in increasing HiYo registrations and revenues, and this product while still generating revenues, no longer constitutes a product that we are focused on. As to PhotoJoy, while we now have completed a marketable product, we expect that through our customer acquisition strategy, this product will start attracting a significant number of downloads, and subsequently generate revenues in the latter part of 2011.

*Revenues from products.* These revenues continued to decrease from \$6.7 million in 2009 to \$5.4 million in 2010. We believe this decrease is attributable to our continued focus on search generated revenues, as well as the decreasing popularity in purchasing downloadable software and the effect of the economic downturn in 2009 had on discretionary purchases. In the latter part of 2010, we saw this trend level out, with new product sales increasing. As we increase our marketing efforts in this area in 2011, we can expect cash sales from products to increase. However, the increase in accounting revenues recorded according to US GAAP, will be delayed as these revenues are for the most part deferred over the period of their subscriptions.

*Advertising and other revenues.* These revenues more than tripled in 2010, from \$0.5 million in 2009 to \$1.3 million in 2010. This increase is attributable to collaboration with other vendors for the sale of their product to our users and an increase in other advertising revenues through a toolbar, on our homepage and other. We expect to be able to continue and grow these revenues, albeit they still are not expected to contribute a significant portion of our revenues in 2011.

*Cost of revenues.* Cost of revenues from products in 2010 was \$1.6 million, as compared to \$1.5 million in 2009. This increase was primarily due to our allocating increasing communication and other infrastructure costs to maintain and servicing our existing user base, as opposed to marketing to new users in the past. Despite this nominal increase, as a result of the increasing portion of revenues attributable to search, the gross profit margin in 2010 increased to 95%, as compared to 94% in 2009. As search generated revenues continue to account for a growing portion of our revenues, we expect the gross profit margin to remain at its current level.

*Research and development expenses, net ("R&D").* R&D increased by \$0.3 million, from \$6.3 million in 2009 to \$6.6 million in 2010, decreasing as a percentage from sales from 24% in 2009 to 22% in 2010. This decrease was a result of us maintaining the existing product suite without enriching the product pipeline for future years. Looking at 2011, we expect this expenditure to increase, although generally remain stable as a percentage of sales. The increase in expenditure in 2011 is planned for contributing to a richer product pipeline to fuel future growth.

*Selling and marketing expenses.* Selling and marketing expenses, increased by \$0.6 million, or 14%, from \$4.6 million in 2009 to \$5.2 million in 2010. This increase was primarily attributable to the consumer research contracted in the fourth quarter as well as the marketing and sales consultants hired. Marketing expenses included approximately \$1.8 million in customer acquisition costs in 2010, similar to the level in 2009. In 2011, as we implement our strategy for growth, we intend to increase this expense more than three-fold, with most of the increase being in the latter part of 2011. As a result, we can expect operating margins to be lower during that part of 2011, due to the fact that a substantial part of the return on that investment is only expected in 2012.

*General and administrative expenses ("G&A").* G&A increased from \$3.3 million in 2009 to \$4.7 in 2010. This increase was primarily due to our building a management team capable of scaling the business model and taking the Company to the next level, both organically and through acquisitions. In the third quarter we engaged a new experienced CEO (while still retaining the prior CEO through the end of the year), created a corporate and business development department, hired a new VP of Corporate Development and started staffing that department. We expect to further invest in enhancing our management team in 2012, however, we do not expect this expenditure to increase as a percentage of revenues.

*Financial income, net.* We recorded \$0.3 million, net, in financial income in 2010, compared to \$0.1 million in 2009. We continue to maintain a stringent investment policy so that a majority of our investments are in US treasury or US government backed securities, with the balance in debentures of a limited sum and relatively short-term maturity, rated at A and higher and dollar denominated or linked. As a result, the returns on our portfolio have been minimal. Assuming interest rates and the financial environment do not change drastically we expect the current rate of return to continue going forward.

*Taxes on Income.* Income tax in 2010 was \$3.2 million, with an effective tax rate of 28%, compared to \$3.5 million, with an effective tax rate of 31% in 2009. This rate reflects our decision to institute a dividend distribution policy, distributing at least 50% of net income as a dividend, in 2009 and 2010. We distributed dividends of \$8.5 million in each of the years, 2009 and 2010. As a result of our policy to distribute dividends, we are not able to take full advantage of the tax reduced tax rates afforded to Approved and Beneficiary Enterprises. As we announced in November 2010, we have changed our dividend distribution policy and do not intend to distribute dividends from earnings in 2011 or beyond. As a result, and assuming a similar tax environment in 2011, we expect to have a substantially lower effective tax rate in 2011.

*Net Income.* The Net Income in 2010 was \$8.4 million, compared to \$8.0 million, in 2009. As described above, this was a result of our increase in revenues being offset by a higher level of expenditure.

## **B. LIQUIDITY AND CAPITAL RESOURCES**

As of December 31, 2011, working capital was \$0.0 million, consisting of approximately \$21.0 current assets and \$21.0 current liabilities. As of December 31, 2010, we had working capital of \$28.1 million and our primary source of liquidity was \$31 million in cash and cash equivalents and marketable securities, partially offset by accrued and other short-term liabilities of \$6.2 million. The decrease in working capital, cash, cash equivalents and marketable securities, as well as the increase in other short term liabilities and expenses, was entirely due to the acquisition of Smilebox Inc. in the second half of 2011. Under the terms of the acquisition agreement, the Company paid approximately \$25 million, substantially in cash at closing and additional payments of up to \$15 million are payable if certain milestones and performance based conditions are met, payable in two installments on the seven and fourteen months anniversary from closing. The first installment, in the amount of approximately \$7 million, is expected to be paid on the seven months anniversary of closing.

The decrease in cash and cash equivalents by \$19.8 million was due to cash paid upon closing the acquisition, partially offset by cash generated from our ongoing activities in 2011.

As of December 31, 2011, we had a credit facility comprised of \$12 million provided by Bank Leumi Le-Israel and \$8 million provided by First International Bank of Israel. The repayment of the debt under this credit facility is structured over three to five years respectively, and we have an option for early repayment. We have not utilized this credit facility as of yet.

We believe that our cash balances and cash generated from operations will be more than sufficient to meet our anticipated cash requirements for operations, at least for the next 12 months.

*Net Cash Provided By Operating Activities.* Net cash provided by operating activities was \$10.7 million, \$9.8 million and \$7.0 million for 2009, 2010 and 2011, respectively. The decrease in cash provided by operating activities in 2011 was primarily a result of the \$2.7 million decrease in net income as the changes in the adjustment of revenues to cash revenues and expenses to cash expenses offsetting each other.

*Net Cash Provided By (Used In) Investing Activities.* Net cash provided by (used in) investing activities was \$13.5 million, (\$10.2) million and (\$8) million in 2009, 2010 and 2011, respectively. While in 2009 and 2010, the net cash provided by or used in investment activities was a result of selling or investing in marketable securities, in 2011 the cash used in investing activities was primarily a result of investing \$21.7 million in cash for the acquisition of Smilebox, partially offset by the \$14.8 million in proceeds from the net sale of marketable securities. In addition, in 2011 the Company invested in equipment and capitalized content and software costs \$1.1 million.

*Net Cash Used In Financing Activities.* Net cash used in financing activities was \$7.6 million, \$7.9 million and \$3.9 million in 2009, 2010 and 2011, respectively. In all these years the cash was used primarily for the payment of dividends to shareholders, a policy that has been discontinued.

## **C. RESEARCH, DEVELOPMENT, PATENTS AND LICENSES, ETC.**

Our research and development activities are conducted internally by our Chief Technology Officer and a 69 person research and development staff.

Research and development expenses, net were \$6.3 million, \$6.6 million and \$7.5 million in the years ended December 31, 2009, 2010 and 2011, respectively. In 2011 our efforts were focused on developing the back-end systems required for tracking the usage of our products and their monetization, developing new products such as our PC optimization tool Fixie that was released in the fourth quarter of 2011 and the iPad and iPhone versions of our photo discovery tool PhotoJoy. In addition, we continued to invest in the mobile version of our photo sharing product Smilebox. In 2012 we plan on increasing our investment in the mobile space, developing a new version of our IncrediMail email client for tablet, as well as further organically enriching our product suite with new products adopted and planned for our demographic of “second wave adopters”. On a whole, we expect in 2012 this investment will increase nominally, although it will likely decrease as a percentage of sales relative to 2011.

#### **D. TREND INFORMATION**

*Sales.* The increase in sales in 2011 compared to 2010 was due to the consolidation of Smilebox activities starting September 2011, as well as a continued increase in search generated revenues and other advertising revenues, partially offset by a decrease in IncrediMail product sales. Together, these increases contributed to the 20% year over year growth in revenues. We expect these same factors to continue and contribute to even accelerate growth in 2012, particularly, the consolidation of Smilebox revenues for a full year, renewed growth in premium product sales both from our Smilebox product and IncrediMail and finally moderate growth in search generated revenues.

Until the acquisition of Smilebox in the second half of 2011, the percentage of sales attributable to search grew from 74% in 2009 to 77% in 2010 and in the first half of 2011 was 78%. With the acquisition of Smilebox and resulting rapid growth in premium product sales, search generate revenues accounted for 66% of total revenues in the second half of 2011, bringing the average for the year to 72%. As a result of the continued rapid growth in premium product sales, while search generated revenues are expected to grow, we expect they will account for an even smaller portion of total revenues in 2012.

*Gross Profit.* While gross profits continue to grow as a result of the growth in revenues, we expect the gross profit margin to decrease somewhat, as it did in the second half of 2011, since the acquisition of Smilebox. This small decrease is a result of Smilebox’s cost structure which includes direct costs related to the payment for the use of premium content by users in sharing their Smilebox creations. We nonetheless anticipate relatively strong profit margins.

*R&D.* R&D expenses increased nominally in 2011. However, as a percentage of sales they decreased as they did in 2010. We expect this trend, of nominal increases while decreasing as a percentage of sales, to continue into 2012.

*Sales and marketing expenses.* Our sales and marketing expenses increased by \$7.7 million, from \$5.2 million in 2010 to \$13 million in 2011. This increase was primarily due to the increase in customer acquisition cost which increased from \$1.8 million in 2010 to \$8 million in 2011. This increase reflects a ramping up of these expenses within 2011, reaching \$3.1 million in the fourth quarter of 2011. This investment is to fuel future accelerated growth and we expect to further increase this investment in 2012 fueling growth in 2012 and 2013. In addition to the increased investment in customer acquisition costs, sales and marketing expenses have increased since the acquisition of Smilebox. We expect these expenses to grow only nominally from the level established in the last quarter of 2011.

*General and administrative expenses.* G&A expenses increased as well in 2011. This increase is attributable to three main factors; (i) our enhancing management with new and experienced professionals capable of taking the Company to the next level by implementing organic and non-organic growth strategies. This effort began in the latter part of 2010 and had full financial effect in 2011, (ii) the acquisition of Smilebox in the middle of 2011, together with required overhead to manage that business, and (iii) approximately \$1.0 million in one-time transaction costs associated with the Smilebox acquisition.

With exception to possible transaction costs associated with a new acquisition, we expect G&A expenses in 2012 to continue at their current level.

*Taxes on Income.* In 2011 we benefited from significant non-recurring tax credits and tax settlements with the Israeli Tax Authorities, as we look towards 2012, we do not currently expect such tax credits and expect an effective tax rate of approximately 20% on our activity in Israel. As to our activity in Redmond, Washington, this will depend on our ability to utilize losses carried forward from previous periods and other factors.

*Industry trends expected to affect our revenues, income from continuing operations, profitability and liquidity or capital resources:*

1. As a result of our in depth consumer research and the success of our email client, we have found that our products address an underserved market of later technology adapters. We have found that these consumers are looking for simple, safe and useful products that assist in better utilizing their time. We intend to address this unique market segment, which is the largest growing audience online today, by further adapting our products to better address their evolving requirements as well as offering them other products and services that they use frequently and address similar needs. This market segment, of roughly 300 million people, is currently underserved as it is not targeted by the new technology companies that are targeting early hi-tech adapters, or by the large conglomerates that seek to service horizontally the general public, rather than a specific vertical demographic. We believe that we on the other hand with our successful experience with our IncrediMail email client, are well equipped to address these needs. We have decided to focus on three basic needs for our consumers: communications, photo sharing and safety and security. These are all areas that our research indicated are frequently used by our audience online (e.g. more than once a month and often multiple times a week) and are related to each other beginning with communications which is staple for anyone online today, using that communication means to share photos and other information and attachments and unfortunately given its very nature and ubiquity this same communication platform is the biggest cause of viruses and malware for one's computer as hackers and criminals use the trust of a friend and the delivery mechanism of photo sharing and email.
2. In recent years, we have witnessed an increase in the use of web-based e-mail solutions such as Microsoft Hotmail, Yahoo! Mail and Google's Gmail. Facebook Mail is relatively new addition to this market, having a lot of potential based on its social network popularity. While our product is based on the use of these email products, and there is still a vast market for PC based email clients, there is no doubt that the popularity of web-based email is growing at the expense of the PC based software. This has caused us to increase our efforts in adapting our product to the specific consumer needs not satisfied by the web-based solution. Further investment is also required in other forms of online communication as audiences (especially younger ones) are using email less. The continual growth in social communication products and services as well as smartphones make it essential for our products to be compatible with Facebook, Twitter, SMS and other forms of social communication. We will continue to make investments both organic and through acquisitions to further solidify our position with new products and services focusing on social communication products and look to increase our investment on the usage of social media to generate more users to our brands.
3. The sharing and storing of digital photos on personal computers, and on photo hosting sites such as Flickr.com, Facebook or Shutterfly has increased substantially in recent years. The convenience of such online storage of photos has created a growing commercial industry with products like personalized photo books, cards, calendars, stationery, scrapbooks (printed and digital) as well as photo backup services and storage services. The printing of 5X7 photos and sharing them via mail has significantly declined yet the number of photos taken with digital cameras has increased to 360 billion or 700,000 per minute according to the PMA and Facebook users now upload and share 190,000 photos per minute. However, a problem often experienced by people that store their photos on their hard disk or on a photo-hosting site is that they simply do not enjoy their photos as they had previously. In the past, people spent time looking through their photo albums, but today photos are saved in a computer folder and easily forgotten about or lost. Access to photos saved on personal computers is not immediate and is somewhat tedious; hence, old favorite photos are neglected over time. Furthermore, so many photos can be overwhelming. Both Smilebox and *PhotoJoy*, are aimed at helping people easily find, create and share their pictures enabling users to enjoy all the photos that they have stored on their computer or online using new capabilities, with no effort from the user. As camera phones continue to improve and more and more users use their camera phones to capture their special momentsthere is significant growth opportunity for us to help users create special memories both "in the moment" and "after the moment."
4. There has been a growing usage of portable platforms bridging between the mobile phone and the PC, enabling users to enjoy a more graphic and creative experience, while not requiring a PC. This trend is most prominent with the advent of the iPhone™ and since then other similar "smart phone" products and the more recent iPad™ and similar products. In addition, and partially as a result of these successes, the Apple-Mac platform popularity has increased as well. Although this trend is attracting an increasing portion of the market, we believe that particularly with regard to our demographic, the PC environment will remain the predominant platform for managing emails in the near future. That being said, as the growth of these alternative platforms increases, we intend to incorporate solutions in our products that will enable cross-platform access.

5. Safety and security are also growing trends for all platforms including Mac, PC, tablets and Smartphones (iPAd and iPhone as well). The more successful a platform the higher degree of probability that professional criminals and hackers will invade your privacy and security. According to the Data Breach Investigations Report published by Verizon in April 2011, individuals affiliated with organized crime perpetrated more than half of the data breaches involving external agents. An underground economy has emerged to support this new industry which makes it a very attractive profit center for many hackers and criminals. The total market is expected to grow to roughly \$16 billion in 2015 according to an IDC report from November 2011. This presents us with a significant opportunity through partnership and/or acquisition to enter this space with a customized solution for our users. Given the established need and competition in this space we feel a partnership or acquisition, is the best entry point and expect to make a significant investment in this space in the future.
6. Rapid adoption of mobile devices as well as a shift to online from traditional retail has opened up the industry to new opportunities and growth possibilities. Users no longer have their information in one place and the persistent connectivity and cloud provide even more ways for criminals to access your data. There would seem to be significant demand for these types of products well into the future.
7. As roughly 72% of our revenues are search generated, we are affected by the general trends and metrics of the search revenue market. One of the most significant metrics is the revenue per thousand impressions ("RPM") rate. In an economic downturn, the amount advertisers are willing to pay naturally declines, reducing their cost per click ("CPC") rate and subsequently our revenues. The RPM rate has fluctuated dramatically over the past months and it is difficult to predict a specific trend in this important metric going forward.
8. The downloadable software market and the way it interacts with search providers have been changing. With its market leading position, Google has been the forerunner of these changes, which have also impacted our agreement with Google. It is difficult to know how process will end, although we are convinced that the process is ongoing and has not reached equilibrium. We will continue to work with Google as well with the other search companies to improve the consumer experience and address the market needs. As more and more products become cloud based services this may also impact the way in which companies like ours generate search revenue. The clear trend is to provide users with a solution that is at least partly cloud driven which enables portability for consumers and easier maintenance for companies. More and more companies however are finding new ways to generate revenues including, advertising and premium sales as well as search from the web based service. Another trend in the market as it relates to downloadable software with search monetization is the intensity of the competition. This past year the amount of competitors and the intensity of the competition have made it more difficult to maximize life time value of a consumer. We continue to focus on providing real value to the consumer from our products and services with a belief that in the long run companies with a real relationship with consumers based on a product that gives them real value is sustainable. This will be especially true in the future as the next generation of browsers may block the installation of toolbars in their current format. As mentioned earlier our solution is one of value. Our focus is on creating products and services that serve the needs of our users and provide them with real value so that they continue to use our products and brand instead of the competition.

#### **E. OFF-BALANCE SHEET ARRANGEMENTS**

We do not have off-balance sheet arrangements (as such term is defined by applicable SEC regulations) that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial conditions, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that are material to investors.

## F. TABULAR DISCLOSURE OF CONTRACTUAL OBLIGATIONS

The following table summarizes our contractual commitments as of December 31, 2011 and the effect those commitments are expected to have on our liquidity and cash flow in future periods:

| Contractual Commitments           | Total    | Payments Due by Period |                                    |           |                      |
|-----------------------------------|----------|------------------------|------------------------------------|-----------|----------------------|
|                                   |          | Less than<br>1 year    | 1-3 Years<br><i>(in thousands)</i> | 3-5 Years | More than<br>5 Years |
| Accrued severance pay(**)         | \$ 946   |                        |                                    |           |                      |
| Uncertain Income Tax Positions(*) | 2,151    |                        |                                    |           |                      |
| Operating leases                  | 2,652    | 760                    | 1,470                              | 422       |                      |
| Total                             | \$ 5,749 | 760                    | 1,470                              | 422       | -                    |

(\*) Uncertain income tax positions are due upon settlement and we are unable to reasonably estimate the ultimate amount or timing of settlement. See Note 10(i) of our Consolidated Financial Statements for further information.

(\*\*) Severance pay obligations to our Israeli employees, as required under Israeli labor law and as set forth in employment agreements, are payable only upon termination, retirement or death of the respective employee and there is no obligation for benefits accrued prior to February 2008, if the employee voluntarily resigns. Of this amount, \$462 is unfunded.

## ITEM 6. DIRECTORS, SENIOR MANAGEMENT AND EMPLOYEES

### A. DIRECTORS AND SENIOR MANAGEMENT

The following table sets forth information regarding our executive officers and directors as of February 29, 2012:

| Name                 | Age | Position                                     |
|----------------------|-----|--|
| Josef Mandelbaum     | 45  | Chief Executive Officer and Director         |
| Iris Beck            | 46  | Director                                     |
| Li Carmel            | 39  | Vice President, Human Resources              |
| Arik Czerniak        | 36  | Director                                     |
| Alan Gelman          | 56  | Director                                     |
| Limor Gershoni Levy  | 41  | General Counsel                              |
| Tamar Gottlieb       | 55  | Director and Chairperson of the Board        |
| Ron Harari           | 40  | General Manager, Communications              |
| Rajiv Jain           | 49  | Chief Technology and Innovation Officer      |
| David Jutkowitz *    | 61  | External Director, member of Audit Committee |
| Yacov Kaufman        | 54  | Chief Financial Officer                      |
| Avichay Nissenbaum * | 45  | External Director, member of Audit Committee |
| Tomer Pascal         | 32  | General Manager, Utility Tools               |
| Andrew Wright        | 49  | General Manager, Photos                      |

\* "Independent" for Nasdaq Stock Market purposes.

David Jutkowitz and Avichay Nissenbaum were elected to serve as our external directors by our shareholders as required by Israeli law. No shareholder has special voting rights with respect to the election of directors or otherwise.

*Josef Mandelbaum* joined the Company as a Chief Executive Officer on July 7, 2010 and was elected as a Director in January 2011. Before joining the Company, Mr. Mandelbaum worked at American Greetings as Chief Executive Officer of the AG Intellectual Properties group, since 2000 and as Senior Vice President of the Sales and Business Development AG Interactive group from 1998 until 2000. Mr. Mandelbaum holds a BA in economics from Yeshiva University and an MBA from the Weatherhead School of Management at Case Western Reserve University.

*Iris Beck* was elected as director in November 2011. Ms. Beck has been the Chief Executive Officer of McCann Erickson Israel since 2009. Between 2002 and 2008 she served as the Chief Marketing Officer of Partner Communications, and between 2001-2002 she served as the Chief Executive Officer of Unilever Israel. Ms. Beck holds a B.A (with distinction) in Economic Science from Haifa University and an MBA (with distinction) from Bar Ilan University, and attended Management courses at INSEAD

*Li Carmel* joined us in November 2009 and serves as Vice President of Human Resources. Li brings with her more than ten years of experience in Human Resources management positions in the Hi-Tech industry. She served as VP of Human Resources at Surf Communications Ltd., as Human Resources Manager at Radware Ltd., and held HR positions at Nice Systems Ltd. and Orbotech Ltd. Li holds a B.A in Psychology and Philosophy, and an M.B.A. from Tel-Aviv University.

*Arik Czerniak* was elected director in December 2009. Arik is a veteran internet entrepreneur and a founder of several consumer focused internet startups. He co-founded SupersonicAds in 2008, a leading social media monetization platform focused on European advertisers, and serves as its Chief Operation Officer. He co-founded Metacafe Inc., one of the world's largest privately held video sites, with 50 million monthly visitors and was its Chief Executive Officer between 2003-2007. Before becoming an entrepreneur, Arik spent 10 years in the Israeli Air Force, and participated in the Talpiot R&D officers project. Arik has a BA in mathematics, physics and computer sciences, and an MBA in finance and banking.

*Alan Gelman* was elected director in August 2011. Mr. Gelman has been the Chief Financial Officer and Deputy CEO of Bezeq Group, Israel's largest and leading telecommunications group since 2008, and between 2006 and 2008 Mr. Gelman was the Chief Financial Officer and Deputy CEO of Delek Group. Between 2001 and 2006 Mr. Gelman was the Chief Financial Officer of Partner Communications Company Ltd., and prior to that the Chief Financial Officer of Barak ITC. Mr Gelman holds a Bachelor's degree in Accounting from Queens College in New York and an MBA from Hofstra University in New York. Mr. Gelman is licensed as a Certified Public Accountant in the USA and in Israel.

*Limor Gershoni Levy* joined us in January 2011 and serves as Vice President, General Counsel and Corporate Secretary. Prior to joining the Company Ms. Gershoni-Levy was General Legal Counsel for seven years at Veraz Networks (NASDAQ: VRAZ), a leading provider of band-width optimization and next generation switching products. In 2010 Veraz merged with Dialogic (NASDAQ: DLGC). Before that, Ms. Gershoni-Levy was General Counsel at Medigate Ltd. a company that developed management software. Ms. Gershoni-Levy has an L.L.M from University Tel Aviv Law School and a L.L.B in Law from Essex University, England.

*Tamar Gottlieb* has served as our director since 2001 and became Chair of the Board of Directors on February 3, 2006, the closing date of our initial public offering. She is a Managing Director of Harvest Capital Markets Ltd., an investment banking and financial consulting firm that she founded in January 2001. Prior to 2001, Ms. Gottlieb held Managing Director or Senior Manager positions in several investment banking institutions, including Investec Clali – Management & Underwriting Ltd. (from July 1997 to January 2001), Oscar Gruss (1996) Ltd. (from February 1996 to May 1997) and Leumi & Co. Investment Bankers Ltd. (from 1980 to 1991). From August 1991 to June 1994, Ms. Gottlieb served as the Founding Managing Director of Maalot – The Israeli Securities Rating Company Ltd., Israel's first credit rating agency. She currently serves as a board member of several Israeli public and private companies, including Emilia Development Ltd., Leumi Mortgage Bank Ltd., Albaad Ltd., Carasso Motors Ltd. and Reit 1 Ltd. In the past she has also served as a director of, among others, El Al Israeli Airlines Ltd. and "Dan" the Company for Public Transport Ltd. Ms. Gottlieb has a B.A. in international relations from the Hebrew University of Jerusalem and an M.A. in economics from Indiana University.

*Ron Harari* joined the Company as Vice President of Products in May 2011 and was recently appointed General Manager of the Communications Business division. Before joining the Company, Ron worked at ICQ/AOL for almost ten years, and was a member of the management team from 2005. During those years, Ron acted as Vice President of Web R&D, Vice President Operations and Vice President Products and Operations. Prior to working at ICQ, Ron served in a range of positions at Walla Communications (Israel's leading portal) and for the Government of Israel. Ron also currently serves as an Advisory Board Member at Treezer, a startup company specializing in ad conversions. Ron has a certificate in multimedia from New York University.

*Rajiv Jain* joined the Company as Chief Technology and Innovation Officer in April 2011. Previously Rajiv was Executive Vice President of Corbis.com and Chief Technology & Innovation Officer at Corbis Inc., where he was responsible for the company's technology as well as its online consumer business. Prior to Corbis, Rajiv's experience includes Chief Technology Officer of American Greetings Interactive (AGI), senior and executive management positions at AT&T Wireless, as General Manager of their e-commerce business; Portal Software Inc. (now Oracle); IBM; Taligent, a joint venture between Apple, Inc, HP and IBM Corporation; and prior to that, Autodesk. Rajiv received a M.S. from the University of Rochester and a B.S. from the Indian Institute of Technology. He also holds eleven software and process patents under his name and currently sits on the Founding Board of University of Washington Information School.

*David Jutkowitz* was reelected to serve another three year term as an "external director" in January, 2011. Mr. Jutkowitz serves as a director of Extal Ltd a producer of aluminum profiles and systems, and of King Engine Bearings Ltd. a manufacturer of engine bearings. Mr. Jutkowitz served as a director of Arad Investment and Industrial Development from 2006 till 2010, and from 2001 until October 2007, Mr. Jutkowitz has served as an external director of Carmel Investment Group Ltd., and was a member of the audit, investment and portfolio committees of Carmel Investment Group Ltd. Between 2000 and 2003, Mr. Jutkowitz held the position of CEO at BXS Ltd., where his responsibilities included managing all stages in development of the business, including the raising of funds from investors and building a local and international distribution. From 1995 until 2002, Mr. Jutkowitz held the position of CEO at E.L. Advanced Science Ltd., where his responsibilities included identifying and acquiring appropriate companies and taking an active part in the management of such companies. From 1976 to 2001, Mr. Jutkowitz held the position of CFO at Etz Lavud Ltd.

*Yacov Kaufman* was engaged to serve as our Chief Financial Officer in 2005. From 1996 to November 2005, Mr. Kaufman was the Chief Financial Officer of Acorn Energy Inc. (formerly Data Systems & Software Inc., NASDAQ: ACFN) that, through its subsidiaries, provides software consulting and development services and serves as an authorized dealer and a value-added-reseller of computer hardware. At Acorn, Mr. Kaufman established and subsequently managed the accounting and financial departments of the company and its subsidiaries. His responsibilities included financial analysis and implementation of procedures for internal control over financial reporting. Mr. Kaufman also served as the comptroller of dsIT Technologies Ltd., a subsidiary of Acorn since 1986, and as its Chief Financial Officer since 1990. From 1993 to 1999, Mr. Kaufman served as a director of Tower Semiconductor Ltd. (Nasdaq: TSEM), an integrated circuits manufacturer and then subsidiary of Acorn. Mr. Kaufman is an Israeli Certified Public Accountant and has a B.A. in accounting and economics from the Hebrew University of Jerusalem and an M.B.A. in business finance from Bar-Ilan University.

*Avichay Nissenbaum* was elected to serve a three year term as an "external director" in July 2009. Mr. Nissenbaum is a general partner and cofounder of Lool Ventures. Prior to founding Lool, Avichay Nissenbaum was the CEO & Co-founder of Yedda, an AOL company and AOL Israel Country Manager. As co-founder and CEO of Yedda, Inc. Avichay led the company to become a prominent player in the Internet social search space which led to the acquisition by AOL (A Time Warner company Nasdaq:TWX). Prior to Yedda Avichay co-founded SmarTeam (Acquired by Dassault Systemes, Nasdaq: DASTY), a market leader in the PLM domain (Product Lifecycle Management). With over 20 years of experience in the software industry, through leadership positions in management, sales, business development, marketing, and operations, Avichay serves as a board member for Winbuyer Ltd., ComSleep Ltd. and advises and helps several startups and entrepreneurs. Avichay holds a B.Sc degree in Computer Science and a B.A in Economics.

*Tomer Pascal* joined us in July 2009 and currently serves as General Manager of the Utility Tools division. Prior this appointment Tomer was the Company Vice President of Marketing. Prior to joining the Company, Tomer was co-founder of PlaySpex, a company operating in the fantasy sports field that raised a seed investment from Gemini Ventures and LightSpeed. Tomer has worked for several companies in the field of online gaming such as 888 Holdings and Ujamu.com as a Product Manager and SEO Specialist. Prior to that, Tomer worked for the Government of Israel as a systems specialist.

*Andrew Wright* joined the Company as General Manger of our Photo division, with the acquisition of Smilebox Inc. in August 2011. Mr. Wright founded Smilebox Inc. in 2005, currently a wholly owned subsidiary of Perion. Prior to Smilebox, Andrew was the Vice President of Games at RealNetworks, where he founded and built the RealArcade games business. Andrew was previously a Product Unit Manager at Microsoft Corporation, where he managed the consumer imaging and publishing business, including Picture It!, Home Publishing, and the Greetings product lines.

## **B. COMPENSATION**

The aggregate direct compensation we paid to our officers as a group (8 persons) for the year ended December 31, 2011, was approximately \$3.0 million, which included approximately \$0.4 million that was set aside or accrued to provide for pension, retirement, severance or similar benefits. This amount does not include expenses we incurred for other payments, including dues for professional and business associations, business travel and other expenses, and other benefits commonly reimbursed or paid by companies in Israel. We did not pay our officers who also serve as directors any separate compensation for their directorship during 2011.



The aggregate direct compensation we paid to our directors who are not officers for their services as directors as a group for the year ended December 31, 2011 was approximately \$256 thousand. Directors are also reimbursed for expenses incurred in order to attend board or committee meetings.

As of February 29, 2012, there were outstanding options to purchase 1,090,000 ordinary shares granted to 14 of our directors and officers, at a weighted average exercise price of \$5.57 per share. These options were granted under our 2003 Israeli Share Option Plan, as amended, (the "2003 Plan").

The compensation of our directors who are not officers of our Company, including our external directors, was approved by the Company's governing bodies, as required under the Israeli law. In accordance with these resolutions, (i) annual gross compensation for external directors is \$25,000, and \$500 (plus value added tax ("V.A.T."), if applicable) per meeting, while other directors, who are not officers, receive annual gross compensation of \$35,000, with no payment per meeting (plus V.A.T., if applicable) to be paid in four equal quarterly installments; (ii) a grant of options to purchase 10,000 of our ordinary shares, with the following terms: (a) each option shall be exercisable for one ordinary share at an exercise equal to the closing price on the date of grant of the options, as reported by the Nasdaq Capital Market; (b) the options shall vest in three equal parts; and (c) any and all other terms and conditions pertaining to the grant of the options shall be in accordance with, and subject to, the "2003 Plan" adopted by the Company in 2003 and our standard option agreement executed by each director and by the Company promptly after the date of grant.

In accordance with the shareholders' approval of December 27, 2007 each of the directors who is not an employee of the Company, receives for each year of service by such person as a director of the Company, an option to purchase 10,000 ordinary shares of the Company (in this subsection - the "Annual Grant"), under the following terms: (a) the Annual Grant shall be made immediately following the annual general meeting of the shareholders of the Company in the relevant year, commencing with the shareholders meeting held on December 27, 2007; (b) each option shall be exercisable for one ordinary share at an exercise price equal to the closing price of an ordinary share on the date of the annual general meeting of the shareholders of the Company upon which such option was granted, as reported by the Nasdaq Global Market; and (c) the options shall vest in four equal portions on each anniversary of the Annual Grant, commencing with the first anniversary. Any and all other terms and conditions pertaining to the grant of the options shall be in accordance with, and subject to, the 2003 Plan and our standard option agreement. In accordance with this resolution, all directors who are not officers were granted 10,000 options on January 6, 2011 and on October 27, 2011, after the 2010 and 2011 annual general meetings.

On July 17, 2008, and following approval by our audit committee and board of directors, our shareholders approved a grant to Ms. Tamar Gottlieb of options to purchase 10,000 ordinary shares of the Company, under the following terms: (a) each option shall be exercisable for one ordinary share at an exercise price equal to the closing price of an ordinary share on July 17, 2008, as reported by the Nasdaq Global Market; and (b) the options shall vest in three equal portions on each anniversary of the date of approval of the grant, commencing with the first anniversary. Any and all other terms and conditions pertaining to the grant of the options hereunder shall be in accordance with, and subject to, the 2003 Plan and the Company's standard option agreement. See "Item 6.E Share Ownership — Employee Benefit Plans — The 2003 Plan" below.

On July 9, 2009, following approval by our audit committee and board of directors, our shareholders amended the terms of options granted to the external directors and the directors of the Company. In accordance with the amendment, our directors' recurring annual stock option grants or an Annual Grant have a vesting period of three years (instead of four years) from the date of grant. Also, upon termination or expiration of the applicable director's service with the Company, provided that the termination or expiration is not "for Cause" and not resulting from the director's resignation, the stock options granted to such director shall retain their original termination dates, and shall not terminate 90 days after the applicable termination date, and the next upcoming tranche of stock options, of each grant, that are scheduled to vest immediately subsequent to the termination date, if any, shall automatically vest and become exercisable immediately prior to the termination date. In addition, to avoid a possible conflict of interest while discussing a Change of Control of the Company (which may result in the termination of the director's term of office), all unvested options held by the director shall automatically vest and become exercisable upon such "Change of Control" event. "Change of Control" is defined for these purposes as: (i) merger, acquisition or reorganization of the Company with one or more other entities in which the Company is not the surviving entity, (ii) a sale of all or substantially all of the assets of the Company; (iii) a transaction or a series of related transactions as a result of which more than 50% of the outstanding shares or the voting rights of the Company are held by any party (whether directly or indirectly).

## C. BOARD PRACTICES

### Board of Directors and Executive Officers

We are deemed a "limited liability public company" under the Israeli Companies Law. As a limited liability public company, we are managed by a board of directors and by our executive officers. Under the Israeli Companies Law and our articles of association, the board of directors is responsible, among other things, for:

- establishing our policies and overseeing the performance and activities of our chief executive officer;
- convening shareholders' meetings;
- preparing and approving our financial statements;
- determining our plans of action, principles for funding them and the priorities among them, our organizational structure and wage policy and examining our financial status;
- issuing securities and distributing dividends.

Our board of directors also appoints and may remove our chief executive officer and may appoint or remove other executive officers, subject to any rights that the executive officers may have under employment agreements.

Upon the closing of our initial public offering (meaning, January 30, 2006), all previously existing special rights to appoint or serve as directors had terminated and our articles of association were amended to remove these special rights.

Our board of directors generally consists of seven directors, two of whom qualify as "external directors" for Israeli law purposes and have been determined by our board of directors to qualify as "independent" for Nasdaq Stock Market Purposes as well. Other than external directors, who are subject to special election requirements under Israeli law, our directors are elected in three staggered classes by the vote of a majority of the ordinary shares present and entitled to vote at meetings of our shareholders at which directors are elected. The members of only one staggered class will be elected at each annual meeting for a three-year term, so that the regular term of only one class of directors expires annually. At our annual general meeting on December 31, 2009, the term of the first class, consisting of Tamar Gottlieb and Yaron Adler, expired, Tamar Gottlieb was reelected, Yaron Adler was not and Arik Czerniak was elected in his place for a three-year term. At our 2011 annual general meeting held in October 2011, the term of the third class, consisting of Arik Ramot, expired, he did not stand for reelection and Iris Beck was elected in his place for a three-year term. The external directors will not be assigned a class and will serve in accordance with Israeli law. On July 9, 2009, Avichay Nissenbaum was elected as an external director for a three-year term and at our 2010 annual shareholder meeting held on January 6, 2011, David Jutkowitz was reelected for another three year term as an external director of the Company, Ofer Adler was reelected for a three year term as director, and Josef Mandelbaum was elected for a three year term as director. In August 2011 the Board of Directors appointed Alan Gelman, to fill the vacancy occurring after the resignation of Ofer Adler for personal reasons, which took effect on August 7<sup>th</sup> 2011. Mr. Gelman was appointed to complete Mr. Adler's term until the annual meeting of shareholders of the Company to be held in the year 2013 and the due election of his successor.

If the number of directors constituting the board is changed, any increase or decrease shall be apportioned among the classes so as to maintain the number of directors in each class as nearly equal as possible, but in no case will a decrease in the number of directors constituting the board shorten the term of any incumbent director.

The board may appoint any other person as a director, whether to fill a vacancy or as an addition to the then current number of directors, provided that the total number of directors shall not at any time exceed seven directors. Any director so appointed shall hold office until the annual general meeting of our shareholders at which the term of his or her class expires, unless otherwise stated in the appointing resolution.

There is no limitation on the number of terms that a director may serve. However, as described below, external directors may serve one term of three years, and subject to certain conditions, an additional two terms of three years each, under specific conditions as prescribed by law.

Nominations for the election of directors may be made by our board of directors in view of the recommendation of the nominating and governance committee or, subject to the Companies Law, by any of our shareholders. However, any shareholder or shareholders holding at least 5% of the voting rights in our issued share capital may nominate one or more persons for election as directors at a general meeting only if a written notice of such shareholder's intent to make such nomination or nominations has been given to our secretary and each such notice sets forth all the details and information as required to be provided under our articles of association.

Shareholders may remove a director who is not an external director from office only by a resolution approved by shareholders holding more than two-thirds of the voting power of the issued and outstanding share capital of the Company.

The board of directors appoints its chairperson from among its members in accordance with our articles of association and subject to the provisions of the Companies Law. Pursuant and subject to our articles of association, the chairperson convenes and presides over the meetings of the board. The quorum required for meetings of the board is a majority of the members of the board who are lawfully entitled to participate and vote at the meeting, and resolutions are approved by a vote of the majority of the members present. If the board of directors meeting is adjourned for failure to obtain a quorum and at the adjourned meeting a quorum is not present, then the quorum shall be constituted by the presence of two directors then in office who are lawfully entitled to participate and vote at that meeting. Subject to the provisions of the Israeli Companies Law a director may appoint an alternate director to attend a meeting in his or her place, but an alternate director so appointed must be approved by the board prior to the relevant meeting.

Pursuant to the requirements of the Israeli Companies Law, our board has determined that at least one of our directors must have accounting and financial expertise (in addition to the external directors that must have accounting and finance expertise). In determining such number of directors, the board considered, among other things, the business of our Company, our size and the scope and complexity of our operations. Such determination also took into account our total number of directors as set forth in the articles of association in accordance with the Israeli Companies Law.

Each of our executive officers serves at the discretion of our board of directors and holds office until his or her successor is elected or his or her earlier resignation or removal.

#### **External Directors**

Under the Israeli Companies Law, Israeli companies whose shares have been offered to the public in or outside of Israel are required to appoint at least two external directors to serve on their board of directors for a three year term. At the extraordinary shareholder meeting held on July 9, 2009, Mr. Avichay Nissenbaum was appointed as an external director. In addition Mr. David Jutkowitz was appointed as an external director at the annual shareholders meeting held on December 27, 2007 and reappointed at the annual shareholders meeting held on January 6, 2011.

Each committee of the board of directors entitled to exercise any powers of the board is required to include at least one external director. The audit committee must include all the external directors.

In accordance with the Companies Law, and the provisions of a recent amendment which was enacted and went into effect during 2011, a person may be appointed as an external director if he or she has professional qualifications or if he or she has accounting and financial expertise. In addition, at least one of the external directors must have accounting and financial expertise. A person may not serve as an external director, if he is a relative of a person controlling the Company, or if at the date of his or her appointment or within the prior two years, that person, or his or her relatives, partners, employers, to whom he reports directly or indirectly or entities under his or her control, are subject to, have or had any affiliation with us, to any entity or person controlling us or to a relative of any entity or person controlling us, at the time of appointment or to another entity, and in a company where there is no person or entity controlling it or a shareholder with a control block of at least 25% of the votes in a shareholders meeting, there is also no affiliation to anyone whom, on the date of appointment, is the chairperson of the board of directors of the company, chief executive officer, a major shareholder who holds at least 5% of the issued and outstanding shares of the company or 5% of the votes at a shareholders meeting, or the most senior executive officer in the finance department of the company. Under the Companies Law, "affiliation" is defined in this context to include an employment relationship, a business or professional relationship maintained on a regular basis, control or service as an office holder. However, the service of a director who was appointed for the purpose of being an external director in a company that intends to first offer its shares to the public is not considered a prohibited affiliation. An office holder is defined in the Companies Law as any general manager, chief business manager, deputy general manager, vice general manager, or any manager assuming the responsibilities of any of these positions regardless of that person's title, as well as a director, or a manager directly subordinate to the general manager.

A person may not serve as an external director if that person's position or other activities create, or may create, a conflict of interest with the person's service as a director or may otherwise interfere with the person's ability to serve as a director. Additionally, no person may serve as an external director if the person, the person's relative, spouse, employer or any entity controlling or controlled by the person, has a business or professional relationship with someone with whom affiliation is prohibited, even if such relationship is not maintained on a regular basis, excepting negligible relationships, or if such person received from the company any compensation as an external director in excess of what is permitted by the Israeli Companies Law. If at the time any external director is appointed, all members of the board are the same gender, then the external director to be appointed must be of the other gender.

External directors are elected by a majority vote at a shareholders' meeting, as long as either:

- the majority of shares voted for the election includes at least majority of the shares held by non-controlling shareholders voted at the meeting, and excluding shares held by a person with a personal interest in the approval of the election, excluding a personal interest which is not as a result of his connection with the controlling shareholder (excluding abstaining votes); or
- the total number of shares of non-controlling shareholders voted against the election of the external director does not exceed two percent of the aggregate voting rights in the company.

The Israeli Companies Law provides for an initial three-year term for an external director, which may be extended for two additional three-year terms. Thereafter (with respect to companies whose securities are listed on certain designated stock exchange, including the Nasdaq Global Market), he or she may be reelected by our shareholders for additional periods of up to three years each, in each case provided that the audit committee and the board of directors confirm that, in light of the external director's expertise and special contribution to the work of the board of directors and its committees, the reelection for such additional period(s) is beneficial to the company. External directors may be removed only:

- by a court, and then only if:
  - the external directors cease to meet the statutory qualifications for their appointment;
  - they violate their duty of loyalty to the company;
  - the director is unable to perform his or her post on a regular basis; or
  - during his or her tenure, the director was convicted in a court outside of the State of Israel on accounts of bribery, deceit, offenses by managers of a corporate body or offenses involving misuse of inside information; or
- if the board of directors determines that the external director has ceased to meet the statutory qualification for appointment or that the external director has violated his or her duty of loyalty to the company, the board shall call a general meeting of the shareholders and any such external director may be removed for such reason(s) by a resolution of the general meeting approved by the same special majority as required for such external director's election.

In the event of a vacancy created by an external director, our board of directors is required under the Companies Law to call a shareholders' meeting to appoint a new external director as soon as practicable.

External directors may be compensated only in accordance with regulations adopted under the Israeli Companies Law, and is otherwise prohibited from receiving any other compensation, directly or indirectly, in connection with service provided as an external director. The regulations provide three alternatives for cash compensation to external directors: a fixed amount determined by the regulations, an amount within a range set in the regulations, or an amount that shall not be lower than the compensation received by another director nor higher than the average compensation to other directors. "Another" or "other" directors are defined in the applicable regulations as directors of the company that are not external directors and who are not (1) controlling shareholders of the company or (2) employees or service providers of the company on a regular basis or (3) serving at, or providing services on a regular basis, to a company that controls the company or to a company that is under common control with the company or (4) directors who do not receive compensation from the company. A company also may issue shares or options to an external director at an amount not lower than that received by another director (as defined in the applicable regulations) nor higher than the average amount granted to other directors (as defined in the applicable regulations). Cash compensation at the fixed amount determined by the regulations does not require shareholder approval. Compensation determined in any other manner requires the approval of the company's audit committee, board of directors and shareholders, in that order. Compensation of external directors must be determined prior to their consent to serve as external directors.

## **Nasdaq Market Governance Requirements for Foreign Private Issuers**

Assuming that we maintain our status as a foreign private issuer, under the Nasdaq Listing Rules, a foreign private issuer may generally follow its home country rules of corporate governance except for certain matters such as composition of the audit committee (as discussed below). NASDAQ Listing Rules specify that the board of directors must contain a majority of independent directors and that the independent directors must have regularly scheduled meetings at which only independent directors are present. Our board contains two independent directors in accordance with the provisions contained in Sections 239-249 of the Israeli Companies Law – 1999 and Rule 10A-3 of the general rules and regulations promulgated under the Securities Act of 1933, rather than a majority of independent directors. Israeli law does not require, nor do our independent directors conduct, regularly scheduled meetings at which only they are present. See "Item 10.B Memorandum and Articles of Association — NASDAQ Listing Rules and Home Country Practices" and "Item 16G – Corporate Governance" for a summary of the significant ways in which our corporate governance practices follow the requirements of Israeli law rather than Nasdaq governance requirements for domestic companies. Investors are cautioned that there are other NASDAQ governance requirements with which, as a foreign private issuer, we may elect not to comply. If we so elect, we will provide disclosure of any Nasdaq governance requirements we elect not to comply with in accordance with NASDAQ's disclosure requirements, as may be in effect from time to time.

### **Committees of the Board of Directors**

Our board of directors has established an audit committee, a compensation committee, investment committee and a nominating and governance committee.

#### ***Audit Committee***

Our audit committee is comprised of David Jutkowitz, Avichay Nissenbaum (both of which are external directors) and Alan Gelman and operates pursuant to a written charter. David Jutkowitz serves as the chairperson of the audit committee.

#### ***NASDAQ Requirements***

Under the listing requirements of the NASDAQ Stock Market, a foreign private issuer is required to maintain an audit committee that has certain responsibilities and authority (such as being directly responsible for the appointment, compensation, retention and oversight of the work of the issuer's public accountants). In addition, applicable NASDAQ Listing Rules require that a foreign private issuer can maintain an audit committee that meets the requirements of Rule 10A-3(b)(subject to the exemptions provided in Rule 10A-3(c)) under the Exchange Act, instead of an audit committee composed solely of independent directors. We currently maintain a board of audit in accordance with Israeli home country regulations, meeting these requirements of Rule 10A-3, in that our audit committee complies with the requirements under Israeli law.

#### ***Israeli Companies Law Requirements***

Under the Israeli Companies Law, the board of directors of a public company must establish an audit committee. The audit committee must consist of at least three directors and must include all of the external directors, and the majority of its members must be independent directors. The audit committee may not include the chairman of the board, any director employed by the company or employed by a person or entity controlling the company or by an entity in control of such a controlling person or entity, director who provides services on an ongoing basis to the company, a person or entity controlling the company as well as a director who derives most of his earnings from a controlling entity. The chairperson of the audit committee must be an external director, the required quorum for audit committee meetings and decisions is a majority of the committee members, of which the majority of members present must be independent and external directors, and any person who is not eligible to serve on the audit committee is further restricted from participating in its meetings and votes, unless the chairman of the audit committee determines that such person's presence is necessary in order to present a certain matter, provided however, that company employees who are not controlling shareholders or relatives of such shareholders may be present in the meetings but not for the actual votes, and likewise, company counsel and secretary who are not controlling shareholders or relatives of such shareholders may be present in the meetings and for the decisions if such presence is requested by the audit committee.

The audit committee provides assistance to the board of directors in fulfilling its legal and fiduciary obligations in matters involving our accounting, auditing, financial reporting, internal control and legal compliance functions by approving the services performed by our independent accountants and reviewing their reports regarding our accounting practices and systems of internal accounting controls. The audit committee also oversees the audit efforts of our independent accountants and takes those actions as it deems necessary to satisfy itself that the accountants are independent of management. Under the Israeli Companies Law, the audit committee is also required to monitor and approve remedial actions with respect to deficiencies in the administration of the company, including by consulting with the internal auditor and recommend remedial actions with respect to such deficiencies, and to review and approve related party transactions.

On December 20, 2010 our Audit committee had been authorized by the Company's board of directors to act as the financial statements review committee in accordance with the Israeli Companies regulations with respect to the procedure in which financial statements should be approved by companies. Such regulations state, among other things, that a financial statements review committee shall discuss and prepare recommendations to the board of directors about matters related to the financial statements such as: estimations, internal control procedures, accounting policies, etc. The regulations permit that the audit committee shall act as the financial statements review committee, provided that the audit committee meets the requirements set forth in the regulations.

#### ***Compensation Committee***

As a foreign private issuer, we comply with our home country regulations with respect to the compensation committee. Unlike the Nasdaq Marketplace Rules, applicable to domestic issuers, which require that the determination of the compensation of an executive officer be made by a majority of the independent directors on the board or a compensation committee comprised solely of independent directors, under the Israeli Companies Law and the Company's article of association, the compensation of an executive officer, who does not serve on our board, can be approved by the compensation committee (in lieu of the audit committee, subject to meeting certain prerequisites) followed by the approval of the board of directors.

Our compensation committee is comprised of Tamar Gottlieb, Avichay Nissenbaum and David Jutkowitz, and operates pursuant to a written charter. The compensation committee is authorized on a yearly basis, to recommend the terms of compensation for officers who are not directors, and to approve the issuance of employee share options under our 2003 Plan and benefit plans and approve incentive compensation for our other employees.

#### ***Investment committee***

Our investment committee is comprised of Tamar Gottlieb, David Jutkowitz, Avichay Nissenbaum and Josef Mandelbaum. The Investment Committee is responsible for formulating the overall investment policies of the Company, and establishing investment guidelines in furtherance of those policies. The Committee monitors the management of the portfolio for compliance with the investment policies and guidelines and for meeting performance objectives over time as well as assist the board of directors in fulfilling its oversight responsibility for the investment of assets of the company.

#### ***Nominating and Governance Committee***

Our nominating and governance committee is comprised of Tamar Gottlieb and David Jutkowitz, and operates pursuant to a written charter. It is responsible for making recommendations to the board of directors regarding candidates for directorships and the size and composition of the board. In addition, the committee is responsible for overseeing our corporate governance guidelines and reporting and making recommendations to the board concerning corporate governance matters. Under Israeli Companies Law, the nominations for director are generally made by our directors but may be made by one or more of our shareholders. However, any shareholder or shareholders holding at least 5% of the voting rights in our issued share capital may nominate one or more persons for election as directors at a general meeting only if a written notice of such shareholder's intent to make such nomination or nominations has been given to our secretary and each such notice sets forth all the details and information as required to be provided under our articles of association.

## Internal Auditor

Under the Israeli Companies Law, the board of directors of a public company must appoint an internal auditor nominated in accordance with the audit committee's recommendation. The role of the internal auditor is to examine whether a company's actions comply with the law and proper business procedure. The internal auditor may be an employee of the company employed specifically to perform internal audit functions but may not be an interested party or office holder, or a relative of any interested party or office holder, and may not be a member of the company's independent accounting firm or its representative. The Israeli Companies Law defines an interested party as a substantial shareholder of 5% or more of the shares or voting rights of a company, any person or entity that has the right to nominate or appoint at least one director or the general manager of the company or any person who serves as a director or as the general manager of a company. The internal auditor's term of office shall not be terminated without his or her consent, nor shall he or she be suspended from such position unless the board of directors has so resolved after hearing the opinion of the audit committee and after giving him or her a reasonable opportunity to present his or her position to the board and to the audit committee. The accounting firm of Yardeni-Gelfand provides us with internal auditor services.

## Certain Employment Agreements with Directors

We have entered into employment agreements, effective July 6, 2010, with Josef Mandelbaum to retain his services as Chief Executive Officer. The employment agreement does not provide for a specified term and may be terminated by either party upon 180 days prior notice. The employment agreement includes the grant of options, the terms of which are as is customary in the Company. However, a portion of the options are also subject to the Company's share reaching a strike price higher than market at the time. Upon termination by us of the employment of the executive other than for "cause" (as set forth in the agreement), we are required to continue to pay the terminated executive his salary, benefits and bonus until the end of the 180 day notice period. However, we will have the option to pay Mr. Mandelbaum a lump sum equal to all amounts due as of the notice date. As required by Israeli law, we will also remit severance payment to Mr. Mandelbaum in an amount equal to one month's salary for each year of employment with us following the first year of employment (and a pro rata portion of such monthly salary for each portion of a year of employment following the first year of employment). Such amount of severance payment will be remitted to the executive even if he voluntarily terminates his employment with us. In the event that we terminate the employment of Mr. Mandelbaum for "cause," we will not be required to give prior notice and/or to pay the executive severance payment, except for payment required by Israeli law. In the event that Mr. Mandelbaum resigns without giving the required notice period, we may deduct from the money that we owe Mr. Mandelbaum an amount equal to the wages to which he would have been entitled had he worked during the notice period. With regard to the options granted, in the event that Mr. Mandelbaum resigns: (1) the period during which his vested options will be exercisable shall be one (1) year from termination date (as such term is defined in the 2003 Plan); and (2) a number of unvested options equal to the pro rata options (as such term is defined in his option agreement) shall become vested. In the event that the employment is terminated by the Company without "cause" (as defined in the 2003 Plan): the period during which vested options will be exercisable shall be the period ending on the expiration date (as set forth in his option agreement) and (2) a number of unvested options equal to the pro rata options (as such term is defined in his option agreement) shall become vested.

Josef Mandelbaum has agreed not to compete with us during the term of the agreement and for a period of 180 days thereafter. The agreement also contains customary confidentiality and intellectual property assignment provisions.

We also have existing employment agreements with our other executive officers. These agreements do not contain any change of control provisions and otherwise contain salary, benefit and non-competition provisions that we believe to be customary in our industry.

## D. EMPLOYEES

As of December 31, 2011 we had 139 employees. The breakdown of our employees by department and fiscal period is as follows:

|                               | December 31, |      |      |
|-------------------------------|--------------|------|------|
|                               | 2009         | 2010 | 2011 |
| Management and administration | 12           | 21   | 24   |
| Support                       | 16           | 14   | 14   |
| Research and development      | 64           | 54   | 69   |
| Selling and marketing         | 19           | 18   | 32   |
| Total                         | 111          | 107  | 139  |

As of December 31, 2011, 93 of our employees were located in Israel, and 46 employees located in the US. In Israel we are subject to certain labor statutes and national labor court precedent rulings, as well as to some provisions of the collective bargaining agreement between the Histadrut, which is the General Federation of Labor in Israel, and the Coordination Bureau of Economic Organizations, including the Industrialist's Association of Israel. These provisions of collective bargaining agreements apply to our Israeli employees by virtue of extension orders issued in accordance with relevant labor laws by the Israeli Ministry of Industry, Trade and Labor, and which apply such agreement provisions to our employees even though they are not directly part of a union that has signed a collective bargaining agreement. The laws and labor court rulings that apply to our employees principally concern minimum wage laws, procedures for dismissing employees, determination of severance pay, leaves of absence (such as annual vacation or maternity leave), sick pay and other conditions for employment. The expansion orders which apply to our employees principally concern the requirement for the length of the workday and the work-week, annual recuperation pay and commuting expenses, compensation for working on the day before and after a holiday and payments to pension funds and other conditions for employment. Furthermore, these provisions provide that the wages of most of our employees are adjusted automatically. The amount and frequency of these adjustments are modified from time to time. Additionally, we are required to insure all of our employees by a comprehensive pension plan or a senior employees' insurance according to the terms and the rates detailed in the order. In addition, Israeli law determines minimum wages for workers, minimum paid leave or vacation, sick leave, working hours and days of rest, insurance for work-related accidents, determination of severance pay, the duty to give notice of dismissal or resignation and other conditions of employment. In addition, certain laws prohibit or limit the employer's ability to dismiss its employees in special circumstances. We have never experienced a work stoppage, and we believe our relations with our employees are good.

Israeli law generally requires the payment of severance by employers upon the retirement or death of an employee or upon termination of employment by the employer or, in certain circumstances, by the employee. The Company's agreements with employees in Israel, joining the Company since February 2, 2008, are in accordance with section 14 of the Severance Pay Law -1963, whereas, the Company's contributions for severance pay shall be instead of its severance liability. Upon contribution of the full amount of the employee's monthly salary, and release of the policy to the employee, no additional calculations shall be conducted between the parties regarding the matter of severance pay and no additional payments shall be made by the Company to the employee. Further, the related obligation and amounts deposits on behalf of such obligation are not stated on the balance sheet, as they are legally released from obligation to employees once the deposit amounts have been paid.

We currently fund most of our ongoing severance obligations through insurance policies. As of December 31, 2011, our net accrued unfunded severance obligations totaled \$0.5 million.

Furthermore, Israeli employees and employers are required to pay predetermined sums to the National Insurance Institute, which covers, amongst other benefits, payments for state retirement benefits and survivor benefits, (similar to the United States Social Security Administration) as well as state unemployment benefits. These amounts also include payments for national health insurance. The payments to the National Insurance Institute can equal up to approximately 17.9% of wages subject to a cap if an employee's monthly wages exceed a specified amount, of which the employee contributes approximately 12% and the employer contributes approximately 5.9%.

## **E. SHARE OWNERSHIP**

### **Security Ownership of Directors and Executive Officers**

The following table sets forth information regarding the beneficial ownership of our ordinary shares as of February 29, 2012 by:

- each of our executive officers;
- each of our directors; and
- all of our directors and executive officers as a group.

Beneficial ownership of shares is determined in accordance with the rules of the SEC and generally includes any shares over which a person exercises sole or shared voting or investment power. Ordinary shares that are subject to warrants or stock options that are presently exercisable or exercisable within 60 days of a specified date are deemed to be outstanding and beneficially owned by the person holding the stock options for the purpose of computing the percentage ownership of that person, but are not treated as outstanding for the purpose of computing the percentage of any other person.



Except as indicated in the footnotes to this table, each shareholder in the table has sole voting and investment power for the shares shown as beneficially owned by them. Percentage ownership is based on 9,917,046 ordinary shares outstanding on February 29, 2012.

| Name  | Number of Ordinary Shares Beneficially Owned | Percentage of Ordinary Shares Outstanding |
|---|--|---|
| Yacov Kaufman (1)                                       | 158,666                                      | 1.6%                                      |
| Andrew Wright   | 128,538                                      | 1.3%                                      |
| Tamar Gottlieb (2)                                      | 104,380                                      | 1.0%                                      |
| Josef Mandelbaum (3)                                    | 60,000                                       | *   |
| David Jutkowitz (4)                                     | 30,000                                       | *   |
| Li Carmel (5)   | 15,000                                       | *   |
| Avichay Nissenbaum (6)                                  | 11,900                                       | *   |
| Tomer Pascal (7)  | 11,667                                       | *   |
| Arik Czemiak (8)  | 10,000                                       | *   |
| Limor Gershoni Levy (9)                                 | 8,333  | *   |
| Rajiv Jain (10)   | 8,333  | *   |
| All directors and officers as a group (11 persons) (11) | 546,817                                      | 5.3%                                      |

\* Represents less than one percent

- (1) Includes options to purchase 20,000 ordinary shares at an exercise price of \$3.00 per share, 30,000 ordinary shares at an exercise price of \$3.51 per share, 33,333 ordinary shares at an exercise price of \$6.75 per share and 8,333 at an exercise price of \$7.50 per share, exercisable within 60 days of this Annual Report.
- (2) Includes options to purchase 10,000 ordinary shares at an exercise price of \$2.30 per share, 10,000 ordinary shares at an exercise price of \$3.26 per share, 10,000 ordinary shares at an exercise price of \$5.21 per share, 3,333 ordinary shares at an exercise price of \$7.85 per share and 6,667 at an exercise price of \$9.98 per share, exercisable within 60 days of this Annual Report.
- (3) Represents options to purchase 50,000 ordinary shares at an exercise price of \$4.38 per share and 10,000 ordinary shares at an exercise price of \$7.50, exercisable within 60 days of this Annual Report.
- (4) Represents options to purchase 10,000 ordinary shares at an exercise price of \$2.30 per share, 10,000 ordinary shares at an exercise price of \$5.21 per share, 3,333 ordinary shares at an exercise price of \$7.85 per share and 6,667 at an exercise price of \$9.98 per share, exercisable within 60 days of this Annual Report.
- (5) Represents options to purchase 6,667 ordinary shares at an exercise price of \$6.15 per share and 8,333 at an exercise price of \$7.50 per share, exercisable within 60 days of this Annual Report.
- (6) Includes options to purchase 6,667 ordinary shares at an exercise price of \$5.86 per share and 3,333 at an exercise price of \$7.85 per share, exercisable within 60 days of this Annual Report.
- (7) Represents options to purchase 6,667 ordinary shares at an exercise price of \$6.15 per share and 5,000 at an exercise price of \$7.50 per share, exercisable within 60 days of this Annual Report.
- (8) Represents options to purchase 3,333 ordinary shares at an exercise price of \$7.85 per share and 6,667 at an exercise price of \$9.98 per share, exercisable within 60 days of this Annual Report.
- (9) Represents options to purchase 8,333 ordinary shares at an exercise price of \$7.11 per share, exercisable within 60 days of this Annual Report.
- (10) Represents options to purchase 8,333 ordinary shares at an exercise price of \$7.25 per share, exercisable within 60 days of this Annual Report.
- (11) Includes options to purchase 285,000 ordinary shares, exercisable within 60 days of this Annual Report.

#### Employee Benefit Plans

Our current equity incentive plan was adopted in 2003 under Section 102 of the Israeli Income Tax Ordinance, providing certain tax benefits in connection with share-based compensation. Please also see Note 11 of our financial statements included in this annual report for information on the options issued under our plan.

Under the 2003 Plan, we may grant to our directors, officers, employees, service providers and controlling shareholders options to purchase our ordinary shares. Following an increase in the number of shares available for grant approved by our board of directors and shareholders in December 2007 and January 2011, as of December 31, 2011 a total of 2,421,403 ordinary shares are subject to the 2003 Plan. Any expired or cancelled options are available for reissuance under the 2003 Plan. Our employees, officers and directors may only be granted options under Section 102 of the Israeli Income Tax Ordinance (the "Tax Ordinance"), which provides for a beneficial tax treatment, and our non-employees (such as service providers) and controlling shareholders may only be granted options under another section of the Tax Ordinance, which does not provide for similar tax benefits. To be eligible for tax benefits under Section 102, options or ordinary shares must be issued through a trustee, and if held by the trustee for the minimum required period, the employees and directors are entitled to defer any taxable event with respect to the options until the earlier of (i) the transfer of the options or underlying shares from the trustee to the employee or director or (ii) the sale of the options or underlying shares to any other third party. Based on elections made by us, our employees and directors will only be subject to capital gains tax of 25% on the sale of the options or the underlying shares, provided the trustee holds their options or, upon their exercise, the underlying shares for the lesser of (i) 30 months, or (ii) 24 months following the re-pricing of any options and for options without re-pricing for 24 months following the end of the calendar year in which the options were granted, and if granted after January 1, 2006, for only 24 months. We may not deduct expenses pertaining to the options for tax purposes.



The tax treatment with respect to options granted to employees and directors under the 2003 Plan is the result of our election of the capital gains tax track under Section 102 of the Tax Ordinance. Section 102 also provides for an income tax track, under which, among other things, the benefit to the employees will be taxed as income, the issuer will be allowed to recognize expenses for tax purposes, and the minimum holding period for the trustee will be 12 months from the date upon which such options are granted.

The board of directors of the Company has determined that it is in the interests of the Company to allow our employees in the United States to participate in our stock option plans for employees. According to the laws in the United States (particularly the U.S. Internal Revenue Code of 1986, as amended) in order for a grant of options to qualify as an "incentive stock option" it must, amongst other requirements, be granted pursuant to a plan which is approved by the stockholders of the granting corporation within 12 months before or after the date such plan is adopted. Therefore, the board of directors has resolved to seek shareholder approval for the adoption of an amendment for U.S. taxpayers to the 2003 Plan (the "U.S. Appendix"), for the award of options to purchase Shares under the 2003 Plan, all of which may be issued under the U.S. Appendix pursuant to "incentive stock options" within the meaning of the U.S. Internal Revenue Code of 1986, as amended. In the annual shareholders meeting of the Company, held on October 27<sup>th</sup>, 2011, the 2003 Plan has been amended, in order to adopt the US Appendix for U.S taxpayers.

Our board of directors has the authority to administer the 2003 Plan and to grant options under the plan. However, the compensation committee appointed by the board provides recommendations to the board with respect to the administration of the plan and also has full power, among other things, to alter any restrictions and conditions of the options, accelerate the rights of an optionee to exercise options and determine the exercise price of the options.

Options granted to date under the 2003 Plan in the past generally vest in three equal parts annually. One of the grants to the directors vested in four equal parts annually. See "Item 6.B Compensation" for a description of options granted under the 2003 Plan to our directors.

The 2003 Plan does not provide for any other acceleration of the vesting period upon the occurrence of certain corporate transactions. However, the board or compensation committee may provide in individual option agreements that if the options are not substituted or exchanged by a successor company, then the vesting of the options shall accelerate.

Adjustments to the number of options or exercise price shall not be made in the event of rights offering on outstanding shares.

In December 2011, the Company's board of directors adopted a compensation policy according to which the eligibility of employees for option grants under the 2003 Plan was established. The compensation policy also sets forth guidelines regarding employee salaries and bonuses.

## **ITEM 7. MAJOR SHAREHOLDERS AND RELATED PARTY TRANSACTIONS**

### **A. MAJOR SHAREHOLDERS**

The following table sets forth information regarding the beneficial ownership of our ordinary shares as of February 29, 2012 by each person or group of affiliated persons that we know beneficially owns more than 5% of our outstanding ordinary shares. Other than with respect to our directors and officers, we have relied on public filings with the SEC. Unless otherwise stated herein, each shareholder's address is c/o Perion Network Ltd., 4 HaNechoshet Street, Tel Aviv 69710, Israel.

Beneficial ownership of shares is determined in accordance with the Securities Exchange Act of 1934 and the rules promulgated thereunder, and generally includes any shares over which a person exercises sole or shared voting or investment power. Ordinary shares that are subject to warrants or stock options that are presently exercisable or exercisable within 60 days of a specified date are deemed to be outstanding and beneficially owned by the person holding the stock options or warrants for the purpose of computing the percentage ownership of that person, but are not treated as outstanding for the purpose of computing the percentage of any other person.

Except as indicated in the footnotes to this table, each shareholder in the table has sole voting and investment power for the shares shown as beneficially owned by such shareholder. Percentage ownership is based 9,917,046 ordinary shares outstanding on February 29, 2012. Our major shareholders do not have different voting rights than our other shareholders.

| Name        | Number of<br>Ordinary<br>Shares<br>Beneficially<br>Owned | Percentage of<br>Ordinary<br>Shares<br>Outstanding |
|-------------|--|--|
| Yaron Adler | 721,232  | 7.3%   |
| Ofer Adler  | 716,956  | 7.2%   |

To our knowledge, as of February 29, 2012, we had 14 stockholders of record of which 7 (including the Depository Trust Company) were registered with addresses in the United States. These United States holders were, as of such date, the holders of record of approximately 92% of our outstanding shares, including shares held through the Depository Trust Company.

## B. RELATED PARTY TRANSACTIONS

It is our policy that transactions with office holders or transactions in which an office holder has a personal interest ("Affiliated Transactions") will be on terms that, on the whole, are no less favorable to us than could be obtained from independent parties.

Generally, Affiliated Transactions which are "extraordinary transactions" (as such term is defined in the Companies Law), must be approved by a majority of our disinterested directors; nevertheless under Israeli law, under certain circumstances, such transactions (i) must first be approved by the audit committee and then by the board of directors and, in certain circumstances must also be approved by the shareholders; or (ii) may be approved by a simple majority of the board (and by a simple majority of the audit committee) and interested directors may participate in the deliberations and the voting with respect to such transactions if the majority of the members of the board (or the audit committee) have a personal interest in the approval of the transaction; provided that in such circumstances the approval of such Affiliated Transaction shall also require the approval of the shareholders.

See "Item 10.B Memorandum and Articles of Association — Approval of Related Party Transactions" for a discussion of the requirements of Israeli law regarding special approvals for transactions involving directors, officers or controlling shareholders.

On July 17, 2008, and following approval by our audit committee and board of directors, our shareholders approved a grant to Ms. Tamar Gottlieb of options to purchase 10,000 ordinary shares of the Company, under the following terms: (a) each option shall be exercisable for one ordinary share at an exercise price equal to the closing price of an ordinary share on July 17, 2008, as reported by the Nasdaq Global Market; and (b) the options shall vest in four equal portions on each anniversary of the date of approval of the grant, commencing with the first anniversary. Any and all other terms and conditions pertaining to the grant of the options hereunder shall be in accordance with, and subject to, the 2003 Plan adopted by the Company in 2003 and the Company's standard option agreement. See "Item 6.E Share Ownership — Employee Benefit Plans — The 2003 Plan" below.

On July 9, 2009, at an extraordinary general meeting the shareholders approved a proposal to amend the terms of options granted to the directors of the Company. It was resolved that; (a) the recurring annual stock option grants to the directors, for board service, will have a vesting period applicable to one term of office of a director, which under the Company's articles of association is a term of three (3) years (instead of a vesting period of four (4) years as was formerly approved by the shareholders) from the date of grant; (b) the stock options granted to a director shall retain their original expiration dates specified upon the date of grant, and shall not terminate 90 days after the Termination Date as set forth in the directors' option agreements, provided that the termination or expiration is not "for Cause" and not resulting from the director's resignation; and (c) the next upcoming tranche of stock options, of each grant, that are scheduled to vest immediately subsequent to the Termination Date, if any, shall automatically vest and become exercisable immediately prior to that Termination Date. In addition, to avoid a possible conflict of interest with respect to a potential Change of Control of the Company (which may result in the termination of the director's term of office), all unvested options held by a director, shall automatically vest and become exercisable upon a "Change of Control" event. "Change of Control" was defined for these purposes as: (i) merger, acquisition or reorganization of the Company with one or more other entities in which the Company is not the surviving entity, (ii) a sale of all or substantially all of the assets of the Company; (iii) a transaction or a series of related transactions as a result of which more than 50% of the outstanding shares or the voting rights of the Company are held by any party (whether directly or indirectly).

**C. INTERESTS OF EXPERTS AND COUNSEL**

Not applicable.

**ITEM 8. FINANCIAL INFORMATION**

**A. CONSOLIDATED STATEMENTS AND OTHER FINANCIAL INFORMATION**

Our audited consolidated financial statements for the year ended December 31, 2011 are included in this annual report pursuant to Item 18.

***Legal Proceedings***

We are not aware of any legal proceedings the outcome of which would have a significant impact on the Company's financial condition.

***Policy on Dividend Distribution***

In November 2010 we announced that as we are focusing on growth and intend to utilize our cash and investments to achieve that growth, we decided to change our dividend policy so that beginning with earnings of 2011 and beyond, we do not intend to distribute any dividends to the holders of our ordinary shares.

All of the ordinary shares of the Company are entitled to an equal share in any dividends declared and paid.

On January 23, 2008 the Company announced that its Board of Directors had resolved to adopt a share buyback plan, and on March 25, 2009, the Company announced that it had elected to continue with the second phase of this plan that authorizes the purchase of up to an additional \$1 million of its ordinary shares. Up to March 5, 2009, the Company repurchased 346,019 ordinary shares in open market transactions.

The distribution of dividends and a buy-back plan is subject to limitations under Israeli law, including permitting the distribution of dividends (and purchasing the company's own shares) only out of profits. See "Item 10.B Memorandum and Articles of Association — Dividend and Liquidation Rights." In addition, the payment of dividends is subject to Israeli withholding taxes. See "Item 10.E Taxation — Israeli Taxation — Taxation of our Shareholders— Taxation of Non-Israeli Shareholders on Receipt of Dividends."

**B. SIGNIFICANT CHANGES**

Since the date of our audited financial statements included elsewhere in this report, there have not been any significant changes other than as set forth in this report under Item 4.A. — "Recent Developments".

## ITEM 9. THE OFFER AND LISTING

### A. OFFER AND LISTING DETAILS

Our ordinary shares have been listed on the Nasdaq Capital Market since January 31, 2006 and since June 27, 2007 on the NASDAQ Global Market ("NASDAQ"), under the symbol "MAIL", and since November 10, 2011 under the symbol "PERI". Our ordinary shares commenced trading as a dual listed company on the Tel Aviv Stock Exchange ("TASE") on December 4, 2007 under the Hebrew letters which read "EMAIL" and since November 16, 2011 under the Hebrew letters which read "PERION".

The following table shows, for the periods indicated, the high and low closing sale prices of our ordinary shares as reported on the NASDAQ and the TASE.

|   | Nasdaq Capital Market or<br>Nasdaq Global Market |          | Tel Aviv Stock Exchange |           |
|---|--|----------|-------------------------|-----------|
|   | High (\$)  | Low (\$) | High (NIS)              | Low (NIS) |
| <b>Five most recent full financial years</b>                              |  |          |                         |           |
| 2011  | 8.00   | 3.54     | 29.34                   | 12.93     |
| 2010  | 10.68  | 3.97     | 40.28                   | 15.85     |
| 2009  | 10.56  | 2.50     | 39.69                   | 9.12      |
| 2008  | 5.17   | 2.00     | 20.39                   | 8.23      |
| 2007  | 9.99   | 4.94     | 25.50                   | 19.57*    |
| <b>Financial quarters during the past two recent full financial years</b> |  |          |                         |           |
| Fourth Quarter 2011   | 5.57   | 3.54     | 20.45                   | 12.93     |
| Third Quarter 2011  | 7.75   | 4.54     | 26.63                   | 17.39     |
| Second Quarter 2011   | 7.57   | 6.74     | 27.75                   | 22.23     |
| First Quarter 2011  | 8.00   | 6.98     | 29.34                   | 24.46     |
| Fourth Quarter 2010   | 7.82   | 5.83     | 28.35                   | 20.95     |
| Third Quarter 2010  | 6.25   | 3.97     | 23.35                   | 15.85     |
| Second Quarter 2010   | 7.32   | 4.46     | 27.14                   | 17.30     |
| First Quarter 2010  | 10.68  | 6.23     | 40.28                   | 23.75     |
| <b>Most recent six months</b>   |  |          |                         |           |
| February 2012   | 5.53   | 5.02     | 20.04                   | 17.86     |
| January 2012  | 5.00   | 4.01     | 18.86                   | 14.70     |
| December 2011   | 4.19   | 3.54     | 16.09                   | 13.24     |
| November 2011   | 5.44   | 3.61     | 20.07                   | 12.93     |
| October 2011  | 5.57   | 4.23     | 20.45                   | 15.69     |
| September 2011  | 5.85   | 4.54     | 20.94                   | 17.39     |

\* Since our listing on the Tel Aviv Stock Exchange on December 4, 2007.

The closing prices of our ordinary shares, as reported on the Nasdaq Global Market and on the Tel Aviv Stock Exchange on March 21<sup>st</sup>, 2012, which is the last full trading day before filing of this annual report, were \$5.21 and NIS 19.04, (equal to \$5.09 based on the Bank of Israel representative exchange rate as of such date), respectively.

\* Since our listing on the Tel Aviv Stock Exchange on December 4, 2007.

### B. PLAN OF DISTRIBUTION

Not applicable.

**C. MARKETS**

Our ordinary shares are quoted on the Nasdaq Global Market under the symbol "PERI", and on the Tel Aviv Stock Exchange under the Hebrew letters which read "PERION".

**D. SELLING SHAREHOLDERS**

Not applicable.

**E. DILUTION**

Not applicable.

**F. EXPENSES OF THE ISSUE**

Not applicable.

**ITEM 10. ADDITIONAL INFORMATION**

**A. SHARE CAPITAL**

At our 2010 annual shareholder meeting held on January 6, 2011, the shareholders resolved to increase the authorized share capital of the Company by NIS 250,000 divided into 25,000,000 ordinary shares, par value NIS0.01 each, and to amend the Company's Articles of Association to reflect such increase of share capital, so that following such increase, the authorized share capital of the Company is NIS 400,000, consisting of 40,000,000 ordinary shares with a nominal value of NIS 0.01 each.

**B. MEMORANDUM AND ARTICLES OF ASSOCIATION**

**Registration Number and Purposes**

Our registration number with the Israeli Companies Registrar is 51-284949-8. Pursuant to Section 3 of our articles of association, our objectives are the development, manufacture and marketing of software and any other objective as determined by our board of directors.

**Dividend and Liquidation Rights**

The holders of the ordinary shares are entitled to their proportionate share of any cash dividend, share dividend or dividend in kind declared with respect to our ordinary shares on or after the date of this annual report. We may declare dividends out of profits legally available for distribution. Under the Israeli Companies Law, a company may distribute a dividend only if the distribution does not create a reasonable risk that the company will be unable to meet its existing and anticipated obligations as they become due. Furthermore, a company may only distribute a dividend out of the company's profits, as defined under the Israeli Companies Law. If the company does not meet the profit requirement, a court may allow it to distribute a dividend, as long as the court is convinced that there is no reasonable risk that such distribution might prevent the company from being able to meet its existing and anticipated obligations as they become due.

Under the Israeli Companies Law, the declaration of a dividend does not require the approval of the shareholders of a company unless the company's articles of association provide otherwise. Our articles of association provide that the board of directors may declare and distribute dividends without the approval of the shareholders. In the event of our liquidation, holders of our ordinary shares have the right to share ratably in any assets remaining after payment of liabilities, in proportion to the paid-up par value of their respective holdings.

These rights may be affected by the grant of preferential liquidation or dividend rights to the holders of a class of shares that may be authorized in the future.

**Voting, Shareholder Meetings and Resolutions**

Holders of ordinary shares have one vote for each ordinary share held on all matters submitted to a vote of shareholders. This right may be changed if shares with special voting rights are authorized in the future.

Our articles of association and the laws of the State of Israel do not restrict the ownership or voting of ordinary shares by non-residents of Israel.

Under the Israeli Companies Law, an annual general meeting of our shareholders should be held once every calendar year, but no later than 15 months from the date of the previous annual general meeting. The quorum required under our articles of association for a general meeting of shareholders consists of at least two shareholders present in person or by proxy holding in the aggregate at least 33 1/3% of the voting power. According to our articles of association a meeting adjourned for lack of a quorum generally is adjourned to the same day in the following week at the same time and place or any time and place as the chairperson of the board of directors designates in a notice to the shareholders with the consent of the holders of the majority voting power represented at the meeting voting on the question of adjournment. In the event of a lack of quorum in a meeting convened upon the request of shareholders, the meeting shall be dissolved. At the reconvened meeting, the required quorum consists of any number of shareholders present in person or by proxy.

Our board of directors may, in its discretion, convene additional meetings as "special general meetings." In addition, the board must convene a special general meeting upon the demand of two of the directors, one fourth of the nominated directors, one or more shareholders having at least 5% of outstanding share capital and at least 1% of the voting power in the company, or one or more shareholders having at least 5% of the voting power in the company. The chairperson of the board of directors presides at each of our general meetings. The chairperson of the board of directors is not entitled to a vote at a general meeting in his capacity as chairperson.

Most shareholders' resolutions, including resolutions to:

- amend our articles of association (except as set forth below);
- make changes in our capital structure such as a reduction of capital, increase of capital or share split, merger or consolidation;
- authorize a new class of shares;
- elect directors, other than external directors;
- appoint auditors; or
- approve most transactions with office holders,

will be deemed adopted if approved by the holders of a majority of the voting power represented at a shareholders' meeting, in person or by proxy, and voting on that resolution. Except as set forth in the following sentence none of these actions require the approval of a special majority. Amendments to our articles of association relating to the election and vacation of office of directors, the composition and size of the board of directors and the insurance, indemnification and release in advance of the company's office holders with respect to certain liabilities incurred by them require the approval at a general meeting of shareholders holding more than two-thirds of the voting power of the issued and outstanding share capital of the company.

#### **Notices**

Under the Israeli Companies Law, shareholders' meetings generally require prior notice of at least 21 days, or 35 days if the meeting is adjourned for the purpose of voting on any of the following matters:

- (1) appointment and removal of directors;
- (2) approval of certain matters relating to the fiduciary duties of office holders and of certain transactions with interested parties;
- (3) approval of certain mergers; and
- (4) any other matter in respect of which the articles of association provide that resolutions of the general meeting may be approved by means of a voting document.

#### **Modification of Class Rights**

The Israeli Companies Law provides that, unless otherwise provided by the articles of association, the rights of a particular class of shares may not be adversely modified without the vote of a majority of the affected class at a separate class meeting.



## **Election of Directors**

Our ordinary shares do not have cumulative voting rights in the election of directors. Therefore, the holders of ordinary shares representing more than 50% of the voting power at the general meeting of the shareholders, in person or by proxy, have the power to elect all of the directors whose positions are being filled at that meeting, to the exclusion of the remaining shareholders. External directors are elected by a majority vote at a shareholders' meeting, provided that either:

- the majority of shares voted for the election includes at least a majority of the shares held by non-controlling shareholders voted at the meeting and excluding shares held by a person with a personal interest in the approval of the election, excluding a personal interest which is not as a result of his connection with the controlling shareholder (excluding abstaining votes); or
- the total number of shares of non-controlling shareholders voted against the election of the external director does not exceed two percent of the aggregate voting rights in the company.

See "Item 6.C Board Practices" regarding our staggered board.

## **Transfer Agent and Registrar**

American Stock Transfer and Trust Company is the transfer agent and registrar for our ordinary shares.

## **Approval of Related Party Transactions**

### ***Office Holders***

The Israeli Companies Law codifies the fiduciary duties that office holders owe to a company. An office holder is defined in the Israeli Companies Law as any general manager, chief business manager, deputy general manager, vice general manager, or any other person assuming the responsibilities of any of these positions regardless of that person's title, as well as a director, or a manager directly subordinate to the general manager. Each person listed in the table under "Management — Executive Officers and Directors" is an office holder under the Israeli Companies Law.

*Fiduciary duties.* An office holder's fiduciary duties consist of a duty of loyalty and a duty of care. The duty of loyalty requires the office holder to act in good faith and to the benefit of the company, to avoid any conflict of interest between the office holder's position in the company and any other of his or her positions or personal affairs, and to avoid any competition with the company or the exploitation of any business opportunity of the company in order to receive personal advantage for himself or others. This duty also requires him or her to reveal to the company any information or documents relating to the company's affairs that the office holder has received due to his or her position as an office holder. The duty of care requires an office holder to act with a level of care that a reasonable office holder in the same position would employ under the same circumstances. This includes the duty to use reasonable means to obtain information regarding the advisability of a given action submitted for his or her approval or performed by virtue of his or her position and all other relevant information pertaining to these actions.

*Compensation.* Under the Israeli Companies Law, all compensation arrangements for office holders who are not directors require approval of the audit committee and the board of directors, in such order. Under our articles of association, our compensation committee has the authority to approve the compensation of all office holders, subject to the requirements of the Israeli Companies Law as referred to above. Arrangements regarding the compensation of directors (including officers who are also directors) require audit committee, board and shareholder approval, in such order.

*Disclosure of personal interest.* The Israeli Companies Law requires that an office holder promptly disclose to the company any personal interest that he or she may have and all related material information known to him or her, in connection with any existing or proposed transaction by the company. "Personal interest", as defined by the Israeli Companies Law, includes a personal interest of any person in an act or transaction of the company, including a personal interest of his relative and of a corporate body in which that person or a relative of that person is a 5% or greater shareholder, a holder of 5% or more of a company's outstanding shares or voting rights, a director or general manager, or in which he or she has the right to appoint at least one director or the general manager, including a personal interest in voting on the basis of a power of attorney that was given to a person by another person even if that other person has no personal interest, and also a vote by a person who got a power of attorney to vote on behalf of a person who do have a personal interest, in the vote in question, all whether the one who votes has a discretion as to how to vote or not. "Personal interest" does not apply to a personal interest stemming merely from the fact that the office holder is also a shareholder in the company.

The office holder must make the disclosure of his personal interest without delay and no later than the first meeting of the company's board of directors that discusses the particular transaction. This duty does not apply to the personal interest of a relative of the office holder in a transaction unless it is an "Extraordinary Transaction". The Israeli Companies Law defines an Extraordinary Transaction as a transaction not in the ordinary course of business, not on market terms or that is likely to have a material impact on the company's profitability, assets or liabilities, and defines a relative as a spouse, sibling, parent, grandparent, descendent, as well as descendent, brother, sister or parent of the spouse and the spouse of any of the foregoing.

*Approvals.* The Israeli Companies Law provides that a transaction with an office holder or a transaction in which an office holder has a personal interest may not be approved if it is adverse to the company's interest. In addition, such a transaction generally requires board approval, unless the transaction is an extraordinary transaction and then it requires the audit committee approval prior to the approval of the board of directors. If the transaction is an extraordinary transaction, or if it concerns a transaction with an office holder who is not a director regarding his terms of service and employment, including, exculpation, indemnification, insurance, an obligation for indemnification or indemnification, then in addition to any approval stipulated by the articles of association, approvals of the company's audit committee and the board of directors is required. Exculpation, indemnification, insurance or compensation of a director would also require shareholder approval. A person, including a director, who has a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee may not attend that meeting or vote on that matter; however, an office holder who has a personal interest in a transaction may be present if the board or committee chairman determined that such presence is necessary for the presentation of the matter. A director with a personal interest in a matter that is considered at a meeting of the board of directors or the audit committee may attend that meeting or vote on that matter if a majority of the board of directors or the audit committee also has a personal interest in the matter; however, if a majority of the board of directors or the audit committee has a personal interest in the transaction, shareholder approval is also required.

### **Shareholders**

The Israeli Companies Law imposes the same disclosure requirements, as described above, on a controlling shareholder of a public company that it imposes on an office holder. For these purposes, a controlling shareholder is any shareholder that has the ability to direct the company's actions, including any shareholder holding 25% or more of the voting rights if no other shareholder owns more than 50% of the voting rights in the company. Two or more shareholders with a personal interest in the approval of the same transaction are deemed to be one shareholder.

Approval of the audit committee, the board of directors and our shareholders is required for:

- extraordinary transactions with a controlling shareholder or in which a controlling shareholder has a personal interest; and
- direct or indirect employment of or receipt of services by the company from a controlling shareholder or a relative of a controlling shareholder.

The shareholder approval must include the majority of shares voted at the meeting. In addition, either:

- the majority must include at least a majority of the shares of the voting shareholders who have no personal interest in the transaction voted at the meeting (excluding abstaining votes); or
- the total shareholdings of those who have no personal interest in the transaction and who vote against the transaction must not represent more than 2% of the aggregate voting rights in the company.

Under the Israeli Companies Law, a shareholder has a duty to act in good faith towards the company and other shareholders and to refrain from abusing his or her power in the company including, among other things, when voting in a general meeting of shareholders or in a class meeting on the following matters:

- any amendment to the articles of association;
- an increase in the company's authorized share capital;
- a merger; or
- approval of related party transactions that require shareholder approval.

A shareholder has a general duty to refrain from depriving any other shareholder of their rights as a shareholder. In addition, any controlling shareholder, any shareholder who knows that it possesses the power to determine the outcome of a shareholder or class vote and any shareholder who, pursuant to the company's articles of association has the power to appoint or prevent the appointment of an office holder in the company, is under a duty to act with fairness towards the company. The Companies Law does not describe the substance of this duty of fairness, but provides that laws applicable to a breach of contract, adjusted according to the circumstances shall apply to a breach of such duties. With respect to the obligation to refrain from acting discriminatorily, a shareholder that is discriminated against can petition the court to instruct the company to remove or prevent the discrimination, as well as provide instructions with respect to future actions.

## Corporate Governance

As stated above, the Israeli legislature, the Knesset, approved an amendment to the Israeli Companies Law which came into effect during 2011. The main purpose of the Amendment is to revise and enhance existing provisions governing corporate governance practices of Israeli companies, and the principle changes in the amendment were incorporated into the above discussions of the Company. Additional changes to the Companies Law pursuant to the amendment include:

- Code of Corporate Conduct. A code of recommended corporate governance practices has been attached as an annex to the Companies Law. In the explanatory notes to the legislation, the Knesset noted that an "adopt or disclose non-adoption" regulation would be issued by the Israeli Securities Authority with respect to such code. As of the date of this Annual Report, the Israeli Securities Authority has not issued any regulations yet with respect to this code, and it has not been determined to what extent this code will be relevant to Israeli companies that are also listed on non-Israeli stock exchanges.
- Fines. The Israeli Securities Authority shall be authorized to impose fines on any person or company performing a violation, in connection with a publicly traded company which reports to the Israeli Securities Authority, and specifically designated as a violation under the amendment.

Although we expect to be in compliance with the Companies Law, there is no assurance that we will not be required to adjust our current corporate governance practices, as discussed in this annual report, pursuant to the provisions of the amendment as aforesaid.

## Anti-Takeover Provisions; Mergers and Acquisitions

*Merger.* The Israeli Companies Law permits merger transactions with the approval of each party's board of directors and shareholders, except that when the merger involves one of the following companies, the approval of the shareholders of these companies is not required:

- an absorbed company which is under the full control and ownership of the surviving company; or
- a surviving company, if all of the following conditions are met: (i) the merger does not entail an amendment of the articles of association or memorandum of association of the surviving company, (ii) the surviving company does not issue in the course of the merger more than twenty percent of the voting rights in the company, and as a result of the share issuance no person shall become a controlling shareholder in the surviving company, and (iii) circumstances that would otherwise mandate an approval by a special majority of the shareholders (as described in the following paragraph) do not exist.

At the general meeting of a merging company which shares are held by the other party to the merger or by any person holding at least 25% of any control measures of the other party to the merger, a merger shall not be deemed approved if the shareholders holding the majority of the voting power present at the meeting object to the merger. In calculating this majority, (i) the abstaining shareholders and (ii) shareholders that are part of the other party to the merger or hold 25% or more of any control measures of the other party to the merger are excluded. Shares held by relatives or companies controlled by a person are deemed held by that person. The term "control measures" of a company includes, among other things, voting power or means of appointing the board of directors.

Under the Israeli Companies Law, a merging company must inform its creditors of the proposed merger. Any creditor of a party to the merger may seek a court order to delay or block the merger, if there is a reasonable concern that the surviving company will not be able to satisfy all of the obligations of the parties to the merger. Moreover, a merger may not be completed until all of the required approvals have been filed by both merging companies with the Israeli Registrar of Companies and (i) 30 days have passed from the time both companies' shareholders resolved to approve the merger, and (ii) at least 50 days have passed from the time that the merger proposal was filed with the Israeli Registrar of Companies.

*Tender Offer.* The Israeli Companies Law requires a purchaser to conduct a tender offer in order to purchase shares in publicly held companies, if as a result of the purchase the purchaser would hold more than 25% of the voting rights of a company in which no other shareholder holds more than 25% of the voting rights, or the purchaser would hold more than 45% of the voting rights of a company in which no other shareholder holds more than 45% of the voting rights. The requirement to conduct a tender offer shall not apply to (i) the purchase of shares in a private placement, provided that such purchase was approved by the company's shareholders as a private placement that is intended to provide the purchaser with more than 25% of the voting rights of a company in which no other shareholder holds more than 25% of the voting rights, or with more than 45% of the voting rights of a company in which no other shareholder holds more than 45% of the voting rights; (ii) a purchase from a holder of more than 25% of the voting rights of a company that results in a person becoming a holder of more than 25% of the voting rights of a company, and (iii) a purchase from the holder of more than 45% of the voting rights of a company that results in a person becoming a holder of more than 45% of the voting rights of a company.

Under the Israeli Companies Law, a person may not purchase shares of a public company or rights to vote in such a company or a class of shares if, following the purchase of shares, the purchaser would hold more than 90% of the company's shares or of any class of shares unless the purchaser makes a tender offer to purchase all of the target company's shares or all the shares of the particular class, as applicable. If, as a result of the tender offer, the purchaser would hold more than 95% of the company's shares or a particular class of shares and more than half of the offerees that has no personal interest has accepted the offer, the ownership of the remaining shares will be transferred to the purchaser. However, the purchaser will be able to purchase all shares if the percentage of the offerees that did not accept the offer constitute less than 2% of the company's shares or of any class of shares subject to the offer. If the purchaser is unable to purchase 95% or more of the company's shares or class of shares, the purchaser may not own more than 90% of the shares or class of shares of the target company.

*Tax Law.* Israeli tax law treats some acquisitions, such as a stock-for-stock swap between an Israeli company and a foreign company, less favorably than U.S. tax law. For example, Israeli tax law may subject a shareholder who exchanges his ordinary shares for shares in a foreign corporation to immediate taxation. Please see "Item 10.E Taxation — Israeli Taxation."

#### **Exculpation, Indemnification and Insurance of Directors and Officers**

Our articles of association allow us to indemnify, exculpate and insure our office holders, which includes our directors, to the fullest extent permitted by the Israeli Companies Law (other than as stated below with respect to certain expenses in connection with administrative enforcement proceedings under the Israeli Securities Law), provided that procuring this insurance or providing this indemnification or exculpation is approved by the audit committee and the board of directors, as well as by the shareholders if the office holder is a director. Our articles of association also allow us to insure or indemnify any person who is not an office holder, including any employee, agent, consultant or contractor who is not an office holder.

Under the Israeli Companies Law, a company may indemnify an office holder in respect of some liabilities, either in advance of an event or following an event. If a company undertakes to indemnify an office holder in advance against monetary liability incurred in his or her capacity as an office holder whether imposed in favor of another person pursuant to a judgment, a settlement or an arbitrator's award approved by a court, the indemnification must be limited to foreseeable events in light of the company's actual activities at the time of the indemnification undertaking and to a specific sum or a reasonable criterion under such circumstances, as determined by the board of directors.

Under the Israeli Companies Law, only if and to the extent provided by its articles of association, a company may indemnify an office holder against the following liabilities or expenses incurred in his or her capacity as an office holder:

- any monetary liability whether imposed on him or her in favor of another person pursuant to a judgment, a settlement or an arbitrator's award approved by a court;
- reasonable litigation expenses, including attorneys' fees, incurred by him or her as a result of an investigation or proceedings instituted against him or her by an authority empowered to conduct an investigation or proceedings, which are concluded either (i) without the filing of an indictment against the office holder and without the levying of a monetary obligation in lieu of criminal proceedings upon the office holder, or (ii) without the filing of an indictment against the office holder but with levying a monetary obligation in substitute of such criminal proceedings upon the office holder for a crime that does not require proof of criminal intent; and
- reasonable litigation expenses, including attorneys' fees, in proceedings instituted against him or her by the company, on the company's behalf or by a third-party, or in connection with criminal proceedings in which the office holder was acquitted, or as a result of a conviction for a crime that does not require proof of criminal intent.

Under the Israeli Companies Law, a company may obtain insurance for an office holder against liabilities incurred in his or her capacity as an office holder, if and to the extent provided for in its articles of association. These liabilities include a breach of duty of care to the company or a third-party, a breach of duty of loyalty and any monetary liability imposed on the office holder in favor of a third-party.

A company may, in advance only, exculpate an office holder for a breach of the duty of care. However, a company may not so exculpate an office holder for a breach of the duty of care in connection with a distribution of dividends or a repurchase of the company's securities. A company may not exculpate an office holder from a breach of the duty of loyalty towards the company.

Under the Israeli Companies Law, however, an Israeli company may only indemnify or insure an office holder against a breach of duty of loyalty to the extent that the office holder acted in good faith and had reasonable grounds to assume that the action would not prejudice the company. In addition, an Israeli company may not indemnify, insure or exculpate an office holder against a breach of duty of care if committed intentionally or recklessly, or an action committed with the intent to derive an unlawful personal gain, or for a fine or forfeit levied against the office holder.

Our audit committee and board of directors have resolved to indemnify our office holders and directors, where the resolution regarding indemnification of our directors was approved by our shareholders as well, per the terms of the Companies law, to the extent permitted by the Companies Law and by our articles of association for liabilities not covered by insurance and that are of certain enumerated events, subject to an aggregate sum equal to 50.0% of the shareholders equity as set forth in the financial report of the preceding year to which a claim for indemnification is made.

A recent amendment to the Israeli Securities Law, 5728-1968 (the "Israeli Securities Law"), and a corresponding amendment to the Israeli Companies Law, authorizes the Israeli Securities Authority to impose administrative sanctions against companies like ours and their office holders for certain violations of the Israeli Securities Law or the Israeli Companies Law.

These sanctions include monetary sanctions and certain restrictions on serving as a director or senior officer of a public company for certain periods of time. The maximum amount of the monetary sanctions that could be imposed upon individuals per instance of violation is a fine of NIS 1,000,000 (currently equivalent to approximately \$293,000), plus the greater of the following amounts payable to persons who suffered damages as a result of the violation: (i) the amount of profits earned or losses avoided by the violator as a result of the violation, up to NIS 1,000,000, or (ii) compensation for damages suffered by the injured persons, up to 20% of the fine imposed on the violator.

The amendments to the Israeli Securities Law and to the Israeli Companies Law provide that only certain types of such liabilities may be reimbursed by indemnification and insurance. Specifically, legal expenses (including attorneys' fees) incurred by an individual in the applicable administrative enforcement proceeding and any compensation payable to injured parties for damages suffered by them (as described in the immediately preceding paragraph) are permitted to be reimbursed via indemnification or insurance, provided that such indemnification and insurance are authorized by the company's articles of association.

In order to be able to indemnify and insure our office holders to the full extent permitted by law, our Articles of Association would have to be amended to include indemnification and insurance in connection with administrative proceedings, including without limitation, the specific amendments to the Israeli Securities Law and the Israeli Companies Law with respect to administrative sanctions described above. Our shareholders at the Annual General Meeting held on October 27, 2011 voted to approve a revised form of indemnification letter that will be issued by the Company to the directors of the Company serving from time to time in such capacity, which included revisions made with respect to indemnification for monetary sanctions in administrative proceedings. The resolution was passed by the required majority amounting in the aggregate to at least a majority of the votes actually cast, but was also subject to the adoption by the shareholders of a resolution to amend the Company's Articles of Association. Such resolution with respect to the amendment of the Articles of Association, while receiving a majority of the votes cast, did not achieve the sufficient special majority required, as it did not receive the affirmative vote of shareholders present in person or by proxy and holding Ordinary Shares amounting in the aggregate to at least more than two-thirds of the voting power of the issued and outstanding share capital of the Company, as such number of shareholders was not present at the Annual General Meeting. As such, the Company has made appropriate amendments to the form of indemnification letter which was approved by the audit committee, board of directors and shareholders, by removing clauses related to indemnification with respect to monetary sanctions as a result of administrative proceedings from the indemnification letter so that it is consistent with the provisions of the Company's current Articles of Association.

## NASDAQ Listing Rules and Home Country Practices

In accordance with Israeli law and practice and subject to the exemption set forth in NASDAQ Listing Rule 5615(a)(3), we follow the provisions of the Israeli Companies Law – 1999 with respect to the following requirements:

- Distribution of annual and quarterly reports to shareholders – Under Israeli law we are not required to distribute annual and quarterly reports directly to shareholders and the generally accepted business practice in Israel is not to distribute such reports to shareholders. We do however make our audited financial statements available to our shareholders at the Company's offices and mail such reports to shareholders upon request. We also file our annual reports with the SEC. As a foreign private issuer, we are generally exempt from the SEC's proxy solicitation rules.
- Quorum – Under Israeli law a company is entitled to determine in its articles of association the number of shareholders and percentage of holdings required for a quorum at a shareholders meeting. Our articles of association provide that a quorum of two or more shareholders holding at least 33.3% of the voting rights in person or by proxy is required for commencement of business at a general meeting. However, the quorum set forth in our articles of association with respect to an adjourned meeting, consists of two or more shareholders in person or by proxy.
- Independence of Directors – Our board contains two external directors in accordance with the provisions contained in Sections 239-249 of the Israeli Companies Law – 1999 and Rule 10A-3 of the general rules and regulations promulgated under the Securities Act of 1933. Israeli law does not require, nor do our independent directors conduct, regularly scheduled meetings at which only they are present.
- Audit Committee – Our audit committee complies with all of the requirements under Israeli law, there are three members to our audit committee, two of which are our external directors. Consistent with Israeli law, the independent auditors are elected at a meeting of shareholders instead of being appointed by the audit committee.
- Nomination of our Directors – With the exception of our external directors, our directors are elected in three staggered classes by the vote of a majority of the shareholders' general meeting. The directors of only one class are elected at each annual meeting for a three year term, so that the regular term of only one class of directors expires annually. The nominations for director which are presented to our shareholders are generally made by our directors but may be made by one or more of our shareholders. However, any shareholder or shareholders holding at least 5% of the voting rights in our issued share capital may nominate one or more persons for election as directors at a general meeting only if a written notice of such shareholder's intent to make such nomination or nominations has been given to our secretary and each such notice sets forth all the details and information as required to be provided under our articles of association. Furthermore, one or more shareholders of a company holding at least one percent of the voting power of the company may nominate a currently serving external director for an additional three year term.
- Compensation of Officers – Provided that the executive officer does not serve on our board, according to the Israeli law compensation of an executive officer requires the approval of the audit committee and the board of directors, in such order. Our articles of association provide that our compensation committee has the authority to approve the compensation of all office holders subject to the requirements of the Israeli Companies Law as referred to above. Arrangements regarding the compensation of directors (including officers who are also directors) require audit committee, board and shareholder approval, in such order. Our compensation committee includes three members of the board, two of whom are our external directors.
- Approval of Related Party Transactions – All related party transactions are approved in accordance with the requirements and procedures for approval of interested party acts and transactions, set forth in sections 268 to 275 of the Israeli Companies Law-1999, and the regulations promulgated thereunder, which require audit committee approval and shareholder approval, as well as board approval, for specified transactions, rather than approval by the audit committee or other independent body of our board which are required under Nasdaq Listing Rules. See also "Item 10.B Memorandum and Articles of Association — Approval of Related Party Transactions" for the definition and procedures for the approval of related party transactions.
- Shareholder Approval – We seek shareholder approval for all corporate action requiring such approval, in accordance with the requirements of the Israeli Companies Law – 1999, which are different or in addition to the requirements for seeking shareholder approval under NASDAQ Listing Rules.

## C. MATERIAL CONTRACTS

Search revenues powered by Google's AdSense for Search program contribute significantly to the Company's results. In 2011 we obtained approximately 72% of our revenues from this venue. On July 1, 2008, we entered into an agreement with Google regarding our participation in Google's AdSense program, which allows us to receive a portion of the amount paid to Google by advertisers for the activity performed through the Company's applications. Since then this agreement has been amended and extended numerous times. Most recently, we signed an agreement with Google which was effective as of January 1, 2011 through January 31, 2013. Although, the agreement may be terminated by either side after one year, neither side exercised this right to date. Google also has other limited termination rights.

On July 27<sup>th</sup> 2011, we signed an Agreement and Plan of Merger with Smilebox Inc., Andrew Wright and Shareholders Representative LLC (the "Acquisition Agreement"), according to which we have purchased 100% of the issued and outstanding equity of Smilebox Inc. The closing of that transaction occurred on August 31, 2011. Following the closing, Smilebox Inc. became a wholly owned subsidiary of Perion Network Ltd., through its Delaware Subsidiary.

In September 2011, we signed agreements with both Bank Leumi Le-Israel and First International Bank of Israel, to secure a credit facility for up to USD 20 million of financing. The credit facility is comprised of USD 12 million provided by Bank Leumi Le-Israel, and USD 8 million provided by First International Bank of Israel. The repayment of the debt is structured over three to five years respectively, and we have an option for early repayment.

The employment agreements with our principal officers are described under "Item 6.C Board Practices — Employment Agreements".

## D. EXCHANGE CONTROLS

Non-residents of Israel who hold our ordinary shares are able to receive any dividends, and any amounts payable upon the dissolution, liquidation and winding up of our affairs, freely repatriable in non-Israeli currency at the rate of exchange prevailing at the time of conversion. However, Israeli income tax is required to have been paid or withheld on these amounts. In addition, the statutory framework for the potential imposition of exchange controls has not been eliminated, and may be restored at any time by administrative action.

## E. TAXATION

The following is a general summary only and should not be considered as income tax advice or relied upon for tax planning purposes.

### ISRAELI TAXATION

THE FOLLOWING DESCRIPTION IS NOT INTENDED TO CONSTITUTE A COMPLETE ANALYSIS OF ALL TAX CONSEQUENCES RELATING TO THE OWNERSHIP OR DISPOSITION OF OUR ORDINARY SHARES. YOU SHOULD CONSULT YOUR OWN TAX ADVISOR CONCERNING THE TAX CONSEQUENCES OF YOUR PARTICULAR SITUATION, AS WELL AS ANY TAX CONSEQUENCES THAT MAY ARISE UNDER THE LAWS OF ANY STATE, LOCAL, FOREIGN OR OTHER TAXING JURISDICTION.

The following is a summary of the material Israeli tax laws applicable to us, and some Israeli Government programs benefiting us. This section also contains a discussion of some Israeli tax consequences to persons acquiring our ordinary shares. This summary does not discuss all the acts of Israeli tax law that may be relevant to a particular investor in light of his or her personal investment circumstances or to some types of investors subject to special treatment under Israeli law. Examples of this kind of investor include residents of Israel or traders in securities who are subject to special tax regimes not covered in this discussion. Since some parts of this discussion are based on new tax legislation that has not yet been subject to judicial or administrative interpretation, we cannot assure you that the appropriate tax authorities or the courts will accept the views expressed in this discussion.

*The discussion below should not be construed as legal or professional tax advice and does not cover all possible tax considerations. Potential investors are urged to consult their own tax advisors as to the Israeli or other tax consequences of the purchase, ownership and disposition of our ordinary shares, including, in particular, the effect of any foreign, state or local taxes.*

## **General Corporate Tax Structure in Israel**

On December 5, 2011, the Israeli Parliament (the Knesset) passed the Law for Tax Burden Reform (Legislative Amendments), 2011 ("the Tax Burden Law") which, among others, cancels effective from 2012, the scheduled progressive reduction in the corporate tax rate. The Law also increases the corporate tax rate to 25% in 2012. Following the amendment, corporate tax rates and capital gains rates are: 2011- 24%, 2012- and thereafter- 25%. The Tax Burden Law was published on 7 December 2011 and will enter into force on 1 January 2012, the effective tax rate payable by a company that derives income from an approved and beneficiary enterprises (as discussed below) may be considerably less.

## **Foreign Exchange Regulations**

Under the Foreign Exchange Regulations the Israeli company is calculating its tax liability in U.S. Dollars according to certain orders. The tax liability, as calculated in U.S. Dollars is translated into NIS according to the exchange rate as of December 31st of each year.

## **Law for the Encouragement of Capital Investments, 1959**

The Law for Encouragement of Capital Investments, 1959 (the "Investment Law") provides that capital investments in a production facility (or other eligible assets) may, upon approval by the Investment Center of the Israel Ministry of Industry and Trade (the "Investment Center"), be designated as an Approved Enterprise. Each certificate of approval for an Approved Enterprise relates to a specific investment program, delineated both by the financial scope of the investment and by the physical characteristics of the facility or the asset. The tax benefits from any certificate of approval relate only to taxable income derived from growth in manufacturing revenues attributable to the specific Approved Enterprise. If a company has more than one approval or only a portion of its capital investments are approved, its effective tax rate is the result of a weighted combination of the applicable rates. The tax benefits under the law are not available for income derived from products manufactured outside of Israel.

Until 2011 (see below "Preferred Enterprise") Currently we had two Approved Enterprise Programs under the Investment Law, which entitle us to certain tax benefits, and Beneficiary Enterprise Programs that began in 2008 and in 2010. The Approved Enterprise Programs granted to us are defined in the Investment Law as Alternative Benefits Programs, which allow for a two years exemption for undistributed income and reduced company tax rate of between 10% and 25% for the following five to eight years, depending on the extent of foreign (non-Israeli) investment in us during the relevant year. The tax rate will be 20% if the foreign investment level is more than 49% but less than 74%, 15% if the foreign investment level is more than 74% but less than 90%, and 10% if the foreign investment level is 90% or more. The lowest level of foreign investment during a particular year will be used to determine the relevant tax rate for that year. The period in which we receive these tax benefits may not extend beyond 14 years from the year in which approval was granted and 12 years from the year in which operations or production by the enterprise began.

A company that has elected to participate in the alternative benefits program and that subsequently pays a dividend out of the income derived from the Approved Enterprise or Beneficiary Enterprise during the tax exemption period will be subject to corporate tax in respect of the amount distributed at the rate that would have been applicable had the company not elected the alternative benefits program (generally 10% to 25%, depending on the foreign (non-Israeli) investment in it). In 2009, the Company changed its dividend policy, committing to distribute 50% of its net income. The Company applied the required taxes to such dividends as required by the law. Since the beginning of 2011, the Company changed its dividend policy, under which it does not intend to distribute dividends in 2011 and beyond.

The Investment Law also provides that an Approved Enterprise is entitled to accelerated depreciation on its property and equipment that are included in an approved investment program.

The benefits available to an Approved Enterprise are conditioned upon terms stipulated in the Investment Law and the regulations thereunder and the criteria set forth in the applicable certificate of approval. If we do not fulfill these conditions in whole or in part, the benefits can be canceled and we may be required to refund the amount of the benefits, with the addition of the Israeli consumer price index linkage differences and interest. We believe that our Approved Enterprises currently operate in compliance with all applicable conditions and criteria, but there can be no assurance that they will continue to do so.



Pursuant to the amendment to the Investments Law, only Approved Enterprises receiving cash grants require the approval of the Investment Center. Approved Enterprises which do not receive benefits in the form of governmental cash grants, such as benefits in the form of tax benefits, are no longer required to obtain this approval (such enterprises are referred to as Beneficiary Enterprises). However, a Beneficiary Enterprise is required to comply with certain requirements and make certain investments as specified in the amended Investment Law. The amendment to the Investment Law addresses benefits that are being granted to Beneficiary Enterprises and the length of the benefits period.

Income derived from sources other than "Approved Enterprise" or "Beneficiary Enterprise" programs during the benefit period will be subject to tax at the regular corporate tax rate.

#### **Tax benefits under the 2005 Amendment**

The Amendment to the Investment Law, effective as of April 1, 2005 has significantly changed the provisions of the Investment Law. An eligible investment program under the amendment will qualify for benefits as a "Beneficiary Enterprise" (rather than the previous terminology of Approved Enterprise). Among other things, the amendment provides for tax benefits to both local and foreign investors and simplifies the approval process.

Tax benefits are available under the Amendment to production facilities (or other eligible facilities), which are generally required to derive more than 25% of their business income from export. In order to receive the tax benefits, the Amendment states that the company must make an investment in the Beneficiary Enterprise exceeding a certain percentage or a minimum amount specified in the Law. Such investment may be made over a period of no more than 3 years ending at the end of the year in which the company requested to have the tax benefits apply to the Beneficiary Enterprise (the "**Year of Election**"). Where the company requests to have the tax benefits apply to an expansion of existing facilities, then only the expansion will be considered a Beneficiary Enterprise and the company's effective tax rate will be the result of a weighted average of the applicable rates. In this case, the minimum investment required in order to qualify as a Beneficiary Enterprise is required to exceed a certain percentage or a minimum amount of the company's production assets at the end of the year before the expansion.

The amended Investment Law specifies certain conditions that a Beneficiary enterprise has to comply with in order to be entitled to benefits. These conditions include among others:

- that the Beneficiary Enterprise's revenues during the applicable tax year from any single market (i.e. country or a separate customs territory) do not exceed 75% of the Beneficiary enterprise's aggregate revenues during such year; or
- that 25% or more of the Beneficiary Enterprise's revenues during the applicable tax year are generated from sales into a single market (i.e. country or a separate customs territory) with a population of at least 12 million residents.

The duration of tax benefits is subject to a limitation of the earlier of 7 to 10 years from the Commencement Year (Commencement Year defined as the later of: (i) the first tax year in which the Company had derived income for tax purposes from the Beneficiary Enterprise or (ii) the year in which the Company requested to have the tax benefits apply to the Beneficiary Enterprise – Year of Election), or 12 years from the first day of the Year of Election. The tax benefits granted to a Beneficiary Enterprise are determined, as applicable to its geographic location within Israel.

Similar to the previously available alternative route, exemption from corporate tax on undistributed income for a period of two to ten years, depending on the geographic location of the Beneficiary Enterprise within Israel, and a reduced corporate tax rate of 10% to 25% for the remainder of the benefits period, depending on the level of foreign investment in each year. Benefits may be granted for a term of seven to ten years, depending on the level of foreign investment in the company. If the company pays a dividend out of income derived from the Beneficiary Enterprise during the tax exemption period, such income will be subject to corporate tax at the applicable rate, (10%-25%, depending on the level of foreign investment in the company), in respect of the **gross amount** of the dividend that may be distributed. The company is required to withhold tax at the source at a rate of 15% from dividends distributed from income derived from the Benefited Enterprise.

There can be no assurance that we will comply with the above conditions in the future or that we will be entitled to any additional benefits under the amended Investment Law.

The Amendment changes the definition of "foreign investment" in the Investments Law so that the definition now requires a minimal investment of NIS 5 million by foreign investors. Furthermore, such definition now also includes the purchase of shares of a company from another shareholder, provided that the company's outstanding and paid-up share capital exceeds NIS 5 million. Such changes to the aforementioned definition will take effect retroactively from 2003.

As a result of the amendment, tax-exempt income generated under the provisions of the Investments Law, as amended, will subject us to taxes upon distribution or liquidation.

#### **Tax benefits under the 2011 Amendment**

The Knesset enacted a reform to the Investment Law, effective January 2011. According to the reform a flat rate tax would apply to companies eligible for the "Preferred Enterprise" status. In order to be eligible for Preferred Enterprise status, a company must meet minimum requirements to establish that it contributes to the country's economic growth and is a competitive factor for the Gross Domestic Product (a competitive enterprise). Certain activities such as mining, are excluded from the scope of a Preferred Enterprise, as are government-owned businesses.

Israeli companies which currently benefit from an Approved or Beneficiary Enterprise status and meet the criteria for qualification as a Preferred Enterprise can elect to apply the new Preferred Enterprise benefits by waiving their benefits under the Approved and Beneficiary Enterprise status.

Benefits granted to a Preferred Enterprise include reduced and gradually decreasing tax rates. In peripheral regions (Development Area A) the reduced tax rate will be 10% in 2011 and 2012, 7% in 2013 and 2014 and 6% starting from 2015. In other regions the tax rate will be 15% in 2011 and 2012, 12.5% in 2013 and 2014 and 12% starting from 2015. Preferred Enterprises in peripheral regions will be eligible for Investment Center grants, as well as the applicable reduced tax rates.

A distribution from a Preferred Enterprise out of the "Preferred Income" would be subject to 15% withholding tax for Israeli-resident individuals and non-Israeli residents (subject to applicable treaty rates). A distribution from a Preferred Enterprise out of the "Preferred Income" would be exempt from withholding tax for an Israeli-resident company. A company electing to waive its Beneficiary Enterprise or Approved Enterprise status through June 30, 2015 may distribute "Approved Income" or "Beneficiary Income" subject to 15% withholding tax for Israeli resident individuals and non-Israeli residents (subject to applicable treaty rates) and exempt from withholding tax for an Israeli-resident company. Nonetheless, a distribution from income exempt under Beneficiary Enterprise and Approved Enterprise programs will subject the exempt income to tax at the reduced corporate income tax rates pertaining to the Beneficiary Enterprise and Approved Enterprise programs upon distribution, or complete liquidation in the case of a Beneficiary Enterprise's exempt income. Since 2011 the Company has changed its dividend policy, under which it does not intend to distribute dividends in 2011 and beyond.

Commencing 2011 the company elected to apply the new preferred Enterprise benefits.

#### **Law for the Encouragement of Industry (Taxes), 1969**

We believe that we currently qualify as an "Industrial Company" within the meaning of the Law for the Encouragement of Industry (Taxes), 1969, or the Industry Encouragement Law. The Industry Encouragement Law defines "Industrial Company" as a company resident in Israel, of which 90% or more of its income in any tax year, other than of income from defense loans, capital gains, interest and dividends, is derived from an "Industrial Enterprise" owned by it. An "Industrial Enterprise" is defined as an enterprise whose major activity in a given tax year is industrial production.

The following corporate tax benefits, among others, are available to Industrial Companies:

- amortization of the cost of purchased know-how and patents, which are used for the development or advancement of the company, over an eight-year period;
- accelerated depreciation rates on equipment and buildings;
- under specified conditions, an election to file consolidated tax returns with additional related Israeli Industrial Companies; and
- expenses related to a public offering are deductible in equal amounts over three years.

Eligibility for the benefits under the Industry Encouragement Law is not subject to receipt of prior approval from any governmental authority. We cannot assure that we qualify or will continue to qualify as an "Industrial Company" or that the benefits described above will be available in the future.

## Taxation of our Shareholders

The Tax Burden Law also increased the tax rate on dividend and capital gains by 5%. As such, starting in 2012, dividends paid to an Israeli resident and to Israeli individuals, will be subject to 25%/30% withholding tax depending on ownership percentage, unless reduced by an applicable tax treaty. Capital gains derived by Israeli residents and Israeli individuals, on most instruments will be subject to tax at a 25%/30% rate unless an exemption is available under domestic law or an applicable tax treaty.

An individual is subject to a 25% tax rate on real capital gains derived from the sale of shares, as long as the individual is not a "substantial shareholder" (generally a shareholder with 10% or more of the right to profits, right to nominate a director and voting rights) in the company issuing the shares.

A substantial shareholder will be subject to tax at a rate of 30% in respect of real capital gains derived from the sale of shares issued by a company in which he or she is a substantial shareholder. The determination of whether the individual is a substantial shareholder will be made on the date on which the securities are sold. In addition, the individual will be deemed to be a substantial shareholder if at any time during the 12 months preceding the date of sale, he or she was a substantial shareholder.

However, according to the Tax Burden Law, capital gains derived from selling shares which were purchased before 2012 will be linearly split and the portion of the gains attributed to the period the shares were held prior to 2012 will be taxed for an individual at the older rate of 20% (and 25% for a substantial shareholder).

*Taxation of Non-Israeli Shareholders on Receipt of Dividends.* Non-residents of Israel are generally subject to Israeli income tax on the receipt of dividends paid on our ordinary shares at the rate of 25%, which tax will be withheld at source, unless a different rate is provided in a treaty between Israel and the shareholder's country of residence. With respect to a substantial shareholder (which is someone who alone, or together with another person, holds, directly or indirectly, at least 10% in one or all of any of the means of control in the corporation at the time of distribution or at any time during the preceding 12 months period), the applicable tax rate to the shareholders will be 30%. Under the U.S.-Israel Tax Treaty, the maximum rate of tax withheld in Israel on dividends paid to a holder of our ordinary shares who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) is 25%. However, generally, the maximum rate of withholding tax on dividends, not generated by our Approved Enterprise, that are paid to a U.S. corporation holding 10% or more of our outstanding voting capital throughout the tax year in which the dividend is distributed as well as the previous tax year, is 12.5%. Furthermore, dividends paid from income derived from our Preferred Enterprise are subject, under certain conditions, to withholding at the rate of 15%. We cannot assure you that we will designate the profits that are being distributed in a way that will reduce shareholders' tax liability. A non-resident of Israel who receives dividends from which tax was withheld is generally exempt from the duty to file returns in Israel in respect of such income, provided such income was not derived from a business conducted in Israel by the taxpayer, and the taxpayer has no other taxable sources of income in Israel.

*Capital Gains Taxes Applicable to Non-Israeli Resident Shareholders.* Shareholders that are not Israeli residents are generally exempt from Israeli capital gains tax on any gains derived from the sale, exchange or disposition of our ordinary shares, provided that (1) such shareholders did not acquire their shares prior to our initial public offering, (2) the shares are listed for trading on the Tel Aviv Stock Exchange and/or a foreign exchange, and (3) such gains did not derive from a permanent establishment of such shareholders in Israel. However, non-Israeli corporations will not be entitled to the foregoing exemptions if an Israeli resident (i) has a controlling interest of 25% or more in such non-Israeli corporation, or (ii) is the beneficiary of or is entitled to 25% or more of the revenues or profits of such non-Israeli corporation, whether directly or indirectly. In certain instances, where our shareholders may be liable to Israeli tax on the sale of their ordinary shares, the payment of the consideration may be subject to the withholding of Israeli tax at the source.

Under the U.S.-Israel Tax Treaty, the sale, exchange or disposition of our ordinary shares by a shareholder who is a U.S. resident (for purposes of the U.S.-Israel Tax Treaty) holding the ordinary shares as a capital asset is exempt from Israeli capital gains tax unless either (i) the shareholder holds, directly or indirectly, shares representing 10% or more of our voting capital during any part of the 12-month period preceding such sale, exchange or disposition, or (ii) the capital gains arising from such sale are attributable to a permanent establishment of the shareholder located in Israel.

*Capital Gains Taxes Applicable to an Israeli Resident Shareholders* The tax rate generally applicable to Israeli individuals on capital gains from by the sale of shares, whether listed on a stock market or not, is 25%, or 30% if the individual is considered a "substantial shareholder" in the company issuing the shares. Israeli corporations are generally subject to corporate tax rate (25%) on capital gains derived from the sale of listed shares.

## Transfer Pricing

In accordance with Section 85A of the Israeli Tax Ordinance, if in an international transaction (whereby at least one party is a foreigner or all or part of the income from such transaction is to be taxed abroad as well as in Israel) there is a special relationship between the parties (including but not limited to family relationship or a relationships of control between companies), and due to this relationship the price set for an asset, right, service or credit was determined or other conditions for the transaction were set such that a smaller profit was realized than what would have been expected to be realized from a transaction of this nature, then such transaction shall be reported in accordance with customary market conditions and tax shall be charged accordingly. This section shall apply solely to transactions that transpire after November 29, 2006, at which time regulations with respect to this section were legislated. The assessment of whether a transaction falls under the aforementioned definition shall be implemented in accordance with one of the procedures mentioned in the regulations and is based, among others, on comparisons of characteristics which portray similar transactions in ordinary market conditions, such as profit, the area of activity, nature of the asset, the contractual conditions of the transaction and according to additional terms and conditions specified in the regulations.

## U.S. FEDERAL INCOME TAX CONSIDERATIONS

The following discussion is a description of the material U.S. federal income tax considerations applicable to an investment in the ordinary shares by U.S. Holders who acquire our ordinary shares and hold them as capital assets for U.S. federal income tax purposes. As used in this section, the term "U.S. Holder" means a beneficial owner of an ordinary share who is:

- an individual citizen or resident of the United States;
- a corporation created or organized in or under the laws of the United States or of any state of the United States or the District of Columbia;
- an estate, the income of which is subject to U.S. federal income taxation regardless of its source; or
- a trust if the trust has elected validly to be treated as a United States person for U.S. federal income tax purposes or if a U.S. court is able to exercise primary supervision over the trust's administration and one or more United States persons have the authority to control all of the trust's substantial decisions.

The term "Non-U.S. Holder" means a beneficial owner of an ordinary share who is not a U.S. Holder. The tax consequences to a Non-U.S. Holder may differ substantially from the tax consequences to a U.S. Holder. Certain aspects of U.S. federal income tax relevant to a Non-U.S. Holder also are discussed below.

This description is based on provisions of the U.S. Internal Revenue Code of 1986, as amended, referred to in this discussion as the Code, existing and proposed U.S. Treasury regulations and administrative and judicial interpretations, each as available and in effect as of the date of this annual report. These sources may change, possibly with retroactive effect, and are open to differing interpretations. This description does not discuss all aspects of U.S. federal income taxation that may be applicable to investors in light of their particular circumstances or to investors who are subject to special treatment under U.S. federal income tax law, including:

- insurance companies;
- dealers in stocks, securities or currencies;
- financial institutions and financial services entities;
- real estate investment trusts;
- regulated investment companies;
- persons that receive ordinary shares as compensation for the performance of services;
- tax-exempt organizations;
- persons that hold ordinary shares as a position in a straddle or as part of a hedging, conversion or other integrated instrument;
- individual retirement and other tax-deferred accounts;
- expatriates of the United States;

- persons (other than Non-U.S. Holders) having a functional currency other than the U.S. dollar; and
- direct, indirect or constructive owners of 10% or more, by voting power or value, of us.

This discussion also does not consider the tax treatment of persons or partnerships that hold ordinary shares through a partnership or other pass-through entity or the possible application of United States federal gift or estate tax or alternative minimum tax.

We urge you to consult with your own tax advisor regarding the tax consequences of investing in the ordinary shares, including the effects of federal, state, local, foreign and other tax laws.

### **Distributions Paid on the Ordinary Shares**

In 2009 and 2010 we instituted a policy for distributing dividends, which policy was changed with respect to profits of 2011 and onwards, (see "Item 8. Financial Information A. Consolidated Statements and Other Financial Information - Policy on Dividend Distribution" for more information about the Company's dividend policy). Therefore, subject to the discussion below under "Passive Foreign Investment Company Considerations," a U.S. Holder generally will be required to include in gross income as ordinary dividend income the amount of any distributions paid on the ordinary shares, including the amount of any Israeli taxes withheld, to the extent that those distributions are paid out of our current or accumulated earnings and profits as determined for U.S. federal income tax purposes. Subject to the discussion below under "Passive Foreign Investment Company Considerations," distributions in excess of our earnings and profits will be applied against and will reduce the U.S. Holder's tax basis in its ordinary shares and, to the extent they exceed that tax basis, will be treated as gain from a sale or exchange of those ordinary shares. Our dividends will not qualify for the dividends-received deduction applicable in some cases to U.S. corporations. Dividends paid in NIS, including the amount of any Israeli taxes withheld, will be includible in the income of a U.S. Holder in a U.S. dollar amount calculated by reference to the exchange rate in effect on the date they are included in income by the U.S. Holder, regardless of whether the payment in fact is converted into U.S. dollars. Any gain or loss resulting from currency exchange fluctuations during the period from the date the dividend is includible in the income of the U.S. Holder to the date that payment is converted into U.S. dollars generally will be treated as ordinary income or loss.

A non-corporate U.S. holder's "qualified dividend income" currently is subject to tax at reduced rates not exceeding 15%. For this purpose, "qualified dividend income" generally includes dividends paid by a foreign corporation if either:

- (a) the stock of that corporation with respect to which the dividends are paid is readily tradable on an established securities market in the U.S., or
- (b) that corporation is eligible for benefits of a comprehensive income tax treaty with the U.S. which includes an information exchange program and is determined to be satisfactory by the U.S. Secretary of the Treasury. The Internal Revenue Service has determined that the U.S.-Israel Tax Treaty is satisfactory for this purpose.

In addition, under current law a U.S. Holder must generally hold his ordinary shares for more than 60 days during the 121 day period beginning 60 days prior to the ex-dividend date, and meet other holding period requirements for qualified dividend income.

Dividends paid by a foreign corporation will not qualify for the reduced rates, if the dividend is paid in a tax year of the recipient beginning after December 31, 2002, unless such corporation is treated, for the tax year in which the dividend is paid or the preceding tax year, as a "passive foreign investment company" for U.S. federal income tax purposes. We do not believe that we will be classified as a "passive foreign investment company" for U.S. federal income tax purposes for our current taxable year. However, see the discussion under "Passive Foreign Investment Company Considerations" below.

Subject to the discussion below under "Information Reporting and Back-up Withholding," a Non-U.S. Holder generally will not be subject to U.S. federal income or withholding tax on dividends received on ordinary shares unless that income is effectively connected with the conduct by that Non-U.S. Holder of a trade or business in the United States.

### **Controlled Foreign Corporation Considerations**

If more than 50% of either the voting power of all classes of voting stock or the total value of stock is owned, directly or indirectly, by citizens or residents of the U.S., U.S. domestic partnerships and corporations or estates or trusts other than foreign estates or trusts, each of which owns 10% or more of the total combined voting power of all classes of stock entitled to vote ("10-Percent Shareholders"), we could be treated as a controlled foreign corporation ("CFC"), for U.S. federal income tax purposes. This classification would, among other consequences, require 10-Percent Shareholders to include in their gross income their pro rata shares of "Subpart F income" (as defined by the Code) and earnings invested in U.S. property (as defined by the Code).

In addition, gain from the sale or exchange of preferred shares by a U.S. person who is or was a 10-Percent Shareholder at any time during the five-year period ending with the sale or exchange is treated as dividend income to the extent of earnings and profits of the company attributable to the stock sold or exchanged. Under certain circumstances, a corporate shareholder that directly owns 10% or more of voting shares may be entitled to an indirect foreign tax credit for income taxes paid by us in connection with amounts so characterized as dividends under the Code.

If we are classified as both a passive foreign investment company, as described below, and a CFC, we would generally not be treated as a passive foreign investment company with respect to 10-Percent Shareholders. We believe that we are not and will not become a CFC.

### **Foreign Tax Credit**

Any dividend income resulting from distributions we pay to a U.S. Holder with respect to the ordinary shares generally will be treated as foreign source income for U.S. foreign tax credit purposes, which may be relevant in calculating such holder's foreign tax credit limitation. Subject to certain conditions and limitations, Israeli tax withheld on dividends may be deducted from taxable income or credited against a U.S. Holder's U.S. federal income tax liability. The limitation on foreign taxes eligible for credit is calculated separately with respect to specific classes of income. The rules relating to the determination of foreign source income and the foreign tax credit are complex, and the availability of a foreign tax credit depends on numerous factors. Each prospective purchaser who would be a U.S. Holder should consult with its own tax advisor to determine whether its income with respect to the ordinary shares would be foreign source income and whether and to what extent that purchaser would be entitled to the credit.

### **Disposition of Ordinary Shares**

Upon the sale or other disposition of ordinary shares, subject to the discussion below under "Passive Foreign Investment Company Considerations," a U.S. Holder generally will recognize capital gain or loss equal to the difference between the amount realized on the disposition and the holder's adjusted tax basis in the ordinary shares. U.S. Holders should consult their own advisors with respect to the tax consequences of the receipt of a currency other than U.S. dollars upon such sale or other disposition.

In the event there is an Israeli income tax on gain from the disposition of ordinary shares, such tax should generally be the type of tax that is creditable for U.S. tax purposes; however, because it is likely that the source of any such gain would be a U.S. source, a U.S. foreign tax credit may not be available. U.S. shareholders should consult their own tax advisors regarding the ability to claim such credit.

Gain or loss upon the disposition of the ordinary shares will be treated as long-term if, at the time of the sale or disposition, the ordinary shares were held for more than one year. Long-term capital gains realized by non-corporate U.S. Holders are generally subject to a lower marginal U.S. federal income tax rate than ordinary income, other than qualified dividend income, as defined above. The deductibility of capital losses by a U.S. Holder is subject to limitations. In general, any gain or loss recognized by a U.S. Holder on the sale or other disposition of ordinary shares will be U.S. source income or loss for U.S. foreign tax credit purposes. U.S. Holders should consult their own tax advisors concerning the source of income for U.S. foreign tax credit purposes and the effect of the U.S.-Israel Tax Treaty on the source of income.

Subject to the discussion below under "Information Reporting and Back-up Withholding", a Non-U.S. Holder generally will not be subject to U.S. federal income or withholding tax on any gain realized on the sale or exchange of ordinary shares unless:

- that gain is effectively connected with the conduct by the Non-U.S. Holder of a trade or business in the United States, or
- in the case of any gain realized by an individual Non-U.S. Holder, that holder is present in the United States for 183 days or more in the taxable year of the sale or exchange, and other conditions are met.

## Passive Foreign Investment Company Considerations

Special U.S. federal income tax rules apply to U.S. Holders owning shares of a passive foreign investment company. A non-U.S. corporation will be considered a passive foreign investment company for any taxable year in which, after applying certain look-through rules, 75% or more of its gross income consists of specified types of passive income, or 50% or more of the average value of its assets consists of passive assets, which generally means assets that generate, or are held for the production of, passive income. Passive income may include amounts derived by reason of the temporary investment of funds. If we were classified as a passive foreign investment company, a U.S. Holder could be subject to increased tax liability upon the sale or other disposition of ordinary shares or upon the receipt of amounts treated as "excess distributions." Under these rules, the excess distribution and any gain would be allocated ratably over the U.S. Holder's holding period for the ordinary shares, and the amount allocated to the current taxable year and any taxable year prior to the first taxable year in which we were a passive foreign investment company would be taxed as ordinary income. The amount allocated to each of the other taxable years would be subject to tax at the highest marginal rate in effect for the applicable class of taxpayer for that year, and an interest charge for the deemed deferral benefit would be imposed on the resulting tax allocated to such other taxable years. The tax liability with respect to the amount allocated to years prior to the year of the disposition, or "excess distribution," cannot be offset by any net operating losses. In addition, holders of stock in a passive foreign investment company may not receive a "step-up" in basis on shares acquired from a decedent. U.S. Holders who hold ordinary shares during a period when we are a passive foreign investment company will be subject to the foregoing rules even if we cease to be a passive foreign investment company.

We believe that we are not a passive foreign investment company for U.S. federal income tax purposes, but we cannot be certain whether we will be treated as a passive foreign investment company for the current year or any future taxable year. Our belief that we will not be a passive foreign investment company for the current year is based on our estimate of the fair market value of our intangible assets, including goodwill, not reflected in our financial statements under U.S. GAAP, and our projection of our income for the current year. If the IRS successfully challenged our valuation of our intangible assets, it could result in our classification as a passive foreign investment company. Moreover, because passive foreign investment company status is based on our income and assets for the entire taxable year, it is not possible to determine whether we will be a passive foreign investment company for the current taxable year until after the close of the year. In the future, in calculating the value of our intangible assets, we will value our total assets, in part, based on our total market value determined using the average of the selling price of our ordinary shares on the last trading day of each calendar quarter. We believe this valuation approach is reasonable. While we intend to manage our business so as to avoid passive foreign investment company status, to the extent consistent with our other business goals, we cannot predict whether our business plans will allow us to avoid passive foreign investment company status or whether our business plans will change in a manner that affects our passive foreign investment company status determination. In addition, because the market price of our ordinary shares is likely to fluctuate and the market price of the shares of technology companies has been especially volatile, and because that market price may affect the determination of whether we will be considered a passive foreign investment company, we cannot assure that we will not be considered a passive foreign investment company for any taxable year.

The passive foreign investment company rules described above will not apply to a U.S. Holder if the U.S. Holder makes an election to treat us as a qualified electing fund. However, a U.S. Holder may make a qualified electing fund election only if we furnish the U.S. Holder with certain tax information. We currently do not provide this information, and we currently do not intend to take actions necessary to permit you to make a qualified electing fund election in the event we are determined to be a passive foreign investment company. As an alternative to making this election, a U.S. Holder of passive foreign investment company stock which is publicly-traded may in certain circumstances avoid certain of the tax consequences generally applicable to holders of a passive foreign investment company by electing to mark the stock to market annually and recognizing as ordinary income or loss each year an amount equal to the difference as of the close of the taxable year between the fair market value of the passive foreign investment company stock and the U.S. Holder's adjusted tax basis in the passive foreign investment company stock. Losses would be allowed only to the extent of net mark-to-market gain previously included by the U.S. Holder under the election for prior taxable years. This election is available for so long as our ordinary shares constitute "marketable stock," which includes stock of a passive foreign investment company that is "regularly traded" on a "qualified exchange or other market." Generally, a "qualified exchange or other market" includes a national market system established pursuant to Section 11A of the Exchange Act. A class of stock that is traded on one or more qualified exchanges or other markets is "regularly traded" on an exchange or market for any calendar year during which that class of stock is traded, other than in de minimis quantities, on at least 15 days during each calendar quarter. We believe that the Nasdaq Global Market will constitute a qualified exchange or other market for this purpose. However, no assurances can be provided that our ordinary shares will continue to trade on the Nasdaq Global Market or that the shares will be regularly traded for this purpose.

The rules applicable to owning shares of a passive foreign investment company are complex, and each prospective purchaser who would be a U.S. Holder should consult with its own tax advisor regarding the consequences of investing in a passive foreign investment company.

### **Information Reporting and Back-up Withholding**

Holders generally will be subject to information reporting requirements with respect to dividends paid in the United States on ordinary shares. In addition, Holders will be subject to back-up withholding tax on dividends paid in the United States on ordinary shares unless the holder provides an IRS certification or otherwise establishes an exemption. Holders will be subject to information reporting and back-up withholding tax on proceeds paid within the United States from the disposition of ordinary shares unless the holder provides an IRS certification or otherwise establishes an exemption. Information reporting and back-up withholding may also apply to dividends and proceeds paid outside the United States that are paid by certain "U.S. payors" or "U.S. middlemen," as defined in the applicable Treasury regulations, including:

- (1) a U.S. person;
- (2) the government of the U.S. or the government of any state or political subdivision of any state (or any agency or instrumentality of any of these governmental units);
- (3) a controlled foreign corporation;
- (4) a foreign partnership that is either engaged in a U.S. trade or business or whose United States partners in the aggregate hold more than 50% of the income or capital interests in the partnership;
- (5) a foreign person that derives 50% or more of its gross income for certain periods from the conduct of a trade or business in the U.S.; or
- (6) a U.S. branch of a foreign bank or insurance company.

The back-up withholding tax rate is 28%. Back-up withholding and information reporting will not apply to payments made to Non-U. S. Holders if they have provided the required certification that they are not United States persons.

In the case of payments by a payor or middleman to a foreign simple trust, foreign grantor trust or foreign partnership, other than payments to a holder that qualifies as a withholding foreign trust or a withholding foreign partnership within the meaning of the Treasury regulations and payments that are effectively connected with the conduct of a trade or business in the United States, the beneficiaries of the foreign simple trust, the person treated as the owner of the foreign grantor trust or the partners of the foreign partnership will be required to provide the certification discussed above in order to establish an exemption from backup withholding tax and information reporting requirements.

The amount of any back-up withholding may be allowed as a credit against a U.S. Holder's U.S. federal income tax liability and may entitle the holder to a refund, provided that required information is furnished to the IRS.

### **F. DIVIDENDS AND PAYING AGENTS**

Not applicable.

### **G. STATEMENT BY EXPERTS**

Not applicable.

### **H. DOCUMENTS ON DISPLAY**

You may request a copy of our U.S. SEC filings, at no cost, by writing or calling us at Perion Network Ltd., 4 HaNechoshet Street, Tel-Aviv 69710, Israel, Attention: Yacov Kaufman, Telephone: +972-3-7696100. A copy of each report submitted in accordance with applicable United States law is available for public review at our principal executive offices. In addition, our filings with the SEC may be inspected without charge at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Information on the operation of the Public Reference Room can be obtained by calling the SEC at 1-800-SEC-0330. Our SEC filings are also available to the public from the SEC's website at [www.sec.gov](http://www.sec.gov).



A copy of each document (or a translation thereof to the extent not in English) concerning Perion that is referred to in this annual report on Form 20-F, is available for public view (subject to confidential treatment of agreements pursuant to applicable law) at our principal executive offices at Perion Network Ltd., 4 HaNechoshet Street, Tel-Aviv 69710, Israel.

## I. SUBSIDIARY INFORMATION

Not applicable.

### ITEM 11. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

*Exchange Rate Risk.* A significant portion of our revenues and expenses are in foreign currencies. As a result numerous balances are denominated or linked to these currencies. Expense related to foreign currency fluctuations in 2010 was \$ 45,000 and in 2011 foreign currency related fluctuations resulted in \$102,000 financial income. These results are components of the exchange rate differences set forth in Note 12(a) of our financial statements.

As of December 31, 2011, balance sheet monetary items in US dollars, our functional currency, and those currencies other than the US dollars were as follows:

|                       | US Dollars                 | New Israeli<br>Shekels | Other<br>Currencies | Total          |
|-----------------------|----------------------------|------------------------|---------------------|----------------|
|                       | In thousands of US dollars |                        |                     |                |
| Current assets        | 12,047                     | 7,100                  | 1,354               | 20,501         |
| Long-term assets      | 204                        | 484                    | -                   | 688            |
| Current liabilities   | (19,401)                   | (1,527)                | (83)                | (21,011)       |
| Long-term liabilities | (1,120)                    | (946)                  | -                   | (2,066)        |
| <b>Total</b>          | <b>(8,270)</b>             | <b>5,111</b>           | <b>1,271</b>        | <b>(1,888)</b> |

The fair value of firmly committed transactions denominated in currencies other than our functional currency, as of December 31, 2011, was a liability of \$44 thousand for less than one year and none for more than one year, all denominated in New Israeli Shekels.

The fair value of derivative instruments and the notional amount of the hedged instruments in New Israeli Shekels, as of December 31, 2011 were as follows:

|  | Notional<br>Amount         | Fair Value |
|--|----------------------------|------------|
|  | In thousands of US dollars |            |
| Zero-cost collar contracts to hedge payroll expenses | 4,300                      | (44)       |

In addition, in territories where our prices are based on local currencies, fluctuations in the dollar exchange rate could affect our gross profit margin. We may compensate for such fluctuations by changing product prices accordingly. We also hold a small part of our financial investments in other currencies, mainly New Israeli Shekels and Euro. The dollar value of those investments may decline. A revaluation of 1% of the foreign currencies (i.e. other than U.S. dollar) would not have a material on our income before taxes possibly reducing it by less than \$0.1 million.

A majority of our costs, including salaries, expenses and office expenses are incurred in New Israeli Shekels. Inflation in Israel may have the effect of increasing the U.S. dollar cost of our operations in Israel. If the U.S. dollar declines in value in relation to the New Israeli Shekel, it will become more expensive for us to fund our operations in Israel. A revaluation of 1% of the New Israeli Shekel will affect our income before tax by less than one percent. The exchange rate of the U.S. dollar to the New Israeli Shekel, based on exchange rates published by the Bank of Israel, was as follows:

|                         | Year Ended December 31, |       |       |
|-------------------------|-------------------------|-------|-------|
|                         | 2009                    | 2010  | 2011  |
| Average rate for period | 3.933                   | 3.733 | 3.578 |
| Rate at year-end        | 3.775                   | 3.549 | 3.821 |

Since 2006 we've engaged a firm to analyze our exposure to the fluctuation in foreign currency exchange rates and are implementing their recommendations since then. However, due to the market conditions, volatility and other factors, its proposals and their implementation occasionally prove to be ineffective or can cause additional finance expenses.

*Interest Rate Risk.* The primary objective of our investment activities is to preserve principal while maximizing the interest income we receive from our investments, without increasing risk. Our current investment policy is to invest in dollar denominated or linked debentures, of limited sums, rated "A" or higher and with an average maturity of no more than 3 years. We are exposed to market risks resulting from changes in interest rates relating primarily to our financial investments in cash, deposits and marketable securities. We do not use derivative financial instruments to limit exposure to interest rate risk. Our interest gains may decline in the future as a result of changes in the financial markets. However, as interests rates are already very low, we believe any such potential loss would be immaterial to us.

**ITEM 12. DESCRIPTION OF SECURITIES OTHER THAN EQUITY SECURITIES**

Not applicable.

## PART II

### ITEM 13. DEFAULTS, DIVIDEND ARREARAGES AND DELINQUENCIES

Not applicable.

### ITEM 14. MATERIAL MODIFICATIONS TO THE RIGHTS OF SECURITY HOLDERS AND USE OF PROCEEDS

A. None.

### ITEM 15. CONTROLS AND PROCEDURES

(a) Disclosure Controls and Procedures. Our management, including our Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of our "disclosure controls and procedures" (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of December 31, 2011. Based on such evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, as of December 31, 2011, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act and the rules thereunder, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and to ensure that information required to be disclosed in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

( b ) Management's Annual Report on Internal Control Over Financial Reporting: Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act. Our internal control over financial reporting is a process to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. Our internal control over financial reporting includes those policies and procedures that:

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

Our management recognizes that there are inherent limitations in the effectiveness of any system of internal control over financial reporting, including the possibility of human error and the circumvention or override of internal control. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation, and may not prevent or detect all misstatements. Further, because of changes in conditions, the effectiveness of internal control over financial reporting may vary over time.

Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2011. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in "Internal Control – Integrated Framework." Our management has concluded, based on its assessment, that our internal control over financial reporting was effective as of December 31, 2011.

Our financial statements have been audited by Kost, Forer, Gabbay & Kasierer (A Member of Ernst & Young Global), an independent registered public accounting firm.

(c) Attestation Report of Registered Public Accounting Firm: This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the SEC that permit us to provide only management's report in this annual report.

( d ) Changes in Internal Control Over Financial Reporting: During the period covered by this report, no changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) have occurred that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**ITEM 16. [Reserved]**

**ITEM 16A. AUDIT COMMITTEE FINANCIAL EXPERT**

Our board of directors has determined that Mr. David Jutkowitz, who is an independent director (as defined in the NASDAQ Listing Rules) and serves on our audit committee, qualifies as an "audit committee financial expert" as defined in Item 16A of Form 20-F.

**ITEM 16B. CODE OF ETHICS**

Our board of directors has adopted a code of conduct applicable to all of our directors, officers and employees as required by the NASDAQ Listing Rules, which also complies with the definition of a "code of ethics" set out in Section 406(c) of the Sarbanes-Oxley Act of 2002. A copy of the code of ethics can be found on our website at: [www.perion.com](http://www.perion.com).

**ITEM 16C. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Fees for the professional services rendered by our independent accountants Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, for each of the last two fiscal years were as follows (in thousands):

|                   | 2010          | 2011          |
|-------------------|---------------|---------------|
| Audit Fees        | \$ 128        | \$ 173        |
| Tax Fees          | 68            | 150           |
| Audit related fee | 9             | 39            |
| Total             | <u>\$ 205</u> | <u>\$ 362</u> |

Audit Fees include fees for professional services rendered by our principal accountant in connection with the audit of our consolidated annual financial statements and review of our unaudited interim financial statements.

Audit related fees include consultation regarding financial reporting and due diligence in connection with acquisitions.

Tax fees include: corporate tax returns, international tax, tax implication regarding our status as a PFIC, VAT advice related to dividend distribution and possible acquisitions.

Our audit committee is responsible for the establishment of policies and procedures for review and pre-approval by the committee of all audit services and permissible non-audit services to be performed by our independent auditor, in order to ensure that such services do not impair our auditor's independence. Pursuant to the pre-approval policy adopted by our audit committee, certain enumerated audit, audit-related and tax services have been granted general pre-approval by our audit committee and need not be specifically pre-approved. Pre-approval fee levels or budgeted amounts for all services to be provided by the independent auditor will be established annually by the audit committee and the committee may also determine the appropriate ratio between the total amount of fees for audit, audit-related, tax services and other services. All requests for services to be provided by the independent auditor will be submitted to our Chief Financial Officer, who will determine whether such services are included within the enumerated pre-approved services. The audit committee will be informed on a timely basis of any pre-approved services that were performed by the auditor. Requests for services that require specific pre-approval will be submitted to the audit committee with a statement as to whether, in the view of the Chief Financial Officer and the independent auditor, the request is consistent with the SEC's rules on auditor independence. The Chief Financial Officer will monitor the performance of all services and determine whether such services are in compliance with the policy.

**ITEM 16D. EXEMPTIONS FROM THE LISTING STANDARDS FOR AUDIT COMMITTEES**

None.

**ITEM 16E. PURCHASES OF EQUITY SECURITIES BY THE ISSUER AND AFFILIATED PURCHASERS**

Not applicable.

**ITEM 16F. CHANGE IN REGISTRANT'S CERTIFYING ACCOUNTANT**

Not applicable.

**ITEM 16G. CORPORATE GOVERNANCE**

As a foreign private issuer whose shares are listed on the Nasdaq Global Market, we are permitted to follow certain home country corporate governance practices instead of certain requirements of the NASDAQ Listing Rules.

As described in Item 10.B "Additional Information – NASDAQ Listing Rules and Home Country Practices," we do not comply with the NASDAQ requirement that an issuer listed on the NASDAQ Global Market have a quorum requirement that in no case be less than 33 1/3% of the outstanding shares of the company's common voting stock. However, our articles of association, consistent with the Israeli Companies Law, provide that the quorum requirements for an adjourned meeting are the presence of a minimum of two shareholders present in person. Our quorum requirements for an adjourned meeting do not comply with the NASDAQ requirements and we instead follow our home country practice.

As a foreign private issuer listed on the NASDAQ Global Market, we may also follow home country practice with regard to, among other things, distribution of annual and quarterly reports to shareholders, approval of related party transactions, composition of the board of directors, approval of compensation of executive officers, director nomination process and regularly scheduled meetings at which only independent directors are present. In addition, we may follow our home country practice, instead of the NASDAQ Marketplace Rules, which require that we obtain shareholder approval for certain dilutive events, such as for the establishment or amendment of certain equity based compensation plans, an issuance that will result in a change of control of the company, certain transactions other than a public offering involving issuances of a 20% or more interest in the company and certain acquisitions of the stock or assets of another company. Under NASDAQ Listing Rules, U.S. domestic issuers are required to solicit proxies, provide proxy statements for all shareholder meetings and provide copies of such proxy materials to NASDAQ; however, as a foreign private issuer, we are generally exempt from the SEC's rules governing the solicitation of shareholder proxies.

See Item 6 "Directors, Senior Management and Employees – Board Practices" and Item 10.B "Additional Information – NASDAQ Listing Rules and Home Country Practices" for a detailed description of the significant ways in which the registrant's corporate governance practices differ from those followed by domestic U.S. companies under the listing standards of the NASDAQ Global Market.

PART III

ITEM 17. FINANCIAL STATEMENTS

Not applicable.

ITEM 18. FINANCIAL STATEMENTS

The following financial statements and related auditors' report are filed as part of this annual report:

|  | <u>Page</u> |
|--|-------------|
| <a href="#"><u>Report of Independent Registered Public Accounting Firm</u></a>   | F-2         |
| <a href="#"><u>Consolidated Balance Sheets as of December 31, 2010 and 2011</u></a>  | F-3 - F-4   |
| <a href="#"><u>Consolidated Statements of Income<br/>for the Years Ended December 31, 2009, 2010 and 2011</u></a>                          | F-5         |
| <a href="#"><u>Consolidated Statements of Changes in Shareholders' Equity<br/>for the Years Ended December 31, 2009, 2010 and 2011</u></a> | F-6         |
| <a href="#"><u>Consolidated Statements of Cash Flows<br/>for the Years Ended December 31, 2009, 2010 and 2011</u></a>                      | F-7 - F-8   |
| <a href="#"><u>Notes to Consolidated Financial Statements</u></a>  | F-9- F-38   |

**ITEM 19. EXHIBITS:**

| <u>No.</u> | <u>Description</u>   |
|------------|--|
| 1.1        | Memorandum of Association of Registrant (1)  |
| 1.2        | Certificate of Change of Name of Registrant (translated from Hebrew)   |
| 1.3        | Amended and Restated Articles of Association of Registrant, dated February 3, 2006 (2)   |
| 4.3        | The Registrant's 2003 Israeli Share Option Plan and the form of Option Agreement (1) and the US Addendum to such plan (4)  |
| 4.4        | Google Services Agreement, dated December 27, 2010(3)  |
| 4.5        | Stock Purchase Agreement among Ofer Adler, the Company and the purchasers listed therein, dated January 24, 2011. (5)  |
| 4.6        | Registration Rights Agreement among the Company and the investors listed therein, dated January 24, 2011. (5)  |
| 4.7        | Commitment Letter and Financial Covenants Letter among the Company and Bank Leumi Le-Israel, B.M., dated September 6 <sup>th</sup> 2011;   |
| 4.8        | Commitment Letter and Financial Covenants Letter among the Company and the First International Bank of Israel, B.M., dated September 6 <sup>th</sup> 2011; (translated from Hebrew)  |
| 4.9        | Agreement and Plan of Merger, dated July 31, 2011, by and among the Company, Incredimail Inc., Seder Merger Inc., Smilebox, Inc. and Andrew Wright and Shareholder Representative Services LLC, as the Shareholder Representative dated as of July 31, 2011. * |
| 8          | List of all subsidiaries   |
| 12.1       | Certification required by Rule 13a-14(a) or Rule 15d-14(a) executed by the Chief Executive Officer of the Company  |
| 12.2       | Certification required by Rule 13a-14(a) or Rule 15d-14(a) executed by the Chief Financial Officer of the Company  |
| 13.1       | Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code  |
| 13.2       | Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code  |
| 14         | Consent of Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, Independent Auditors  |

---

(1) Previously filed with the SEC on October 25, 2005 as an exhibit to our registration statement on Form F-1/A (File No. 333-129246).

(2) Previously filed with the SEC on January 5, 2006 as an exhibit to our registration statement on Form F-1/A (File No. 333-129246).

(3) Previously filed with the SEC on March 8, 2011 as an exhibit to our annual report on Form 20-F. Confidential treatment was requested and approved with respect to certain portions of this exhibit pursuant to 17.C.F.R. §§ 230.406 and 200.83. Omitted portions were filed separately with the SEC.

(4) Previously filed with the SEC on September 15, 2011 as an Appendix to Exhibit 1 of our Notice of Annual General Meeting of Shareholders filed on Form 6-K (File No. 000-51694)

(5) Previously filed with the SEC on March 9, 2011 as an exhibit to our annual report on Form 20-F.

\* Confidential treatment was requested with respect to certain portions of this exhibit pursuant to 17.C.F.R. §§ 230.406 and 200.83. Omitted portions were filed separately with the SEC.

PERION NETWORK LTD. AND ITS SUBSIDIARIES  
(Formerly: Incredimail Ltd.)

CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2011

IN U.S. DOLLARS

INDEX

|  | <u>Page</u> |
|--|-------------|
| <a href="#"><u>Report of Independent Registered Public Accounting Firm</u></a>   | F-2         |
| <a href="#"><u>Consolidated Balance Sheets as of December 31, 2010 and 2011</u></a>  | F-3 - F-4   |
| <a href="#"><u>Consolidated Statements of Income<br/>for the Years Ended December 31, 2009, 2010 and 2011</u></a>                          | F-5         |
| <a href="#"><u>Consolidated Statements of Changes in Shareholders' Equity<br/>for the Years Ended December 31, 2009, 2010 and 2011</u></a> | F-6         |
| <a href="#"><u>Consolidated Statements of Cash Flows<br/>for the Years Ended December 31, 2009, 2010 and 2011</u></a>                      | F-7 - F-8   |
| <a href="#"><u>Notes to Consolidated Financial Statements</u></a>  | F-9- F-38   |

---





**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

**To the Shareholders and Board of Directors of**

**PERION NETWORK LTD.**

We have audited the accompanying consolidated balance sheets of Perion Network Ltd. (formerly: Incredimail Ltd.) ("the Company") and its subsidiaries as of December 31, 2010 and 2011, and the related consolidated statements of income, changes in shareholders' equity and cash flows for each of the three years in the period ended December 31, 2011. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audits included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company and its subsidiaries as of December 31, 2010 and 2011, and the consolidated results of their operations and their cash flows for each of the three years in the period ended December 31, 2011, in conformity with U.S. generally accepted accounting principles.

Tel-Aviv, Israel  
March 22, 2012

KOST FORER GABBAY & KASIERER  
A Member of Ernst & Young Global

CONSOLIDATED BALANCE SHEETS

U.S. dollars in thousands

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2010             | 2011             |
| <b>ASSETS</b>                          |                  |                  |
| <b>CURRENT ASSETS:</b>                 |                  |                  |
| Cash and cash equivalents              | \$ 16,055        | \$ 11,260        |
| Marketable securities                  | 14,973           | -                |
| Trade receivables                      | 2,795            | 3,265            |
| Other receivables and prepaid expenses | 4,485            | 6,447            |
| <u>Total current assets</u>            | <u>38,308</u>    | <u>20,972</u>    |
| <b>LONG-TERM ASSETS:</b>               |                  |                  |
| Severance pay fund                     | 877              | 484              |
| Property and equipment, net            | 1,381            | 1,300            |
| Other intangible assets, net           | 202              | 6,606            |
| Goodwill                               | -                | 24,753           |
| Other assets                           | 580              | 777              |
| <u>Total long-term assets</u>          | <u>3,040</u>     | <u>33,920</u>    |
| <u>Total assets</u>                    | <u>\$ 41,348</u> | <u>\$ 54,892</u> |

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

**CONSOLIDATED BALANCE SHEETS**

U.S. dollars in thousands (except share and per share data)

|  | December 31,     |                  |
|--|------------------|------------------|
|  | 2010             | 2011             |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>                      |                  |                  |
| <b>CURRENT LIABILITIES:</b>                                      |                  |                  |
| Trade payables   | \$ 1,831         | \$ 3,207         |
| Deferred revenues  | 2,204            | 4,280            |
| Payment obligation related to acquisition                        | -                | 6,574            |
| Accrued expenses and other liabilities                           | 6,206            | 6,950            |
| <b>Total current liabilities</b>                                 | <b>10,241</b>    | <b>21,011</b>    |
| <b>LONG-TERM LIABILITIES:</b>                                    |                  |                  |
| Deferred revenues  | 1,576            | 1,120            |
| Accrued severance pay  | 1,379            | 946              |
| <b>Total long-term liabilities</b>                               | <b>2,955</b>     | <b>2,066</b>     |
| <b>COMMITMENTS AND CONTINGENT LIABILITIES</b>                    |                  |                  |
| <b>SHAREHOLDERS' EQUITY:</b>                                     |                  |                  |
| Share capital -  |                  |                  |
| Ordinary shares of NIS 0.01 par value -                          |                  |                  |
| Authorized: 15,000,000 and 40,000,000 shares at December 31,     |                  |                  |
| 2010 and 2011, respectively; Issued and outstanding: 9,701,750   |                  |                  |
| and 9,916,194 shares at December 31, 2010 and 2011, respectively | 22               | 22               |
| Additional paid-in capital                                       | 23,734           | 25,714           |
| Accumulated other comprehensive income                           | 100              | -                |
| Retained earnings  | 5,298            | 7,081            |
| Treasury stock   | (1,002)          | (1,002)          |
| <b>Total shareholders' equity</b>                                | <b>28,152</b>    | <b>31,815</b>    |
| <b>Total liabilities and shareholders' equity</b>                | <b>\$ 41,348</b> | <b>\$ 54,892</b> |

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

CONSOLIDATED STATEMENTS OF INCOME

U.S. dollars in thousands (except per share data)

|                                  | Year ended December 31, |           |           |
|----------------------------------|-------------------------|-----------|-----------|
|                                  | 2009                    | 2010      | 2011      |
| Revenues:                        |                         |           |           |
| Search                           | \$ 20,011               | \$ 22,792 | \$ 25,466 |
| Products                         | 6,717                   | 5,404     | 7,191     |
| Other                            | 467                     | 1,301     | 2,816     |
|                                  | 27,195                  | 29,497    | 35,473    |
| Cost of revenues                 | 1,505                   | 1,606     | 2,840     |
| Gross profit                     | 25,690                  | 27,891    | 32,633    |
| Operating expenses:              |                         |           |           |
| Research and development, net    | 6,254                   | 6,607     | 7,453     |
| Selling and marketing            | 4,616                   | 5,244     | 12,984    |
| General and administrative       | 3,334                   | 4,741     | 7,649     |
| Total operating expenses         | 14,204                  | 16,592    | 28,086    |
| Operating income                 | 11,486                  | 11,299    | 4,547     |
| Financial income, net            | 72                      | 322       | 1,293     |
| Income before taxes on income    | 11,558                  | 11,621    | 5,840     |
| Taxes on income                  | 3,545                   | 3,232     | 172       |
| Net income                       | \$ 8,013                | \$ 8,389  | \$ 5,668  |
| Net earnings per Ordinary share: |                         |           |           |
| Basic                            | \$ 0.86                 | \$ 0.87   | \$ 0.58   |
| Diluted                          | \$ 0.84                 | \$ 0.85   | \$ 0.57   |

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

**STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

U.S. dollars in thousands

|  | <u>Share<br/>capital</u> | <u>Additional<br/>paid-in<br/>capital</u> | <u>Accumulated<br/>other<br/>comprehensive<br/>income</u> | <u>Retained<br/>earnings</u> | <u>Treasury<br/>stock</u> | <u>Total<br/>shareholders'<br/>equity</u> |
|--|--------------------------|---|---|------------------------------|---------------------------|---|
| Balance as of January 1, 2009  | \$ 21                    | \$ 23,358                                 | \$ 12   | \$ 3,035                     | \$ (882)                  | \$ 25,544                                 |
| Cumulative effect from adoption of FSP No. 115-2/124-2 (primarily codified in ASC 320-10, "Investments - Debt and Equity Securities - Overall") on April 1, 2009 | -                        | -   | (210)   | 210                          | -                         | -   |
| Stock based compensation expense   | -                        | 672                                       | -   | -                            | -                         | 672                                       |
| Exercise of share options  | -                        | 984                                       | -   | -                            | -                         | 984                                       |
| Dividends  | -                        | (2,624)                                   | -   | (5,872)                      | -                         | (8,496)                                   |
| Repurchase of Ordinary shares  | -                        | -   | -   | -                            | (120)                     | (120)                                     |
| Comprehensive income:  |                          |   |   |                              |                           |   |
| Net income   | -                        | -   | -   | 8,013                        | -                         | 8,013                                     |
| Reclassification adjustments to income on marketable securities, net   | -                        | -   | 405   | -                            | -                         | 405                                       |
| <b>Balance as of December 31, 2009</b>   | <b>21</b>                | <b>22,390</b>                             | <b>207</b>  | <b>5,386</b>                 | <b>(1,002)</b>            | <b>27,002</b>                             |
| Stock based compensation expense   | -                        | 761                                       | -   | -                            | -                         | 761                                       |
| Excess tax benefit from share-based payment arrangements   | -                        | 209                                       | -   | -                            | -                         | 209                                       |
| Exercise of share options  | 1                        | 374                                       | -   | -                            | -                         | 375                                       |
| Dividends  | -                        | -   | -   | (8,477)                      | -                         | (8,477)                                   |
| Comprehensive income:  |                          |   |   |                              |                           |   |
| Net income   | -                        | -   | -   | 8,389                        | -                         | 8,389                                     |
| Reclassification adjustments to income on marketable securities, net   | -                        | -   | (107)   | -                            | -                         | (107)                                     |
| <b>Balance as of December 31, 2010</b>   | <b>22</b>                | <b>23,734</b>                             | <b>100</b>  | <b>5,298</b>                 | <b>(1,002)</b>            | <b>28,152</b>                             |
| Stock based compensation expense   | -                        | 1,200                                     | -   | -                            | -                         | 1,200                                     |
| Exercise of share options  | *)                       | 30  | -   | -                            | -                         | 30  |
| Dividends  | -                        | -   | -   | (3,885)                      | -                         | (3,885)                                   |
| Issuance of shares related to acquisition  | *)                       | 750                                       | -   | -                            | -                         | 750                                       |
| Comprehensive income:  |                          |   |   |                              |                           |   |
| Net income   | -                        | -   | -   | 5,668                        | -                         | 5,668                                     |
| Reclassification adjustments to income on marketable securities, net   | -                        | -   | (100)   | -                            | -                         | (100)                                     |
| <b>Balance as of December 31, 2011</b>   | <b>\$ 22</b>             | <b>\$ 25,714</b>                          | <b>\$ -</b>   | <b>\$ 7,081</b>              | <b>\$ (1,002)</b>         | <b>\$ 31,815</b>                          |

\*) Represent amount of less than \$1

Total comprehensive income for the years ended December 31, 2009, 2010 and 2011 amounted to \$8,418, \$8,282 and \$5,568, respectively.

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

|  | Year ended December 31, |                 |                 |
|--|-------------------------|-----------------|-----------------|
|  | 2009                    | 2010            | 2011            |
| <b>Cash flows from operating activities:</b>   |                         |                 |                 |
| Net income   | \$ 8,013                | \$ 8,389        | \$ 5,668        |
| Adjustments required to reconcile net income to net cash provided by operating activities: |                         |                 |                 |
| Depreciation and amortization  | 715                     | 739             | 1,388           |
| Stock based compensation expense, net  | 672                     | 761             | 1,183           |
| Accretion of payment obligation related to acquisition                                     | -                       | -               | 100             |
| Excess tax benefit from share-based payment arrangements                                   | -                       | (209)           | -               |
| Amortization of premium and accrued interest on marketable securities                      | 105                     | 42              | (16)            |
| Loss (gain) from marketable securities and long-term investment, net                       | 20                      | (108)           | 100             |
| Deferred taxes, net  | 1,515                   | (385)           | (1,140)         |
| Accrued severance pay, net   | (144)                   | 216             | (40)            |
| Net changes in operating assets and liabilities:   |                         |                 |                 |
| Trade receivables  | (126)                   | (475)           | (383)           |
| Other receivables and prepaid expenses   | 122                     | 544             | (1,100)         |
| Other long-term assets   | (45)                    | 17              | 60              |
| Trade payables   | (909)                   | 374             | 108             |
| Deferred revenues  | (462)                   | (106)           | 998             |
| Accrued expenses and other liabilities   | 1,198                   | (25)            | 112             |
| Other  | -                       | 9               | -               |
| Net cash provided by operating activities  | <u>10,674</u>           | <u>9,783</u>    | <u>7,038</u>    |
| <b>Cash flows from investing activities:</b>   |                         |                 |                 |
| Purchase of property and equipment   | (513)                   | (246)           | (316)           |
| Proceeds from sale of property and equipment   | -                       | 12              | -               |
| Proceeds from short-term bank deposits   | 1,042                   | -               | -               |
| Investment in short-term bank deposits   | (974)                   | -               | -               |
| Restricted cash  | 169                     | -               | 90              |
| Capitalization of software development and content costs                                   | (75)                    | (180)           | (829)           |
| Acquisition of subsidiary, net of acquired cash  | -                       | -               | (21,712)        |
| Proceeds from sales of marketable securities   | 23,277                  | 10,745          | 26,704          |
| Investment in marketable securities  | <u>(9,435)</u>          | <u>(20,534)</u> | <u>(11,915)</u> |
| Net cash (used in) provided by investing activities  | <u>13,491</u>           | <u>(10,203)</u> | <u>(7,978)</u>  |

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

CONSOLIDATED STATEMENTS OF CASH FLOWS

U.S. dollars in thousands

|   | Year ended December 31, |           |           |
|---|-------------------------|-----------|-----------|
|   | 2009                    | 2010      | 2011      |
| <u>Cash flows from financing activities:</u>                      |                         |           |           |
| Exercise of share options   | 984                     | 375       | 30        |
| Excess tax benefit from share-based payment arrangements          | -                       | 209       | -         |
| Repurchase of Ordinary shares                                     | (120)                   | -         | -         |
| Dividend paid   | (8,496)                 | (8,477)   | (3,885)   |
| Net cash used in financing activities                             | (7,632)                 | (7,893)   | (3,855)   |
| (Decrease) increase in cash and cash equivalents                  | 16,533                  | (8,313)   | (4,795)   |
| Cash and cash equivalents at beginning of year                    | 7,835                   | 24,368    | 16,055    |
| Cash and cash equivalents at end of year                          | \$ 24,368               | \$ 16,055 | \$ 11,260 |
| <u>Supplemental disclosure of cash flow activities:</u>           |                         |           |           |
| <u>Cash paid (received) during the year for:</u>                  |                         |           |           |
| Income taxes  | \$ 1,790                | \$ 2,719  | \$ (631)  |
| <u>Supplemental disclosure of non-cash investing activities:</u>  |                         |           |           |
| Purchase of property and equipment on credit                      | \$ -                    | \$ 418    | \$ -      |
| Issuance of shares in connection with the acquisition of Smilebox | \$ -                    | \$ -      | \$ 750    |

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

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

---

**U.S. dollars in thousands (except share and per share data)**

**NOTE 1:- GENERAL**

Perion Network Ltd. ("Perion") (formerly: Incredimail Ltd.) and its wholly-owned subsidiaries (collectively referred to as the "Company"), is a digital media company that provides products and services to consumers to help make their everyday life simpler and more enjoyable, focusing on second wave adopters. The Company's products include: IncrediMail, an e-mail client; Smilebox, a photo sharing and social expression product and service; PhotoJoy, a photo discovery and sharing screensaver & wallpaper product; and Fixie, a PC optimization product. The Company generates revenues primarily through search, the sale of premium products and services, and advertising.

The Company was incorporated under the laws of Israel in 1999 and commenced operations in 2000.

In November 2011, the Company changed its name from IncrediMail Ltd. to Perion Network Ltd.

The Company has one major customer which accounted for 68%, 70% and 67% of total revenues, in 2009, 2010 and 2011, respectively. This customer represents 63% and 68% of total trade receivable as of December 31, 2010 and 2011, respectively. Losing this customer could cause a material adverse effect to the Company's results of operations and financial position. The major customer has limited termination rights. On December 27, 2010, the Company signed an agreement with the customer, effective January 1, 2011 through January 31, 2013.

**NOTE 2:- ACQUISITION OF SMILEBOX INC.**

On August 31, 2011, the Company completed the acquisition of all of the outstanding shares of Smilebox Inc. ("Smilebox"). The Company included the financial results of Smilebox in its consolidated financial statements from the date of acquisition. Under the Purchase Agreement, the total consideration is composed of cash and Ordinary shares of the Company, as follows:

- \$ 24,269 in cash;
- 128,538 Ordinary shares of the Company issuable at closing at fair value of \$ 750;
- \$ 7,000 in cash and in Ordinary shares of the Company (subject to certain adjustments), payable within 7 months following the closing (March 2012). In connection with this consideration, the Company recorded a \$ 6,474 liability; and
- A milestone-based contingent cash and Ordinary shares of the Company payment ("Contingent Payment") of up to \$ 8,000 payable in September 2012. The Company recognized a liability of zero with respect to this Contingent Payment, which represents its fair value.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 2:- ACQUISITION OF SMILEBOX INC. (Cont.)**

In addition the Company incurred acquisition related costs in a total amount of \$ 1,069, which are included in general and administrative expenses for the year ended December 31, 2011. Acquisition related costs include compensation to executive, legal and accounting fees directly related to the acquisition.

Smilebox provides a subscription allowing people to connect with family and friends in a creative and personal way. Smilebox enable users to personalize hundreds of unique, multimedia designs with their photos, videos, and music and then share them via print, email, blog or DVD. The main reason for this acquisition was to enrich the Company's product suite to include other consumer products that bear similar characteristics appealing to its unique demographic segment. A significant amount of the acquisition was recorded as goodwill due to the synergies with Smilebox.

Under business combination accounting, the total purchase price was allocated to Smilebox's net tangible and intangible assets based on their estimated fair values as set forth below. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill.

|  |                  |
|--|------------------|
| Cash                                   | \$ 2,100         |
| Trade receivables                      | 87               |
| Other receivables and prepaid expenses | 616              |
| Property and equipment                 | 191              |
| Long-term prepaid expenses and other   | 449              |
| Trade payables                         | (1,268)          |
| Accrued expenses and other liabilities | (1,171)          |
| Deferred revenues                      | (622)            |
| Intangible assets                      | 6,358            |
| Goodwill                               | 24,753           |
|  | <u>31,493</u>    |
| Total purchase price                   | <u>\$ 31,493</u> |

Intangible assets:

In performing the purchase price allocation, the Company considered, among other factors, analysis of historical financial performance, highest and best use of the acquired assets and estimates of future performance of Smilebox's products. The fair value of intangible assets was based on market participant approach to valuation, performed by a third party valuation firm using estimates and assumptions provided by management. The following table sets forth the components of intangible assets associated with Smilebox acquisition:

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 2:- ACQUISITION OF SMILEBOX INC (Cont.)**

|                                | <b>Fair value</b> |
|--------------------------------|-------------------|
| Customer relationships         | \$ 1,488          |
| Technology                     | 3,000             |
| Trade name                     | 1,870             |
| <b>Total intangible assets</b> | <b>\$ 6,358</b>   |

The following unaudited condensed combined pro forma information for the years ended December 31, 2010 and 2011, gives effect to the acquisition of Smilebox as if the acquisition had occurred on January 1, 2010. The pro forma information is not necessarily indicative of the results of operations, which actually would have occurred if the acquisition had been consummated on that date, nor does it purport to represent the results of operations for future periods. For the purposes of the pro forma information, the Company has assumed that net income includes additional amortization of intangible assets related to the acquisition of \$ 3,635 and \$ 1,613 in 2010 and 2011, respectively.

|                                   | <b>Year ended December 31</b> |                  |
|-----------------------------------|-------------------------------|------------------|
|                                   | <b>2010</b>                   | <b>2011</b>      |
|                                   | <b>Unaudited</b>              | <b>Unaudited</b> |
| Revenues                          | \$ 36,290                     | \$ 44,378        |
| Net income (loss)                 | \$ (218)                      | \$ 6,053         |
| Basic earnings (loss) per share   | \$ (0.02)                     | \$ 0.61          |
| Diluted earnings (loss) per share | \$ (0.02)                     | \$ 0.60          |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES

a. Use of estimates:

The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates, judgments and assumptions. The Company's management believes that the estimates, judgments and assumptions used are reasonable based upon information available at the time they are made. These estimates, judgments and assumptions can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, the Company's management evaluates estimates, including those related to fair values and useful lives of intangible assets, fair values of stock-based awards, income taxes, and contingent liabilities. Such estimates are based on historical experience and on various other assumptions that are believed to be reasonable, the results of which form the basis for making judgments about the carrying values of assets and liabilities.

b. Financial statements in U.S. dollars:

The Company has operations in Israel and a significant portion of the Israeli expenses are currently paid in new Israeli shekels ("NIS"); however, the markets for the Company's products are located outside of Israel and the Company generates most of its revenues in U.S. dollars ("dollars"). The Company's management believes that the dollar is the currency of the primary economic environment in which the Company operates. Thus, the functional and reporting currency of the Company is the dollar.

Accordingly, monetary accounts maintained in currencies other than the dollar are remeasured into dollars, in accordance with Accounting Standards Codification ("ASC") 830, "Foreign Currency Matters". All transaction gains and losses of the remeasured monetary balance sheet items are reflected in the statement of income as financial income or expenses, as appropriate.

c. Principles of consolidation:

The consolidated financial statements include the accounts of Perion and its subsidiaries. Intercompany balances and transactions have been eliminated upon consolidation.

d. Cash equivalents:

The Company considers short-term unrestricted highly liquid investments that are readily convertible into cash, purchased with original maturities of three months or less to be cash equivalents.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

e. Marketable securities:

The Company accounts for investments in debt securities in accordance with ASC 320, "Investments - Debt and Equity Securities". Management determines the appropriate classification of its investments in debt securities at the time of purchase and reevaluates such determinations at each balance sheet date.

At December 31, 2010, all marketable securities were designated as available-for-sale and, as such, are carried at fair value. Unrealized gains and losses are comprised of the difference between market value and amortized costs of such securities and are reflected, net of tax, as "accumulated other comprehensive income" in shareholders' equity. Realized gains and losses on marketable securities are included in earnings and are derived using the specific identification method for determining the cost of securities.

The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity. Such amortization together with interest and dividends on securities are included in "financial income, net".

The Company recognizes an impairment charge when a decline in the fair value of its investments in debt securities is below the cost basis of such securities is judged to be other-than-temporary. Factors considered in making such a determination include the duration and severity of the impairment, the reason for the decline in value, the potential recovery period and the Company's intent to sell, including whether it is more likely than not that the Company will be required to sell the investment before recovery of cost basis. For securities that are deemed other-than-temporarily impaired, the amount of impairment is recognized in the statement of income and is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income.

f. Property and equipment:

Property and equipment are stated at cost, net of accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets at the following annual rates:

|                                    | %      |
|------------------------------------|--------|
| Computers and peripheral equipment | 33     |
| Office furniture and equipment     | 7 - 15 |

Leasehold improvements are depreciated using the straight-line method over the term of the lease or the estimated useful life of the improvements, whichever is shorter.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

- g. Impairment of long-lived assets and intangible assets subject to amortization:

Property and equipment and intangible assets subject to amortization are reviewed for impairment in accordance with ASC 360, "Accounting for the Impairment or Disposal of Long-Lived Assets", whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to the future undiscounted cash flows expected to be generated by the assets. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. For each of the three years in the period ended December 31, 2011, no impairment losses have been identified.

In determining the fair values of long-lived assets for purpose of measuring impairment, Company's assumptions include those that market participants will consider in valuations of similar assets.

- h. Goodwill and other intangible assets:

Goodwill and certain other purchased intangible assets have been recorded as a result of acquisitions. Goodwill represents the excess of the purchase price in a business combination over the fair value of net tangible and intangible assets acquired. Goodwill is not amortized, but rather is subject to an impairment test. The Company performs an annual impairment test during the fourth quarter of each fiscal year, or more frequently if impairment indicators are present. The Company operates in one operating segment, and this segment comprises its only reporting unit.

ASC 350, "Intangibles - Goodwill and Other" prescribes a two-phase process for impairment testing of goodwill. The first phase screens for impairment, while the second phase (if necessary) measures impairment.

Goodwill impairment is deemed to exist if the net book value of a reporting unit exceeds its estimated fair value. In such case, the second phase is then performed, and the Company measures impairment by comparing the carrying amount of the reporting unit's goodwill to the implied fair value of that goodwill. An impairment loss is recognized in an amount equal to the excess. For each of the three years in the period ended December 31, 2011, no impairment losses have been identified.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Intangible assets that are not considered to have an indefinite useful life are amortized over their estimated useful lives, which range from 3 to 10.25 years. The acquired customer arrangements are amortized over their estimated useful lives in proportion to the economic benefits realized. This accounting policy results in accelerated amortization of such customer arrangements as compared to the straight-line method. Other intangible assets consist primarily of technology and trade names and are amortized over their estimated useful lives on a straight-line basis.

i. Revenue recognition:

The Company generates revenues from search related advertising, receiving a share of the advertising revenues from companies providing search capabilities. In addition, the Company offers advertisers the ability to place text-based ads on its home page and website and banners in its email clients. Advertisers are charged monthly based on the number of times a user clicks on one of the ads. The Company recognizes revenue from advertisement at that time.

In addition, the Company also derives revenues from: (i) product sales (ii) other. Revenues from products include licensing the right to use its email software, content database, photo sharing and social expression product and e-mail anti spam. Revenues from other services include search related advertising and other advertising.

In accordance with ASC 605-50, "Customer Payments and Incentives", the Company accounts for cash consideration given to customers, for whom it does not receive a separately identifiable benefit or cannot, reasonably estimate fair value, as a reduction of revenue rather than as an expense.

Revenues from software license products are recognized when all criteria outlined in ASC 985-605, "Software - Revenue Recognition" are met. Revenues from software license products are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable, and collectability is probable. Company's e-mail product users may also purchase a license to its content database. This content database provides additional Perion Network content files in the form of email background, animation sounds, graphics and e-mail notifies. Content database licensing fees are recognized over the license period. Lifetime licensing revenues are recognized over the estimated usage period of the content database. In accordance with its policy, the Company reviews the estimated usage period of the lifetime licensing on an ongoing basis.

Revenues from email anti-spam license fees, photo sharing, social expression product and service are recognized ratably over the term of the license.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

Deferred revenues include upfront payments received from customers, for whom revenues have not yet been recognized.

j. Cost of revenues:

Cost of revenues consists primarily of salaries and related expenses, license fees, amortization of acquired technology, amortization of capitalized research and development costs and payments for content and server maintenance, all related to its product revenues and communicating with its users. The direct cost relating to search and advertising revenues is immaterial.

k. Research and development costs:

Research and development costs incurred in the process of software production before establishment of technological feasibility, are charged to expenses as incurred. Costs of the production of a product master incurred subsequent to the establishment of technological feasibility are capitalized according to the principles set forth in ASC 985-20, "Software - Costs of Software to Be Sold, Leased, or Marketed". Based on the Company's product development process, technological feasibility is established upon completion of the detailed program design ("DPD") (the DPD of a computer software product that takes product function, feature, and technical requirements to their most detailed, logical form and is ready for coding).

Costs incurred by the Company between completion of the DPD and the point at which the product is ready for general release, are capitalized unless considered immaterial.

Capitalized software development costs are amortized commencing with general product release by the straight-line method over the estimated useful life of the software product.

l. Income taxes:

The Company accounts for income taxes in accordance with ASC 740, "Income Taxes". This Statement prescribes the use of the liability method whereby deferred tax assets and liability account balances are determined based on differences between financial reporting and tax bases of assets and liabilities and are measured using the enacted tax rates and laws that will be in effect when the differences are expected to reverse. The Company provides a valuation allowance, if necessary, to reduce deferred tax assets to their estimated realizable value.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The Company accounts for uncertain tax positions in accordance with ASC 740, which contains a two-step approach for recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that, on an evaluation of the technical merits, the tax position will be sustained on audit, including resolution of any related appeals or litigation processes. The second step is to measure the tax benefit as the largest amount that is more than 50% likely to be realized upon ultimate settlement. In the years ended December 31, 2009 and 2010 the Company accrued interest and penalties related to unrecognized tax benefits in its tax expenses. During 2009 and 2010 interest expense amounted to \$ 201 and \$ 140, respectively. Starting 2011, the Company changed the classification of interest from tax expenses to financial expenses as it distorts its tax expense. Interest for 2011 amounted to income of \$ 988. As the amount included in tax expense for interest during 2009 and 2010 was immaterial, the Company did not reclassify such amounts to conform to current year's presentation.

m. Advertising costs:

Advertising costs are expensed as incurred and consist primarily of customer acquisition cost. Advertising costs for each of the three years in the period ended December 31, 2011 amounted to \$ 1,938, \$ 1,782 and \$ 8,136, respectively.

n. Concentrations of credit risk:

Financial instruments that potentially subject the Company to concentrations of credit risk consist principally of cash and cash equivalents and trade receivables.

The majority of the Company's cash and cash equivalents are invested mainly in dollar instruments with major banks in Israel and the U.S. deposits in the U.S. may be in excess of insured limits and are not insured in other jurisdictions. Generally, these deposits may be redeemed upon demand and, therefore, bear minimal risk.

The Company is subject to a low amount of credit risk with respect to sales of the Company's software products and content database, as these sales are primarily obtained through credit card sales. The Company's major customer is financially sound, and the Company believes low credit risk is associated with this customer. To date, the Company has not experienced any material bad debt losses.

The Company entered into option strategies intended to protect against the increase in value of forecasted non-dollar currency cash flows. The derivative instruments hedge a portion of the Company's non-dollar currency exposure



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

o. Severance pay:

The Company's liability for severance pay is calculated pursuant to Israel's Severance Pay Law based on its employees' most recent monthly salaries, multiplied by the number of years of their employment, or a portion thereof, as of the balance sheet date.

This liability is fully provided for by monthly deposits in insurance policies and by an accrual.

The deposited funds include profits (losses) accumulated up to the balance sheet date. The deposited funds may be withdrawn only upon the fulfillment of the obligation pursuant to Israel's Severance Pay Law or labor agreements.

The Company's agreements with employees in Israel, joining the Company since February 2, 2008, are in accordance with section 14 of the Severance Pay Law, 1963, where the Company's contributions for severance pay shall be instead of its severance liability. Upon contribution of the full amount of the employee's monthly salary, and release of the policy to the employee, no additional calculations shall be conducted between the parties regarding the matter of severance pay and no additional payments shall be made by the Company to the employee. Further, the related obligation and amounts deposited on behalf of such obligation are not stated on the balance sheet, as they are legally released from obligation to employees once the deposit amounts have been paid.

Severance expenses for the years ended December 31, 2009, 2010 and 2011 amounted to \$ 362, \$ 786 and \$ 586, respectively.

p. Net earnings per Ordinary share:

Basic net earnings per Ordinary shares are computed based on the weighted average number of Ordinary shares outstanding during each year. Diluted net earnings per Ordinary share are computed based on the weighted average number of Ordinary shares outstanding during each year, plus dilutive potential Ordinary shares considered outstanding during the year, in accordance with ASC 260, "Earnings Per Share".

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

The total weighted average number of Ordinary shares related to the outstanding options excluded from the calculations of diluted net earnings per Ordinary share because these securities are anti-dilutive was 789,411, 922,069 and 1,266,919 for the years ended December 31, 2009, 2010 and 2011, respectively.

q. Accounting for stock-based compensation:

The Company accounts for stock-based compensation under ASC 718, "Compensation - Stock Compensation", which requires the measurement and recognition of compensation expense based on estimated fair values for all share-based payment awards made to employees and directors.

ASC 718 requires companies to estimate the fair value of equity-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as an expense over the requisite service periods in the Company's consolidated statement of income.

The Company recognizes compensation expenses for the value of its awards, which have graded vesting based on service conditions, using the straight line method, over the requisite service period of each of the awards, net of estimated forfeitures. For awards containing multiple service and market conditions, all the conditions must be satisfied in order for the award to vest, the Company recognizes compensation expenses over the longest derived service period, based on the accelerated attribution method, net of estimated forfeitures. Estimated forfeitures are based on actual historical pre-vesting forfeitures.

The Company estimates the fair value of standard stock options granted using the Binomial option-pricing model and options with exercise that is subject to a stock price target, using the Monte Carlo simulations. The option-pricing models require a number of assumptions, of which the most significant are; expected stock price, volatility and the expected option term. In 2009 and 2010, expected volatility was calculated based upon an average between historical volatilities of the Company, similar entities and industry sector index similar to the Company's characteristics, since it did not have sufficient company specific data. In 2011, expected volatility was calculated based upon actual historical stock price movements. The expected option term was calculated based on the Company's assumptions of early exercise multiples which were calculated based on comparable companies and termination exit rate which was calculated based on actual historical data. The expected option term represents the period that the Company's stock options are expected to be outstanding. The risk-free interest rate is based on the yield from U.S. Treasury zero-coupon bonds with an equivalent term.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)**

In November 2010 the Company's Board decided to change its dividend policy so that beginning with earnings of 2011 and beyond, the Company does not intend to distribute any dividends to the holders of its Ordinary shares, as result the Company has no foreseeable plans to pay dividends.

The fair value of the Company's stock options granted to employees and directors was estimated using the following weighted average assumptions:

|                                 | <b>Year ended December 31,</b> |               |               |
|---------------------------------|--------------------------------|---------------|---------------|
|                                 | <b>2009</b>                    | <b>2010</b>   | <b>2011</b>   |
| Risk free interest rate         | 2.73%                          | 1.62%         | 2.23%         |
| Dividend yield                  | 0%-13.82%                      | 0%-7.83%      | 0%            |
| Weighted average dividend yield | 13.01%                         | 5.65%         | 0%            |
| Expected volatility             | 55.41%-74.67%                  | 62.77%-64.56% | 47.31%-65.27% |
| Weighted average volatility     | 65.04%                         | 63.67%        | 56.29%        |
| Expected term (years)           | 3.915                          | 4.6           | 3.75          |

r. Derivative instruments:

The Company uses derivative instruments to protect against foreign currency fluctuations. These instruments were not designated as cash flow hedge as defined by ASC 815, "Derivative and Hedging" and, therefore, the Company recognized the changes in fair value of these instruments in the statement of income as financial income or expense, as incurred.

s. Fair value of financial instruments:

The carrying amounts of financial instruments carried at cost, including cash and cash equivalents, trade receivables, other receivables, trade payables and other liabilities approximate their fair value due to the short-term maturities of such instruments.

The Company follows the provisions of ASC 820, "Fair Value Measurements and Disclosures". Under this standard, fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (i.e., the "exit price") in an orderly transaction between market participants at the measurement date.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In determining fair value, the Company uses various valuation approaches. ASC 820 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that the most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the observability of inputs as follows:

- Level 1 - Valuations based on quoted prices in active markets for identical assets that the Company has the ability to access.
- Level 2 - Valuations based on one or more quoted prices in markets that are not active or for which all significant inputs are observable, either directly or indirectly.
- Level 3 - Valuations based on inputs that are unobservable and significant to the overall fair value measurement.

The availability of observable inputs can vary from investment to investment and is affected by a wide variety of factors including, for example, the type of investment, the liquidity of markets and other characteristics particular to the transaction. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment, and is categorized as Level 3.

The Company's marketable securities are traded in markets that are not considered active, but are valued based on quoted market prices, broker or dealer quotations and, therefore, are categorized as Level 2.

The Company's assets (liabilities) measured at fair value on a recurring basis as of December 31, 2011, included money market funds and treasury notes in the total amount of \$ 40 presented as part of cash and cash equivalents and derivative financial instruments, in the amount of \$ (44) presented as part of accrued expenses and other liabilities, all measured using input type Level 2. The Company's assets measured at fair value on a recurring basis as of December 31, 2010, included money market funds and treasury notes in the total amount of \$ 9,094 presented as part of cash and cash equivalents, marketable securities in the amount of \$ 14,973 and derivative financial instruments, in the amount of \$ 27 presented in other receivables and prepaid expenses, all measured using input type Level 2.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

t. Treasury shares:

The Company repurchases its Ordinary shares from time to time on the open market and holds such shares as treasury shares. The Company presents the cost to repurchase treasury shares as a reduction of shareholders' equity.

u. Comprehensive income:

The Company accounts for comprehensive income in accordance with ASC 220, "Comprehensive Income". This statement establishes standards for the reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Comprehensive income generally represents all changes in shareholders' equity during the period except those resulting from investments by, or distributions to, shareholders. The Company determined that its items of other comprehensive income relates to unrealized gains and losses on available for sale securities.

v. Business combinations:

The Company accounts for business combination in accordance with ASC 805, "Business Combinations". The underlying principles require that the Company recognize separately from goodwill the assets acquired and the liabilities assumed, generally at their acquisition date fair values. Goodwill as of the acquisition date is measured as the excess of consideration transferred and the net of the acquisition date fair values of the assets acquired and the liabilities assumed. While the Company uses its best estimates and assumptions as a part of the purchase price allocation process to accurately value assets acquired and liabilities assumed at the acquisition date, the Company's estimates are inherently uncertain and subject to refinement. As a result, during the measurement period, which may be up to one year from the acquisition date, the Company may record adjustments to the assets acquired and liabilities assumed with the corresponding offset to goodwill. Upon the conclusion of the measurement period or final determination of the values of assets acquired or liabilities assumed, whichever comes first, any subsequent adjustments are recorded in the consolidated statement of income. The direct transaction costs associated with the business combination are expensed as incurred.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 3:- SIGNIFICANT ACCOUNTING POLICIES (Cont.)

In addition, uncertain tax positions and tax related valuation allowances assumed in connection with a business combination are initially estimated as of the acquisition date. The Company reevaluates these items quarterly with any adjustments to preliminary estimates being recorded to goodwill provided that they are within the measurement period. Subsequent to the measurement period or final determination of the tax allowance's or contingency's estimated value, whichever comes first, changes to these uncertain tax positions and tax related valuation allowances will affect provision for income taxes in the consolidated statement of income.

w. Impact of recently issued Accounting Standards:

In May 2011, the Financial Accounting Standards Board issued guidance that changed the requirement for presenting "Comprehensive Income" in the consolidated financial statements. The update requires an entity to present the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. The currently available option to disclose the components of other comprehensive income within the statement of shareholders' equity will no longer be available. The update is effective for fiscal years, and interim periods within those years, beginning after December 15, 2011 and should be applied retrospectively. The adoption of the standard will have no impact on the financial position or results of operations, but will result in a change in the presentation of the basic consolidated financial statements. The Company is still evaluating whether to present other comprehensive income in a single continuous statement of comprehensive income or in two separate but consecutive statements.

In September 2011, the FASB amended the guidance on the annual testing of goodwill for impairment. The amended guidance will allow companies to assess qualitative factors to determine if it is more likely than not that goodwill might be impaired and whether it is necessary to perform the two-step goodwill impairment test required under current accounting standards. The guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, with early adoption permitted. The adoption of this guidance is not expected to have a material impact on the Company's consolidated financial statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**U.S. dollars in thousands (except share and per share data)**

**NOTE 4:- MARKETABLE SECURITIES**

The Company's marketable securities are classified as available-for-sale securities and are carried at fair value. The following table summarizes amortized costs, gross unrealized holding gains and losses and market value of marketable securities as of December 31, 2010:

|                                   | <u>Amortized<br/>cost</u> | <u>Gross<br/>unrealized<br/>gains</u> | <u>Gross<br/>unrealized<br/>losses</u> | <u>Fair<br/>value</u> |
|-----------------------------------|---------------------------|---------------------------------------|--|-----------------------|
| Corporate debentures              | \$ 6,805                  | \$ 116                                | \$ 9                                   | \$ 6,912              |
| U.S. Government agency debentures | 7,405                     | 10                                    | 13                                     | 7,402                 |
| Government debentures             | 218                       | 20                                    | -                                      | 238                   |
| U.S. municipal bonds              | 419                       | 2                                     | -                                      | 421                   |
|                                   | <u>\$ 14,847</u>          | <u>\$ 148</u>                         | <u>\$ 22</u>                           | <u>\$ 14,973</u>      |

**NOTE 5:- OTHER RECEIVABLES AND PREPAID EXPENSES**

|                         | <u>December 31,</u> |                 |
|-------------------------|---------------------|-----------------|
|                         | <u>2010</u>         | <u>2011</u>     |
| Government authorities  | \$ 3,773            | \$ 5,555        |
| Prepaid expenses        | 228                 | 471             |
| Current severance fund  | 243                 | -               |
| Deferred tax asset, net | -                   | 246             |
| Other                   | 241                 | 175             |
|                         | <u>\$ 4,485</u>     | <u>\$ 6,447</u> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 6:- PROPERTY AND EQUIPMENT, NET**

|                                    | <b>December 31,</b> |                 |
|------------------------------------|---------------------|-----------------|
|                                    | <b>2010</b>         | <b>2011</b>     |
| Cost:                              |                     |                 |
| Computers and peripheral equipment | \$ 3,570            | \$ 3,861        |
| Office furniture and equipment     | 400                 | 533             |
| Leasehold improvements             | 533                 | 606             |
|                                    | <u>4,503</u>        | <u>5,000</u>    |
| Accumulated depreciation           | <u>3,122</u>        | <u>3,700</u>    |
| Property and equipment, net        | <u>\$ 1,381</u>     | <u>\$ 1,300</u> |

Depreciation expenses totaled \$ 625, \$ 627 and \$ 588 for the years ended December 31, 2009, 2010 and 2011, respectively.

During 2011, the Company recorded a reduction of \$ 10 to the cost and accumulated depreciation of fully depreciated equipment no longer in use.

**NOTE 7:- GOODWILL AND OTHER INTANGIBLE ASSETS, NET**

a. Goodwill:

Changes in goodwill as of December 31, 2011 are as follows:

|                             | <b>December<br/>31,<br/>2011</b> |
|-----------------------------|----------------------------------|
| Goodwill, beginning of year | \$ -                             |
| Acquisition of Smilebox     | <u>24,753</u>                    |
| Goodwill, end of year       | <u>\$ 24,753</u>                 |



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE GOODWILL AND OTHER INTANGIBLE ASSETS, NET (Cont.)  
7:-

- b. Other intangible assets, net

Net other intangible assets consisted of the following:

|  | Useful<br>life | December 31,  |                 |
|--|----------------|---------------|-----------------|
|  |                | 2010          | 2011            |
| Original amount:                       |                |               |                 |
| Capitalized software development costs | 3              | \$ -          | \$ 739          |
| Capitalized content costs              | 3              | 413           | 503             |
| Domain                                 | 3              | 35            | 52              |
| Technology                             | 3              | -             | 3,000           |
| Trade name                             | 10.25          | -             | 1,870           |
| Customer relationship                  | 4.3-6.3        | -             | 1,488           |
|  |                | <u>448</u>    | <u>7,652</u>    |
| Accumulated amortization:              |                |               |                 |
| Capitalized software development costs |                | -             | 22              |
| Capitalized content costs              |                | 215           | 329             |
| Domain                                 |                | 31            | 39              |
| Technology                             |                | -             | 333             |
| Trade name                             |                | -             | 61              |
| Customer relationship                  |                | -             | 262             |
|  |                | <u>246</u>    | <u>1,046</u>    |
| Other intangible assets, net:          |                |               |                 |
| Capitalized software development costs |                | -             | 717             |
| Capitalized content costs              |                | 198           | 174             |
| Domain                                 |                | 4             | 13              |
| Technology                             |                | -             | 2,667           |
| Trade name                             |                | -             | 1,809           |
| Customer relationship                  |                | -             | 1,226           |
|  |                | <u>\$ 202</u> | <u>\$ 6,606</u> |

- c. Amortization expense amounted to \$ 90, \$ 112 and \$ 800 for the years ended December 31, 2009, 2010 and 2011, respectively.
- d. The estimated future amortization expense of other intangible assets as of December 31, 2011 is as follows:

|            |                 |
|------------|-----------------|
| 2012       | \$ 2,155        |
| 2013       | 1,809           |
| 2014       | 1,244           |
| 2015       | 303             |
| Thereafter | <u>1,095</u>    |
|            | <u>\$ 6,606</u> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 8:- ACCRUED EXPENSES AND OTHER LIABILITIES**

|                                  | <b>December 31,</b> |                 |
|----------------------------------|---------------------|-----------------|
|                                  | <b>2010</b>         | <b>2011</b>     |
| Employees and payroll accruals   | \$ 1,827            | \$ 1,556        |
| Current severance pay            | 287                 | -               |
| Government authorities           | 1,135               | 1,429           |
| Uncertain tax position liability | 1,388               | 2,151           |
| Deferred tax liabilities, net    | 996                 | -               |
| Accrued expenses and other       | 573                 | 1,814           |
|                                  | <u>\$ 6,206</u>     | <u>\$ 6,950</u> |

**NOTE 9:- COMMITMENTS AND CONTINGENT LIABILITIES**

The facilities of the Company are rented under operating lease agreements that expire in 2015. The Company leases its motor vehicles under cancelable operating lease agreements.

Aggregate minimum lease commitments under operating leases as of December 31, 2011, were as follows:

|      |                 |
|------|-----------------|
| 2012 | \$ 760          |
| 2013 | 735             |
| 2014 | 735             |
| 2015 | 422             |
|      | <u>\$ 2,652</u> |

Total rent expenses for the years ended December 31, 2009, 2010 and 2011 amounted to \$ 448, \$ 503 and \$ 586, respectively.

Total lease expenses for the years ended December 31, 2009, 2010 and 2011 amounted to \$ 382, \$ 395 and \$ 349, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 10:- INCOME TAXES

- a. Tax benefits under the Israel Law for the Encouragement of Capital Investments, 1959 (the "Law");

Various industrial programs of the Company have been granted "Approved Enterprise" and "Beneficiary Enterprise" status, which provides certain benefits, including tax exemptions and reduced tax rates. Income not eligible for Approved Enterprise and Beneficiary Enterprise benefits is taxed at a regular rate.

In the event of distribution of dividends from the said tax-exempt income, the amount distributed will be subject to corporate tax at the rate ordinarily applicable to the Approved Enterprise's income. The tax-exempt income attributable to the "Approved Enterprise" programs mentioned above can be distributed to shareholders without subjecting the Company to taxes only upon the complete liquidation of the Company. Tax-exempt income generated under the Company's Beneficiary Enterprise program will be subject to taxes upon dividend distribution or complete liquidation. The entitlement to the above benefits is conditional upon the Company's fulfilling the conditions stipulated by the Law and regulations published thereunder. Should the Company fail to meet such requirements in the future, income attributable to its Approved Enterprise and Beneficiary Enterprise programs could be subject to the statutory Israeli corporate tax rate and the Company could be required to refund a portion of the tax benefits already received, with respect to such programs. As of December 31, 2011, management believes that the Company is in compliance with all the conditions required by the Law.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 10:- INCOME TAXES (Cont.)

In November 2010 the Company's Board decided to change its dividend policy so that beginning with earnings of 2011 and beyond, the Company does not intend to distribute any dividends to the holders of its Ordinary shares. As of December 31, 2011, tax exempt income incurred up to December 31, 2010 that was not distributed was approximately \$ 8,900. Should this amount be distributed, it would be taxed at the reduced corporate tax rate applicable to such profits (currently 25%), and income tax liability of up to approximately \$ 2,225 would be incurred as of December 31, 2011.

The Knesset enacted a reform to the Investment Law, effective January 2011. According to the reform a flat tax rate will apply to companies eligible for the "Preferred Enterprise" status. In order to be eligible for Preferred Enterprise status, a company must meet minimum requirements to establish that it contributes to the country's economic growth and is a competitive factor for the Gross Domestic Product (a competitive enterprise). Israeli companies which currently benefit from an Approved or Beneficiary Enterprise status and meet the criteria for qualification as a Preferred Enterprise can elect to apply the new Preferred Enterprise benefits by waiving their benefits under the Approved and Beneficiary Enterprise status.

Commencing 2011, the Company elected to apply the new Preferred Enterprise benefits. Benefits granted to a Preferred Enterprise include reduced and gradually decreasing tax rates. The tax rate is 15% in 2011 and 2012, 12.5% in 2013 and 2014 and 12% starting from 2015.

A distribution from a Preferred Enterprise out of the "Preferred Income" would be subject to 15% withholding tax for Israeli-resident individuals and non-Israeli residents (subject to applicable treaty rates). A distribution from a Preferred Enterprise out of the "Preferred Income" would be exempt from withholding tax for an Israeli-resident company.

b. Corporate tax rates in Israel:

The regular corporate tax rate in Israel in 2009, 2010 and 2011 is 26%, 25% and 24%, respectively. In December 5, 2011 the Knesset passed a law for changing the tax burden, which cancels, among others, the gradual reduction in the rates of the Israeli corporate tax. In addition, the Israeli corporate tax will be increased to 25% starting from 2012. The real capital gains tax was also increased to 25%, accordingly.

c. Income taxes of non-Israeli subsidiaries:

Non-Israeli subsidiaries are taxed according to the tax laws in their respective countries of residence.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 10:- INCOME TAXES (Cont.)

d. Tax reports filed by the Company in Israel through the year ended December 31, 2008 are considered final. The U.S tax returns of the U.S subsidiaries Smilebox and Incredimail Inc. remain subject to examination by the U.S tax authorities for the tax years beginning on December 31, 2007 and December 31, 2008, respectively.

e. Tax loss carry-forwards:

Net operating loss carry-forwards as of December 31, 2011 are as follows:

|                  |                  |
|------------------|------------------|
| United States *) | <u>\$ 17,053</u> |
|------------------|------------------|

Net operating losses in the U.S. may be carried forward through periods which will expire in the years starting from 2026 up to 2031.

\*) Utilization of U.S. net operating losses may be subject to substantial annual limitation due to the "change in ownership" provisions of the Internal Revenue Code of 1986 and similar state provisions. The annual limitation may result in the expiration of net operating losses before utilization.

f. Deferred tax assets, net:

Deferred taxes reflect the net tax effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 10:- INCOME TAXES (Cont.)**

Components of the Company's deferred tax assets (liabilities) are as follows:

|   | <b>December 31,</b> |             |
|---|---------------------|-------------|
|   | <b>2010</b>         | <b>2011</b> |
| Deferred tax assets:                                  |                     |             |
| Employee benefits                                     | \$ 214              | \$ 106      |
| Net operating loss carry forwards                     | -                   | 6,821       |
| Losses on marketable securities                       | 119                 | -           |
| Other   | 197                 | 225         |
| Deferred tax assets, before valuation allowance       | 530                 | 7,152       |
| Valuation allowance                                   | (93)                | (4,113)     |
| Total deferred tax assets, net of valuation allowance | 437                 | 3,039       |
| Deferred tax liabilities:                             |                     |             |
| Intangible assets                                     | \$ -                | \$ (2,281)  |
| Deferred revenues                                     | -                   | (427)       |
| Exempt income *)                                      | (1,305)             | -           |
| Capitalized software development costs                | -                   | (85)        |
| Unrealized gain on marketable securities              | (26)                | -           |
| Total deferred tax liabilities                        | (1,331)             | (2,793)     |
| Deferred tax asset (liability), net                   | \$ (894)            | \$ 246      |
| Domestic:   |                     |             |
| Current deferred tax asset, net                       | -                   | 246         |
| Current deferred tax liability, net                   | (996)               | -           |
| Non-current deferred tax asset, net                   | 102                 | -           |
|   | \$ (894)            | \$ 246      |

\*) Deferred tax liability recorded in 2010 on the exempt income that the Company did not have the intention to permanently re-invest.

Current deferred tax assets, net, is included within other receivables and prepaid expenses in the balance sheets. Current deferred tax liability, net, is included within accrued expenses and other liabilities in the balance sheets. Non-current deferred tax asset, net is included within other assets on the balance sheets.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 10:- INCOME TAXES (Cont.)**

g. A reconciliation of the Company's effective tax rate to the statutory tax rate in Israel is as follows:

|  | <b>Year ended December 31,</b> |             |             |
|--|--------------------------------|-------------|-------------|
|  | <b>2009</b>                    | <b>2010</b> | <b>2011</b> |
| Income before taxes on income  | \$ 11,558                      | \$ 11,621   | \$ 5,840    |
| Statutory tax rate in Israel   | 26%                            | 25%         | 24%         |
| Theoretical income tax expense   | \$ 3,005                       | \$ 2,905    | \$ 1,402    |
| Increase (decrease) in tax expenses resulting from:  |                                |             |             |
| "Approved Enterprise" benefits   | (4)                            | -           | (1,751)     |
| Non-deductible expenses  | 232                            | 230         | 78          |
| Previous years taxes   | 185                            | -           | (156)       |
| Losses and timing differences for which no deferred taxes were recorded                            | -                              | -           | 994         |
| Tax adjustment in respect of different tax rate  | -                              | -           | (400)       |
| Losses (gains) from marketable securities and ARSs for which valuation allowance has been provided | 22                             | -           | -           |
| Other  | 105                            | 97          | 5           |
| Taxes on income  | \$ 3,545                       | \$ 3,232    | 172         |
| Benefit per Ordinary share, resulting from "Approved Enterprise" status:                           |                                |             |             |
| Basic  | \$ -                           | \$ -        | \$ 0.18     |
| Diluted  | \$ -                           | \$ -        | \$ 0.18     |

h. Income taxes are comprised as follows:

|                                | <b>Year ended December 31,</b> |             |             |
|--------------------------------|--------------------------------|-------------|-------------|
|                                | <b>2009</b>                    | <b>2010</b> | <b>2011</b> |
| Deferred tax (benefit) expense | \$ 1,515                       | \$ (385)    | \$ (1,140)  |
| Current taxes                  | 1,845                          | 3,617       | 1,468       |
| Previous years taxes           | 185                            | -           | (156)       |
|                                | \$ 3,545                       | \$ 3,232    | \$ 172      |

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

U.S. dollars in thousands (except share and per share data)

NOTE 10:- INCOME TAXES (Cont.)

- i. Uncertain tax position:

A reconciliation of the beginning and ending balances of unrecognized tax benefits is as follows:

|   | <u>December 31,</u> |                 |
|---|---------------------|-----------------|
|   | <u>2010</u>         | <u>2011</u>     |
| Balance at January 1                        | \$ 1,341            | \$ 1,388        |
| Additions for prior year tax positions      | -                   | 505             |
| Additions in tax positions for current year | <u>47</u>           | <u>258</u>      |
| Balance at December 31                      | <u>\$ 1,388</u>     | <u>\$ 2,151</u> |

- j. Income (loss) before taxes on income is comprised as follows:

|                 | <u>Year ended December 31,</u> |                  |                 |
|-----------------|--------------------------------|------------------|-----------------|
|                 | <u>2009</u>                    | <u>2010</u>      | <u>2011</u>     |
| Domestic        | \$ 11,532                      | \$ 11,553        | \$ 8,325        |
| Foreign - U.S.A | <u>26</u>                      | <u>68</u>        | <u>(2,485)</u>  |
|                 | <u>\$ 11,558</u>               | <u>\$ 11,621</u> | <u>\$ 5,840</u> |



NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

NOTE 11:- SHAREHOLDERS' EQUITY

a. Ordinary share:

The Ordinary shares entitle their holders to voting rights, the right to receive cash dividend and the right to a share in excess assets upon liquidation of the Company. In January 6, 2011 the shareholders resolved to increase the authorized share capital of the Company to 40,000,000 Ordinary shares with a nominal value of NIS 0.01 each.

b. Treasury shares:

In July 2008, the Company's Board of Directors authorized the repurchase of up to \$ 3,750 in the open market, subject to normal trading restrictions. During 2009, the Company purchased 45,455 of its Ordinary shares for total consideration of \$ 120, which were recorded as Treasury stock, at cost as part of shareholders' equity.

c. Share option plans:

In 2003, the Company adopted a share option plan ("the 2003 Option Plan"). Under the 2003 Option Plan, employees, officers and non-employees may be granted options to acquire Ordinary shares. Pursuant to the 2003 Option Plan, the Company has reserved for issuance a total of 3,368,000 Ordinary shares. As of December 31, 2011, 645,331 options were still available for future grant under the 2003 Option Plan.

Options granted under the 2003 Plan vested over three to four years from the grant date. The options expire no later than five years from the date of grant.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 11:- SHAREHOLDERS' EQUITY (Cont.)**

A summary of the activity in the share options granted to employees and directors for the year ended December 31, 2011 and related information is as follows:

|                                       | <u>Number of<br/>options</u> | <u>Weighted<br/>average<br/>exercise price</u> | <u>Weighted<br/>average<br/>remaining<br/>contractual<br/>Term (in<br/>Years)</u> | <u>Aggregate<br/>intrinsic<br/>value</u> |
|---------------------------------------|------------------------------|--|---|--|
| Outstanding at January 1, 2011        | 1,608,946                    | \$ 5.43  | 3.24  | \$ 3,858                                 |
| Granted                               | 700,000                      | 7.19   |   |  |
| Exercised *)                          | (167,825)                    | 3.46   |   |  |
| Cancelled                             | (134,050)                    | 7.16   |   |  |
| Forfeited                             | (230,999)                    | 7.76   |   |  |
| Outstanding at December 31, 2011 **)  | <u>1,776,072</u>             | <u>\$ 5.87</u>                                 | <u>3.39</u>   | <u>\$ 113</u>                            |
| Exercisable at December 31, 2011 ***) | <u>445,072</u>               | <u>\$ 5.14</u>                                 | <u>2.04</u>   | <u>\$ 113</u>                            |

\*) During 2011, 10,000 share options were exercised in consideration for cash received in an amount of \$ 30, the remaining 157,825 were exercise under net-share settlement.

\*\*) Represents intrinsic value of 149,403 outstanding options that are in-the-money as of December 31, 2011. The remaining 1,626,669 outstanding options are out of the money as of December 31, 2011, and their intrinsic value was considered as zero.

\*\*\*) Represents intrinsic value of 149,403 outstanding options that are in-the-money as of December 31, 2011. The remaining 295,669 outstanding options are out of the money as of December 31, 2011, and their intrinsic value was considered as zero.

The weighted-average grant-date fair value of options granted during the years 2009, 2010 and 2011 was \$ 1.68, \$ 1.23 and \$ 2.29, respectively.

As of December 31, 2011, the total compensation cost related to options granted to employees, not yet recognized, amounted to \$ 1,456. The cost is expected to be recognized over a weighted average period of 2.01 years.

Aggregate intrinsic value of options exercised in 2009, 2010 and 2011 amounted to \$ 281, \$ 713 and \$ 580, respectively.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 12:- SUPPLEMENTARY DATA ON SELECTED CONSOLIDATED STATEMENTS OF INCOME ITEMS**

a. Financial income, net:

|  | <b>Year ended December 31,</b> |               |                 |
|--|--------------------------------|---------------|-----------------|
|  | <b>2009</b>                    | <b>2010</b>   | <b>2011</b>     |
| <b>Financial income:</b>                               |                                |               |                 |
| Interest from bank deposits and marketable securities  | \$ 360                         | \$ 449        | \$ 304          |
| Gains from marketable securities, net                  | -                              | -             | 71              |
| Exchange rate differences , net                        | 12                             | -             | 102             |
| Interest from government authorities, net              | -                              | -             | 988             |
| Other  | 9                              | -             | -               |
|  | <u>381</u>                     | <u>449</u>    | <u>1,465</u>    |
| <b>Financial expenses:</b>                             |                                |               |                 |
| Losses from marketable securities, net                 | 237                            | 38            | -               |
| Exchange rate differences , net                        | -                              | 45            | -               |
| Accretion of payment obligation related to acquisition | -                              | -             | 100             |
| Other  | 72                             | 44            | 72              |
|  | <u>309</u>                     | <u>127</u>    | <u>172</u>      |
|  | <u>\$ 72</u>                   | <u>\$ 322</u> | <u>\$ 1,293</u> |

b. Research and development costs, net:

|  | <b>Year ended December 31,</b> |                 |                 |
|--|--------------------------------|-----------------|-----------------|
|  | <b>2009</b>                    | <b>2010</b>     | <b>2011</b>     |
| <b>Total costs</b>                     | \$ 6,254                       | \$ 6,607        | \$ 8,192        |
| Capitalized software development costs | -                              | -               | (739)           |
|  | <u>\$ 6,254</u>                | <u>\$ 6,607</u> | <u>\$ 7,453</u> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

U.S. dollars in thousands (except share and per share data)

**NOTE 12:- SUPPLEMENTARY DATA ON SELECTED CONSOLIDATED STATEMENTS OF INCOME ITEMS (Cont.)**

c. Net earnings per Ordinary share:

Computation of basic and diluted net earnings per share is as follows:

1. Numerator:

|   | <b>Year ended December 31,</b> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <b>2009</b>                    | <b>2010</b> | <b>2011</b> |
| Net income available to Ordinary shareholders | \$ 8,013                       | \$ 8,389    | \$ 5,668    |

2. Denominator:

|   | <b>Year ended December 31,</b> |             |             |
|---|--------------------------------|-------------|-------------|
|   | <b>2009</b>                    | <b>2010</b> | <b>2011</b> |
| Denominator for basic net earnings per share -                                    |                                |             |             |
| Weighted average number of Ordinary shares, net of treasury stock                 | 9,347,915                      | 9,622,181   | 9,796,380   |
| Effect of dilutive securities:  |                                |             |             |
| Add - stock options   | 214,806                        | 209,447     | 205,791     |
| Denominator for diluted net earnings per share - adjusted weighted average shares | 9,562,721                      | 9,831,628   | 10,002,171  |

**NOTE 13:- DERIVATIVE FINANCIAL INSTRUMENTS**

In order to reduce the impact of changes in foreign currency exchange rates on its results, the Company enters into foreign currency exchange forward contracts and options contracts to purchase and sell foreign currencies to hedge a portion of its foreign currency net exposure resulting from payroll expenses denominated in NIS.

The foreign currency exchange forward contracts and options contracts are not designated as hedging instruments under hedge accounting. These instruments are generally short term in nature, with typical maturities of less than one year, and are subject to fluctuations in foreign exchange rates. Gains or losses on these derivatives, which partially offset the foreign currency impact from the underlying exposures were classified into financial income (expenses), net and amounted to \$ (25), \$ 69, and \$ (2) for the years ended December 31, 2009, 2010 and 2011, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

---

U.S. dollars in thousands (except share and per share data)

**NOTE 13:- DERIVATIVE FINANCIAL INSTRUMENTS (Cont.)**

The Company measured the fair value of the contracts in accordance with ASC No. 820 at level 2.

The Company's derivatives expose it to credit risks from possible non-performance by counterparties. The maximum amount of loss due to credit risk that the Company would incur if counterparties to the derivative financial instruments failed completely to perform according to the terms of the contracts, based on the gross fair value of the Company's derivative contracts that are favorable to the Company, was approximately \$ 44 presented as part of accrued expenses and other liabilities, as of December 31, 2011. The Company has limited its credit risk by entering into derivative transactions exclusively with investment-grade rated financial institutions and monitors the creditworthiness of these financial institutions on an ongoing basis.

The notional amounts of the Company's derivative instruments as of December 31, 2010 and 2011 amounted to \$ 1,950 and \$ 4,300, respectively. Notional values are U.S. dollar translated and calculated based on forward rates for forward contracts and based on spot rates for options. Gross notional amounts do not quantify risk or represent assets or liabilities of the Company, but are used in the calculation of settlements under the contracts.

**SIGNATURES**

The registrant hereby certifies that it meets all of the requirements for filing on Form 20-F and that it has duly caused and authorized the undersigned to sign this annual report on its behalf.

Perion Network Ltd.

By: /s/ Josef Mandelbaum

Josef Mandelbaum  
Chief Executive Officer

Date: March 22, 2012

## EXHIBIT INDEX

| <u>No.</u> | <u>Description</u>   |
|------------|--|
| 1.1        | Memorandum of Association of Registrant (1)  |
| 1.2        | Certificate of Change of Name of Registrant (translated from Hebrew)   |
| 1.3        | Amended and Restated Articles of Association of Registrant, dated February 3, 2006 (2)   |
| 4.3        | The Registrant's 2003 Israeli Share Option Plan and the form of Option Agreement (1) and the US Addendum to such plan (4)  |
| 4.4        | Google Services Agreement, dated December 27, 2010(3)  |
| 4.5        | Stock Purchase Agreement among Ofer Adler, the Company and the purchasers listed therein, dated January 24, 2011. (5)  |
| 4.6        | Registration Rights Agreement among the Company and the investors listed therein, dated January 24, 2011. (5)  |
| 4.7        | Commitment Letter and Financial Covenants Letter among the Company and Bank Leumi Le-Israel, B.M., dated September 6 <sup>th</sup> 2011;   |
| 4.8        | Commitment Letter and Financial Covenants Letter among the Company and the First International Bank of Israel, B.M., dated September 6 <sup>th</sup> 2011; (translated from Hebrew)  |
| 4.9        | Agreement and Plan of Merger, dated July 31, 2011, by and among the Company, Incredimail Inc., Seder Merger Inc., Smilebox, Inc. and Andrew Wright and Shareholder Representative Services LLC, as the Shareholder Representative dated as of July 31, 2011. * |
| 8          | List of all subsidiaries   |
| 12.1       | Certification required by Rule 13a-14(a) or Rule 15d-14(a) executed by the Chief Executive Officer of the Company  |
| 12.2       | Certification required by Rule 13a-14(a) or Rule 15d-14(a) executed by the Chief Financial Officer of the Company  |
| 13.1       | Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code  |
| 13.2       | Certification required by Rule 13a-14(b) or Rule 15d-14(b) and Section 1350 of Chapter 63 of Title 18 of the United States Code  |
| 14         | Consent of Kost Forer Gabbay & Kasierer, a member of Ernst & Young Global, Independent Auditors  |

---

(1) Previously filed with the SEC on October 25, 2005 as an exhibit to our registration statement on Form F-1/A (File No. 333-129246).

(2) Previously filed with the SEC on January 5, 2006 as an exhibit to our registration statement on Form F-1/A (File No. 333-129246).

(3) Previously filed with the SEC on March 8, 2011 as an exhibit to our annual report on Form 20-F. Confidential treatment was requested and approved with respect to certain portions of this exhibit pursuant to 17.C.F.R. §§ 230.406 and 200.83. Omitted portions were filed separately with the SEC.

(4) Previously filed with the SEC on September 15, 2011 as an Appendix to Exhibit 1 of our Notice of Annual General Meeting of Shareholders filed on Form 6-K (File No. 000-51694)

(5) Previously filed with the SEC on March 9, 2011 as an exhibit to our annual report on Form 20-F.

\* Confidential treatment was requested with respect to certain portions of this exhibit pursuant to 17.C.F.R. §§ 230.406 and 200.83. Omitted portions were filed separately with the SEC.

(-)  
Emblem of the Ministry of Justice  
Corporations Authority

(-)  
Emblem of the State of Israel

**State of Israel  
Justice Ministry – The Israeli Corporations Authority  
Registrar of Companies and Partnerships**

**Certificate of Change of Name**

I hereby confirm that  
The Company: Incredimail Ltd.  
Registered Number 512849498

Has changed its name, and shall be henceforth named:

PERION NETWORK LTD.

Given in Jerusalem

9 Cheshvan 5772  
November 6, 2011

(-)  
Stamp of the Ministry of  
Justice  
Registrar of Companies and Partnerships

(-)  
Boaz Avrahami, Adv.  
Corporations Authority  
Registrar of Companies and Partnerships

---





To: IncrediMail Limited (the "**Company**" and/or the "**Borrower**")

Date: September 6, 2011

Dear Sirs,

Whereas you have informed us of your intention also to use the Credit (as defined below) for the purpose of acquisitions of assets, including various companies; and

Whereas you have requested the Bank to provide you with the Credit (as defined below) in the event of realization of your abovementioned intention; and

Whereas we, the undersigned, Bank Leumi le-Israel B.M. (the "**Bank**"), shall be willing to provide you with a credit framework, in a total principal amount which shall not exceed USD 12,000,000;

NOW Therefore, at your request, we confirm that the Bank shall be willing to grant you credits, loans and/or other banking facilities as specified below in the aggregate amount of up to US\$12,000,000 (Twelve Million United States Dollars), (hereinafter: the "**Credit Framework**" or the "**Credit**"), on the terms and subject to the conditions set out below:-

**1. Drawing of the Loan**

- 1.1. The Credit shall be available for drawing by the Borrower, in several installments, in its sole discretion, of up to a total amount of US\$12,000,000, from the date that this letter comes into force (the "**Date of Entering Into Force**") until the end of the Availability Period (as defined in Schedule B), subject to the terms and conditions of this letter.
- 1.2. In order to draw the Credit, the Borrower shall provide the Bank with a written drawing request in the Bank's customary form (the "**Drawing Request**"). The Drawing Request shall specify, inter alia, the amount of the Credit and the drawing request date (the "**Drawing Date**"). The Borrower shall provide the Bank with the Drawing Request by not less than seven business days prior to the Drawing Date specified in the Drawing Request.
- 1.3. Prior to the granting of the Credit, the Borrower shall provide the Bank with all such reasonable documents and shall sign all such reasonable forms which the Bank shall require, in such texts as shall be customary in the Bank and agreed upon by the Company, with respect to the granting of the Credit. In addition, the Borrower shall provide the Bank, upon request, with its confirmation that all approvals, if any, required under any law or agreement, in order to close the Credit Framework, have been duly received by it.
- 1.4. Prior to the granting of the Credit, the Borrower shall provide the Bank with an executed letter of undertaking (the "**Financial Covenants**") which shall be in the text attached hereto as Schedule A.

**2. Terms of the Loan – as specified in schedule B attached hereto and forming an integral part hereof.**

---



### **3. Collateral**

- 3.1. The drawing of any part of the Credit Framework and the continuing maintenance thereof are subject to your providing the following collateral in a form and text acceptable to the Bank as collateral for the repayment of all your debts to the Bank:
  - 3.1.1. The abovementioned executed letter of Financial Covenants.
  - 3.1.2. a debenture containing a first degree floating charge over all of your assets (the "**Debenture**");
  - 3.1.3. The Bank hereby acknowledges that following the receipt by First International Bank of Israel ("FIBI") of a debenture to secure credit to be granted by FIBI to the Borrower, the Bank shall be required to enter a pari passu intercreditor agreement ("Pari Passu") with FIBI which shall be signed in a text acceptable by the Bank.
- 3.2. The Bank hereby acknowledges and agrees that any specific collateral granted to secure a car lease agreement and/or a landlord commitment and/or hedging activity in a total aggregate amount that shall not exceed \$750,000 USD shall rank prior to the Debenture, subject to receiving similar consent from FIBI, if applicable.

### **4. Additional Conditions for the granting of the Credits**

A material breach, in the Bank's reasonable opinion, by you and/or a breach not cured by you as detailed hereinbelow, of any of your obligations to the Bank (including, without limitation, the obligations contained in this letter), shall constitute an event of default under the Credit, entitling the Bank not to grant the Credit or to require the immediate repayment of the Credit if already granted, subject to a prior written notice of 5 business days, during which period any such material breach was not cured by you.

Without derogating from the above, the granting of the Credit and the continuation of the maintaining of the Credit, in whole or in part, is subject to the fulfillment of all of the following provisions:

- 4.1. The Borrower shall provide the Bank with the collateral specified in section 3 above.
- 4.2. The Borrower shall provide the Bank with executed copies, upon the Bank's demand and upon reasonable terms and conditions acceptable to the Bank, as a reasonable banker, and to its full satisfaction, of all of the documents, agreements, corporate resolutions, and consents which shall be required, in accordance with the law and/or regulation, in respect of the Credit and the collateral.
- 4.3. No event, shall occur, whether such an event depends or does not depend on the Borrower, which entitles the Bank, in its reasonable opinion, and according to the Bank's usual documents signed by the Borrower to require immediate repayment of any amount due or becoming due to the Bank from the Borrower under any document signed or to be signed by the Borrower in favour of the Bank.
- 4.4. In the opinion of the Bank, acting as a reasonable banker, no change has occurred that prohibits, prevents or limits the Bank's ability to grant the Credit, due to changes in local or international financial markets, changes as a result of a demand, instruction or request made by or referred by the Bank of Israel or by any other legal authority which is a result of an amendment to any Law, and that no legal impediment exists which prohibits, in the Bank's reasonable opinion, the granting of the Credit or any part thereof according to any Law. Provided that in the case of changes in local or international financial markets, in the opinion of the Bank, acting as a reasonable banker, no change has occurred that prevents or materially limits the Bank's ability to grant the Credit.



- 4.5. The Borrower shall sign all customary forms and documents in form and scope which the Bank shall reasonably consider necessary with respect to the granting of the Credit Facility.
- 4.6. The Bank shall receive to its full satisfaction, prior to the granting of the Credit or any part thereof, copies of all governmental and other permits and consents required under any law, if required, with respect to the granting of the Credit and with respect to the said collaterals.
- 4.7. No material adverse change shall have occurred in the opinion of the Bank, in the business or financial position of the Borrower, and or its ability to repay its obligations to the Bank.
- 4.8. No adverse change shall have occurred in the limitations imposed upon the Bank, including changes in the policy of the Bank of Israel or any change in law not existing on the date of signature hereof, relating to Credits (including liquidity requirements relating to the Credit in respect of foreign currency and/or Israeli currency).

In this document, the expression "law" shall mean any law, regulation, or instructions of the Bank of Israel or any other authority, whether or not having the force of law, including agreements between the Bank and the Bank of Israel or such other authority.

- 4.9. For the avoidance of any doubt, it is hereby clarified that the above shall not derogate from and/or prejudice in any manner the Bank's rights and/or the Borrower's obligations in accordance with any document executed and/or to be executed by the Borrower in favour of the Bank.

**5. Fees and Commissions - as specified in schedule C attached hereto and forming an integral part hereof.**

6. This letter is personal to you and may not be relied upon by any other party. Your rights under this letter are not assignable or transferable in any manner whatsoever to any third party. The terms contained in this letter are confidential may not be disclosed in whole or part to any other person or entity without our prior written consent.
7. If the terms and conditions specified above are acceptable to you, please confirm your agreement thereto by countersigning this letter in the space provided below and returning a copy thereof to us by no later than September 13, 2011. Without derogating from any of the terms set out herein, the Bank's proposal herein for the granting of the Credit Framework to you according to the terms and conditions hereof, shall only come into force if you shall return this letter to us, by the date specified in the immediately preceding sentence, countersigned by you, and pay us the non refundable commitment fee set out in paragraphs 2 to schedule C.
8. Furthermore, this letter shall cease to be in force and effect if the Borrower fails to fulfill all the terms of this letter, to the full satisfaction of the Bank, by October 2, 2011.

Yours faithfully,

BANK LEUMI LE-ISRAEL B.M.



---

Date: September 6 2011

Bank Leumi le-Israel B.M.

Dear Sir/Madam,

We hereby confirm our agreement to the above and instruct you to debit the Loan Account with the commissions specified in Clause 5 above, whenever same shall be due, whether the account is in credit or in debit or shall be become overdrawn as a result thereof.

IncrediMail Limited

\_\_\_\_\_  
\_\_\_\_\_

I, the undersigned, \_\_\_\_\_, the lawyer acting for IncrediMail Ltd., hereby confirm that the board of directors of IncrediMail Ltd, unanimously adopted written resolutions on \_\_\_\_\_, authorizing Messrs \_\_\_\_\_ and \_\_\_\_\_ to countersign this letter, that the resolutions specified above, were duly passed in accordance with the law and the memorandum and articles of association of IncrediMail Ltd. and that the same have been duly signed by all the directors of IncrediMail Ltd. I further confirm that the above signature composition binds IncrediMail Ltd.

\_\_\_\_\_, Adv. \_\_\_\_\_  
Date Name Surname Signature

Schedule A – Financial Covenants

To: Bank Leumi le-Israel B.M.

Date: September 6, 2011

Dear Sirs,

Whereas as one of the conditions for the granting of loans, credit facility as set forth in the attached Commitment letter or other banking services and receiving various undertakings and guarantees from us, to the undersigned **IncrediMail Ltd.** (hereinafter: the "**Company**"), you have requested that we issue this document and we have agreed to do so;

Now therefore we hereby declare and undertake as follows:

**1. Financial Covenants**

We agree that the granting and maintaining of loans shall be subject to the Company fulfilling the following Financial Covenants (as defined below) at all times:

Leverage (Capital Structure)

- 1.1 The Company's aggregate amount of non pledged cash in its funds, as reflected in its quarterly Financial Reports, shall at all time be no less than 37.5% of the then aggregate outstanding Debt and obligations of the Company to all Financial Institutions.

Profit Ratios

- 1.2 The Company's Debt to EBITDA ratio, on a quarterly basis, shall not exceed, at all times, 3.5;
- 1.3 The Company's EBITDA, on an annual basis, shall not, at any time, be less than 8 Million USD, excluding the Company's EBITDA for the first and the second quarter of 2012, which then shall not be less than 6.6 Million USD.

In this clause, the following words and expressions shall have the following meanings:

**"Consumer Price Index"** – the Consumer Price Index as published by the Israeli Central Bureau of Statistics.

**"Debt"** – the aggregate amount of all of the debts and/or obligations of the Company to any Financial Institution in respect of loans, credit facilities, and guarantees including without limitation any obligations of the Company in connection with any corporate guarantees granted by the Company to any Financial Institution as security for any debt of third parties and/or its subsidiaries and/or any obligations of the Company in connection with any bank guarantees issued by any Financial Institution, at the request of and upon the liability of the Company, to a third party as security for any debt created by the Company and/or its subsidiaries provided that Debt shall not include debts or obligations of the Company in respect of any hedging transactions save for debts resulting from hedging transactions that have been terminated.

"**The Index Known**" – the Consumer Price Index for the month of \_\_\_\_\_ published on \_\_\_\_\_ being \_\_\_\_\_ points.

"**Financial Institutions**" – any banking corporation, insurance company, and any other credit provider.

"**Financial Reports**" – the annual and quarterly financial reports of the Company, on a solo basis, as approved by the Company's CEO & CFO, in accordance with United States Generally Accepted Accounting Principles (US GAAP) including inter alia, a balance sheet, a profit and loss statement, a cash flow statement, a statement of changes in equity, and such other reports or notes as may be required by US GAAP and/or by any authority.

"**Total Assets**", "**Equity**", "**Operating Profit**", "**Net Profit**", "**Current Assets**", "**Current Liabilities**", "**Financing Expenses**" – as defined in the Financial Reports.

"**EBITDA**" – the accumulated operating profits from current activities according to the quarterly Financial Reports for the four consecutive quarters terminating on the date of the latest quarterly financial report, before Financing Expenses (interest, bank fees, linkage differentials, exchange rate and currency differentials) and taxes, plus depreciation and appreciation expenses and reductions that were recorded in such periods.

The covenants stated in paragraphs 1 above (hereinafter: "**the Financial Covenants**") are based on current standards of accounting, accounting principles and accounting policy (hereinafter: "**the Accounting Standards**") as reflected in the Company's most recent financial reports (hereinafter: "**the Latest Accounts**").

Different Accounting Standards other than those on the basis of which the Latest Accounts were prepared, including, but not limited to the implementation of the International Financial Reporting Standards (IFRS), or new or different accounting standards in the US and/or the US GAAP (hereinafter "**the New Accounting Standards**") may affect the Financial Covenants.

Accordingly, the Company hereby agrees as follows:

If it becomes evident to the Bank, in its sole discretion, based on applicable accounting standards, that there have been /are about to be changes in the Company's Financial Reports as a result of the New Accounting Standards that by regulation apply to the company, the Bank may, after consultation with the Company but without requiring its consent, inform the Company and/or decide mutually with the Company of changes that need to be made to the Financial Covenants (hereinafter: "**the Amended Financial Covenants**"), in order to adapt them to such changes, with the intent of adapting them according to the original financial purpose for which they were determined.

The Bank's decision regarding the Amended Financial Covenants shall bind the Company as from the date of delivery of the aforementioned decision, and this document shall be deemed to include, as from such date, the Amended Financial Covenants.

## **2. Undertaking not to Merge**

We undertake not to effect, not to undertake to effect and not to take any actions whatsoever to effect a merger with another/other corporation(s), without receiving the Bank's prior written consent thereto. For this purpose, the Company undertakes to provide the Bank with all information and documents reasonably required by the Bank, at the Bank's reasonable discretion, with respect to the requested merger, in order that the Bank may determine its position with respect to such merger. It is further clarified that the Company's mergers of a subsidiary in a way that the merged subsidiary shall be merged with and into the Company, shall require the Bank's consent which will not be unreasonably denied except for mergers of any subsidiaries existing on the date hereof.

In this document, the expression "merger", means - merger according to the eighth or ninth chapter of the Companies Law 5759-1999 and any action which results in the acquisition of the majority of the Company's assets by another person or corporation.

**3. Undertakings regarding future acquisitions**

In the event that the Company shall at any time acquire any corporation, we hereby undertake and agree:

- 3.1 In the case of an Israeli corporation, to grant to the Bank a first ranking fixed pledge of the shares of such corporation, unlimited in amount, which pledge shall rank pari passu to the rights of the First International Bank of Israel in such collateral, and to sign a deed of pledge in the Bank's customary form as well as such other documents as may be required by the Bank to create and/or perfect the aforementioned pledge; and
- 3.2 In the case of a foreign corporation, not to pledge or charge and not to undertake to pledge or charge, in any manner whatsoever and for any reason whatsoever, the shares of such corporation, in favour of any third party whomsoever, without receiving the Bank's prior written consent.

For the purpose of this clause the term "shares" shall include shares of the capital stock, partnership interests, membership rights and/or any other means of ownership and/or control in a corporation.

**4. Undertaking to Provide Financial Reports**

We undertake to deliver to the Bank the following Financial Reports:

- 4.1 No later than on March 31 of every year, annual financial reports of the Company, on a consolidated basis, including inter alia, a balance sheet, a profit and loss statement, and a cash flow statement for such year, and such other reports as may be required by any authority in respect of the 31st of December of the previous year, audited by a qualified external accountant.
- 4.2 To provide quarterly financial reports of the Company, on a consolidated basis, including inter alia, a balance sheet, a profit and loss statement, and a cash flow statement for such year, and such other reports as may be required by any authority.
- 4.3 Within 60 days after the end of each calendar quarter, quarterly Financial Reports (on a solo basis) in respect of the immediately preceding financial quarter, as approved by the CEO & the CFO of the Company, with the conversion table (how to convert the solo into consolidated basis) attached to it.

- 4.4 No later than 45 days following the end of each calendar quarter, quarterly consolidated financial reports signed and approved by the Company's Chief Financial Officer with regard to the Company's debtors, debts to the banking system and the Company's creditors. The aforementioned financial reports shall include the following:
- 4.4.1 **List of Principal Debtors** – This report shall include information regarding the Company's principal debtors both in Israel and abroad, cheques and promissory notes for collection, advances from clients (that were not provided against bank guarantees) and information regarding the age of its debtors and the names of its principal clients.
  - 4.4.2 **Report Regarding the Company's Overall Liabilities to the Banking System and to Other Secured Creditors** – This report shall specify short term credit, long term loans, letters of credit issued, guarantees and overall credit granted by each bank and by each creditor.
  - 4.4.3 **Report Specifying Additional Liabilities** – This report shall specify liabilities to employees (in respect of overtime, vacation, compensation and retirement), Income Tax provisions, indebtedness to Local Authorities and indebtedness to Governmental Authorities (e.g. Income Tax, Social Security, Purchase Tax, Property Tax etc.).
- 4.5 In addition to the aforementioned the Company shall provide the Bank, exercising reasonable discretion of a reasonable banker: any additional report, document or information and any clarifications thereto that may be requested by the Bank. Without derogating from the generality of the aforesaid, such additional information may include a detailed business plan as provided by the Company to its board of directors, reports that the Company provided to its shareholders, all in the form and order as reasonably requested by the Bank.

**5. Undertaking to Provide Additional Reports**

We undertake to furnish the Bank with copies of any permit, notice, report or other document that we are obliged to provide to the Registrar of Companies and/or the Securities Authority and are publicly available, with the exclusion of the aforementioned Financial Reports and/or any undertaking specified in section 3.3.

**6. Undertaking not to Issue Bearer Securities**

We undertake not to issue bearer securities without the prior written consent of the Bank.

We declare that, as at the date of execution of this document, the Company has not issued any bearer securities.



**7. Extent of Undertakings**

The aforesaid undertakings shall be in force so long as there are or will become due to the Bank by the Company any amounts whatsoever on account of the Credit granted and/or which shall be granted by the Bank in the future and/or as long as the various undertakings and guarantees in favour of the Bank or for its benefit shall be in force.

In case we shall not comply with some or all of the Financial Covenants and/or in the event of a material breach of, or failure to substantially fulfill, in the Bank's reasonable opinion, any of the undertakings herein provided, the Bank shall, without prejudicing of any other of the Bank's rights, be entitled but not obliged to declare our indebtedness and undertakings, in whole or in part, to be immediately due and payable, subject to the prior written notice of seven (7) days to the Company, and to impose on us following such acceleration of debt any sum that the Bank reasonably incurred to cover its losses and/or expenses due to the aforementioned.

Notwithstanding the foregoing, if in the Bank's opinion acting as a reasonable banker, such notice period is likely to materially jeopardize the Bank's ability to recover all or part of our indebtedness and undertakings – the Bank shall be entitled to immediately demand repayment of our aforesaid indebtedness without prior notice.

For the avoidance of doubt, the foregoing shall not in any way derogate from our undertakings under any document signed or to be signed by us, nor shall the foregoing in any way diminish any of the Bank's rights to declare our indebtedness and undertakings, in whole or in part, to be immediately due and payable under any document or law.

Yours faithfully,

\_\_\_\_\_  
(signature)



#### **Schedule B – Terms of the Loan**

1. The Credit shall be provided to you on demand during the period of the Credit as defined hereinbelow.
2. The Credit shall be used by you for the purpose of financing investments and for the acquisition of companies. However, the Bank shall not be required to monitor or verify the application of any money borrowed by you under the Credit.
3. The Credits shall each be granted in the Borrower's existing bank account (the "**Loan Account**"), No. 682-110-088800/22 in the name of IncrediMail Limited and IncrediMail Limited shall provide the Bank, upon request, with any additional reasonable and customary documents of the banks and sign such reasonable and customary forms of the bank as shall be reasonably and customary required by the Bank to maintain the Loan Account.
4. The currency of the Credit and all other terms regarding the Credit, including the interest rate on account of any part of the Credit, shall be USD.
5. The period of drawing the Credit shall not exceed 12 months from the date of entering into force (the "**Date of Entering Into Force**") of this letter agreement (the "**Availability Period**").
6. The repayment period of any part of the Credit drawn from the Date of Entering Into Force until 29<sup>th</sup> February 2012 (the "Credit A Period") shall be equal to the number of months from the date of Drawing Date plus 48 months, and the repayment period of any part of the Credit drawn from March 1<sup>st</sup> 2012 until August 31<sup>st</sup>, 2012 (the "Credit B Period") shall be 48 months from the Date of Entering Into Force (i.e. terminating on August 2015).
7. Interest and principal shall be paid on a quarterly basis.
8. The Loan shall bear interest at a rate of the Initial Interest (as defined hereinbelow) plus a Fixed Supplement of 3% margin per annum

In this document, the expression "**Initial Interest**" shall mean: (i) The rate of interest prior to the addition of any margin, as set by Bank Leumi le-Israel B.M., for its clients for the purpose of extending USD variable interest term loan in an amount, and for a period which are similar to the amount, and period of the requested credit, at the time on which the interest rate for the requested credit is set (in this definition, the "**Determination Date**"). (ii) The provisions of sub-clause (i) apply both to credit which bears a fixed interest rate as well as to credit which bears a variable interest rate.

(iii) Where the credit bears interest on a variable basis, i.e. the interest is determined as a fixed supplement (in this definition, the "**Fixed Supplement**") above any base interest rate which fluctuates throughout the period of the said credit, then the rate of the Fixed Supplement shall be set on the Determination Date in accordance with the principles specified in sub-clause (i) above, and the rate of the Fixed Supplement above the base interest rate shall not be changed during the period of such credit. (iv) Notice from Bank Leumi le-Israel B.M. with respect to the Initial Interest set by it shall bind the Borrower and may not be contradicted.

Date: September 6, 2011

To  
The First International Bank of Israel Ltd.  
Ramat Hachayal Branch

Dear Sirs,

**WHEREAS**, Incredimail Ltd. (the "**Company**") is and/or will be indebted to the bank for various amounts of money on account of credit, documentary credit, various loans, overdraft in the Company's checking account, debit account or other account, various letters of indemnification and guaranty, discounts of bills, and other banking services made available and/or that will be made available to the Company or other persons guaranteed by Company (the "**Banking Services**");

**WHEREAS**, the people/corporations listed in Annex A attached herein and constituting an integral part of this letter constitute Interested Parties and/or Controlling Shareholder as defined in the Israeli Securities Law 5728-1968 (the "**Interested Parties**");

**WHEREAS**, as one of the conditions for providing Banking Services, the bank requires the Company to execute this letter including the undertakings detailed below, and the Company agrees to the aforementioned condition.

**THEREFORE**, the Company hereby declares and undertakes to the bank that as long as the Company benefits from credit and Banking Services provided to it from the bank, and as long as the Company has liabilities and undertakings towards the bank in accordance with the bank's records, the following shall apply:

1. The Company shall at all times comply with the following financial conditions and ratios, which will be examined in accordance with the Company's quarterly and annual financial statements, as defined below:

"**Company's Financial Statements**" – the Company's Consolidated Financial Statements prepared in accordance with any law and accepted accounting standards, including, amongst others, balance sheets, income statement, cash flow statement, statement of changes in shareholders' equity, including any of their notes, and in addition, any other report, notice, or document required/or that will be required pursuant to any law and/or authorities and/or bodies and/or authorized entities; annual statements shall be compiled and audited by a an external auditor, in accordance with the principles, reporting requirements, accepted accounting regulations determined/or that will be determined by the Institute of Certified Public Accountants in Israel from time to time, pursuant to any law, and the quarterly statements, subject to Section 7.2 below, and pursuant to the rules and principles, reporting requirements, and accounting standards determined /or that will be determined by the relevant authorities in the United States, from time to time (the SEC and FASB) and/or any law.

---

For the removal of doubt it shall be clarified, as long as the Company publishes quarterly statements, these shall be provided to the bank as prescribed for in Section 7.2 below, and in the event the Company ceases to publish its quarterly statements, the Company is hereby obligated to provide the bank with quarterly or administrative statements, signed by the CFO of the Company.

- 1.1. The Company's Tangible Equity Capital in accordance with the abovementioned Financial Statements, shall not be less than \$10,000,000 USD and its portion of the balance sheet shall not be less than 15%.

**Tangible Equity Capital** – as the term appears in the Company's Financial Statements (including, amongst others, the Company's paid up share capital, capital reserves, and unallocated profit, while deducting the cost of shares of the Company held by it or by its subsidiaries and deducting minority rights) with the addition of deferred shareholders loans, deducting for loans and/or capital notes granted to Interested Parties and/or Affiliates, and deducting guaranties granted by the Company to secure the debts of Interested Parties and/or Affiliates, and deducting intangible assets as they appear in the Company's Financial Statements, including but not limited to, deferred expenses, goodwill, patents, trademarks, trade names, copyrights, etc.

Notwithstanding the above, during the first three years as of the date the this letter is signed (for purposes of this section below, the "**Aforementioned Period**") Intangible Assets on Account of Acquisitions made during the Aforementioned Period (as defined below), shall not be deducted from the Company's equity capital. The Company undertakes that during the Aforementioned Period, the Tangible Equity Capital shall be no less than \$20,000,000 USD and its portion of the balance sheet shall not be less than 30%.

**Intangible Assets on Account of Acquisitions** – Assets which are classified in the Company's Consolidated Financial Statements as intangible assets and which originate from an acquisition/acquisitions by the Company of holdings in any corporations, including of the Company's subsidiaries and/or affiliates, as such information will be approved by the Company's accountant, at those times prescribed for in Section 7.4 below.

Interested Parties, and/or Subsidiaries, and/or Affiliates shall have the definitions ascribed to them in the Israeli Securities Law 5728-1968.

Amounts deducted from the Company's equity capital for the purpose of calculating said equity capital, shall also be deducted from the Balance sheet for purpose of balance sheet calculation, as prescribed in the first part of Section 1.1 above.

---

- 1.2. The Company's annual EBITDA amount (which shall be calculated using the previous four consecutive quarters published in the quarterly statements) shall be no less than \$6,000,000 USD.

As of the 2012 third-quarter financial statements, the Company's annual EBITDA amount (calculated in the same manner described above) shall be no less than \$8,000,000 USD.

As of the 2013 third-quarter financial statements, the Company's annual EBITDA amount (calculated in the same manner as described in this section above) shall be no less than \$10,000,000 USD.

**EBITDA** – shall be defined as operational profit with depreciation and amortization, included as part of the expenses deducted in order to calculate operational profit.

- 1.3. The ratio between the Company's Financing Obligations according to the consolidated financial statements and the EBITDA in annual terms shall not exceed 3.5.

**Financing Obligations** – defined as loans (short and long term) received from banks and other financial institutions, obligations on account of finance leasing, bonds and convertible bonds. For the removal of doubt, operational leasing shall not be taken into account within the framework of Financing Obligations.

- 1.4. The Company's aggregate amount of Cash after deducting pledged Cash shall not be less than \$8,000,000 USD.

**Cash** – As the term appears in the Company's Financial Statements, including cash and cash equivalents, short term deposits, and short term investments.

- 1.5. The Company's aggregate Financing Obligations towards the bank (principal) shall not exceed, at any time, 40% of the Company's aggregate Financing Obligations towards the entire banking system (principal), including banks and other financial institutions.
-

2. The Company hereby declares that as of the date this letter is signed, the Company is in compliance with these financial conditions and ratios. The Company hereby approves that in the event that the credit granted by the bank shall be used by the Company for acquiring holdings in any corporations which were incorporated in Israel, and if the acquired corporations have not merged into the Company (as the term "merger" is defined in the Companies Law, 5799-1999, and/or the Anti-Trust Law -1988 ) the bank will have the right to demand that a lien be placed in the bank's favor on the abovementioned holdings by way of a first ranking fixed charge without monetary limit, in an amount and margin which are to the bank's full satisfaction.
  3. The Company hereby undertakes that in the event the credit provided by the bank will be used by the Company for acquiring holdings in any corporations which are incorporated abroad, and if such acquired corporations have not merged with the Company (as the term "merger" is defined in the Companies Law, 5799-1999, and/or the Anti-Trust Law -1988 ), then, without derogating from the Company's obligations pursuant to the debenture of floating charge, the Company will execute an undertaking to not create liens on the abovementioned acquired companies.
  4. The Company hereby undertakes that in the event new accounting standards from those used in previous Financial Statements are adopted, including but not limited to cases where changes were adopted due to the implementation of new standards and/or a change in estimates and/or in accounting principles, the Company shall approach the bank in order to adjust the Company's obligations, pursuant to Section 1 above, with the changes caused by the aforementioned adoption. In the event the Company and the bank cannot come to agreement as to the necessary adjustments within thirty (30) days of the Company approaching the bank, or any other time frame agreed upon by both parties, such a disagreement shall constitute a claim for immediate repayment of the Company's obligations and liabilities.
  5. If, at its sole discretion as a reasonable banking institution, the bank considers that a change has been made to the holdings or ownership structure of the account holders, which results in: (i) the bank being in regulatory breach, including towards the Bank of Israel for "Sole Debtor" limitations or "Group of Debtors" (which cannot be fixed or remedied by agreement of the parties); or (ii) the occurrence of an issue relating to money laundering (which cannot be amended or remedied by agreement of the parties); or (iii) in its discretion as a reasonable banking institution, the bank will no longer be interested in providing credit to any new owners on account of issues concerning such new owners' identities.
  6. The Company hereby undertakes that in the event it acquires holdings in any type of corporation, the aforementioned acquired corporation's field of operations will be similar or complementary to that of the Company.
  7. Loans received/or that will be received by the Company from Interested Parties (the "**Shareholder Loans**") shall be subordinate and deferred in relation to the Company's obligations and liabilities towards the bank, which will have a liquidation preference in relation to the Shareholder Loans, as they may exist at any time.
-

In the most recent Financial Statements published by the Company prior to the signing of this letter, it was published that there are no Shareholder Loans.

The Company hereby declares that as of the date this letter is signed, there have been no changes to the aforementioned statement concerning Shareholder Loans as detailed in the most Financial Statements published by the Company for the bank, prior to the date this letter is signed.

8. The Company hereby undertakes, as of the date this letter is signed and as long as the Company's obligation and liabilities towards the bank have not been fully repaid, the Company is restricted from making any payments or repayments on account of Shareholder Loans and/or dividend payments and/or management fees and/or indemnity payments and/or consulting fees, or any other payment, in part or in full, to an Interested Party in the Company, except for payments detailed in this section below, for which the Company has the right to repay, subject to the Company being in compliance with all its obligations at any time including after the aforementioned payments have been made, as detailed in Section 1 above:

- 8.1. Compensation for a Company Employee or Director

9. As of the date this letter is signed, and as of the date the credit-line approval letter has been given to the Company, the Company shall provide the bank with the following ongoing reports:

- 9.1. Within 120 days of the 31<sup>st</sup> of December for any year, the Company shall provide the bank with all Financial Statements for December 31 of the preceding year. The aforementioned Financial Statements shall be audited by an external certified accountant.

- 9.2. Within 90 days of the end of the months of March, June, and September of each year, the Company shall provide the bank with all Financial Statements for the calendar quarter ending on the last day of each of the aforementioned months, while it is clear and known to the bank that the aforementioned Financial Statements will not be reviewed by an external accountant.

For the removal of doubt it is clarified that for as long as the Company publishes quarterly statements, said statements shall be provided to the bank as prescribed for in this section above, and in the event the Company ceases to publish its quarterly statements, the Company is obligated to provide the bank with quarterly or administrative quarterly statements, as prescribed in this section above, duly signed by the CFO of the Company.

---

- 9.3. Within 20 days of each end of quarter, the Company will provide the Company with data as to Company inventory (including a breakdown of the different types of inventory), debtors (including customers in Israel and abroad, various debtors, and Company obligations to creditors with liquidation preferences) and any balance of debt within the banking system. The aforementioned data will refer to the last day of each quarter.
- 9.4. An approval executed by the Company's external accountant, in the following language, shall be provided by the Company at any time the Company provides Financial Statements to the bank (quarterly, including administrative and annual) with respect to the value of Intangible Assets on Account of Acquisitions, as defined above, originating from acquisitions made within 3 years of the date this letter is signed. The aforementioned approval shall be in the following language:
- "I, the undersigned \_\_\_\_\_ serve as an external accountant for Incredimail Ltd. In my capacity as the Company's external accountant and at the company's request, and in light of Section 7.4 to the Letter of Undertaking executed by the company on \_\_\_\_\_ (the "Letter of Undertaking"), I hereby approve that as of \_\_\_\_\_ the value of all Intangible Assets on Account of Acquisitions (as defined in the Letter of Undertaking) originating from acquisitions made after the date the Letter of Undertaking was signed, equals USD \_\_\_\_\_".*
- 9.5. No later than February 15 of each year, the Company shall provide the bank with its annual budget and monthly statement of cash flow referring in advance to such year.
- 9.6. In the event the Company shall prepare additional Financial Statements, whether in Israel or abroad, audited or unaudited, and/or other financial reports such as prospectuses, the Company shall provide the bank with copies of the aforementioned statements immediately after their approval.
- 9.7. Without derogating from this section, bank representatives will be entitled to meet with the Company's accountant at any time they so request in order to confirm information concerning the Company's financial situation.
10. The Company shall immediately inform the bank of any lawsuit filed against the Company valued at \$500,000 USD or greater, or the submission or commencement of any legal proceedings or those that the Company has knowledge of their future commencement in a court, tribunal or other judicial body in Israel or abroad, equal to the monetary amount mentioned above.
11. The Company is hereby notified that in event of breach of one or more of the undertakings pursuant to this letter, including a breach emanating from the adoption of standards different than those used by the Company as of the date this Letter of Undertaking is signed, in part or in whole, then in addition to all legal relief the bank is entitled to by virtue of any document that was executed or that will be executed by the Company, or by virtue of any law, the bank will be entitled, but not obligated, to demand immediate repayment of all amounts owed to the bank by the Company on account of the Banking Services, in whole or in part, and to exercise any collateral and/or guarantee given by or on behalf of the Company, subject to the provision of 7 days prior written notice, and on condition that for the duration of said period, the Company did not remedy said breach, excluding cases of extraordinary urgency where such a waiting period, as mentioned above, may, at the bank's opinion and at its discretion as a reasonable banking institution, cause damage. In such cases, the bank will be entitled to immediately exercise its rights.
-



12. Any undertakings by the Company pursuant to this letter and any of the bank's rights hereunder, are additional and independent to any undertakings, guarantees, and collateral received and/or which will be received from the Company and/or an Interested Parties and/or any of them as the case may be, and will not influence or be influenced by the aforementioned .
13. Any waiver by the bank of a prior breach or non-performance of one or more undertakings towards it, whether such an undertaking is included in this document, or is included in any other document agreed upon between the parties, shall not constitute a justification for any additional breach or non-performance of any such condition or undertaking. Any abstention by the bank from utilizing any right given to it by virtue of any document and/or any law shall not constitute a waiver of said right.
14. For the avoidance of doubt, it is hereby clarified that this letter does not derogate from or reduce in any manner from the Company's undertakings towards the bank, and/or any right the bank has towards the Company and/or towards Interested Parties pursuant to the General Debit Contract and/or the general conditions for account management, and any other document signed/or which will be signed by them or by any of them.

Sincerely,

---

Incredimail Ltd. Signature

---

Date: September 6, 2011

To:  
Incredimail Ltd.

Dear Sirs,

**Re: Approval of Credit Line and Collateral**

We hereby confirm that subject to the conditions of Section 3 below and subject to the creation and/or the existence at all times of the collateral set forth in Section 2 below to our full satisfaction, we will grant you a credit line for the receipt of credit and banking services as detailed in Section 1 below.

1. **Description of the Credit Line**                      **Credit Line Amount: 8 Million US Dollars**

A credit line for long term loans in NIS/foreign currency for a period of up to 5 years, with semi-annual payment of the principal and interest.

2. **The Credit Line Will Be Secured by the Following Collateral:**

A. A first-ranking floating charge without a monetary limit on all the property of the company as well as all the insurance rights in connection therewith, and a fixed charge on the share capital and goodwill of the company pari passu with other banks in accordance with terms which will be agreed upon with such banks to the full satisfaction of the bank. The advance rate against the collateral will be based on a quarterly report which will be delivered to us in accordance with the provisions of the Letter of Undertaking.

Notwithstanding the foregoing, you will be authorized to create fixed charges on deposits with other banks for securing leasing contracts and hedging activities, and you will be authorized to create fixed charges in favor of leasing companies on vehicles for the sole purpose of securing leasing transactions, provided that the total value of the deposits and vehicles with respect to which such liens were placed will not exceed \$750,000 at any time.

B. An undertaking with respect to financial criteria in language which will be agreed upon by us and which is attached to this approval (the "**Letter of Undertaking**").

C. If the credit provided by the bank will be used by the company for acquiring holdings in any corporations which were incorporated in Israel, and insofar as the acquired corporations were not merged with your company (as the term "merger" is defined in the Companies Law, 1999 and/or in the Anti-Trust Law, 1988), the bank will have the right to demand that a lien be placed on the foregoing holdings by way of a first ranking fixed charge without a monetary limit within the bank's accepted margins. If the bank will demand such a lien, insofar as the credit for the purpose of acquiring the holdings will be provided by additional bank(s), a charge will also be placed on the holdings in favor of such additional banks, pari passu, in accordance with terms which will be agreed upon with such additional banks to the full satisfaction of the bank.

---

If the credit provided by the bank will be used by the company for acquiring holdings in any corporations which were incorporated abroad, and insofar as such acquired corporations were not merged with your company (as the term "merger" is defined in the Companies Law, 1999 and/or the Anti-Trust Law, 1988), then, without derogating from your obligations pursuant to the floating charge debenture, you will execute in our favor an undertaking to not create liens on the foregoing acquired corporation(s).

It is clarified that:

-The bank will be authorized to change from time to time the advance rate against any of the collateral set forth above in accordance with the procedures of the bank, as well as to demand a periodic update of the valuation of the charged assets in accordance with our common practice and/or additional collateral as applicable.

-In an event pursuant to which the bank will be entitled to immediate repayment of the credit and foreclosure of the collateral, all the collateral that it holds will be used to cover your debts and obligations towards the bank in full, irrespective of the advance rate with respect to any specific collateral.

3. The Credit Line and the Foregoing Banking Services are Subject to the Following Terms:

- A. The execution of the letter of general terms for the management of the account, including the credit chapter and/or the general debit contract (the "**General Terms**"), the collateral documents, and various framework agreements as required by us including the Form 88-8 in language which is to the satisfaction of the bank. Satisfying the general terms which were signed and/or will be signed by us as well as any other document which was signed and/or will be signed by you.
  - B. There will be no preclusion whatsoever from providing credit or any portion thereof in accordance with the law and/or the instructions of Bank of Israel and/or any other authorized entity applicable to the provision of the credit.
  - C. There will be no change in the provisions of the law and/or Bank of Israel and/or any other authorized entity applicable to the provision of the credit.
  - D. There will be no adverse change, as determined by our reasonable judgment, in the value of your collateral, condition of the business, activities, assets or financial condition.
  - E. There will not be an event pursuant to which the bank will be entitled, in accordance with the provisions of the General Terms and/or other documents which were signed by us, to immediate repayment of the credit, even if the credit has not been previously extended; provided that if the bank did not provide an extension to repair the breach, in any other letter, the bank provided seven days prior written notice and the company does not correct such breach in such period of time, with the exception of cases of particular urgency in which such a period is likely to result in damage, as determined by the bank's judgment as a reasonable banking corporation. In such cases the bank will be authorized to exercise its rights immediately.
-

- F. The provision of the credit line, in whole or in part, shall not cause a deviation from limitations which are imposed on the obligations of any lender or group of lenders, or a deviation from any other limitation which applies to the bank, in accordance with the instructions of the Bank of Israel.
- G. The presentation of the financial statements as set forth in the Letter of Undertaking.
- H. There was no substantial reduction in the market value of the securities issued by the company, to the extent such were issued.
4. This letter is intended exclusively for you. You may not disclose this letter to any third party whatsoever nor use the letter in any other respect, except with the prior written consent of the bank, subject to the provisions of the law as applicable to the company as a public company which is traded on the NASDAQ and the Tel Aviv Stock Exchange. In the event that it will be incumbent on the company to disclose information as set forth above due to requirements of applicable law, the company shall fulfill the requirements of the applicable law and/or the requirements of the applicable stock exchange and/or authority and will provide the bank with due notice thereof.

5. Term of the Approval of the Credit Line

The term of the above credit line will be (one year from the date of the letter).

The bank will be authorized at all times to terminate the credit line or any portion thereof or to amend such credit line under the circumstances set forth in Section 3 above.

6. Fees

Your account will be charged for this approval with the fees set forth in Exhibit A hereto.

At your service at all times,

Sincerely,

The First International Bank of Israel Ltd.

---

PORTIONS OF THIS AGREEMENT WERE OMITTED AND HAVE BEEN FILED SEPARATELY WITH THE SECRETARY OF THE COMMISSION PURSUANT TO AN APPLICATION FOR CONFIDENTIAL TREATMENT UNDER RULE 24b-2 OF THE SECURITIES EXCHANGE ACT OF 1934; [\*\*\*] DENOTES OMISSIONS.

*EXECUTION COPY*

---

**AGREEMENT AND PLAN OF MERGER**

**among**

**INCREMAIL LTD.**

**and**

**INCREMAIL, INC.**

**and**

**SEDER MERGER, INC.**

**and**

**SMILEBOX, INC.**

**and**

**ANDREW WRIGHT**

**and**

**SHAREHOLDER REPRESENTATIVE SERVICES LLC,**

**AS THE SHAREHOLDER REPRESENTATIVE**

---

Dated as of July 31, 2011

---

## TABLE OF CONTENTS

|                             | <b>Page</b>   |    |
|-----------------------------|---|----|
| <a href="#">Section 1.</a>  | <a href="#">THE MERGER.</a>   | 1  |
| <a href="#">Section 2.</a>  | <a href="#">REPRESENTATIONS AND WARRANTIES OF THE COMPANY.</a>                      | 16 |
| <a href="#">Section 3.</a>  | <a href="#">REPRESENTATIONS AND WARRANTIES OF PARENT, PURCHASER AND MERGER SUB.</a> | 41 |
| <a href="#">Section 4.</a>  | <a href="#">REPRESENTATIONS AND WARRANTIES OF FOUNDER.</a>                          | 43 |
| <a href="#">Section 5.</a>  | <a href="#">CERTAIN COVENANTS OF THE COMPANY.</a>                                   | 44 |
| <a href="#">Section 6.</a>  | <a href="#">ADDITIONAL COVENANTS OF THE PARTIES.</a>                                | 47 |
| <a href="#">Section 7.</a>  | <a href="#">CONDITIONS PRECEDENT TO OBLIGATIONS OF PARENT AND PURCHASER.</a>        | 52 |
| <a href="#">Section 8.</a>  | <a href="#">CONDITIONS PRECEDENT TO OBLIGATIONS OF THE COMPANY.</a>                 | 54 |
| <a href="#">Section 9.</a>  | <a href="#">TERMINATION.</a>  | 55 |
| <a href="#">Section 10.</a> | <a href="#">INDEMNIFICATION, ETC.</a>   | 56 |
| <a href="#">Section 11.</a> | <a href="#">MISCELLANEOUS PROVISIONS.</a>   | 62 |
| <a href="#">Section 12.</a> | <a href="#">SHAREHOLDER REPRESENTATIVE</a>  | 68 |

## AGREEMENT AND PLAN OF MERGER

THIS AGREEMENT AND PLAN OF MERGER (this "**Agreement**") is made and entered into as of July 31, 2011, by and among INCREDIMAIL LTD., a company organized under the laws of Israel ("**Parent**"), INCREDIMAIL INC., a corporation organized under the laws of Delaware wholly owned by Parent ("**Purchaser**"), SEDER MERGER INC., a corporation organized under the laws of Washington wholly owned by Purchaser ("**Merger Sub**"), SMILEBOX, INC., a corporation organized under the laws of Washington (the "**Company**"), ANDREW WRIGHT ("**Founder**") and SHAREHOLDER REPRESENTATIVE SERVICES LLC, a Colorado limited liability company, solely in its capacity as agent of the Participating Securityholders (the "**Shareholder Representative**"). Certain other capitalized terms used in this Agreement are defined below or in Exhibit A.

### WITNESSETH:

WHEREAS, Parent, Purchaser, Merger Sub and the Company have approved the acquisition of the Company by Purchaser, by means of the merger of Merger Sub with and into the Company, upon the terms and subject to the conditions set forth in this Agreement;

WHEREAS, the board of directors and the requisite shareholders of the Company (the "**Shareholders**") have approved the Merger upon the terms and subject to the conditions set forth herein;

WHEREAS, Parent, Purchaser, Merger Sub, Founder and the Company desire to make certain representations, warranties, covenants and agreements in connection with the Merger and also to prescribe various conditions to the consummation thereof; and

NOW, THEREFORE, in consideration of the foregoing and the representations, warranties, covenants and agreements herein contained, the parties hereto, intending to be legally bound, hereby agree as follows:

#### Section 1. THE MERGER.

1 . 1 **The Merger.** At the Effective Time (as defined below) and upon the terms and subject to the conditions of this Agreement and in accordance with the Washington Business Corporation Act (the "**WBCA**"), Merger Sub shall be merged with and into the Company (the "**Merger**"). Following the Merger, the Company shall continue as the surviving corporation (the "**Surviving Corporation**") and the separate corporate existence of Merger Sub shall cease.

1 . 2 **Effective Time.** Subject to the terms and conditions set forth in this Agreement, on the Closing Date (as defined below): (a) Articles of Merger in substantially the form of Exhibit B (the "**Articles of Merger**") shall be duly executed and thereafter delivered to the Secretary of State of the State of Washington for filing pursuant to Section 23B.11.050 of the WBCA; and (b) the parties shall make such other filings with the Secretary of State of the State of Washington as shall be necessary to effect the Merger. The Merger shall become effective at such time as the Articles of Merger are duly filed with the Secretary of State of the State of Washington in accordance with Section 23B.11.050 of the WBCA or such later time as Purchaser and the Company may agree upon and as may be set forth in the Articles of Merger (the time the Merger becomes effective being referred to herein as the "**Effective Time**").

---

**1.3 Closing of the Merger.** The closing of the Merger (the “Closing”) shall take place at a time and on a date, as agreed to by the parties, which shall be no later than one Business Day after satisfaction (or waiver) of the latest to occur of the conditions set forth in Sections 7 and 8 (the “Closing Date”), at the offices of Goldfarb Seligman & Co., 98 Yigal Alon Street, Tel-Aviv, Israel, unless another time, date or place is agreed to in writing by the parties hereto. The parties (other than the Shareholder Representative) shall use their best efforts to cause the conditions set forth in Sections 7 and 8 to be satisfied within twelve Business Days after the date hereof.

**1.4 Effects of the Merger.** The Merger shall have the effects set forth in the WBCA. Without limiting the generality of the foregoing and subject thereto, at the Effective Time, all the properties, rights, privileges, powers, patents, trademarks, licenses, registrations, franchises, cash and other assets of every kind and description of the Company and Merger Sub shall be transferred to, vest in and devolve upon the Surviving Corporation without further act or deed, and all debts, liabilities and duties of the Company and Merger Sub shall become the debts, liabilities and duties of the Surviving Corporation. At any time, or from time to time, after the Effective Date, the last acting officers of Merger Sub, or the corresponding officers of Surviving Corporation, may, in the name of Merger Sub, execute and deliver or cause to be executed and delivered all such deeds and instruments and to take or cause to be taken such further or other action as Surviving Corporation may deem necessary or desirable in order to vest in and conform to Surviving Corporation title to and possession of any property of Merger Sub acquired or to be acquired by reason of or as a result of the Merger herein provided for and otherwise to carry out the intents and purposes hereof, and the proper officers and directors of Surviving Corporation are fully authorized in the name of Merger Sub or otherwise to take any and all such action.

**1.5 Articles of Incorporation and Bylaws.** The Articles of Incorporation of the Surviving Corporation in effect at the Effective Time will be amended and restated as set forth on Exhibit A to the Articles of Merger until further amended in accordance with applicable law. The Bylaws of the Surviving Corporation shall be the Bylaws of the Company immediately prior to the Effective Time until further amended in accordance with applicable law.

**1.6 Directors.** The directors of Merger Sub at the Effective Time shall be the directors of the Surviving Corporation, each to hold office in accordance with the Articles of Incorporation and Bylaws of the Surviving Corporation until such director’s successor is duly elected or appointed and qualified.

**1.7 Officers.** The officers of the Company at the Effective Time shall be the officers of the Surviving Corporation, each to hold office in accordance with the Articles of Incorporation and Bylaws of the Surviving Corporation until such officer’s successor is duly elected or appointed and qualified.



## 1.8 Conversion of Shares

(a) At the Effective Time:

(i) (A) Each share (a “**Series A Preferred Share**”) of the Company’s Series A Preferred Stock, \$0.001 par value, outstanding at the Effective Time, but excluding Dissenting Shares (as defined in Section 1.11 hereof) and Excluded Shares (as defined in Section 1.8(a)(ii) hereof), shall by virtue of the Merger and without any action on the part of any party hereto or any holder thereof, be converted into the right to receive cash in the per share amount calculated as set forth on the spreadsheet (the “**Signing Spreadsheet**”) attached hereto as Exhibit C) (the “**Series A Amount**”), subject to adjustments and payable as provided in this Agreement.

(B) Each share (a “**Series B Preferred Share**” and, together with the Series A Preferred Shares, the “**Preferred Shares**” or the “**Preferred Stock**”) of the Company’s Series B Preferred Stock, \$0.001 par value, outstanding at the Effective Time, but excluding Dissenting Shares and Excluded Shares, shall by virtue of the Merger and without any action on the part of any party hereto or any holder thereof, be converted into the right to receive cash in the per share amount calculated as set forth in the Signing Spreadsheet (the “**Series B Amount**” and, together with the Series A Amount, the “**Preferred Amount**”), subject to adjustments and payable as provided in this Agreement.

(C) Each share (a “**Common Share**” and, together with the Preferred Shares, each a “**Share**”) of the Company’s common stock, \$0.001 par value (“**Company Common Stock**” and, together with the Preferred Stock, the “**Company Capital Stock**”), outstanding at the Effective Time, including Common Shares issued prior to the Effective Time upon exercise of Company Stock Options or Company Warrants or other convertible securities, but excluding Dissenting Shares and Excluded Shares, shall by virtue of the Merger and without any action on the part of any party hereto or any holder thereof, be converted into the right to receive cash in the per share amount calculated as set forth in the Signing Spreadsheet (the “**Common Amount**” and, with respect to the Preferred Shares, together with the applicable Preferred Amount, the “**Share Amount**”), subject to adjustments and payable as provided in this Agreement.

(D) Neither Parent nor Purchaser shall assume outstanding Company Stock Options, or issue any securities in exchange therefor, in connection with the transactions contemplated hereby. Immediately prior to the Effective Time and subject to consummation of the Merger and the terms and conditions of this Agreement, the vesting of all outstanding Company Stock Options shall be accelerated in full and at the Effective Time, each then outstanding Company Stock Option shall terminate, and the holder thereof shall have the right to receive a cash payment in the amount equal to the product of (y) the Net Value of each In-the-Money Option (as defined in Section 1.10(a) below) (the “**Option Net Value**”) and (z) the number of shares of Common Stock subject thereto (such product, the “**Option Amount**”), less any applicable Tax withholding, which the parties agree shall be a payment on a “change in the ownership” (as defined in Treasury Reg. Section 1.409A-3(i)(5)(v)) of the Company. The Company shall take all actions reasonably necessary to effect the transactions contemplated by this Section 1.8(a)(i)(D) under the Stock Option Plans, Company Stock Option agreements and any other applicable plan or arrangement of the Company.

(E) Prior to the Effective Time, the Company shall amend each outstanding Company Warrant (and/or otherwise take all necessary and appropriate actions) to provide that, subject to consummation of the Merger and the terms and conditions of this Agreement, at the Effective Time, each then outstanding Company Warrant shall terminate, and the holder thereof shall have the right to receive the consideration equal to the product of (y) the Net Value of each In-the-Money Warrant (the “**Warrant Net Value**”) and (z) the number of shares of Company Capital Stock subject thereto (such product, the “**Warrant Amount**”), less any applicable Tax withholding.

(F) The Share Amounts set forth in the Signing Spreadsheet are an estimate only, and the actual Share Amounts to be paid to the Shareholders, Optionholders and Warranholders shall be as set forth in the Closing Spreadsheet (as defined in Section 6.7).

(G) The maximum consideration payable as set forth in this Agreement in connection with the Merger for all of the issued and outstanding capital stock of the Company on a Fully Diluted Basis as of the Closing Date shall be forty million U.S. Dollars (\$40,000,000) (the “**Maximum Merger Consideration**”), of which up to (i) twenty-five million U.S. Dollars (\$25,000,000) shall be payable at the Closing (the “**Closing Payment**”), (ii) seven million U.S. Dollars (\$7,000,000) shall be payable pursuant to Section 1.9(d) (the “**Deferred Payment**”) and (iii) eight million U.S. Dollars (\$8,000,000) shall be payable pursuant to Section 1.13 (the “**Contingent Payment**”), subject to downward adjustment and payable as provided in this Agreement. Such payments shall be made in cash, except that 10% of the Merger Consideration (as defined in Section 1.9(a) hereof) payable for the Founder (as defined in Exhibit A hereto) as part of each of the Closing Payment, the Deferred Payment and the Contingent Payment shall be paid in the form of Parent Shares (as defined in Exhibit A hereto) at the Market Value thereof (as defined in Exhibit A hereto) (each such payment for the Founder in the form of Parent Shares being referred to herein as the “**Founder Share Consideration**”). Notwithstanding anything contained herein to the contrary, in no event shall the Maximum Merger Consideration exceed the sum of (1) the product of the Series A Amount multiplied by the number of Series A Preferred Shares (the “**Total Series A Amount**”), (2) the product of the Series B Amount multiplied by the number of Series B Preferred Shares (the “**Total Series B Amount**”), (3) the product of the Common Amount multiplied by the number of Common Shares, (4) the sum of the Option Amount for all In-the-Money Options, (5) the sum of the Warrant Amount for all In-the-Money Warrants (the “**Total Warrant Amount**”) and the sum of the Warrant Amount for the Preferred Warrant (as defined in Exhibit A) together with the Total Series A Amount and the Total Series B Amount, the “**Total Preferred Share Amount**”), in each case outstanding as of the Effective Time (including Dissenting Shares but excluding Excluded Shares) (the amounts in clauses (1) through (5) above, the “**Total Share Amount**”), (6) the Transaction Cost Amount and (7) the Working Capital Shortfall. If the sum of the Total Share Amount plus the additional aggregate amounts referred to in clauses (6) and (7) above would exceed the Maximum Merger Consideration, then the Merger Consideration shall, for all purposes hereunder, be adjusted downward, dollar-for-dollar, by such aggregate amount and, consequently, each Preferred Amount and the Common Amount shall be adjusted downward proportionately (based on the proportion each such Preferred Amount, Common Amount, Option Net Value or Warrant Net Value bears to the Total Share Amount) to numbers such that such sum does not exceed the Maximum Merger Consideration.

(ii) Each Share held in the treasury of the Company and each Share held by Parent, Purchaser, Merger Sub, any other subsidiary of Parent or Purchaser, or any subsidiary of the Company immediately prior to the Effective Time (“**Excluded Shares**”) will, by virtue of the Merger and without any action on the part of the Company or the holder thereof, be canceled, retired and cease to exist, and no consideration will be delivered in exchange therefor.

(iii) Each outstanding share of common stock of Merger Sub shall be converted into one (1) fully paid and non-assessable share of common stock of the Surviving Corporation and shall constitute the only shares of capital stock of the Surviving Corporation outstanding immediately after the Effective Time.

(b) The merger consideration payable pursuant to this Agreement to each holder of Shares, Company Stock Options or Company Warrants (the “**Merger Consideration**”), including Dissenting Shares but excluding Excluded Shares, shall be the sum of (1) the product of the Series A Amount multiplied by the number of Series A Preferred Shares held by such holder, (2) the product of the Series B Amount multiplied by the number of Series B Preferred Shares held by such holder, (3) the product of the Common Amount multiplied by the number of Common Shares held by such holder, (4) the aggregate of the Option Amount for all In-the-Money Options held by such holder and (5) the aggregate of the Warrant Amount for all In-the-Money Warrants held by such holder (such sum for each holder in clauses (1), (2) and the Warrant Amount for the Preferred Warrant held by such holder, being referred to herein as such holder’s “**Holder Preferred Share Amount**”) and the sum for each holder in clauses (1) through (5) being referred to herein as such holder’s “**Holder Share Amount**”).

(c) If between the date of this Agreement and the Effective Time, the number of outstanding shares of Company Common Stock, Preferred Stock, Company Stock Option or Company Warrant is changed into a different number of shares or a different class or option, by reason of any stock dividend, subdivision, reclassification, recapitalization, split-up, combination, exchange of shares, or the like, the per Share amounts set out in Sections 1.8(a) and (b) and the Signing Spreadsheet will be correspondingly adjusted to reflect such change.

### **1.9 Payment for Shares; Escrow Fund.**

(a) At the Effective Time, Purchaser shall deposit with U.S. Bank National Association, a national banking association (the “**Paying Agent**”), for the benefit of the holders of Shares, In-the-Money Options and In-the-Money Warrants, excluding Dissenting Shares (and any Shares with respect to which dissenters’ rights have not terminated) and Excluded Shares, the Closing Payment, as follows: (A) cash in an amount equal to twenty-five million U.S. Dollars (\$25,000,000) less (i) the Transaction Cost Amount, (ii) the Working Capital Shortfall, (iii) any amount retained by Purchaser in respect of Dissenting Shares pursuant to Section 1.11(b) and (iv) the Market Value of the Founder Share Consideration; and (B) two certificates representing 90% and 10%, respectively, of the Founder Share Consideration. The Closing Payment shall be allocated in the following order: (i) ten percent (10%) of the cash portion of the Closing Payment, as adjusted pursuant to Section 1.9(a)(A)(i) to (iii), (and any interest accruing thereon) and ten percent (10%) of the Founder Share Consideration shall constitute the “**Escrow Fund**” and shall be held by the Paying Agent, acting in its capacity as escrow agent pursuant to the Escrow Agreement, and applied for the payment of indemnification obligations under Article 10 hereof, (ii) fifty thousand U.S. Dollars (\$50,000) shall be transferred to the Shareholder Representative and shall constitute the Representative Fund in accordance with Section 12.5 hereof, (iii) one hundred percent (100%) of the Total Preferred Share Amount shall be distributed to the holders of the Preferred Shares and the Preferred Warrant (the “**Preferred Holders**”), and (iv) the remaining cash portion of the Closing Payment (the “**Common Merger Consideration**”) and ninety percent (90%) of the Founder Share Consideration shall be distributed by the Paying Agent to the Shareholders, Optionholders and Warrantholders pursuant to Section 1.9(b) hereof (the sum of the amounts set forth in clauses (iii) and (iv), the “**Distribution Amount**”). The Company and the Purchaser shall each pay one-half of the fees and expenses of the Paying Agent.

(b) Promptly after the Effective Time, the Paying Agent shall cause to be mailed to each Person who was, at the Effective Time, (i) a holder of record of Shares as set forth in the Closing Spreadsheet (excluding Dissenting Shares (and any Shares with respect to which dissenters' rights have not terminated) and Excluded Shares) (each, a "**Participating Shareholder**") a form of letter of transmittal in substantially the form of Exhibit D (which specifies that delivery shall be effected and risk of loss and title to the certificates shall pass only upon delivery of the certificates to Purchaser) and instructions for use in effecting the surrender of the certificates that, immediately prior to the Effective Time, represented any of such Shares, (ii) an Optionholder or a Warrantholder, a letter in a form reasonably acceptable to the Company and Purchaser, notifying such Person of the treatment of the applicable Company Options and Company Warrants in the Merger. Upon surrender to the Paying Agent of such certificates (or affidavit of loss or destruction in lieu thereof, including any suitable bond or indemnity that may be required by Purchaser or the Paying Agent in its sole discretion), together with such letter of transmittal, duly executed and completed in accordance with the instructions thereto, the Paying Agent shall promptly, but in no event later than three Business Days thereafter cause to be paid to the respective Participating Shareholder entitled thereto an amount equal to (A) in the case of the holders of Series A Preferred Stock, Series B Preferred Stock and the Preferred Warrant, the product of the Total Preferred Share Amount *multiplied by* such Participating Shareholder's Consideration Fraction for Preferred Stock (as defined in Exhibit A); and (B) in the case of the holders of Common Stock, the product of the Distribution Amount *less* the Total Preferred Share Amount *multiplied by* such Participating Shareholder's Consideration Fraction (as defined in Exhibit A), less any required Tax (as defined in Exhibit A) withholdings (it being understood that any amounts to be distributed in respect of any Option Amount shall be delivered by the Paying Agent to Purchaser and Purchaser shall cause such amounts, less applicable withholding Taxes, to be disbursed to the applicable Optionholder); provided that if a Participating Shareholder delivers such certificates and properly completed letter of transmittal at least three Business Days prior to the Closing, the Paying Agent shall cause such payment to be made within three Business Days of the Closing Date. Such payments (and the payments to be made pursuant to Sections 1.9(d) and 1.9(e) hereof) shall be made by wire transfer or check in accordance with the instructions, and delivered in person or by mail to the address, specified in the applicable letter of transmittal. No interest will be paid or will accrue on the amount payable upon the surrender of any such certificate. If payment is to be made to a Person other than the registered holder of the certificate surrendered, it shall be a condition of such payment that the certificate so surrendered shall be properly endorsed or otherwise in proper form for transfer and that the Person requesting such payment shall pay any transfer or other Taxes required by reason of the payment to a Person other than the registered holder of the certificate surrendered or establish to the reasonable satisfaction of Purchaser that such Tax has been paid or is not applicable. Purchaser or the Paying Agent, as applicable, may withhold and deduct any amounts paid in accordance with this Agreement for payment of all applicable deductions and withholding Taxes to the extent provided by applicable Legal Requirements, *provided* that Purchaser or the Paying Agent, as applicable, shall reduce such deduction or withholding in the event it is provided with certificates or other documentation, in form and substance reasonably satisfactory to Purchaser, evidencing any valid exemption from such deduction or withholding. Notwithstanding the foregoing, the Founder shall receive the Founder Share Consideration in lieu of cash in the amount of the Market Value thereof. At the request of the Paying Agent, the Shareholder Representative shall direct the Paying Agent with respect to the proper allocation of the Merger Consideration among the respective securityholders of the Company; for the avoidance of doubt, none of the Parent, Purchaser or the Surviving Company shall be liable for the allocation of the Merger Consideration among the respective securityholders of the Company.

(c) After the Effective Time, there shall be no transfers on the stock transfer books of the Surviving Corporation of shares of capital stock of the Company that were outstanding immediately prior to the Effective Time.

(d) On the seven-month anniversary of the Closing Date, Purchaser shall deposit with the Paying Agent the Deferred Payment, as follows: (A) cash in the amount of seven million U.S. Dollars (\$7,000,000), subject to adjustment as set forth in this Agreement, *less* the Market Value of the Founder Share Consideration; and (B) a certificate representing the Founder Share Consideration. Ninety percent (90%) of each of the cash and Founder Share Consideration of the Deferred Payment, as adjusted if applicable, shall be distributed by the Paying Agent to the Participating Shareholders holding shares of Common Stock and the Optionholders holding In-the-Money Options and the Warrantholders holding In-the-Money Warrants other than the Preferred Warrant (each, a "**Participating Securityholder**"), and the balance shall be added to the Escrow Fund and shall be held by the Paying Agent, acting in its capacity as escrow agent pursuant to the Escrow Agreement, and applied for the payment of indemnification obligations under Article 10 hereof (it being understood that any amounts to be distributed in respect of any Option Amount shall be delivered by the Paying Agent to Purchaser and Purchaser shall cause such amounts, less applicable withholding Taxes, to be disbursed to the applicable Optionholder). The Deferred Payment shall be subject to downward adjustment to the extent, if any, that the Company Net Working Capital (as defined in Section 1.12(a) hereof, substituting "Measurement Date" (as defined below) for "Closing Date") on any Measurement Date shall be less than two hundred sixty one thousand U.S. Dollars (\$261,000) (the "**Post-closing WC Adjustment**"). The amount of the Post-closing WC Adjustment shall be determined based on the Measurement Date on which the Company Net Working Capital was the lowest of all the Measurement Dates, provided that the Post-Closing WC Adjustment shall not exceed seven hundred fifty thousand U.S. Dollars (\$750,000). A "**Measurement Date**" shall mean the last day of each calendar month ending after the Closing Date and on or prior to the seven-month anniversary of the Closing Date. The Shareholder Representative may object to Purchaser's calculation of the Post-closing WC Adjustment by providing written notice of such objection to Purchaser within 10 Business Days after receipt of such calculation. Any disputes between Purchaser and the Shareholder Representative regarding the Post-closing WC Adjustment shall be resolved in the same manner as set forth in Section 1.12(e) and (f) hereof, *mutatis mutandis*, and the fees of the Reviewing Accountant, if applicable, shall be allocated in the same manner as set forth in Section 1.12(h) hereof, *mutatis mutandis*. Purchaser shall be entitled to withhold any amount of Post-closing WC Adjustment that is in dispute until such dispute is resolved. Notwithstanding the foregoing, in the event that, prior to the payment of the Deferred Payment, Parent publishes a consolidated balance sheet of Parent reflecting an aggregate amount of cash and cash equivalents and marketable securities of less than eight million U.S. Dollars (\$8,000,000), then upon the written request of the Shareholder Representative, unless Parent presents the Shareholder Representative with evidence of an available credit line in an amount that, together with the foregoing amount, exceeds eight million U.S. Dollars (\$8,000,000), the Deferred Payment shall become immediately due and payable; provided, however, that Purchaser may withhold from the Deferred Payment an amount equal to seven hundred fifty thousand U.S. Dollars (\$750,000) for the purpose of making the Post-Closing WC Adjustment, and the amount by which such withheld amount exceeds the amount of the Post-closing WC Adjustment, if any, shall be deposited with the Paying Agent on the seven-month anniversary of the Closing Date in the same manner as set forth in the first sentence of this Section 1.9(d), subject to Purchaser's right to withhold the amount in dispute, if any, until such dispute is resolved. Promptly following the receipt of the Deferred Payment by the Paying Agent, but in no event later than three Business Days thereafter, the Paying Agent shall cause each Participating Securityholder to receive its portion of the distributable portion of the Deferred Payment, which shall equal the product of the distributable portion of the Deferred Payment *multiplied* by such Participating Securityholder's Consideration Fraction, less any required Tax withholdings.

(e) (i) Promptly following the final determination of the amount of the Contingent Payment pursuant to Section 1.13 of the Merger Agreement, Purchaser shall transfer such amount, if any, to the Paying Agent. Ninety percent (90%) of each of the cash and Founder Share Consideration of the Contingent Payment, if any, shall be distributed by the Paying Agent to the Participating Securityholders, and the balance shall be added to the Escrow Fund and shall be held by the Paying Agent, acting in its capacity as escrow agent pursuant to the Escrow Agreement, and applied for the payment of indemnification obligations under Article 10 hereof, provided, however, that the amount of the Contingent Payment to be added to the Escrow Fund shall be reduced (and distributed instead to the Participating Securityholders) to the extent that the Deferred Payment was reduced pursuant to Section 10.7(a) below. Promptly following the payment of the Contingent Payment, if any, but in no event later than three Business Days thereafter the Paying Agent shall cause each Participating Securityholder to receive its portion of the distributable portion of the Contingent Payment, which shall equal the product of the distributable portion of the Contingent Payment *multiplied* by such Participating Securityholder's Consideration Fraction, less any required Tax withholdings (it being understood that any amounts to be distributed in respect of any Option Amount shall be delivered by the Paying Agent to Purchaser and Purchaser shall cause such amounts, less applicable withholding Taxes, to be disbursed to the applicable Optionholder).

(f) One hundred and eighty (180) days following the Effective Time or the date of payment by Purchaser of the Deferred Payment or the Contingent Payment, as the case may be, Purchaser shall be entitled to cause the Paying Agent to deliver to it any funds (including any interest received with respect thereto) made available to the Paying Agent that have not been disbursed to holders of certificates or agreements formerly representing Shares outstanding on the Effective Time, and thereafter such holders shall be entitled to look to Purchaser only as general creditors thereof with respect to the cash payable upon due surrender of their certificates or agreements.

(g) Notwithstanding the foregoing, neither the Paying Agent nor any party hereto shall be liable to any holder of certificates formerly representing Shares for any amount paid to a public official pursuant to any applicable abandoned property, escheat or similar law. The Surviving Corporation shall pay all charges and expenses in connection with the exchange of cash for Shares.

(h) With respect to the Founder Share Consideration that is being held in escrow by the Paying Agent: (A) any dividends that are paid in respect thereof shall be held in escrow by the Paying Agent and released at the same time and to the same Person as the underlying Founder Share Consideration; and (B) all voting rights in respect thereof shall be exercised by the Paying Agent pursuant to a proxy granted by the Founder. The Paying Agent shall vote such Founder Share Consideration in favor of all proposals that the Board of Directors of Parent shall recommend to vote in favor.

#### **1.10 Company Convertible Securities.**

(a) For purposes of this Agreement, “**Stock Option Plans**” means the Smilebox 2005 Stock Option Plan and the Smilebox 2007 Stock Plan; and “**Company Stock Option**” means each outstanding option to purchase shares of Company Common Stock under the Stock Option Plans. “**In-the-Money Options**” means all Company Stock Options that have an exercise price in excess of the Common Amount as calculated pursuant to Section 1.10(b) below. “**In-the-Money Warrants**” means all Company Warrants that have an exercise price in excess of the Common Amount as calculated pursuant to Section 1.10(b) below.

(b) Immediately prior to the Effective Time, each Company Stock Option and Company Warrant shall become fully vested and exercisable in full. The Option Amount for each In-the-Money Option and the Warrant Amount for each In-the-Money Warrant shall be included in the disbursement of the Closing Payment, Deferred Payment and Contingent Payment, if any, as and when such disbursements are made to the Participating Shareholders plus the applicable portion of any amounts required to be disbursed from the Escrow Fund and Representative Fund to the Participating Shareholders in accordance with the terms in Sections 1.9 and 12.5. The Paying Agent shall pay by wire transfer of immediately available funds to the Surviving Corporation within three (3) Business Days after the Closing, on each of the disbursement dates for the Deferred Payment and Contingent Payment and on the date of release of any amounts from the Escrow Fund for the benefit of the Optionholders of In-the-Money Options, and Purchaser shall cause the Surviving Corporation to pay to each Optionholder of In-the-Money Options within three (3) Business Days of each such date, the consideration that each such holder is entitled to receive with respect to such In-the-Money Option less any applicable Tax withholding.

(c) For purposes of calculating In-the-Money Options and In-the-Money Warrants, the Common Amount shall be calculated based on the aggregate Merger Consideration paid through such payment date. By way of illustration, if a Company Stock Option or Company Warrant is not an In-the-Money Option or In-the Money Warrant, respectively, at the time of the Closing but becomes an In-the-Money Option or In-the-Money Warrant as of the date the Deferred Payment shall be due and payable based on the sum of the Closing Payment Amount and the Deferred Payment Amount, such Company Stock Option or Company Warrant shall be an In-the-Money Option or In-the-Money Warrant, respectively, for purposes of the Deferred Payment and the Common Amount shall be as adjusted based on the sum of the Closing Payment and the Deferred Payment for purposes of determining the Option Net Value or Warrant Net Value, respectively.

**1.11 Dissenting Shares.**

(a) Notwithstanding any provision of this Agreement to the contrary and to the extent available under the WBCA, Shares that are outstanding immediately prior to the Effective Time and that are held by any Shareholder who is entitled to demand and properly demands the appraisal for such shares (the “**Dissenting Shares**”) pursuant to, and who complies in all respects with, the provisions of Section 23B.13 of the WBCA shall not be converted into, or represent the right to receive, the Merger Consideration. Any such Shareholder shall instead be entitled to receive payment for such Shareholder’s Dissenting Shares in accordance with the provisions of Section 23B.13 of the WBCA, *provided, however*, that all Dissenting Shares held by any Shareholder who shall have failed to perfect or who otherwise shall have withdrawn, in accordance with the WBCA, or lost such Shareholder’s rights to appraisal of such shares under the WBCA, shall thereupon be deemed to have been converted into, and to have become exchangeable for, as of the Effective Time, the right to receive the applicable Merger Consideration, without any interest thereon, upon surrender of the certificate or certificates that formerly evidenced such Shares in the manner provided in Section 1.9 hereof.



(b) The Company shall give Purchaser (i) prompt notice of any dissenters' rights demands received by the Company for any Shares, withdrawals of such demands and any other instruments served pursuant to the WBCA and received by the Company and (ii) the opportunity to participate in all negotiations and proceedings with respect to such demands. The Company shall not, except with the prior written consent of Purchaser, which shall not be unreasonably withheld, make any payment or agree to make any payment with respect to, or offer to settle or settle, any such demands. Each Dissenting Shareholder who, pursuant to the provisions of the WBCA, becomes entitled to payment of the value of the Dissenting Shares will receive payment therefor but only after the value therefor has been agreed upon or finally determined pursuant to such provisions. Any portion of the Share Amount that would otherwise have been payable with respect to Dissenting Shares if such Shares were not Dissenting Shares will be retained by Purchaser.

#### **1.12 Working Capital Adjustment.**

(a) Pursuant to Section 6.8 hereof, not less than two (2) Business Days prior to the Closing, the Company shall deliver to Purchaser a certificate executed by the principal financial officer of the Company (in his or her capacity as such) detailing the Company's good faith best estimate of Company Net Working Capital, including a draft of the Company's unaudited balance sheet as of the Closing Date prepared on a consistent basis with the Financial Statements (as defined in Section 2.4 hereof) (the "**Company Net Working Capital Certificate**"). The Company Net Working Capital Certificate shall be prepared by the Company in accordance with GAAP consistently applied by the Company and in accordance with Schedule 1.12 and shall fairly and accurately present the Company's good faith best estimate (based on reasonable assumptions) of the balance sheet of the Company and the estimated Company Net Working Capital as of the close of business on the Closing Date. The Company Net Working Capital Certificate shall be used to reduce the Merger Consideration payable at the Closing to the extent, if any, that the amount of Company Net Working Capital set forth therein shall be less than \$346,000 (the "**Working Capital Target**", and the amount of such deficiency, if any, being referred to herein as the "**Working Capital Shortfall**").

"**Company Net Working Capital**" means (A) the Company's total current assets as of the close of business on the Closing Date (as determined in accordance with GAAP consistently applied by the Company) less (B) the Company's total current liabilities as of the close of business on the Closing Date (as determined in accordance with GAAP consistently applied by the Company). The calculation of Company Net Working Capital shall be based on the Financial Statements and the methodology relating thereto is set forth in Schedule 1.12, which the parties agree will be the methodology used in determining the Company Net Working Capital.

(b) Within 90 days after the Closing, Purchaser may object to the Company Net Working Capital calculations included in the Company Net Working Capital Certificate (the "**NWC Calculations**") by delivering to the Shareholder Representative a certificate (the "**Purchaser NWC Certificate**") executed by Purchaser's Chief Financial Officer (in his or her capacity as such), or a representative thereof, setting forth Purchaser's calculation of the Company Net Working Capital as of the close of business on the Closing Date and the amount by which Company Net Working Capital as calculated by Purchaser is less than the Company Net Working Capital set forth in the Company Net Working Capital Certificate. Any Purchaser NWC Certificate shall be prepared in accordance with GAAP and in accordance with Schedule 1.12 and shall take into account any information not available to the parties at the time the Company Net Working Capital Certificate was delivered.

(c) Following the delivery by Purchaser of the Purchaser NWC Certificate, the Shareholder Representative and his representatives shall be given such access as they may reasonably require during Purchaser's normal business hours (or such other times as the parties may agree) and upon reasonable notice to those books and records of the Company in the possession of, and/or under the control of, Purchaser, and access to such personnel or representatives of the Company and Purchaser as they may reasonably require for the purposes of resolving any disputes or responding to any matters or inquiries raised concerning the Purchaser NWC Certificate and/or the calculation of the Company Net Working Capital.

(d) The Shareholder Representative may object to the Company Net Working Capital calculations set forth in the Purchaser NWC Certificate by providing written notice of such objection to Purchaser within 20 Business Days after Purchaser's delivery of the Purchaser NWC Certificate (the "**Notice of Objection**").

(e) If the Shareholder Representative timely provides the Notice of Objection, then the parties shall confer in good faith for a period of up to 10 Business Days following Purchaser's timely receipt of the Notice of Objection, in an attempt to resolve any disagreement, and any resolution by them shall be in writing and shall be final and binding.

(f) If, after such 10 Business Day period, the Shareholder Representative and Purchaser cannot resolve any such disagreement, then the parties shall engage an auditing firm acceptable to both the Shareholder Representative and Purchaser (the "**Reviewing Accountant**") to review the NWC Calculations. Each of the parties to this Agreement shall, and shall cause their respective officers, directors, employees and representatives to, provide full cooperation to the Reviewing Accountant. The Reviewing Accountant shall (i) act in its capacity as an expert and not as an arbitrator, (ii) consider only those matters as to which there is a dispute between the parties and (iii) be instructed to reach its conclusions regarding any such dispute within 30 days after its appointment and provide a written explanation of its decision. In the event that Purchaser and the Shareholder Representative shall submit any dispute to the Reviewing Accountant, each such party may submit a "position paper" to the Reviewing Accountant setting forth the position of such party with respect to such dispute, to be considered by such Reviewing Accountant as it deems fit. The Reviewing Accountant shall promptly determine the Company Net Working Capital and such determination shall be final and binding on the parties.

(g) If the Company Net Working Capital, as determined pursuant to Section 1.12(b) (in the event there is no Notice of Objection), Section 1.12(e) or Section 1.12(f), as the case may be, is less than the Company Net Working Capital set forth in the Company Net Working Capital Certificate (such difference, the "**Negative Adjustment Amount**"), then the amount of the Deferred Payment shall be reduced by the amount of the Negative Adjustment Amount.

(h) If the Company Net Working Capital as determined by the Reviewing Accountant is closer to the Company Net Working Capital as set forth in the Notice of Objection than to the Company Net Working Capital as set forth in the Purchaser NWC Certificate, then two-thirds of the fees and expenses of the Reviewing Accountant shall be borne by Purchaser and one-third thereof shall be borne by the Participating Securityholders by way of reduction of the Deferred Payment. Otherwise, one-third of such fees and expenses shall be borne by Purchaser and two-thirds thereof shall be borne by the Participating Securityholders by way of reduction of the Deferred Payment.

(i) Notwithstanding the foregoing, if the Deferred Payment shall be due and payable pursuant to Section 1.9(d) hereof prior to the final determination of Company Net Working Capital pursuant to this Section 1.12, then any amounts described in Section 1.12(g) and Section 1.12(h) as reducing the Deferred Payment, as reasonably estimated by Purchaser, shall be held by the Paying Agent and distributed upon the final determination of Company Net Working Capital.

### **1.13 Contingent Payment**

(a) As part of the Merger Consideration, if the Company meets the financial and business performance criteria described in Section 1.13(h) hereof (the “**Milestones**”) during the Earn-out Period, then promptly following the final determination of the amount of the Contingent Payment in accordance with this Section 1.13, Purchaser shall deposit such amount with the Paying Agent, for the benefit of the holders of Shares in accordance with Section 1.9(e) hereof, as follows: (A) the amount of the Contingent Payment in cash *less* the Market Value of the Founder Share Consideration; and (B) a certificate representing the Founder Share Consideration. The “**Earn-out Period**” shall mean the period from October 1, 2011 to September 30, 2012.

(b) Promptly following the expiration of the Earn-out Period, but in no event more than 45 days thereafter, Purchaser shall deliver to the Shareholder Representative a certificate setting forth, in reasonable detail, Purchaser’s calculation of the Company’s performance in respect of the Milestones during the Earn-out Period and the resulting amount of the Contingent Payment, if any (the “**Earn-out Statement**”).

(c) Following the delivery by Purchaser of the Earn-out Statement, the Shareholder Representative and his representatives shall be given such access as they may reasonably require during Purchaser’s normal business hours (or such other times as the parties may agree) and upon reasonable notice to those books and records of the Company in the possession of, and/or under the control of, Purchaser, and access to such personnel or representatives of the Company and Purchaser as they may reasonably require for the purposes of confirming the Earn-out Statement.

(d) Within 45 days following receipt of the Earn-out Statement (the “**Milestone Objection Period**”), the Shareholder Representative may object to the Earn-out Statement by delivering to Purchaser a certificate executed by the Shareholder Representative setting forth the Shareholder Representative’s calculation of Company’s performance in respect of the Milestones and the resulting amount of the Contingent Payment (the “**Milestone Objection Notice**”). If the Shareholder Representative fails to deliver such Milestone Objection Notice within the Milestone Objection Period, then the calculation by Purchaser of the amount of the Contingent Payment shall be deemed finally determined.

(e) However, if the Shareholder Representative delivers such Milestone Objection Notice within the Milestone Objection Period, then the dispute regarding such amount shall be resolved in the same manner as set forth in Section 1.12(e) and (f) hereof, *mutatis mutandis*.

(f) Promptly following the final determination of the amount of the Contingent Payment, Purchaser shall pay such amount to the Paying Agent for distribution to the Participating Securityholders pursuant to Section 1.9(e).

(g) If the amount of the Contingent Payment as determined by the Reviewing Accountant is closer to the amount as set forth in the Milestone Objection Notice than to the amount as set forth in the Earn-out Statement, then two-thirds of the fees and expenses of the Reviewing Accountant shall be borne by Purchaser and one-third thereof shall be borne by the Participating Securityholders by way of reduction of the Contingent Payment. Otherwise, one-third of such fees and expenses shall be borne by Purchaser and two-thirds thereof shall be borne by the Participating Securityholders by way of reduction of the Contingent Payment. To the extent that the amount of the Contingent Payment is not high enough to absorb such reduction, the balance shall be considered Section 10.5 Damages.

(h) Milestones: Set forth below are the Milestones:

( i ) **Net Revenue**: The Company shall have generated Net Revenue during the Earn-out Period greater than\*\*\*. “**Net Revenue**” shall mean the sales of the Company, net of taxes, commissions, allowances and fees, determined in accordance with GAAP, as consistently applied by the Company but excluding any Search Related Revenue. “**Search Related Revenue**” shall mean revenue generated by Google (or other search-engine) searches performed by users of the Company’s products.

( i i ) **New Installs**: At least \*\*\* new “PC” and “Mac” customers shall have installed the Company’s product (determined pursuant to the Company’s historical methodology consistently applied) (“**New Installs**”) during the Earn-out Period, *provided* that (i) such New Installs are acquired directly by the Company and not through third-party distribution or business development partnerships (“**Direct Users**”) and (ii) at least \*\*\* of the amount of the Company’s customer acquisition costs (“media buy”) (as determined pursuant to the Company’s historical methodology consistently applied) during the Earn-out Period will be spent in Canada, France, Germany, the United Kingdom and the United States.

( i i i ) **EBITDA**: The Company shall have generated EBITDA during the Earn-out Period of at least \*\*\* while adhering to the Company’s business plan, a copy of which is attached hereto as Exhibit E, as may be revised with the approval by Parent (the “**Business Plan**”), without materially shifting resources among general and administrative expenses, sales and marketing expenses, and research and development expenses. “**EBITDA**” shall mean net income *plus* the sum of the following expenses: interest, tax and depreciation and amortization, determined in accordance with GAAP, as consistently applied by the Company but excluding any stock-based compensation expense, Search Related Revenue and Search Related Expenses. “**Search Related Expenses**” shall mean the material expenses incurred to generate Search Related Revenue.

( i v ) **Search Functionality:** The Company shall have maintained Search Functionality throughout the Earn-out Period. “**Search Functionality**” shall mean that each new Windows PC Direct User of the Company’s product in English, during the process of download thereof, is offered Parent’s search service, as described in Schedule 1.13(h) attached hereto; provided, however, that during the first thirty days following the Effective Time, the Search Functionality shall be required to be maintained for the MSN channel only, and provided further that Search Functionality shall be implemented (i) for the Company’s other channels as soon as practicable during such thirty-day period and (ii) in other languages and for Mac Direct Users of the Company’s product as soon as practicable after being made available by Parent. This milestone shall be deemed to be not satisfied if (A) Search Functionality does not function for three consecutive days and the Company fails to restore Search Functionality within seven days after it becomes aware of such problem or (B) Search Functionality does not function for an aggregate of 21 days during the Earn-out Period.

(i) If all four of the Milestones shall have been met by the Company, then the amount of the Contingent Payment shall be the amount determined as follows: the product of (x) eight million U.S. Dollars (\$8,000,000), and (y) one minus a fraction, the numerator of which shall be \*\*\* minus the Net Revenue rounded to the nearest dollar (provided that the numerator shall not be lower than zero), and the denominator of which shall be \*\*\*; provided that the maximum Contingent Payment Amount shall be eight million U.S. Dollars (\$8,000,000). For the avoidance of doubt, if any of the four Milestones is not met by the Company, then the amount of the Contingent Payment shall be zero.

**1.14 Parent’s Undertakings.** Parent undertakes that:

(a) During the Earn-out Period, it shall provide resources to the Company to enable the Company to meet the Milestones consistent with the Business Plan, provided, however, that if (i) the Company’s actual cumulative Net Revenue for any period of three consecutive calendar months during the Earn-Out Period is less than \*\*\* of the projected Net Revenue for such period set forth in the Business Plan or (ii) the Company’s actual cumulative Net Revenue from the commencement of the Earn-out Period through the end of any calendar month shall be \*\*\* or more lower than the projected Net Revenue for such period set forth in the Business Plan, Parent shall be entitled to make changes to the Business Plan in its sole discretion, even if such changes adversely affect the Company’s ability to meet the Milestones.

(b) During the Earn-out Period, it shall use its best efforts to ensure that no covenants in its credit agreements or indentures will restrict its ability to pay the Deferred Amount or the Contingent Payment.

(c) Until the payment of the Deferred Payment, it shall use its best efforts to maintain cash and cash equivalents and marketable securities in the aggregate amount of at least eight million U.S. Dollars (\$8,000,000).

**Section 2. REPRESENTATIONS AND WARRANTIES OF THE COMPANY.**

The Company represents and warrants to and for the benefit of Parent, Purchaser and Merger Sub, as of the date hereof and as of the Closing as follows, subject to the exceptions set forth in the respective parts of the attached Disclosure Schedule corresponding to the section numbers below and such other sections in this Section 2 where the relevance of such disclosure is reasonably apparent on the face of such disclosure:

**2.1 Due Organization; Etc.**

(a) The Company is a corporation duly incorporated and organized and validly existing under the laws of the State of Washington and has all requisite corporate power and authority to own and use its assets and conduct its business as now conducted and Currently Proposed to be Conducted.

(b) Neither the Company nor any of its Subsidiaries have conducted any business under or otherwise used, for any purpose or in any jurisdiction, any fictitious name, assumed name, trade name or other than its own name.

(c) Neither the Company nor any of its Subsidiaries is nor have they ever been required to be qualified, authorized, registered or licensed to do business as a foreign corporation in any foreign jurisdiction in which they conduct business.

(d) **Part 2.1(d)** of the Disclosure Schedule accurately sets forth (i) the names of the members of the Company's and the Subsidiaries' board of directors, (ii) the names of the members of each committee of the Company's and the Subsidiaries' board of directors, and (iii) the names and titles of the Company's and the Subsidiaries' officers.

(e) Except for the Entities set forth in **Part 2.1(e)** of the Disclosure Schedule, the Company does not own any interest in any Entity and the Company has never owned, beneficially or otherwise, any shares or other securities of, or any direct or indirect equity interest in, any Entity. The Company has not agreed and is not obligated to make any future investment in or capital contribution to any Entity. The Company has not guaranteed and is not responsible or liable for any obligation of any Entity. **Part 2.1(e)** of the Disclosure Schedule accurately sets forth the Company's holdings in each of the Subsidiaries (including the percentage of the outstanding share capital represented by such holdings) and a description of each Subsidiary's business, activities and operations. Each Subsidiary is duly organized and validly existing under the laws of its incorporation, and each Subsidiary has full corporate power and authority to own, lease and operate its properties and assets to conduct its business as now being conducted. Except as specified in Part 2.1(e) of the Disclosure Schedule, no person has any right to participate in, or receive any payment based on any amount relating to, the revenue, income, value or net worth of any Subsidiary or any component or portion thereof, or any increase or decrease in any of the foregoing. The Company has no existing obligation or undertaking of any kind whatsoever to make additional contributions or investments in any of the Entities set forth in **Part 2.1(e)** of the Disclosure Schedule. The Subsidiaries of the Company are inactive and have no liabilities, contingent or otherwise. For the purposes of the remainder of this Section 2, unless the context otherwise requires or indicates, all references to the "Company" shall include each Subsidiary.

**2.2 Charter Documents; Records.** The Articles of Incorporation and Bylaws of the Company have been duly adopted by all necessary corporate action and procedures on the part of the Company and in accordance with all applicable laws. True, complete and correct copies of the Articles of Incorporation and Bylaws of the Company, including all amendments thereto, currently in effect (the “**Charter Documents**”) have been made available to Purchaser and are attached to this Agreement as **Exhibit F** and **Exhibit G**, respectively. The Company has made available to Purchaser accurate and complete copies of (1) the capital stock records of the Company, (2) the minutes and other records of the meetings and other proceedings (including any actions taken by written consent or otherwise without a meeting) of the shareholders of the Company, the board of directors of the Company and all committees of the board of directors of the Company, in each case, since its inception and (3) all material documents provided to members of the board of directors and such committees in connection with meetings thereof since January 1, 2010 excluding materials related to financing and merger scenarios with third parties. There have been no formal meetings or other proceedings of the shareholders of the Company, the board of directors of the Company or any committee of the board of directors of the Company that are not fully reflected in such minutes or other records. There has not been any violation of any of the provisions of the Company’s Articles of Incorporation or Bylaws, nor has the Company taken any action that is inconsistent with any resolution adopted by its shareholders, its board of directors or any committee thereof. The books of account, capital stock ledger, minute books and other records of the Company are accurate, up-to-date and complete in all material respects, and have been maintained in accordance with applicable law.

**2.3 Capitalization.**

(a) The authorized capital stock of the Company as of the date hereof is, and except for the conversion of any Preferred Stock outstanding prior to the date hereof to Company Common Stock after the date hereof but prior to the Closing Date, on the Closing Date shall be:

(i) 5,233,605 shares of Preferred Stock, of which 2,020,438 shares have been designated Series A Preferred Stock, of which 2,020,438 shares are issued and outstanding immediately prior to the Closing, and of which 3,213,167 shares have been designated Series B Preferred Stock, 2,973,139 of which shares are issued and outstanding immediately prior to the Closing. The rights, privileges and preferences of the Preferred Stock are as stated in the Charter Documents. All of the outstanding shares of Preferred Stock have been duly authorized, are fully paid and nonassessable and were issued in compliance with all applicable federal and state securities laws.

(ii) 15,000,000 shares of Common Stock, of which 4,315,760 shares are issued and outstanding immediately prior to the Closing. All of the outstanding shares of Common Stock have been duly authorized, are fully paid and nonassessable and were issued in compliance in all material respects with all applicable federal and state securities laws.

(b) The Company has reserved 1,271,830 shares of Common Stock for issuance to officers, directors, employees and consultants of the Company pursuant to its 2005 Stock Option Plan duly adopted by the board of directors of the Company and approved by the Company's shareholders (the "**2005 Stock Plan**"). Of such 1,271,830 reserved shares of Common Stock, no shares have been issued pursuant to restricted stock purchase or similar agreements, options to purchase 1,439,800 shares have been granted (of which 856,800 are currently outstanding and 415,030 have been exercised) and no shares remain available for issuance to officers, directors, employees and consultants pursuant to the 2005 Stock Plan. The Company has reserved 860,630 shares of Common Stock for issuance to officers, directors, employees and consultants of the Company pursuant to its 2007 Stock Plan duly adopted by the board of directors of the Company and approved by the Company's shareholders (the "**2007 Stock Plan**"). Of such 860,630 reserved shares of Common Stock, no shares have been issued pursuant to restricted stock purchase or similar agreements, 1,101,950 options have been granted (of which 674,575 are currently outstanding and 2,000 shares have been exercised) and 184,055 shares remain available for issuance to officers, directors, employees and consultants pursuant to the 2007 Stock Plan. A detailed capitalization table showing the numbers of outstanding shares or options held by each Shareholder, Warranholder or Optionholder, and the applicable vesting schedule, if any, is set forth in the Signing Spreadsheet.

(c) Except for (i) conversion privileges of the Preferred Stock, (ii) outstanding Company Stock Options issued pursuant to the Stock Option Plans and (iii) except as set forth in the Investors' Rights Agreement, there are no outstanding or authorized subscriptions, options, calls, warrants, rights (including conversion or preemptive rights and rights of first refusal or similar rights), commitments, convertible securities, or other agreements of any character directly or indirectly, orally or in writing, obligating the Company to issue any additional shares or any securities convertible into, or exchangeable for, or evidencing the right to subscribe for, any shares of the Company Capital Stock. None of the Company's stock purchase agreements or stock option documents contains a provision for acceleration (or lapse of a repurchase right) upon the occurrence of any event. The Company has never adjusted or amended the exercise price of any stock options previously awarded, whether through amendment, cancellation, replacement grant, repricing, or any other means. There has not been, and the issuance of the Shares has never caused there to be, any anti-dilution adjustment to any of the Company's outstanding securities.

(d) 100% of the issued and outstanding Company Capital Stock, on an actual basis and on an as-converted (or as-exercised) basis, taking into consideration any and all convertible or exchangeable securities and other interests in the Company, is owned beneficially and of record by the Shareholders, Optionholders and Warranholders as set forth in the Signing Spreadsheet, which includes the class of security and address of each such holder, and will be owned immediately following the Closing by the Purchaser, free and clear of any Encumbrances.



(e) The Signing Spreadsheet accurately sets forth as of the date hereof, and the Closing Spreadsheet will accurately set forth as of the Closing, the name of each Person that is the registered owner of any Shares and/or Company Stock Options and the number and kind of such Shares so owned, or subject to Company Stock Options so owned, by such Person. The number of such Shares set forth as being so owned, or subject to Company Stock Options so owned, by such Person will constitute the entire interest of such person in the issued and outstanding share capital, voting securities or other securities of the Company. As of the date hereof, no other Person not disclosed in the Signing Spreadsheet, and as of the Closing, no other Person not disclosed in the Closing Spreadsheet, will have a right to acquire any shares of Shares or Company Stock Options from the Company.

#### **2.4 Financial Statements.**

(a) The Company has delivered to Purchaser complete and correct copies of the audited financial statements of the Company for each of the fiscal years ended on December 31, 2008, December 31, 2009 and December 31, 2010 (collectively, the “**Annual Financial Statements**”) and the related audited statements of operations, statements of shareholders’ equity and statements of cash flows of the Company for the year then ended, together with the notes thereto, and the reviewed balance sheet of the Company as of June 30, 2011 and the related reviewed statements of operations, statements of shareholders’ equity and statements of cash flows of the Company for the period then ended, together with the notes thereto (the “**Interim Financial Statements**,” and together with the Company Annual Financial Statements, the “**Financial Statements**”).

(b) Attached hereto as Exhibit H are complete and correct copies of the Financial Statements, consistent with the books and records of the Company. The Financial Statements present fairly in all material respects the financial position of the Company as of the respective dates thereof and the results of operations, changes in shareholders' equity and cash flows of the Company for the periods covered thereby. The Financial Statements have been prepared in accordance with GAAP consistently applied throughout the periods covered and comply with the requirements of all applicable law and regulations, except as may be indicated in the notes to such financial statements, and except that unaudited financial statements may not contain footnotes and are subject to year-end audit adjustments.

(c) All proper and necessary books of account, minute books, registers and records have been maintained by the Company, are in its possession and contain accurate information in all material respects relating to all transactions to which the Company has been a party.

(d) A complete list of the Company’s borrowings and loan facilities as of the date hereof, is set forth in Part 2.4(d) of the Disclosure Schedule. Except (i) as set forth on or reserved against in the Financial Statements (including the notes thereto), (ii) for obligations and liabilities incurred since the date of the Financial Statements in the ordinary course of business consistent with past practice and in accordance with the provisions of this Agreement, (iii) for obligations under contracts or agreements, and (iv) for obligations or liabilities set forth in Part 2.4(b) of the Disclosure Schedule, the Company has no material liabilities (regardless whether such liabilities would need to be reflected on the Financial Statements in accordance with GAAP), contingent or otherwise, relating to or affecting the Company or any of its assets or properties.

**2.5 Absence of Changes.** Except as set forth in **Part 2.5** of the Disclosure Schedule or as specifically disclosed in the Financial Statements (including the notes thereto), since December 31, 2010:

(a) there have been no changes, events, occurrences or developments of the Company which, individually or in the aggregate, have had or could reasonably be expected to have a Material Adverse Effect (as defined in Exhibit A) on the Company, other than changes, events, occurrences or developments affecting the Company's sector as a whole;

(b) the Company has not declared, accrued, set aside or paid any dividend or made any other distribution in respect of any capital stock, and has not repurchased, redeemed or otherwise reacquired any shares or other securities of the Company except the repurchase of Common Stock upon termination of service of any employee, director or consultant of the Company, pursuant to Stock Subscription Agreements, a form of which was delivered to Purchaser;

(c) the Company has not sold, issued or authorized the issuance of (i) any capital stock or other security of the Company, other than upon exercise of a Company Stock Option, (ii) any Company Stock Option or other right to acquire any capital stock or any other security of the Company or (iii) any instrument convertible into or exchangeable for any capital stock or other security of the Company;

(d) the Company has not amended or waived any of its rights under, or permitted the acceleration of vesting under (i) any provision of any agreement or grant letter awarding or evidencing any outstanding Company Stock Option, or (ii) any share purchase agreement;

(e) there has been no amendment to the Company's Articles of Incorporation, and the Company has not effected or been a party to any Acquisition Transaction (as defined in Exhibit A) (except the issuance of Company Stock Options pursuant to the Stock Option Plans), recapitalization, reclassification of shares, split, reverse split or similar transaction;

(f) the Company has not formed any subsidiary or acquired any equity interest or other interest in any other Entity;

(g) the aggregate capital expenditures of the Company have not exceeded \$10,000;

(h) the Company has not (i) entered into any Contract (as defined in Exhibit A) that is or would constitute a Material Agreement (as defined in Section 2.10(a)), or (ii) amended or prematurely terminated, or waived any right or remedy under, any Material Agreement; in excess of \$10,000;

(i) the Company has not (i) acquired, leased or licensed any right or other asset from any other Person, (ii) sold or otherwise disposed of, or leased or licensed, any right or other asset to any other Person, or (iii) waived or relinquished any right, except, in each case, for rights or other assets acquired, leased, licensed or disposed of under \$10,000 in the ordinary course of business and consistent with the Company's past practices;

(j) the Company has not, (i) written off as uncollectible, or established any extraordinary reserve with respect to, any Account Receivable or other indebtedness, or (ii) written off or written down, or made any determination to write off, write down or otherwise revalue, any other of its assets or properties, or changed any reserves or liabilities associated therewith;

(k) the Company has not made any pledge of any of its assets or otherwise permitted any of its assets to become subject to any Encumbrance;

(l) the Company has not (i) lent money to any Person (other than pursuant to routine advances made to employees in the ordinary course of business), or (ii) incurred or guaranteed any indebtedness for borrowed money in excess of \$10,000;

(m) the Company has not (i) established or adopted any employee benefit plan, (ii) paid any bonus or made any profit-sharing or similar payment to any of its directors, officers or employees, (iii) increased the amount of the wages, salary, commissions, fringe benefits or other compensation or remuneration payable to, any of its directors, officers or employees, or (iv) hired any new employees for whom annual compensation exceeds \$90,000;

(n) there has been no resignation or termination of employment of any officer or employee of the Company or any notice, whether oral or written, by any officer or employee of the Company for whom annual compensation exceeds \$90,000 of his intention to terminate his employment with the Company;

(o) the Company has not changed any of its methods of accounting or accounting practices in any respect, including any change with respect to reserves (whether for bad debts, contingent liabilities or otherwise) except as required by concurrent changes in GAAP;

(p) the Company has not (i) failed to file any material Tax Return or pay any material Tax timely when due, (ii) made or changed any election with respect to any material Tax, (iii) adopted or changed any accounting method in respect of any material Taxes, (iv) entered into any Tax allocation agreement, Tax sharing agreement, Tax indemnity agreement or closing agreement, settlement or compromise of any claim or assessment in respect of any material Taxes, or (v) consented to any extension or waiver of the limitation period applicable to any claim or assessment in respect of any Taxes with any Governmental Body or otherwise;

(q) the Company has not entered into a Contract required to be disclosed on **Part 2.9(g)(1)(i)** or **Part 2.9(g)(1)(ii)** of the Disclosure Schedule;

(r) the Company has not failed to pay or otherwise satisfy any liabilities in excess of \$5,000 when due, except for liabilities set forth in **Part 2.5** of the Disclosure Schedule which the Company is disputing in good faith;

(s) the Company has not commenced or settled any Legal Proceeding (as defined in Exhibit A), and no Legal Proceeding has been commenced or threatened against the Company;

(t) the Company has not entered into any material transaction or taken any other material action outside the ordinary course of business or inconsistent with its past practices and

(u) the Company has not agreed or committed to take any of the actions referred to in clauses “(b)” through “(t)” above.

**2.6 Properties and Assets.** A true and complete listing of the Company’s properties and assets, which includes all depreciable properties and assets which individually, or as part of a group of similar properties or assets, have a net book value of \$5,000 or more (except for bank accounts, accounts receivable and Intellectual Property described, respectively, in Part 2.7(a), Part 2.7(b) or Part 2.9(g) of the Disclosure Schedule) is contained in Part 2.6 of the Disclosure Schedule. The Company has good and marketable title to its property and assets, including without limitation those reflected in the Financial Statements, free and clear of any Encumbrance of whatsoever nature over or in the relevant property other than Permitted Encumbrances. With respect to the property and assets that are leased, the Company is in compliance with all provisions of such leases in all respects, such leases are valid, binding and enforceable against the lessor thereunder, and the Company holds leasehold interests in such assets free and clear of all Encumbrances other than Permitted Encumbrances.

**2.7 Bank Accounts; Receivables.**

(a) Part 2.7(a) of the Disclosure Schedule identifies (by institution, account number and account name) each account maintained by or for the benefit of the Company at any bank or other financial institution (each, a “**Bank Account**”), and sets forth the respective balance of each such Bank Account as of the date hereof.

(b) Except as set forth in Part 2.7(b) of the Disclosure Schedule, the Company has no Accounts Receivable. Part 2.7(b) of the Disclosure Schedule provides an accurate and complete breakdown and aging of all Accounts Receivable, notes receivable and other receivables of the Company as of the date hereof. All Accounts Receivable of the Company (including those accounts receivable that have not yet been collected) (i) are properly reflected on the books and records of the Company in accordance with GAAP, (ii) represent valid obligations of customers of the Company arising from bona fide transactions entered into in the ordinary course of business, and (iii) are current and, to the Company’s Knowledge, will be collected in full within a reasonable period of time, not to exceed sixty (60) days from the date of this Agreement, without any counterclaim or set off. The Company’s reserve for contractual allowances and doubtful accounts as reflected in the Financial Statements is adequate and has been calculated in a manner consistent with past practice.

## 2.8 Equipment; Leasehold.

(a) All material items of equipment and other tangible assets owned by or leased to the Company are adequate for the uses to which they are being put, are in good condition and repair (ordinary wear and tear excepted) and are adequate for the conduct of the Company's business in the manner in which such business is currently being conducted and Currently Proposed to be Conducted.

(b) The Company does not own any real property or any interest in real property, except for the leasehold created under the real property leases identified in **Part 2.8(b)** of the Disclosure Schedule.

## 2.9 Intellectual Property and Other Intangible Assets.

(a) As used herein, the term

(i) **"Intellectual Property"** shall mean all designs, trademarks and trade-names, all computer programs and related flowcharts, programmer notes, updates and data, whether in object or source code form, and all hardware, algorithms, utilities flowcharts, logic, documentation, processes, formulations, data, experimental methods, or results, descriptions, business or scientific plans, depictions, customer lists and any other written, printed or electronically stored materials or information, including pricing plans, market research or data, potential marketing strategies, prospective users and distribution channels, engineering drawings, information concerning specialized suppliers, specifications for products and/ or processes and/or software, test protocols, databases, data compilations and all other materials relating thereto, and copies thereof in any storage media, and all other works of authorship, inventions, concepts, ideas, know how and discoveries and all instantiations or embodiments of the foregoing or of any Intellectual Property Rights in any form and/or media.

(ii) **"Intellectual Property Rights"** shall mean any or all of the following and all rights in, arising out of, or associated therewith throughout the world (A) common law trademarks and service marks that the Company has owned or used with the intent of creating or benefiting from any common law rights relating to such marks and/or any trade names logos, trademark and service mark registrations and applications therefore and all goodwill associated therewith throughout the world, (B) all United States and foreign patents and utility models and applications therefor and all reissues, divisions, re-examinations, renewals, extensions, provisionals, continuations and continuations-in-part thereof; (C) all copyrights, copyright registrations and applications therefor; (D) mask work rights, mask work registrations and applications therefor; (E) all trade secrets and other rights in know-how and confidential or proprietary information whether or not subject to statutory registration; (F) domain names; and (G) any similar, corresponding or equivalent rights to any of the foregoing anywhere in the world.

(iii) **"Company Intellectual Property"** shall mean all Intellectual Property and Intellectual Property Rights owned by the Company.

(b) The Company owns all right, title and interest in and to, or has a valid and enforceable right to use, free and clear of all claims and Encumbrances (other than Permitted Encumbrances), the Intellectual Property used in the conduct of the Company's business as currently conducted or Currently Proposed to be Conducted. The use of Company Intellectual Property in the Company's business as currently conducted or Currently Proposed to be Conducted does not violate, infringe, or constitute a misappropriation of any Intellectual Property Rights of any other Person, including without limitation, of its present or former employees or the former employers of its present or former employees. There are no Persons who have claimed in writing to the Company to own, or who have been granted by the Company an exclusive license to, any Company Intellectual Property. Other than under the Immaterial License-In Contracts the Company is not obligated to make any payments by way of royalties, fees or otherwise to any owner or licensor of, or other claimant to, any Intellectual Property Rights, with respect to the use thereof in connection with the conduct of the Company's business or otherwise. The Registered Intellectual Property Rights are valid and enforceable.

(c) Any and all Intellectual Property which has been developed or is currently being developed by any Persons for the Company that is purported to be Company Intellectual Property: (i) has been developed in the course of their employment or engagement with the Company, such that pursuant to applicable law all Intellectual Property arising therefrom has become the exclusive property of the Company, or (ii) has been validly assigned solely to the Company free of any claims and under signed written agreements providing that all such Intellectual Property are owned exclusively by the Company and all moral rights have been explicitly waived. The Company has taken reasonable steps consistent with industry standards to maintain the secrecy of the Company's nonpublic information (where "nonpublic information" means information that is not generally known or readily ascertainable through proper means, whether tangible or intangible) from which the Company derives independent economic value, actual or potential, from the nonpublic information not being generally known. The Company has taken security measures to protect the secrecy, confidentiality and value of all the Company Intellectual Property, which measures are reasonable and customary in the industry in which it operates. Each current and former Service Provider who, either alone or in concert with others, developed, invented, discovered, derived, programmed or designed the Company Intellectual Property, or who has knowledge of or access to information about the Company Intellectual Property, has entered into a valid and legally binding written assignment of inventions and non-disclosure agreement with the Company regarding ownership and treatment of the Company Intellectual Property. With respect to Service Providers who are employees, such agreements are substantially similar to the forms provided to Purchaser.

(d) The Company has not received any claim, notice or other communication (written, oral or otherwise) alleging that the Company has violated or by conducting its business as currently conducted or Currently Proposed to be Conducted, would violate, misappropriate, or infringe any Intellectual Property Rights of any other Person. The Company has not received written notice of any infringement or misappropriation of or conflict with asserted rights of others, with respect to any Company Intellectual Property. To the Knowledge of the Company, there are no facts, and no facts have been asserted, which would reasonably be expected to render any of the Company Intellectual Property invalid or unenforceable.

(e) To the Knowledge of the Company, none of its employees, officers or directors are obligated under any Contract, or subject to any judgment, decree or order of any court or administrative agency that restrict such person from performing his duties for the Company and/or will render the Company Intellectual Property infringing or in violation of such Contract or that would conflict with the Company's business as conducted or Currently Proposed to be Conducted. It currently is not, and, to the Knowledge of the Company, will not in connection with the Company's business as currently conducted or Currently Proposed to be Conducted, become necessary to utilize any inventions, and specifically, inventions covered by patents or patent applications, of any current or former Service Provider (or people the Company currently intends to hire) made prior to their service with the Company, other than those that have been assigned to the Company pursuant to valid instruments of assignment.

(f) **Part 2.9(f)** of the Disclosure Schedule lists all Intellectual Property Rights that are the subject of an application or registration filed or recorded with any public legal authority by or on behalf of the Company worldwide ("**Registered Intellectual Property Rights**") and the jurisdictions in which it has been issued or registered or in which any application for such issuance and registration has been filed, or in which any other filing or recordation has been made; and all actions that are required to be taken by the Company on or before December 15, 2011 with respect to such Intellectual Property Rights in order to avoid abandonment of such Intellectual Property Rights, and identifies all third parties that share ownership rights to the Registered Intellectual Property Rights with the Company. Each item of Registered Intellectual Property Rights is subsisting (or in the case of applications, applied for), all registration, maintenance and renewal fees currently due in connection with such Registered Intellectual Property Rights have been paid and all documents, recordations and certificates in connection with such Registered Intellectual Property Rights currently required to be filed have been filed with the patent, copyright, trademark or other authorities in the United States and/or foreign jurisdictions in which the Registered Intellectual Property Rights are registered or applied for, as the case may be, for the purposes of prosecuting, maintaining and perfecting such Registered Intellectual Property Rights and recording Company's ownership interests therein.

(g) **Part 2.9(g)(1)(i)** of the Disclosure Schedule lists all licenses, sublicenses, and other Contracts to which Company is a party and pursuant to which any Person is authorized to use any Company Intellectual Property, other than (i) non-exclusive end-user licenses to Company products granted in the ordinary course of business for an annual consideration of less than \$5,000 or non-exclusive "shrink wrap" or other form-based generally, commercially available licenses licensed for an annual fee of less than \$1,000 per single user; (ii) standard terms governing third Person's access to, and use of, the Company's website; and (iii) confidentiality or non-disclosure agreements entered into in the ordinary course of business. **Part 2.9(g)(1)(ii)** of the Disclosure Schedule lists all licenses, sublicenses, and other Contracts to which Company is a party and pursuant to which Company is authorized to use Intellectual Property Rights of any third party, other than (i) non-exclusive licenses to Intellectual Property Rights owned by a third Person granted to Company in the ordinary course of business for an annual consideration of less than \$5,000; (ii) standard end user contracts for "shrink wrap" or other form-based generally, commercially available licensed software not in excess of \$1,000 per seat; (iii) nonexclusive licenses under which the Company uses any "free" or "open source" software; and (iv) confidentiality or non-disclosure agreements entered into in the ordinary course of business (collectively hereinafter: "**Immaterial License-In Contracts**"). Each of the Contracts listed in **Part 2.9(g)(1)(i) or (ii)** of the Disclosure Schedule is in full force and effect and is a valid and binding obligation of Company. The Company is not in material default of any license, sublicense, or Contract listed in **Part 2.9(g)(1)(i) or (ii)** of the Disclosure Schedule. The Company is not obligated to transfer or license any Company Intellectual Property to a third Person, nor is the Company, as of the Closing obligated to transfer or license any Intellectual Property Rights later obtained by the Company, to a third Person, nor will the consummation of the transactions contemplated by this Agreement violate or result in material breach, modification or termination of any Contract listed in **Part 2.9(g)(1)(i) or (ii)** of the Disclosure Schedule. The Company Intellectual Property and other Intellectual Property and Intellectual Property Rights licensed to the Company constitutes all of the Intellectual Property Rights necessary to enable the Company to conduct its business in the manner in which such business has been and is being conducted and Currently Proposed to be Conducted.

(h) Except as set forth in **Part 2.9(h)** of the Disclosure Schedule, the Company has not incorporated Open Source Materials (as defined below) into, combined Open Source Materials with, or distributed Open Source Materials with any products sold or distributed by Company, or derived any Company Intellectual Property or products sold or distributed by Company from Open Source Materials. “**Open Source Materials**” means software or other material that is distributed as “free software” or “open source software” or meeting the Open Source Definition (as promulgated by the Open Source Initiative) or the Free Software Definition (as promulgated by the Free Software Foundation), or any substantially similar license, including but not limited to any license under licensing terms approved by the Open Source Initiative (including but not limited to the GNU General Public License (GPL), GNU Lesser General Public License (LGPL), Mozilla Public License (MPL), BSD licenses, the Artistic License, the Netscape Public License, the Sun Community Source License (CSL) the Sun Industry Standards License (SISL) and the Apache License). Where Open Source Materials have been utilized, the Company is in compliance with all terms and conditions of all licenses for such Open Source Materials and such Open Source Materials have been utilized in a manner that does not create, or purport to create, obligations on the Company to grant to any third party any rights under any Company Intellectual Property and/or to (a) distribute any Company Intellectual Property that are incorporated into, combined with, derived from, or distributed with the Open Source Materials, (b) disclose or distribute any Company Intellectual Property in source code form, or (c) license any Company Intellectual Property for the purpose of making derivative works or for redistribution at no charge. The Company has not disclosed, delivered or licensed to any Person any source code owned by Company, other than disclosures to Service Providers involved in the development of Company Intellectual Property by or for the Company under terms set forth in Section 2.9 (c) above, and, except for the escrow agreements set forth in **Part 2.9(h)** of the Disclosure Schedule (the “**Escrow Agreements**”), has no escrow agreement or other Contract between the Company and any Person that would give such Person or any other Person the right to obtain a copy of the source code and program documentation (or any portion thereof) owned by the Company upon any event including the liquidation, dissolution or winding up of the Company, upon termination, breach or alleged breach of any Contract between the Company and such Person, or under any other circumstances. No event has occurred that would give rise to the release of the escrow under any of the Escrow Agreements. In respect of agreements disclosed in **Part 2.9(h)** of the Disclosure Schedule that have expired or been terminated, all source code and/or other escrow materials and copies thereof have been returned to Company. Without limiting the foregoing, neither the execution of this Agreement nor any of the transactions contemplated by this Agreement will result in a release from escrow or other delivery to a third party of any Company source code.



(i) In each case in which the Company has acquired any Intellectual Property Rights from any Person, the Company has obtained a valid and enforceable assignment sufficient to irrevocably transfer all rights in such Intellectual Property and Intellectual Property Rights (including the right to seek past and future damages with respect to such Intellectual Property Rights) to the Company. With respect to Registered Intellectual Property Rights, to the maximum extent provided for by, and in accordance with, applicable laws and regulations, the Company has recorded each such assignment with the relevant Government Body, including the U.S. Patent and Trademark Office, the U.S. Copyright Office, or their respective equivalents in any relevant foreign jurisdiction.

(j) Privacy. The Company has established privacy policies with respect to the personal data collected by Company, which are in conformance with applicable law in all material respects. The Company is in compliance in all material respects with such privacy policies and with all applicable laws and regulations relating to the use, collection, storage, disclosure and transfer of any personal data collected by the Company or by third parties having authorized access to the records of the Company. The execution, delivery and performance of this Agreement, will comply with all applicable laws and regulations relating to privacy and with the Company's privacy policies. The Company has not received any complaint regarding the Company's collection, use or disclosure of personal data.

(k) Digital Millennium Copyright Act. The Company operates and has operated its business in such a manner as to take reasonable advantage, if and when applicable, of the safe harbors provided by Section 512 of the Digital Millennium Copyright Act ("DMCA"), including by informing users of its products and services of such policy, designating an agent for notice of infringement claims, registering such agent with the United States Copyright Office, and taking appropriate action expeditiously upon receiving notice of possible infringement in accordance with the "notice and take-down" procedures of the DMCA.

## 2.10 Agreements.

(a) All the material Contracts to which the Company is a party and which are in effect as of the date of this Agreement (the "**Material Agreements**") are listed in Part 2.10(a) of the Disclosure Schedule, which also provides an accurate description of the material terms of each Material Agreement that is not in written form. Without limitation, any Contract to which Company is a party involving any of the following shall be deemed to be a "**Material Agreement**":

- (i) an Acquisition Transaction (other than Company Stock Options issued pursuant to the Stock Option Plans);
- (ii) the acquisition or disposition of any direct or indirect equity or other interest of the Company in any other Entity;
- (iii) any legal partnership or joint venture between the Company and any other Person;
- (iv) any material Contract under which any third Person is authorized to distribute, sell, market or take orders for any Company product;
- (v) the purchase of materials, supplies, equipment or services by or from the Company involving more than \$50,000 over the life of the agreement;
- (vi) the license, use, purchase or other acquisition or disposition of any material Intellectual Property Rights by the Company from or to any other Person (excluding (1) non-exclusive end-user licenses to Company products granted in the ordinary course of business or non-exclusive “shrink wrap” or other form-based licenses licensed for an annual fee of less than \$1,000 per single user; (2) standard terms governing third Person’s access to, and use of, the Company’s website; (3) confidentiality or non-disclosure agreements entered into in the ordinary course of business);
- (vii) any material Contract that expires more than twelve months after the date of this Agreement or which may be renewed at the option of any Person other than the Company so as to expire more than twelve months after the date of this Agreement, in each case which is not terminable at the discretion of the Company within twelve months after the date of this Agreement;
- (viii) any trust indenture, mortgage, promissory note, loan agreement or other Contract for the borrowing of money, any currency exchange, commodities or other hedging arrangement or any leasing transaction of the type required to be capitalized in accordance with GAAP;
- (ix) any Contract for capital expenditures by the Company in excess of \$25,000 in the aggregate;
- (x) any lease by the Company of any machinery, equipment, motor vehicles, office furniture, fixtures or other personal property having an original cost of more than \$50,000;
- (xi) any employment, consulting, advisory or similar services agreement with an individual involving the payments by the Company of more than \$50,000 per year;

(xii) any (1) non-disclosure, confidentiality, or similar agreement between the Company and any other Person not entered into in the ordinary course of business or (2) assignment of invention, work for hire or similar agreement between the Company and any other Person, except to the extent any such agreement is contained in an employment agreement between the Company and an Employee, a copy of which has been made available to counsel to the Purchaser;

(xiii) any Contract with any Person with whom the Company does not deal at arm's length; or

(xiv) any guarantee, support, indemnification, assumption or endorsement by the Company of, or any similar commitment by the Company with respect to, the obligations, liabilities (whether accrued, absolute, contingent or otherwise) or indebtedness of any other Person, excluding indemnification of directors and officers of the Company.

(b) Each Material Agreement is in full force and effect, and is enforceable by the Company in accordance with its terms, subject to (i) laws of general application relating to bankruptcy, insolvency and the relief of debtors, and (ii) rules of law governing specific performance, injunctive relief and other equitable remedies. The Company has no Knowledge of the invalidity of or grounds for rescission, avoidance or repudiation of any of the Material Agreements and the Company has not received any notice of any intention to terminate any such agreement.

(c) There are no Contracts in force restricting the competitive freedom of the Company to engage in any line of business or to compete with any other Person, in each case which is material to the Company.

(d) The Company has made available to Purchaser accurate and complete copies of all written Material Agreements identified in **Part 2.10(a)** of the Disclosure Schedule, including all amendments thereto.

(e) The Company has not violated or breached, or committed any default under, any Material Agreement, and, to the Company's Knowledge, no other Person has violated or breached, or committed any default under, any Material Agreement. To the Company's Knowledge, no event has occurred, and no circumstance or condition exists, that (with or without notice or lapse of time) will, or could reasonably be expected to, (A) result in a material violation or breach of any of the provisions of any Material Agreement, (B) give any Person the right to declare a default or exercise any remedy under any Material Agreement, (C) give any Person the right to accelerate the maturity or performance of any Material Agreement, or (D) give any Person the right to cancel, terminate or modify any Material Agreement. The Company has not received any notice or other communication, or otherwise has Knowledge, regarding any actual or possible material violation or breach of, or material default under, any Material Agreement and, to the Knowledge of the Company, no party to any of the Material Agreements has made a claim to the effect that the Company has failed to perform a material obligation thereunder. The Company has not waived any of its rights in excess of \$5,000 under any Material Agreement.

(f) No Person is renegotiating, or has a right pursuant to the terms of any Material Agreement to renegotiate, any amount paid or payable to the Company under any Material Agreement or any other material term or provision of any Material Agreement.

(g) **Part 2.10(g)** of the Disclosure Schedule identifies and provides a brief description of each proposed bid, offer, award, written proposal, term sheet or similar document has been submitted or received by the Company regarding an Acquisition Transaction since December 31, 2006 which is still pending except where disclosure of such terms or the existence of such proposed Acquisition Transaction (except Company Stock Options issued pursuant to the Stock Option Plans) is prohibited by confidentiality agreements.

**2.11 Capital Expenditure and Commitments.** Except as disclosed in the Financial Statements (including the notes thereto):

(a) Except as set forth in **Part 2.11(a)** of the Disclosure Schedule, the Company has not made or undertaken to make any material capital commitment, expenditure or purchase in excess of \$25,000.

(b) The Company is not a party to any hire, hire purchase, credit sale or conditional sale agreement or any contract providing for payment on deferred terms in respect of assets purchased by the Company.

(c) The Company is not aware of any Encumbrances on, over or affecting the issued or unissued capital stock of the Company, nor is the Company aware of any agreement or commitment to give or create any such Encumbrance and no claim has been made by any Person to be entitled to any such Encumbrance.

(d) The Company has not given any guarantee, indemnity or security for, or otherwise agreed to become directly or contingently liable for, any obligation of any other individual or entity, except in its ordinary course of business, and to the best of its Knowledge, no individual or entity has given any guaranty of or security for any of the Company's obligations.

(e) There are in force no powers of attorney given by the Company with respect to any asset or business of the Company, and no individual or entity, as agent, representative, distributor or otherwise, is entitled or authorized to bind or commit the Company to any obligation not in the ordinary course of the Company's business.

(f) Other than as set forth in **Part 2.11(f)** of the Disclosure Schedule, the Company has not made any application to nor received any grant, allowance or other support or benefits (including, without limitation, tax benefits) from any Governmental Body, nor was at any time during the conception of any of the Intellectual Property, any developer, inventor or other contributor to the Intellectual Property, operating under any grants from any Governmental Body or performing research sponsored by any Governmental Body or private source.

## **2.12 Compliance with Legal Requirements.**

(a) The Company has carried on its business and affairs in accordance with all applicable laws and regulations in all material respects and in accordance with its corporate documents. The Company has no Knowledge of, and has not received any written notice of, any material violation or material default with respect to any statute, regulation, order, decree, or judgment of any court or any Governmental Body. The Company has been granted and there are now in force all material approvals, consents and licenses necessary for the carrying on of its business in the places and in the manner in which it is now carried on, and to the Company's Knowledge there are no circumstances which evidence or indicate that any such approvals, consents or licenses, to the extent material to the Company's business or assets, are likely to be suspended, canceled, revoked or not renewed.

(b) All documents required to be filed with or delivered to the Secretary of State of Washington in respect of the Company have been properly filed or delivered in a timely manner in all material respects.

**2.13 Governmental Authorizations and Consents.** **Part 2.13** of the Disclosure Schedule identifies each Governmental Authorization (as defined in **Exhibit A**) held by the Company, accurate and complete copies of which have been made available by the Company to Purchaser. The Governmental Authorizations identified in **Part 2.13** of the Disclosure Schedule are valid and in full force and effect, and collectively constitute, and the Company currently has, all Governmental Authorizations necessary to enable the Company to conduct its business in the manner in which it is currently being conducted. The Company is, and at all times has been, in compliance in all material respects with the terms and requirements of the Governmental Authorizations identified in **Part 2.13** of the Disclosure Schedule. The Company has not received any notice or other communication from any Governmental Body regarding (a) any actual or possible violation of or failure to comply with any term or requirement of any Governmental Authorization, or (b) any actual or possible revocation, withdrawal, suspension, cancellation, termination or modification of any Governmental Authorization.

## **2.14 Tax Matters.**

(a) The Company has promptly paid, or fully provided for in its Financial Statements in accordance with GAAP, all material Taxes for which it is or hereafter may become liable or accountable in the period from the date of its incorporation to the Closing Date. The Company is not a party to any Tax allocation agreement, Tax sharing agreement, Tax indemnity agreement or Tax closing agreement.

(b) All material Tax Returns required to have been filed by or with respect to the Company have been duly filed (including any extensions), and each such Tax Return correctly and completely reflects Tax liability and all other information required to be reported thereon. All such Tax Returns are true, complete and correct in all material respects through the date thereof, and all information necessary to prepare and file Tax Returns in respect of subsequent periods is available and accurately reflected in the books and records of the Company. True, complete and correct copies of the Tax Returns filed by the Company with the applicable Governmental Bodies in respect of 2007, 2008 and 2009 have been provided to Purchaser. The Company has at all times and within the requisite time limits promptly, fully and accurately observed, performed and complied with all obligations or conditions imposed on it under any Legal Requirement relating to material Taxes. The Company has not settled or compromised any claim or assessment in respect of any material Taxes, or requested or consented to any extension or waiver of the limitation period applicable to any claim or assessment in respect of any material Taxes with any Governmental Body or otherwise.

(c) No Government Body has notified the Company in writing regarding the Company's treatment of any item or transaction relating to Taxes, and there are no audits, disputes, examinations, letter rulings or other similar proceedings regarding any material Taxes or Tax Returns of the Company currently in progress.

(d) The Company does not own any assets in Israel.

(e) There are no Encumbrances of any sort on the assets of the Company relating to or attributable to Taxes other than liens for Taxes not yet due and payable.

(f) The Company is not, nor has it been, a United States real property holding corporation (as defined in Section 897(c)(2) of the Code (as defined in Section 2.15(a) below)) during the applicable period specified in Section 897(c)(1)(a) of the Code. The Company does not own any real property, and the Merger shall not give rise to any real estate transfer or excise taxes, including without limitation any State of Washington real estate excise tax.

(g) Neither the Company nor any Subsidiary has received a Tax ruling from any Governmental Body or entered into any closing agreement in respect of Tax with a Governmental Body with respect to any Tax year.

(h) The Company and each Subsidiary have complied in all material respects with all applicable Legal Requirements, rules and regulations relating to the payment and withholding of Taxes (including withholding of Taxes pursuant to Sections 1441 and 1442 of the Code or similar provisions under any non-U.S. laws) and have, within the time and the manner prescribed by law, withheld and paid over to the proper Governmental Authority all amounts required to be so withheld and paid over under applicable Legal Requirements.

(i) Neither the Company nor any Subsidiary will be required to include any material item of income in, or exclude any material item of deduction from, taxable income for any taxable period (or portion thereof) ending after the Closing Date as a result of any of the following that occurred or exists on or prior to the Closing Date: (i) an installment sale or other open transaction or (ii) any adjustment under Section 481(a) or 263A of the Code or any comparable provision under any Legal Requirement relating to Taxes by reason of a change in the accounting method of the Company or any Subsidiary or otherwise.

(j) All Tax deficiencies that have been claimed, proposed, assessed or asserted against the Company or any Subsidiary have been fully paid or finally settled, and no issue has been raised in any examination by any Governmental Authority that could reasonably be expected to result in the proposal or assertion of a Tax deficiency for another year not so examined.

(k) No power of attorney has been granted by or with respect to the Company or any Subsidiary with respect to any matter relating to Taxes other than a power of attorney that has fully lapsed.

(l) All transactions that could give rise to an understatement of the U.S. federal income tax liability of the Company or any Subsidiary within the meaning of Section 6662(d) of the Code are adequately disclosed on Tax Returns in accordance with Section 6662(d)(2)(B) of the Code if there is or was no substantial authority for the treatment giving rise to such understatement.

(m) Neither the Company nor any Subsidiary has any liability with respect to Taxes relating to the operation of the Company and/or any Subsidiary prior to December 31, 2010 in excess of the amounts accrued in accordance with GAAP with respect thereto as reflected in the Annual Financial Statements, and since the date of the Annual Financial Statements, neither the Company nor any Subsidiary has incurred any liability for Taxes, except with respect to operations in the ordinary course of business after such date.

(n) All related party transactions involving the Company or any Subsidiary is at arm's length in compliance with Section 482 of the Code and the Treasury Regulations promulgated thereunder and any similar provision of non-U.S., state and local law. Each of the Company and the Subsidiaries has maintained in all respects all necessary documentation in connection with such related party transactions in accordance with Sections 482 and 6662 of the Code and the Treasury Regulations promulgated thereunder and any similar provision of non-U.S., state and local law.

(o) Neither the Company nor any Subsidiary has been a member of any affiliated group within the meaning of Section 1504(a) of the Code, or any similar affiliated or consolidated group for Tax purposes under state, local or non-U.S. law (other than a group the common parent of which is the Company), or has any liability for Taxes of any Person (other than the Company and each Subsidiary) under Treasury Regulation Section 1.1502-6 or any similar provision of state, local or non-U.S. law as a transferee or successor, by contract or otherwise.

(p) During the five (5) year period ending on the date of this Agreement, neither the Company nor any Subsidiary has been either a "distributing corporation" or a "controlled corporation" within the meaning of Section 355 of the Code.

(q) Neither the Company nor any Subsidiary has engaged in any reportable transactions that were required to be disclosed pursuant to Section 6011 of the Code and the Treasury Regulations promulgated thereunder.

(r) The Company and its Subsidiaries have at all times been residents for Tax purposes of their respective countries of incorporation. No claim has been made in writing by any Governmental Body in any jurisdiction where the Company or any Subsidiary does not file Tax Returns that it is or may be subject to Tax by such jurisdiction.

(s) All records which the Company and its Subsidiaries are required under applicable Legal Requirements to keep for Tax purposes (including without limitation all documents and records likely to be needed to defend any challenge by any Governmental Body to the transfer pricing of any transactions between the Company and any of its Subsidiaries) have been duly kept (in accordance with all applicable statutory requirements).

(t) The consummation of the transactions contemplated by this Agreement will not, either alone or in combination with another event, result in any payment (whether in cash or property or the vesting of property) to any "disqualified individual" (as such term is defined in Treasury Regulation Section 280G(c)) pursuant to any Company Employee Plan that would reasonably be construed, individually or in combination with any other such payment, to constitute an "excess parachute payment" (as defined in Section 280G(b)(1) of the Code). No Service Provider is entitled to receive any gross-up or additional payment by reason of the tax required by Section 409A or 4999 of the Code being imposed on such person.

(u) Each grant of Company Stock Options was validly issued and properly approved by the Board of Directors of the Company (or a duly authorized committee or subcommittee thereof) in compliance with all applicable Legal Requirements and recorded on the Financial Statements in accordance with GAAP consistently applied. No Company Stock Option has an exercise price that is less than the fair market value of the Company Common Stock as of the date such Company Stock Option was granted or has any feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of such option, in each case, determined in accordance with the regulations and guidance under Code Section 409A.

## 2.15 Employees.

(a) The following definitions will apply to this Section 2.15:

(i) "Code" shall mean the Internal Revenue Code of 1986, as amended;

(ii) "Company Employee Plan" shall mean any plan, program, policy, practice, contract, agreement or other arrangement providing for compensation, severance, termination pay, deferred compensation, performance awards, stock or stock-related awards, fringe benefits or other employee benefits or remuneration of any kind, whether written or unwritten or otherwise, funded or unfunded, including without limitation, each "employee benefit plan," within the meaning of Section 3(3) of ERISA which is or has been maintained, contributed to, or required to be contributed to, by the Company or any ERISA Affiliate for the benefit of any Employee, or with respect to which the Company or any ERISA Affiliate has or may have any liability or obligation;

(iii) "ERISA" shall mean the Employee Retirement Income Security Act of 1974, as amended;

(iv) "ERISA Affiliate" shall mean any other person or entity under common control with the Company within the meaning of Section 414(b), (c), (m) or (o) of the Code and the regulations issued thereunder;



(v) “**Multiemployer Plan**” shall mean any “**Pension Plan**” (as defined below) which is a “multiemployer plan,” as defined in Section 3(37) of ERISA;

(vi) “**Pension Plan**” shall mean each Company Employee Plan which is an “employee pension benefit plan,” within the meaning of Section 3(2) of ERISA;

(b) **Part 2.15(b)** of the Disclosure Schedule contains an accurate and complete list of each Company Employee Plan. Neither the Company nor any ERISA Affiliate contributes to or has any contingent obligations to any Multiemployer Plan. Neither the Company nor any ERISA Affiliate has incurred any liability (including secondary liability) to any Multiemployer Plan as a result of a complete or partial withdrawal from such Multiemployer Plan under Section 4201 of ERISA or as a result of a sale of assets described in Section 4204 of ERISA.

(c) Neither the Company nor any ERISA Affiliate has ever maintained, established, sponsored, participated in, or contributed to, any Pension Plan which is subject to Title IV of ERISA or Section 412 of the Code. Neither the Company nor any ERISA Affiliate has any liability with respect to any post-retirement benefit under any Company Employee Plan which is a welfare plan (as defined in section 3(l) of ERISA), other than liability for health plan continuation coverage described in Part 6 of Title I(B) of ERISA or other applicable Legal Requirement.

(d) Each Company Employee Plan complies, in both form and operation, in all material respects, with its terms, ERISA and the Code, and, to the Company’s Knowledge no condition exists or event has occurred with respect to any such plan which would result in the incurrence by the Company or any ERISA Affiliate of any material liability, fine or penalty. No Company Employee Plan is being audited or investigated by any government agency or is subject to any pending or, to the Company’s Knowledge, threatened claim or suit. Neither the Company nor any ERISA Affiliate nor any fiduciary of any Company Employee Plan has engaged in a prohibited transaction under section 406 of ERISA or section 4975 of the Code.

(e) **Part 2.15(e)** of the Disclosure Schedule sets forth a complete and accurate list of all salaried or compensated officers, employees (“**Employees**”), advisers and consultants of the Company (together with Employees, “**Service Providers**”), including names, positions and dates of employment or retention, and correctly reflects their annual base salaries or base rate of cash compensation payable to them, annual target bonus opportunity, and commission arrangements. The Company has provided or made available to Purchaser correct and complete fully executed copies of all documents embodying each Company Employee Plan (“**Service Providers Agreements**”). The Company has paid all such salaries, benefits and other entitlements to its Service Providers in a timely manner. Each of the Service Providers Agreements were entered into prior to or coincident with the commencement of each Service Provider’s applicable relationship with the Company.

(f) The Company does not have any material liability with respect to any misclassification of any Person as an independent contractor rather than an employee of the Company. All consultant agreements are terminable at will by the Company upon not more than thirty (30) days prior notice.

(g) The Company has set aside all benefits under Company Employee Plans to which any Employee or former Employee is or may be entitled including, *inter alia*, severance pay, termination notice, accrued and unpaid vacation days, leave and health. All contributions under Company Employee Plans (including employer contributions and employee salary reduction contributions), including 401(k) plans, to which each Employee is actually entitled as of the Closing Date or would be entitled if terminated by the Company on the Closing Date, have been (or will be prior to Closing) fully contributed to each such plan. If any Company Employee Plans were to be terminated on the Closing Date, all benefits accrued to the day prior to the Closing Date (whether or not vested) would be fully funded in accordance with the actuarial assumptions and method utilized by such plan for valuation purposes.

(k) The Company is not, and to its Knowledge, no Service Provider, is, in violation of any material term of any employment, consulting, independent contractor, non-disclosure, non-competition, inventions assignment or any other Contract relating to the relationship of such Service Provider with the Company. Neither the execution, delivery or performance of this Agreement, nor the consummation of the Merger, will result in any payment or other benefit (including any bonus, golden parachute or severance payment) to any current or former Service Provider (whether or not under any benefit plan), or increase the benefits payable under any Company Employee Plan, or result in any acceleration of the time of payment or vesting of any such benefits.

(l) The Company is not bound by or subject to (and none of its assets or properties is bound by or subject to) any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or, to the Knowledge of the Company, has sought to represent any of the Service Providers, representatives or agents of the Company. There is no strike or other labor dispute involving the Company pending, or to the Knowledge of the Company threatened, nor is the Company aware of any labor organization activity involving its Service Providers. The employment of each officer and Employee of the Company is terminable at the will of the Company upon not more than thirty (30) days' prior notice. To its Knowledge, the Company has complied in all material respects with all applicable state and federal equal employment opportunity laws and with other Legal Requirements related to employment. To the Company's Knowledge, no Employee of the Company is in violation of any term of any employment contract, proprietary information agreement or other agreement relating to the right of any such individual to be employed by the Company, and to the Company's Knowledge, the continued employment by the Company of its present Employees will not result in such violation. The Company has not received any notice alleging that any such violation has occurred.

(j) The Company is in compliance, in all material respects with all applicable Legal Requirements, Contracts, policies, custom and procedures relating to employment, employment practices, wages, bonuses, terms and conditions of employment (including employee compensation matters).

**2.16 Environmental Matters.** The Company is in compliance in all material respects with all applicable Environmental Laws, which compliance includes the possession by the Company of all permits and other Governmental Authorizations required under applicable Environmental Laws, and compliance with the terms and conditions thereof. The Company has not received any notice or other communication (in writing or otherwise), whether from a Governmental Body, citizens group, employee or otherwise, that alleges that the Company is not in compliance with any Environmental Law, and, to the Company's Knowledge, there are no circumstances that may prevent or interfere with the Company's compliance with any Environmental Law in the future. To the Company's Knowledge, no current or prior owner of any property leased or controlled by the Company has received any notice or other communication (in writing or otherwise), whether from a Governmental Body, citizens group, employee or otherwise, that alleges that such current or prior owner or the Company is not in compliance with any Environmental Law with respect to such property. All Governmental Authorizations currently held by the Company pursuant to Environmental Laws are identified in **Part 2.16** of the Disclosure Schedule. (For purposes of this Section 2.16: (i) "**Environmental Law**" means any Legal Requirement relating to pollution, hazardous materials or protection of human health or the environment (including ambient air, surface water, ground water, land surface or subsurface strata), including any law or regulation relating to emissions, discharges, releases or threatened releases of Materials of Environmental Concern, or otherwise relating to the manufacture, processing, distribution, use, treatment, storage, disposal, transport or handling of Materials of Environmental Concern; and (ii) "**Materials of Environmental Concern**" include chemicals, pollutants, contaminants, wastes, toxic substances, petroleum and petroleum products and any other substance that is now regulated by any Environmental Law.)

**2.17 Insurance.**

(a) **Part 2.17(a)** of the Disclosure Schedule lists all material insurance policies held by or on behalf of the Company, including the names of the brokers, insurers, the principal insured and each named insured or beneficiary, the policy number and period of coverage, the type of interest and asset covered by the insurance policy, the annual premiums, the amount of any deductible, termination provisions, change of control provisions, waiver of subrogation rights and information regarding any claims made or outstanding against any of the policies over the past three years. The insurance policies listed on **Part 2.17(a)** of the Disclosure Schedule include all policies of insurance that are required by material commercial contracts relating to the Company, in the amounts required under the respective contracts. The insurance policies listed on **Part 2.17(a)** of the Disclosure Schedule are in full force and effect, all premiums due and payable thereon have been paid and no written notice of cancellation or termination has been received and is still in force with respect to any such policy. The insurance policies referred to in this Section 2.17(a) will remain in full force and effect and will not in any way be affected by or terminate by reason of the Merger or any of the other transactions contemplated by this Agreement.

(b) The Company has insurance against the types of risks and losses usually insured against by companies carrying on the same or a similar business, and in amounts and with such coverage limits as are generally appropriate to such businesses. Without prejudice to the generality of the foregoing, the insurance policies of the Company are all provided by well-established and reputable insurers, are for the full replacement or reinstatement value of all of the Company's assets of an insurable nature, and insure the Company against the risk of accident, damage, injury, third party loss (including product liability) and loss of profits.

(c) To the Company's Knowledge, the Company has not done anything or suffered any damage which has rendered or might render any policies of insurance taken out by it void or voidable or which might result in an increase in premiums or refusal of the insurer to renew them under customary terms and conditions, and the Company has complied in all material respects with all conditions attached to such policies.

(d) There is no claim outstanding under any of such policies nor, to the best of the Company's Knowledge, are there any circumstances likely to give rise to such a claim.

**2.18 Related Party Transactions.** Except as set forth in **Part 2.18** of the Disclosure Schedule: (a) no Related Party has, and no Related Party has at any time had, any direct or to the Company's Knowledge, indirect interest in any material asset used in or otherwise relating to the business of the Company; (b) no Related Party is, or has at any time been, indebted to the Company; (c) no Related Party has entered into, or has had any direct or to the Company's Knowledge, indirect financial interest in, any Material Agreement, transaction or business dealing involving the Company; (d) no Related Party is competing or has any time competed directly or indirectly, with the Company; and (e) no Related Party has any claim or right against the Company (including indemnification agreements but excluding rights to receive compensation and benefits for services performed as a Service Provider of the Company as set forth in Section 2.15 or reimbursements for reasonable expenses incurred on behalf of the Company in the ordinary course of business and consistent with past practice). For purposes of this Section 2.18 each of the following shall be deemed to be a "**Related Party**": (i) each Person that, directly or indirectly, controls the Company; (ii) each individual who is, or who has at any time been, an officer or director of the Company or of any Person referred to in clause (i) above in the past 12 months; (iii) each Family Member (as defined in Exhibit A) of each of the individuals referred to in clauses "(i)" and "(ii)" above; (iv) any trust or other Entity (other than the Company) in which any one of the individuals referred to in clauses "(ii)" and "(iii)" above holds (or in which more than one of such individuals collectively hold), beneficially or otherwise, a material voting, proprietary or equity interest and (v) any Person that owns 5% or more of the Company's outstanding capital stock or has the right to appoint at least one director of the Company.

**2.19 Legal Proceedings; Orders.**

(a) Except as set forth in **Part 2.19** of the Disclosure Schedule, there is no pending Legal Proceeding (or any Legal Proceeding subject to appeal) and, to the Company's Knowledge, no Person has threatened to commence any Legal Proceeding: (i) that involves the Company or any of the assets owned or used by the Company or any Person whose liability the Company has or may have retained or assumed, either contractually or by operation of law; or (ii) that questions the validity of this Agreement or the right of the Company to enter into the Agreement, or to consummate the transactions contemplated hereby, or that might result in any change in the current equity ownership of the Company, nor to the Company's Knowledge is there any basis for the foregoing. To the Company's Knowledge, no event has occurred, and no claim, dispute or other condition or circumstance exists, that will, or that could reasonably be expected to, give rise to or serve as a basis for the commencement of any such Legal Proceeding.

(b) There is no order, writ, injunction, judgment or decree of any court or government agency or instrumentality of any Governmental Body, in each case relating to the Company, to which the Company, or any of the assets owned or used by the Company, is subject. To the Company's Knowledge, no Service Provider is subject to any order, writ, injunction, judgment or decree of any court or government agency or instrumentality of any Governmental Body, in each case relating to the Company, that prohibits such Service Provider from engaging in or continuing any conduct, activity or practice relating to the Company's business.

**2.20 Authority; Binding Nature of Agreement**

(a) The Company has the requisite corporate power and authority to enter into and to perform its obligations under this Agreement and other agreements to which it is party contemplated hereby or which are ancillary hereto and to consummate the transactions contemplated hereby and thereby; and the execution, delivery and performance by the Company of this Agreement and all such other transactions have been duly authorized by all necessary corporate action on the part of the Company. Assuming that this Agreement constitutes a legal, valid and binding obligation of the other parties hereto, this Agreement constitutes the legal, valid and binding obligation of the Company, enforceable against the Company in accordance with its terms, subject to (i) laws of general application relating to bankruptcy, insolvency and the relief of debtors, and (ii) rules of law governing specific performance, injunctive relief and other equitable remedies.

(b) Without limiting the generality of the foregoing, the board of directors of the Company has unanimously (i) approved and declared advisable this Agreement, the Merger and the other transactions contemplated hereby, (ii) recommended approval and adoption of this Agreement, the Merger and the other transactions contemplated hereby by the Shareholders, and (iii) has not withdrawn or modified such approval or recommendation. The Company has obtained all necessary consents to approve this Agreement and the consummation of the Merger and the other transactions contemplated by this Agreement from any Warrantholder, Optionholder, Shareholder or creditor of the Company.

(c) The approval of (i) the holders of a majority of the outstanding Shares voting together as a single class on an as-if converted basis and (ii) the holders of sixty-six percent (66%) of the outstanding Preferred Shares voting together as a single class on an as-if converted basis are the only shareholder votes necessary to approve and adopt this Agreement and the Merger on behalf of the Company. Written consents of Shareholders representing the due approval and adoption of this Agreement and the Merger by the requisite vote have previously been delivered to Purchaser. The Company shall duly notify each non-consenting Shareholder of such approval in accordance with the Charter Documents and the WBCA within two Business Days of the date hereof.

**2.21 Non-Contravention; Consents.** Neither (1) the execution, delivery or performance of this Agreement or any of the other agreements referred to in this Agreement, nor (2) the consummation of the Merger, will directly or indirectly (with or without notice or lapse of time):

- (a) contravene, conflict with or result in a violation of any of the provisions of the Company's Articles of Incorporation;
- (b) contravene, conflict with or result in a violation of, or give any Governmental Body or other Person the right to challenge any of the transactions contemplated by this Agreement or to exercise any remedy or obtain any relief under, any Legal Requirement or any order, writ, injunction, judgment or decree applicable to the Company, or any of the assets owned or used by the Company, is subject;
- (c) contravene, conflict with or result in a violation of any of the terms or requirements of, or give any Governmental Body the right to revoke, withdraw, suspend, cancel, terminate or modify, any Governmental Authorization that is held by the Company or that otherwise relates to the Company's business or to any of the assets owned or used by the Company;
- (d) contravene, conflict with or result in a violation or breach of, or result in a default under, any provision of any Material Agreement, or give any Person the right to (i) declare a default or exercise any remedy under any such Material Agreement, (ii) accelerate the maturity or performance of any such Material Agreement, (iii) cancel, terminate or modify any such Material Agreement; or (iv) receive notice of the transaction; or
- (e) result in the imposition or creation of any lien or other Encumbrance upon or with respect to any asset owned or used by the Company.

Except as set forth in **Part 2.21** of the Disclosure Schedule, the Company is not and will not be required to make any filing with or give any notice to, or to obtain any Consent (as defined in Exhibit A) from, any Person in connection with (x) the execution, delivery or performance of this Agreement or any of the other agreements referred to in this Agreement, or (y) the consummation of the Merger.

**2.22 No Conflicting Interest.** The Company is not indebted, directly or indirectly, to any of its officers or directors (other than in connection with compensation) or to their respective spouses or children, in any amount whatsoever other than in connection with, expenses or advances of expenses incurred in the ordinary course of business or relocation expenses of employees. None of the Company's officers or directors, or any members of their immediate families, are, directly or indirectly, indebted to the Company or, to the Company's Knowledge, have any direct or indirect ownership interest in any firm or corporation with which the Company is affiliated or with which the Company has a business relationship, or any firm or corporation which competes with the Company. To the Company's Knowledge, none of the Company's officers or directors or any members of their immediate families are, directly or indirectly, interested in any Material Contract with the Company.

**2.23 Brokers.** No broker, finder or investment banker, for which the Company, Parent, Purchaser or Merger Sub may be liable, is entitled to any brokerage, finder's or other fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of the Company or any of its directors, officers, employees or agents.

**2.24 Propriety of Past Payments.** Neither the Company nor, to the Company's Knowledge, any agent, employee or other Person associated with or acting on behalf of the Company, has, directly or indirectly, used any corporate funds for unlawful contributions, gifts, entertainment or other unlawful expenses relating to political activity, made any unlawful payment to any government official or employee or to any political party or campaign from corporate funds, or made any unlawful bribe, rebate, payoff, influence payment, kickback or other similar unlawful payment.

**2.25 Full Disclosure.** Neither this Agreement (including the exhibits attached hereto and the Disclosure Schedule) nor any certificate furnished or to be furnished in connection herewith by the Company (i) contains any untrue or misleading statement of a material fact, or (ii) omits to state any material fact necessary in order to make such statements contained and to be contained herein and therein (in the light of the circumstances under which such representations, warranties and information were or will be made or provided) not false or misleading.

**Section 3. REPRESENTATIONS AND WARRANTIES OF PARENT, PURCHASER AND MERGER SUB.**

Parent, Purchaser and Merger Sub represent and warrant to the Company, as of the date hereof and as of the Closing Date, as follows:

**3.1 Due Organization; Etc.** Parent is a corporation duly organized and validly existing under the laws of the State of Israel, Purchaser is a corporation duly organized and validly existing under the laws of the State of Delaware, and Merger Sub is a corporation duly organized and validly existing under the laws of the State of Washington. Each of Parent, Purchaser and Merger Sub has all requisite corporate power and authority to own, lease and operate its properties and to carry on its businesses as now conducted and to enter into and perform its obligations under this Agreement and other agreements to which it is a party contemplated hereby and which are ancillary hereto and to consummate the transactions contemplated hereby.

**3.2 Financial Ability.** Parent has funds available to it sufficient to effect the transactions contemplated by this Agreement and will ensure that Purchaser has sufficient funds to do the same.

**3.3 Authority; Binding Nature of Agreement.** Each of Parent, Purchaser and Merger Sub has the right, power and authority to enter into and perform its obligations under this Agreement and other agreements to which it is a party contemplated hereby and which are ancillary hereto, and the execution, delivery and performance of this Agreement and other agreements to which it is a party contemplated hereby and which are ancillary hereto by Parent, Purchaser and Merger Sub have been duly authorized by all necessary corporate action on the part of Parent, Purchaser and Merger Sub. This Agreement constitutes the legal, valid and binding obligation of Parent, Purchaser and Merger Sub, enforceable against it in accordance with its terms, subject to (i) laws of general application relating to bankruptcy, insolvency and the relief of debtors, and (ii) rules of law governing specific performance, injunctive relief and other equitable remedies.

**3.4 Consents and Approvals.** Except for (i) the filing of the Articles of Merger as required by the WBCA and (ii) compliance with the HSR Act, if required, no filing or registration with, no notice to and no permit, authorization, consent or approval of any third party or any Governmental Body is necessary for the consummation by Parent, Purchaser and Merger Sub of the Merger.

**3.5** **No Violation.** Neither the execution and delivery of this Agreement by Parent, Purchaser and Merger Sub, the performance by each of Parent, Purchaser and Merger Sub of its obligations hereunder nor the consummation by Parent, Purchaser and Merger Sub of the Merger will (a) violate, conflict with or result in any breach of any provision of the respective organization documents of Parent, Purchaser and Merger Sub, (b) violate, conflict with or result in a violation or breach of, or constitute a default (with or without due notice or lapse of time or both) under the terms, conditions or provisions of any mortgage, indenture, license or material agreement to which Parent, Purchaser or Merger Sub is a party or (c) violate any order, writ, judgment, injunction, decree, statute, rule or regulation of any court or domestic or foreign Governmental Body applicable to Parent, Purchaser or Merger Sub.

**3.6** **Brokers.** No broker, finder or investment banker, for which the Company or the Shareholders may be liable, is entitled to any brokerage, finder's or other fee or commission in connection with the transactions contemplated by this Agreement based upon arrangements made by or on behalf of Parent, Purchaser or Merger Sub or any of their respective directors, officers, employees or agents.

**3.7** **Capitalization; Valid Issuance.** The authorized share capital of Parent consists of 40,000,000 Parent Shares, of which 9,772,558 Parent Shares were issued and outstanding as of July 25, 2011. The Parent Shares to be issued pursuant to this Agreement will, when issued in accordance with the provisions of this Agreement, be validly issued, fully paid and nonassessable.

**3.8** **Parent SEC Documents; Financial Statements.**

(a) Parent has timely filed all forms, reports and documents required under the Exchange Act (as defined in Exhibit A hereto) to be filed with the SEC (as defined in Exhibit A hereto) since July 1, 2010 (the "**Parent SEC Documents**"). Each of the Parent SEC Documents complied in all material respects with all applicable requirements of the Exchange Act and the rules and regulations promulgated thereunder, each as in effect on the dates such forms, reports, and documents were filed, and no such statement or report contained an untrue statement of a material fact or omitted to state any material fact necessary to make the statements made therein, in light of the circumstances under which they were made, not misleading.

(b) The consolidated financial statements of Parent and its consolidated subsidiaries for the year ended December 31, 2010 and the unaudited consolidated financial statements of Parent for the three months ended March 31, 2011 included in the Parent SEC Documents (i) were prepared in accordance with U.S. GAAP applied on a consistent basis throughout the periods covered, except as may be indicated in the notes to such financial statements, and except that unaudited financial statements may not contain footnotes and are subject to year-end audit adjustments, and (ii) fairly present the consolidated financial position of Parent and its subsidiaries as of the respective dates thereof and the consolidated results of operations of Parent and its subsidiaries for the periods covered thereby.



#### Section 4. REPRESENTATIONS AND WARRANTIES OF FOUNDER.

The Founder represents and warrants to Parent, Purchaser and Merger Sub, as of the date hereof and as of the Closing Date, as follows:

**4.1 Authority.** The Founder has all requisite power and authority to execute and deliver this Agreement and to consummate the transactions contemplated hereby. No consent, approval, order, license, permit, action by, or authorization of or designation, declaration, or filing with any Governmental Body on the part of the Founder is required that has not been, or will not have been, obtained by the Founder prior to the Closing in connection with the valid execution, delivery and performance of this Agreement. Neither the execution and delivery of this Agreement nor compliance by the Founder with the terms and provisions hereof or thereof, will conflict with, or result in a breach or violation of, any of the terms, conditions and provisions of: (i) any judgment, order, injunction, decree, or ruling of any court or Governmental Body, (ii) any agreement, contract, lease, license or commitment to which the Founder is a party or to which it or any of its properties are subject or (iii) any Legal Requirement.

**4.2 Experience; Receipt of Information; Consultation with Advisers.** The Founder is an “Accredited Investor” as such term is defined in Rule 501 of Regulation D promulgated under the Securities Act (as defined in Exhibit A hereto). The Founder has such knowledge and experience in financial and business matters as to be capable of evaluating the merits and risks relating to acquiring Parent Shares and, by reason of the Founder’s financial and business experience, he has the capacity to protect his interest in connection with the acquisition of such Parent Shares. The Founder understands that its acquisition of such Parent Shares involves a high degree of risk. Without prejudice to the representations and warranties of Parent, the Founder and his counsel have been afforded the opportunity to ask questions and otherwise conduct a due diligence inquiry.

**4.3 Acquisition for Own Account, etc.** The Founder is acquiring Parent Shares for his own account for investment and not with a view of distributing them. No other Person will have any direct or indirect beneficial interest in the Parent Shares acquired by the Founder pursuant to this Agreement. The Founder understands that, in connection with the acquisition of the Purchaser Shares as contemplated herein, the Purchaser Shares have not been and will not be registered under the Securities Act or registered or qualified under the securities laws of any U.S. state or other jurisdiction, in each case by reason of specific exemptions from the registration provisions of the Securities Act and the securities laws of such states or other jurisdictions, the availability of which depend upon, among other things, the bona fide nature of the investment intent and the accuracy of the Founder’s representations as expressed herein and in response to Purchaser’s inquiries, if any.

**4.4 Restricted Securities.** The Founder understands that the Parent Shares that he is acquiring pursuant to this Agreement are and will be “restricted securities” under the Securities Act in that such securities will be acquired from Parent in a transaction not involving a public offering under the Securities Act, and that under U.S. federal and state laws and applicable regulations, such Parent Shares may be resold without registration under the Securities Act only in certain limited circumstances and that otherwise such securities must be held indefinitely. In this connection, the Founder represents that it understands the resale limitations imposed by the Securities Act and is familiar with SEC Rule 144, as presently in effect, and the conditions which must be met in order for that rule to be available for resale of “restricted securities.” The Founder also acknowledges that he may be deemed to be an “affiliate” of Parent under SEC Rule 144 and that certain resale limitations thereunder shall apply to him for so long as he remains an “affiliate” and for three months thereafter.

**4.5 Tax Matters.** The Founder has had an opportunity to review with his own Tax advisors the Tax consequences to him of the transactions contemplated by this Agreement, including the receipt of Parent Shares. The Founder understands that he must rely solely on his advisors and not on any statements or representations by Parent, Purchaser, Merger Sub, the Company or any of their attorneys, investment advisors, accountants or other agents with respect to Tax matters.

**Section 5. CERTAIN COVENANTS OF THE COMPANY.**

**5.1 Operation of the Company's Business.** Other than as contemplated hereunder or with the prior written consent of Purchaser, during the period commencing on the date of this Agreement and continuing until the earlier of the termination of this Agreement and the Closing (the "**Pre-Closing Period**"):

- (a) the Company shall conduct its business and operations in the ordinary course and in substantially the same manner as such business and operations have been conducted prior to the date of this Agreement;
- (b) the Company shall use reasonable efforts to preserve intact its current business organization, keep available the services of its current employees and consultants, and maintain its relations and good will with all suppliers, customers, landlords, creditors, employees, consultants and other Persons having business relationships with the Company;
- (c) the Company shall keep in full force all insurance policies referred to in **Part 2.17(a)** of the Disclosure Schedule;
- (d) the Company shall report regularly (but in no event less frequently than weekly) to Purchaser concerning the status of the Company's business;
- (e) the Company shall use its commercially reasonable efforts to ensure that all Employees shall continue to be employed by the Company at Closing. This covenant shall not derogate from the right of Purchaser to terminate the employment of any Employees, in its sole discretion, following the Closing;
- (f) the Company shall not declare, accrue, set aside or pay any dividend or make any other distribution in respect of any shares of the Company, except for a cash dividend in an amount that would not result in the Company Net Working Capital being lower than the Working Capital Target (as such terms are defined in Section 1.12 above), and shall not repurchase, redeem or otherwise reacquire any shares or other securities of the Company, except pursuant to restricted stock purchase agreements that were outstanding prior to the date hereof;

(g) the Company shall not sell, issue or authorize the issuance of (i) any capital stock, except for the issuance of capital stock upon the exercise or conversion of securities that were outstanding prior to the date hereof, (ii) any option or right to acquire any capital stock of the Company, or (iii) any instrument convertible into or exchangeable for any capital stock or other security of the Company;

(h) the Company shall not amend or waive any of its rights under, or permit the acceleration of vesting under, (i) any provision of any share or option plan, (ii) any provision of any agreement evidencing any outstanding Company Stock Option, or (iii) any provision of any share purchase agreement;

(i) the Company shall not amend or permit the adoption of any amendment to the Company's Articles of Incorporation or Bylaws, or effect or permit the Company to become a party to any Acquisition Transaction, recapitalization, reclassification of shares, split, reverse split or similar transaction;

(j) the Company shall not form any subsidiary or acquire any equity interest or other interest in any other Entity;

(k) the Company shall not make any capital expenditure, during the Pre-Closing Period;

(l) the Company shall not, other than in the ordinary course of business consistent with past practice, (i) enter into, or permit any of the assets owned or used by it to become bound by, any Contract that is or would constitute a Material Agreement, or (ii) amend or prematurely terminate, or waive any material right or remedy under, any such Contract;

(m) the Company shall not (i) acquire, lease or license any right or other asset from any other Person, except for rights or other assets acquired, leased or licensed in the ordinary course of business consistent with past practice, (ii) sell or otherwise dispose of, or lease or license, any right or other asset to any other Person, except for rights or other assets disposed of, leased or licensed in the ordinary course of business consistent with past practice, or (iii) waive or relinquish any material right;

(n) the Company shall not (i) lend money to any Person or Persons, except for advances of business expenses in the ordinary course of business consistent with past practice, or (ii) incur or guarantee any indebtedness for borrowed money;

(o) the Company shall not (i) establish, adopt or amend any employee benefit plan or arrangement, (ii) except as may be required by an applicable Legal Requirement, any Contract outstanding on the date hereof, pay any bonus or make any profit-sharing payment, cash incentive payment or similar payment to, or increase the amount of the wages, salary, commissions, fringe benefits or other compensation or remuneration payable to, any of its directors, officers, employees or consultants, or make any arrangement with regard to any of the foregoing, (iii) hire any new employee or consultant, (iv) amend or prematurely terminate any of the existing agreements with any employees or consultants or (v) enter into any arrangement with securityholders;

- (p) the Company shall not change any of its methods of accounting or accounting practices in any material respect, or alter its practices with respect to the collection of receivables or payment of payables except as required by concurrent changes in GAAP;
- (q) the Company shall not make any Tax election;
- (r) the Company shall not commence or settle any material Legal Proceeding;
- (s) the Company shall not enter into any transaction or relationship with any Related Party; and
- (t) the Company shall not agree or commit to take any of the actions described in clauses “(f)” through “(s)” above.

**5.2 No Negotiation.** During the Pre-Closing Period, neither the Company nor any of its officers, directors, employees or other agents shall directly or indirectly:

- (a) solicit or encourage the initiation of any inquiry, proposal or offer from any Person (other than Parent and Purchaser) relating to a possible Acquisition Transaction;
- (b) participate in any discussions or negotiations or enter into any agreement with, or provide any information to, any Person (other than Parent and Purchaser) relating to or in connection with a possible Acquisition Transaction (except outstanding Company Warrants set forth in **Part 2.3(c)** of the Disclosure Schedule); or
- (c) consider, entertain or accept any proposal or offer from any Person (other than Parent and Purchaser) relating to a possible Acquisition Transaction (except outstanding Company Warrants set forth in **Part 2.3(c)** of the Disclosure Schedule).

The Company shall promptly notify Purchaser in writing of any inquiry, proposal or offer relating to a possible Acquisition Transaction that is received by the Company or any Representatives thereof during the Pre-Closing Period, including the material terms thereof.

**5.3 Access to Information.**

- (a) During the Pre-Closing Period, (i) the Company shall afford Parent and Purchaser and their accountants, counsel and other representatives, reasonable access upon reasonable prior notice and during normal business hours to (A) all of the Company’s properties, books, Contracts and records and (B) all other information concerning the business, properties and personnel (subject to restrictions imposed by applicable Legal Requirements) of the Company as Parent or Purchaser may reasonably request, and (ii) the Company shall make available to Parent and Purchaser and their accountants, counsel and other representatives correct and complete copies of the Company’s (A) internal financial statements, (B) Tax Returns, Tax elections and all other records and workpapers relating to Taxes and (C) receipts for any Taxes paid to foreign Tax Authorities, if any.

(b) Subject to compliance with applicable Legal Requirements, during the Pre-Closing Period, the Company shall confer from time to time as requested by Purchaser with one or more representatives of Purchaser to discuss any material changes or developments in the operational matters of the Company and the general status of the ongoing operations of the Company.

**Section 6. ADDITIONAL COVENANTS OF THE PARTIES.**

**6.1 Filings and Consents.** As promptly as practicable after the execution of this Agreement, each party to this Agreement (a) shall make all filings (if any) and give all notices (if any) required to be made and given by such party in connection with the transactions contemplated by this Agreement, and (b) shall use all commercially reasonable efforts to obtain all Consents (if any) required to be obtained (pursuant to any applicable Legal Requirement or Contract, or otherwise) by such party in connection with or to give full effect to transactions contemplated by this Agreement; *provided, however*, that (i) the Company shall be responsible for making all filings with and obtaining all such Consents from Governmental Bodies pursuant to Legal Requirements applicable to the Company or its businesses or properties, and for obtaining all such Consents (if any) required to be obtained from parties to Contracts by which the Company or its properties are bound, (ii) Parent shall be responsible for making all filings with and obtaining all such Consents from Governmental Bodies pursuant to Legal Requirements applicable to the Parent, Purchaser or Merger Sub or their respective business or properties; and (iii) each party shall provide the others with such assistance and information as is reasonably required to make such filings or to obtain such Consents; *provided further*, that Parent and Purchaser shall not be obligated to consent to any divestitures or operational limitations or activities in connection therewith.

Each party to this Agreement shall promptly deliver to the other parties a copy of each such filing made, each such notice given and each such Consent obtained by such party during the Pre-Closing Period. Each party shall promptly provide the other parties with copies of all filings made by the other party with any state, federal or foreign Governmental Body in connection with this Agreement and the transactions contemplated hereby.

**6.2 Public Announcements.**

(a) During the Pre-Closing Period, (a) the Company shall not (and the Company shall not permit any of its Representatives to) issue any press release or make any public statement regarding this Agreement, or regarding any of the transactions contemplated by this Agreement, without Parent's prior written consent, and (b) Parent shall not (and Parent shall not permit any of its Representatives to) issue any press release or make any public statement regarding this Agreement, or regarding any of the transactions contemplated by this Agreement, without the Company's prior written consent. Notwithstanding the provisions of the preceding sentence, Parent shall be permitted to issue any press release or publicly file any information as is required by any Legal Requirement or stock market rule, including information required to be disclosed in connection with Parent's proposed public debt offering. The parties agree to announce this Agreement and the consummation of the Merger to the Company's employees, customers, vendors and strategic partners at such time and in such form as is mutually agreed upon by all parties to this Agreement.

(b) In addition, during the Pre-Closing Period, the Company shall provide notice to Parent and reasonable opportunity to review the substance of any press release that the Company proposes to issue, to the extent not governed by Section 6.2(a); provided, however, that the Company shall be entitled to issue any press release not governed by Section 6.2(a) in its sole discretion.

**6.3 Reasonable Best Efforts.** During the Pre-Closing Period, (a) the Company shall use its reasonable best efforts to cause the conditions set forth in Section 7 to be satisfied on a timely basis, and (b) Purchaser shall use its reasonable best efforts to cause the conditions set forth in Section 8 and assist the Company in causing the condition set forth in Section 7.11, to be satisfied on a timely basis.

**6.4 Employment Matters.**

(a) The Company acknowledges and agrees that, notwithstanding any confidentiality, non-compete or intellectual property ownership obligations of any Service Provider, the Service Providers shall be permitted to engage in the business of the Company on behalf of Parent, Purchaser and the Surviving Corporation.

(b) The Company shall continue to pay until the Closing Date all salaries, benefits and other entitlements to its Service Providers in a timely manner. The Company shall continue to set aside until the Closing Date all benefits under the Company Employee Plans to which any Employee or former Employee is or may be entitled including, *inter alia*, severance pay, termination notice, accrued and unpaid vacation days, leave and health.

(c) For a period beginning on the Effective Time and ending on the last day of the calendar year in which the Closing occurs (the “**Benefits Period**”), Purchaser shall maintain the Company Employee Plans (not including the Stock Option Plans) in effect as of the Closing Date, or, alternatively, provide the Employees of the Company who remain employed by the Company or the Surviving Corporation or one of its subsidiaries after the Effective Time (collectively, the “**Continuing Employees**”) with benefits that are not materially less favorable in the aggregate as those provided to the employees of the Company as of the Closing Date under the Company’s “employee welfare benefit plans” as defined in Section 3(1) of ERISA and “employee pension benefit plans” as defined in Section 3(2) of ERISA. During the Benefits Period, Purchaser shall, in the case of any Continuing Employees who become employed by the Surviving Corporation, (i) for purposes of determining eligibility, vesting and benefit accrual (including for purposes of vacation accrual) under any Company Employee Plans sponsored by the Purchaser in which the Continuing Employees begin to participate (other than a defined benefit plan) (“**Purchaser Employee Plans**”), and to the extent permitted by such Purchaser Employee Plans and applicable law, Purchaser shall use commercially reasonable efforts to cause such Continuing Employees to receive service credit under each Purchaser Employee Plan (other than a defined benefit plan) for their period of service with the Company prior to the Closing to the same extent as was recognized under the Company’s corollary Company Employee Plan, except where doing so would cause a duplication of benefits; (ii) all vacation accrued by Continuing Employees under the vacation policies of the Company shall be carried over by Purchaser and shall be permitted to be maintained up to the levels permitted under the applicable policy of the Company; (iii) Purchaser shall use commercially reasonable efforts to cause any insurer to waive all limitations as to preexisting conditions exclusions (or actively at work or similar limitations), evidence of insurability requirements and waiting periods with respect to participation and coverage requirements applicable to the Continuing Employees and their eligible dependents under any medical, dental and vision plans sponsored by the Purchaser that such Continuing Employees may be eligible to participate in during the Benefits Period; and (iv) Purchaser shall use commercially reasonable efforts to cause any insurer to provide Continuing Employees and their eligible dependents with credit for any co-payments, deductibles, offsets and maximum out-of-pocket requirements (or similar payments) made under the Company Employee Plans for the year in which the Closing occurs under Purchaser’s medical, dental and vision plans for the purposes of satisfying any applicable deductible, out-of-pocket, maximum out-of-pocket requirements or similar requirements under any Purchaser plan in the year in which the Closing occurs. For the calendar year following the year in which the Closing occurs, Purchaser shall consult with the Company’s chief executive officer to determine the benefit plans for the Continuing Employees.

**6.5 Tax Liability.** Each party shall be solely responsible for all its respective Tax obligations deriving from the transactions contemplated in this Agreement.

**6.6 Notification.** During the Pre-Closing Period, the Company shall promptly notify Purchaser, and Purchaser shall promptly notify the Company and the Shareholder Representative, in writing of the discovery of any of the following:

(a) any event, condition, fact or circumstance that occurred or existed on or prior to the date of this Agreement and that caused or constitutes an inaccuracy in or breach of any representation or warranty made by the relevant party in this Agreement;

(b) any event, condition, fact or circumstance that occurs, arises or exists after the date of this Agreement and that causes or constitutes, or could reasonably be seen as likely to cause or constitute, an inaccuracy in or breach of any representation or warranty made by the relevant party in this Agreement;

(c) any breach of any material covenant or obligation of the relevant party; and

(d) any event, condition, fact or circumstance that would make the timely satisfaction of any of the conditions set forth in Section 7 (in the case of the Company or Section 8 (in the case of Parent or Purchaser) impossible or unlikely.

**6.7 Closing Spreadsheet.** The Company shall prepare and deliver to Purchaser and the Paying Agent, at or prior to the Closing, a spreadsheet (the “Closing Spreadsheet”) in the form provided by Purchaser prior to the Closing, reasonably acceptable to Purchaser, which Closing Spreadsheet shall be dated as of the Closing Date and shall set forth all of the following information (in addition to the other required data and information specified therein), as of the Closing Date and immediately prior to the Closing: (a) the names of all the Shareholders, Warrantheolders and Optionholders and their respective street and email addresses, telephone number, taxpayer identification numbers (if any), bank information (including the respective bank name and number, branch name and address, swift number and account number); (b) the number and class of Shares held by, or subject to Company Warrants or the Company Stock Options held by, such Persons and, in the case of outstanding Shares, the respective certificate numbers; (c) the exercise price per share and expiration date of each Company Stock Option, whether such Company Stock Option is an incentive stock option (as defined in the Code) or a non-qualified stock option and whether the Optionholder is an employee of the Company; (d) the exercise price per share and expiration date for each Company Warrant; (e) whether or not each Optionholder is a U.S. person under the Code; (f) the Series A Amount, the Series B Amount, the Common Amount, the Option Amount for each In-the-Money Option, the Warrant Amount for each In-the-Money Warrant, each prior to any adjustments that may be made pursuant to this Agreement; (g) the Consideration Fraction of each Shareholder, Optionholder and Warrantheolder; (h) the Net Value for each Warrantheolder and each Optionholder; (i) the Holder Share Amount of each Shareholder, each Warrantheolder and each Optionholder; and (j) the amount of the Closing Payment distributable to each Shareholder, each Warrantheolder and each Optionholder pursuant to Section 1.9(a) hereof. The Company shall prepare and deliver to Purchaser, a draft of the Closing Spreadsheet not later than two (2) Business Days prior to the Closing Date.

**6.8 Certain Closing Certificates.** The Company shall prepare and deliver to Purchaser, a draft of each of the Company Net Working Capital Certificate and the Transaction Costs Certificate not later than two (2) Business Days prior to the Closing Date. The Company shall prepare and deliver the final Company Net Working Capital Certificate and the final Transaction Costs Certificate to Purchaser at or prior to the Closing. Without limiting the generality or effect of the foregoing or the provisions of Section 5.3 hereof, the Company shall provide to Purchaser, promptly after Purchaser’s request, copies of the documents or instruments evidencing the amounts set forth on any such draft or final certificate, as well as the draft Closing Spreadsheet and the final Closing Spreadsheet delivered pursuant to Section 6.7 hereof.

**6.9 Renewal.** The Company shall use its reasonable best efforts to renew the agreement set forth in Schedule 6.9 hereof prior to the Closing.

**6.10 Indemnification and Insurance.**

(a) From and after the Closing, the Surviving Corporation shall fulfill and honor in all respects its obligations pursuant to any indemnification agreements between the Company and its current and former directors and officers as of the Closing that are set forth in **Part 2.18** of the Disclosure Schedule and any indemnification provisions under the Charter Documents as in effect on the Closing Date, in each case, subject to applicable Legal Requirements.



(b) Notwithstanding anything in this Section 6.10 to the contrary, no Person shall be entitled to indemnification pursuant to this Section 6.10 for any matter involving fraud in connection with this Agreement or the transactions contemplated thereby.

(c) The Company may, in its discretion, purchase a “tail” insurance policy to go into effect upon the Effective Time, which policy (i) contains terms that are substantially similar to those of the Company’s directors’ and officers’ insurance policy in effect on the date of this Agreement, (ii) has an effective term of six (6) years from the Effective Time and (iii) covers each currently serving officer and director of the Company. The cost of such policy, and any related professional fees, shall be considered Transaction Costs for purposes of this Agreement.

**6.11 Restriction on Disposition of Parent Shares.**

(a) Without in any way limiting the representations set forth in Section 4B above, the Founder agrees not to make any disposition of any Parent Shares acquired hereunder unless and until the Founder shall have furnished Parent with a written opinion of counsel, reasonably satisfactory to Parent, that such disposition will not require registration of any securities under the Securities Act or the consent of or a permit from appropriate authorities under any applicable U.S. state securities law.

(b) Notwithstanding the foregoing, Parent will not require opinions of counsel for transactions made pursuant to SEC Rule 144, provided it is provided with all certificates and other information it may reasonably request to permit it to determine that the subject disposition is, in fact, exempt from the registration requirements of the Securities Act pursuant to SEC Rule 144. In the case of any disposition of any of the Parent Shares pursuant to SEC Rule 144, in addition to the matters set forth in this Section 6.11(b), the Founder shall promptly forward to Parent a copy of any Form 144 filed with the SEC with respect to such disposition. If SEC Rule 144 is amended or if the SEC’s interpretations thereof in effect at the time of any such disposition by the Founder have changed from its present interpretations thereof, the Founder shall provide Parent with any such additional documents as it may reasonably require.

**6.12 Securities Act Legend.** The certificates evidencing the Parent Shares issuer pursuant to this Agreement will bear the following legend reflecting the foregoing restrictions on the transfer of such securities, in addition to any legend required by applicable U.S. state securities laws:

**“THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED. THEY MAY NOT BE SOLD, OFFERED FOR SALE, TRANSFERRED, PLEDGED OR HYPOTHECATED IN THE ABSENCE OF A REGISTRATION STATEMENT IN EFFECT WITH RESPECT TO THE SECURITIES UNDER SUCH ACT OR AN OPINION OF COUNSEL OR OTHER EVIDENCE SATISFACTORY TO THE COMPANY THAT SUCH REGISTRATION IS NOT REQUIRED OR UNLESS SOLD PURSUANT TO RULE 144 UNDER SUCH ACT.”**

**Section 7. CONDITIONS PRECEDENT TO OBLIGATIONS OF PARENT AND PURCHASER.**

The obligations of Parent and/or Purchaser, as applicable, to consummate the transactions contemplated by this Agreement are subject to the satisfaction, at or prior to the Closing, of each of the following conditions, any or all of which may be waived in writing by Parent and/or Purchaser, as applicable:

**7.1 Accuracy of Representations.** Each of the representations and warranties made by the Company and the Founder, respectively, in this Agreement shall have been complete and accurate as of the date of this Agreement, and shall have been complete and accurate in all material respects (except for those heretofore qualified by materiality, in which case, no additional standard of materiality shall be applied) as of the Closing Date as if made on the Closing Date (except that those representations and warranties which address matters only as of a particular date shall have been true and correct only on such date).

**7.2 Performance of Covenants.** All of the covenants and obligations that the Company is required to comply with or to perform at or prior to or at the Closing shall have been complied with and performed in all material respects.

**7.3 Consents.** All Consents required to be obtained by the Company in connection with the transactions contemplated by this Agreement, as set forth on Schedule 7.3 hereof, shall have been obtained in a form satisfactory to Purchaser, and shall be in full force and effect.

**7.4 Agreements and Documents.** Purchaser shall have received the following agreements and documents, each of which shall be in full force and effect:

- (a) the legal opinion of Wilson Sonsini Goodrich & Rosati in form attached hereto as Exhibit I and dated as of the Closing Date;
- (b) a certificate executed by the Chief Executive Officer and principal financial officer of the Company which certifies that the conditions relating to the Company set forth in Sections 7.1, 7.2, 7.3, 7.5, 7.6, 7.7(b) and (c), 7.8, 7.9, 7.10 and 7.11 have been duly satisfied;
- (c) a certificate executed by the Founder which certifies that the condition relating to the Founder set forth in Section 7.1 has been duly satisfied;
- (d) the Closing Spreadsheet (as such term is defined in Section 6.7 hereof) completed to include all of the information specified in said Section 6.7 in a form acceptable to Purchaser and a certificate executed by the Chief Executive Officer of the Company dated as of the Closing Date, certifying that such Closing Spreadsheet is true, correct and complete;
- (e) the Company Net Working Capital Certificate, which certificate shall be accompanied by such supporting documentation, information and calculations as are necessary for Purchaser to verify and determine the amount of Company Net Working Capital;

- (f) the Transaction Costs Certificate, which certificate shall be accompanied by such supporting documentation, information and calculations as are reasonably necessary for Purchaser to verify and determine the Transaction Cost Amount;
- (g) written resignations of all directors of the Company, effective as of the Closing Date;
- (h) a proxy from the Founder in favor the Paying Agent in accordance with Section 1.9(h) hereof, in a form reasonably acceptable to Parent; and
- (i) the Escrow Agreement.

**7.5 No Restraints.** No temporary restraining order, preliminary or permanent injunction or other order preventing the consummation of the transactions contemplated by this Agreement shall have been issued by any court of competent jurisdiction and remain in effect, and there shall not be any Legal Requirement enacted or deemed applicable to the transactions contemplated by this Agreement that makes consummation of the transactions contemplated by this Agreement illegal, which Legal Requirement shall not have been removed within thirty (30) days of enactment.

**7.6 No Legal Proceedings.** No Person shall have commenced or taken substantial steps towards any Legal Proceeding challenging or seeking the recovery of a material amount of damages in connection with the transactions contemplated by this Agreement or seeking to prohibit or limit the exercise by Purchaser of any material right pertaining to its ownership of shares of the Company.

**7.7 Employment Agreements; Options.**

(a) An Employment Agreement between the Company and each key Employee identified by Purchaser on Schedule 7.7(a) hereto, in form and substance reasonably acceptable to the parties thereto, shall have been duly executed and delivered.

(b) At least 80% of the Employees set forth on Schedule 7.7(b) hereto shall be employees of the Company at Closing, and none of such Employees shall have given any notice or other indication that he or she is not willing to remain employed by the Company following the Closing. This condition shall not derogate from the right of Purchaser to terminate the employment of any Employees, in its sole discretion, following the Closing.

(c) Except for the Shares, as of the Closing, there shall be no outstanding options, warrants or other rights to subscribe for, purchase or acquire any securities of the Company.

**7.8 No Liens.** All Encumbrances on any assets of the Company shall have been terminated effective immediately prior to the Effective Time other than liens for Taxes not yet due and payable. UCC termination statements and the non-U.S. equivalent termination statements, as applicable, shall have been filed wherever UCC financing statements or non-U.S. equivalent liens perfection statements were filed, and any security interests on file with the Patent and Trademark Office of the Copyright Office or any equivalent non-U.S. Governmental Body shall have been released and evidence of the foregoing reasonably satisfactory to Purchaser shall have been provided to it.

**7.9** **No Debt.** All indebtedness of any shareholder, director, officer or employee of the Company owing to the Company shall have been paid in full prior to the Closing.

**7.10** **No Material Adverse Effect.** There shall have been no events, changes or effects, individually or in the aggregate, with respect to the Company having a Material Adverse Effect on the Company.

**7.11** **Search Functionality.** The requirements for Search Functionality shall have been met in accordance with the criteria set forth in Schedule 1.13(h), subject to Purchaser fulfilling its obligations as set forth therein.

**7.12** **Financial Statements.** The Company shall have delivered to Parent an unaudited statement of operations, statement of shareholders' equity and statement of cash flows of the Company for the period commencing on January 1, 2011 and ending at the end of the full month immediately preceding the Closing Date, and for the corresponding period of the previous fiscal year, and a balance sheet as of the end of such periods, certified by the Chief Executive Officer of the Company that such financial statements (i) present fairly in all material respects the financial position of the Company as of the respective dates thereof and the results of operations, changes in shareholders' equity and cash flows of the Company for the periods covered thereby, (ii) have been prepared in accordance with GAAP consistently applied throughout the periods covered and (iii) comply with the requirements of all applicable law and regulations, including SEC Regulation S-X, subject to year-end audit adjustments being prepared in accordance with GAAP consistently applied.

**Section 8. CONDITIONS PRECEDENT TO OBLIGATIONS OF THE COMPANY.**

The obligations of the Company to consummate the transactions contemplated by this Agreement are subject to the satisfaction, at or prior to the Closing, of the following conditions any or all of which may be waived in writing by the Company:

**8.1** **Accuracy of Representations.** Each of the representations and warranties made by Parent, Purchaser and Merger Sub in this Agreement shall have been accurate as of the date of this Agreement, and shall be complete and accurate in all material respects (except for those heretofore qualified by materiality, in which case, no additional standard of materiality shall be applied) as of the Closing Date as if made on the Closing Date (except that those representations and warranties which address matters only as of a particular date shall have been true and correct only on such date).

**8.2** **Performance of Covenants.** All of the covenants and obligations that Parent, Purchaser and Merger Sub are required to comply with or to perform at or prior to the Closing shall have been complied with and performed in all material respects.

**8.3** **Documents.** The Company shall have received the following agreements and documents, each of which shall be in full force and effect:

(a) a certificate executed by the Chief Executive Officer and Chief Financial Officer of each of Parent, Purchaser and Merger Sub certifying that the conditions set forth in Sections 8.1 and 8.2 have been duly satisfied;

(b) an Employment Agreement between the Company and each key Employee identified by Purchaser on Schedule 7.7(a) hereto, in form and substance reasonably acceptable to the parties thereto, shall have been duly executed and delivered;

(c) evidence of the transfer of the cash portion of the Closing Payment to the account of the Paying Agent identified in writing by the Paying Agent prior to the Closing;

(d) irrevocable instructions from Parent to its transfer agent to promptly issue in the name of the Founder and send to the Paying Agent two share certificates representing the Founder Share Consideration in accordance with Section 1.9(a) hereof; and

(e) the Escrow Agreement.

**8.4** **No Restraints.** No temporary restraining order, preliminary or permanent injunction or other order preventing the consummation of the transactions contemplated by this Agreement shall have been issued by any court of competent jurisdiction and remain in effect, and there shall not be any Legal Requirement enacted or deemed applicable to the transactions contemplated by this Agreement that makes consummation of the transactions contemplated by this Agreement illegal, which Legal Requirement shall not have been removed within (30) days of enactment.

**Section 9. TERMINATION.**

**9.1** **Termination Events.** This Agreement may be terminated prior to the Closing:

(a) By either the Company or Purchaser if a court of competent jurisdiction or other Governmental Body shall have issued an order, decree or ruling or taken any other action (which order, decree or ruling the parties hereto shall use their best efforts to lift) and such was not at the request of the party seeking termination of the Agreement, in each case permanently restraining, enjoining or otherwise prohibiting the transactions contemplated by this Agreement, and such order, decree, ruling or other action shall have become final and nonappealable; or

(b) by Purchaser if the Closing has not taken place on or before September 27, 2011 (other than as a result of any failure on the part of Parent, Purchaser or Merger Sub to comply with or perform any covenant or obligation of Parent, Purchaser or Merger Sub set forth in this Agreement); or

(c) by the Company if the Closing has not taken place on or before September 27, 2011 (other than as a result of the failure on the part of the Company to comply with or perform any covenant or obligation set forth in this Agreement); or

(d) by the mutual written consent of Purchaser and the Company; or

(e) by Purchaser, if (i) the Company shall breach any representation, warranty, obligation or agreement hereunder such that the conditions referred to in Section 7.1 or Section 7.2 would not be satisfied and such breach shall not have been cured within seven (7) Business Days following written notice of such breach, *provided* that the right to terminate this Agreement by Purchaser under this Section 9.1(e) shall not be available where Parent, Purchaser or Merger Sub is at that time in breach of this Agreement, (ii) the board of directors of the Company shall have withdrawn or modified its recommendation of this Agreement or the Merger in a manner adverse to Parent or Purchaser or recommended, endorsed, accepted or agreed to an Acquisition Transaction (except with regard to Company Stock Options or pending Company Warrants set forth in **Part 2.3** of the Disclosure Schedule) or shall have resolved to do any of the foregoing or the approval of the Shareholders of this Agreement or the Merger shall have been rescinded or invalidated, (iii) the Company or any of its respective officers, directors, employees or other agents, shall have failed to comply with Section 5.2 or (iv) there shall have been an event such that any of the conditions set forth in Section 7.1 would be incapable of being satisfied; or

(f) by the Company, if (i) Parent, Purchaser or Merger Sub shall breach any representation, warranty, obligation or agreement hereunder such that the conditions referred to in Section 8.1 or Section 8.2 would not be satisfied and such breach shall not have been cured within seven (7) Business Days following written notice of such breach, *provided* that the right to terminate this Agreement by the Company under this Section 9.1(f) shall not be available where the Company is at that time in breach of this Agreement; (ii) the board of directors of Parent, Purchaser or Merger Sub shall have withdrawn or modified its recommendation of this Agreement or the Merger; or (iii) there shall have been an event such that any of the conditions set forth in Section 8.1 would be incapable of being satisfied;

**9.2 Termination Procedures.** If Purchaser wishes to terminate this Agreement pursuant to Section 9.1(a), Section 9.1(b) or Section 9.1(e), Purchaser shall deliver to the Company a written notice stating that Purchaser is terminating this Agreement and setting forth a brief description of the basis on which Purchaser is terminating this Agreement. If the Company wishes to terminate this Agreement pursuant to Section 9.1(a), Section 9.1(c) or Section 9.1(f), the Company shall deliver to Purchaser a written notice stating that the Company is terminating this Agreement and setting forth a brief description of the basis on which the Company is terminating this Agreement.

**9.3 Effect of Termination.** If this Agreement is terminated pursuant to Section 9.1, all further obligations of the parties under this Agreement shall terminate; *provided, however*, that: (a) no party shall be relieved of any obligation or liability arising from any prior breach by such party of any provision of this Agreement; and (b) the parties shall, in all events, remain bound by and continue to be subject to the provisions set forth in Sections 6.2 and 11 herein.

## **Section 10. INDEMNIFICATION, ETC.**

### **10.1 Survival of Representations, Etc.**

(a) The representations and warranties made by the Company (including the representations and warranties set forth in Section 2 and the representations and warranties of the Company set forth in any closing certificate) are deemed to be made on the date of this Agreement and at the Closing, and shall survive the Closing and shall expire on the 18-month anniversary of the Closing Date (the “**Termination Date**”); *provided, however*, that if, at any time prior to the Termination Date, any Parent Indemnitee delivers to the Shareholder Representative a written notice alleging the existence of an incompleteness of, inaccuracy in or a breach of any of the representations and warranties made by the Company (and setting forth in reasonable detail the basis for such Parent Indemnitee’s belief that such an incompleteness, inaccuracy or breach may exist) and asserting a claim for recovery based on such alleged incompleteness, inaccuracy or breach, then the claim asserted in such notice shall survive the Termination Date until such time as such claim is fully and finally resolved; *provided, further*, that notwithstanding the foregoing, the representations and warranties contained in Section 2.9 (*Intellectual Property*) (the “**IP Representation**”), as modified by the proviso contained in Section 10.5(viii), shall survive the Closing and the Termination Date and shall expire on the 30-month anniversary of the Closing Date; and *provided, further*, that notwithstanding the foregoing, the representations and warranties contained in Sections 2.1(a) (*Due Organization*), 2.1(e) (*Investments*), 2.3 (*Capitalization*), 2.14 (*Tax Matters*), 2.20 (*Authority*) and 2.23 (*Brokers*) (collectively, the “**Special Representations**”) shall survive the Closing and the Termination Date and shall expire on the expiration date of the applicable statute of limitations.

(b) The representations, warranties, covenants and obligations of the Company, and the rights and remedies that may be exercised by the Parent Indemnitee, shall not be limited or otherwise affected by or as a result of either (i) any waiver of Closing conditions by Parent, Purchaser, Merger Sub or any of their Representatives, or (ii) any information furnished to, or any investigation made by or knowledge of, any of the Parent Indemnitees or any of their respective Representatives.

(c) The representations and warranties made by Parent, Purchaser and Merger Sub (including the representations and warranties set forth in Section 3 and the representations and warranties of Parent, Purchaser or Merger Sub set forth in any closing certificate) shall survive the Closing and shall expire on the Termination Date; *provided, however*, that if, at any time prior to the Termination Date, the Shareholder Representative delivers to Purchaser a written notice alleging the existence of an inaccuracy in or a breach of any of the representations and warranties made by Parent, Purchaser or Merger Sub (and setting forth in reasonable detail the basis for the Shareholder Representative's belief that such an inaccuracy or breach may exist) and asserting a claim for recovery based on such alleged inaccuracy or breach, then the claim asserted in such notice shall survive the Termination Date until such time as such claim is fully and finally resolved.

(d) The representations, warranties, covenants and obligations of Parent, Purchaser and Merger Sub, and the rights and remedies that may be exercised by the Shareholder Representative, shall not be limited or otherwise affected by or as a result of either (i) any waiver of Closing conditions by the Company or any of its Representatives, or (ii) any information furnished to, or any investigation made by or knowledge of, the Company, the Shareholder Representative or any of their respective Representatives.

## 10.2 **Indemnification.**

(a) From and after the Closing Date (but subject to Section 10.1(a)), the Participating Securityholders shall, severally and not jointly, indemnify and hold the Parent Indemnitees harmless from and against any Damages (as defined in Exhibit A) that are directly or indirectly suffered or incurred by any of the Parent Indemnitees (regardless of whether or not such Damages relate to any third-party claim) and which arise from or as a result of, or are directly or indirectly connected with: (i) any incompleteness of, inaccuracy in or breach of any representation or warranty by the Company set forth in Section 2 or elsewhere in this Agreement or in any closing certificate; (ii) any failure to comply with, or breach of any covenant or obligation of the Company set forth in this Agreement or any of the Company's obligations pursuant to the Merger; (iii) the matters set forth on Schedule 10.2 hereof; or (iv) any Legal Proceeding relating to any incompleteness, inaccuracy, failure or breach referred to above (including any Legal Proceeding commenced by any Parent Indemnitee for the purpose of enforcing any of its rights under this Section, 10.2 (collectively, "**Section 10.2 Damages**"); *provided, however*, that no Parent Indemnitee shall be entitled to any such indemnification in respect of Section 10.2 Damages unless and until the Damages sought by all Parent Indemnitees exceed two hundred fifty thousand U.S. Dollars (\$250,000) in the aggregate (the "**Basket**"), whereupon indemnification may be sought by the Parent Indemnitees for the full extent of such Damages (including the first \$250,000); *provided, further*, that the Basket shall not be applicable for the matters set forth on Schedule 10.2 hereof for (x) determining entitlement to any indemnification for such matters nor (y) aggregating such Damages with other Section 10.2 Damages to meet the Basket.

(b) Any payment for Section 10.2 Damages the Participating Securityholders are obligated to make to a Parent Indemnitee shall be paid by release of funds from the Escrow Fund by the Paying Agent on the thirty-first Business Day after the date notice of any sums due and owing (the "**Notice of Claim**") is given to the Shareholder Representative (with a copy to the Paying Agent pursuant to the terms of the Escrow Agreement) by the applicable Parent Indemnitee, subject to the agreement of the Shareholder Representative and the applicable Parent Indemnitee to release such funds on an earlier date in accordance with the terms of the Escrow Agreement or objection of the Shareholder Representative within 16 Business Days of receipt of the Notice of Claim, and shall accordingly reduce the amount in the Escrow Fund. The Notice of Claim shall set forth in reasonable detail a description of the claim and amount of Damages. The Shareholder Representative may object to the Notice of Claim by providing written notice of such objection to the applicable Parent Indemnitee within 16 Business Days after the delivery of the Notice of Claim (the "**Notice of Escrow Objection**"). If the Shareholder Representative timely provides the Notice of Escrow Objection, then the parties shall confer in good faith for a period of up to 10 Business Days following Purchaser's timely receipt of the Notice of Escrow Objection, in an attempt to resolve any disagreement, and any resolution by them shall be in writing and shall be final and binding. If, after such 10 Business Day period, the Shareholder Representative and applicable Parent Indemnitee cannot resolve any such disagreement, then the parties shall resolve the disagreement in accordance with Section 11.7 hereof.



(c) The Company acknowledges and agrees that, if the Surviving Corporation suffers, incurs or otherwise become subject to any Damages as a result of or in connection with any incompleteness of, inaccuracy in or breach of any representation, warranty, covenant or obligation, then (without limiting any of their rights as Parent Indemnitees) Purchaser and Parent shall also be deemed, by virtue of its direct or indirect ownership of the shares of the Company, to have incurred Damages as a result of and in connection with such incompleteness, inaccuracy or breach.

(d) The Participating Securityholders shall not be required to indemnify any Parent Indemnitee for an aggregate amount of Section 10.2 Damages exceeding the Escrow Fund, as may be adjusted as set forth in Section 1.9 above, which shall be the sole and exclusive remedy for Parent Indemnitees for Section 10.2 Damages; provided, that any incompleteness of, inaccuracy in or breach of the IP Representation (except for any incompleteness of, inaccuracy in or breach of any of the IP Infringement Representations that would not have occurred had such representations been qualified by the Company's Knowledge) or the Special Representations shall be considered Section 10.5 Damages (as defined below).

(e) Within ten days after the Termination Date (the "**Escrow Release Date**"), if the amount of cash remaining in the Escrow Fund exceeds the amount of any Section 10.2 Damages or Section 10.5 Damages set forth in a Notice of Claim that has not been fully resolved and paid prior to the Escrow Release Date (the "**Unresolved Claims**"), Purchaser and the Shareholder Representative shall deliver joint written instructions to the Paying Agent to disburse or cause to be disbursed to each Participating Securityholder from the Escrow Fund an amount equal to such Participating Securityholder's Consideration Fraction of such remaining cash after reserving the amount of cash set forth in the Notice of Claim for the Unresolved Claims (it being understood that any amounts to be released in respect of any Option Amount shall be delivered by the Paying Agent to the Purchaser and Purchaser shall cause such amounts, less applicable withholding Taxes, to be disbursed to the applicable Optionholder). Following the Escrow Release Date, if an Unresolved Claim is finally resolved, Purchaser and the Shareholder Representative shall deliver joint written instructions to the Paying Agent within three Business Days of such resolution to disburse or cause to be disbursed to each Participating Securityholder any remaining cash in the Escrow Fund in an amount equal to each Participating Securityholder's Consideration Fraction of such remaining cash after reserving the amount of cash set forth in the Notice of Claim for any remaining Unresolved Claims (it being understood that any amounts to be released in respect of any Option Amount shall be delivered by the Paying Agent to the Purchaser and Purchaser shall cause such amounts, less applicable withholding Taxes, to be disbursed to the applicable Optionholder).

**10.3 Defense of Third Party Claims.** In the event of the assertion or commencement by any Person of any claim or Legal Proceeding (whether against the Company, the Surviving Corporation, Parent, Purchaser or any other Person) with respect to which any of the Parent Indemnitees shall have the right to seek indemnification pursuant to this Section 10, Purchaser shall promptly notify the Shareholder Representative of such claim, and shall have the right to conduct the defense of such claim, *provided, however*, that any failure of Purchaser to notify the Shareholder Representative shall not limit any of the rights of the Parent Indemnitees under this Section 10, except to the extent that such failure materially and adversely affects the Participating Securityholders' interests in the matter, it being understood that a Notice of Claims in respect of a breach of a representation and warranty must be delivered prior to the expiration of any applicable survival period specified in Section 10.1 for such representation and warranty. The reasonable costs of the defense of any such Legal Proceeding shall be considered Damages for which the Parent Indemnitees shall be entitled to seek indemnification under this Section 10, and the Shareholder Representative shall be entitled to participate in the defense of any such Legal Proceeding at the expense of the Participating Securityholders. Notwithstanding the foregoing, Parent and/or Purchaser shall not settle any such claim or Legal Proceeding without the consent of the Shareholder Representative, such consent not to be unreasonably withheld; *provided, however*, that if the consent of the Shareholder Representative is so obtained, such settlement of any such claim or Legal Proceeding shall alone be determinative of the amount of the claim and neither the Shareholder Representative nor any person who has a beneficial interest therein shall have any power or authority to object under any provision of this Section 10 to the amount of any demand by Parent or Purchaser with respect to such settlement.

**10.4 Exercise of Remedies by Third Parties.** No Person who is not a party to this Agreement (or any successor thereto or assign thereof) shall be permitted to assert any indemnification claim or exercise any other remedy under this Agreement unless the applicable party (or any successor thereto or assign thereof) shall have consented to the assertion of such indemnification claim or the exercise of such other remedy.

**10.5 Indemnification for Other Matters.** In addition to and not by way of limitation of the rights of the Parent Indemnitees elsewhere under this Section 10, the Participating Securityholders shall, severally and not jointly, indemnify and hold the Parent Indemnitees harmless from and against all Damages incurred in connection with: (i) any Transaction Costs incurred or paid by the Company that were not deducted from the Closing Payment pursuant to Section 1.9(a); (ii) any Damages arising out of the procedures, including Legal Proceedings, relating to resolving the claims of Dissenting Shares, and all payments with respect to any Dissenting Share in excess of the applicable Holder Share Amount; (iii) to the extent not covered in clause (ii) above, any Legal Proceeding with a Shareholder, Warrantholder, Optionholder, Employee or former shareholder, warrant holder, option holder, or employee of the Company or any other Person, seeking to assert, or based upon, ownership or rights to ownership of any Company Capital Stock or that he, she or it is entitled to any consideration (or additional consideration) pursuant to this Agreement or any transaction contemplated hereby; (iv) any amounts payable under Section 10 hereof pursuant to Section 1.13(g) hereof (*Contingent Payment*); (v) any Taxes for which the Company is or becomes liable for any transactions effected prior to the Closing or for any Tax period ending on or before the Closing Date; (vi) any amounts that are paid to any present or former officers, directors or employees of the Company pursuant to any indemnification provisions under the Charter Documents as in effect on the date of this Agreement and pursuant to any indemnification agreements listed on Part 2.18 of the Disclosure Schedule, with respect to claims arising out of matters occurring at or prior to the Closing; (vii) any fraud of the Company or its officers, directors or employees in connection with this Agreement, the Merger or the other transactions contemplated hereby; (viii) any incompleteness of, inaccuracy in or breach of the IP Representation or any Special Representation, provided that, (A) after the Termination Date, the IP Infringement Representations (as defined below) shall be deemed to be qualified by the Company's Knowledge and (B) until the Termination Date, any incompleteness of, inaccuracy in or breach of any of the IP Infringement Representations that would not have occurred had such representations been qualified by the Company's Knowledge shall be considered Section 10.2 Damages; and (ix) any Legal Proceeding, including Legal Proceedings commenced by any Parent Indemnitee for the purpose of enforcing its rights under this Section 10.5 (all such indemnified matters constituting, together, the "**Section 10.5 Damages**"). The term "**IP Infringement Representations**" shall mean the representations and warranties of the Company set forth in the second sentence of Section 2.9(b) and, to the extent they relate to the violation, infringement or misappropriation of Intellectual Property Rights of a third party, the first sentence of Section 2.9(b) and the last sentence of Section 2.9(g).

**10.6 Purchase Price.** Any payments made to a Parent Indemnitee pursuant to this Section 10 shall be treated as an adjustment to the purchase price paid to the Participating Securityholders for Tax purposes.

**10.7 Shareholder Liability.**

(a) No Participating Shareholder, Optionholder or Warrantholder shall be liable for indemnification under Section 10 in excess of the Merger Consideration payable to it pursuant to this Agreement, including any amounts held in the Escrow Fund (other than for any fraud committed by such Participating Securityholder). Subject to Section 10.7(d), any Parent Indemnitees shall recover the amount of indemnification to which it may be entitled pursuant to Section 10 (whether or not involving a third party claim) initially from the Escrow Fund, which shall be the sole and exclusive remedy for Parent Indemnitees for indemnification for Section 10.2 Damages. If the Escrow Fund has been exhausted, any Parent Indemnitee shall then recover the amount of indemnification for Section 10.5 Damages by way of reduction of the amount of the Deferred Payment and/or the Contingent Payment payable by Purchaser pursuant to this Agreement. Thereafter, the Participating Securityholders shall indemnify, severally and not jointly, the Parent Indemnitees based on each Participating Securityholder's Consideration Fraction. If the total amount paid by the Participating Securityholders shall not have fully satisfied the indemnification obligations owing to the Parent Indemnitees hereunder, the Preferred Holders shall indemnify, severally and not jointly, the Parent Indemnitees based on each Preferred Holder's Consideration Fraction for Preferred Stock; provided that the Preferred Holders shall have no liability to indemnify the Parent Indemnitees hereunder until and if the Participating Securityholders shall have first satisfied at least 80% of their aggregate indemnification obligations hereunder. Once the indemnification obligations payable hereunder to the Parent Indemnitees shall have been determined by agreement with the Shareholder Representative, or pursuant to Section 11.7 hereof, such determination shall be binding on all the Participating Securityholders and Preferred Holders. If any Participating Securityholders shall default, in whole or in part, on their respective indemnification obligations hereunder (the amounts of such payment defaults, the "**Default Amounts**"), and the Preferred Holders shall have satisfied the indemnification obligations payable to the Parent Indemnitees hereunder in full, the Preferred Holders shall be entitled to collect the applicable Default Amounts from the defaulting Participating Securityholders, severally and not jointly. Following the Closing, no Participating Securityholder or Preferred Holder shall be entitled to contribution or any other payments from the Company for any indemnification obligations that such Participating Securityholder or Preferred Holder is obligated to pay hereunder. For any indemnification payable out of the Merger Consideration for the Founder, the Founder shall pay its indemnification obligations to the Parent Indemnitees at the same ratio of the Merger Consideration allocated to the Founder (ninety percent (90%) cash and ten percent (10%) in the form of Parent Shares), the number of which Parent Shares shall be determined by dividing (x) the amount of Damages to be paid by the Founder by (y) the Market Value of the Parent Shares).

(b) Notwithstanding the foregoing or anything to the contrary set forth in this Agreement, no Participating Securityholder or Preferred Holder shall be liable for indemnification for Damages under this Section 10 related to or arising from (i) the value, condition, or diminution of any Tax asset (e.g. net operating loss carry forward or tax credit carry forward) of the Company or (ii) the ability of Parent, Purchaser or the Surviving Corporation or their Affiliates to utilize any such Tax asset for any taxable period commencing after the Effective Time.

(c) Damages in each case shall be net of the amount of any Tax Benefit actually realized by any Parent Indemnitee. For purposes of the preceding sentence, a “**Tax Benefit**” shall mean an actual net reduction in the amount of Taxes required to be paid by such Parent Indemnitee below the amount of Taxes that it would have been required to pay but for the deductibility of such Damages and such reduction occurs within one year after such Damages were incurred by such Parent Indemnitee. Accordingly, any payment under this Section 10 shall initially be made without regard to this subsection. The amount of any reduction hereunder shall be adjusted to reflect the final determination with respect to such Parent Indemnitee’s liability for Taxes, if applicable.

(d) The Damages incurred or suffered by a Parent Indemnitee shall be reduced by (i) the amount of any related insurance proceeds actually received by such Parent Indemnitee or its Affiliates in connection with the corresponding claim (net of Parent’s reasonable estimate of the present value of any increases in insurance premiums resulting from such claim) and (ii) any other compensatory payments actually received by such Parent Indemnitee or its Affiliates from any other Persons by way of subrogation, indemnification, guarantee or similar mechanism with respect to the Damages for which indemnification is claimed. If any amount referenced in this Section 10.7(d) is actually received after the related indemnification payment has been made, then the related Parent Indemnitee shall remit such amounts to the Paying Agent for distribution to the Participating Securityholders.

**10.8 Remedies.** From and after the Closing, the rights of the parties under this Section 10 shall be the exclusive remedy of the Parent Indemnitees from and after the Effective Time for any claims arising under this Agreement, including claims of breach of any representation, warranty or covenant in this Agreement. Notwithstanding the above, any Parent Indemnitee shall be (a) entitled to seek any available remedy of law or equity (including rescission or restitution) with respect to fraud and willful misconduct, (b) entitled to seek injunctive relief to enjoin the breach, or threatened breach, of any provision of this Agreement, and (c) entitled to seek the equitable remedy of specific performance in connection with this Agreement.

**Section 11. MISCELLANEOUS PROVISIONS.**

**11.1 Entire Agreement.** This Agreement and the other agreements referred to herein set forth the entire understanding of the parties hereto relating to the subject matter hereof and thereof and supersede all prior agreements and understandings among or between any of the parties relating to the subject matter hereof and thereof.

**11.2 Further Assurances.** Each party hereto shall execute and cause to be delivered to each other party hereto such instruments and other documents, and shall take such other actions, as such other party may reasonably request (prior to, at or after the Closing) for the purpose of carrying out or evidencing any of the transactions contemplated by this Agreement.

**11.3 Fees and Expenses.** Whether or not the Merger is consummated, each party to this Agreement shall bear and pay all fees, costs and expenses (including legal fees and accounting fees) that have been incurred or that are incurred by such party in connection with this Agreement and the transactions contemplated by this Agreement, including all fees, costs and expenses incurred by such party in connection with or by virtue of (a) the investigation and review conducted with respect to the other party's business (and the furnishing of information to in connection with such investigation and review), (b) the negotiation, preparation and review of this Agreement (including the Disclosure Schedule) and all agreements, certificates, opinions and other instruments and documents delivered or to be delivered in connection with the transactions contemplated by this Agreement, as well as the related letter of intent, and (c) the preparation and submission of any filing or notice required to be made or given in connection with any of the transactions contemplated by this Agreement, and the obtaining of any Consent required to be obtained in connection with any of such transactions (collectively, "**Transaction Costs**").

**11.4 Notices.** Any notice or other communication required or permitted to be delivered to any party under this Agreement shall be in writing and shall be deemed properly delivered, given and received when delivered (by hand, by courier or express delivery service, by electronic mail or by facsimile) to the address or facsimile telephone number set forth beneath the name of such party below (or to such other address or facsimile telephone number as such party shall have specified in a written notice given to the other parties hereto):

if to Parent, Purchaser or Merger Sub:

IncrediMail Ltd.  
HaNechoshet Street  
Tel Aviv, Israel 69710  
Facsimile: +972- (3) 644 5502  
Email: josef@incredimail.com  
Attention: Chief Executive Officer

*with a copy to (which shall not constitute notice):*

Goldfarb Seligman & Co.  
Electra Tower  
98 Yigal Alon Street  
Tel-Aviv 67891, Israel  
Facsimile: + 972 (3) 521 2212  
Attention: Adam M. Klein, Adv.  
Email: adam.klein@goldfarb.com

*and*

Summit Law Group, PLLC  
315 Fifth Avenue South, Suite 1000  
Seattle, Washington 98104  
Facsimile: (206) 676-7065  
Attention: Mark Worthington, Esq.  
Email: markw@summitlaw.com

if to the Shareholder Representative:

Shareholder Representative Services LLC  
601 Montgomery Street, Suite 2020  
San Francisco, CA 94111  
Facsimile: (415) 962-4147  
Telephone: (415) 367-9400  
Attention: Managing Director  
Email: deals@shareholderep.com

*with a copy to (which shall not constitute notice):*

Wilson Sonsini Goodrich & Rosati  
701 Fifth Avenue, Suite 5100  
Seattle, Washington, 98104  
Facsimile: 206-883-2699  
Attention: Craig E. Sherman, Esq.  
Email: CSherman@wsgr.com

if to the Company:

Smilebox, Inc.  
15809 Bear Creek Parkway, Suite 320  
Redmond, Washington 98052  
Facsimile: (425) 881-9625  
Attention: Chief Executive Officer  
Email: andrew@smilebox.com

*with a copy to (which shall not constitute notice):*

Wilson Sonsini Goodrich & Rosati  
701 Fifth Avenue, Suite 5100  
Seattle, Washington, 98104  
Facsimile: 206-883-2699  
Attention: Craig E. Sherman, Esq.  
Email: CSherman@wsgr.com

or such other address with respect to a party as such party shall notify each other party in writing as above provided. Any notice sent in accordance with this Section 11.4 shall be effective (i) if mailed, seven (7) Business Days after mailing, (ii) if sent by messenger, upon delivery, (iii) if sent by overnight courier, two (2) Business Days after mailing, and (iv) if sent via telecopier or email, when sent, with an acknowledgment of sending being produced by the sending facsimile machine or computer, as applicable, or (if sent on a non-Business Day) on the first Business Day following the acknowledgement of sending.

**11.5 Headings.** The headings contained in this Agreement are for convenience of reference only, shall not be deemed to be a part of this Agreement and shall not be referred to in connection with the construction or interpretation of this Agreement.

**11.6 Counterparts.** This Agreement may be executed in several counterparts, each of which shall constitute an original and all of which, when taken together, shall constitute one agreement.

**11.7 Dispute Resolution.**

(a) Except as otherwise provided in this Agreement, all disputes arising directly under this Agreement or the grounds for termination thereof, including whether any payments may be due under this Agreement, shall be resolved as follows. Representatives of both parties shall meet to attempt to resolve any such dispute. If the dispute cannot be resolved by such meeting, either party may make a written demand to the other party or parties for formal dispute resolution and specify therein the scope of the dispute. The parties hereby agree to submit to binding arbitration by a single arbitrator selected by the parties and administered by the American Arbitration Association and shall take place in New York, New York. The parties agree that arbitration shall be the sole, exclusive and final remedy for any disputes arising directly under this Agreement. Within thirty (30) days after such written notification, the parties agree to meet for one day with an impartial mediator. Accordingly, the parties may not pursue court action regarding any dispute arising directly under this Agreement.

(b) Notwithstanding the provisions of Section 11.7(a), each party shall have the right, without the requirement of first seeking a remedy through any dispute resolution alternative (including mediation or arbitration) that has been agreed upon, to seek preliminary injunctive or other equitable relief in the event that such party determines that eventual redress through the dispute resolution alternative will not provide a sufficient remedy for any violation of this Agreement by the other party.

**11.8** Governing Law; Jurisdiction; Waiver of Jury Trial.

(a) THIS AGREEMENT SHALL BE DEEMED TO BE MADE IN AND IN ALL RESPECTS SHALL BE EXCLUSIVELY INTERPRETED, CONSTRUED AND GOVERNED BY AND IN ACCORDANCE WITH THE LAW OF THE STATE OF NEW YORK WITHOUT REGARD TO THE CONFLICT OF LAW PRINCIPLES THEREOF; *PROVIDED, HOWEVER*, THAT MATTERS INVOLVING THE PROCEDURES OF THE MERGER (INCLUDING DISSENTING RIGHTS) SHALL BE GOVERNED BY THE WBCA.

(b) The parties hereby irrevocably exclusively submit to the jurisdiction of the courts of the State of New York and the Federal courts of the United States of America located in the City of New York for the purpose set forth in Section 11.7(b).

(c) EACH PARTY ACKNOWLEDGES AND AGREES THAT ANY CONTROVERSY WHICH MAY ARISE UNDER THIS AGREEMENT IS LIKELY TO INVOLVE COMPLICATED AND DIFFICULT ISSUES, AND THEREFORE EACH SUCH PARTY HEREBY IRREVOCABLY AND UNCONDITIONALLY WAIVES ANY RIGHT SUCH PARTY MAY HAVE TO A TRIAL BY JURY IN RESPECT OF ANY LITIGATION DIRECTLY OR INDIRECTLY ARISING OUT OF OR RELATING TO THIS AGREEMENT OR ANY DOCUMENT ANCILLARY THERETO OR THE TRANSACTIONS CONTEMPLATED BY THIS AGREEMENT OR ANY DOCUMENT ANCILLARY THERETO. EACH PARTY CERTIFIES AND ACKNOWLEDGES THAT (1) NO REPRESENTATIVE, AGENT OR ATTORNEY OF ANY OTHER PARTY HAS REPRESENTED, EXPRESSLY OR OTHERWISE, THAT SUCH OTHER PARTY WOULD NOT, IN THE EVENT OF LITIGATION, SEEK TO ENFORCE THE FOREGOING WAIVER, (2) EACH SUCH PARTY UNDERSTANDS AND HAS CONSIDERED THE IMPLICATIONS OF THIS WAIVER, (3) EACH SUCH PARTY MAKES THIS WAIVER VOLUNTARILY, AND (4) EACH SUCH PARTY HAS BEEN INDUCED TO ENTER INTO THIS AGREEMENT BY, AMONG OTHER THINGS, THE WAIVERS AND CERTIFICATIONS IN THIS SECTION 11.8.

**11.9** Successors and Assigns. This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective successors and permitted assigns. The Company may not assign any of its rights under this Agreement to any other Person without obtaining first the written consent of Purchaser. Parent, Purchaser or Merger Sub may not assign any of their respective rights under this Agreement to any other Person without obtaining first the written consent of the Company.

**11.10** Remedies. The parties to this Agreement agree that, in the event of any breach or threatened breach by any party to this Agreement of any covenant, obligation or other provision set forth in this Agreement for the benefit of any other party to this Agreement, such other party shall be entitled to (a) a decree or order of specific performance or mandamus to enforce the observance and performance of such covenant, obligation or other provision, and (b) an injunction restraining such breach or threatened breach. Such remedies, and any other rights and remedies provided in this Agreement, are in addition to such other rights and remedies available under applicable law.



**11.11 Waiver.**

(a) failure on the part of any Person to exercise any power, right, privilege or remedy under this Agreement, and no delay on the part of any Person in exercising any power, right, privilege or remedy under this Agreement, shall operate as a waiver of such power, right, privilege or remedy; and no single or partial exercise of any such power, right, privilege or remedy shall preclude any other or further exercise thereof or of any other power, right, privilege or remedy.

(b) No Person shall be deemed to have waived any claim arising out of this Agreement, or any power, right, privilege or remedy under this Agreement, unless the waiver of such claim, power, right, privilege or remedy is expressly set forth in a written instrument duly executed and delivered on behalf of such Person; and any such waiver shall not be applicable or have any effect except in the specific instance in which it is given.

**11.12 Amendments.** This Agreement may not be amended, modified, altered or supplemented other than by means of a written instrument duly executed and delivered on behalf of Parent, Purchaser, Merger Sub, the Company and the Shareholder Representative, provided that, with respect to provisions not relating directly to the Shareholder Representative, the consent of the Shareholder Representative shall not be unreasonably withheld.

**11.13 Severability.** In the event that any provision of this Agreement, or the application of any such provision to any Person or set of circumstances, shall be determined to be invalid, unlawful, void or unenforceable to any extent, the remainder of this Agreement, and the application of such provision to Persons or circumstances other than those as to which it is determined to be invalid, unlawful, void or unenforceable, shall not be impaired or otherwise affected and shall continue to be valid and enforceable to the fullest extent permitted by law.

**11.14 Parties in Interest.** Except for the provisions of Section 10, none of the provisions of this Agreement are intended to provide any rights or remedies to any Person other than the parties hereto and their respective successors and assigns (if any).

**11.15 Construction.**

(a) For purposes of this Agreement, whenever the context requires: the singular number shall include the plural, and vice versa; the masculine gender shall include the feminine and neuter genders; the feminine gender shall include the masculine and neuter genders; and the neuter gender shall include the masculine and feminine genders.

(b) The parties hereto agree that any rule of construction to the effect that ambiguities are to be resolved against the drafting party shall not be applied in the construction or interpretation of this Agreement.

(c) As used in this Agreement, the words "include" and "including," and variations thereof, shall not be deemed to be terms of limitation, but rather shall be deemed to be followed by the words "without limitation."

(d) Except as otherwise indicated, all references in this Agreement to “Sections,” “Schedules” and “Exhibits” are intended to refer to Sections of this Agreement and Schedules and Exhibits to this Agreement.

**11.16 Conflict Waiver.** Each of the parties hereto acknowledges and agrees, on its own behalf and on behalf of its directors, members, partners, officers, employees and Affiliates, that the Company is the client of Wilson Sonsini Goodrich & Rosati (the “**Firm**”). After the Closing, it is possible that the Firm will represent the Participating Securityholders, the Shareholder Representative and their respective Affiliates (individually and collectively, the “**Seller Group**”) in connection with matters related to this Agreement or the Escrow Agreement, including, without limitation, matters related to the Escrow Fund and any claims related thereto pursuant to this Agreement. Parent, Purchaser and the Company hereby agree that the Firm (or any successor) may represent the Seller Group in the future in connection with matters related to this Agreement or the Escrow Agreement and any claims that may be made thereunder pursuant to this Agreement. The Firm (or any successor) may serve as counsel to Seller Group or any director, member, partner, officer, employee, representative, or Affiliate of the Seller Group, in connection with any litigation, claim or obligation arising out of or relating to this Agreement or the Escrow Agreement or the transactions contemplated by this Agreement or the Escrow Agreement, and each of the parties hereto hereby consents thereto and waives any conflict of interest arising therefrom. Each of the parties hereto acknowledges that such consent and waiver is voluntary, has been carefully considered and the parties have consulted with counsel or been advised they should do so in connection with this waiver and consent.

## **Section 12. SHAREHOLDER REPRESENTATIVE**

**12.1 Power of Attorney.** Effective as of the date hereof, for purposes of this Agreement, each Participating Securityholder, without any further action on the part of any such Participating Securityholder, shall be deemed to have consented to the appointment of Shareholder Representative Services LLC as the Shareholder Representative, as the attorney-in-fact for and on behalf of such Participating Securityholder, and the taking by the Shareholder Representative of any and all actions and the making of any decisions required or permitted to be taken by him under this Agreement and the Escrow Agreement, including without limitation: (i) to execute this Agreement and the Escrow Agreement in the capacity of Shareholder Representative; (ii) to give and receive notices and communications; notices or communications to or from the Shareholder Representative shall constitute notice to or from each of the Participating Securityholders; (iii) to approve or object to disbursements by the Payment Agent of the Escrow Fund in satisfaction of indemnification claims by Parent or any Parent Indemnitee, to agree to, negotiate, enter into settlements and compromises of, and demand arbitration and comply with orders of courts and awards of arbitrators with respect to claims relating to the Escrow Fund; (iv) to enforce the rights of the Participating Securityholders to receive the Merger Consideration from Purchaser following the Effective Time; and (v) to take all actions necessary or appropriate in the judgment of the Shareholder Representative for the accomplishment of the foregoing. Each Participating Securityholder hereby agrees to receive correspondence from the Shareholder Representative, including in electronic form.

**1 2 . 2 Decision Binding.** A decision, act, consent or instruction of the Shareholder Representative shall constitute a decision of all the Participating Securityholders and shall be final, binding and conclusive upon each of such Participating Securityholders, and Parent, Purchaser, Merger Sub, the Surviving Corporation, the Paying Agent and the Company may rely upon any such decision, act, consent or instruction of the Shareholder Representative as being the decision, act, consent or instruction of every such Participating Securityholder. Each of Parent, Purchaser, Merger Sub, the Surviving Corporation, the Paying Agent and the Company is hereby relieved from any liability to any person for any acts done by it in accordance with such decision, act, consent or instruction of the Shareholder Representative.

**1 2 . 3 Replacement of Shareholder Representative.** The Shareholder Representative may be removed by the Shareholders representing a majority in interest of the Shareholders (based on the number of shares of Common Stock on an as-converted basis held by them, as set forth on the Signing Spreadsheet or, if delivered, the Closing Spreadsheet) (the “**Required Shareholders**”) upon not less than 10 days’ prior written notice to the other parties hereto (including the Paying Agent), which notice shall be accompanied with an instrument executed by a substitute agent accepting the position of a Shareholder Representative. In the event of a dissolution of the Shareholder Representative, resignation, or any other vacancy in its position, the Required Shareholders may appoint a substitute agent upon not less than 10 days’ prior written notice to the other parties hereto (including the Paying Agent), which notice shall be accompanied with an instrument executed by a substitute agent accepting the position of a Shareholder Representative. After the end of such prior notice period, the successor Shareholder Representative shall, without further acts, be vested with all the rights, powers, and duties of the predecessor Shareholder Representative as if originally named as Shareholder Representative. If the position of Shareholder Representative shall be vacant for more than 30 days, Parent or Purchaser may file a petition to a court of competent jurisdiction to appoint a successor to such position. The Shareholder Representative may not be an employee of the Company, Parent, Purchaser, any Parent Indemnitee or any of their respective Affiliates.

**12.4 Protection of Shareholder Representative.** The Shareholder Representative will incur no liability with respect to any action taken or suffered by it in reliance upon any notice, direction, instruction, consent, statement or other document believed by it to be genuine and to have been signed by the proper person (and shall have no responsibility to determine the authenticity thereof), nor for any other action or inaction, except his own willful misconduct or bad faith. In all questions arising under this Agreement, the Shareholder Representative may rely on the advice of counsel, and the Shareholder Representative will not be liable to Participating Securityholders or Preferred Holders for anything done, omitted or suffered in good faith by the Shareholder Representative based on such advice. The Participating Securityholders and Preferred Holders shall, severally and not jointly, indemnify, defend and hold the Shareholder Representative and its members, managers, employees, successors and assigns harmless from and against any loss, damage, tax, liability and expense (collectively, "**Representative Losses**") that may be incurred by the Shareholder Representative arising out of or in connection with the acceptance or administration of the Shareholder Representative's duties, except as caused by the Shareholder Representative's willful misconduct or bad faith, including the legal costs and expenses of defending such Shareholder Representative against any claim or liability in connection with the performance of the Shareholder Representative's duties. If not paid directly to the Shareholder Representative by the Participating Securityholders and Preferred Holders, any such Representative Losses may be recovered by the Shareholder Representative from (i) initially the funds in the Representative Fund (as defined below), (ii) if the funds from the Representative Fund have been exhausted, then from the amounts in the Escrow Fund otherwise distributable to the Participating Securityholders pursuant to the terms hereof and the Escrow Agreement at the time of distribution in accordance with written instructions delivered by the Shareholder Representative to the Escrow Agent, and (iii) if the funds from the Escrow Funds have been exhausted then from any Deferred Payment or Contingent Payment actually payable to the Participating Securityholders pursuant to written instructions delivered by the Shareholder Representative to Purchaser or the Paying Agent, as the case may be; provided, that while this section allows the Shareholder Representative to be paid from the Representative Fund, the Escrow Fund, a Deferred Payment or a Contingent Payment, this does not relieve the Participating Securityholders and Preferred Holders from their obligation to promptly pay such Representative Losses as they are suffered or incurred, nor does it prevent the Shareholder Representative from seeking any remedies available to it at law or otherwise. Any payment by Purchaser to the Shareholder Representative pursuant to the written instructions of the Shareholder Representative shall be considered for purposes of this Agreement to have been paid to the Participating Securityholders or the Preferred Holders, as the case may be. The liability of the Participating Securityholders shall be allocated pro rata based on their respective Consideration Fractions. The Preferred Holders shall have no liability to indemnify the Shareholder Representative hereunder until the Participating Securityholders shall have first satisfied their obligations hereunder up to 80% of the aggregate Merger Consideration payable to all Participating Securityholders. Thereafter, any excess Representative Losses shall be allocated pro rata among the Preferred Holders based on their respective Consideration Fraction for Preferred Stock up to the aggregate of the Total Preferred Share Amount. If there are any excess Representative Losses thereafter, the liability shall be allocated pro rata among the Participating Securityholders and the Preferred Holders based on the Merger Consideration payable under this Agreement.

**12.5 Reimbursement of Shareholder Representative's Expenses.** Each Participating Securityholder and Preferred Holder agrees to reimburse the Shareholder Representative for its pro rata portion of all reasonable out-of-pocket expenses incurred by the Shareholder Representative in the performance of its duties hereunder (including but not limited to any attorney's fees and costs incurred in connection with the Shareholder Representative's duties pursuant to this Agreement) based on their respective Consideration Fraction and Consideration Fraction for Preferred Stock, as applicable, in accordance with the priority set forth in Section 12.4 above. A portion of the Closing Payment in cash in the amount of fifty thousand U.S. Dollars (\$50,000) shall be set aside from the Closing Payment to cover the expenses incurred by the Shareholder Representative (the "**Representative Fund**"), which shall be wired to SRS by the Paying Agent upon the Closing of the Merger, and which shall be held by the Shareholder Representative as agent and for the benefit of the Participating Securityholders in a segregated client bank account and shall be used for the purposes of paying directly, or reimbursing the Shareholder Representative for, any third party expenses pursuant to this Agreement. The Shareholder Representative will hold these funds separate from its corporate funds, will not use these funds for its operating expenses or any other corporate purposes and will not voluntarily make these funds available to its creditors in the event of bankruptcy. The Participating Securityholders shall not receive interest or other earnings on the Representative Fund and the Participating Securityholders irrevocably transfer and assign to the Shareholder Representative any ownership right that they may have in any interest that may accrue on funds held in the Representative Fund. The Participating Securityholders acknowledge that the Shareholder Representative is not providing any investment supervision, recommendations or advice. The Shareholder Representative shall have no responsibility or liability for any loss of principal of the Representative Fund other than as a result of its willful misconduct or bad faith. For tax purposes, the Representative Fund shall be treated as having been received and voluntarily set aside by the Participating Securityholders at the time of Closing. The parties agree that SRS is not acting as a withholding agent or in any similar capacity in connection with the Representative Fund. Each Participating Securityholder agrees that Representative Losses may be deducted by the Shareholder Representative from the Representative Fund. Any remaining amount in the Representative Fund upon the completion of the Shareholder Representative's duties hereunder shall be distributed to the Paying Agent for distribution to the Participating Securityholders based on each Participating Securityholder's Consideration Fraction.

[SIGNATURE PAGES FOLLOW]

IN WITNESS WHEREOF, the parties hereto have caused this Agreement to be executed and delivered as of the date first above written.

**INCREMAIL LTD.**

By: \_\_\_\_\_  
Name:  
Title:

**INCREMAIL, INC.**

By: \_\_\_\_\_  
Name:  
Title:

**SEDER MERGER, INC.**

By: \_\_\_\_\_  
Name:  
Title:

**SMILEBOX, INC.**

By: \_\_\_\_\_  
Name:  
Title:

**FOUNDER**

\_\_\_\_\_  
Name: Andrew Wright

**SHAREHOLDER REPRESENTATIVE SERVICES LLC**, solely in its capacity as the Shareholder Representative

By: \_\_\_\_\_  
Name:  
Title: Managing Director

**EXHIBIT A**

**CERTAIN DEFINITIONS**

For purposes of the Agreement (including this Exhibit A):

**Accounts Receivable.** “Accounts Receivable” shall mean all accounts receivable, including without limitation, all trade accounts receivable, notes receivable, from customers, vendor credits and accounts receivable from employees and all other obligations from customers with respect to sales of goods or services by the Company.

**Acquisition Transaction.** “Acquisition Transaction” shall mean any transaction involving:

- (a) the sale, license, disposition or acquisition of all or a material portion of the Company’s business or assets;
- (b) the issuance, disposition or acquisition of (i) any capital stock or other equity security of the Company (other than Common Shares issued to employees of the Company upon exercise of options), (ii) any option, call, warrant or right (whether or not immediately exercisable) to acquire any capital stock or other equity security of the Company, or (iii) any other security, instrument or obligation that is or may become convertible into or exchangeable for any capital stock or other equity security of the Company; or
- (c) any merger, consolidation, business combination, reorganization or similar transaction involving the Company.

**Affiliate.** An “Affiliate” of a specified Person shall mean a Person that directly, or indirectly through one or more intermediaries, controls or is controlled by, or is under common control with, the Person specified. For this purpose, “control,” shall mean the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a Person, whether through the ownership of voting securities, by contract or otherwise.

**Agreement.** “Agreement” shall mean the Agreement to which this Exhibit A is attached (including the Disclosure Schedule and other Schedules and Exhibits thereto), as it may be amended from time to time.

**Business Day.** “Business Day” shall mean any day other than Friday, Saturday, Sunday or a day on which commercial banks in the State of Washington and/or the State of Israel are required or authorized by law to remain closed.

**Company Warrant.** “Company Warrant” shall mean any warrant of the Company convertible into Shares.

**Consent.** “Consent” shall mean any permit, authorization, approval, consent, ratification, permission, waiver or authorization (including any Governmental Authorization).

---

**Consideration Fraction.** “Consideration Fraction” as to any Shareholder or Optionholder or Warrantholder shall mean a fraction obtained by dividing (1) such holder’s Holder Share Amount (excluding the Holder Preferred Share Amount) by (2) the Total Share Amount (excluding the Total Preferred Share Amount).

**Consideration Fraction for Preferred Stock.** “Consideration Fraction for Preferred Stock” as to any Shareholder or Warrantholder shall mean a fraction obtained by dividing (1) such holder’s Holder Preferred Share Amount by (2) the Total Preferred Share Amount.

**Contract.** “Contract” shall mean any written, oral or other agreement, contract, subcontract, lease, promise, understanding, instrument, obligation, license, arrangement, permit, concession, franchise, purchase order, sales order contract, note, bond, warranty, mortgage, indenture, deed of trust, loan, credit agreement, insurance policy, benefit plan or legally binding commitment or undertaking of any nature.

**Currently Proposed to be Conducted.** “Currently Proposed to be Conducted” shall mean the Company’s first release of each of the Smilebox for iPhone product and the Print and Ship to Home service for PC and Mac computers, but excluding in all cases the Search Functionality.

**Damages.** “Damages” shall include any loss, damage (including incidental damages but excluding consequential damages), injury, liability, claim, demand, settlement, judgment, award, fine, penalty, Tax, fee (including reasonable attorneys’ fees), charge, cost (including costs of investigation) or expense of any nature.

**Disclosure Schedule.** “Disclosure Schedule” shall mean the schedule titled “Disclosure Schedule” (dated as of the date of the Agreement) delivered to Parent, Purchaser and Merger Sub on behalf of the Company.

**Encumbrance.** “Encumbrance” shall mean any lien, pledge, hypothecation, charge, mortgage, security interest, encumbrance, claim, conditional and installment sale agreement, option, right of first refusal, preemptive right, call, community property interest or restriction of any nature (including any restriction on the voting of any security (including voting trust and voting agreement), any restriction on the transfer of any security or other asset, any restriction on the receipt of any income derived from any asset, any restriction on the use of any asset and any restriction on the possession, exercise or transfer of any other attribute of ownership of any asset). The grant of a non-exclusive license, in itself, under or to the Company Intellectual Property shall not be considered to be an Encumbrance, unless the Contract containing such license grant contains other terms that would be considered to be an Encumbrance.

**Entity.** “Entity” shall mean any corporation (including any non-profit corporation), general partnership, limited partnership, limited liability partnership, joint venture, estate, trust, company (including any limited liability company), firm or other enterprise, association, organization or entity.

**Escrow Agreement.** “Escrow Agreement” shall mean the Escrow Agreement among Parent, Purchaser, the Company, the Shareholder Representative and the Paying Agent to be entered into on or prior to the Closing Date in connection with this Agreement.

**Exchange Act.** “Exchange Act” shall mean the U.S. Securities Exchange Act of 1934, as amended.

**Family Member.** “Family Member” shall mean, in respect of a natural Person, (i) a spouse of such Person, (ii) a descendant of such Person or of a such Person’s spouse, (iii) such Person’s antecedent, (iv) such Person’s brother or sister or (v) a spouse of any of the Persons referred to in clauses (ii), (iii), (iv) or (v) above.

**Founder.** “Founder” shall mean Andrew Wright.

**Fully Diluted Basis.** “Fully Diluted Basis” shall mean all issued and outstanding shares of common stock, preferred stock and other kinds of capital stock or voting securities, with all convertible and exercisable securities (or other rights to acquire capital stock) deemed converted or exercised, as the case may be, into shares of capital stock in accordance with their terms, whether or not then currently vested, exercisable, exchangeable or convertible.

**GAAP.** “GAAP” shall mean generally accepted accounting principles in the United States applied on a consistent basis.

**Governmental Authorization.** “Governmental Authorization” shall mean any: permit, license, certificate, franchise, permission, clearance, registration, qualification or authorization issued, granted, given or otherwise made available by or under the authority of any Governmental Body or pursuant to any Legal Requirement.

**Governmental Body.** “Governmental Body” shall mean any: (a) nation, state, commonwealth, province, territory, county, municipality, district or other jurisdiction of any nature; (b) federal, state, local, municipal, foreign or other government; or (c) governmental or quasi-governmental authority of any nature (including any governmental division, department, agency, commission, instrumentality, official, organization, unit, body or Entity and any court or other tribunal).

**Knowledge.** “Knowledge” shall mean information or matters of which the Company’s principal executive officer, principal financial officer or principal technology officer actually know or should have reasonably known given the nature of his or her duties in the Company; *provided, however*, that with respect to Intellectual Property and Intellectual Property Rights, the term “should have reasonably known” does not require the Company, or any of the foregoing officers, to conduct, have conducted, obtain or have obtained any freedom-to-operate opinions or similar opinions of counsel or any patent, trademark, or other Intellectual Property Rights or Intellectual Property clearance searches, and Company will not be imputed to have knowledge of any third party patents, trademarks or other Intellectual Property Rights or Intellectual Property that were not actually known by the foregoing officers but that would have been revealed by such inquiries, opinions or searches.



**Legal Proceeding.** “Legal Proceeding” shall mean any claim, action, suit, litigation, arbitration, complaint, proceeding (including any civil, criminal, administrative, investigative or appellate proceeding), hearing, inquiry, audit, examination or investigation commenced, brought, conducted or heard by or before, or otherwise involving, any court or other Governmental Body or any arbitrator or arbitration panel.

**Legal Requirement.** “Legal Requirement” shall mean any local, municipal, foreign or other law, statute, constitution, principle of common law, resolution, ordinance, code, edict, decree, rule, regulation, ruling or requirement issued, enacted, adopted, promulgated, implemented or otherwise put into effect by or under the authority of any Governmental Body.

**Market Value.** “Market Value” of any Parent Shares shall mean (i) the average closing market price per Parent Share on the NASDAQ Stock Market for the ten (10) trading days immediately preceding the Closing Date multiplied by (ii) such Parent Shares.

**Material Adverse Effect.** A “Material Adverse Effect” on an Entity shall mean (i) a material adverse effect on the business, operations, assets, liabilities, prospects, condition (financial or otherwise) or financial performance or results of such Entity and its subsidiaries, taken as a whole or (ii) any change, circumstance, development, state of facts, event or effect that prevents or materially impedes, interferes with, hinders or delays the consummation of the transactions contemplated by this Agreement; *provided, however*, that none of the following shall be taken into account in determining whether there has been a “Material Adverse Effect”: (1) the effects of changes that are generally applicable to the industry in which the Company operates, *provided* that the Company is not materially disproportionately adversely affected thereby relative to other industry participants, (2) the effects of changes that are generally applicable to the economy in the United States, *provided* that the Company is not materially disproportionately adversely affected thereby relative to other industry participants, (3) any effects or changes directly resulting from the public announcement of this Agreement, the transactions contemplated hereby or the consummation of such transactions, (4) the effects of the performance by the parties hereto of their respective obligations under this Agreement or the effects of not taking any action prohibited by the terms hereof, (5) regulatory or political conditions, or securities markets in the United States or worldwide or any outbreak of hostilities, terrorist activities or war, or any material worsening of any hostilities, activities or war underway as of the date hereof, *provided* that the Company is not materially disproportionately adversely affected thereby relative to other industry participants, or (6) any change in Legal Requirement, *provided* that the Company is not materially disproportionately adversely affected thereby relative to other industry participants.

**Net Value.** “Net Value” shall mean the excess, if any, of the Common Amount, as adjusted, over the exercise price of a Company Stock Option or Company Warrant, as applicable.

**Optionholder.** “Optionholder” shall mean any Person holding a Company Stock Option.

**Parent Indemnitees.** “Parent Indemnitees” shall mean each of Parent, Purchaser, the Surviving Corporation, Merger Sub, the successors and assigns of each of the foregoing and the Representatives of each of the foregoing.

**Parent Shares.** “Parent Shares” shall mean ordinary shares, par value NIS 0.01 per share, of the Parent.

**Permitted Encumbrance.** “Permitted Encumbrance” shall mean Encumbrances for Taxes not yet due and payable, that arise in the ordinary course of business or that do not materially impact the Company’s ownership or use of its property or assets.

**Person.** “Person” shall mean any individual, Entity or Governmental Body.

**Preferred Warrant.** “Preferred Warrant” shall mean the warrant of the Company, held by Best Buy Stores, L.P., convertible into 163,200 Series B Preferred Shares, to the extent the Series B Preferred Shares are not converted into Common Shares prior to the Effective Time.

**Representatives.** “Representatives” shall mean officers, directors, employees, agents, attorneys, accountants, advisors and representatives.

**SEC.** “SEC” shall mean the United States Securities and Exchange Commission.

**Securities Act.** “Securities Act” shall mean the U.S. Securities Act of 1933, as amended.

**“Subsidiary”** shall mean any Person of which (i) a majority of the outstanding share capital, voting securities, economic interests or other equity interests are owned, directly or indirectly, by the Company or (ii) the Company is entitled, directly or indirectly, to appoint a majority of the board of directors, board of managers or comparable body of such Person.

**Tax.** “Tax” (and, with correlative meaning, “Taxes” and “Taxable”) shall mean (i) any net income, alternative or add-on minimum tax, gross income, estimated, gross receipts, sales, use, ad valorem, value added, transfer, franchise, fringe benefit, share capital, profits, license, registration, withholding, payroll, social security (or equivalent), employment, unemployment, disability, excise, severance, stamp, occupation, premium, property (real, tangible or intangible), environmental or windfall profit tax, custom duty or other tax, governmental fee or other like assessment or charge of any kind whatsoever, together with any interest or any penalty, addition to tax or additional amount (whether disputed or not) imposed by any Governmental Body responsible for the imposition of any such tax (domestic or foreign) (each, a “**Tax Authority**”), (ii) any Liability for the payment of any amounts of the type described in clause (i) of this sentence as a result of being a member of an affiliated, consolidated, combined, unitary or aggregate group for any Taxable period, and (iii) any Liability for the payment of any amounts of the type described in clause (i) or (ii) of this sentence as a result of being a transferee of or successor to any Person or as a result of any express or implied obligation to assume such Taxes or to indemnify any other Person.

**Tax Returns.** “Tax Returns” shall mean returns, reports and information statements with respect to Tax required to be filed by or on behalf of the Company with the U.S. Internal Revenue Service and any other taxing authority domestic or foreign.

**Transaction Cost Amount.** “Transaction Cost Amount” shall mean the aggregate amount of Transaction Costs of the Company whether paid or accrued prior to or after the Effective Time, including without limitation, the Transaction Costs payable to the Shareholder Representative (excluding the Representative Fund paid out of the Closing Payment), Wilson Sonsini Goodrich & Rosati and Moss Adams LLP (including 50% of its fee for conducting a review of the Interim Financial Statements and its entire fee for conducting a FIN 48 analysis), the fee of the independent firm that Purchaser will retain (which selection of the firm is subject to the consent of the Company, not to be unreasonably withheld) to conduct a valuation of the intangible assets acquired by the Company from Prelick Corporation (which the parties will endeavor to conclude no later than September 30, 2011), 50% of the fees and expenses of the Paying Agent, and the cost of the “tail” insurance policy and any related professional fees in accordance with Section 6.10(c) hereof, as such amounts are set forth on the Transaction Costs Certificate.

**Transaction Costs Certificate.** “Transaction Costs Certificate” shall mean a certificate executed by the principal financial officer of the Company dated as of the Closing Date, certifying the Transaction Cost Amount (including an itemized list of each Transaction Cost with a description of the nature of such expense and the Person to whom such expense was or is owed). The Transaction Costs Certificate shall include a representation of the Company, certified by the principal financial officer of the Company, that such certificate includes all of the Transaction Costs paid or payable at any time prior to, at or following the Closing, it being the expressed intent of the parties hereto that to the maximum extent possible all the Transaction Costs be deducted in the calculation of the Merger Consideration and that there be no Transaction Costs to be indemnified pursuant to Section 10.5 hereof.

**Warrantholder.** “Warrantholder” shall mean any Person holding a Company Warrant.

**List of all subsidiaries**

1. IncrediMail Inc., a Delaware corporation
  2. Perion Interactive Ltd., an Israeli corporation
  3. Smilebox Inc., a Washington Corporation
- 
-

CERTIFICATIONS

I, Josef Mandelbaum, Chief Executive Officer of Perion Network Ltd., certify that:

1. I have reviewed this annual report on Form 20-F of Perion Network Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and
5. The Company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: March 22, 2012

/s/ Josef Mandelbaum  
Josef Mandelbaum,  
Chief Executive Officer

---

---

CERTIFICATIONS

I, Yacov Kaufman, Chief Financial Officer of Perion Network Ltd., certify that:

1. I have reviewed this annual report on Form 20-F of Perion Network Ltd.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the Company as of, and for, the periods presented in this report;
4. The Company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Company and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Company, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the Company's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the Company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting; and
5. The Company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Company's auditors and the audit committee of the Company's board of directors (or persons performing the equivalent functions):
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Company's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's internal control over financial reporting.

Date: March 22, 2012

/s/ Yacov Kaufman  
Yacov Kaufman,  
Chief Financial Officer

---

---

CERTIFICATION OF PERIODIC FINANCIAL REPORTS  
UNDER 18 U.S.C 1350

In connection with the Annual Report on Form 20-F of Perion Network Ltd., (the "Issuer"), for the year ended December 31, 2011, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned hereby certifies that:

1. The Report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. Information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Issuer.

/s/ Josef Mandelbaum  
Josef Mandelbaum  
Chief Executive Officer

Date: March 22, 2012

---

---

CERTIFICATION OF PERIODIC FINANCIAL REPORTS  
UNDER 18 U.S.C 1350

In connection with the Annual Report on Form 20-F of Perion Network Ltd., (the "Issuer") for the year ended December 31, 2011, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned hereby certifies that:

1. The Report containing the financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. Information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Issuer.

/s/ Yacov Kaufman  
Yacov Kaufman  
Chief Financial Officer

Date: March 22, 2012

---



CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation by reference in the Registration Statements on Form S-8 (File Nos. 333-171781, 333-152010, 333-133968), pertaining to the 2003 Israeli Share Option Plan, of our report dated March 22, 2012, with respect to the consolidated financial statements of the Company and its subsidiaries included in this Annual Report on Form 20-F for the year ended December 31, 2011.

Tel Aviv, Israel  
March 22, 2012

KOST FORER GABBAY & KASIERER  
A member of Ernst & Young Global

---

---

