

SECURITIES AND EXCHANGE COMMISSION

FORM 10-K

Annual report pursuant to section 13 and 15(d)

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FILER

**HPL TECHNOLOGIES INC**

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

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## FORM 10-K

(Mark One)

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

For the fiscal year ended March 31, 2002

OR

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

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

Commission file number: 000-32967

### HPL TECHNOLOGIES, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware

(State of Incorporation)

77-0550714

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

2033 Gateway Place, Suite 400, San Jose, California

(Address of Principal Executive Offices)

95110

(Zip Code)

(408) 437-1466

(Registrant's telephone number, including area code)

Securities registered under Section 12(b) of the Act:

None

Securities registered under Section 12(g) of the Act:

Common Stock, \$0.001 Par Value

(Title of Class)

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

As of May 31, 2002, the issuer had outstanding 30,800,118 shares of common stock and the aggregate market value of the shares of common stock held by non-affiliates on that date was \$201,975,462 based upon the last sale price of the issuer's common stock reported on the Nasdaq National Market on that date. For purposes of calculating the shares of common stock held by non-affiliates, all officers and directors of the Company were deemed to be affiliates of the Company.

## DOCUMENTS INCORPORATED BY REFERENCE

Portions of Item 10 and Items 11 and 12 of Part III of this Form 10-K are incorporated by reference from the issuer's Proxy Statement for the Annual Meeting of Stockholders to be held on July 30, 2002.

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**PART I****FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements that involve substantial risks and uncertainties. In some cases you can identify these statements by forward-looking words such as "anticipate," "believe," "could," "estimate," "expect," "intend," "may," "should," "will," and "would" or similar words. You should read statements that contain these words carefully because they may discuss our future expectations, contain projections of our future results of operations or of our financial position or state other "forward-looking" information. However, there may be events in the future that we are not able to accurately predict or control. The factors listed in Item 7 under the caption "Risk Factors," as well as any cautionary language in this report, provide examples of risks, uncertainties and events that may cause our actual results to differ materially from the expectations we describe in our forward-looking statements. You should be aware that the occurrence of any of the events described in these risk factors and elsewhere in this report could have a material adverse effect on our business, financial condition and results of operations.

**ITEM 1. BUSINESS****OVERVIEW**

HPL Technologies, Inc. (alternatively referred to as "HPL," "we," "us," "our," or the "Company") provides yield-optimization and productivity improvement solutions that enable semiconductor and flat panel display ("FPD") producers to enhance the efficiency of the technology development, design, test and fabrication processes. Our core products include a flexible software platform supported by numerous software modules, that enable our customers to accelerate the process in which they identify, measure and correct sources of product failure in the semiconductor product development and manufacturing process and flat-panel manufacturing processes. By accelerating this learning and corrective process, we enable our customers to recognize the higher levels of revenue and profitability associated with the earlier phases of a product's market introduction. Additionally, identifying and eliminating failures early in the product cycle also permits our customers to quickly improve the quality of their products, reduce production inefficiencies and deliver higher volume production earlier.

We have principally conducted business as Heuristic Physics Laboratories, Inc. ("HPLI"), a California corporation, since 1989. HPLI merged on July 30, 2001 with a wholly-owned subsidiary of HPL Technologies, Inc., a newly organized Delaware corporation, and each outstanding share of HPLI common stock was converted into 1.7 shares of HPL common stock. As a result of the merger, HPLI effectively reincorporated into Delaware and we adopted a holding company structure. Unless we specify otherwise, all references to the Company and HPL in this report refer to HPL and its subsidiaries. Our principal executive offices are located at 2033 Gateway Place, Suite 400, San Jose, California 95110 and our telephone number is (408) 437-1466.

**INDUSTRY BACKGROUND**

The semiconductor product development process can be grouped into four broad stages: 1) process technology development, 2) design, 3) fabrication and 4) test:

1) **Process Technology Development.** The production process begins with the development of "process technology," during which design and manufacturing limitations are assessed and their potential impact on yield is determined. Based on the results of this assessment, "design rules" are created that set forth the production limitations and chip-design tolerances, such as the smallest feature size that can be reliably produced in a given fabrication facility.

2) Design. The second stage is the design of a semiconductor product, which entails the layout of increasingly complex circuit components and interconnections. A typical semiconductor design includes millions of microscopic circuit components and interconnections all within the size of a square centimeter. For a semiconductor design to be manufactured and work properly, it must be designed with exact precision, and expressly for a given semiconductor process.

3) Fabrication. The third step, fabrication, consists of hundreds of individual manufacturing steps that form patterns on a wafer to create electrical components (devices). These devices are connected to form the desired electronic circuitry or function of the semiconductor. Increasing interaction between semiconductor designs and wafer fabrication processes is creating new causes of failure previously not experienced. During the wafer fabrication process, the manufacturer has several opportunities to conduct measurements and inspections on the wafer to determine whether the products are being manufactured correctly. Accurate measurement and analysis is crucial to the semiconductor development and production processes because it enables early detection and resolution of problems that can result in significant cost savings for the manufacturer.

4) Test. The final stage is testing wafers and products for defects caused by the design or manufacturing processes. Thorough and accurate testing allows the defects to be correlated to the design factor or manufacturing step where they were introduced. Testing and diagnosis is done on the wafer during and immediately after its production, and also on the final products after the wafer is diced and packaged into individual chips.

The efficiency of the semiconductor product development process is commonly characterized in terms of "yield," which is the percentage of properly functioning devices produced at each stage in the production process. The typical product experiences "yield crashes" at predictable points in the development lifecycle. In the transition from design to fabrication, target yields are often difficult to attain initially as fabrication processes are being modified and developed to produce working products. As fabrication volume increases, yield drops are frequently experienced as equipment and processes are pushed to maximize throughput and reduce costs. In the test stage, yield losses come about as test coverage and product variability issues are identified.

Another component of yield to be considered is the increased revenue that is associated with the measured speed of microprocessors, application specific integrated circuits (ASICs) and telecom devices. Parts operating at higher frequencies typically command a higher asking price. While they share a common design, higher frequency parts are made when the electrical properties of all the layers come closest to the original design specifications. Statistical Process Control is used to baseline fabrication capabilities, thus optimizing product specifications, while Advanced Process Control contributes to minimizing inherent manufacturing variability through improved use of metrology data.

In general, each new semiconductor design is characterized by a unique production yield learning curve. Initial yields on advanced processes are typically low, but often improve over time due to "yield learning," which is the process of identifying and resolving yield-limiting root causes. Because sales prices and profit margins are typically much higher in the early stage of a new semiconductor product cycle, a small acceleration along the yield learning curve creates an advantage on the product experience curve, which has a disproportionate revenue and profitability impact. As the product experience increases, cost reduction and efficiency gains become important. As a result, monitoring and maintaining yield on an ongoing basis to maximize production efficiency becomes a primary manufacturing focus. In a volatile market environment where capacity utilization rates fluctuate, yield improvement always remains important, as manufacturers strive to improve efficiencies and maximize the return on investment. Given the costs of a semiconductor fabrication facility and the economics of production efficiency, the rate of yield learning can be a determining factor in profitability and market dominance of a given company.

Yield improvement is a multi-faceted challenge. There are thousands of factors that may affect yield in the semiconductor production process. These factors are attributed to flaws or deficiencies in the design, fabrication and test stages, and are commonly characterized as

random or systematic failures. Random failures are typically caused by defects introduced in the fabrication process, such as incomplete etch resulting in a metal bridge between two adjacent metal lines, whereas systematic failures can be attributed to any non-random source, including equipment or environmental changes, design sensitivity and material defects. With each successive generation, semiconductor yields become sensitive to existing failure modes and are exposed to new failure modes. This has led to a general trend of requiring more data to improve yields. The sheer volume of data and the related analysis has become an impediment to growth in the yield learning curve. To identify the factors that affect yield, semiconductor companies must collect and analyze an immense (and growing) amount of data that is generated throughout the semiconductor product development lifecycle, often from multiple worldwide locations and increasingly, from fabrication partners. In any semiconductor fabrication facility, there are likely to be as many as 50 different sets of data produced, frequently in as many different formats, with tens of thousands of individual parameters that need to be tracked. While this data provides important clues regarding yield enhancement, the efficient collection, correlation and analysis across the various data sets is a substantial challenge for the semiconductor industry.

The flat-panel market experiences the same yield dynamics as the semiconductor market. Although the processes in flat-panel display manufacturing are typically less complex and in absolute terms have smaller data volumes, the need for improvement in the yield learning curve to capitalize a "first mover" advantage still exists. In market segments, where large displays are preferred such as notebook computer, the flat-panel manufacturer is exposed to more yield risk than the typical semiconductor manufacturer. A single defect on a semiconductor wafer only affects one "chip" cut from that wafer whereas a single defect in a large flat panel display may result in a fatal defect for the entire panel.

## **HPL PRODUCTS AND TECHNOLOGY**

Our core software and its underlying technology have evolved on the principle that every step of the product development process affects yield. By providing products that focus and integrate across all stages of the product development process, customers are now able to take a holistic approach to yield optimization rather than attempting to improve yields using point solution base products. Our yield-optimization software integrates data sets from the process technology development, design, fabrication and test stages of the product development process, and enables companies to: synthesize that data into a unified format for analysis; analyze the data to identify yield enhancement opportunities; and allows the user to view and manipulate the information for maximum productivity.

Our platform is built on the vision that a yield optimization solution should be:

Functionally comprehensive;

Open and equipment vendor-neutral;

Collaborative for cross-domain insight;

User-configurable for extensibility; and

Scalable across all data formats.

Our yield-optimization solution consists of a software platform called YIELDirector™, and numerous software modules, which are sold individually or in pre-configured groups. We license our YIELDirector™ platform as a standalone product or with pre-configured groups of software modules called the YIELDirector™ Standard Configuration. In addition, we license other pre-configured software modules. These products can be licensed as part of our standard configurations or in conjunction with the YIELDirector™ platform.

## *YIELDirector™ platform*

YIELDirector™ is the software platform that provides the infrastructure for our yield-optimization solutions. This platform is responsible for integrating data from throughout the semiconductor production process into a database where it is normalized, catalogued and can be automatically accessed for visualization, data analysis, correlation, charting and reporting.

The YIELDirector™ software platform is the framework on which our software modules, as well as customer-developed modules, can be integrated. The YIELDirector™ software platform utilizes an advanced data structure and extensive data filtering functionality that enables data types to be added or modified without resorting to extensive database reconstruction. New data types or attributes can be added using simple configuration procedures, while data filters can control the query and retrieval processes using the new attributes. Reconfigurable analysis engines can also process the new attributes if the new data types are specified for calculation. In addition, new analysis engines may be integrated into the platform to apply altogether new analysis capability on the new and existing data types.

The user interface for the YIELDirector™ platform and software modules is YIELDXPLORER™, which provides consistent and intuitive access to the functions offered by YIELDirector™ via an interactive browser, based on point-and-click control windows. This user interface can be easily customized according to the needs, expertise and security level of each individual user without the assistance of a software developer. Such customization allows users to present the specific type of data relevant to their operations in intuitive formats, such as charts, tables or wafer maps.

## *Standard software modules*

We have developed numerous software modules that support a wide variety of functionality, including visualization, data analysis, correlation charting, data importation, automation and reporting. Examples of these modules include WAFERVIEW™, for displaying semiconductor wafer maps, IMAGEVIEW™, for displaying defect images, and flow-analysis modules such as equipment commonality analysis, wafer zonal analysis and data mining. Most of our modules are designed to run solely on our YIELDirector™ platform while others can run on the platform or independently.

## *YIELDirector™ standard configurations*

The YIELDirector™ standard configurations consist of particular sets of our software modules configured to perform specific types of yield-optimization analysis. Since these standard products are simply pre-defined module configurations, they can be easily upgraded and expanded as requirements change, allowing the user a great deal of flexibility and customization.

PARAMETRIC YIELDirector™. This product provides a comprehensive system for analysis and investigation of factors that affect yield in the context of semiconductor design and parametric sensitivity. Parametric sensitivity is a measure of how much the yield, and the performance of the finished semiconductor, depend on normal variations in the fabrication process, such as equipment variations. This is important for setting specification limits for variations, while simultaneously improving the design to reduce sensitivity to them.

MEMORY YIELDirector™. This product helps accelerate yield learning and problem solving for the manufacturing of advanced semiconductors. While it is difficult to identify and locate defects in logic chips, defects in memory chips can be more easily identified and traced to a precise location. For this reason, logic device manufacturers frequently produce memory devices to help diagnose potential yield problems in the production of logic chips. This product also automates the analysis of fabrication and test data for all types of memory devices, as well as logic chips with embedded memories. Using specially developed analysis algorithms, the system automatically classifies failed bitmaps into failure patterns, or signatures. These signatures are then correlated to defect inspection data to identify the

root causes of the failure. Defined by the device layout, the failure signatures can also be used to immediately indicate the process step(s) at which a problem has occurred, even without corresponding defect data.

YIELDirector-FPD™. This product helps accelerate yield learning and problem solving for the manufacturing of advanced flat panel displays. Although the geometries used to manufacture flat panel displays are typically much larger than those used for semiconductors, the transition towards larger plate and screen sizes make them increasingly susceptible to defects, driving an industry requirement for advanced analysis solutions. YIELDirector-FPD™ incorporates data collection, visualization and analysis capabilities that enable users to systematically identify and prioritize improvements in the FPD manufacturing process.

#### *Design-For-Yield standard configurations*

HPL has a broad view of a yield solution in which information and knowledge that is acquired from manufacturing is dynamically applied to the product development flow to continually improve yield throughout a product's lifecycle. HPL calls this concept Integrated Yield Optimization. Design-For-Yield ("DFY") is the application of Integrated Yield Optimization techniques specifically to the design flow.

To accomplish this, DFY makes use of fab-knowledgeable tools that are embedded into the existing design flow to predict and improve a design's yield before it is committed to silicon. These tools augment the existing design for manufacture ("DFM") software by specifically addressing yield. Other DFY tools that have knowledge of realistic defects that occur in the fab are used to improve the quality of the manufacturing test programs. This ensures an accurate assessment of a device's yield by reducing the number of test escapes. Furthermore, automated diagnosis of device failures is facilitated by DFY techniques, information and tools.

#### *DFY Products*

YIELD PROJECTOR™ is used by design engineers to predict and improve a design's yield before it reaches manufacturing. YIELD PROJECTOR™ uses defect distribution information from the manufacturing process and a design's layout to simulate the yield impact on the design of a wide-range of random defects that could be introduced during the manufacturing process. YIELD PROJECTOR™ reports to the user the number of fatal defects (defects that will cause a failure in the device) on each layer of the design along with the projected yield of that layer. YIELD PROJECTOR™ also highlights yield problems directly in design layout so design engineers can compare various layout options and critical feature usage to improve a design's immunity to random and systematic manufacturing defects. The use of YIELD PROJECTOR™ can reduce the cost of bad parts and speed time to volume production.

YIELD PROJECTOR™ can also be used with HPL's TestChip Solution when ramping up a new technology node to determine the new processes failure rates for critical design factors and the fault density statistics.

SAFARI™ grades the effectiveness of test programs for standalone and embedded memories. Using Safari, design and test engineers can optimize their test programs or Built in Self Test Logic to achieve the best balance between defect coverage and runtime. Safari's knowledgebase can be used by failure analysis technicians to quickly pinpoint the root cause of device failures to improve the manufacturing process.

ReFLEx™ is used by test engineers to identify the most likely bridging and open faults based on the interaction of the design layout and the manufacturing process. The resulting fault list is used to generate more effective test pattern sets that reduce the number of faulty products that escape

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detection during testing. ReFLEx™ can be used by failure analysis technicians to quickly pinpoint the root cause of device failures to improve the manufacturing process.



LAYOUTVIEW™. This product displays semiconductor physical layout information. In addition, cross-sectional layer models may be defined to assist in layout tracing and analysis. LAYOUTVIEW™ also allows users to highlight selected circuit connections and manipulate layer views.

### *Navigator Standard Configurations*

Identifying the physical defect responsible for electrical test failures is an important yield improvement activity. Physical failure analysis involves a combination of de-processing techniques and imaging technologies. Each of the NAVIGATOR products are capable of driving all industry-standard imaging and failure analysis tools, including scanning electron microscopes, focused ion beams, optical review stations and multi-beam systems. The NAVIGATOR products enable detailed visualization and intuitive, high accuracy navigation of advanced imaging equipment from any level of the chip, including layout, wafer or bitmap. The NAVIGATOR products are sold directly to end-users and to semiconductor equipment OEMs to be bundled with their failure analysis equipment. The NAVIGATOR products can operate on a stand-alone basis or interface with the YIELDirector™ platform.

DEFECT NAVIGATOR™. This product is configured to accept defect data from fabrication inspection equipment for systematic review, analysis and visual observation of the defects, while remotely navigating the review station using an interactive wafer map display. DEFECT NAVIGATOR™ consists of a data file converter, navigational algorithms and two imaging modules: WAFERVIEW™ for mapping defect locations and IMAGEVIEW™ for displaying related defect images.

BITMAP NAVIGATOR™. This product is a multipurpose viewing and navigation tool that dramatically enhances memory array analysis. BITMAP NAVIGATOR™ will guide the microscope or scanning electron microscope directly to the location of the failed bit so that the failure analysis engineer can detect physical defects. Once the wafer test equipment has stored its resulting failed bitmaps, BITMAP NAVIGATOR™ translates the files into visual representation for analysis and correlation. The data management structure is optimized for rapid display, easy manipulation and intuitive analysis of faulty memory arrays. BITMAP NAVIGATOR™ is comprised of a bitmap data converter, navigational algorithms and our BITMAPVIEW™ display product.

LAYOUT NAVIGATOR™. This product targets the failure analysis, design and product engineering community. The failure analysis engineer can identify suspected defect locations on the layout, and LAYOUT NAVIGATOR™ will guide the microscope to that spot for inspection. This product enables the user to view the device design by process layer and provides statistical results about the design. The user can perform a layer-by-layer inspection or stack the layers to identify areas that may be vulnerable to the specified design. LAYOUT NAVIGATOR™ is compatible with most scanning electron microscopes.

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## RECENT ACQUISITIONS

On December 5, 2001, we acquired FabCentric, Inc., a company engaged in the development and sale of software products to the semiconductor industry. The FabCentric acquisition has added two unique products to our offerings: RME™, the industry's only recipe management and off-line editing solution and YieldNavigator™, a rule-based-event-driven decision engine. Many integrated device manufacturers ("IDMs") and foundries look to RME™ as a valuable tool in reducing whole wafer scrap, which is due to running wrong "recipes," sometimes for days at a time. In addition, RME™ is a critical component for integrated advanced process control strategies currently being adopted by all major semiconductor fabricators.

On February 15, 2002, we acquired Covalar Technologies Group, Inc. and its wholly-owned subsidiary TestChip Technologies, Inc., a company focused on providing solutions to semiconductor manufacturers to help them develop and accelerate advanced process technologies. With this acquisition, we acquired our TestChip solutions which include a platform of design and test tools coupled with a comprehensive offering of intellectual property used to generate circuits and test programs for semiconductor process technology development and characterization. The TestChip methodology offers significant automation compared to current prevailing development practices used by semiconductor manufacturers. This methodology accelerates the development and adoption of new technology and reduces the time to volume production. TestChip's design and test tools provide data that can be integrated into the YIELDirector™ Platform to provide yield analysis and optimization solutions, allowing HPL to offer yield solutions starting with the beginning of a semiconductor development cycle.

On April 10, 2002, we acquired Defect & Yield Management, Inc., a defect analysis and yield optimization software company. Its principal product is ODYSSEY™, a defect data management system. The system integrates data from fabrication inspection equipment and provides inter-tool data communication, defect sampling and analysis. The system collects and organizes data that can be integrated into our DEFECT YIELDirector™ Platform as part of a larger analysis solution.

## **OTHER SERVICES**

Our Integrated Yield-Optimization ("IYO™") solution is a methodology that approaches the semiconductor production problem from a comprehensive perspective covering design, fabrication and test issues relating to yield loss. IYO considers the complex interactions between design and a customer's specific fabrication process. Our IYO solution was developed by industry veterans and consists of a set of combined products and services from our YIELDirector™, Design for Yield, and TestChip offerings.

## **SALES AND MARKETING**

We rely on our direct sales force and on our industry partner relationships to penetrate the semiconductor market. Our direct sales efforts have focused primarily on licensing our software products to IDMs, foundries and fabless semiconductor design companies. Our direct sales force operates out of our headquarters in San Jose, California and our facilities in Boston, Massachusetts; Austin, Texas; Plano, Texas; Yokohama, Japan; Taipei, Taiwan; Aix-en-Provence, France; Yerevan, Armenia, and Singapore.

Our sales and marketing personnel also focus on developing our relationships with industry partners, which include semiconductor original equipment manufacturers ("OEMs") who bundle our products in their hardware. These joint-marketing relationships provide us with access to the customer bases of these OEMs. We intend to continue to expand our industry partnerships in the future.

In March 2000, we entered into a distribution agreement with Canon Sales Co., under which Canon was appointed as the exclusive distributor of certain of our products in Japan. The distribution agreement does not limit sales of our products to customers located in Japan by semiconductor equipment OEMs. The initial term of the distribution agreement is until March 2003, and it will automatically renew for additional one-year periods until terminated by either party.

We believe enhancing our presence in the semiconductor market is important to our success. We use a variety of marketing programs including sales brochures, trade shows and targeted advertising in industry journals to build awareness of our products.

## **RESEARCH AND DEVELOPMENT**

The market for yield optimization is characterized by rapid technological development and product innovation. We believe that timely development of new products and enhancements to existing products are necessary to maintain our competitive position. Accordingly, we devote a significant portion of our human and financial resources to research and development programs and seek to maintain close relationships with customers to remain responsive to their needs.

The complexity of yield optimization requires expertise in physical integrated circuit ("IC") design and fabrication as well as software development. Today, we employ a staff of software development engineers completely devoted to the development of yield-optimization software products. Our team also encompasses a core group of engineers and technicians with extensive education, experience and expertise in the semiconductor domain. Virtually every discipline associated with the lifecycle of an IC is represented at our company, including device physics, product design, product engineering, yield engineering, failure analysis engineering, fab management, process engineering and testing.

## **COMPETITION**

The worldwide market for productivity-enhancement tools and systems for semiconductor companies is highly competitive and characterized by rapidly changing technologies. We face direct competition from semiconductor companies that have developed or have the ability to develop their own proprietary yield-optimization tools and systems, as well as third-party providers of yield-management software and services.

We have found that the tools and systems against which our products and services most commonly compete are those that semiconductor companies have created in-house as part of a specific fabrication process or through a dedicated development group. We must overcome a tendency that some producers may have to resist outside solutions.

The third-party providers that compete in the market for yield-optimization tools are, generally, divisions of larger semiconductor equipment OEMs, such as KLA-Tencor. The success of our business or other businesses like ours might prompt increased competition. As a result, we must continue to improve existing products, develop new products and protect our innovations through intellectual property laws in order to continue to differentiate our product offering.

Significant factors in our target market's choice of productivity-enhancement software include its performance, ease of use, reliability, price, compatibility with existing systems, installed base, and technical service and support. While price is an important competitive factor, we believe that customers will choose the most effective productivity software, even if it is more expensive, because of the added profitability from better production yield. We also believe that currently no competitor offers productivity-enhancement solutions that are similar to the comprehensive yield-optimization platform and development tools we offer.

## **INTELLECTUAL PROPERTY**

Our future success and competitive position depends heavily upon our continued ability to develop new proprietary technology while protecting our existing intellectual property. To protect our products and the underlying technology, and to prevent competitors from using our technology in their products, we use a combination of patents, trade secrets and copyrights. As of March 31, 2002, we held three US patents expiring at different times between 2013 and 2017, and had fourteen US patent applications pending. We expect that if granted, the duration of these patents will be 20 years from the date of filing the application. We have additional patent applications that we are developing internally and may file in the future.

There is no assurance that any of our current or future patent applications will result in patents, and our existing or future patents may be circumvented, declared invalid or challenged as to scope or ownership. For these and other reasons, we may not realize any competitive advantage from our existing patents and any patents that we may be granted in the future. Furthermore, others may develop technologies that are similar or superior to our proprietary technologies or design around any patents that we may hold. To the extent that others are able to obtain patents that overlap with our technologies or processes, we may be required to license these patents. If we are unable to license these patents or obtain licenses on acceptable terms, we may need to alter our products or discontinue selling them altogether. In addition, we have not secured patent protection in foreign countries and we cannot be certain that the steps we take to prevent misappropriation of our intellectual property abroad will be effective, or that the application of foreign laws to technology developed abroad will not adversely effect the validity or enforceability of our US patents.

Much of our intellectual property has not been patented or is not patentable. Accordingly, we have historically protected our non-patented intellectual property as a trade secret. Trade secret protection is in many ways inferior to patent protection. Others may reverse-engineer our non-patented technologies and lawfully use any underlying technology that is discovered in this process. We typically enter into confidentiality agreements with prospective customers, distributors and business partners prior to disclosing material proprietary information. These agreements prohibit unauthorized use and disclosure of our trade secrets and other proprietary information. We currently require all of our employees to enter into similar agreements. While we believe that these agreements provide a measure of protection of our intellectual property, they may be declared invalid or unenforceable, or we may not have the resources to seek enforcement in the event of a breach. Additionally, courts only protect trade secrets from misappropriation to the extent that we have taken reasonable steps to protect the

confidentiality of these trade secrets. It is possible that a court would find our trade-secret protection practices inadequate and therefore declare portions of our trade secrets unprotected from misappropriation.

We generally rely on US and Armenian copyright law and international treaties for protection of our software source code, software object code, training materials and user manuals created by our employees. As of March 31, 2002, we have registered 15 copyrights with the US Copyright Office. While US copyright law protects the expression of an idea, it does not protect the idea itself from copying. As a result, others may be able to glean valuable concepts and methods from our copyrighted material and lawfully use these ideas and methods in a competing venture by simply changing the manner of expression. In an effort to protect our software from misappropriation, we do not typically divulge our source code to customers or vendors, although we have on three occasions placed our source code in escrow in connection with certain transactions.

## EMPLOYEES

As of March 31, 2002, we employed approximately 300 individuals. None of our employees are represented by a labor union or are subject to a collective bargaining agreement. We believe that our relationship with our employees is good.

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## DIRECTORS AND EXECUTIVE OFFICERS

The following table sets forth the directors and executive officers of the Company, their ages and positions as of June 15, 2002:

<u>Name</u>	<u>Age</u>	<u>Position</u>
Y. David Lepejian	41	President, Chief Executive Officer and Director
Ita Geva	48	Chief Financial Officer
Elias Antoun	45	Director
Osamu Kano	65	Director
Lawrence Kraus	39	Director, Vice President – Heuristic Physics Laboratories, Inc.
Dr. Yervant Zorian	46	Director
Brian Duffy	43	Vice President – Platform Division
Tom T. Ho	41	Vice President – Solution Division
Mark Milligan	40	Vice President – Design-for-Manufacturability Division
Gene Mullinnix	50	Vice President – Engineering
Rita Rubinstein	51	Vice President – Administration & Human Resources
Michael P. Scarpelli	35	Vice President – Corporate Development

*Y. DAVID LEPEJIAN.* Mr. Lepejian is a co-founder of the Company and has served as a director and as the President and Chief Executive Officer of Heuristic Physics Laboratories, Inc. ("HPLI"), the Company's principal operating subsidiary, since its formation in 1989 and as the President and Chief Executive Officer of the Company since its formation in June 2000. Prior to founding HPLI, Mr. Lepejian served for four years as an engineer at Xicor, Inc., a programmable semiconductor manufacturing firm.

*ITA GEVA.* Ms. Geva has served as our Chief Financial Officer since April 2000, initially on a part-time basis and since June 2000, on a full-time basis. From September 1999 to June 2000, Ms. Geva served as Acting Chief Financial Officer at Faroudja, Inc., a producer of video processing and video image enhancement products. Prior to serving as Acting Chief Financial Officer of Faroudja, Ms. Geva served as Faroudja's Controller from February 1996 to September 1999 and, prior to that, served as Faroudja's Accounting Manager.

*ELIAS ANTOUN.* Mr. Antoun has served as President and Chief Executive Officer of MediaQ, Incorporated, a semiconductor manufacturer, since February 2000. From March 1998 to January 2000, Mr. Antoun served as Executive Vice President, Consumer Products Division at LSI

Logic. Mr. Antoun served as President of LSI Logic K.K., a Japanese subsidiary of LSI Logic, from January 1996 to March 1998. Mr. Antoun previously served as HPL's Chief Financial Officer from September 1989 to December 1990.

*OSAMU KANO.* Mr. Kano has served as the president of Innoquest Corporation since July 1991 and has served on the board of directors of Innotech Corporation, a publicly traded company, since June 1991. Previously, Mr. Kano served as a director of LAM Research Corporation from December 1986 until December 1998 and as a director of Altius Solutions, Inc. from January 1997 until October 2000.

*LAWRENCE KRAUS.* Mr. Kraus is co-founder of the Company and has served as a member of the board of directors of the Company's principal operating subsidiary, HPLI since its formation in 1989. In February 2001, Mr. Kraus became HPLI's Vice President of Strategic Marketing. Mr. Kraus previously served as HPLI's Director of Hardware Development from May 1989 to January 1995 and as the Vice President and General Manager of HPLI's hardware divisions until their sale to Credence Systems Corporation in June 1998. With the sale of the hardware divisions to Credence, Mr. Kraus joined Credence as a Director of Operations and served in that capacity until February 2001.

*DR. YERVANT ZORIAN.* Dr. Zorian has served as Vice President and Chief Scientist at Virage Logic Corporation since June 2000 and as Chief Technology Advisor at LogicVision from November 1996 until June 2000. Dr. Zorian was a Distinguished Member of the Technical Staff at Bell Laboratories, Lucent Technologies from November 1987 until November 1996.

*BRIAN DUFFY.* Mr. Duffy is our Vice President of the Platform Division and is chiefly responsible for overseeing product development. Mr. Duffy has served as Vice President of the Platform Division since March 2001. Prior to that time, Mr. Duffy served as Vice President of Engineering, Vice President of Physical Design Analysis and as a Director of Strategic Marketing. Before joining us in September 1998, Mr. Duffy worked at KLA-Tencor as a Director of Product Planning from March 1996 and as a Senior Manager of Marketing from February 1995 to February 1996.

*TOM T. HO.* Mr. Ho joined the Company in September 1998 and has served as Vice President of the Solution Division since March 2001. Prior to that time, Mr. Ho served as Vice President of Application Services and as a Director of Product Development. From August 1996 to September 1998, Mr. Ho served as a Senior Product Engineering Manager at National Semiconductor where, among other things, he worked to design and implement yield monitoring systems to increase manufacturing efficiency and output. Prior to that, Mr. Ho served as a Senior Product Engineer at Microunity System Engineering from July 1991 to July 1996.

*MARK MILLIGAN.* Mr. Milligan joined HPL in November 2001 as Vice President and General Manager of our Design-for-Yield Division, a new division focused on addressing yield issues during the circuit design process. From 1997 to 2001, Mr. Milligan was Vice President of Marketing for Synopsys in the High Level Verification division and the DesignSphere initiative. Prior to joining Synopsys, Mr. Milligan held various technical and marketing roles at Sunrise Test Systems, an early startup that focused on Design-for-Test. After its acquisition by Viewlogic, Mr. Milligan served as Vice President and General Manager of the Sunrise division from 1994 to 1997.

*GENE MULLINNIX.* Mr. Mullinnix is our Vice President of Engineering, responsible for oversight of our TestChip Division. Mr. Mullinnix joined HPL in February 2002 in connection with the Company's acquisition of TestChip. Prior to the acquisition, Mr. Mullinnix served as the Vice President of Engineering of TestChip for one year. Prior to joining TestChip, Mr. Mullinnix worked for eighteen years in various positions at Motorola including Operations and Program Manager for Non-Volatile Memories Technology Center, Site and Wafer Fab Operations Manager, and Global Technology Manager. Mr. Mullinnix managed wafer fabs for Motorola in California and North Carolina with responsibilities in wafer fab operations, site management, technology development and a design center. Mr. Mullinnix organized and developed the Microcontroller Technology Group's External Manufacturing Operations establishing and managing foundry relationships in Asia, Japan, Europe and Israel. Mr. Mullinnix holds a B.S. degree in Engineering from Texas A&M University and has been an advisor and lecturer at Texas A&M University, Duke University, University of North Carolina and was author and contributor for several training texts in semiconductor technologies for the Texas Engineering Extension Service.

*RITA RUBINSTEIN.* Ms. Rubinstein has served as our Vice President of Administration & Human Resources since April 1999 and as corporate secretary since July 1999. Ms. Rubinstein also serves as the Vice President of Operations of HPLA, our Armenian subsidiary. Prior

to joining us in 1999 as a full-time employee, Ms. Rubinstein served as a human resources and administration consultant. From 1993 to August 1998, Ms. Rubinstein served as the Vice President of Administration and Human Resources for two public companies in Israel. Prior to that Ms. Rubinstein served as Corporate Vice President of Administration and Human Resources at Optrotech (Orbotech) a high-tech inspection and imaging solutions company.

*MICHAEL P. SCARPELLI.* Mr. Scarpelli joined the Company in January 2002 and serves as our Vice President of Corporate Development. Mr. Scarpelli's primary role is the oversight of the Company's

mergers and acquisitions. Mr. Scarpelli is also responsible for managing strategic partnerships, strengthening the Company's infrastructure and assisting divisional general managers with internal business processes. Prior to joining HPL, Mr. Scarpelli was a partner at PricewaterhouseCoopers LLP, where he served as an auditor for the last 12 years. Mr. Scarpelli is a Certified Public Accountant and a Chartered Accountant.

## ITEM 2. PROPERTIES

The following table sets for the Company's principal properties as of May 15, 2002. We believe that our existing facilities are adequate for our current needs.

Location	Square Footage	Expiration of Lease Term	Uses
Austin, Texas	25,140	February 2006	Offices
Bedford, Massachusetts	12,050	October 2005	Offices
Newton, Massachusetts	2,695	February 2003	Offices
San Jose, California	12,500	December 2005	Executive offices
San Jose, California	2,098	May 2003	Offices
Plano, Texas	18,302	March 2006	Offices
Yerevan, Armenia	14,080	*	Offices; research and development

(\*) The Company has three separate leases for its facilities in Yerevan, Armenia. These leases expire June 2002, August 2002, and December 2002.

## ITEM 3. LEGAL PROCEEDINGS

None.

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

None.

## PART II

## ITEM 5. MARKET FOR COMMON STOCK AND RELATED STOCKHOLDER MATTERS

HPL common stock is quoted on the Nasdaq National Market System under the symbol "HPLA." The following table sets forth the high and low sales prices of our common stock, as quoted on Nasdaq, from July 30, 2001, the date of our initial public offering, to March 31, 2002.

Fiscal 2002	Price Range	
	High	Low
First Quarter	N/A	N/A
Second Quarter	\$ 15.74	\$ 3.45
Third Quarter	\$ 18.85	\$ 4.25
Fourth Quarter	\$ 18.65	\$ 11.19

As of May 31, 2002, there were approximately 123 holders of record of our common stock and 30,800,118 shares of common stock outstanding. No dividends have been paid on our common stock since inception, and we do not anticipate paying any dividends in the foreseeable future.

### RECENT SALES OF UNREGISTERED SECURITIES

On December 5, 2001, we acquired FabCentric, Inc., a California corporation ("FabCentric"). In connection with this acquisition, we issued a total of 703,355 shares of common stock to the FabCentric shareholders and reserved 23,231 shares of common stock for issuance upon exercise of outstanding FabCentric stock options assumed by us. This offering was exempt from registration under Rule 506, promulgated under the Securities Act of 1933.

On February 15, 2002, we acquired Covalar Technologies Group, Inc., a Texas corporation ("Covalar"). In connection with this acquisition, we issued a total of 1,481,566 shares of common stock to the Covalar shareholders and reserved: (i) 600,000 shares of common stock that may be issued pursuant to an earn-out provision and (ii) 418,434 shares of common stock that may be issued upon exercise of outstanding Covalar stock options assumed by us. This offering was exempt from registration under Rule 506, promulgated under the Securities Act of 1933.

On April 10, 2002, we acquired Defect & Yield Management, Inc., a Delaware corporation ("DYM"). In connection with this acquisition, we issued a total of 967,260 shares of common stock to the DYM shareholders and assumed options to purchase up to 82,740 shares of common stock that may be issued upon exercise of outstanding DYM stock options. We may also issue additional shares with a value of up to \$5 million pursuant to an earn-out provision in the purchase agreement. This offering was exempt from registration under Rule 506, promulgated under the Securities Act of 1933.

### USE OF PROCEEDS FROM SALES OF REGISTERED SECURITIES.

Our Registration Statement on Form S-1 (Commission File No. 333-61810) for our initial public offering of common stock was declared effective on July 30, 2001. We sold a total of 6,900,000 shares of common stock to an underwriting syndicate for aggregate gross offering proceeds of \$75.9 million. In connection with this offering, we incurred total expenses of approximately \$7.2 million, consisting of \$5.3 million for underwriting discounts and commissions, and approximately \$1.9 million of other expenses. None of these expenses were paid directly or indirectly to any of our directors, officers, or their associates, persons owning 10% or more of any class of our securities, or affiliates of HPL. Offering proceeds, net of expenses were approximately \$68.7 million. We have applied the proceeds to temporary investments in a money market investment account, the purchase of short-term investments and have spent a portion of the proceeds on research and development, sales and marketing and the acquisitions of Tyecin-Innotech Corporation, FabCentric, Covalar, and DYM.

## ITEM 6. SELECTED FINANCIAL DATA

The selected consolidated financial data set forth below should be read in conjunction with "Management's Discussion and Analysis of Financial Condition and Results of Operations," and the consolidated financial statements of HPL and the notes to the consolidated financial statements included elsewhere in this annual report on Form 10-K. The consolidated statement of operations data for each of the years in the five-year period ended March 31, 2002, and the consolidated balance sheet data at March 31, 2002, 2001, 2000, 1999 and 1998 are derived from our consolidated financial statements. Prior to June 1998, we were primarily engaged in the design and manufacturing of automated test equipment. In June 1998, we sold that hardware business to focus on the development of yield-optimization software and consulting services for the semiconductor industry. The historical results are not necessarily indicative of results to be expected for any future period. The per share data give effect to the reincorporation merger in which each outstanding share of common stock of Heuristic Physics Laboratories, Inc. was converted into 1.7 shares of common stock of HPL.

	Years Ended March 31,				
	2002	2001	2000	1999	1998
<i>(in thousands, except per share data)</i>					
<b>Statement of Operations Data:</b>					
Revenues:					
Software licenses	\$ 30,343	\$ 10,908	\$ 3,039	\$ 45	\$ 853
Consulting services, maintenance and other	6,811	2,511	665	103	286
<b>Total revenues</b>	<b>37,154</b>	<b>13,419</b>	<b>3,704</b>	<b>148</b>	<b>1,139</b>
Cost of revenues:					
Software licenses	802	133	9	1	38
Consulting services, maintenance and other (1)	2,255	916	259	61	233
<b>Total cost of revenues</b>	<b>3,057</b>	<b>1,049</b>	<b>268</b>	<b>62</b>	<b>271</b>
<b>Gross profit</b>	<b>34,097</b>	<b>12,370</b>	<b>3,436</b>	<b>86</b>	<b>868</b>
Operating expenses:					
Research and development (1)	6,534	3,381	2,851	2,503	1,076
Sales, general and administrative (1)	9,968	4,329	3,155	2,613	883
Stock-based compensation	3,547	2,369	580	64	75
Amortization of intangible assets	294	137	148	11	-
<b>Total operating expenses</b>	<b>20,343</b>	<b>10,216</b>	<b>6,734</b>	<b>5,191</b>	<b>2,034</b>
<b>Income (loss) from operations</b>	<b>13,754</b>	<b>2,154</b>	<b>(3,298)</b>	<b>(5,105)</b>	<b>(1,166)</b>
Interest income (expense) and other, net	908	(190)	(248)	48	-
<b>Income (loss) before income taxes and discontinued operations</b>	<b>14,662</b>	<b>1,964</b>	<b>(3,546)</b>	<b>(5,057)</b>	<b>(1,166)</b>
Provision for (benefit from) income taxes	7,918	1,423	-	(1,982)	(766)
<b>Income (loss) from continuing operations</b>	<b>6,744</b>	<b>541</b>	<b>(3,546)</b>	<b>(3,075)</b>	<b>(400)</b>
Discontinued operations:					



Income from discontinued operations (net of income tax of \$17 in 1999 and \$766 in 1998)	-	-	-	25	1,128
Gain on sale of discontinued operations (net of income tax of \$1,965)	-	-	-	2,916	-
Net income (loss)	\$ 6,744	\$ 541	\$ (3,546)	\$ (134)	\$ 728
Income (loss) per common share from continuing operations—basic	\$ 0.28	\$ 0.03	\$ (0.21)	\$ (0.19)	\$ (0.02)
Income (loss) per common share from continuing operations—diluted	\$ 0.21	\$ 0.02	\$ (0.21)	\$ (0.19)	\$ (0.02)
Net income (loss) per share—basic	\$ 0.28	\$ 0.03	\$ (0.21)	\$ (0.01)	\$ 0.04
Net income (loss) per share—diluted	\$ 0.21	\$ 0.02	\$ (0.21)	\$ (0.01)	\$ 0.04
Shares used in per share computations:					
Basic	24,038	17,496	17,068	16,422	16,349
Diluted	32,853	27,831	17,068	16,422	17,981

(1) Excludes the following stock-based compensation charges:

Cost of revenues	\$ 39	\$ 60	\$ 2	\$ -	\$ -
Research and development	692	296	96	23	75
Sales, general administrative	2,816	2,013	482	41	-
	\$ 3,547	\$ 2,369	\$ 580	\$ 64	\$ 75

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Consolidated Balance Sheet Data:	March 31,				
	2002	2001	2000	1999	1998
	(in thousands)				
Cash, cash equivalents and short-term investments	\$ 60,132	\$ 989	\$ 178	\$ 332	\$ -
Working capital (deficit)	67,477	(193)	(2,090)	(957)	(225)
Total assets	131,199	7,504	5,031	1,895	954
Long-term debt, less current portion	280	295	1,857	78	-
Total stockholders' equity (deficit)	116,970	228	(2,727)	193	257

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## ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with Item 1: Business; Item 6: Selected Financial Data; and Item 8: Financial Statements and Supplementary Data. This discussion and analysis contains forward-looking statements that involve risks, uncertainties and assumptions. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth under "Risk Factors" and elsewhere in this report.

### OVERVIEW

We provide comprehensive yield-optimization solutions to the semiconductor industry and flat-panel display manufacturers. We license our software products and sell related services through our direct sales force, our Japanese distributor, Canon, and semiconductor equipment manufacturers ("OEMs") that bundle our software with their hardware.

In 1992, we began selling yield analysis and data visualization software embedded in memory analysis test equipment. We sold our hardware business to Credence Systems Corporation in June 1998 to focus our resources on the development and sales of yield-optimization software and services for the semiconductor industry. This sale shifted our focus from hardware to software and related services, significantly altered our revenue mix, and significantly reduced revenues for the year ended March 31, 1999. We have accounted for our hardware business as a discontinued operation.

In July 2001, we sold 6,900,000 shares of our common stock in our initial public offering, raising aggregate gross offering proceeds of \$75.9 million. In connection with this offering, we incurred total expenses of approximately \$7.2 million, consisting of \$5.3 million for underwriting discounts and commissions and approximately \$1.9 million in other expenses. A portion of the net proceeds have been used to expand our operations, including payments related to the following acquisitions:

On October 4, 2001, we acquired all of the outstanding shares of Tyecin-Innotech Corporation ("Tyecin"), a corporation organized under the laws of Japan, for approximately \$789,000 in cash. The transaction was accounted for using the purchase method of accounting. The purchase price was allocated to tangible net assets acquired of approximately \$708,000 and goodwill of approximately \$81,000. Tyecin provides software support and services to manufacturing companies. The acquisition provides us with an experienced workforce in Japan and will help support existing and future customers in Japan.

On December 5, 2001, we acquired FabCentric, Inc. ("FabCentric"), for an estimated purchase price of approximately \$8.5 million. In connection with the acquisition, all of the shares of FabCentric's common, Series A preferred and Series B preferred stock outstanding immediately prior to the consummation of the acquisition were converted into 703,355 shares of our common stock. We also assumed FabCentric's outstanding stock options, which converted into options to purchase 23,231 shares of our common stock. The transaction was accounted for using the purchase method of accounting. FabCentric is engaged in the business of software development and sales to semiconductor companies. The acquisition gives us access to FabCentric's customer base, complementary technology and a highly skilled workforce.

On February 15, 2002, we acquired all of the outstanding common shares of Covalar Technologies Group, Inc. ("Covalar"), a design yield optimization and productivity improvement software company which offers solutions to semiconductor companies that include testing, analysis and advanced circuit design. In connection with the acquisition, we issued 1,481,566 shares of our common stock, paid \$10.0 million in cash and assumed options to purchase 418,434 shares of our common stock. We have also reserved an additional 600,000 shares of common stock to be issued to Covalar shareholders if certain revenue targets are achieved in the twelve months following the closing of the acquisition on February 15, 2002. The aggregate purchase price was approximately \$36.0 million. The transaction was

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accounted for using the purchase method of accounting. The acquisition of Covalar will allow us to offer our customers a complete end-to-end software and related services solution from design through manufacturing, gain a broader customer base and relationships, and provide us with a highly skilled workforce.

On April 10, 2002, we acquired all of the outstanding capital stock of Defect & Yield Management, Inc., a Delaware corporation ("DYM"). DYM is engaged in the sale and support of fab floor defect data management software. In connection with the acquisition, we paid the shareholders \$2.0 million in cash, issued 967,260 shares of HPL common stock and agreed to assume stock options to purchase up to 82,740 shares of HPL's common stock. The total value of the transaction, including estimated transaction costs of \$400,000 was \$16.7 million. We may issue additional shares of common stock with a value of up to \$5.0 million, depending on the number of qualifying software maintenance contracts, as defined, which are entered into by DYM in the first year following the effective date of the acquisition. The acquisition will provide the Company access to an installed customer base in over 70 facilities worldwide.

Our standard payment terms for our customers provide for payment in 30 days. To date, we have not made concessions to secure payment of our receivables. It is frequently the case that our receivables are outstanding for more than 30 days. Our accounts receivable from international customers have been outstanding longer than our domestic receivables and we expect this to continue to be the case.

In each of the last three fiscal years, a relatively small number of customers have accounted for a large portion of our revenues, and the composition of our major customers has changed from year to year. This is because we currently have a limited sales force, our products have a lengthy sales cycle and we recognize relatively large license revenues upon entering into perpetual licensing agreements. We had three end-user customers that individually accounted for at least 10% of our revenues in the years ended March 31, 2002 and 2000 and we had four end-user customers that accounted for at least 10% of our revenues in the year ended March 31, 2001. In the aggregate, these customers accounted for 51%, 74% and 44% of our revenues in the years ended March 31, 2002, 2001 and 2000, respectively. Additionally, most of our international sales are from our Japanese distributor which represented 78% and 43% of our sales in the years ended March 31, 2002 and 2001, respectively. As we expand our sales and marketing activities and increase our sales force, we expect to gain a larger number of customers and experience less significant customer concentration.

## CRITICAL ACCOUNTING POLICIES

The discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect our reported assets, liabilities, revenues and expenses, and our related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to revenue recognition, goodwill and intangible assets and income taxes. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. Our estimates then form the basis of judgments about the carrying 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.

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We believe the following critical accounting policies and the related judgments and estimates significantly affect the preparation of our consolidated financial statements:

### **Revenue Recognition**

Revenue recognition rules are very complex, and certain judgments affect the application of our revenue policy. The amount and timing of our revenue is difficult to predict, and any shortfall in revenue or delay in recognizing revenue could cause our operating results to vary significantly from quarter to quarter. In addition to determining our results of operations for a given period, our revenue recognition determines the timing of certain expenses, such as commissions, royalties and other variable expenses.

We derive revenues principally from the sale of software license, software maintenance contracts and consulting services. We offer two types of licenses: perpetual and time-based. Perpetual licenses have no expiration date, while time-based licenses require renewal. Our software product licenses provide a narrowly defined subset of features for a given customer. The customer may acquire additional licenses to extend the functionality of our products as its technologies and facilities change or if it wishes to use additional features of our software for its production process. Our licenses usually limit the number of people who can use the software at a given time. Historically, most of our revenues have come from the sale of perpetual licenses, although we expect to derive more revenues from time-based licenses in the future.

Revenues from software licenses are generally recognized upon the execution of a binding agreement and delivery of the software, provided that: the fee is fixed or determinable; vendor-specific objective evidence exists to allocate a portion of the total license fee to any undelivered elements of the arrangement; collection is reasonably assured; and the agreement does not contain customer acceptance clauses. If customer acceptance clauses exist, revenues are recognized upon customer acceptance and all other revenue recognition criteria are met.

If the consulting or other services sold in connection with the software license are essential to the functionality of the software, we recognize revenue on either a percentage-of-completion or completed contract basis. For the percentage-of-completion method we recognize revenues using labor hours incurred as the measure of progress against the total labor hours estimated for completion of the project. We consider a project completed after all contractual obligations are met. At times, an unbilled accounts receivable balance can exist which comprises of revenue recognized in advance of contractual billings. We make provisions for estimated contract losses in the period in which the loss becomes probable and can be reasonably estimated. Estimates of total labor hours or expected losses on contracts are subject to judgment and actual amounts may differ significantly from those estimates.

For contracts with multiple obligations (e.g., deliverable and undeliverable products, post-contract support and other services), we allocate revenues to the undelivered element of the contract based on objective evidence of its fair value. This objective evidence is the sales price of the element when sold separately or the renewal rate specified in the agreement for licensing arrangements with terms of one year or greater that include post-contract customer support and software updates. We recognize revenues allocated to undelivered products when the criteria for software license revenues set forth above are met. Revenues from time-based software licenses are generally recognized ratably over the period of the licenses. Determining whether objective evidence of fair value exists is subject to judgment and resulting fair values used in determining the value of the undelivered elements is also subject to judgment and estimates.

Software maintenance revenues are recognized ratably over the term of the maintenance period, which is generally one year. Our software maintenance includes product maintenance updates, Internet-based technical support and telephone support. Revenues derived from our consulting services are recognized as the services are performed.

We also derive revenues from the sale of software licenses, maintenance and post-contract support services through our distributors. Revenues from sales made through our distributors which have return rights are recognized when the distributors have sold the software licenses or service to their customers. Revenues from maintenance and post-contract support services sold through our distributors are recognized ratably over the contract period.

Amounts invoiced to our customers in excess of recognized revenues are recorded as deferred revenues. The timing and amounts invoiced to customers can vary significantly depending on specific contract terms and can therefore have a significant impact on deferred revenues in any given period.

### **Goodwill and Intangible Assets**

Consideration paid in connection with acquisitions is required to be allocated to the acquired assets, including identifiable intangible assets, goodwill, and liabilities acquired. Acquired assets and liabilities are recorded based on our estimate of fair value, which requires significant judgment with respect to future cash flows and discount rates. For intangible assets, we are required to estimate the useful life of the asset and recognize its cost as an expense over the useful life. We use the straight-line method to expense long-lived assets, except goodwill, which results in an equal amount of expense in each period. We regularly evaluate acquired businesses for potential indicators of impairment of goodwill and intangible assets. Our judgments regarding the existence of impairment indicators are based on market conditions, operational performance of our acquired businesses and identification of reporting units. Future events could cause us to conclude that impairment indicators exist and that goodwill and other intangible assets associated with our acquired businesses are impaired. Beginning in the first quarter of 2003, the methodology for assessing potential impairments of intangibles will change based on new accounting rules issued by the Financial Accounting Standards Board (see recent accounting pronouncements) and it is not expected to have a material effect on our financial position or results of operations. Any resulting impairment loss in the future based on this policy could have a material adverse impact on our financial condition and results of operations.

### **Income Taxes**

We are required to estimate our income taxes in each of the jurisdictions in which we operate as part of the process of preparing our consolidated financial statements. This process involves us estimating our actual current tax exposure together with assessing temporary

differences resulting from differing treatment of items, such as deferred revenue, for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our net deferred tax assets will be recovered from future taxable income and to the extent we believe that recovery is not likely, we must establish a valuation allowance. While we have considered future taxable income in assessing the need for the valuation allowance, in the event we were to determine that we would be unable to realize our deferred tax assets in the future, an adjustment to the deferred tax asset would be made, decreasing income in the period in which such determination was made.

## RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 141, "Business Combinations." SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The provisions of SFAS No.141 have been adopted as of July 1, 2001 and did not have a significant impact on our consolidated financial statements.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets", which is required to be applied starting with fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, SFAS No. 142 includes provisions upon adoption for the classification of certain existing recognized intangibles as

goodwill, assessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. We will fully adopt SFAS No. 142 in the first quarter of fiscal 2003 and the adoption is not expected to have a material impact on our consolidated financial statements. We are applying the non-amortization provisions of SFAS No. 142 for any business combination consummated on or after July 1, 2001.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed, and requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. SFAS No. 144 will be effective for fiscal years beginning after December 15, 2001. We do not expect the adoption of SFAS No. 144 to have a material effect on our consolidated financial statements.

## RESULTS OF OPERATIONS

The following table sets forth statement of operations data for the periods indicated as a percentage of total revenues.

	Years ended March 31,		
	2002	2001	2000
<b>Revenues:</b>			
Software licenses	82%	81%	82%
Consulting services, maintenance and other	18%	19%	18%
<b>Total revenues</b>	<b>100%</b>	<b>100%</b>	<b>100%</b>
<b>Cost of revenues:</b>			
Software licenses	2%	1%	0%
Consulting services, maintenance and other	6%	7%	7%
<b>Total cost of revenues</b>	<b>8%</b>	<b>8%</b>	<b>7%</b>

Gross profit	92%	92%	93%
Operating expenses:			
Research and development	18%	25%	77%
Sales, general and administrative	27%	32%	85%
Stock-based compensation	9%	18%	16%
Amortization of intangible assets	1%	1%	4%
Total operating expenses	55%	76%	182%
Income (loss) from operations	37%	16%	(89%)

### Comparison of years ended March 31, 2002 and 2001

*Revenues.* Total revenues increased 177% or \$23.8 million to \$37.2 million in the year ended March 31, 2002, up from \$13.4 million in the year ended March 31, 2001. This increase was primarily driven by increases in software licenses and maintenance revenues, which we believe resulted from increased market acceptance of our products.

Software license revenue increased 178% or \$19.4 million to \$30.3 million in the year ended March 31, 2002, up from \$10.9 million in the year ended March 31, 2001. Approximately \$19.0 million was due to increased license revenue from the sale of software licenses for the *YIELDirector* family of products and related software modules and \$400,000 was due to a favorable arbitration ruling during the third quarter of 2002.

Consulting services, maintenance and other revenues increased 171% or \$4.3 million to \$6.8 million in the year ended March 31, 2002, up from \$2.5 million in the year ended March 31, 2001. This increase was due to an increase in maintenance fees from a greater number of customers, an increase in consulting services related to acquired companies and increased complementary hardware sales.

*Gross profit.* As a percentage of revenues, gross profit remained unchanged at 92% for the years ended March 31, 2002 and March 31, 2001. Gross profit has been and will continue to be affected by a variety of factors, the most important of which is the relative mix of revenues among software licenses, maintenance fees and consulting services. We expect gross profit levels to remain at approximately 90% for the year ending March 31, 2003.

*Research and development.* Research and development expenses represented 18% of revenues in the year ended March 31, 2002 compared to 25% of revenues in the year ended March 31, 2001. Actual costs increased to \$6.5 million for the year ended March 31, 2002, up from \$3.4 million for the year ended March 31, 2001. This increase is primarily attributable to the hiring of additional software engineers and technical staff and increases of headcount related to acquisitions completed during the year. Salaries and related benefits of research and development engineers represent the single largest component of our research and development expenses. With the planned ongoing expansion of our research and development efforts in the United States and internationally, we expect research and development costs to increase in future periods in absolute dollars but remain relatively stable as a percentage of revenue at approximately 20%.

*Sales, general and administrative.* Sales, general and administrative expenses for the year ended March 31, 2002 were \$10.0 million, or 27% of revenues, compared to \$4.3 million, or 32% of revenues in the year ended March 31, 2001. The increase in costs was primarily due to increases in staff and an increase in professional fees and the headcount increases related to acquisitions we completed during the year ended March 31, 2002. We anticipate that general and administrative expenses will increase in absolute terms in future periods as we continue to expand our operations as a public company. We also anticipate that sales and marketing expenses will increase in absolute dollars as we continue to expand our sales and marketing departments, target new customers for our technologies, further develop brand name recognition for our products and establish and grow our international sales and marketing offices.

*Stock-based compensation.* Stock-based compensation expense for the year ended March 31, 2002 increased to \$3.5 million, compared with \$2.4 million for the year ended March 31, 2001. Stock-based compensation expense in the year ended March 31, 2002 increased from the previous year primarily as a result of recording deferred compensation early in fiscal 2002 related to the issuance of stock options at less than their deemed fair market value. The cost of these options are being amortized on an accelerated basis to expense over the term of the options. Additionally, as a result of our acquisitions where we have recorded deferred compensation related to stock options assumed, we expect stock-based compensation expense in the near term to increase and then decrease in the future. Stock-based

compensation expense may increase in subsequent periods if we assume stock options in connection with other acquisitions.

*Amortization of intangible assets.* Amortization of intangible assets was \$294,000 in the year ended March 31, 2002, compared to \$137,000 in the year ended March 31, 2001. This increase in amortization resulted from the acquisitions of FabCentric and Covalar in the current year. We expect this amount to increase in the year ending March 31, 2003 as there will be a full year's amortization of the intangible assets acquired as well as amortization of the intangible assets acquired in connection with the acquisition of DYM in the first quarter of fiscal 2003.

*Interest income (expense) and other, net.* Interest income, net of interest and other expenses for the year ended March 31, 2002 was \$908,000, compared with net expense of \$190,000, for the year ended March 31, 2001. This increase was due to greater interest income from higher average balances of cash, cash equivalents and short-term investments generated from our initial public offering and cash flows provided by operations.

*Provision for income taxes.* Our effective tax rate for the year ended March 31, 2002 was 54% compared with 72.5% for the year ended March 31, 2001. The provision for income taxes for the years ended March 31, 2002 and 2001 is primarily affected by the non-deductibility for income tax purposes of stock-based compensation and the amortization of intangible assets. The effective rate for the years ended March 31, 2002 and 2001 was based on statutory federal and state tax rates net of the estimated realization of deferred tax assets. The increase in the tax provision of \$6.5 million to \$7.9 million in the year ended March 31, 2002 from \$1.4 million in the year ended March 31, 2001 was due to higher profits generated from our operations.

### **Comparison of years ended March 31, 2001 and 2000**

*Revenues.* Total revenues increased 262% to \$13.4 million for the year ended March 31, 2001, up from \$3.7 million for the year ended March 31, 2000. Of this increase, approximately 81% was due to a rise in software license revenues, primarily from sales of our YIELDirector platform, software modules and Standard Configurations first introduced for sale in the second half of the year ended March 31, 2000.

Product sales in the years ended March 31, 2001 and 2000 were highly concentrated, with 74% of total revenues in the year ended March 31, 2001 coming from four customers and 44% of total revenues in the year ended March 31, 2000 coming from three customers. The remainder of the increase in revenues was due to software maintenance contracts recognized ratably over the contract term and increased consulting activities.

*Gross profit.* As a percentage of revenues, gross profit remained relatively unchanged at 92% for the year ended March 31, 2001 compared to 93% for the year ended March 31, 2000. Gross profit has been affected by a variety of factors, the most important of which is the relative mix of revenues among software licenses, maintenance fees and consulting services.

*Research and development.* Research and development expenses represented 25% of revenues in the year ended March 31, 2001 compared to 77% of revenues in the year ended March 31, 2000. Actual costs increased to \$3.4 million for the year ended March 31, 2001 from \$2.9 million for the year ended March 31, 2000. This increase is primarily attributable to the hiring of additional software engineers and technical staff. Salaries and benefits of research and development engineers represent the single largest component of our research and development expenses.

*Sales, general and administrative.* Sales, general and administrative expenses for the year ended March 31, 2001 were \$4.3 million, or 32% of revenues, compared to \$3.2 million, or 85% of revenues

in the year ended March 31, 2000. The increase was primarily due to staff increases and professional fees in connection with our preparation for an initial public offering.

*Stock-based compensation.* Stock-based compensation expense increased to \$2.4 million in the year ended March 31, 2001 from \$580,000 in the year ended March 31, 2000. This increase was due to the issuance of stock options at less than their deemed fair market value and the release from escrow of shares issued in connection with the acquisition of Yield Management Associates in February 1999. As a result of this transaction, we recorded non-cash expenses of \$1.3 million and \$351,000 for the years ended March 31, 2001 and 2000, respectively. The stock-based compensation charges recorded in the year ended March 31, 2001 for the issuance of stock options will be amortized on an accelerated basis over the next four years.

*Amortization of intangible assets.* Amortization of intangible assets was \$137,000 in the year ended March 31, 2001. Amortization of intangible assets was \$148,000 in the year ended March 31, 2000. The amortization of intangibles remained relatively stable between periods.

*Interest income (expense) and other, net.* Interest expense declined to \$190,000 in the year ended March 31, 2001 from \$248,000 in the year ended March 31, 2000.

*Provision for income taxes.* Our effective tax rate for the years ended March 31, 2001 and 2000 was 72.5% and 0%, respectively. The provision for income taxes for the year ended March 31, 2001 reflects the non-deductibility for income tax purposes of stock-based compensation and amortization of intangible assets. The effective rate for the year ended March 31, 2001 is based on statutory federal and state tax rates net of the estimated realization of deferred tax assets. In the year ended March 31, 2000 we incurred an operating loss for which we have recorded a valuation allowance for the full amount of our net deferred tax assets, as the future realization of the tax benefit was not likely as of March 31, 2000.

## **LIQUIDITY AND CAPITAL RESOURCES**

Net cash provided by operating activities for the year ended March 31, 2002 was approximately \$4.6 million compared to \$2.0 million for the year ended March 31, 2001 and a use of \$1.7 million in the year ended March 31, 2000. Our cash flow provided by operations for the year ended March 31, 2002 was primarily attributed to our net income, adjusted for certain non-cash items including the tax benefit from stock options, depreciation and amortization, stock-based compensation, an increase in income tax payable, and offset primarily by an increase in accounts receivable and prepaid assets. Our positive cash flow from operations for the year ended March 31, 2001 was primarily attributed to our net income, adjusted for certain non-cash items including the depreciation and amortization and stock-based compensation, an increase in income tax payable, and offset primarily by an increase in accounts receivable and deferred revenue. Our negative cash flow from operations for the year ended March 31, 2000 was primary attributed to our net loss, an increase in accounts receivable, and offset primarily by an increase in accrued liabilities and deferred revenue. Our standard payment terms for our customers provide for payment in 30 days. Although our payment terms are stated in our customer agreements, our experience with certain customers is that they take longer to pay and that some payments from international customers are not received for up to 180 days.

Net cash used in investing activities was \$28.1 million for the year ended March 31, 2002 compared to \$870,000 for the year ended March 31, 2001 and \$48,000 for the year ended March 31, 2000. Our investing activities for the year ended March 31, 2002 consisted primarily of the acquisitions of Tyecin, FabCentric and Covalar, purchases of marketable securities, and equipment purchases. The investing activities for the year ended March 31, 2001 consisted primarily of the issuance of notes receivable of \$750,000.



Net cash provided by financing activities was \$68.7 million for the year ended March 31, 2002, primarily from our initial public offering completed in August 2001, and proceeds from exercise of stock options, partially offset by the repayment of notes payable and capital lease obligations. Net cash used in financing activities was \$272,000 for the year ended March 31, 2001, primarily from repayments of notes payable and capital lease obligations. Net cash provided by financing activities was \$1.6 million for the year ended March 31, 2000, primarily from the issuance of the convertible debenture.

We are currently not in compliance with certain non-financial covenants of the \$1.5 million secured convertible debenture issued by our subsidiary Heuristic Physics Laboratories, Inc. to Applied Materials, and as a result Applied Materials may declare all outstanding obligations under the debenture immediately due and payable. To date, the holder of the debenture has not demanded repayment of the debenture. If the Company repays the debenture, the debenture holder will forfeit its right to convert the debenture into shares of common stock.

Future payments due under debt, lease obligations, and an employee loan as of March 31, 2002 are as follows (in thousands):

Year Ending March 31,	Convertible Debenture(1)	Capital Lease Obligations(2)	Operating Leases	Employee Loan(3)	Total
2003	\$ 1,500	\$ 222	\$ 1,371	\$ 450	\$ 3,543
2004	-	198	1,223	-	1,421
2005	-	70	1,233	-	1,303
2006	-	20	930	-	950
2007	-	13	11	-	24
	\$ 1,500	\$ 523	\$ 4,768	\$ 450	\$ 7,241

(1) This debenture may be converted at any time at the option of the holder into our common stock at a conversion price of \$1.45 per share (see Note 7 of Notes to Consolidated Financial Statements).

(2) From 2003 to 2007, we will make interest payments totaling \$49,000 for capital leases obligations; this interest component is included in the commitment schedule above.

(3) As of May 2002, we have loaned the remaining balance of \$450,000 to the employee and the total outstanding note receivable is \$750,000 (see Note 10 of Notes to Consolidated Financial Statements).

In connection with the acquisition of Covalar, we have reserved an additional 600,000 shares of common stock to be issued to Covalar shareholders if certain revenue targets are achieved in the twelve months following the closing of the acquisition on February 15, 2002.

In connection with the acquisition of DYM, we may issue additional shares of common stock with a value of up to \$5.0 million, depending on the number of qualifying software maintenance contracts entered by DYM in the first year following the closing of the acquisition.

We believe our current cash and cash equivalent balances, our short-term investments, and cash flows we expect to generate from operations, will be sufficient to meet our capital requirements for at least the next twelve months. Our future capital requirements will depend on many factors, including the rate of revenue growth, profitability, spending on research and development programs, expansion of sales and marketing and administrative activities, introductions of new products and product enhancements, market acceptance of our products and acquisitions of other companies or technologies.

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**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

In the normal course of business, our financial position is subject to a variety of risks, including market risk associated with interest rate and foreign currency exchange movements. We regularly assess these risks and have established policies and business practices to protect against these and other exposures. As a result, we do not anticipate material potential losses in these areas.

### **Interest Rate Risk**

We are exposed to interest rate risk on our \$1.5 million convertible debenture and our investment portfolio which is primarily in fixed rate securities at March 31, 2002. We invest excess cash in debt instruments of the US Government and its agencies, and in high quality corporate issuers and, limit the amount of credit exposure to any one issuer. Changes in the fixed rate interest market would change the estimated value of our debenture. Our investments in fixed rate securities may have their fair market value adversely impacted due to a rise in interest rates. We believe that a change in long-term interest rates would not have a material effect on our business, financial condition results of operations or cash flow. Our cash and cash equivalents consist of cash and highly liquid money market instruments with original or remaining maturities of 90 days or less. Because of the short maturities of these instruments, a sudden change in market interest rates would not have a material impact on the fair value of the portfolio, but it may cause the amount of income we derive to vary significantly from period to period. A hypothetical 10% increase in interest rates would result in approximately \$109,000 decrease in the fair value of our available-for-sale securities as of March 31, 2002.

### **Foreign Exchange Risk**

Our sales are primarily denominated in US dollars and, as a result, we have relatively little exposure to foreign currency exchange risk with respect to revenues. Our sales through our Japanese subsidiaries, which represented approximately 4.5% of total revenues for the year ended March 31, 2002, are denominated in yen. A 10% adverse change in yen exchange rates would not have had material impact on revenues for the year ended March 31, 2002. Additionally, our exposure to foreign exchange rate fluctuations arises in part from intercompany accounts which can be denominated in the functional currency of the foreign subsidiary. As exchange rates vary when the accounts are translated, results may vary from expectations and adversely impact earnings. The effect of foreign exchange rate fluctuations for the fiscal 2002 was not material.

While our sales are generally denominated in US dollars, our international subsidiaries' books and records are maintained in the local currency. As a result, our financial statements are remeasured in US dollars using a combination of current and historical exchange rates. The functional currencies of our foreign subsidiaries are their local currencies. We translate certain assets and liabilities to US dollars at the current exchange rate as of the applicable balance sheet date. Revenues and expenses are translated at the average exchange rates prevailing during the period. Adjustments resulting from the translation of the foreign subsidiaries' financial statements are recorded in accumulated other comprehensive income (loss) in stockholders' equity.

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## **RISK FACTORS**

### **RISKS ASSOCIATED WITH OUR BUSINESS**

#### **There are significant barriers to widespread adoption of our yield-optimization products by the semiconductor industry.**

In order for our business to grow, we must overcome certain barriers to the adoption of our yield-optimization products by the semiconductor industry. Many semiconductor designers and manufacturers have in-house yield-management systems and may be reluctant to implement our software because they may believe that third-party tools will not incorporate their existing know-how and methodology. If participants in this industry reject using third-party software to optimize their yield, our growth would be impaired, which would negatively affect our results of operations and cause our business to fail. In addition, because our yield-optimization solutions are relatively new to the semiconductor industry and can be difficult to explain, intensive marketing and sales efforts will be necessary to educate prospective industry partners and customers regarding the uses and benefits of our technologies and software products. Accordingly, we cannot assure you that our

software products will gain acceptance at the level or in the time frame we anticipate. Such a failure to gain acceptance would have a material adverse effect on our business.

**The semiconductor industry has experienced downturns in the past and any future downturns could adversely affect our revenues and operating results.**

Our business depends in part on the economic health of our customers: IDMs, or integrated device manufacturers, fabless semiconductor companies, and semiconductor equipment OEMs, or original equipment manufacturers. The semiconductor industry is prone to periods of oversupply resulting in significantly reduced capital expenditures, and it is currently experiencing such a downturn. When the industry last experienced a slowdown in 1998, some semiconductor manufacturers postponed or canceled capital expenditures for previously planned expansions or new fabrication facility construction projects, resulting in a substantial decline in worldwide semiconductor capital expenditures.

Current conditions and future downturns could lead to another slowdown in growth that would have a similar effect on the willingness of semiconductor companies to purchase our yield-optimization products and services or to purchase equipment from semiconductor equipment OEMs that have embedded our software in their products. Significant downturns could materially and adversely affect our business and operating results. In addition, we expect to continue increasing our investment in engineering, research and development, and marketing, which limits our ability to reduce expenses during such downturns.

**In any particular period, we derive a substantial portion of our revenues from a small number of customers, and our revenues may decline significantly if any major customer cancels or delays a purchase of our products.**

In each of the years ended March 31, 2002, 2001, and 2000, customers that individually accounted for at least 10% of our revenues together represented 51%, 74% and 44% of our revenues, respectively, and in each of these years, there was substantial change among the companies that represented our largest customers. In the year ended March 31, 2002, sales to three end customers accounted for 19%, 18%, and 14%, respectively, of our revenues. The large percentage of revenues derived from a small group of customers has resulted from the relatively large license revenues we recognize upon entry into perpetual licensing agreements, from our current limited sales force, and from the lengthy sales cycle for our products. Because we derive most of our revenues from sales of perpetual licenses and because our existing customers' needs for additional products are based on intermittent events, such as the introduction of new technologies or processes, building of new facilities or the need to increase capacity of existing facilities, our largest customers change substantially from

period to period. Delays or failures in selling new licenses to existing or new customers would cause significant period-to-period changes in our operating results, which may result in our failure to meet market expectations. We may also incur significant expense and devote management attention to the pursuit of potentially significant license revenues, but ultimately fail to secure these revenues.

**We have a long and variable sales cycle, which can result in uncertainty and delays in generating additional revenues.**

Because our yield-optimization software and services are often unfamiliar to our prospective customers, it can take a significant amount of time and effort to explain the benefits of our products. For example, it generally takes at least six months after our first contact with a prospective customer before we start licensing our products to that customer. In addition, due to the nature of fabrication facility deployment and the extended time required to bring a fabrication facility to full capacity, capital expenditures vary greatly during this time. Accordingly, we may be unable to predict accurately the timing of any significant future sales of software licenses. We may also spend substantial time and management attention on potential licenses that are not consummated, thereby foregoing other opportunities.

**We must continually replace the revenues generated from the sale of perpetual licenses in order to maintain and grow our business.**

Over the past year, we have generated the bulk of our revenues from the sale of perpetual licenses. These licenses produce large amounts of revenues in the periods in which the license fees are recognized and are not necessarily indicative of a commensurate level of revenues

from the same customers in future periods. Our period-to-period growth will depend significantly on our ability to expand the number of users of our products within our customers' organizations, license additional software to our customers and attract new customers. We may not be successful in these sales efforts and, consequently, revenues in any future period may not match that of prior periods.

**Our operating results may fluctuate significantly and any failure to meet financial expectations may disappoint investors and could cause our stock price to decline.**

Historically, our quarterly operating results have fluctuated and we expect them to continue to fluctuate in the future due to a variety of factors, many of which are outside of our control. Because of our current limited sales force, the lengthy sales cycle of our products and the intermittent needs of customers, we derive our revenues primarily from a relatively small number of large transactions in any given operating period. Accordingly, the timing of large orders has significantly affected, and will continue to significantly affect, quarterly operating results. Factors that could cause our revenues and operating results to vary from period to period include:

large sales unevenly spaced over time;

timing of new products and product enhancements by us and our competitors;

the cyclical nature of the semiconductor industry;

changes in our customers' development schedules, expenditure levels and product support requirements; and

incurrence of sales and marketing and research and development expenses that may not generate revenues until subsequent quarters.

As a result, we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and may not be accurate indicators of future performance. These factors may

cause our operating results to be below market expectations in some future quarters, which could cause the market price of our stock to decline.

**We may not succeed in developing new products and our operating results may decline as a result.**

Our customers and competitors operate in rapidly evolving markets that are characterized by introduction of new technologies and more complex designs, shorter product life cycles and disaggregation of the industry into new subsectors. For example, ever-smaller geometries are being used in semiconductors and new materials are being employed to enhance performance. We must continually create new software and add features and functionality to our existing software products to keep pace with these changes in the semiconductor industry. Specifically, we need to focus our research and development to:

interface with new semiconductor-producing hardware and systems that others develop;

remain competitive with companies marketing third-party yield-management software and consulting services;

continue developing new software modules that are attractive to existing customers, many of which have purchased perpetual licenses and are under no ongoing obligation to make future purchases from us; and

attract new customers to our software.

Maintaining and capitalizing on our current competitive strengths will require us to invest heavily in research and development, marketing, and customer service and support. Although we intend to devote substantial expenditures to product development, we may not be able to create new products in a timely manner that adequately meet the needs of our existing and potential customers. A failure to do so would adversely affect our competitive position and would result in lower sales and a decline in our profitability.

**We may not be able to effectively compete against other companies, which could impair our growth and profitability.**

We target IDMs, fabless semiconductor companies, foundries and semiconductor equipment OEMS. The tools and systems against which our products and services most commonly compete are those that semiconductor companies have created in-house. In order to grow our business, we must convince these producers of the benefit of an outside solution. The third-party providers against whom we compete are, generally, divisions of larger semiconductor equipment OEMs, such as KLA-Tencor. These companies can compete on the basis of their greater financial, engineering and manufacturing resources, and their long-standing relationships with the same companies we are targeting. If we cannot compete successfully against these forms of competition, the growth of our business will be impaired.

In addition, a key part of our strategy is to gain competitive advantage by establishing YIELDirector, our proprietary system platform and integrated yield-optimization software, as the standard in the semiconductor industry. If we do not rapidly establish ourselves as the leading yield-optimization solution provider, we may not be able to grow fast enough to compete effectively with existing and future competitors.

Errors in our products or the failure of our products to conform to specifications could hurt our reputation and result in our customers demanding refunds or asserting claims against us for damages.

Because our software products are complex, they could contain errors or "bugs" that can be detected at any point in a product's lifecycle. We have a team dedicated to detecting errors in our products prior to their release in order to enable our software developers to remedy any such errors. In the past we have discovered errors in some of our products and have experienced delays in the delivery

of our products because of these errors. In addition, we have software engineers and developers who participate in the maintenance and support of our products and assist in detecting and remedying errors after our products are sold. On some occasions in the past, we have had to replace defective products that were already delivered. These delays and replacements have principally related to new product releases. Detection of any significant errors may result in:

the loss of, or delay in, market acceptance and sales of our products;

the delay or loss of revenues;

diversion of development resources;

injury to our reputation; or

increased maintenance and warranty costs.

**Any of these problems could harm our business and operating results.**

If our products fail to conform to specifications, customers could demand a refund for the purchase price or assert claims for damages. Liability claims could require us to spend significant time and money in litigation or to pay significant damages. Any such claims, whether or not successful, could seriously damage our reputation and our business.

**We may have difficulty sustaining profitability and may experience losses in the future.**

The year ended March 31, 2001 was our first profitable year since we shifted the focus of our business to yield-optimization software and services from our prior focus on automated test equipment. In order to sustain profitability, we will need to continue to generate new sales while controlling our costs. We expect to increase the size of our company in the next twelve months, and we may not be able to successfully generate enough revenues to remain profitable with this growth. We anticipate that our expenses will increase in the next twelve months as we:

increase our direct sales and marketing personnel and activities;

develop our technology, expand our existing product lines and create additional software modules for our products;

develop additional strategic alliances with third-party providers of semiconductor design, fabrication and test solutions; and

implement additional internal systems, develop additional infrastructure and hire additional management.

Any failure to increase our revenues and control costs as we implement our product and distribution strategies would harm our profitability and would likely negatively affect the market price of our common stock.

**Our limited operating history selling our software products makes our business difficult to evaluate.**

Because we are in the early stages of our development as a provider of yield-optimizing software, it may be difficult to evaluate our business operations and prospects. Past revenues and sales figures may be a poor indicator of future performance. In addition, we have only sold our current product line for approximately three years. This makes it more difficult for us to plan for the further development of our business than if we had a more mature business line.

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**If we are unable to effectively manage our growth, our financial and managerial resources may be stressed and our business may be harmed.**

If we cannot manage our growth, our financial condition and operating results could be seriously harmed. We have increased our workforce over the last 12 months and expect to continue adding employees over the next 12 months, primarily in research and development and sales and marketing. We expect this growth to place significant strain on our managerial and financial resources, as well as on our limited financial and management controls, reporting systems and procedures. Any future growth will require us to continue to implement and improve operational, financial and management information and control systems on a timely basis, and to maintain effective cost controls. Since our growth has occurred over a limited time period, we cannot fully assess our ability to continue managing our growth in the future. Our inability to manage any future growth effectively may be harmful to revenues and profitability.

**Any acquisitions we make could disrupt our business and harm our financial condition.**

We completed three acquisitions in fiscal 2002 and one additional acquisition in the first quarter of fiscal 2003. We may attempt to acquire additional businesses or technologies that we believe fit strategically with our business. Although we have not experienced significant operational difficulties in connection with our prior acquisitions, these acquisitions were of small companies and because these acquisitions were recently completed, we are still in the process of integrating operations. Future acquisitions may result in unforeseen operating difficulties and expenditures, and may require significant management attention that would otherwise be available for ongoing business and product development. Since we will not be able to accurately predict these difficulties and expenditures, it is possible that these costs will outweigh the value we realize from a future acquisition. In addition to the risks that we would face in integrating any new acquisitions, we could face the following risks:

we could realize substantial acquisition-related expenses, which would reduce our net income in future years;

we could lose key employees and customers as a result of changes in management; and

our investigation of potential acquisition candidates might not reveal problems and liabilities associated with the businesses, technologies or products that we acquire.

In addition, if we conduct acquisitions using convertible debt or equity securities, the increased number of shares could result in lower earnings per share.

**We rely on the services of certain key personnel, and those persons' knowledge of our business and technical expertise would be difficult to replace.**

Our products and technologies are complex and we are substantially dependent upon the continued service of our existing managerial and senior engineering personnel, including Y. David Lepejian, our President and Chief Executive Officer. We do not have employment agreements with many of our executive officers and our key man life insurance on Mr. Lepejian is limited to \$2.7 million. The loss of any of our key employees could adversely affect our business and slow our product development processes or sales and marketing efforts.

A failure to effectively compete for, recruit and retain a significant number of technical and sales and marketing personnel would hinder our research and development and marketing efforts.

Because of the complexity of our products and technologies, there is a limited number of people who have the required skill, experience and training to qualify for employment by us. The market for these employees is characterized by intense competition, as well as a high level of employee mobility, which makes it particularly difficult to attract and retain the qualified technical personnel we require. If

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we are unable to recruit and retain a sufficient number of technical personnel, we may not be able to complete development of, or upgrade or enhance, our products in a timely manner.

The expansion of our sales and marketing department will also require the hiring and retention of personnel for whom there is a high demand. We plan to hire additional sales personnel, but competition for qualified sales people is intense, and we might not be able to hire a sufficient number of qualified sales people. If we are unable to recruit and retain a sufficient number of sales and marketing personnel, we may not be able to increase market awareness of our products and generate sales of our products as quickly as our investors and analysts might hope or expect.

## RISKS RELATED TO OUR INTERNATIONAL OPERATIONS

### **Our business could be harmed by political or economic instability in the Republic of Armenia.**

Our software products are largely developed, produced, delivered and supported from our facilities in the Republic of Armenia. Armenian employees participate in our direct sales and marketing efforts. Changes in the political or economic conditions in Armenia and the surrounding region, such as fluctuations in exchange rates, the imposition of currency transfer restrictions or limitations, or the adoption of burdensome trade or tax policies, procedures, rules, regulations or tariffs, could adversely affect our ability to develop new products and take advantage of Armenia's low labor and production costs, and to otherwise conduct business effectively in Armenia.

Armenia voted for independence in 1991 and adopted its current constitution in 1995. Laws protecting property (including intellectual property) are not well established and may be difficult to enforce. In recent years, Armenia has suffered significant political and economic instability. Any future political and economic instability could interfere with our ability to retain or recruit employees, significantly increase the cost of our operations, or result in regulatory restrictions on our business, making it difficult for us to maintain our business in Armenia or disrupting our Armenian operations. Any significant increase in the costs of our Armenian operations (whether due to inflation, imposition of additional taxes or other causes) would diminish, and could eliminate their current cost-advantages. Furthermore, we cannot assure you that restrictive foreign-relations laws or policies on the part of Armenia or the United States will not constrain our ability to operate effectively in both countries. If we lose or choose to terminate any part of our Armenian operation, replacements could be costly and we could experience delays in our product development, thereby harming our competitive position and adversely affecting our results of operations.

### **Our expansion into international markets may result in higher costs and could reduce our operating margins due to the higher costs of international sales.**

Our current strategy for growth includes further expansion in Asia, Europe, and other international markets. To effectively further this strategy, we must find additional partners to sell our products in international markets and expand our direct international sales presence. We would likely incur higher sales costs by expanding our direct sales staff abroad, but we might not realize corresponding increases in revenues or profitability. Furthermore, we may be forced to share sales revenues with distributors or other sales partners abroad in order to successfully penetrate foreign markets. Even if we successfully expand our direct and indirect international sales efforts, we cannot be certain that we will be able to create or increase international market penetration or demand for our products.

### **Problems with international business operations could adversely affect our sales.**

Sales to customers located outside the United States accounted for approximately 92%, 48% and 13% of our revenues in the years ended March 31, 2002, 2001 and 2000, respectively. We anticipate that sales to customers located outside the United States will represent a significant portion of our total

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revenues in future periods. In addition, many of our customers rely on third-party foundries operating outside of the United States. Accordingly, our operations and revenues are subject to a number of risks associated with foreign commerce, including the following:

managing foreign distributors;

staffing and managing foreign branch offices;

political and economic instability abroad;



foreign currency exchange fluctuations;

changes in tax laws and tariffs;

timing and availability of export licenses;

inadequate protection of intellectual property rights in some countries; and

obtaining governmental approvals for certain technologies.

Any of these factors could result in decreased sales to international customers and domestic customers that use foreign fabrication facilities.

Our accounts receivable from international customers are generally outstanding longer than our domestic receivables and, as a result, we may need a proportionately greater amount of working capital to support our international sales.

## **INTELLECTUAL PROPERTY-RELATED RISKS**

**Our success depends in part on our ability to protect our intellectual property, and any inability to do so could cause our business material harm.**

Our success depends in significant part on our intellectual property. While we have attempted to protect our intellectual property through patents, copyrights, or the maintenance of trade secrets, there can be no assurance that these measures will successfully protect our technology or that competitors will not be able to develop similar technology independently. It is possible, for example, that the claims we are allowed on any of our patents will not be sufficiently broad to protect our technology. In addition, patents issued to us could be challenged, invalidated or circumvented and the rights granted under those patents might not provide us with any significant competitive advantage. We have not attempted to secure patent protection in foreign countries, and the laws of some foreign countries do not protect our intellectual property as effectively as the laws of the United States. Also, our source code developed in Armenia may not receive the same copyright protection that it would receive if it was developed in the United States. As we increase our international presence, we expect that it will become more difficult to monitor the development of competing products that may infringe on our rights as well as unauthorized use of our products.

**Our operating results would suffer if we were subject to a protracted intellectual property infringement claim or one with a significant damages award.**

Litigation regarding intellectual property rights frequently occurs in the software industry. We expect we will be subject to infringement claims as the number of competitors in our industry segment grows. While we are unaware of any claims that our products infringe on the intellectual property rights of others, such claims may arise in the future. Regardless whether these claims have merit, they could:

be costly to defend;

divert senior management's time, attention and resources;

cause product shipment delays; and

require us to enter into costly licensing or royalty arrangements.

Any of these potential results of intellectual property infringement claims could limit our ability to maintain our business and negatively affect our operating results.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Index to Consolidated Financial Statements

Consolidated Financial Statements:

Report of Independent Accountants	36
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Consolidated Statements of Cash Flows for each of the three years in the period ended March 31, 2002	39
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Financial Statement Schedules:

All schedules are omitted because they are not applicable or the required Information is shown in the Consolidated Financial Statements or Notes thereto.

Supplementary Financial Data:

Quarterly Financial Data (unaudited) for the two years ended March 31, 2002	60
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Report of Independent Accountants

To the Board of Directors and  
Stockholders of HPL Technologies, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of HPL Technologies, Inc. and its subsidiaries at March 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended March 31, 2002 in conformity with accounting principles generally accepted in the United States of America. 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 of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit 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.

/s/ PricewaterhouseCoopers LLP

San Jose, California

May 7, 2002

**HPL Technologies, Inc.**  
**Consolidated Statements of Operations**  
*(In thousands, except per share amounts)*

	Years ended March 31,		
	2002	2001	2000
<b>Revenues:</b>			
Software licenses	\$ 30,343	\$ 10,908	\$ 3,039
Consulting services, maintenance and other	6,811	2,511	665
<b>Total revenues</b>	<b>37,154</b>	<b>13,419</b>	<b>3,704</b>
<b>Cost of revenues:</b>			
Software licenses	802	133	9
Consulting services, maintenance and other (1)	2,255	916	259
<b>Total cost of revenues</b>	<b>3,057</b>	<b>1,049</b>	<b>268</b>
<b>Gross profit</b>	<b>34,097</b>	<b>12,370</b>	<b>3,436</b>
<b>Operating expenses:</b>			
Research and development (1)	6,534	3,381	2,851
Sales, general and administrative (1)	9,968	4,329	3,155
Stock-based compensation	3,547	2,369	580
Amortization of intangible assets	294	137	148
<b>Total operating expenses</b>	<b>20,343</b>	<b>10,216</b>	<b>6,734</b>
<b>Income (loss) from operations</b>	<b>13,754</b>	<b>2,154</b>	<b>(3,298)</b>
<b>Interest income (expense) and other, net</b>	<b>908</b>	<b>(190)</b>	<b>(248)</b>
<b>Income (loss) before income taxes</b>	<b>14,662</b>	<b>1,964</b>	<b>(3,546)</b>
<b>Provision for income taxes</b>	<b>7,918</b>	<b>1,423</b>	<b>–</b>
<b>Net income (loss)</b>	<b>\$ 6,744</b>	<b>\$ 541</b>	<b>\$ (3,546)</b>
<b>Net income (loss) per share:</b>			
Basic	\$ 0.28	\$ 0.03	\$ (0.21)

Diluted	\$ 0.21	\$ 0.02	\$ (0.21)
Shares used in per share calculations:			
Basic	24,038	17,496	17,068
Diluted	32,853	27,831	17,068

(1) Excludes the following stock-based compensation charges:

Cost of revenues	\$ 39	\$ 60	\$ 2
Research and development	692	296	96
Sales, general and administrative	2,816	2,013	482
	\$ 3,547	\$ 2,369	\$ 580

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

**HPL Technologies, Inc.**  
**Consolidated Balance Sheets**  
*(In thousands, except per share data)*

	March 31,	
	2002	2001
<b>ASSETS</b>		
<i>Current assets:</i>		
Cash and cash equivalents	\$ 45,821	\$ 989
Short-term investments	14,311	-
Accounts receivable, net of allowances of \$524 and \$163, respectively	16,475	4,828
Unbilled accounts receivable	783	-
Prepaid expenses and other current assets	2,179	971
Total current assets	79,569	6,788
Property and equipment, net	3,691	478
Goodwill	42,904	-
Intangible assets, net	2,701	32
Other assets	2,334	206
<b>Total Assets</b>	<b>\$ 131,199</b>	<b>\$ 7,504</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<i>Current liabilities:</i>		
Accounts payable	\$ 2,468	\$ 415
Accrued liabilities	2,613	1,045
Income tax payable	2,743	1,552
Deferred revenue	2,574	2,407

Capital lease obligations—current portion	194	62
Convertible debenture	1,500	1,500
<b>Total current liabilities</b>	<b>12,092</b>	<b>6,981</b>
Capital lease obligations—net of current portion	280	95
Note payable	—	200
Other liabilities	1,857	—
<b>Total liabilities</b>	<b>14,229</b>	<b>7,276</b>
<b>Commitments (Note 8)</b>		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.001 par value, 10,000 shares authorized, no shares issued and outstanding at March 31, 2002 and 2001	—	—
Common stock, \$0.001 par value; 75,000 shares authorized; 29,400 and 17,828 shares issued and outstanding at March 31, 2002 and 2001	29	18
Additional paid-in capital	118,706	5,715
Deferred stock-based compensation	(4,017)	(1,512)
Retained earnings (accumulated deficit)	2,751	(3,993)
Accumulated other comprehensive loss	(499)	—
<b>Total stockholders' equity</b>	<b>116,970</b>	<b>228</b>
<b>Total Liabilities and Stockholders' Equity</b>	<b>\$ 131,199</b>	<b>\$ 7,504</b>

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

**HPL Technologies, Inc.**  
**Consolidated Statements of Cash Flows**  
(In thousands)

	Years ended March 31,		
	2002	2001	2000
<b>Cash flows from operating activities:</b>			
Net income (loss)	\$ 6,744	\$ 541	\$ (3,546)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	904	463	456
Allowance for doubtful accounts	361	163	—
Accreted interest expense	25	70	99
Deferred taxes	(46)	(129)	—
Tax benefit from stock options	6,337	—	—
Stock-based compensation	3,547	2,369	580
Loss on disposal of property and equipment	—	92	—
Changes in assets and liabilities, net of effects from acquisitions:			

Accounts receivable	(10,715)	(1,616)	(3,185)
Unbilled accounts receivable	(393)	–	–
Prepaid expenses and other current assets	(1,696)	166	(140)
Other assets	(523)	–	(10)
Accounts payable	(363)	152	(202)
Accrued liabilities	799	(679)	1,273
Income taxes payable	1,191	1,552	–
Deferred revenue	(1,537)	(1,191)	2,969
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided by (used in) operating activities	4,635	1,953	(1,706)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Cash flows from investing activities:</b>			
Acquisition of property and equipment	(1,302)	(120)	(48)
Issuance of notes receivable	(3,045)	(750)	–
Repayment of notes receivable	2,745	–	–
Acquisitions, net of cash acquired	(12,095)	–	–
Purchases of marketable securities	(14,360)	–	–
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash used in investing activities	(28,057)	(870)	(48)
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Cash flows from financing activities:</b>			
Proceeds from issuance of notes payable and line of credit	84	–	595
Repayments of notes payable and line of credit	(284)	(220)	(175)
Proceeds from issuance of convertible debenture	–	–	1,500
Issuance (redemption) of common stock	69,048	45	(244)
Principal payments on capital lease obligations	(144)	(97)	(76)
	<u>          </u>	<u>          </u>	<u>          </u>
Net cash provided by (used in) financing activities	68,704	(272)	1,600
	<u>          </u>	<u>          </u>	<u>          </u>
Effect of exchange rate changes on cash and cash equivalents	(450)	–	–
	<u>          </u>	<u>          </u>	<u>          </u>
Net increase (decrease) in cash and cash equivalents	44,832	811	(154)
Cash and cash equivalents at beginning of period	989	178	332
	<u>          </u>	<u>          </u>	<u>          </u>
Cash and cash equivalents at end of period	\$ 45,821	\$ 989	\$ 178
	<u>          </u>	<u>          </u>	<u>          </u>
<b>Supplemental disclosures of cash flow information:</b>			
Interest paid	\$ 202	\$ 147	\$ 110
Income taxes paid	\$ 793	\$ –	\$ –
Acquisition of property and equipment under capital lease obligations	\$ 461	\$ –	\$ 173
Issuance of common stock and options assumed in connection with acquisitions	\$ 33,592	\$ –	\$ 61

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

	Common stock		Additional paid-in capital	Deferred stock-based Compensation	Retained earnings (accumulated deficit)	Accumulated other comprehensive loss	Total stockholders' equity (deficit)
	Shares	Amount					
Balances as of March 31, 1999	16,854	\$ 17	\$ 995	\$ (48)	\$ (771)	\$ -	\$ 193
Issuance of stock options to employees	-	-	1,085	(1,085)	-	-	-
Issuance of stock options to non-employees	-	-	47	(47)	-	-	-
Stock-based compensation	-	-	-	580	-	-	580
Issuance of warrants	-	-	229	-	-	-	229
Issuance of common stock in connection with SDT acquisition	517	1	60	-	-	-	61
Escrow release of stock-based compensation shares	-	-	326	(326)	-	-	-
Redemption of common stock	(128)	(1)	(26)	-	(217)	-	(244)
Net loss	-	-	-	-	(3,546)	-	(3,546)
Balances as of March 31, 2000	17,243	17	2,716	(926)	(4,534)	-	(2,727)
Issuance of common stock upon exercise of stock options	585	1	44	-	-	-	45
Issuance of stock options to employees	-	-	1,683	(1,683)	-	-	-
Escrow release of stock-based compensation shares	-	-	1,272	(1,272)	-	-	-
Stock-based compensation	-	-	-	2,369	-	-	2,369
Net income	-	-	-	-	541	-	541
Balances as of March 31, 2001	17,828	18	5,715	(1,512)	(3,993)	-	228
Components of comprehensive income:							
Net income	-	-	-	-	6,744	-	6,744
Unrealized loss on available for sale securities, net of tax	-	-	-	-	-	(49)	(49)
Foreign currency translation adjustment	-	-	-	-	-	(450)	(450)
Total comprehensive income							6,245
Issuance of stock options to employees	-	-	3,863	(3,863)	-	-	-
Issuance of stock options to non-employees	-	-	162	-	-	-	162
Stock-based compensation	-	-	-	3,385	-	-	3,385
Issuance of common stock in public offering and exercise of options	9,387	9	69,039	-	-	-	69,048
Issuance of common stock and options assumed in connection with acquisitions	2,185	2	33,590	(2,027)	-	-	31,565
Tax benefit from exercise of stock options	-	-	6,337	-	-	-	6,337

Balances as of March 31, 2002	29,400	\$	29	\$	118,706	\$	(4,017)	\$	2,751	\$	(499)	\$	116,970
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The accompanying notes are an integral part of these consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1. NATURE OF OPERATIONS

HPL Technologies, Inc. ("HPL" or the "Company") is engaged in the sale, support and providing of services related to the yield optimization software it designs for companies involved in the design, fabrication and testing of semiconductors and flat panel displays. The Company also provides training and services in the methodologies and applications of integrated yield optimization techniques.

Prior to the reincorporation in July 2001, the Company, a Delaware corporation, principally conducted business as Heuristic Physics Laboratories, Inc. ("HPLI"). Through the merger of a wholly-owned subsidiary of HPL with HPLI, a California corporation formed in June 1989, HPLI became a wholly-owned subsidiary of the Company. HPL issued 1.7 shares for each outstanding share of common stock of HPLI exchanged in the merger. HPLI continues to do business as a wholly-owned subsidiary of the Company. This merger has been accounted for in a manner similar to a pooling of interests.

The consolidated financial statements for prior years have been retroactively adjusted to reflect the merger and stock conversion.

### NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Principles of consolidation

The accompanying consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries after the elimination of intercompany balances and transactions.

#### Reclassifications

Certain prior year balances have been reclassified to conform to the current year's presentation.

#### Use of estimates

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the financial statements. These estimates may affect the amounts of assets and liabilities reported in the balance sheet, the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expense during the periods presented. Actual amounts may differ from those estimates.

#### Revenue recognition

The Company recognizes revenue in accordance with the provisions of Statement of Position ("SOP") 97-2, "Software Revenue Recognition," as amended by SOP 98-4, SOP 98-9 and Staff Accounting Bulletin No. 101, "Revenue Recognition in Financial Statements" issued by the Securities and Exchange Commission. The Company's revenues are primarily derived from three sources: (i) software license revenue, derived primarily from sales to end users and original equipment manufacturers on a per installation basis; (ii) maintenance revenue,



derived primarily from providing post-contract customer support and software updates to end users; and (iii) consulting services revenues derived from providing training and consulting services to end users.

If the consulting or other services sold in connection with a software license are essential to the functionality of the software, the Company recognizes revenue on either a percentage-of-completion or completed contract basis. For the percentage-of-completion method, the Company recognizes revenues using labor hours incurred as the measure of progress against the total labor hours estimated for completion. The Company considers a project completed after all contractual obligations are met. Unbilled accounts receivable comprises revenue recognized in advance of contractual billings.

Provisions for estimated contract losses are recognized in the period in which the loss becomes probable and can be reasonably estimated. When the services sold are not essential to the functionality of the software, the Company recognizes revenues from software licenses upon delivery of the software and execution of a binding agreement with the customer, provided that the fee is fixed or determinable, collection is reasonably assured and there are no customer acceptance clauses. When customer acceptance clauses exist, revenues are recognized upon customer acceptance.

For contracts with multiple obligations (e.g., deliverable and undeliverable products, post-contract support and other services), the Company allocates revenues to the undelivered element of the contract based on objective evidence of its fair value. This objective evidence is the sales price of the element when sold separately or the renewal rate specified in the agreement for licensing arrangements with terms of one year or more that include post-contract customer support and software updates. The Company recognizes revenues allocated to undelivered products when all other of the criteria for revenue recognition has been met.

Revenues for time-based software licenses for periods of one year or less are recognized ratably over the term of the contract. When the contract term is greater than one year and there is a stated renewal rate, which is substantive, in the arrangement for maintenance and post-contract support services, the Company recognizes the license fee upon delivery of the software assuming all other revenue recognition criteria have been met.

Revenues from maintenance and post-contract support services are recognized ratably over the contractual period. Payments for maintenance and support services are generally made in advance and are non-refundable. Revenues from training and consulting services are recognized as the related services are performed. Customer advances and billed amounts due from customers in excess of revenue recognized are recorded as deferred revenue.

The Company also derives revenues from the sale of its software licenses, maintenance and post-contract support services through distributors. Revenues from sales made through distributors which have return rights are recognized when the distributors have sold the software licenses or service to their customers. Revenues from maintenance and post-contract support services sold through distributors are recognized ratably over the contractual period.

Deferred revenue includes advance payments received for maintenance and support services and license revenues received or due under the terms of the contracts for which customer acceptance has not been received.

### **Cost of revenues**

Cost of revenues consists primarily of expenses directly related to the cost of media on which a product is delivered, third party software royalties, product fulfillment costs, and direct customer service, consulting and support costs such as salaries and related expenses.

### **Software development costs**

Costs related to research, design and development of software products are generally expensed as incurred. Software development costs are capitalized beginning when a product's technological feasibility has been established through the time of general release of the product.

Based on the Company's product development process, technological feasibility is established upon the completion of a working model. Costs eligible for capitalization, incurred after achieving technological feasibility and before general release of its product, were not material in the years ended March 31, 2002, 2001 and 2000. Accordingly, all software development costs have been charged to research and development expense in the accompanying consolidated statements of operations.

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### **Cash, cash equivalents and short-term investments**

The Company invests its excess cash in debt instruments of the US Government and its agencies and in high-quality corporate issuers. The Company considers all highly liquid investments with an original or remaining maturity of three months or less at the date of purchase to be cash equivalents. Short-term investments are classified as securities available-for-sale and are reported at fair value based on quoted market prices as of the balance sheet date. Realized gains or losses and declines in value judged to be other than temporary, if any, are determined on the specific identification method and are reflected in other income or loss. Net unrealized gains or losses, net of tax, are recorded directly in stockholders' equity.

### **Property and equipment**

Property and equipment are stated at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets, as follows:

Computers and equipment	3 years
Furniture, fixtures and other	3 to 7 years

Computers and equipment acquired under capital leases are amortized over the shorter of the lease term or the useful life of the asset. Leasehold improvements are amortized using the straight-line method over the shorter of the remaining lease term or the estimated useful life of the improvement. Repair and maintenance costs are expensed as incurred. When property and equipment are retired or otherwise disposed of, the cost and accumulated depreciation are relieved from the accounts and the net gain or loss is included in the determination of income or loss.

Depreciation expense totaled \$610,000, \$326,000 and \$308,000 for the years ended March 31, 2002, 2001, and 2000, respectively.

### **Goodwill and intangible assets**

Goodwill and intangible assets are stated at cost less accumulated amortization which is recognized using the straight line method over the estimated useful life. Management periodically evaluates long-lived assets for impairment. Goodwill related to business combinations consummated on or after July 1, 2001 is not amortized.

Intangible assets acquired in business combinations consist primarily of purchased technology and customer backlog and are being amortized on a straight-line basis over their estimated useful life which ranges from six months to three years. Amortization expense totaled \$294,000, \$137,000 and \$148,000 for the years ended March 31, 2002, 2001 and 2000, respectively.

### **Long-lived assets**

The Company monitors events and changes in circumstances that could indicate the carrying amounts of long-lived assets may not be recoverable. When such events or changes in circumstances are present, the Company assesses the recoverability of long-lived assets by determining whether the carrying value of the assets will be recovered through non-discounted expected future cash flows. If the 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.

## Foreign currency translations

The functional currency for the Company's international subsidiaries are the local currencies. These international subsidiaries' financial statements are translated to United States dollars using period-end rates of exchange for assets and liabilities, and the average rates of exchange for the year

for revenues and expenses. Translation gains (losses) are recorded in accumulated other comprehensive income (loss) in stockholders' equity. Net gains and losses resulting from foreign exchange transactions are included in other income (loss), net and were not significant in any of the periods presented.

## Income taxes

Deferred tax assets and liabilities are recognized for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on temporary differences between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

## Advertising expense

Advertising costs are included in sales, general and administrative expenses and are expensed as incurred. Advertising expense totaled \$105,000, \$61,000 and \$21,000 for the years ended March 31, 2002, 2001 and 2000, respectively.

## Stock-based compensation

The Company accounts for its employee stock option plans using the intrinsic value method described in Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" and related interpretations. Under APB Opinion No. 25, deferred stock compensation is recorded for the difference, if any, between an option's exercise price and the fair value of the underlying common stock on the grant date of the option. As permitted by Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting for Stock-Based Compensation," the Company has adopted the "disclosure only" alternative described in SFAS No. 123 for its employee stock plans.

The Company accounts for stock issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force Consensus ("EITF") No. 96-18 "Accounting for Equity Instruments that Are Issued to Other than Employees For Acquiring, or in Conjunction with Selling, Goods or Services." Under SFAS No. 123 and EITF No. 96-18, stock options and warrants issued to non-employees are accounted for at their fair value calculated using the Black-Scholes option pricing model.

Compensation expense resulting from employee and non-employee stock options are amortized to expense using an accelerated approach over the term of the options in accordance with Financial Accounting Standards Board Interpretation ("FIN") No. 28, "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans."

## Concentration of credit risk

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist principally of cash, cash equivalents and short-term investments and accounts receivable. Cash, cash equivalents and short-term investments are managed by three financial institutions that management believes are credit worthy.

The Company performs ongoing credit evaluations of its customers' financial condition, generally requires no collateral from its customers and maintains allowances for potential credit losses.

At March 31, 2002, accounts receivable from the Company's Japanese distributor accounted for 90% of accounts receivable. At March 31, 2001, the Company's Japanese distributor and a domestic customer accounted for 80% and 12% of accounts receivable, respectively.

### Accumulated other comprehensive income (loss)

Accumulated other comprehensive income (loss) consists of gains and losses that are not recorded in the statements of operations but instead are recorded directly to stockholders' equity. The Company's components of accumulated other comprehensive income (loss) include net unrealized losses on available-for-sale securities, net of tax, and the cumulative foreign currency translation adjustment.

### Net income (loss) per share

Basic and diluted net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of shares of common stock outstanding during the period, less shares outstanding that are subject to repurchase. The calculation of diluted net income (loss) per share excludes shares of potential common stock if their effect is antidilutive. Potential common stock consists of shares of common stock that are incremental common shares issuable upon the exercise of stock options and warrants, computed using the treasury stock method, and shares issuable upon conversion of the convertible debenture, computed using the if-converted method. The following table presents the calculation of net income (loss) per common share—basic and diluted (in thousands, except per share information):

	Years ended March 31,		
	2002	2001	2000
<b>Numerator:</b>			
Net income (loss)	\$ 6,744	\$ 541	\$ (3,546)
Adjustments for elimination of interest expense on assumed conversion of convertible debenture	76	73	—
Net income (loss)	<u>\$ 6,820</u>	<u>\$ 614</u>	<u>\$ (3,546)</u>
<b>Denominator:</b>			
Weighted average common shares outstanding-basic	24,038	17,496	17,068
Adjustments for dilutive stock options	7,662	9,128	—
Adjustments for warrants	121	175	—
Adjustments for assumed conversion of convertible debenture	1,032	1,032	—
Weighted average common shares outstanding-diluted	<u>32,853</u>	<u>27,831</u>	<u>17,068</u>
Net income (loss) per common share—basic	\$ 0.28	\$ 0.03	\$ (0.21)
Net income (loss) per common share—diluted	\$ 0.21	\$ 0.02	\$ (0.21)

The shares excluded from the calculation of diluted net income (loss) per share are detailed in the table below (in thousands):

	March 31,		
	2002	2001	2000
Outstanding stock options	120	—	9,542
Convertible debenture	—	—	1,032
Shares issuable under warrants	—	—	221

Shares held in escrow	-	-	170
Contingent shares issuable to former Covalar shareholders	600	-	-
	<hr/>	<hr/>	<hr/>
Total	720	-	10,965
	<hr/>	<hr/>	<hr/>

### Recent accounting pronouncements

In July 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 141, "Business Combinations." SFAS No. 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The provisions of SFAS No.141 have been adopted as of July 1, 2001 and did not have a significant impact on the Company's consolidated financial statements.

In July 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets", which is required to be applied starting with fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, SFAS No. 142 includes provisions upon adoption for the classification of certain existing recognized intangibles as goodwill, assessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. SFAS No. 142 will be fully adopted by the Company in the first quarter of fiscal 2003 and is not expected to have a material impact on its consolidated financial statements. The Company is applying the non-amortization provisions of SFAS No. 142 for any business combination consummated on or after July 1, 2001.

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses financial accounting and reporting for the impairment of long-lived assets and for long-lived assets to be disposed, and requires that one accounting model be used for long-lived assets to be disposed of by sale, whether previously held and used or newly acquired. SFAS No. 144 will be effective for fiscal years beginning after December 15, 2001. The Company does not expect the adoption of SFAS No. 144 to have a material effect on its consolidated financial statements.

### NOTE 3. BUSINESS COMBINATIONS

#### Semiconductor Diagnosis & Test Corp.

Between January 1994 and April 1997, the Company acquired a 31% interest in Semiconductor Diagnosis & Test Corp., a California corporation, ("SDT"), that was engaged in software development, for a total purchase price of \$44,000.

In April 1999, the Company acquired the remaining 69% interest in SDT for a total purchase price of \$86,000 and merged it into the Company. The transaction was accounted for using the purchase method of accounting. The purchase consideration consisted of 516,385 shares of common stock of the Company valued at \$0.12 per share and the forgiveness of a \$25,000 non-interest-bearing unsecured debt payable from SDT to the Company. The President and Chief Executive Officer of the Company was a minority shareholder of SDT and as a result received 88,828 shares of common stock of the total consideration given.

#### Yield Management Associates, Inc.

In February 1999, the Company acquired Yield Management Associates, Inc. ("YMA"), a Vermont corporation that provided consulting in the field of yield management. The Company's purchase price includes cash consideration of \$250,000. In addition, 340,000 shares of

common stock valued at \$50,000 (as of the date of acquisition) and a Put Option (described below) were issued to retain a key employee and recorded as deferred stock-based compensation.

The transaction has been accounted for as a purchase and the purchase price was allocated to the fair value of the tangible assets acquired, liabilities assumed and to an intangible employment contract asset, which was amortized on a straight-line basis over two years.

The 340,000 common shares were placed in escrow, to be released to the former stockholder of YMA in equal quarterly installments over a two-year period from the date of acquisition as long as this former stockholder remains an employee of the Company. Within 30 days of the release date, this employee may elect to have shares of the common shares redeemed at a redemption price of \$1.91 per share of common stock by the Company (the "Put Option"). During the year ended March 31, 2000, the Company repurchased 127,500 shares under this Put Option for cash of \$244,000.

In September 2000, the Company entered into an agreement with the employee to accelerate the release of the two remaining quarterly installments. The employee did not elect to have those shares redeemed by the Company. At March 31, 2001, no common shares remained in escrow.

Under APB Opinion No. 25, the release of the shares from escrow based on the former stockholder's employment and the related Put Option resulted in variable compensation accounting. For the years ended March 31, 2001 and 2000, the stock-based compensation expense was \$1,272,000 and \$351,000, respectively.

### **Tyecin-Innotech**

On October 4, 2001, the Company acquired all of the outstanding shares of Tyecin-Innotech Corporation ("Tyecin"), a corporation organized under the laws of Japan, that was engaged in the business of providing software support and services to manufacturing companies for approximately \$789,000 in cash. The transaction was accounted for using the purchase method of accounting. The purchase price was allocated to tangible net assets acquired of approximately \$708,000 and goodwill of approximately \$81,000. The acquisition provides the Company with an experienced workforce in Japan and will help support existing and future customers in Japan. Amounts allocated to goodwill will not be amortized and are not expected to be deductible for tax purposes.

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### **FabCentric**

In January and March 2001, in conjunction with the potential acquisition of FabCentric Inc. ("FabCentric"), the Company loaned \$750,000 to FabCentric in exchange for unsecured notes receivable bearing interest at the rate of 8% per annum. The notes were due and payable one year after issuance and are included in other assets in the accompanying consolidated balance sheets at March 31, 2001.

The Company resumed discussions and on December 5, 2001, the Company acquired FabCentric, a company engaged in the business of software development and sales to semiconductor companies. In connection with the acquisition, the Company issued 703,355 shares of common stock and assumed options to acquire 23,231 shares of its common stock. The transaction was accounted for using the purchase method of accounting. The acquisition will give the Company access to FabCentric's customer base, complementary technology and a highly skilled workforce.

The purchase price is summarized as follows (in thousands):

Fair market value of common stock	\$ 8,032
Fair market value of options assumed	223
Acquisition related costs	250
	<hr/>
Total consideration	\$ 8,505

The purchase price allocation is as follows (in thousands):

Tangible assets acquired	\$	253
Deferred tax asset		1,182
Intangible assets acquired		660
Deferred compensation		106
Goodwill		11,214
Liabilities assumed		(4,910)
Total	\$	8,505

Deferred compensation recorded in connection with the acquisition will be amortized over the remaining term of the options assumed, generally less than four years. Intangible assets acquired will be amortized over their estimated useful life of six months to three years (weighted-average useful life of 2.36 years). Amounts allocated to goodwill will not be amortized and are not expected to be deductible for tax purposes.

### Covalar Technologies Group, Inc.

On February 15, 2002, the Company acquired Covalar Technologies Group, Inc. ("Covalar"), a design yield optimization and productivity improvement software company which offers solutions to semiconductor companies which include testing, analysis and advanced circuit design. The results of Covalar have been included in the consolidated financial statements since the February 15, 2002 acquisition date. In connection with the acquisition, the Company issued 1,481,566 shares of its common stock, paid \$10.0 million in cash and assumed options to purchase 418,434 shares of the Company's common stock. The Company has also reserved 600,000 shares of its common stock to be issued to Covalar shareholders if certain revenue targets are achieved in the twelve months following the closing of the acquisition on February 15, 2002. The transaction was accounted for using the purchase method of accounting. The acquisition of Covalar will allow the Company to offer its customers a complete end-to-end software and related services solution from design through

manufacturing, gain a broader customer base and relationships, and provide the Company with a highly skilled workforce.

The purchase price is summarized as follows (in thousands):

Cash	\$	10,000
Fair market value of common stock		20,531
Fair market value of options assumed		4,806
Acquisition related costs		675
Total	\$	36,012

The allocation of the preliminary purchase price to assets acquired and liabilities assumed is as follows (in thousands):

Tangible assets acquired	\$	3,909
Intangible assets acquired		2,330
Deferred compensation		1,921
Goodwill		31,609

Liabilities assumed	(2,187)
Unfavorable leases assumed	(1,143)
Deferred tax liability	(427)
Total	\$ 36,012

Deferred compensation recorded in connection with the merger will be amortized over the remaining term of the options assumed generally less than four years. Acquired intangible assets will be amortized over their estimated useful life of six months to three years (weighted-average useful life of 2.85 years). Amounts allocated to goodwill will not be amortized and are not expected to be deductible for tax purposes.

The Company has included the results of operations of the acquired entities beginning as of the respective acquisition dates.

The following unaudited pro forma revenues, net income (loss) and net income (loss) per share data for the years ended March 31, 2002 and 2001 are based on the respective historical financial statements of the Company, Tyecin, FabCentric, and Covalar. The pro forma data reflects the consolidated results of operations as if the mergers with Tyecin, FabCentric and Covalar occurred at the beginning of each of the years indicated and includes the amortization of intangible assets and deferred compensation. The pro forma financial data presented are not necessarily indicative of the Company's results of operations that might have occurred had the transactions been completed at the beginning of

the years specified, and do not purport to represent what the Company's consolidated results of operations might be for any future period.

(Unaudited ProForma) (in thousands except for per share data)	Years Ended March 31,	
	2002	2001
Revenue	\$ 44,746	\$ 24,786
Net income (loss)	\$ 785	\$ (1,967)
Net income (loss) per share:		
Basic	\$ 0.03	\$ (0.10)
Diluted	\$ 0.02	\$ (0.10)

Shares used in computing per share amounts:

Basic	26,788	19,681
Diluted	33,719	19,681

#### NOTE 4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following (in thousands):

	March 31,	
	2002	2001
Computers, equipment and other	\$ 2,890	\$ 648
Furniture and fixtures	782	12
Leasehold improvements	603	215
Leased equipment and furniture	770	347



	5,045	1,222
Less: Accumulated depreciation	(1,354)	(744)
	<u>3,691</u>	<u>478</u>

At March 31, 2002 and 2001, accumulated depreciation on the leased property and equipment was \$292,000 and \$187,000, respectively.

#### NOTE 5. ACCRUED LIABILITIES

Accrued liabilities consist of the following (in thousands):

	March 31,	
	2002	2001
Payroll and related expenses	\$ 588	\$ 554
Professional fees	638	311
Other accrued expenses	1,387	180
	<u>\$ 2,613</u>	<u>\$ 1,045</u>

Included in payroll and related expenses are interest and penalties of zero and \$364,000 as of March 31, 2002 and 2001, respectively, related to the late payment of payroll withholding taxes to various governmental agencies.

#### NOTE 6. LOANS PAYABLE

The Company has a revolving line of credit agreement with a bank, under which it may borrow up to \$100,000. The revolving line of credit bears interest at the rate of prime plus 2.5% and is renewable

annually. As a condition to this facility, the Company agreed not to incur or assume any new indebtedness for borrowed money or acquire or sell assets outside of the normal course of business without the bank's written consent. In March 2001, the Company repaid the outstanding principal balance and accrued interest totaling \$103,000. As of March 31, 2002, there was no outstanding balance and the line of credit will expire unless renewed on June 24, 2002.

In July 1999, the Company issued to a third party an unsecured note, due June 15, 2000, bearing interest at the rate of 8% per annum, with a detachable warrant to acquire common or preferred stock. This note was prepayable at any time at the Company's option without penalty or premium. The warrant is exercisable for up to 82,591 shares at an exercise price of \$1.45 per share and expires in March 2004. The fair value of the warrant at the time of issuance was determined to be \$79,000 and was amortized as a financing charge over the term of the note. In March 2001, the Company repaid the outstanding principal balance and accrued interest of \$135,000. The warrant was exercised during the year ended March 31, 2002.

In June 1999, the Company issued to a third party an unsecured note, due June 15, 2002, bearing interest at the rate of 8% per annum, with a detachable warrant to acquire common or preferred stock. This note may be prepaid at any time at the Company's option without penalty or premium. The warrant is exercisable for up to 137,652 shares at an exercise price of \$1.45 per share and expires three years from the date that the note is repaid in full. The fair value of the warrant at the time of issuance was determined to be \$150,000. The value of the warrant was amortized as a financing charge over the term from the note. At March 31, 2001, \$200,000 was outstanding on this note. In

August 2001, the Company repaid the outstanding principal balance and accrued interest of approximately \$2,000. As of March 31, 2002, the warrant related to this note remained outstanding.

#### NOTE 7. CONVERTIBLE DEBENTURE

In February 2000, the Company issued a \$1.5 million convertible debenture against which all of HPLI's assets have been pledged as security. The debenture bears interest at the rate of 8% per annum. This debenture may be converted at any time at the option of the holder to common stock of the Company, at a conversion price of \$1.45 per share. The debenture, if not converted, is due on February 15, 2005. The note provides that if the Company completes its initial public offering, the holder has the right to demand repayment. As of March 31, 2002, the holder has not demanded repayment.

At March 31, 2002, the Company was not in compliance with certain non-financial covenants of the debenture. As a result, the debenture holder may declare all outstanding obligations under the debenture immediately due and payable. If the Company repays the debenture, the debenture holder will forfeit its right to convert the debenture into 1,032,388 shares of common stock of the Company at \$1.45 per share.

#### NOTE 8. COMMITMENTS

The Company leases its facilities under operating lease agreements that expire at various dates through March 15, 2007. Rent expense for all operating leases for the years ended March 31, 2002, 2001 and 2000 was \$652,000, \$609,000 and \$923,000, respectively.

Minimum future lease payments under non-cancelable operating leases and future minimum payments under capital lease agreements at March 31, 2002 are included in the table below (in thousands):

Year ending March 31,	Capital leases	Operating leases
2003	\$ 222	\$ 1,371
2004	198	1,223
2005	70	1,233
2006	20	930
2007	13	11
	523	\$ 4,768
Less: Amount representing interest (5% to 22.1%)	49	
Present value of capital lease obligations	474	
Less: Current portion	194	
Non-current portion	\$ 280	

#### NOTE 9. CAPITAL STOCK

##### Common stock

The Company has reserved the following shares of authorized but unissued common stock for future issuance (in thousands):

March 31,

	2002	2001
Conversion of outstanding convertible debenture (Note 7)	1,032	1,032
Exercise of warrants (Note 6)	138	220
Stock option plan	11,845	9,614
Employee stock purchase plan	647	-
Other non-qualified stock options	-	1,632
	13,662	12,498

## Stock option plans

In May 2001, the Company adopted its 2001 Equity Incentive Plan (the "Plan") and reserved a total of 12,750,000 shares of its common stock for issuance to directors, employees and consultants under the Plan. Options granted under the Plan expire 10 years from the date of grant and generally vest over a four-year period. Under the Plan, eligible employees and consultants who own less than ten percent of voting power of all classes of stock, can receive options to purchase shares of the Company's common stock at a price no less than 100% and 85% of the fair value on the grant date for incentive stock options and non-statutory stock options, respectively. Those eligible employees and consultants who own more than ten percent of voting power of all classes of stock, can receive options to purchase shares of the Company's common stock at a price no less than 110% of the fair value on the grant date for incentive stock options and nonqualified stock options.

Prior to the adoption of the Plan, the Company's subsidiary, HPLI adopted the 1998 Stock Option Plan (the "1998 Plan"). All options outstanding under the 1998 Plan were exchanged for substitute options granted under the Plan in connection with HPLI's merger with the Company. No new options have been granted under the 1998 Plan since that time. HPLI has also granted a stock option to an employee to purchase up to 1,632,000 shares of HPLI common stock at an exercise price of \$0.02 per share and were fully vested. This option was exercised in the year ended March 31, 2002

## Employee stock purchase plan

The 2001 Employee Stock Option Purchase Plan (the "ESPP") was adopted by the Company's Board of Directors on May 22, 2001. A total of 660,000 shares of common stock may be purchased under the ESPP. Subject to the terms of the ESPP, the number of shares of common stock reserved and available for issuance pursuant to the ESPP will automatically increase on March 1 of each year until and including March 1, 2011 by a number of shares equal to the lesser of (i) 150,000, (ii) one percent of the number of shares of all classes of common stock outstanding on that date of, or (iii) a lesser number determined by the Board of Directors or a committee appointed by the Board of Directors. Qualified employees can elect to have up to 15 percent (30 percent for the Company's employees in the Republic of Armenia) of their annual earnings withheld, up to a maximum of \$25,000 in fair market value of shares under the ESPP in any calendar year, or portion of a calendar year, included in an offering period. No more than 1,500 shares can be purchased on any purchase date by an individual employee.

The purchase price of the stock is 85% of the lower of the fair market value at the beginning of the twenty-four month offering period or at the end of each six-month purchase period. For the year ended March 31, 2002, 12,845 shares were issued under the ESPP.

The following table summarizes information with respect to stock option activity under the Plan:

Years ended March 31,	2002		2001		2000	
	Shares (000's)	Weighted Average	Shares (000's)	Weighted Average	Shares (000's)	Weighted Average

		Exercise Price		Exercise Price		Exercise Price			
Outstanding at beginning of year	7,431	\$	0.22	8,029	\$	0.11	6,701	\$	0.09
Granted	2,222		7.81	558		1.56	1,651		0.19
Exercised	(759)		0.15	(586)		0.08	–		–
Forfeited	(244)		0.10	(570)		0.09	(323)		0.14
Outstanding at end of year	8,650	\$	2.18	7,431	\$	0.22	8,029	\$	0.11
Shares available for grant	3,195								

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The following table summarizes information regarding options outstanding and exercisable under the Plan as of March 31, 2002:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number Outstanding (000's)	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price	Number Exercisable (000's)	Weighted Average Exercise Price
\$0.04 - \$0.09	2,176	6.44	\$ 0.08	1,578	\$ 0.08
\$0.10	2,720	1.30	0.10	2,040	0.10
\$0.12 - \$1.17	1,484	7.69	0.46	630	0.42
\$1.18 - \$12.35	1,632	9.26	5.93	317	3.43
\$12.38 - \$13.87	613	9.77	12.56	–	–
\$14.33	25	9.97	14.33	–	–
	8,650	5.82	\$ 2.18	4,565	\$ 0.37

Pro forma information regarding net income (loss) per share as required by SFAS No. 123, the Company to disclose information as if it had accounted for its employee stock options under the fair value method of SFAS No. 123. The weighted average fair value of options granted for the years ended March 31, 2002, 2001, and 2000 was \$6.73, \$3.30 and \$0.63, respectively. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and the following weighted average assumptions:

Years ended March 31,	Stock Options			Employee Stock Purchase Plan
	2002	2001	2000	2002
Expected volatility	85%	85%	85%	85%
Weighted average risk free interest rate	3.96%	6.00%	5.69%	3.50%
Expected life	5 years	5 years	5 years	0.5 years
Expected dividend yield	–	–	–	–

If compensation cost had been determined in accordance with SFAS No. 123, net income (loss) and net income (loss) per common share would have been changed to the pro forma amounts indicated below:

(in thousands, except per share data)

Years Ended March 31,

	2002	2001	2000
Net income (loss)			
As reported	\$ 6,744	\$ 541	\$ (3,546)
Pro forma	\$ 5,347	\$ (623)	\$ (3,846)
Net income (loss) per share—basic:			
As reported	\$ 0.28	\$ 0.03	\$ (0.21)
Pro forma	\$ 0.22	\$ (0.04)	\$ (0.23)
Net income (loss) per share – diluted:			
As reported	\$ 0.21	\$ 0.02	\$ (0.21)
Pro forma	\$ 0.17	\$ (0.04)	\$ (0.23)

### Deferred stock-based compensation

In connection with the granting of stock options to employees, the Company recorded deferred stock-based charges, net of cancellations, totaling approximately \$3,863,000, \$1,683,000 and \$1,085,000 for the years ended March 31, 2002, 2001 and 2000, respectively. This amount represents the difference between the exercise price at which the stock options were granted and the deemed fair value of the Company's common stock for accounting purposes on the date of grant. In connection with the

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acquisitions of FabCentric and Covalar, the Company recorded deferred compensation totaling \$2,027,000. These amounts are included as a component of stockholders' equity and, in accordance with the method described in FIN No. 28, are being amortized on an accelerated basis by charges to operations over the vesting period of the options, which is generally four years. Accordingly, this resulted in an expense of \$3,385,000, \$1,087,000, and \$209,000 for the years ended March 31, 2002, 2001, and 2000, respectively.

### NOTE 10. RELATED PARTY

During 2001, the Company sold certain software and maintenance to a company that is affiliated with a director of HPL. The Company recognized approximately \$271,000 in revenue related to the company in the year ended March 31, 2001. In addition, HPL purchased software products from this company in 2002 totaling approximately \$700,000. The Company recognized approximately \$37,000 in revenue related to the company in the year ended March 31, 2002. The contract has rates and terms that management believes are comparable with those entered into with independent third parties.

In October 2001, the Company acquired all of the outstanding capital stock of Tyecin for approximately \$789,000 in cash. At the time of the acquisition, Tyecin was a 90% owned subsidiary of Innotech Corporation. A director of HPL was also the president of Innotech Corporation and serves on the board of directors of Innoquest Corporation, the parent corporation to Innotech Corporation.

In the fourth quarter of fiscal 2002 and the first quarter of fiscal 2003, the Company provided a loan to an officer of the Company for an aggregate sum of \$750,000 pursuant to his employment arrangement. The loan is secured by a second deed of trust on the officer's home and bears interest at a rate equal to the higher of: (i) 6%, or (ii) the short-term "applicable federal rate" (assuming semi-annual compounding) as periodically published by the Internal Revenue Service. The employment arrangement provides that 20% of the principal sum and accrued interest will be forgiven annually over a period of five years, commencing on the first anniversary of the officer's employment, provided that he remains continuously employed by the Company during that time.

In the third quarter of fiscal 2002, the Company loaned to an employee an advance to pay withholding taxes due upon exercise of a stock option to purchase 1,632,000 shares of the Company's common stock. The loan, which bears interest at a rate of 5% per annum and is due on September 21, 2003, was secured by 1.3 million shares of Company's common stock held by the employee. The principal balance of \$2,745,000 and accrued interest were repaid in total during the quarter ended March 31, 2002.

**NOTE 11. FAIR VALUE OF FINANCIAL INSTRUMENTS**

The estimated fair value of financial instruments has been determined using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required in interpreting market data to develop estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Company would realize in a current market exchange.

Cash, cash equivalents, accounts receivable, notes receivable, revolving line of credit and accounts payable are carried at cost, which approximates their fair value because of the short maturities of these instruments. The Company's short-term investments are reported at fair value.

The following is a summary of cash, cash equivalents and short-term investments (in thousands):

	<b>March 31, 2002</b>			
	<b>Amortized</b>	<b>Gross</b>	<b>Gross</b>	<b>Estimated</b>
	<b>Cost</b>	<b>Unrealized</b>	<b>Unrealized</b>	<b>Fair Value</b>
		<b>Gains</b>	<b>(Losses)</b>	
Checking and saving	\$ 17,586	\$ –	\$ –	\$ 17,586
Money market funds	14,719	–	–	14,719
Commercial paper	4,260	1	–	4,261
Corporate debt securities	5,549	1	(6)	5,544
US Government agencies	18,067	–	(45)	18,022
	<u>\$ 60,181</u>	<u>\$ 2</u>	<u>\$ (51)</u>	<u>\$ 60,132</u>
<b>Included in:</b>				
Cash and cash equivalents				\$ 45,821
Short-term investments				14,311
				<u>\$ 60,132</u>

Cash balances at March 31, 2001 were primarily in non-interest bearing accounts.

The fair value of notes payable is estimated based on expected cash flow and the convertible debenture is estimated based on a Black-Scholes model.

The estimated fair value of these liabilities is summarized as follows (in thousands):

	<b>March 31, 2002</b>		<b>March 31, 2001</b>	
	<b>Carrying</b>	<b>Estimated</b>	<b>Carrying</b>	<b>Estimated</b>
	<b>amount</b>	<b>fair value</b>	<b>amount</b>	<b>fair value</b>
Notes payable	\$ –	\$ –	\$ 200	\$ 200
Convertible debenture	\$ 1,500	\$ 15,562	\$ 1,500	\$ 9,031

**NOTE 12. COMPREHENSIVE INCOME (LOSS)**

The following is a detail of comprehensive income (loss):

(in thousands)	For The Years Ended March 31,		
	2002	2001	2000
Net income (loss)	\$ 6,744	\$ 541	\$ (3,546)
Cumulative translation adjustment-foreign currency translation losses	(450)	-	-
Unrealized loss on available for sale securities, net of tax	(49)	-	-
Comprehensive income (loss)	\$ 6,245	\$ 541	\$ (3,546)

### NOTE 13. EMPLOYEE BENEFIT PLAN

The Company has a 401(k) Profit Sharing Plan (the "Profit Sharing Plan") qualified under Section 401(k) of the Internal Revenue Code of 1986. Each eligible employee may elect to contribute up to the maximum IRS annual deferral amount. The Company, at the discretion of its board of directors, may match employee contributions to the Profit Sharing Plan or make contributions to the Profit Sharing Plan for all eligible employees. The Company has elected not to make matching or other contributions to the Profit Sharing Plan for the years ended March 31, 2002, 2001 and 2000.

### NOTE 14. INCOME TAXES

The components of the provision for income taxes are as follows (in thousands):

	Years ended March 31,		
	2002	2001	2000
Federal	\$ 7,125	\$ 1,170	\$ -
State	1,194	382	-
	8,319	1,552	-
Deferred:			
Federal	(345)	(110)	-
State	(56)	(19)	-
	(401)	(129)	-
Provision for income taxes	\$ 7,918	\$ 1,423	\$ -

The Company's deferred tax assets and liabilities are as follows (in thousands):

	March 31,	
	2002	2001
Deferred tax assets:		
Net operating loss and credit carryforwards	\$ 1,888	\$ -
Other accruals	566	147
	2,454	147

Deferred tax liabilities:		
Depreciation	(89)	(18)
Intangible assets	(979)	–
	<u>(1,068)</u>	<u>(18)</u>
Net deferred tax assets	\$ 1,386	\$ 129

Based on the available objective evidence, management believes it is more likely than not that the net deferred tax assets will be fully realizable for the year ended March 31, 2002. Accordingly, the Company has provided no valuation allowance as of March 31, 2002.

Reconciliation of the statutory federal income tax to the Company's effective tax is as follows:

	Years Ended March 31,		
	2002	2001	2000
Tax at federal statutory rate	35.0%	34.0%	(34.0)%
State, net of federal benefit	3.4	13.8	(0.7)
Other	0.6	5.2	23.6
Option compensation	8.8	41.0	2.9
Foreign tax rate differential	6.2	–	–
Valuation allowance	–	(21.5)	8.2
	<u>54.0%</u>	<u>72.5%</u>	<u>0.0%</u>

#### NOTE 15. SEGMENT AND GEOGRAPHIC INFORMATION

The Company has determined that it has one reportable business segment: the sale of yield optimization software used in the design, fabrication and testing of semiconductors and flat panel displays. The Company has a facility in the Republic of Armenia, which has fixed assets with a net book value of \$152,000 as of March 31, 2002, and \$75,000 as of March 31, 2001.

The following is a geographic breakdown of the Company's revenues by destination for the following periods (in thousands):

	Years ended March 31,		
	2002	2001	2000
United States	\$ 2,932	\$ 7,019	\$ 3,235
Japan	29,421	5,770	231
France	1,647	517	–
Rest of the world	3,154	113	238
	<u>\$ 37,154</u>	<u>\$ 13,419</u>	<u>\$ 3,704</u>

For the year ended March 31, 2002, the Company derived revenue from three end-user customers which comprised 19%, 18%, and 14% of the Company's total revenues, respectively. Sales through Canon Sales Co. ("Canon"), the Company's Japanese distributor, represented 78% of the Company's total revenues.



For the year ended March 31, 2001, the Company derived revenue from four end-user customers which comprised 22%, 21%, 21% and 10% of the Company's total revenues, respectively. Sales through Canon including sales to two of the four end-user customers represented 43% of the Company's total revenues.

For the year ended March 31, 2000, the Company derived revenues from three customers which comprised 17%, 15% and 12% of the Company's total revenues, respectively.

#### NOTE 16. SUBSEQUENT EVENT

On April 10, 2002, the Company acquired 100% of the outstanding common and preferred shares of Defect & Yield Management, Inc. ("DYM"), a defect analysis and yield optimization software company offering software solutions to semiconductor companies. The results of DYM will be included in the consolidated financial statements from April 10, 2002, the acquisition date. In connection with the acquisition, the Company issued 967,260 shares of its common stock, paid \$2.0 million in cash and assumed options to purchase up to 82,740 shares of the Company's common stock. The Company has also reserved shares to issue up to \$5.0 million of its common stock to be issued to DYM shareholders

if a certain number of customer maintenance contracts with the current DYM installed base of customers are achieved in the one year period ended April 9, 2003. The transaction will be accounted for using the purchase method of accounting. The acquisition of DYM will provide the Company access to an installed customer base in over 70 facilities worldwide.

The aggregate purchase price was approximately \$16.7 million, is summarized as follows (in thousands):

Cash	\$ 2,000
Fair market value of common stock	13,474
Fair market value of options assumed	852
Estimated acquisition related costs	400
	<hr/>
Total	\$ 16,726
	<hr/>

The final purchase price allocation will be determined upon finalization of the closing balance sheet and completion of an appraisal and a comprehensive evaluation of the fair value of all assets acquired and liabilities assumed. The preliminary purchase price allocation, which is subject to change based on the Company's final analysis, is as follows (in thousands):

Tangible assets acquired	\$ 900
Deferred tax asset	2,572
Intangible assets acquired	1,300
Deferred compensation	121
Goodwill	13,981
Liabilities assumed	(1,680)
Deferred tax liability	(468)
	<hr/>
Total	\$ 16,726
	<hr/>

Deferred compensation recorded in connection with the acquisition will be amortized over the remaining term of the options assumed generally less than five years. Acquired intangible assets will be amortized over their estimated useful life of three years. Amounts allocated to goodwill will not be amortized.

**Supplementary Financial Data**  
**Quarterly Data (Unaudited)**

<i>(in thousands, except per share amounts)</i>	For the Quarters Ended			
	June 30,	September 30,	December 31,	March 31,
	2001	2001	2001	2002
<b>Year ended March 31, 2002</b>				
Revenues	\$ 5,557	\$ 6,982	\$ 10,903	\$ 13,712
Gross profit	\$ 5,230	\$ 6,448	\$ 9,819	\$ 12,600
Net income	\$ 426	\$ 1,121	\$ 2,344	\$ 2,853
Net income per share:				
Basic	\$ 0.02	\$ 0.05	\$ 0.09	\$ 0.10
Diluted	\$ 0.02	\$ 0.04	\$ 0.07	\$ 0.08
Shares used in computing per share amounts:				
Basic	17,836	22,674	27,015	28,437
Diluted	28,151	31,793	35,073	36,196

<i>(in thousands except per share amounts)</i>	For the Quarters Ended			
	June 30,	September 30,	December 31,	March 31,
	2000	2000	2000	2001
<b>Year ended March 31, 2001</b>				
Revenues	\$ 1,927	\$ 3,297	\$ 3,751	\$ 4,444
Gross profit	\$ 1,766	\$ 3,097	\$ 3,217	\$ 4,290
Net income (loss)	\$ (261)	\$ 66	\$ 172	\$ 564
Net income (loss) per share:				
Basic	\$ (0.02)	\$ –	\$ 0.01	\$ 0.03
Diluted	\$ (0.02)	\$ –	\$ 0.01	\$ 0.02
Shares used in computing per share amounts:				
Basic	17,095	17,248	17,816	17,828
Diluted	17,095	26,830	27,684	26,924

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

None.

### **PART III.**

## **ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information concerning our executive officers required by this Item is incorporated by reference to the section in Item 1 of this Report entitled "Directors and Executive Officers."

There is incorporated herein by reference the information required by this Item included in the Company's Proxy Statement for the 2002 Annual Meeting of Stockholders under the captions "Proposal No. 1-Election of One Class 2 Director" and "Section 16(a) Beneficial Ownership Reporting Compliance," which will be filed with the Securities and Exchange Commission no later than 120 days after the close of the fiscal year ended March 31, 2002.

## **ITEM 11. EXECUTIVE COMPENSATION**

There is incorporated herein by reference the information required by this Item included in the Company's Proxy Statement for the 2002 Annual Meeting of Stockholders under the caption "Executive Compensation," which will be filed with the Securities and Exchange Commission no later than 120 days after the close of the fiscal year ended March 31, 2002.

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

There is incorporated herein by reference the information required by this Item included in the Company's Proxy Statement for the 2002 Annual Meeting of Stockholders under the caption "Security Ownership of Certain Beneficial Owners and Management," which will be filed with the Securities and Exchange Commission no later than 120 days after the close of the fiscal year ended March 31, 2002.

## **ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

There is incorporated herein by reference the information required by this Item included in the Company's Proxy Statement for the 2002 Annual Meeting of Stockholders under the caption "Certain Relationships and Related Transactions," which will be filed with the Securities and Exchange Commission no later than 120 days after the close of the fiscal year ended March 31, 2002.

### **PART IV**

## **ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K**

**(a)** Financial Statements:

Financial Statements for the three years ended March 31, 2002 are included in Item 8. All schedules are omitted because they are not applicable or the required information is shown in the financial statements or notes thereto.

**(b)** Reports on Form 8-K:

(c) Exhibits:

The following exhibits are incorporated by reference or filed as part of this report.

Exhibit Number	Description
3.1	Amended and Restated Certificate of Incorporation of Registrant. (1)
3.2	Bylaws of Registrant. (1)
4.1	Form of Common Stock Certificate. (1)
10.1	2001 Amended and Restated Equity Incentive Plan (1)
10.2	2001 Amended and Restated Employee Stock Purchase Plan (1)
10.3	HPL Technologies, Inc. 2001 Foreign Subsidiary Employee Stock Purchase Plan, as amended (2)
10.4	Form of Officer and Director Indemnification Agreement (1)
10.5	Employment Offer Letter from Heuristic Physics Laboratories, Inc. to Ita Geva, dated April 3, 2000 (1)
10.6	Amendment, dated October 16, 2001, to that certain Employment Offer Letter from Heuristic Physics Laboratories, Inc. to Ita Geva, dated April 3, 2000 (3)
10.7	Employment Offer Letter from HPL Technologies, Inc. to Michael Scarpelli, dated December 4, 2001. (3)
10.8	Employment Offer Letter from HPL Technologies, Inc. to Mark Milligan, dated September 26, 2001. (3)
10.9	Security Agreement, dated September 21, 2001, by and between Philip Gruebele and HPL Technologies, Inc. (2)
10.10	Business Agreement Concerning Distribution and Support of HPL Products and Services in Japan by Canon Sales Co., Inc., dated March 15, 2000 (1)
10.11	Memorandum of Understanding between Heuristic Physics Laboratories, Inc. and Canon Sales Co., Inc. (1)
10.12	Secured Convertible Debenture dated February 15, 2000 between Applied Materials, Inc., and Heuristic Physics Laboratories, Inc. (1)
10.13	Real property lease dated August 19, 1998 by and between Heuristic Physics Laboratories, Inc. and Spieker Properties, L.P., (San Jose, California) (1)
10.14	Real property lease dated May 25, 1997 by and between HPL Armenia and the Armenian Research Institute of Scientific Engineering Information (Yerevan, Armenia) (English translation) (1)

- 10.15 Real property lease dated June 5, 1997 by and between HPL Armenia and the Armenian Research Institute of Scientific Engineering Information (Yerevan, English translation) (1)
- 10.16 Real property lease by and between HPL Armenia and the Armenian Research Institute of Scientific Engineering Information dated June 1, 2001 (Yerevan, English translation) (1)
- 10.17 Industrial Lease Agreement, dated as of November 17, 2000, between Research Interchange One L.P., a Texas Limited Partnership and Testchip Technologies, Inc., a Texas Corporation.

- 10.18 First Amendment, dated as of March 28, 2001, to Industrial Lease Agreement, dated as of November 17, 2000, between Research Interchange One L.P., a Texas Limited Partnership and Testchip Technologies, Inc., a Texas Corporation.
- 10.19 Second Amendment, dated June 6, 2001, to Industrial Lease Agreement, dated as of November 17, 2000, between Research Interchange One L.P., a Texas Limited Partnership and Testchip Technologies, Inc., a Texas Corporation.
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- 10.21 Lease Agreement, dated June 1, 2000, between Jackson-Shaw Technology II, LTD and Testchip Technologies, Inc.
- 10.22 Amendment, dated August 7, 2000, to Lease Agreement, dated June 1, 2000, between Jackson-Shaw Technology Center, II, LTD. and Testchip Technologies.
- 10.23 Modification and Ratification of Lease, dated October 31, 2001, between Jackson-Shaw Technology Center, II, LTD. and Testchip Technologies.
- 21.1 Subsidiaries of the registrant
- 23.1 Consent of PricewaterhouseCoopers LLP, Independent Accountants
- 24.1 Powers of Attorney. (Contained on Signature Page)
- (1) Incorporated by reference from our Registration Statement on Form S-1 filed with the Commission May 29, 2001, as amended (Registration No. 333-61810).
- (2) Incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended September 30, 2001.
- (3) Incorporated by reference from our Quarterly Report on Form 10-Q for the quarter ended December 31, 2001.

**SIGNATURE**

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

HPL Technologies, Inc.

Dated: June 24, 2002

/s/ Y. DAVID LEPEJIAN  
By: Y. David Lepejian  
President and Chief Executive Officer

### POWERS OF ATTORNEY AND SIGNATURES

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Y. David Lepejian and Rita Rubinstein as his true and lawful attorney-in-fact and agent, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this report, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities Exchange Commission, granting unto said attorney-in-fact and agent full power and authority to do and perform each and every act and thing requisite and necessary to be done, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent or his substitute may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Y. DAVID LEPEJIAN</u> Y. David Lepejian	President, Chief Executive Officer and Director (Principal Executive Officer)	June 24, 2002
<u>/s/ ITA GEVA</u> Ita Geva	Chief Financial Officer (Principal Financial and Accounting Officer)	June 24, 2002
<u>/s/ ELIAS ANTOUN</u> Elias Antoun	Director	June 24, 2002
<u>/s/ OSAMU KANO</u> Osamu Kano	Director	June 24, 2002
<u>/s/ LAWRENCE KRAUS</u> Lawrence Kraus	Director	June 24, 2002
<u>/s/ DR. YERVANT ZORIAN</u> Dr. Yervant Zorian	Director	June 24, 2002

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EXHIBIT INDEX

## INDUSTRIAL LEASE AGREEMENT

This lease agreement (the "Lease") is made and entered into as of the 17th day of November, 2000, between Research Interchange One L. P. a Texas Limited Partnership (the "Landlord"), and Testchip Technologies, Inc., a Texas Corporation (the "Tenant"):

### WITNESSETH:

**SEC. 1. LEASED PREMISES:** In consideration of the mutual covenants set forth herein, Landlord hereby leases to Tenant and Tenant hereby leases from Landlord for the rental and on the terms and conditions hereinafter set forth approximately 25,140 square feet of rentable space as indicated on the plan attached hereto as EXHIBIT "A" and known as Suite 180 (the "Premises") in the office and warehouse building (the "Building") located at 9300 United Drive, in the city of Austin, Travis County, Texas. The Building is part of a multi-building complex (the "Project"), which is located on the land (the "Land") more particularly described on EXHIBIT "B" attached hereto. The Premises, Building, Project and Land together with all improvements (including, without limitation, all parking facilities) thereon are herein collectively called the "Property".

It is agreed that the total rentable area of the Project is 121,870 square feet and that the Premises (and Tenant's pro rata share for Additional Rental purposes) is agreed to be 20.63% thereof. It is agreed that the total rentable area of the Building is 50,210 square feet and that the Premises (and Tenant's pro rata share of the Building for Additional Rental purposes) is agreed to be 50.07% thereof. All categories of Additional Rental shall be based on the prorations in this paragraph except for water and wastewater service to the Building which shall be fully charged to the tenants of the Building regardless of the occupancy rate of the Building.

**SEC. 2. TERM:** Subject to the conditions set forth herein, and in any exhibit or addendum hereto, signed by both parties, the term of this Lease shall begin on the earlier of the date that Tenant actually occupies the Premise or March 1, 2001 ("Commencement Date") and shall end at midnight on February 28, 2006, subject to delay as provided in the Work Letter attached hereto as EXHIBIT "G". If the Commencement Date begins prior to March 1, 2001, Base Rental as hereinafter defined will not be charged to Tenant prior to March 1, 2001. Additional Rental as hereinafter defined will be charged to Tenant from the Commencement Date of the Lease however.

**SEC. 3. USE:** The Premises shall be used and occupied by Tenant solely for office, wholesale sales, shipping and warehouse purposes and for no other purpose. The office area of the Premises may be used only for general office purposes, and not for storage, loading, shipping or other warehouse-type purposes. No manufacturing operations may be conducted at the Premises. For this purpose, manufacturing shall be defined as production of a tangible product for sale at the wholesale or retail level. The term manufacturing shall not include light assembly or construction conducted in connection with Tenant's current business activities. It is further agreed that operation of a Test Lab shall not be construed as manufacturing. No vehicle maintenance or servicing may take place on the Premises or the Project.

**SEC. 4. ADVANCE AND SECURITY DEPOSIT:** A security deposit of \$32,436.00 ("Security Deposit") and \$37,464.00 representing Base Rental and Additional Rental due under this Lease for the first full month of the term of this Lease is due from Tenant on Lease execution date. Upon the occurrence of any event of default by Tenant, Landlord may, from time to time with prior written notice, without prejudice to any other remedy, use the Security Deposit to the extent necessary to satisfy delinquent Rent or to cure any Tenant default or to compensate Landlord for any loss or damage which Landlord may suffer by reason of Tenant's default. If any portion of the Security Deposit

is so used or applied, Tenant shall, upon demand therefore, deposit cash with Landlord in an amount sufficient to restore the Security Deposit to its original amount and Tenant's failure to do so shall constitute a default hereunder by Tenant. If Tenant shall fully and faithfully perform every provision of this Lease to be performed by it, the Security Deposit shall be returned to Tenant within sixty (60) days after termination of this Lease.

**SEC. 5. BASE RENTAL:** As part of the consideration for the execution of this Lease, Tenant agrees to pay as "Base Rental", the total sum listed on Exhibit D payable at the office of Landlord in monthly installments, as shown on Exhibit D each in legal tender of the United States of America, in advance, without demand and without deduction, on the first day of each calendar month during their term hereof: provided, however, that if the term of this Lease commences on a date other than the first day of a calendar month, the first rental payment, to be made on Lease execution shall be the rental for one full calendar month plus the pro rated rental remainder for the calendar month in which the Lease term commences.

**SEC. 6. ADDITIONAL RENTAL:** In addition to the Base Rental, as specified in this Lease, Tenant agrees to pay to Landlord as additional rent ("Additional Rental) an amount equal to Tenant's pro rata share of the Operating Expenses (as hereinafter defined) for each calendar year during the term of this Lease. Tenant's liability for Additional Rental for any partial year during the term of this Lease shall be prorated based upon the ratio of the number of days within the term of this Lease as compared to the total number of days in such year.

**A. Operating Expenses:** For the purposes of determining Additional Rental, "Operating Expenses" shall mean all of Landlord's costs and expenses paid or incurred in operating and maintaining the Property for a particular calendar year or portion thereof, as determined by Landlord; provided, however, that Operating Expenses shall not include any expenses otherwise the obligation of the Tenant under the other terms of this Lease.

Operating Expenses shall include, without limitation:

(i) all general real estate taxes and all special assessments, costs and expenses of contesting the validity or amount of real estate taxes; insurance premiums; water, sewer, electrical and other utility charges not separately metered to the Premises; landscape and sprinkler maintenance costs; pest control costs; exterior lighting maintenance costs including replacement elements; asphalt and concrete paving maintenance costs; telecommunications equipment maintenance costs; security services (if provided by Landlord, in Landlord's sole discretion); license, permit and inspection fees; property management fees which do not exceed the greater of four percent (4%) of gross rent (Base Rental plus Additional Rental) or the going rate for the management of similar properties; trash removal; and, in general, all other costs and expenses which would generally be regarded as operating and maintenance costs and expenses, including those which would normally be amortized over a period not to exceed five (5) years.

(ii) the costs of any capital improvements made to the Project by Landlord that reduce operating expenses or that are required under any governmental law or regulation not applicable to the Project or not in effect at the time it was constructed, such cost to be amortized over such reasonable period as Landlord shall determine with a return on capital at the then current prime interest rate (as published by the Wall Street Journal) on the unamortized balance or at such higher interest rate as may have been paid by Landlord on funds borrowed for the purpose of constructing such capital improvements. However, the portion of any increase in annual Operating Expenses for capital improvements that reduce operating expenses shall never exceed the amount of reduction in the annual Operating Expenses attributable to such improvements.

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Operating Expense Exclusion. Notwithstanding anything to the contrary in this Lease, Operating Expenses shall not include, (i) the wages and benefits of any on-site employees above the level of Building manager; (ii) the wages and benefits of any employee who does not devote substantially all of his or her time to the Building unless such wages and benefits are allocated to, reflect the actual time spent on operating and managing the Building vis-à-vis time spent on matters unrelated to operating and managing the Building.

Federal and State taxes imposed upon or measured by the gross receipts or income of Landlord shall not be considered a part of Operating Expenses unless a future change in the method of taxation causes any franchise, gross receipts, income, profit or other tax to be levied against Landlord in substitution in whole or in part for or in lieu of or in addition to any tax included as an Operating Expense hereunder. In such event, any such franchise, gross receipts, income, profit or other tax shall (with appropriate adjustments, where necessary) be deemed to be Operating Expenses for the purposes hereof.

or the purpose of this Section, payments made by tenants of the Project, either to third parties or to Landlord, under agreements for direct reimbursement for services (e.g., separately metered utilities, separately contracted janitorial services, property taxes directly reimbursed to Landlord, etc.) shall not be included in Operating Expenses.

**B. Monthly Payment of Estimated Additional Rental:** Tenant's proportionate share of Operating Expenses for the remainder of the calendar year after the Commencement Date and for each subsequent calendar year shall be estimated by Landlord, and written notice thereof shall be given to Tenant. Upon receipt of said written notice from Landlord, the estimated Additional Rental shall be due and payable as herein provided. For any such remainder of the calendar year after the Commencement Date, Tenant agrees to pay Landlord each month, at the same time the Base Rental is due, an amount equal to the amount of such estimated monthly Additional Rental for the remainder of such calendar year, and during each calendar year thereafter Tenant agrees to pay Landlord each month, at the same time the Base Rental is due, an amount equal to one-twelfth ( $1/12$ ) of the estimated annual Additional Rental due.

**C. Annual Adjustment of Additional Rental:** Within seventy-five (75) days after the end of each calendar year, Landlord shall prepare and deliver to Tenant a statement showing Tenant's total amount of Additional Rental. Within thirty (30) days after receipt of the aforementioned statement, Tenant agrees to pay Landlord, or if Tenant has overpaid, Landlord shall credit against the next Additional Rental payment or payments due from Tenant, as the case may be, the difference between Tenant's actual Additional Rental due for the preceding calendar year and the estimated Additional Rental paid by Tenant during such year. Upon completion of the year end statement of Additional Rental, Landlord may revise the estimated Additional Rental for the then current year by giving Tenant written notice to that effect, and thereafter Tenant agrees to pay Landlord, in each of the remaining months of such year, an additional amount equal to the amount of such annual increase or decrease in the estimated Additional Rental divided by the number of months remaining in such year. Tenant shall have the right to audit Landlord's Additional Rental charges, at Tenant's expense, within sixty (60) days of receipt by Tenant of any particular year-end accounting for Additional Rental. If any errors are found resulting in an overcharge to the Tenant, Landlord will reimburse the overcharge to the Tenant and if the overcharge is more than 5% of the yearly Additional Rental charged to Tenant, Landlord will reimburse to Tenant the reasonable costs of the audit.

**SEC. 7. RENT:** The Base Rental, Additional Rental, and all other sums required to be paid by Tenant hereunder, are sometimes collectively referred to as, and shall constitute, "Rent".

Rent shall be paid by Tenant when due, or if paid by mail the rent must be postmarked before the due date and received within five (5) business days of due date, without prior demand therefore and

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without deduction or set off unless otherwise specifically provided herein, at the office of the Landlord or at such other place as Landlord may designate from time to time.

In the event any installment of Base Rental, Additional Rent or other amount due from Tenant to Landlord under this Lease shall not be paid when due, a late charge of five cents (\$.05) per each dollar so overdue may be charged by Landlord for the purpose of defraying Landlord's administrative expenses incident to the handling of such overdue payments, and Tenant agrees to pay such Rent to Landlord upon demand, unless the delay is caused by United States Postal Service performance outside of Tenant's control.

**SEC. 8. PAYMENT FOR OTHER SERVICES:** Tenant agrees to pay to Landlord all charges for any services, goods, or materials furnished by Landlord at Tenant's request which are not required to be furnished by Landlord under this Lease, within 10 days after written receipt of Landlord's request for payment.

**SEC. 9. TENANT'S OCCUPANCY AND USE:** The Premises shall be used solely for the purpose specified in Section 3. Tenant will not use, occupy or permit the use or occupancy of the Premises for any purpose which is, directly or indirectly, forbidden by law, ordinance or governmental or municipal regulation or order, or which may be dangerous to life, limb or property; or permit the maintenance of any public or private nuisance; or do or permit any other thing which may disturb the quiet enjoyment of any other tenant of the Project; or keep any substance or carry on or permit any operation which might emit offensive odors or conditions into other portions of the Property or use any apparatus which might make undue noise or set up vibrations in the Project; or permit anything to be done which would increase the fire and extended coverage insurance rate on the Project or contents, and if there is any increase in such rate by reason of acts of Tenant, then Tenant agrees to pay such increase promptly upon demand by Landlord. Payment by Tenant of any such rate increase shall not be a waiver of Tenant's duty to comply herewith. Tenant agrees to comply with all requirements of the Americans with Disabilities Act (Public Law 101-336 July 26, 1990) and the Texas Architectural Barriers Act (Article 9102, Tex. Rev. Civ. St. (1991)) applicable to the Premises and applicable to the Project to the extent necessary to accommodate any special requirements of Tenant's employees, invitees and customers not applicable to the other tenants in the Project. Tenant acknowledges that it shall be wholly responsible for any accommodations or alterations which need to be made to the Premises to accommodate Tenant's employees, customers and invitees and for making any additional accommodations or alterations which need to be made to the Project to accommodate any special requirements of Tenant's employees, invitees and customers not applicable to the other tenants in the Project. **Tenant agrees to indemnify and hold Landlord harmless from any and all expense (including, without limitation, attorneys' fees), liabilities, costs, or damages suffered by Landlord as a result of Tenant's failure to comply with its obligations under this Section 9.**

**SEC. 10. SUITABILITY OF PREMISES:** Except as provided in Exhibit G, Tenant warrants to Landlord that it has, prior to the execution hereof, fully inspected the Premises and that it has made, performed, obtained and received all studies, inspections, reports, diagnoses and tests that Tenant desires relative to the Premises and Tenant's proposed business use of the Premises. Tenant understands and agrees that it is accepting the Premises in its present "AS-IS", "WHERE-IS" condition, "WITH ALL FAULTS", subject to the provisions of Section 16 and Exhibit G herein and also subject to any non-cosmetic, significant latent construction defects in any other component of the Premises in existence at the Commencement Date which reveal themselves on or before May 31, 2001. Tenant warrants that it used all due diligence in conducting all studies, inspections, diagnoses and tests on the Premises that Tenant deemed necessary or appropriate. Tenant acknowledges that Landlord has not made and does not make, and Landlord hereby disclaims, any and all warranties, express or implied, which in any way relate to the Premises or the condition thereof, including without limitation any implied warranty of suitability or habitability. Tenant further understands that Landlord has relied

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upon Tenant's having made all inspections Tenant desired prior to leasing the Premises from Landlord, and that but for such inspections by Tenant, Landlord would not have leased the Premises to Tenant.

**SEC. 11. LANDLORD'S RIGHT OF ACCESS:** Landlord or its authorized agents shall at any and all reasonable times, with reasonable notice to Tenant (except during an emergency), have the right to enter the Premises to inspect the same, to supply any service Landlord deems necessary to provide hereunder, to show the Premises to prospective purchasers or tenants, improve or repair the Premises or any other portion of the Property all without being deemed guilty of an eviction of Tenant and without abatement of Rent, and may for that purpose erect scaffolding and other necessary structures where reasonably required by the character of the work to be performed, provided the business of Tenant shall be interfered with as little as is reasonably practicable. Tenant hereby waives any claim for damages for any injury or inconvenience to or interference with Tenant's business, any loss of occupancy or quiet enjoyment of the Premises, and any other loss occasioned thereby unless due to Landlord's willful misconduct or gross negligence. Landlord shall have the right to use any and all means which Landlord may deem proper to open any door(s) in an emergency without liability therefore.

**SEC. 12. QUIET POSSESSION:** Upon Tenant's paying the Rent reserved hereunder and observing and performing all of the covenants, conditions and provisions on Tenant's part to be observed and performed hereunder, Tenant shall have the quiet possession of the Premises for the entire Term hereof, subject to all of the provisions of this Lease, and subject to the terms of all restrictions, easements and other matters of record applicable to the Property.

**SEC. 13. UTILITIES:** Landlord agrees to provide normal utility connections to the building in which the Premises are located for water, electricity, telephone service and sewage service to the Premises. Tenant shall arrange for and promptly pay to the applicable utility company all charges for electricity, telephone service, sewage service and other utilities furnished to the Premises, including, but not limited to initial connection charges. Tenant shall pay for all wiring, risers, transformers, electrical panels, air conditioning or heating equipment and other item necessary, or as required by Landlord (in Landlord's reasonable discretion), to accommodate Tenant's design loads and capacities in the Premises, or as required by the utility company, including the cost of installation and maintenance thereof. Notwithstanding the foregoing, Landlord may refuse to install and withhold consent for Tenant's installation of any wiring, risers, transformers, electrical panels, or air conditioning or heating equipment if, in Landlord's sole reasonable judgment, the same are not necessary or would cause damage or injury to the Project or the Premises, or cause or create a dangerous or hazardous condition or entail excessive or unreasonable alterations or repairs to the Project or the Premises or would interfere with or create or constitute a disturbance to other tenants or occupants of the Project. In no event shall Landlord incur any liability for Landlord's refusal to install, or Landlord's withholding of consent for Tenant's installation of, any such facility or equipment. Landlord may, if it so elects, furnish one or more utility services to the Tenant, and in such event Tenant shall purchase the use of such services as are tendered by Landlord and shall pay on demand as additional Rent the rates established therefore by Landlord which shall not exceed the rates which would be charged for the same services if furnished directly by the local public utility company supplying such service. Unless caused by the gross negligence or willful misconduct of Landlord, Landlord shall not be liable in damages or otherwise for failure, stoppage or interruption of any such service, nor shall the same be construed as an eviction of the Tenant, work an abatement of Rent, or relieve Tenant from the operation of any covenant or agreement; but in the event of any failure, stoppage or interruption thereof, Landlord shall use reasonable diligence to cause such service to be resumed promptly after written notice to Landlord of such failure, stoppage or interruption.

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**SEC. 14. REPAIRS AND MAINTENANCE:**

**A. Landlord's Repairs:** Subject to reimbursement pursuant to Section 6. above, Landlord shall provide or cause to be provided, cleaning and maintenance of the public portions of the Project, including landscaping, exterior lighting, asphalt and concrete paving, as Landlord shall reasonably deem appropriate. Unless otherwise expressly stipulated herein, Landlord shall not be required to make any improvements or repairs of any kind or character in the Premises during the term of this Lease, other than structural repairs to exterior and load-bearing walls, the foundation, and the roof, but only after such repairs have been requested by Tenant in writing. Landlord's obligation to make repairs shall be limited to material, substantial, structural repairs only, and not to repairs of a cosmetic or minor nature. Landlord shall not be liable to Tenant for any damage or inconvenience and Tenant shall not be entitled to any abatement or reduction of Rent by reason of any repairs, alterations or additions made by Landlord under this Lease or made by Landlord under other tenant leases in the Project. Pursuant to five (5) days advance written notice to Tenant, Landlord may at its option and at the sole cost and expense of Tenant, repair or replace any damage or injury done to the Project or any part thereof, caused by Tenant, Tenant's agents, employees, licensees, invitees or visitors; and Tenant shall pay the costs thereof plus a fifteen percent (15%) administrative fee to Landlord upon receipt of written demand. All requests for repairs and maintenance that are the responsibility of Landlord pursuant to any provision of this Lease must be made in writing to Landlord at the address set forth herein, or as subsequently changed from time to time by Landlord in writing.

**B. Tenant's Repairs:** Except for those items expressly the responsibility of the Landlord pursuant to Section 14.A. above, Tenant agrees to maintain and keep the Premises in good repair and condition at Tenant's expense. Tenant's obligation to maintain the Premises shall include the obligation to maintain the heating, ventilation and air conditioning systems and related equipment servicing the Premises, and Tenant shall at all times during the term of this Lease keep in full force and effect an agreement with a third party contractor for the maintenance of such heating, ventilation and air conditioning systems and related equipment, such contractor to be approved in advance, in writing by Landlord. Additionally, Tenant shall maintain all exterior glass, storefront doors and overhead doors attached to the Premises. The

maintenance and repair of electrical, telecommunications, water, waste water and gas facilities providing such services to the Premises shall be the Tenant's responsibility. Tenant agrees not to commit or allow any waste or damage to be committed on any portion of the Property, and at the termination of this Lease, by lapse of time or otherwise, to deliver up the Premises to Landlord in as good condition as they existed on the date of possession by Tenant, ordinary wear and tear alone excepted, and Landlord shall have the right to re-enter and resume possession of the Premises whether or not the Premises are vacated by Tenant.

**SEC. 15. TENANT'S ALTERATIONS, FIXTURES AND PERSONAL PROPERTY:** Tenant covenants and agrees that it will make no structural change or other change affecting the exterior of the Building or Project without Landlord's written consent in advance, such consent not to be unreasonably withheld, and without first furnishing the Landlord fifteen (15) days advance notice outlining in detail the proposed changes or alterations. Tenant covenants and agrees that it will make no other alterations or additions exceeding \$2,500 in value without Landlord's written consent in advance, which consent shall not be unreasonably withheld, and without first furnishing the Landlord fifteen (15) days advance notice outlining in detail the proposed changes or alterations. All changes, alterations, and additions must be of a high quality consistent with the original construction provided. All penetrations of the roof shall be performed by Landlord's roof contractor, so as to maintain all existing roof warranties.

Any such changes, interior alterations or additions approved in writing by Landlord shall be surrendered to Landlord upon termination of this Lease. All costs and expenses of any approved changes, interior alterations or additions shall be borne solely by Tenant. Any contractor or person making such improvements for Tenant must first be approved in writing by Landlord.

Tenant may remove its trade fixtures, office supplies, movable office furniture or equipment and other personal property not attached to the building in which the Premises are located provided: (a) such removal is made prior to the termination of this Lease; (b) Tenant is not in default of any obligation or covenant under this Lease at the time of such removal; and (c) Tenant promptly repairs all damage caused by such removal.

**SEC. 16. TENANT FINISH:** Except as otherwise provided in the Work Letter attached hereto as Exhibit G, all installations and improvements now or hereafter placed on the Premises shall be for Tenant's account and at Tenant's cost, which cost shall be payable by Tenant to Landlord upon demand as additional Rent. Upon completion of the initial improvements in accordance with the Work Letter, Tenant agrees to execute and deliver to Landlord a letter accepting delivery of the Premises, in the form attached as Exhibit F.

Landlord shall have the right at any time to change the arrangement, locations and/or size of the public parts of the Project and, upon giving Tenant reasonable notice thereof, to change the name, number or designation by which the Project is commonly known.

**SEC. 17. LIENS BY TENANT:** Tenant shall keep the Premises free from any liens arising out of any work performed, materials furnished, or obligations incurred by or for Tenant. In the event that Tenant shall not, within ten (10) days following the imposition of any such lien, cause the same to be released of record by payment or posting of a proper bond, Landlord shall have, in addition to all other remedies provided herein and by law, the right but not the obligation, to cause the same to be released by such means as it shall deem proper, including payment of or defense against the claim giving rise to such lien. All sums paid by Landlord and all expenses incurred by it in connection therewith shall create automatically an obligation of Tenant to pay, on demand, an equivalent amount together with interest at the rate of 12% per annum. No work which Landlord permits Tenant to perform in the Premises shall be deemed to be for the immediate use and benefit of Landlord so that no mechanics or other lien shall be allowed against the estate of Landlord by reason of its consent to such work.

**SEC. 18. SUBLETTING AND ASSIGNING:** Tenant shall not assign this lease, or allow it to be assigned, in whole or in part, by operation of law or otherwise, or mortgage or pledge the same, or sublet the Premises, or any part thereof, without the prior written consent of Landlord, which consent shall not be unreasonable withheld, and in no event shall any such assignment or sublease ever release Tenant from any obligation or liability hereunder. No assignee or sublessee of the Premises or any portion thereof may assign or sublet the Premises or any portion thereof. Landlord shall not collect any rents or other payments from any party other than Tenant unless Tenant is in default under the

terms of the Lease. Any collection by Landlord from any approved assignee or sublessee or any other party on behalf of Tenant's account shall not be construed to constitute a novation or a release of Tenant from further performance of its obligations under this Lease.

If the Tenant desires to assign or sublet all or any part of the demised Premises, it shall submit all necessary information as may be required by Landlord at least sixty (60) days in advance of the date on which Tenant desires to make such assignment or sublease, and shall submit a copy of the proposed assignment or sublease. Within fifteen (15) days after Landlord's receipt of Tenant's proposed assignment or sublease and the other information, Landlord shall have the option to:

(a) Cancel the Lease as to the Premises or portion thereof proposed to be assigned or sublet; or

(b) Consent to the proposed assignment or sublease. Should Tenant sublease space for an amount that is in excess of the agreed rental rate in this lease, Landlord shall have the right to 50% of such excess, or should Tenant sublease space for less than the agreed rental rate in this Lease, Tenant shall be obligated to Landlord for the difference between the agreed upon rental rate in this Lease and the rate in the sublease agreement; or

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(c) Refuse its consent to the proposed assignment or sublease but allow Tenant to continue in the search for an assignee or sublessee that may be acceptable to Landlord.

Notwithstanding anything herein to the contrary, Landlord will allow Tenant to sublease, without Landlord's prior written consent, to any subsidiary or affiliated corporation of which Tenant owns all or substantially all of its assets or any parent corporation which owns all of Tenant. In no event will any such sublease ever release Tenant from any obligation or liability hereunder. For the purposes of this Lease, the sale of fifty percent (50%) or more of the capital stock or other equity interest in Tenant shall be deemed an assignment of this Lease, except for the sale of capital stock or other stock in an initial or subsequent public equity offering.

**SEC. 19. FIRE AND CASUALTY:** The parties hereto mutually agree that if the Premises or Project are partially or totally destroyed by fire or other casualty, then Landlord may, at Landlord's option, repair and restore the Premises and Project, to substantially the same condition in which the Premises and Project were before such damage, or it may terminate the Lease; provided, however, that in the event the Premises or Project are completely destroyed or so badly damaged that in Landlord's reasonable estimation, repairs cannot be commenced within ninety (90) days and completed within six (6) months thereafter, then Landlord shall so notify Tenant and this Lease shall be terminable as of the date of the occurrence of the damage or destruction, by either party hereto by serving written notice upon the other within thirty (30) days after such notice; and provided further, that in any event if repairs have not been commenced within ninety (90) days from the date of said damage and thereafter completed within nine (9) months from commencement, this Lease may be immediately terminated by Tenant as of the date of occurrence of the damage or destruction, by serving notice upon the Landlord at any time prior to commencement of construction if the grounds for termination is failure to commence construction within ninety (90) days, or at any time prior to completion of construction if termination is based upon the failure to complete construction within nine (9) months.

In the event the Premises are completely destroyed or so damaged by fire or other casualty that it cannot reasonably be used by Tenant for the purposes herein provided and this Lease is not terminated as above provided, then there shall be a total abatement of Rent until the Premises are made usable. In the event the Premises are partially destroyed or damaged by fire or other hazard so that such Premises can be only partially used by Tenant for the purpose herein provided, then there shall be a partial abatement in the Rent corresponding to the time and extent which the Promises cannot be used by Tenant. Landlord shall not be obligated in any way or manner to insure any personal property (including, but not limited to, any fixtures, furniture, machinery, goods, supplies or improvements) of Tenant or which Tenant may have upon or within the Premises or any fixtures installed by or paid for by Tenant upon or within the Premises.

Except as provided in Section 20 below, if any portion of the, Property shall be damaged by fire or other casualty resulting from the fault or negligence of Tenant, or the agents, employees, licensees, or invitees of Tenant, such damage shall be repaired by and at the expense of Tenant under the direction and supervision of Landlord, and Rent shall continue without abatement.



**SEC. 20. WAIVER OF SUBROGATION:** Landlord and Tenant hereby waive any rights each may have against the other, on account of any loss or damage occasioned to Landlord or Tenant, as the case may be, their respective property, the Premises, its contents or to the other portion of the Property arising from any risk covered by valid and enforceable insurance, to the extent of such coverage. Landlord and Tenant each agree to cause an endorsement to be furnished to their respective insurance policies recognizing this waiver of subrogation, or take such other action as to reasonably requested by the other party to verify the effectiveness of this waiver of subrogation.

**SEC. 21. DEFAULT BY TENANT:**

**A. Event of Default:** The occurrence of any of the following shall constitute a material default and breach of this lease by Tenant:

- (i) Any failure by Tenant to pay Rent or to make any other payment required to be made by Tenant hereunder when due, where such failure continues for ten (10) days after written notice to Tenant;
- (ii) Any failure by Tenant to observe and perform any other provision of this Lease to be observed or performed by Tenant, where such failure continues for twenty (20) days after written notice to Tenant;
- (iii) Tenant admits in writing that it cannot meet its obligations as they become due; or is declared insolvent according to any law; or assignment of Tenant's property is made for the benefit of creditors; or a receiver or trustee is appointed for Tenant or its property; or the interest of Tenant under this Lease is levied on under execution or other legal process; or any petition is filed by or against Tenant to declare Tenant bankrupt or to delay, reduce or modify Tenant's debts or obligations; or any petition is filed or other action taken to reorganize or modify Tenant's capital structure if Tenant be a corporation or other entity (provided that no such levy, execution, legal process or petition filed against Tenant shall constitute a breach of this Lease if Tenant shall contest the same by appropriate proceedings and shall remove or vacate the same within thirty (30) days from the date of its creation, service or filing).
- (iv) Lessee shall cease its business in the Premises or shall vacate any substantial portion of the Premises, and discontinues payment of rent.
- (v) Lessee shall fail or refuse to move into or take possession of the Premises within fifteen (15) days after the date on which the term of this Lease commences under the terms of Section 2 of this Lease.

**B. Landlord's Remedies:** In the event of any such default by Tenant, Landlord, at its option, may have one or more of the following remedies, in addition to all other legal rights and remedies:

- (i) Landlord may terminate this Lease and without further notice repossess the Premises by picking or changing locks to the Premises or otherwise, and be entitled to recover as damages a sum of money equal to the total of (1) the cost of recovering the Premises, (2) the unpaid Rent earned at the time of termination, (3) the balance of the Rent for the remainder of the term, (4) costs of reletting and refurbishing, and (5) any other sum of money and damages owed by Tenant to Landlord;
- (ii) Landlord may immediately terminate Tenant's right of possession of the Premises, but not terminate the Lease, and without notice or demand enter upon the Premises or any part thereof and take absolute possession of the same, pick or change the locks, and, at Landlord's sole option may relet the Premises or any part thereof for such terms and such rents as Landlord may reasonably elect. In the event Landlord shall elect to so relet, then rent received by Landlord from such reletting shall be applied first to the payment of any indebtedness other than Rent due hereunder from Tenant to Landlord, second to the payment of any cost of such reletting, including, without limitation, refurbishing costs and leasing commissions, and third to the payment of Rent due and unpaid hereunder, and Tenant shall satisfy and pay any deficiency upon demand therefore from time to time. In no event will Landlord be obligated to pay to Tenant any excess Rent received from reletting. Any entry into and possession of the Premises by Landlord shall be without liability or responsibility to Tenant and shall not be in lieu of or in substitution for any other legal rights of Landlord

hereunder. Tenant further agrees that Landlord may file suit to recover any sums due under the terms of this Lease and that no recovery of any portion due

Landlord hereunder shall be any defense to any subsequent action brought for any amount not previously reduced to judgment in favor of Landlord. Reletting of the Premises shall not be construed as an election on the part of Landlord to terminate this Lease and, notwithstanding any such reletting without termination, Landlord may at any time thereafter elect to terminate this Lease for default.

(iii) Landlord may offset against any security deposits held by Landlord for any non-payment of Rent or any damage to the Premises or any sums due under the terms of this Lease.

(iv) Landlord may enter upon the Premises and do whatever Tenant is obligated to do under the terms of this Lease; and Tenant agrees to reimburse Landlord on demand for any expenses which Landlord may incur in effecting compliance with Tenant's obligation under this Lease, and Tenant further agrees that Landlord shall not be liable for any damages resulting to the Tenant from such action.

(v) Landlord may change the door locks on the Premises, and Landlord shall have no obligation to provide a new key to such locks. Tenant hereby waives the provisions of Section 93.002 Texas Property Code (and any successor statute), to the extent permitted by law.

**SEC. 22. Intentionally omitted.**

**SEC. 23. DEFAULT BY LANDLORD:** Except as otherwise provided in this Lease, Landlord shall be in default under this Lease if Landlord fails to perform any of its obligations hereunder and said failure continues for a period of thirty (30) days after written notice thereof from Tenant to Landlord (unless such failure cannot reasonably be cured within thirty (30) days and Landlord shall have commenced to cure said failure within said thirty (30) days and continues diligently to pursue the curing of the same.) If Landlord shall be in default under this Lease and, if as a consequence of such default, Tenant shall recover a money judgment against Landlord, such judgment shall be satisfied only out of the right, title and interest of Landlord in the Project as the same may then be encumbered and Landlord shall not be liable for any deficiency. In no event shall Tenant have the right to levy execution against any property of Landlord other than its interest in the Project.

**SEC. 24. INDEMNITY OF LANDLORD-INSURANCE:**

**A. Indemnity:** Tenant covenants that Landlord shall not be liable to Tenant or to Tenant's agents, employees, customers or invitees for any injury to person or damage to property, including consequential loss or damage, arising out of the construction, use, occupancy or enjoyment of the Premises by Tenant or any person therein or holding under Tenant or by, or through the acts or omissions of other tenants of the Project or Landlord, except to the extent caused by Landlord's gross negligence or willful misconduct. Tenant hereby agrees, as part of the material consideration for this Lease, to indemnify and save Landlord harmless from all claims, action, demands, costs and expenses and liability whatsoever, including reasonable attorneys' fees, on account of any such real or claimed damage or liability, and from all liens, claims and demands occurring in, on or at any portion of Premises or arising out of the construction, use, occupancy or enjoyment of any portion of the Premises and its facilities by Tenant or anyone holding under Tenant, or any repairs or alterations which Tenant may make upon the Premises.

**B. Tenant's Insurance:** Tenant, at its own expense, shall maintain during the term of this Lease a policy or policies of comprehensive general liability insurance, including personal injury and property damage, with contractual liability endorsement, in the amount of One Million Dollars (\$1,000,000) for property damage and One Million Dollars (\$1,000,000) per occurrence and Two Million Dollars (\$2,000,000) in the aggregate for personal injuries or deaths of persons occurring in or about the Premises and automobile liability insurance in the amount of One Million Dollars (\$1,000,000). Tenant, at its own expense, shall also maintain during the term of this Lease fire and extended coverage

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insurance covering the replacement cost of (i) all alterations, additions, partitions and improvements installed or placed in the Premises by Tenant or by Landlord on behalf of Tenant, including storefront, exterior doors and all plate glass; and (ii) all of Tenant's personal property contained within the Premises. Said policies shall (i) name the Landlord and management company as additional insured and insure Landlord's and management company's contingent liability under or in connection with this Lease (except for the workers' compensation policy, which instead shall include a waiver of subrogation endorsement in favor of Landlord); (ii) be issued by an insurance company which is acceptable to Landlord and has at least an "A" rating from A. M. Best; and (iii) provide that said insurance shall not be canceled unless thirty (30) days prior written notice has been given to Landlord. Said policy or policies or certificates thereof shall be delivered to Landlord by Tenant on or before the Commencement Date and upon each renewal of said insurance. Tenant, at its own expense, shall maintain during the term of this Lease a policy or policies of workers' compensation or 24 hour-7 day a week health and accident insurance coverage for Tenant's employees.

**SEC. 25. ATTORNEY'S FEES:** In the event of any legal action or proceeding brought by either party against the other arising out of this Lease, the prevailing party shall be entitled to recover reasonable attorney's fees and costs incurred in such action and such amount shall be included in any judgment rendered in such proceeding.

**SEC. 26. TRANSFER OR ASSIGNMENT BY LANDLORD:** Landlord shall have the right to assign or transfer, in whole or in part, every feature of its right and obligations hereunder and the Property. Such assignments or transfers may be made to a corporation, trust, trust company, individual or group of individuals or any other type entity, and howsoever made shall be in all things respected and recognized by Tenant. In the event of a sale or conveyance by Landlord of the Property, the same shall operate to release Landlord from any and all liability under this Lease arising after the date of such sale. Tenant's right to quiet possession of the Premises shall not be disturbed so long as Tenant shall pay the Rent and observe and perform all of the provisions of this Lease to be observed and performed by Tenant, unless this Lease is terminated pursuant to specific provisions relating thereto or contained herein. If any security deposit has been made by Tenant, Landlord may transfer such security deposit to the purchaser and thereupon Landlord shall be discharged from any further liability in reference thereto.

**SEC. 27. ESTOPPEL CERTIFICATE:** Tenant shall, within ten (10) business days after a request of the Landlord or any mortgagee of Landlord, without additional consideration, execute and deliver an Estoppel Certificate certifying the following:

- (a) This Lease is in full force and effect; and
- (b) The date through which Rent has been paid; and
- (c) This Lease has not been modified or amended (or a description of any modifications or amendments if it has been modified or amended); and
- (d) Neither Landlord nor Tenant is in default and each has fully performed all of its obligations hereunder (or a description of any defaults if Landlord or Tenant has defaulted); and
- (e) Any such further information as may be requested by Landlord or Landlord's mortgagee.

**SEC. 28. CONDEMNATION:** If the whole or substantially the whole of the Project or the Premises should be taken for any public or quasi-public use, by right of eminent domain or otherwise or should be sold in lieu of condemnation then this Lease shall terminate as of the date when physical possession of the Project or the Premises is taken by the condemning authority. If less than the whole or substantially the whole of the Project or the Premises is taken or sold, Landlord (whether or not the Premises are affected thereby) or Tenant (in the event the Premises are materially affected by such condemnation) may terminate this Lease by giving written notice thereof to the other party, in which

event this Lease shall terminate as of the date when physical possession of such portion of the Project or Premises is taken by the condemning authority. If this Lease is not so terminated upon any such taking or sale, the Base Rental payable hereunder shall be diminished by an equitable amount, and Landlord shall, to the extent Landlord deems feasible, restore the Project and the Premises to substantially their former condition, but such work shall not exceed the scope of the work done by Landlord in originally constructing the Project and installing improvements in the Premises, nor shall Landlord in any event be required to spend for such work an amount in excess of the amount received by Landlord as compensation for such taking. All amounts awarded upon a taking of any part or all of the Property, Project or the Premises shall belong to Landlord, and Tenant shall not be entitled to and expressly waives all claims to any such compensation.

**SEC. 29. TAXES ON TENANT'S PROPERTY:** Tenant shall be liable for and shall pay, prior to their becoming delinquent, any and all taxes and assessments levied against any personal property or trade or other fixtures or equipment placed by Tenant in or about the Premises, including any additional real estate taxes or assessments which may be levied against the Property by reason of Tenant's fixtures and/or furnishings in the Premises.

**SEC. 30. SIGNS:** No signs of any kind or nature, symbol or identifying mark shall be put on the Project, the Property, in the halls, elevators, staircases, entrances, parking areas or upon the doors or walls, whether plate glass or otherwise, of the Premises nor within the Premises so as to be visible from the public areas or exterior of the building in which the Premises are located, without prior written approval of Landlord which consent shall not be unreasonably withheld. All signs or lettering shall conform in all respects to the sign and/or lettering criteria established by Landlord.

**SEC. 31. PARKING:** Subject to the following terms and conditions, Tenant shall have a non-exclusive license to use 91 parking spaces associated with the Project. Tenant's right to such parking spaces are subject to Landlord's rights to grant other tenants of the Project the rights to parking spaces associated with the Project. Landlord reserves the right from time to time to assign, or re-assign, the location of such parking spaces in any manner that Landlord in Landlord's sole discretion deems beneficial to the operation of the Project, provided that Tenant shall always have the non-exclusive license to use 91 parking spaces associated with the Project. Should Landlord, pursuant to this right, re-assign spaces to reserved or other preferential parking associated with the Building, Tenant shall be entitled to a portion of such spaces based on its rentable square footage as a percentage of total Building square footage. Tenant agrees that it will employ its best efforts to prevent the use by Tenant's employees and visitors of parking spaces allocated to other tenants. Landlord reserves the right to promulgate rules and regulations for the use of all parking areas at any time during the term of this Lease. All motor vehicles (including all contents thereof), shall be parked in such spaces at the sole risk of Tenant, its employees, agents, invitees and licensees, it being expressly agreed and understood that Landlord has no duty to insure any of said motor vehicles (including the contents thereof), and that Landlord it not responsible for the protection and security of such vehicles, or the contents thereof. Landlord shall have no liability whatsoever for any property damage and/or personal injury which might occur as a result of or in connection with the parking of said motor vehicles in any of the parking spaces. Nothing herein shall be deemed to create a bailment between the parties hereto, it being expressly agreed and understood that the only relationship created between Landlord and Tenant hereby is that of licensor and licensee, respectively.

**SEC. 32. RULES AND REGULATIONS:** Such reasonable rules and regulations applying to all Tenants in the Project as may be adopted by Landlord for the safety, care, cleanliness, preservation of good order, or operation of the Premises, the Project and the Property, are hereby made a part hereof and Tenant agrees to comply with all such rules and regulations. Landlord shall have the right at all times to change any of the rules and regulations or to amend them in any manner deemed reasonable by the Landlord. All changes and amendments will be sent by Landlord to Tenant in writing and shall be thereafter carried out and observed by Tenant (See "Rules and Regulations" attached hereto as EXHIBIT "C").

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**SEC. 33. FORCE MAJEURE:** In the event Landlord shall be delayed, hindered, or prevented front the performance of any act required hereunder by reason of acts of God, strikes, lockouts, labor disputes, labor troubles, inability to procure materials, failure of power, restrictive governmental laws or regulations, riots, insurrection, war or other cause not within the reasonable control of Landlord, then the

performance of such act shall be excused for the period of the delay and the period for the performance of any such act shall be extended for a period equivalent to the period of such delay.

**SEC. 34. HOLDING OVER:** In the event Tenant, or any party claiming under Tenant, retains possession of the Premises after the expiration or earlier termination of this Lease, such possession shall be an unlawful detainer, and no tenancy or interest shall result from such possession; such parties shall be subject to immediate eviction and removal, and Tenant or any such party shall pay Landlord as Rent for the period of such hold-over an amount equal to 150% of the Rent in effect at the time of such termination or expiration.

Tenant will vacate the Premises and deliver same to Landlord immediately upon Tenant's receipt of notice to do so from Landlord. The Rent during such hold-over period shall be payable to Landlord on demand. No holding over by Tenant, whether with or without consent of Landlord, shall operate to extend this Lease.

**SEC. 35. NON-WAIVER:** No waiver by Landlord of any provision of this Lease or of any breach by Tenant hereunder shall be deemed to be a waiver of any other provision hereof, or of any subsequent breach by Tenant of the same or any other provision. Landlord's consent to or approval of any act by Tenant requiring Landlord's consent or approval shall not be deemed to render unnecessary the obtaining of Landlord's consent to or approval of any subsequent act of Tenant. No act or thing done by Landlord or Landlord's agents during the term of this Lease shall be deemed an acceptance of a surrender of the Premises, unless done in writing signed by Landlord. The delivery of the keys to any employee or agent of Landlord shall not operate as a termination of the Lease or a surrender of the Premises. The acceptance of any Rent by Landlord following a breach of this Lease by Tenant shall not constitute a waiver by Landlord of such breach or any other breach unless such waiver is expressly stated in writing signed by Landlord.

**SEC. 36. SUBORDINATION AND ATTORNMENT:**

**A. Subordination:** This Lease shall be subject to and subordinate to any lease wherein Landlord is the lessee and to the lien of any and all mortgages or deeds of trust, regardless of whether such lease, mortgages or deeds of trust now exist or may hereafter be created with regard to all or any part of the Project or the Property, or both, and to any and all advances to be made thereunder, and to the interest thereon, and all modifications, consolidations, renewals, replacements and extensions thereof. Tenant also agrees that any lessor or mortgagee may elect to make this Lease prior and superior to any lease or lien of its mortgage or deed of trust. Any such election must be in writing and shall be effective when filed in the Real Property Records of the County in which the Project is located. In the event of such election, this Lease shall be deemed prior and superior to the said lease or lien of said mortgage or deed of trust, whether this Lease is dated prior to or subsequent to the date of said lease, mortgage or deed of trust.

**B. Attornment:** In the event of any proceedings brought for the foreclosure of any mortgage or deed of trust covering the Property, or any part thereof, or in the event of the exercise of a power of sale pursuant thereto and upon the written request of a purchaser at such foreclosure proceedings, Tenant shall, at the request of such purchaser, attorn to and recognize such purchaser as Landlord under this Lease.

**C. Instruments of Confirmation:** The above subordination and attornment clauses shall be self-operative and no further instruments of subordination or attornment need be required by any mortgagee, trustee, lessor, purchaser or assignee. In confirmation thereof, Tenant agrees that, upon ten

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(10) days prior written notice from Landlord, or any such lessor or mortgagee, Tenant shall execute and deliver whatever instruments may be required for such purposes in order to carry out the intent of this Section. In the event that Tenant should fail to execute and deliver such instruments in compliance with this Section, Tenant hereby irrevocably constitutes Landlord as its attorney-in-fact to execute such instrument in Tenant's name, place and stead, it being agreed that such power is one coupled with an interest.

**D. Non-Disturbance Agreement:** Upon written request by Tenant, Landlord agrees to request of any existing lessor, mortgagee or lien holder, a non-disturbance agreement executed by such party, stating that so long as Tenant is not in default under this Lease, Tenant's leasehold estate, and the right to the use, possession, tenancy and occupancy hereunder, shall remain undisturbed and survive any and all

terminations of such Lease or foreclosures or conveyances in lieu thereof or other actions taken or entered into to enforce any such lease, mortgage or deed of trust. Landlord shall have no obligation beyond the requesting of such non-disturbance agreement, and shall not be in default hereunder in the event such lessor, mortgagee or other lien holder refuses to execute and deliver such non-disturbance agreement.

**SEC. 37. ENVIRONMENTAL COMPLIANCE:** Other than incidentally in the course of Tenant's business or practice, Tenant shall not use, and shall not permit any servant, licensee, employee, agent, or invitee to use any portion of the Premises or Project for the placement, storage, manufacture, disposal, or handling of any "Hazardous Materials" (as herein defined). To the extent used in the course of Tenant's business or practice, Tenant shall manage, handle, and provide safeguards for the Premises, the remainder of the Project, and all persons coming to the Premises, or to the Project, in accordance with all rules, regulations, orders, guidelines, or other instructions or directives of the United States of America, any State, any political subdivision of either of such governmental entities, or any other governmental entity having authority to regulate such Hazardous Materials. In the event there is no entity with authority to regulate any portion of the Hazardous Materials used in the ordinary course of Tenant's practice, then Tenant agrees to handle, use, and dispose of such Hazardous Materials in the same manner that a prudent person would handle the same, and consistent with standard industry practice. Tenant shall, upon Landlord's written request, provide Landlord with a written list of any Hazardous Materials handled by it at the Premises as well as such other information as Landlord may request regarding such Hazardous Materials and Tenant's handling of the same. In the event that Landlord shall reasonably determine that the handling by Tenant of any Hazardous Material shall pose an unacceptable risk to Landlord or its affiliates, Landlord reserves the right to require additional liability insurance and/or bonding of Tenant's operations. In the event that Landlord shall elect to require such insurance or bonding of Tenant, Tenant shall be solely responsible for obtaining same. Landlord may object at any time to Tenant's improper use, handling, disposal or record keeping practices concerning such Hazardous Materials and Tenant shall immediately correct such practices as soon as receiving any notice of such concerns from Landlord (unless Tenant can demonstrate that such practices are proper under both current law and current, customary industry practice). Notwithstanding the foregoing, Landlord shall be under no obligation to supervise Tenant's business, operations or procedures. Tenant shall be responsible for the costs of any removal, abatement, or remediation of any Hazardous Materials placed, stored, manufactured, disposed of, or handled by Tenant or Tenant's servants, licensees, or any of Tenant's employees, agents, or invitees, in the Premises or elsewhere on the Project. Such costs shall include, without limitation, the reasonable cost of any consultant retained by Landlord in connection with such work. **Tenant shall indemnify Landlord and hold Landlord harmless from and against any loss, cost, liability, or expense (including reasonable attorney's fees and court costs) arising out of the placement, storage, manufacture, disposal, handling, removal, abatement, or remediation of any Hazardous Materials by Tenant, or any removal, abatement or remediation of any Hazardous Materials required hereunder to be performed or paid for by Tenant, with respect to any portion of the Premises or Project, or arising out of any breach by Tenant of its obligations under this Section 37.** The provisions of this Section 37 shall survive the termination of this

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Lease. The term "Hazardous Materials" as used herein shall mean (i) any substance the presence of which requires special handling, investigation, notification, or remediation under any federal, state, or local statute, regulation, ordinance, order, action, policy, or common law; (ii) any substance which is or becomes defined as a hazardous waste, hazardous substance, pollutant or contaminant under any federal, state, or local statute, regulation, rule, or ordinance or amendments thereto; (iii) any substance which is toxic, explosive, corrosive, flammable, infectious, radioactive, carcinogenic, mutagenic, or otherwise hazardous and is or becomes regulated by any governmental authority, agency, department, commission, board, agency, or instrumentality of the United States, the State of Texas, or any political subdivision thereof; (iv) any substance the presence of which causes or threatens to cause an erosion, contamination, drainage, or nuisance problem (including to adjacent properties, nearby public roads and rights-of-way) or poses or threatens to pose a hazard to the health or safety of persons in or about the Project; (v) any substance which contains gasoline, diesel fuel, or other petroleum hydrocarbons; and (vi) any substance which contains polychlorinated biphenyls, asbestos, or urea formaldehyde foam insulation.

**SEC. 38. SUCCESSORS AND ASSIGNS:** Except as otherwise provided in this Lease, all of the covenants, conditions and provisions of this Lease shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, personal representatives, successors and assigns.

**SEC. 39. INTEREST ON TENANT'S OBLIGATION:** Any Rent, or other amount due from Tenant to Landlord which is not paid when due shall bear interest at the lesser of twelve percent (12%) per annum or the highest rate allowed by law on such amounts from the date such payment is due until paid, but the payment of such interest shall not excuse or cure the default.

**SEC. 40. TIME:** Time is of the essence.

**SEC. 41. APPLICABLE LAW:** This Lease shall be governed by and construed pursuant to the laws of the State of Texas.

**SEC. 42. SEVERABILITY:** If any provision of this Lease or the application thereof to any person or circumstances shall be invalid or unenforceable to any extent, the remainder of this Lease and the application of such provisions to other persons or circumstances shall not be affected thereby and shall be enforced to the greatest extent permitted by law.

**SEC. 43. EXAMINATION OF LEASE:** Submission of this instrument for examination or signature by Tenant does not constitute a reservation of or option for lease, and it is not effective as a lease or otherwise until execution by and delivery to both Landlord and Tenant.

**SEC. 44. AUTHORITY OF TENANT:** If Tenant executes this Lease in other than an individual capacity, each of the persons executing this Lease on behalf of Tenant does hereby personally covenant and warrant that Tenant is a duly authorized and existing legal entity as herein represented, that Tenant has and is qualified to do business in Texas, that Tenant has the full right and authority to enter into this Lease, and that each person signing on behalf of Tenant is authorized to do so. Upon request the signatories hereto will furnish satisfactory evidence of their authority to execute this Lease on behalf of Tenant.

**SEC. 45. BROKERS:** Tenant warrants that it has had no dealings with any real estate broker or agent in connection with the negotiation of this Lease, excepting only the following broker(s) and that it knows of no other real estate broker(s) or agent(s) who is (are) or might be entitled to a commission in connection with this Lease: Jackson & Cooksey. Landlord agrees to pay real estate commissions due in connection with this Lease only to the broker(s) named herein and only pursuant to the terms of a separate written agreement with said broker(s) which has been signed by Landlord. Tenant agrees to indemnify and hold harmless Landlord from and against any liability from all other claims for commission arising from the negotiation of this Lease, to the extent based upon the acts of Tenant.

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**SEC. 46. NOTICES:** All notices which Landlord or Tenant may be required, or may desire, to serve on the other shall be in writing and may be served, as an alternative to personal service, by depositing the same with the U.S. Postal Service, by registered or certified mail, return receipt requested, postage prepaid, addressed as follows: (i) to Landlord at the address set forth below; (ii) to Tenant at the address set forth below; or (iii) to the Tenant at the Premises. Any requirement of notice or service set forth herein shall be deemed satisfied three (3) business days after deposit with the Postal Service. The addresses stated below shall be effective for all notices to the respective parties until written notice of a change of address is given pursuant to the provisions hereof.

If to Tenant	If to Landlord:	Research Interchange One, L.P.
	By Mail:	P.O. Box 10085 Austin, Texas 78766-1085 Research Interchange One, L.P.
_____	By Delivery:	7600 Burnet Road, Ste. 210 Austin, Texas 78757

**SEC. 47 MISCELLANEOUS PROVISIONS:**

**A. Captions:** The title captions appearing in this Lease are inserted and included solely for convenience and shall never be considered or given any effect in construing this Lease, or any provision or provisions hereof, or in connection with the duties, obligations or liabilities of the respective parties hereto or in ascertaining intent, if any question of intent exists.

**B. Limitation on Personal Liability of Landlord:** Notwithstanding anything to the contrary contained in this Lease, it is understood and agreed that there shall be no personal liability on the part of the Landlord or any of its successors or assigns, with respect to any of the terms, covenants and conditions of this Lease, and Tenant shall look solely to the interest of Landlord in the Premises in the event of any default or liability of Landlord under this Lease, such exculpation of liability to be absolute and without any exception whatsoever.

**C. Personal Pronouns:** All personal pronouns used in this Lease shall include the other genders, whether used in the masculine, feminine or neuter gender, and the singular shall include the plural whenever and as often as may be appropriate.

**D. Recordation:** Tenant agrees not to record this Lease.

**SEC. 48. ENTIRE AGREEMENT:** This Lease contains all of the agreements of the parties hereto with respect to any matter covered or mentioned in this Lease, and no prior agreement, understanding or representation pertaining to any such matter shall be effective for any purpose. No provision of this Lease may be amended or added to except by an agreement in writing signed by the parties hereto or their respective successors in interest.

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**SEC. 49. EXHIBITS:** The following exhibits are attached to and made a part of this Lease for all purposes:

- Exhibit A–Floor Plan of Premises
- Exhibit B–Legal Description of the Land
- Exhibit C–Rules and Regulations
- Exhibit D–Schedule of Rental Rates
- Exhibit E–Special Provisions
- Exhibit F–Letter of Acceptance
- Exhibit G–Work Letter

**Tenant**

**Testchip Technologies, Inc.**

By: /s/ Brenda Stoner

Name: Brenda Stoner

Title: Vice President

Date: November 13, 2000

**Landlord**

**Research Interchange One, L. P.**

By: /s/ Brian F. Gaston

Name: Brian F. Gaston

Title: President of the General Partner



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**EXHIBIT A**  
**RESEARCH INTERCHANGE-BUILDING A**  
**9300 UNITED DRIVE**  
**AUSTIN, TEXAS**

**[FLOOR PLAN]**

Note: Details pertinent to the location and number of exterior parking spaces, curbs, green space, glass and glazing, overhead doors and personnel entry/exit doors may have been changed during construction. See building site for actual conditions.

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**EXHIBIT "B"**  
**LAND**  
**(LEGAL DESCRIPTIONS)**

The Land is described in a survey dated November 1, 1999 by Ralph Harris Surveyor Inc., Invoice No. 35895, Work Order No. 34475, as follows:

9.131 acres consisting of Lot 3, a 0.365 acre portion of Lot 1 and a 3.545 acre portion of Lot 2, all of Research Interchange Subdivision, a subdivision in Travis County, Texas, according to the map or plat of record in Volume 95, Page 305, Plat Records of Travis County, Texas, and a 0.957 acre portion of Lot 2, Northwestern Industrial Addition of record in Volume 11, Page 18, and a 0.578 acre portion of Lot A Industrial Terrace Section 5, of record in Volume 83, Page 125D, all of the Travis County, Texas Plat Records.

At some date in the future, the property within the Land may be involved in the amended plat process such that the boundaries of the Land correspond to legal lot lines. Upon such amendment, this description of the Land will be substituted with the new legal lot designation.

AGREED AND ACCEPTED:

Tenant /s/ Brenda Stoner

Landlord /s/ Brian F. Gaston

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**EXHIBIT C**  
**RULES AND REGULATIONS**

1. Tenant will refer to Landlord all contractors, contractor's representatives and installation technicians rendering any service for Tenant for Landlord's supervision and/or written approval before performance of any such contractual services. This shall apply to all work performed in the Project, including, without limitation: (1) installation of telephones, electrical devices and attachments, and installations of any and

every nature affecting floors, wall, woodwork, trim, windows, ceiling, equipment or any other physical portion of the Project, (2) painting or (3) drilling, boring, cutting or stringing of wires.

2. Tenant shall not place, install or operate on the Property any engine, stove, machinery, or conduct mechanical operations or cook therein, or place or use in or about the Premises any explosives, gasoline, kerosene, oil, acids, caustics, or any other flammable, explosive, hazardous or odorous material without the prior written consent of Landlord. **Microwave usage by Tenant's employees and guests is acceptable and the prior consent of Landlord shall not be required.** If consent is granted, Tenant will be required to furnish approved fire extinguishers and have them inspected and approved by the proper local authorities on an annual basis.

3. Landlord will not be responsible for any lost or stolen personal property, equipment, money or jewelry, from any of the Property or any public areas regardless of whether such loss occurs when the area is locked against entry or not.

4. Tenant, or the employees, agents, servants, visitors, or licensees of Tenant shall not at any time or place, leave or discard any rubbish, paper articles, or objects of any kind whatsoever outside the doors of the Premises, or in the passageways of any portion of the Property other than in designated trash receptacles. Drums, pallets, equipment, vehicles, etc. are not allowed to be stored outside of the Premises or the Building.

5. No birds, animals, or vehicles shall be brought into or kept in or about the Project, except for vehicles and parked or stored in areas designated by Landlord.

6. Landlord shall have the right to determine and prescribe the proper weight and proper position of any unusually heavy equipment, including without limitation, all safes, large files and computers, that are to be placed in the Premises, and only those which in the sole opinion of the Landlord will not damage the floors, structure, and/or elevators may be moved into said Premises. Any damage, occasioned in connection with the moving or installation of such aforementioned articles in said Premises, or the existence of same in said Premises shall be paid for by Tenant.

7. Tenant shall give immediate notice to the Property Manager in case of accidents in the Premises or any portion of the Property or of defects therein or in any fixtures or equipment, or of any other type of emergency on or about the Property.

8. Tenant shall not use the Premises or permit the Premises to be used for photographic or multigraph reproductions except in connection with its own business and then only with the Landlord's prior written consent.

9. Any requests by Tenant will be attended to only upon application at the office of the Property Manager. Employees of the Property shall not perform any work or do anything outside their regular duties unless under special instructions from the office of the Property Manager.

10. The parking areas and driveways are to be used only for the purposes intended by Landlord and shall not be obstructed or misused in any way. Parking in any unauthorized area is prohibited. Landlord may from time to time designate parking areas and make other rules and regulations governing parking on the Property. Tenant shall not leave any vehicle in a state of disrepair (including, without limitation, flat tires, out of date inspection stickers, or license plates) on the Project. No vehicle

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maintenance or servicing shall occur on the Project. If Tenant or any of its employees, agents or invitees park their vehicles in areas other than designated parking areas or leave any vehicle in a state of disrepair, Landlord shall have the right to remove such vehicles at Tenant's expense, in accordance with applicable laws.

11. Tenant shall not place anything or allow anything to be placed on the glass of any window, door, partition or wall and the expense of any breakage or damage resulting from the violation of this rule shall be borne by the Tenant who, or whose employees or invitees shall have caused it.

12. The toilet rooms, urinals, wash bowls and other apparatus shall not be used for any purposes other than that for which they were constructed and no foreign substance of any kind whatsoever shall be thrown therein and the expense of any breakage, stoppage or damage resulting from the violation of this rule shall be borne by the Tenant who, or whose employees or invitees shall have caused it.

13. Landlord reserves the right to exclude or expel from the building any person who in the judgment of Landlord is under the influence of liquor or drugs, or who shall in any manner do any act in violation of any of these Rules and Regulations.

14. Without the written consent of Landlord, Tenant shall not use the name of the Building in connection with or in promoting or advertising the business of Tenant except as Tenant's address.

15. Landlord shall have the right to control and operate the public portions of the Property, the public facilities, as well as facilities furnished for the common use of the tenants of the Project, in such manner as it deems best for the benefit of the tenants generally.

16. Trash removal is the Tenant's responsibility and all costs associated with such removal, if not removed by Tenant, shall be borne by the Tenant. Tenant shall maintain adequate receptacles for such removal, the design, placement, and capacity of such receptacles to be approved by Landlord. It is the Tenant's responsibility to maintain in a clean condition, the truck area immediately adjoining the Premises. At Tenant's request, Landlord will make best efforts to provide for a shared dumpster for the tenants in the Building and pass through the cost in an appropriate manner through Additional Rental charges.

17. Landlord reserves the right at any time to rescind any of these Rules and Regulations of the Project and to make such other and further Rules and Regulations as in its sole judgment shall from time to time be needful for the safety, protection, care and cleanliness of the Project, the Premises and the parking areas, the operation thereof, the preservation of good order therein and the protection and comfort of the other tenants in the Project and their agents, employees and invitees, which Rules and Regulations, when made and written notice thereof is given to Tenant, shall be binding upon Tenant in like manner as if originally herein prescribed.

AGREED AND ACCEPTED: Tenant /s/ Brenda Stoner  
Landlord /s/ Brian F. Gaston

**EXHIBIT D  
RENTAL RATES**

<b>Time Period</b>	<b>Monthly Base Rental*</b>	<b>Total Base Rental*</b>
<b>3/01/2001-2/29/2004</b>	<b>\$ 32,436.00</b>	<b>\$ 1,167,696.00</b>
<b>3/01/2004-2/28/2006</b>	<b>\$ 35,680.00</b>	<b>\$ 856,320.00</b>
	<b>TOTAL:</b>	<b>\$ 2,024,016.00</b>

\*Exclusive of Additional Rental.

AGREED AND ACCEPTED: Tenant /s/ Brenda Stoner  
Landlord /s/ Brian F. Gaston

**EXHIBIT E**  
**SPECIAL PROVISIONS**

1. **Option to Renew the Lease:** Tenant is granted the option to renew this Lease for one (1) additional term of five (5) years (the "**Renewal Term**"), such Renewal Term commencing on the date following the expiration of this Lease. If Tenant wishes to exercise the foregoing option, Tenant shall give Landlord written notice thereof at least nine (9) months prior to the beginning of the Renewal Term, in which event the Lease will be renewed at the Fair Market Value Rent (hereinafter defined) as reasonably determined by Landlord and Tenant. In the event that a renewal agreement has not been executed at least six (6) months prior to Lease termination, this option shall become null and void.

"**Fair Market Value Rent**" shall mean the monthly rent charged tenants for space in comparable buildings (age, number of stories, total size, comparable location) in the area in which the Premises are located, taking into account all financial terms, including without limitation, base rent, free rent, escalations, refurbishment or new construction costs funded by the respective parties, credit worthiness of the Tenant, allowances, and leasing and brokerage commissions.

The foregoing option to renew shall terminate if this Lease is assigned or the Premises sublet to any entity other than a Related Entity.

2. **One-time Right of First Refusal:** Tenant shall have a one-time right to lease the available vacant space immediately contiguous to the Premises of this Lease. If Landlord has an acceptable bona fide offer for the space, Tenant's right to lease will be under the same terms and conditions as the offer. Written acceptance or rejection of Tenant's right to lease must be received by Landlord within five (5) business days of receiving the option right and Tenant must execute the lease for the space within ten (10) business days. If Tenant elects not to accept the offer, then this One-time Right of First Refusal will become null and void forevermore.

Upon eight (8) months prior written notice, Tenant shall have the right to require Landlord to provide Tenant with up to twenty-one (21) Additional Parking Spaces ("APS") on land owned by Bill Gaston, Inc. on property adjacent to the Project and to the south of the Project currently described as the portion of Lot 1, Block A, Research Interchange Subdivision, Travis County, Texas not contained in the Project ("Phase 2"), provided Bill Gaston, Inc. or a related entity owns Phase 2 at the time of Tenant's exercise of this right. Upon delivery of the APS, Tenant shall pay additional Rent in the amount of \$50 per parking space leased. If Tenant ever reduces the number of APS it requires, Tenant will be limited to that number of APS thereafter.

Upon redevelopment of Phase 2, Landlord shall be allowed to cease leasing the APS to Tenant. Landlord will work cooperatively with Tenant to provide Tenant with up to 21 APS upon completion of the redevelopment of Phase 2 under terms reasonably determined in Landlord's sole discretion taking into account the cost of development of the parking structures associated with the redevelopment of Phase 2. If Tenant leases APS in the redevelopment of Phase 2, Tenant will be not be allowed to reduce the number of APS it leases during the term of this Lease or its renewal.

AGREED AND ACCEPTED:	Tenant	<u>/s/ Brenda Stoner</u>
	Landlord	<u>/s/ Brian F. Gaston</u>

**EXHIBIT F**  
**LETTER OF ACCEPTANCE**

TENANT:

LANDLORD:

DATE LEASE SIGNED:

TERM OF LEASE: \_\_\_\_\_ MONTHS

ADDRESS OF PREMISES:

COMMENCEMENT DATE:

EXPIRATION DATE:

The above-described Premises are accepted by Tenant as in compliance with the Lease and suitable for the purpose for which they were leased. The above-described Lease commences and expires on the dates set forth above. Tenant acknowledges that it has received from Landlord \_\_\_\_\_ keys to the Premises.

TENANT

\_\_\_\_\_  
(Name of Tenant)

By \_\_\_\_\_  
(Signature)

\_\_\_\_\_  
(Name and Title)

LANDLORD

\_\_\_\_\_  
(Name of Landlord)

By \_\_\_\_\_  
(Signature)

\_\_\_\_\_  
(Name and Title)

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**EXHIBIT G  
WORK LETTER**

It is agreed that Landlord will complete construction of the Premises leased by Landlord to Tenant in that certain Lease to which a copy of this Work Letter is attached, in accordance with the following:

1. Within ten (10) working days of the execution of the Lease, Tenant shall provide to Landlord (a) a preliminary space plan showing all proposed interior partitions, doors, plumbing fixtures and millwork and (b) preliminary specifications for all interior improvements and finishes. Such space plan and specifications shall be (a) prepared by either Landlord's architect and engineer or an architect and engineer selected by Tenant, provided that the Tenant's architect and engineer must be previously approved in writing at Landlord's sole discretion and Landlord's architect and engineer shall review the working drawings and specifications of materials at Tenant's expense, (b) in accordance with such specifications as Landlord has established for the construction of all interior improvements within the Project (the "Building

Standards") and (c) subject to approval by Landlord. Landlord shall have a period of five (5) days after receipt of the preliminary space plan and specifications in order to approve or disapprove same. If Landlord shall disapprove Tenant's plans and specifications within such five (5) day period and advise Tenant in writing of the changes which will be necessary in order for Landlord to approve same, Tenant shall make the changes in the preliminary space plan and specifications required by Landlord and submit a revised preliminary space plan and specifications to Landlord not later than five (5) days after receipt of Landlord's written comments thereon and/or requirements with respect thereto. Any delay occasioned as a result of Landlord's disapproval of Tenant's plans and specifications shall not delay the Commencement Date under this Lease. In the event that Landlord fails to approve the originally submitted preliminary space plan and specifications within the aforesaid five (5) day period or to disapprove same with comments and/or requirements with respect thereto having been submitted to Tenant by Landlord within such five (5) days, Tenant shall have the right to give Landlord written notice of Landlord's failure to approve or disapprove Tenant's plans and specifications on or before the expiration of five (5) days following the expiration of the aforesaid five (5) day period, and if Landlord shall not have responded to such notice from Tenant within five (5) days thereafter by enumerating reasons for Landlord's disapproval of Tenant's plans and specifications, this Lease automatically shall be null and void and neither Landlord nor Tenant shall have any further rights or obligations hereunder. When the preliminary space plan and specifications as revised are approved by Landlord, then the architect and engineer mutually selected by Tenant and Landlord, but under contract to Landlord, shall commence the preparation of the construction documents for the Improvements. At such time as the construction documents are completed then Tenant and Landlord shall review same and each initial and date the construction documents (the "Construction Documents").

2. Landlord shall obtain at least three (3) bids for the construction of the Improvements in accordance with the Construction Documents. The selection of the general contractor to perform the construction of the Improvements shall be made by Landlord with the consent of Tenant and shall be based on the following: (a) the contractor's qualifications and experience, (b) the ability of the contractor to perform on the schedule and meet or exceed the projected commencement date and (c) the contractor's proposed contract amount. The cost of the Improvements for the purpose of billing shall equal the cost to Landlord of constructing such Improvements (including the cost of supervision and coordination) plus the following amount: 4% if Landlord employs a general contractor.

3. Architectural and engineering fees relating to the Premises (including any architectural and engineering fees incurred by Landlord in reviewing Tenant's working drawings and specifications and in modifying Landlord's master working drawings to incorporate plans prepared by Tenant's architect or engineer, where an architect or engineer other than Landlord's architect or engineer has prepared Tenant's working drawings and specifications) shall be paid by Tenant. All costs and expenses incurred in the construction of Improvements shall be borne by Tenant (and are hereinafter referred to as

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"Tenant's Costs"); provided, however, that Tenant shall receive an allowance (the "Allowance") of \$703,920.00 to be credited against the billing costs of constructing the Improvements. Any excess (the "Excess") of Tenant's Costs over the Allowance shall be payable as follows:

- (a) Tenant shall pay to Landlord, prior to the commencement of construction of the Improvements, an amount equal to the greater of: (i) \$90,000 or (ii) sixty percent (60%) of the Excess (as then estimated by Landlord);
- (b) After substantial completion of the Improvements, but prior to occupancy of the Premises by Tenant, Tenant shall pay to Landlord an amount equal to eighty percent (80%) of the then unpaid balance of the Excess (as then estimated by Landlord); and
- (c) As soon as the final accounting can be prepared and submitted to Tenant, Tenant shall pay to Landlord the entire unpaid balance of the actual Excess, based on the final costs to Landlord measured as described in Paragraph 2 hereof.

The amounts payable hereunder shall constitute Rent due pursuant to the Lease at the times specified herein and failure to make any such payments when due shall constitute a default under the Lease, entitling Landlord to all of its remedies thereunder, as well as all remedies otherwise available to Landlord.

The Excess to be paid by Tenant shall be required to be at least \$150,000.00. In the event that the Excess is less than \$150,000.00, the amount of the difference (the "Make-up Amount") shall be paid to Landlord by Tenant as soon as the final accounting is determined as in

Section 3(c) herein. In the event that a Make-up Amount is due and paid by Tenant, the remaining Base Rental shall be reduced by amortizing the Make-up Amount over the remaining primary Term of the Lease using an 11% amortization factor.

4. If Tenant requests any changes in the approved plans and specifications for the Improvements, Tenant shall present Landlord with revised plans and specifications. If Landlord approves such changes, Landlord shall incorporate such changes in the Improvements; Landlord, however, may require, prior to proceeding with any changes, additional cash advances against the Excess in the event Landlord determines that Tenant's proposed changes will increase the amount of such Excess.

5. If Tenant requests changes in the approved plans and specifications for the improvements and if such changes shall delay the work to be performed hereunder, or if Tenant shall otherwise delay the completion of said work, including, without limitation, delay resulting from Tenant's failure to timely submit final working drawings and specifications of materials for Landlord's approval, then, notwithstanding any provision to the contrary in the Lease, Tenant's obligation to pay rent hereunder shall nevertheless commence on the date in Section 2 of the Lease and the Commencement Date under the Lease shall not be delayed as hereinafter provided. If by the Commencement Date specified in Section 2 of the Lease, the Premises have not been substantially completed pursuant to the terms of this Work Letter, due to any cause other than delays caused by Tenant as provided above, then, as Tenant's sole remedy for the delay in Tenant's occupancy of the Premises, the Commencement Date shall be delayed and the Rent under the Lease shall not commence until the earlier of actual occupancy by Tenant or substantial completion of the Improvements.

6. Within seven (7) days after delivery of the Improvements to Tenant, Tenant shall have the right to submit a written "punch list" to Landlord, setting forth any defective item of construction, and Landlord shall promptly cause such items to be corrected. During the first year of the term of this Lease, Tenant shall give notice to Landlord whenever any defect becomes reasonably apparent, and Landlord will use reasonable efforts to enforce the warranties of the contractors.

7. All terms herein used shall have the same meaning as when used in the Lease.

AGREED AND ACCEPTED:	Tenant	/s/ Brenda Stoner
	Landlord	/s/ Brian F. Gaston

### QuickLinks

- [EXHIBIT 10.17](#)
- [INDUSTRIAL LEASE AGREEMENT](#)
- [WITNESSETH](#)
- [EXHIBIT A RESEARCH INTERCHANGE-BUILDING A 9300 UNITED DRIVE AUSTIN, TEXAS](#)
- [EXHIBIT "B" LAND \(LEGAL DESCRIPTIONS\)](#)
- [EXHIBIT C RULES AND REGULATIONS](#)
- [EXHIBIT D RENTAL RATES](#)
- [EXHIBIT E SPECIAL PROVISIONS](#)
- [EXHIBIT F LETTER OF ACCEPTANCE](#)
- [EXHIBIT G WORK LETTER](#)

**First Amendment to the Lease  
between Testchip Technologies, Inc. as Tenant  
And Research Interchange One L.P. as Landlord  
for the Premises at 9300 United Drive, Suite 180, Austin, Texas**

Research Interchange One L. P. as Landlord and Testchip Technologies, Inc. as Tenant mutually agree to the following modifications to the Lease for the Premises at 9300 United Drive, Suite 180, Austin, Texas entered into on November 17, 2000:

1. Notwithstanding anything in the Lease to the contrary, the Commencement Date of the Lease shall be March 16, 2001 and the Base Rental and Additional Rental shall commence on March 16, 2001.
2. Any and all expenses generated by or through the Waddill Group architecture firm shall be capped at \$68,228.40 for the purpose of reimbursement through the Allowance provided in Exhibit G, paragraph 3 of the Lease. Any and all expenses relating to the wiring of the Tenant supplied power poles shall be capped at \$2,000.00 for the purpose of reimbursement through the Allowance provided in Exhibit G, paragraph 3 of the Lease. Any excess expense over \$68,228.40 for the Waddill Group or \$2,000.00 for the wiring of Tenant's power poles shall be paid directly by Tenant and not included in the minimum \$150,000 of Excess (Tenant's Costs over the Allowance) required under Exhibit G, paragraph 3.

All other terms in the Lease shall remain the same and in full force and effect.

<u>Tenant</u>	<u>Landlord</u>
<b>Testchip Technologies, Inc.</b>	<b>Research Interchange One, L.P.</b>
By: <u>/s/ Mark Harward</u>	By: <u>/s/ Brian F. Gaston</u>
Name: <u>Mark Harward</u>	Name: <u>Brian F. Gaston</u>
Title: <u>President and CEO</u>	Title: <u>President of the General Partner</u>
Date: <u>March 28, 2001</u>	Date: <u>March 28, 2001</u>

QuickLinks

[EXHIBIT 10.18](#)

[First Amendment to the Lease between Testchip Technologies, Inc. as Tenant And Research Interchange One L.P. as Landlord for the Premises at 9300 United Drive, Suite 180, Austin, Texas](#)



**SECOND AMENDMENT TO THE LEASE BETWEEN**  
**Research Interchange One, L.P. as Landlord and**  
**Testchip Technologies, Inc. as Tenant**  
**For the Premises at 9300 United Drive, Suite 180, Austin, Texas**  
**Dated November 17, 2000**

This amendment to the Lease for the Premises at 9300 United Drive, Suite 180, Austin, Texas, dated November 17, 2000, (the "Lease") and amended by First Amendment on March 28, 2001 by and between Research Interchange One, L. P. a Texas Limited Partnership (the "Landlord"), and Testchip Technologies, Inc., (the "Tenant") is made and entered into between Landlord and Tenant as of the sixth day of June, 2001.

**WITNESSETH**

**WHEREAS**, expenses incurred by Landlord for the build-out of Tenant's improvements were less than the \$703,920.00 Allowance called for in Exhibit G of the Lease.

**WHEREAS**, Landlord and Tenant desire to amend the Lease with respect to the Base Rental called for in Exhibit D of the Lease as a result of Landlord spending \$13,930.01 less than the Allowance under the formula contained in Exhibit G for such purpose.

**NOW THEREFORE**, in consideration of the foregoing and the mutual promises and covenants contained herein, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Landlord and Tenant agree as follows:

1. *Defined Terms.* Unless otherwise defined herein, capitalized terms used herein and defined in the Lease shall be used herein as so defined in the Lease.

2. *Amended Provisions.* All terms and conditions of the Lease shall remain the same except that the Base Rental shall change for the months shown below:

	<u>New Monthly Base Rental</u>	
June 1, 2001 to February 29, 2004	\$	32,121.00
March 1, 2004 to February 28, 2006	\$	35,365.00

3. *Further Amendment.* Should additional expenses applicable to Landlord's Allowance be paid by Landlord, further adjustments will be made under the adjustment provision of Exhibit G of the Lease.

(SIGNATURES ON FOLLOWING PAGE]

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**IN WITNESS WHEREOF**, Landlord and Tenant have executed this amendment effective as of the date first written above.

LANDLORD

Research Interchange One, L. P.

By: /s/ Brian F. Gaston

Print Name: Brian F. Gaston

Print Title: President

TENANT

Testchip Technologies, Inc.

By: /s/ Martin Kaup

Print Name: Martin Kaup

Print Title: Assistant Controller

QuickLinks

[EXHIBIT 10.19](#)

[SECOND AMENDMENT TO THE LEASE BETWEEN Research Interchange One, L.P. as Landlord and Testchip Technologies, Inc. as Tenant For the Premises at 9300 United Drive, Suite 180, Austin, Texas Dated November 17, 2000](#)

**THIRD AMENDMENT TO THE LEASE BETWEEN**  
**Research Interchange One, L.P. as Landlord and**  
**Testchip Technologies, Inc. as Tenant**  
**For the Premises at 9300 United Drive, Suite 180, Austin, Texas**  
**Dated November 17,2000**

This amendment to the Lease for the Premises at 9300 United Drive, Suite 180, Austin, Texas, dated November 17, 2000, (the "Lease") and amended by First Amendment on March 28, 2001 and Second Amendment on June 6, 2001 by and between Research Interchange One, L. P. a Texas Limited Partnership (the "Landlord"), and Testchip Technologies, Inc., (the "Tenant") is made and entered into between Landlord and Tenant as of the first day of October, 2001.

**WITNESSETH**

**WHEREAS**, Tenant has requested a modification of the rental structure from Landlord.

**WHEREAS**, Landlord and Tenant desire to amend the Lease with respect to the Base Rental called for in Exhibit D of the Lease as a result.

**NOW THEREFORE**, in consideration of the foregoing and the mutual promises and covenants contained herein, and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, Landlord and Tenant agree as follows:

1. *Defined Terms.* Unless otherwise defined herein, capitalized terms used herein and defined in the Lease shall be used herein as so defined in the Lease.

2. *Amended Provisions.* All terms and conditions of the Lease shall remain the same except that the Base Rental shall change for the months shown below:

	<u>New Monthly Base Rental</u>
October 1, 2001 to March 31, 2002	\$ 16,060.50
April 1, 2002 to September 30, 2003	\$ 38,035.00

and,

If the Premises, or any portion thereof is subleased between October 1, 2001 and September 30, 2003, all rent from such sublessee will be paid directly to Landlord and applied first to a maximum of \$5,914.00 per month of Base Rental first applied to the Base Rental due for September 2003 and then to each preceding month to the month of April, 2002, then to Tenant's Additional Rental obligations, then to Tenant's current Base Rental obligations. Any sublease rent left over would be applied as per the Lease Agreement. If sublease rent is received by Landlord during this twenty-four month period, a rental reduction will be granted by Landlord at the rate of ten percent per annum of the sublease rent applied to the monthly maximum of \$5,914.00 of Base Rental, from the date of sublease rent receipt to the month of application.

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**IN WITNESS WHEREOF**, Landlord and Tenant have executed this amendment effective as of the date first written above.

LANDLORD

Research Interchange One, L. P.

By: /s/ Brian F. Gaston

Print Name: Brian F. Gaston

Print Title: President

TENANT

Testchip Technologies

By: /s/ Merrill J. Wersheimer

Print Name: Merril J. Wersheimer

Print Title: CFO

QuickLinks

[EXHIBIT 10.20](#)

[THIRD AMENDMENT TO THE LEASE BETWEEN Research Interchange One, L.P. as Landlord and Testchip Technologies, Inc. as Tenant For the Premises at 9300 United Drive, Suite 180, Austin, Texas Dated November 17,2000](#)

**COMMERCIAL LEASE AGREEMENT**

Jackson Shaw Technology Center II  
Limited Partnership

to

Testchip Technologies, Inc.

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**EXHIBITS:**

- Exhibit A–Legal Description
- Exhibit B–Tenant Improvements
- Exhibit C–Sign Criteria
- Exhibit D–Rules & Regulations
- Exhibit E–Renewal Option
- Exhibit F–Expansion Right of First Refusal

**COMMERCIAL LEASE AGREEMENT**

THIS LEASE AGREEMENT is entered into by and between:

1. **LANDLORD: Jackson-Shaw Technology Center II Limited Partnership**
2. **TENANT: TestChip Technologies, Inc.**

3. **LEASED PREMISES:** In consideration of the rents, terms and covenants of this Commercial Lease Agreement (this "Lease"), Landlord hereby leases to Tenant certain premises (the "Leased Premises") consisting of approximately **18,302** square feet within the 83,286 square foot building (the "Building") located at **2600 Technology Drive, Suite 600, Plano, Texas, 75074**, together with the non-exclusive light to use, in common with other tenants, the common areas of the Project, which are all areas neither exclusively leased to another tenant nor expressly reserved to or by Landlord. The land upon which the Building is located is described in the attached Exhibit A and, together with the Building, landscaping, parking and driveway areas, sidewalks, and other improvements thereon, shall be referred to in this Lease as the "Project."

4. **TERM:**

(a) The term of this Lease shall be **66** months commencing on **August 1, 2000**, the "Commencement Date" and terminating on the last day of the 66th month following the Commencement Date (the "Termination Date"). This Commencement Date may be subject to change, however, pursuant to Paragraph 4(c) below.

(b) Tenant acknowledges that it accepts the Leased Premises as suitable for Tenant's purposes subject only to Paragraph 4(c) below, if applicable. If this Lease is executed before the Leased Premises become available for occupancy, or if Landlord cannot acquire possession of the Leased Premises prior to the Commencement Date stated above, Tenant agrees to accept possession of the Leased Premises at such time as Landlord is able to tender the same, which date shall then be the Commencement Date of the Lease term.

(c) Landlord agrees to install at its cost and expense the improvements, if any, described in the plans and specifications described in Exhibit B. If such improvements are not completed and the Leased Premises are not ready for occupancy on the Commencement Date stated above, other than as a result of the omission, delay or default by Tenant or anyone acting under or on behalf of Tenant, the rent under this Lease shall not commence until substantial completion of the work described in said plans and specifications, and the Commencement Date of the Lease term shall be the date of such substantial completion and Tenant secures Certificate of Occupancy. Landlord shall notify Tenant in writing as soon as such improvements are substantially completed and ready for occupancy. If Tenant believes that such improvements have not been substantially completed as aforesaid, Tenant shall notify Landlord in writing of its objections within three (3) days after receipt of the completion notice from Landlord. Landlord shall have a reasonable time after receipt of such notice (but in no event more than 10 days) in which to commence such corrective action as may be necessary and shall notify Tenant in writing as soon as it deems such corrective action has been completed so that the Leased Premises are completed and ready for occupancy. In the event of any dispute as to substantial completion or work performed or required to be performed by Landlord, the certificate of a registered architect shall be conclusive and binding on all parties.

(d) Tenant acknowledges that no representations or promises regarding construction, repairs, alterations, remodeling, or improvements to the Leased Premises have been made by Landlord, its agents, employees, or other representatives, unless such are expressly set forth in this Lease or any Exhibit hereto. Tenant is solely responsible for applying for and obtaining a Certificate of Occupancy for the Leased Premises and will satisfy itself as to the business park restrictions and all zoning and similar restrictions and regulations prior to commencement of any construction. Failure of Tenant to provide written notice of such objections prior to commencement of construction shall be deemed

acceptance by Tenant. Tenant agrees that if its occupancy of the Leased Premises is delayed under the circumstances described in Paragraphs 4(b) and (c) above, this Lease shall nonetheless continue in full force and effect. Adjustment of the rent commencement date as above provided shall constitute full settlement of all claims by Tenant against Landlord by reason of any such delay in possession of the Leased Premises. Tenant's taking possession of the Leased Premises shall conclusively establish that the improvements, if any, to be made by Landlord under the terms of this Lease have been completed in accordance with the plans and specifications therefor and that the Leased Premises are in good and satisfactory condition as of the date of Tenant's possession, unless Tenant notifies Landlord in writing specifying any bona fide deficiencies after taking possession. Landlord shall use reasonable diligence to repair promptly such items but Tenant shall have no claim for damages or rebate or abatement of rent by reason thereof. In conjunction with, or at any time after, the Commencement Date, Tenant shall, upon demand, execute and deliver to Landlord an Estoppel letter (as referred to in paragraph 33 herein) to acknowledge the Commencement Date.

##### 5. **BASE RENT AND SECURITY DEPOSIT:**

(a) Tenant agrees to pay to Landlord the following rental amounts (sometimes referred to in this Lease as the "Base Rent" or "Base Rental"): **months 1 and 4 through 6, \$155,568.00 per year payable in monthly installments of \$12,964.00 each, Months 7-66, \$205,908.00 per year payable in monthly installments of \$17,159.00 each. Landlord agrees to waive months 2 and 3 of the primary Lease Term.** Payment of rent is subject to proration for partial months and to adjustment for early or delayed occupancy under the terms hereof, and, if the area of the Leased Premises is, on the Commencement Date, different than the area stated in Paragraph 3 above, then Base Rent shall be adjusted to reflect **the then applicable** per square foot rate. On the commencement date of the Lease Agreement the first month's Base Rent shall be payable. All subsequent payments shall be made to Landlord monthly, in advance, without demand, deduction or offset, in lawful money of the United States of America at the address stated below. All installments of Base Rent shall be due and payable on or before the first (1st) day of each month during the Lease term.

(b) Upon the date Tenant executes the Lease Agreement, there shall be due and payable by Tenant a Security Deposit in the amount of **\$17,159.00**. Such deposit shall be held by Landlord (without any obligation to pay interest thereon or segregate such money from Landlord's general funds except as may be required by applicable law) as security for the performance of Tenant's obligations under this Lease. Tenant agrees to increase such Security Deposit from time to time so that it is at all times equal to one monthly Base Rental installment plus the average monthly additional rentals arising pursuant to Paragraph 6 below.

Tenant shall deposit cash with Landlord in an amount sufficient so to increase the Security Deposit to such amount within five (5) days after written demand by Landlord. It is expressly understood that the Security Deposit is not an advance payment of rental or a measure of Landlord's damages in the event of Tenant's default under this Lease. Upon the occurrence of any event of default by Tenant under this Lease, Landlord may, from time to time, without prejudice to any other remedy provided herein or provided by law, use, apply, or retain all or part of the Security Deposit for the payment of (i) any Base Rent, (ii) additional rentals arising under Paragraph 6 below, and (iii) other sums due hereunder, including without limitation any amount which Landlord may spend or become obligated to spend by reason of Tenant's default or to compensate Landlord for any damage, injury, expense or liability caused to Landlord by such default or breach (all of which items (i), (ii) and (iii) are sometimes referred to in the aggregate as "Rent"). If any portion of the Security Deposit is so used or applied, Tenant shall, within five (5) days after written demand thereof, deposit cash with Landlord in an amount sufficient to restore the Security Deposit to the amount required by this Paragraph. Tenant's failure to do so shall be an event of default under this Lease. The balance of the Security Deposit shall be returned by Landlord to Tenant at such time after termination of this Lease that all of Tenant's obligations have been fulfilled.

(c) Other remedies for nonpayment of Rent notwithstanding, if the monthly Base Rental payment is not received by Landlord on or before the tenth (10th) day of the month for which such rent is due, or if any other Rent payment due Landlord by Tenant hereunder is not received by Landlord within ten (10) days of the due date, a service charge of two hundred (\$200.00) dollars shall be additionally due and payable by Tenant as an administrative charge for the excess efforts necessitated by such tardiness in payment. Such service charge shall be cumulative of any other remedies Landlord may have for nonpayment of Rent and other sums payable under this Lease.

(d) If three (3) consecutive monthly Base Rental payments or any ten (10) [in total, cumulative from the beginning of the Lease term] monthly Base Rental payments during the Lease term (or any renewal or extension thereof) are not received by Landlord within ten (10) days of the due date, the Base Rent hereunder shall automatically become due and payable by Tenant in advance in quarterly installments equal to three (3) months' Base Rent each. The first of such quarterly Base Rent payments shall be due and payable on the first day of the next succeeding month and on the first day of every third (3rd) month thereafter. This remedy shall be cumulative of any other remedies of Landlord under this Lease for nonpayment of Rent.

## **6. ADDITIONAL RENTAL:**

### **(a) Taxes and Insurance:**

(1) "Tax and Insurance Costs" shall mean all of the following paid or payable by Landlord with respect to the Project or any portion thereof: (i) all federal, state and local sales, use, ad valorem, rental, value added, and other taxes (other than Landlord's income or franchise taxes) and special assessments and other governmental charges; and (ii) all insurance premiums, including, without limitation, public liability, casualty, rental and property damage insurance.

(2) Landlord shall pay all Tax and Insurance Costs; however, Landlord may in its discretion defer such payment to the extent permitted by applicable laws so long as contested by Landlord in good faith and so long as Tenant's occupancy of the Premises is not lawfully disturbed.

(3) For each calendar year of the term of this Lease, Tenant shall pay to Landlord as additional Rent hereunder its "pro rata portion" of the Tax and Insurance Costs computed by multiplying the Tax and Insurance Costs by a fraction, the numerator of which is the number of rentable square feet in the Leased Premises, and the denominator of which is the number of rentable square feet in the Building.

(4) Along with the Base Rent Tenant shall pay one-twelfth of its pro rata portion of Tax and Insurance Costs as estimated from time to time by Landlord, during the term of this Lease. As soon as available after the expiration of each calendar year during the term of this Lease, Landlord shall submit a reconciliation statement to Tenant setting forth (i) Tenant's pro rata portion of the Tax and Insurance Costs due from Tenant for the preceding calendar year, (ii) the amount of Tax and Insurance Costs paid by Tenant during such calendar year, and (iii) the amount, if any, either overpaid or remaining due from Tenant to Landlord. Within (10) days



after receipt of such statement, Tenant shall remit to Landlord the amount said statement shows to be due from Tenant or, if Tenant has overpaid, Landlord shall credit the amount overpaid to Tenant's pro rata portion of Tax and Insurance Costs next due. If Tenant is not in default and this Lease terminated at the end of such prior year, Landlord shall refund such overpayment to Tenant.

(5) For the calendar years in which this Lease commences and terminates, Tenant's liability for its pro rata portion of the Tax and Insurance Costs for such partial calendar years shall be subject to pro rata adjustment based upon the number of days of the term elapsing during such partial year. Where the applicable charges are not available prior to the end of the term hereof, then the aforesaid adjustment shall be made between Landlord and Tenant after Landlord shall

have received the charges for such period, it being specifically agreed that Landlord's and Tenant's obligations under this Paragraph shall survive the expiration of the term of this Lease.

(6) The failure of Landlord to exercise its rights hereunder to estimate Tax and Insurance Costs and require payment of same as additional Rent shall not constitute a waiver of such rights which rights may be exercised from time to time at Landlord's discretion.

**(b) Common Area Maintenance:**

(1) "Common Area Maintenance Expenses" shall mean any and all expenses (other than the Tax and Insurance Costs described above) arising from the maintenance, repair, replacement and operation of, and modifications and improvements to comply with governmental mandate to, the Project's common areas and any portions of the Project for which Landlord is responsible hereunder (excluding only expenses associated with structural integrity of the roof, foundation, and exterior walls) including, but not limited to, management fees, utility expenses (if furnished by Landlord), wages and fringe benefits payable to employees of Landlord whose duties are connected with the operation and maintenance of the Project, amounts paid to contractors or subcontractors for work or services performed in connection with the operation and maintenance of the Project, including without limitation common areas and parking areas and roof, exterior wall and foundation work that is not related to structural integrity. Any capitalized expenditures included within the foregoing (together with reasonable finance charges) will be amortized for purposes of this Paragraph over the useful life of the improvement.

(2) The term "Common Area Maintenance Expenses" shall not include repair, restoration or other work occasioned by fire, windstorm or other casualty with respect to which Landlord actually receives insurance proceeds, income and franchise taxes of Landlord, expenses incurred in leasing to or procuring of tenants, leasing commissions, advertising expenses, expenses for the renovating of space for new tenants, interest or principal payments or any mortgage or other indebtedness of Landlord, compensation paid to any employee of Landlord above the grade of building superintendent, or depreciation allowance or expense.

(3) Tenant agrees to pay as additional Rent its pro rata portion (as defined in Paragraph 6(a)(3) above) of the Common Area Maintenance Expenses. Along with the Base Rent Tenant shall pay one-twelfth of its pro rata portion of Common Area Maintenance Expenses as estimated from time to time by Landlord, during the term of this Lease. As soon as available after the expiration of each calendar year during the term of this Lease, Landlord shall submit a statement to Tenant setting forth (i) Tenant's pro rata portion of the Common Area Maintenance Expenses due from Tenant for the preceding calendar year, (ii) the amount of Common Area Expenses paid by Tenant during such calendar year, and (iii) the amount, if any, either overpaid or remaining due from Tenant to Landlord. Within ten (10) days after receipt of such statement, Tenant shall remit to Landlord the amount said statement shows to be due from Tenant or, if Tenant has overpaid, Landlord shall credit the amount overpaid to Tenant's pro rata portion of Common Area Maintenance Expenses next due. Landlord agrees to provide a cap on controllable expenses including but not limited to management fees, landscape maintenance, general maintenance and insurance of six percent (6%) per year. If Tenant is not in default and this Lease terminated at the end of such prior year, Landlord shall refund such overpayment to Tenant.

(4) For the calendar years in which this Lease commences and terminates, Tenant's liability for its pro rata portion of the Common Area Maintenance Expenses for such partial calendar years shall be subject to pro rata adjustment based upon the number of days of the term elapsing during such partial year. Where the applicable expenses are not available prior to the end of the term hereof, then the aforesaid adjustment shall be made between Landlord and Tenant after Landlord shall have received all of the expenses for such period, it being specifically agreed that

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Landlord's and Tenant's obligations under this Paragraph shall survive the expiration of the term of this Lease.

(5) The failure of Landlord to exercise its rights hereunder to estimate expenses and require payment of same as additional Rent shall not constitute a waiver of such rights which rights may be exercised from time to time at Landlord's discretion.

(c) In any event, Tenant shall be responsible for insuring and paying all taxes upon Tenant's furniture, machinery, goods, supplies, fixtures, Alterations (below defined) or other improvements, and other property on the Project.

#### **7. TENANT REPAIRS AND MAINTENANCE:**

(a) Tenant shall maintain all parts of the Leased Premises and their appurtenances (except those for which Landlord is expressly responsible under this Lease) in good, clean and sanitary condition, at its own expense. Tenant shall promptly make all necessary repairs and replacements to the Leased Premises, including but not limited to electric light lamps or tubes, windows, glass and plate glass, interior and exterior doors, any special office entry, interior walls and finish work, floors and floor coverings, downspouts, gutters, heating and air conditioning systems, dock boards, truck doors, dock bumpers, and plumbing work and fixtures. Replacement and repair parts, materials and equipment shall be of quality equivalent to those initially installed within the Leased Premises, and repair and maintenance work shall be done in a good and workmanlike manner and in accordance with existing laws, rules, regulations and ordinances.

(b) Tenant shall not damage or disturb the integrity, structural integrity, or support of any wall, roof, or foundation of the Building. Any damage to these areas caused by Tenant or Tenant's Representatives (defined in Paragraph 7(g)) shall be promptly repaired by Tenant at its sole cost and expense.

(c) Intentionally Deleted

(d) Tenant shall, at its own cost and expense, enter into a regularly scheduled preventive maintenance service contract with a maintenance contractor for servicing all heating, ventilation and air conditioning systems and equipment within, and any other equipment or machinery installed by Landlord in, or to serve, the Leased Premises. The maintenance contractor and the contract are subject to Landlord approval which shall not be unreasonably withheld. The service contract must include all services suggested by the equipment manufacturer within the operation/maintenance manual and must become effective (and a copy delivered to Landlord) within thirty (30) days of the date Tenant takes possession of the Leased Premises. If Tenant fails to enter into such service contract as required, Landlord shall have the right to do so on Tenant's behalf, and Tenant agrees to pay Landlord the direct cost and direct expense of same upon demand, and such amount shall be considered additional Rent.

(e) Tenant shall at its own expense keep the Leased Premises pest-free and pay all charges for pest control and extermination within the Leased Premises.

(f) At the termination of this Lease, Tenant shall deliver the Leased Premises "broom clean" to Landlord in the same good order and condition as existed at the Commencement Date of this Lease, ordinary wear, natural deterioration beyond the control of Tenant, and damage by fire, tornado or other casualty excepted. Tenant shall give written notice to Landlord at least thirty (30) days prior to vacating the Leased Premises and shall arrange to meet with Landlord for a joint inspection of the Leased Premises prior to vacating. In the event of Tenant's failure to give such notice or arrange such joint inspection, Landlord's inspection at or after Tenant's vacating the Leased Premises shall be conclusively deemed correct for purposes of determining Tenant's responsibility for repairs and restoration.

(g) Not in limitation on the foregoing, it is expressly understood that Tenant shall repair and pay for all damage caused by the negligence of Tenant, Tenant's employees, officers, directors, partners, agents, invitees, licensees, contractors, representatives, or others for whom Tenant is legally responsible (all such persons and entities being herein collectively referred to as "Tenant's Representatives") or caused by Tenant's default hereunder.

(h) If Landlord shall give Tenant written notice of defects or need for repairs for which Tenant is responsible under this Lease, and if Tenant shall fail to make same within 30 days of Landlord's written notification or such shorter time as reasonable if expedited repair is needed to avoid injury or damage, Landlord shall have the option to cure said defect or repair, and Tenant shall pay to Landlord all costs and expenses incurred on demand.

#### 8. LANDLORD'S REPAIRS:

(a) Landlord shall be responsible, at its expense, for, but only for, the structural integrity of the roof, foundation and exterior walls of the Building. In further limitation on Landlord's responsibilities hereunder, (i) any repair to the roof, foundation or exterior walls occasioned by the act of omission of Tenant or Tenant's Representatives shall be the responsibility of Tenant; (ii) the term "walls" as used in this Paragraph 8 shall not include windows, glass or plate glass, interior doors, special store fronts, office entries or exterior doors; and (iii) Landlord's liability with respect to any defects, repairs or maintenance for which Landlord is responsible at its expense under this Lease shall be limited to the cost of such repairs or maintenance or the curing of such defect. Tenant shall promptly give Landlord written notice of defects or need for repairs, after which Landlord shall have 30 days to commence to repair or cure such defect.

(b) Landlord shall perform the work which gives rise to Common Area Maintenance Expenses, subject to payment therefor by Tenant pursuant to the provisions of Paragraph 6(b) above. If the need for any such work shall come to the attention of Tenant, Tenant will promptly so notify Landlord in writing.

9. **UTILITY SERVICE:** Tenant shall pay the cost of all utility services including, but not limited to, initial connection charges and deposits and all charges for gas, water, trash disposal, sewer, telephone or other telecommunications, and electricity used on the Leased Premises. Tenant shall pay all costs caused by Tenant introducing excessive pollutants into the sanitary or storm sewer system, including permits, fees, assessments, and charges levied by any governmental subdivision for any pollutants or solids other than ordinary human waste.

10. **SIGNS:** No sign, door plaques, advertisement, or notice shall be displayed, painted or affixed by Tenant on any part of the Project, Building, parking facilities, or Leased Premises without prior written consent of Landlord, not to be unreasonably withheld. The color, size, character, style, material, placement and location and method of attachment to the Building shall be subject to Landlord's approval, and to any applicable governmental laws, ordinances, regulations, project specifications, and other requirements. Signs, if approved by Landlord, shall be placed by a contractor approved by Landlord and paid for by Tenant. Tenant shall remove all such signs at the termination of this Lease. Such installations and removals shall be made in such manner as to avoid injury or defacement of the Project and other improvements, and Tenant, at its sole expense, shall repair any injury or defacement, including, without limitation, any discoloration caused by such installation and/or removal. Landlord may erect a sign or signs on the Leased Premises indicating that the Leased Premises are for lease during the six (6) month period prior to the expiration of this Lease.

11. **USAGE:** Tenant warrants and represents to Landlord that the Leased Premises shall be used and occupied only for the purpose of: **general office**. Any change in the stated usage purposes shall be subject to the prior written approval of Landlord not to be unreasonably withheld. Tenant shall occupy the Leased Premises, conduct its business, and control Tenant's Representatives in a lawful and reputable way and as not to create any nuisance. Tenant shall not commit, or allow to be committed,

any waste on the Leased Premises or the Project. Tenant may not use the Leased Premises for the use, storage, or distribution of hazardous or environmentally offensive substances, for underground storage, or for any unlawful purposes.

## 12. **INSURANCE:**

(a) Tenant shall not permit the Leased Premises to be used in any way which would be hazardous or which would in any way increase the cost of or render void any insurance on the improvements, and Tenant shall immediately, on demand, cease any use which violates the foregoing or to which Landlord's insurer or any governmental or regulatory authority objects. If at any time during the term of this Lease Tenant's use or vacancy shall cause an increase in premiums, and in particular, but without limitation, if the State Board of Insurance or other insurance authority disallows any of Landlord's sprinkler credits or imposes an additional penalty or surcharge in Landlord's insurance premiums because of Tenant's original or subsequent placement or use of storage racks or bins or method of storage or because of the nature of Tenant's inventory or any other act of Tenant, Tenant agrees to pay as additional Rent the increase in Landlord's insurance premiums.

(b) Tenant, at its sole cost and expense, shall procure and maintain throughout the term of this Lease a policy or policies of insurance insuring Landlord, Landlord's management company and lender, and Tenant against all claims for property damages, personal injury or death of others occurring on or in connection with: (i) the Leased Premises; (ii) the condition of the Leased Premises; (iii) Tenant's operations in and maintenance and use of the Leased Premises; (iv) Tenant's and Tenant's Representatives' use of the common areas of the Project, and (v) Tenant's liability assumed under this Lease. The limits of such policy or policies shall be not less than **\$1,000,000.00** combined single limit coverage per occurrence for injury to persons (including death) and/or property damage or destruction, including loss of use.

(c) All such policies shall be procured by Tenant from insurance companies satisfactory to Landlord naming the following as co-insureds: (i) Landlord; (ii) Landlord's management company, **Jackson-Shaw Company**; and, (iii) Landlord's mortgage holder, if any. Certified copies of such policies together with receipt for payment of premiums, shall be delivered to Landlord prior to the Commencement Date of this Lease. Not less than fifteen (15) days prior to the expiration date of any such policies, certified copies of renewal policies and evidence of the payment of renewal premiums shall be delivered to Landlord. All such original and renewal policies shall provide for at least thirty (30) days written notice to Landlord before such policy may be canceled or changed to reduce insurance coverage provided thereby. Upon request of Landlord, Tenant further agrees to complete and return to Landlord an insurance questionnaire (such form to be provided by Landlord) regarding Tenant's insurance coverage and intended use of the Leased Premises. Tenant warrants and represents that all information contained in such questionnaire shall be true and correct as of the date thereof and shall be updated by Tenant from time to time upon Landlord's request.

## 13. Intentionally Deleted

14. **COMPLIANCE WITH LAWS, RULES AND REGULATIONS:** Tenant shall comply with all applicable laws, ordinances, orders, rules and regulations of state, federal, municipal, or other agencies or bodies relating to, the use, condition and occupancy of and business conducted on the Leased Premises, including without limitation, the Americans with Disabilities Act, the Resource Conservation and Recovery Act, the Comprehensive Environmental Response Act, and the rules, regulations and directives of the U.S. Environmental Protection Agency.

15. **ASSIGNMENT AND SUBLETTING:** The Tenant agrees not to assign, transfer, or mortgage this Lease or any right or interest therein or sublet the Leased Premises or any part thereof, without the prior written consent of Landlord such consent not to be unreasonably withheld. No assignment or subletting shall relieve Tenant of its obligations hereunder, and Tenant shall continue to be liable as a principal (and not as a guarantor or surety) to the same extent as though no assignment or subletting

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had been made. Consent by Landlord to any one assignment or subletting shall not be construed to be consent to any additional assignment or subletting. Each such successive act shall require similar consent of Landlord. Landlord shall be reimbursed by Tenant for any costs or expenses incurred as a result of Tenant's request for consent to any such assignment or subletting, including legal costs not to exceed \$800.00. In the event Tenant subleases the Leased Premises, or any portion thereof, or assigns this Lease with the consent of the Landlord at an annual

Base Rental exceeding that stated herein, such excess shall be paid by Tenant to Landlord as additional Rent hereunder within ten (10) days after receipt by Tenant. Upon the occurrence of an "event of default" as defined below, if all or any part of the Leased Premises is then assigned or sublet, Landlord may, in addition to any other remedies provided by this Lease or provided by law, collect directly from the assignee or subtenant all rents due to Tenant. Landlord shall have a security interest in all property on the Leased Premises to secure payment of such sums. Any collection directly by Landlord from the assignee or subtenant shall not be construed, however, to constitute a novation or a release of Tenant from the further performance of its obligations under the Lease. Notwithstanding the foregoing, it is expressly agreed that if this Lease is assigned to any person or entity pursuant to the provisions of the Bankruptcy Code, 11 U.S.C. Sec. 101, et. seq., as amended (the "Bankruptcy Code"), any and all monies or other considerations payable or otherwise to be delivered in connection with such assignment shall be paid or delivered to Lessor, shall be and remain the exclusive property of Landlord and shall not constitute property of Tenant or of the estate of Tenant within the meaning of the Bankruptcy Code. Any and all monies or other considerations constituting Landlord's Property under the preceding sentence not paid or delivered to Landlord shall be held in trust for the benefit of Landlord and be promptly paid or delivered to Landlord. Any person or entity to which this Lease is assigned pursuant to the provisions of the Bankruptcy Code shall be deemed without further act or deed to have assumed all of the obligations arising under this Lease on and after the date of such assignment. Any such assignee shall upon demand execute and deliver to Landlord an instrument confirming such assumption.

#### 16. ALTERNATIONS AND IMPROVEMENTS:

(a) Tenant shall not make or perform, or permit the making or performance of, any initial or subsequent tenant finish work or any alterations, installations, decorations, improvements, additions or other physical changes in or about the Leased Premises that are structural in nature or exceed \$5000.00 in costs (referred to collectively as "Alterations") without Landlord's prior consent, such consent not to be unreasonably withheld. Landlord shall be under no obligation to allow Alterations of any kind and may withhold its consent without cause. Notwithstanding the foregoing provisions or Landlord's consent to any Alterations, all Alternations shall be made and performed in conformity with and subject to the following provisions: All Alternations shall be made and performed at Tenant's sole cost and expense in a good and workmanlike manner. Alternations shall be made only by contractors or mechanics approved by Landlord, such approval not to be unreasonably withheld. Tenant shall submit to Landlord detailed plans and specifications (including architectural layout, mechanical and structural drawings) for each proposed Alteration and shall not commence any such Alteration without first obtaining Landlord's written approval of such plans and specifications. Prior to the commencement of each proposed Alteration, Tenant shall furnish to Landlord a certificate evidencing worker's compensation insurance coverage for all persons to be employed in connection with such Alterations, including those to be employed by all contractors and subcontractors, and of comprehensive public liability insurance (including property damage coverage) in which Landlord, its agents, and any lessor under any ground or underlying lease, and any mortgagee of the Building shall be named as parties insured, which policies shall be issued by companies and shall be in form and amounts satisfactory to Landlord and shall be maintained by Tenant until the completion of such Alteration. Tenant shall cause its contractor and each subcontractor to provide Landlord with a Certificate of Completion of the Alterations and a Bills Paid Affidavit and full Lien Waiver. Tenant shall, if required by Landlord at the time of Landlord's consent to the Alterations, agree to restore the Leased Premises at the termination of this Lease to their condition prior to making such Alterations. All permits, approvals and certificates

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required by all governmental authorities shall be timely obtained by Tenant and submitted to Landlord. Notwithstanding Landlord's approval of plans and specifications for any Alterations, all Alterations shall be made and performed in full compliance with all applicable laws, orders, rules, standards and regulations of Federal, State, County, and Municipal authorities, including, without limitation, all directions, pursuant to law, of all public officers, and with all applicable rules, orders, regulations and requirements of the local Board of Fire Underwriters or any similar body ("Applicable Laws"). Landlord's approval shall not in any way be considered an indication that the plans and specifications comply with Applicable Laws. All materials and equipment to be incorporated in the Leased Premises as a result of all Alterations shall be new and first quality. No such materials or equipment shall be subject to any lien, encumbrance, chattel mortgage or title retention or security agreement. Whether such Alterations are being performed by Tenant in connection with Tenant's initial occupancy of the Leased Premises or subsequently, Tenant agrees to make proper application for, and obtain, a Building Permit and a Certificate of Occupancy from the city in which the Leased Premises are located. Tenant shall furnish copies of such permit and certificate to Landlord promptly after issuance of same.

(b) All appurtenances, fixtures, improvements, and other property attached to or installed in the Leased Premises, whether by Landlord or Tenant or others, and whether at Landlord's expense or Tenant's expense, or the joint expense of Landlord and Tenant, shall be and remain the property of Landlord, except that any such fixtures, improvements, additions, and other property which have been installed at the sole expense of Tenant and which are removable without material damage to the Leased Premises shall be and remain the property of Tenant. If no event of default has occurred, Tenant may, and if Landlord so elects Tenant shall, remove any property belonging to Tenant at the end of the term hereof, and Tenant shall repair or, at Landlord's option, shall pay to Landlord the cost of repairing any damage arising from such removal. Any replacements of any property of Landlord, whether made at Tenant's expense or otherwise, shall be and remain the property of Landlord.

#### **17. CONDEMNATION:**

(a) If, during the term (or extension or renewal) of this Lease, all or a substantial part of the Leased Premises are taken for any public or quasi-public use under any governmental law, ordinance or regulation, or by right of eminent domain or by private purchase in lieu thereof, and the taking would prevent or materially interfere with the then current use of the Leased Premises, this Lease shall terminate and the Rent shall be prorated during the unexpired portion of this Lease effective on the date physical possession is taken by the condemning authority.

(b) If a portion of the Leased Premises is taken and this Lease is not terminated as provided in Paragraph 17(a) above, if condemnation proceeds are sufficient and if restoration is feasible, Landlord may, at its option restore the Project (other than Alterations) in order to make it reasonably tenantable and suitable for Tenant's approved use. During such restoration, Rent shall be reduced by the amount of business or rent interruption insurance proceeds actually received by Landlord. Upon completion of such restoration, the Rent payable under this Lease during the unexpired portion of the term shall be adjusted to such an extent as may be fair and reasonable under the circumstances.

(c) In the event of such taking or private purchase in lieu thereof, Tenant may seek a separate award for any loss of improvements made or paid for by Tenant, its personal property, and its moving expenses (so long as no such claim diminishes Landlord's claim or award), but all other claims of any nature shall belong to Landlord. In the event Tenant does not receive such a separate award, Landlord shall be entitled to receive any and all sums awarded for the taking.

(d) Notwithstanding anything herein to the contrary, if the holder of any indebtedness secured by a mortgage or deed of trust covering the Building and/or Project requires that the condemnation proceeds be applied to such indebtedness, then Landlord shall have the right to terminate this Lease by delivering written notice of termination to Tenant within fifteen (15) days after such requirement is imposed. All rights and obligations under this Lease shall then cease. If Landlord does not receive

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condemnation proceeds sufficient for restoration (such as when its mortgagee does not allow the proceeds to be used for such purposes) and if restoration is economically reasonably feasible, Tenant will have the option of supplementing available proceeds to allow restoration, and Tenant's actual costs will be reimbursed through a monthly prorata credit against rent beginning after Landlord's mortgage has been paid in full.

#### **18. FIRE AND CASUALTY:**

(a) If the Building should be damaged or destroyed by fire, tornado, or other casualty, Tenant shall give immediate verbal and written notice thereof to Landlord.

(b) If the Building should be totally destroyed by fire, tornado, or other casualty, or if it should be so damaged thereby that rebuilding or repairs cannot reasonably be completed within one hundred eighty (180) days after the date on which Landlord is notified by Tenant of such damage, at the option of either Landlord or Tenant, this Lease shall terminate, and the Rent shall be abated during the unexpired portion of this Lease effective upon the date of occurrence of such damage.

(c) If the Building should be damaged by any peril that will be wholly compensated (subject to deductibles) by the insurance maintained by Landlord or if Landlord, in its sole discretion, so chooses notwithstanding a deficiency in such proceeds, and if rebuilding or repairs can reasonably be completed within one hundred eighty (180) days after the date on which Landlord is notified by Tenant of such damage, this Lease shall not terminate, and Landlord shall then proceed with reasonable diligence to rebuild and repair the Building to substantially the same condition in which it existed prior to such damage. Landlord shall not be required, however, to rebuild, repair, or replace Tenant's furniture, fixtures, Alterations, inventory or other personal property. If the Leased Premises are untenantable in whole or in part during restoration, the Rent payable hereunder during the period in which they are untenantable shall be reduced by untenantable portion in both Tenant and Landlord's reasonable discretion. If Landlord should fail to complete such repairs and rebuilding within one hundred eighty (180) days after the date on which Landlord is notified by Tenant of such damage, Tenant may terminate this Lease by delivering written notice of termination to Landlord. Such termination shall be Tenant's exclusive remedy and all rights and obligations of the parties under the Lease shall then cease. Notwithstanding the foregoing provisions of this Paragraph 18(c), Tenant agrees that if the Leased Premises, the Building and/or Project are damaged by fire or other casualty caused by the fault or negligence of Tenant or Tenant's Representatives, Tenant shall have no option to terminate this Lease even if the damage cannot be repaired within one hundred eighty (180) days, and the Rent shall not be abated or reduced before or during the repair period.

(d) Notwithstanding anything herein to the contrary, if the holder of any indebtedness secured by a mortgage or deed of trust covering the Building and/or Project requires that the insurance proceeds be applied to such indebtedness, then Landlord shall have the right to terminate this Lease by delivering written notice of termination to Tenant within fifteen (15) days after such requirement is imposed. All rights and obligations under this Lease shall then cease. If Landlord does not receive insurance proceeds sufficient for restoration (such as when its mortgagee does not allow the proceeds to be used for such purposes) and if restoration is economically reasonably feasible, Tenant will have the option of supplementing available proceeds to allow restoration, and Tenant's actual costs will be reimbursed through a monthly prorata credit against rent beginning after Landlord's mortgage has been paid in full.

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19. **CASUALTY INSURANCE:** Landlord shall at all times during the term of this Lease maintain a policy or policies of business or rental interruption insurance and a policy or policies of insurance insuring the Building against eighty percent (80%) of full replacement cost for loss or damage by fire, explosion, and other customary hazards. Such policies will not insure any personal property (including, but not limited to any furniture, machinery, goods, or supplies) of Tenant or which Tenant may have in the Leased Premises or any fixtures installed by or paid for by Tenant upon or within the Leased Premises or any Alterations or other improvements which Tenant may construct or install on the Leased Premises or any signs identifying Tenant's business located on the exterior of the Building, insurance for all of which shall be Tenant's responsibility.

20. **WAIVER OF SUBROGATION:** To the extent that Landlord or Tenant receives casualty insurance proceeds, such recipient hereby waives and releases any and all rights, claims, demands and causes of action such recipient may have against the other on account of any loss or damage occasioned to such recipient or its businesses, real and personal properties, the Leased Premises, the Building, the Project, or its contents, arising from any risk or peril covered by any insurance policy carried by either party and for which such proceeds are actually received. Inasmuch as the above mutual waivers will preclude the assignment of any such claim by way of subrogation (or otherwise) to an insurance company (or any other person), each party hereto agrees immediately to give to its respective insurance companies written notice of the terms of such mutual waivers and to have their respective insurance policies properly endorsed, if necessary, to prevent the invalidation of such insurance coverages by reason of such waivers. This provision shall be cumulative of Paragraph 21 below.

21. **HOLD HARMLESS:** Landlord shall not be liable to Tenant, Tenant's Representatives, or any other person for any injury to person or damage to property on or about the Leased Premises or the Project caused by the negligence or misconduct of Tenant, Tenant's Representatives, or any other persons entering upon the Leased Premises or the Project. Tenant agrees to indemnify and hold Landlord harmless from any and all loss, attorney's fees, expenses, or claims arising out of any such damage, loss or injury. Tenant shall not be liable to Landlord, Landlord's employees, agents, invitees, licensees or visitors for any injury to person or damage to property on or about the Leased Premises or the Project caused by the negligence or misconduct of Landlord, its agents, employees, agents, invitees, licensees or visitors. Landlord agrees to indemnify and hold Tenant harmless from any and all loss, attorney's fees, expenses, or claims arising out of any such damage, loss or injury.

22. **QUIET ENJOYMENT:** Landlord warrants that it has full right to execute and to perform this Lease and to grant the estate demised herein and that Tenant, upon payment of the required Rent and performance of the covenants and agreements contained in this Lease, shall peaceably and quietly have, hold, and enjoy the Leased Premises during the full term of this Lease, including any extensions or renewals thereof.

23. **LANDLORD'S RIGHT OF ENTRY:** Landlord shall have the right to enter the Leased Premises for the following reasons: inspection, cleaning or making repairs, making such alterations or additions as Landlord may deem necessary or desirable; installation of utility lines servicing the Leased Premises or any other space in the Building, determining Tenant's use of the Leased Premises, or for determining if any event of default under this Lease has occurred. Landlord shall attempt to give twenty-four (24) hours verbal notice to Tenant prior to such entry, except in cases of emergency or when an event of default has occurred in which cases Landlord may enter the Leased Premises at any time and without prior notice. During the period that is six (6) months prior to the end of the Lease term, Landlord and Landlord's agents and representatives shall have the right to enter the Leased Premises at any reasonable time during business hours, with reasonable notice, for the purpose of showing the Leased Premises and shall have the right to erect on the Leased Premises a suitable sign indicating the Leased Premises are available for lease.

24. **ASSIGNMENT OF LANDLORD'S INTEREST IN LEASE:** Landlord shall have the right to transfer and assign, in whole or in part, its rights and obligations with respect to the Project, the Leased Premises, and this Lease, including Tenant's Security Deposit. Upon and after such transfer, Landlord shall be released from any further obligation under this Lease and Tenant agrees to look solely to Landlord's successor for the performance of such obligations.

25. Intentionally Deleted

26. **DEFAULT BY TENANT:** The following shall be events of default by Tenant under this Lease:

(a) Tenant's failure to pay, within ten (10) days after it is due, any installment of Rent or other payment required pursuant to this Lease;

(b) Tenant's abandonment or vacation of any part of the Leased Premises, and Tenant is in default of the Rent payments due under this Lease;

(c) Tenant's failure to comply with any term, provision or covenant of this Lease, other than the defaults listed in the other subparagraphs of this Paragraph 26, and the failure is not cured within ten (10) days after written notice thereof to Tenant;

(d) Tenant's filing of a petition or adjudication as a debtor or bankrupt insolvent under the Bankruptcy Code or any similar law or statute of the United States or any state; or appointment of a receiver or trustee for all or substantially all of the assets of Tenant; or Tenant's transfer in fraud of creditors or assignment for the benefit of creditors of all or substantially all of Tenant's assets;

(e) Tenant doing or permitting to be done any act which results in a lien being filed against the Leased Premises and the same is not removed within sixty (90) days after Landlord's notice thereof to Tenant.

27. **REMEDIES FOR TENANT'S DEFAULT:** Upon the occurrence of any event of default, Landlord shall have the option to pursue any one or more of the following remedies without any prior notice or demand:

(a) Landlord may terminate this Lease, in which event Tenant shall immediately surrender the Leased Premises to Landlord, and if Tenant fails to do so, Landlord may, without prejudice to any other remedy which it may have, enter upon and take possession of the Leased Premises, and expel or remove Tenant and any other person who may be occupying all or any part of the Leased Premises. Landlord shall not be liable for prosecution or any claim for damages as a result of such actions. Tenant agrees to pay on demand the amount of all losses, costs, expenses, deficiencies, and damages, including, without limitation, reasonable



reconfiguration expenses, rental concessions and other inducements to new tenants, advertising expenses and broker's commissions, which Landlord may incur or suffer by reason of Tenant's default or the termination of this Lease under this subparagraph, whether through inability to rent the Leased Premises on satisfactory terms or otherwise. Tenant acknowledges that its obligation to pay Base Rent and all additional Rent hereunder is not only compensation for use of the Leased Premises but also compensation for sums already expended and/or being expended by Landlord with respect to its obligations hereunder and with respect to the Leased Premises, and Tenant acknowledges that Tenant's default in timely payment of all sums due hereunder shall constitute significant financial loss to Landlord. Tenant further acknowledges that any failure to pay any sum due hereunder shall evidence Tenant's inability to meet its debts as they become due. In such event, in addition to Landlord's other remedies hereunder, Landlord shall be entitled to accelerate all Base Rental remaining unpaid hereunder, the entirety of which shall at the option of Landlord be immediately due and payable to the extent allowed by law.

(b) Without termination of this Lease, Landlord may enter upon and take possession of the Leased Premises and expel or remove Tenant and any other person who may be occupying all or any part of the Leased Premises (without being liable for prosecution or any claim for damages therefor) and relet the Leased Premises on behalf of Tenant and receive directly the rent from the reletting. Tenant agrees to pay Landlord on demand any deficiency that may arise by reason of any reletting of the Leased Premises and to reimburse Landlord on demand for any losses, costs, and expenses, including without limitation, reconfiguration expenses, rental concessions and other inducements to new tenants, advertising costs or broker's commissions, which Landlord may incur or suffer as a result of Tenant's default or in reletting the Leased Premises. In the event Landlord is successful in reletting the Leased Premises at a rental in excess of that agreed to be paid by Tenant pursuant to this Lease, Tenant agrees that Tenant shall not be entitled, under any circumstances, to such excess rental, and Tenant does hereby specifically waive any claim to such excess rental.

(c) Without terminating this Lease, Landlord may enter upon the Leased Premises (without being liable for prosecution or any claim for damages therefor) and do whatever Tenant is obligated to do under the terms of this Lease. Tenant agrees to reimburse Landlord on demand for any losses, costs and expenses which Landlord may incur in effecting compliance with Tenant's obligations under this Lease. Tenant further agrees that Landlord shall not be liable for any damages resulting to Tenant from effecting compliance with Tenant's obligations under this subparagraph, whether caused by the negligence of Landlord or otherwise.

(d) With respect to Landlord's entry upon the Leased Premises under the provisions of subparagraphs (a), (b), and (c) above, no restriction of, or obligation imposed upon Landlord by, Texas Property Code Section 93.002 shall apply, such Section being superseded hereby. In particular, but without limitation, Landlord will have no duty or responsibility to Tenant to tender a key in the event of a change of locks, and Tenant will have no further right of possession except as otherwise expressly agreed by Landlord in writing.

(e) Landlord may pursue any remedy provided at law or in equity.

(f) Landlord shall have no duty to relet the Premises, and the failure of Landlord to do so shall not release or affect Tenant's liability for Rent and other charges due hereunder or for damages.

(g) No re-entry or reletting of the Premises or any filing or service of an unlawful detainer action or similar action shall be construed as an election by Landlord to terminate this Lease unless a written notice of such intention is given by Landlord to Tenant. Notwithstanding any such reletting without termination, Landlord may at any time thereafter elect to terminate this Lease and Tenant's right to possession hereunder.

(h) Intentionally Deleted.

28. **TERMINATION OF OPTIONS:** If there exist any options or special rights which Landlord may have granted Tenant under this Lease including, but not limited to, options or rights regarding extensions of the term, expansion of the Leased Premises, or acquisition of any other interesting the Leased Premises, the Building, or the Project, then all such options and rights independent of the leasehold estate hereby

granted to Tenant by Landlord. Landlord and Tenant agree and acknowledge that the negotiated consideration for any such options or special rights is Tenant's entry into this Lease and that no portion of any sums due and payable by Tenant to Landlord hereunder is attributable thereto. In addition to, and not in lieu of, the above remedies of Landlord for Tenant's default, any and

all such options or special rights shall be automatically terminated upon the occurrence of the following events:

(a) Tenant shall have failed to pay when due any installment of Rent or other sums payable under this Lease for any three (3) consecutive months during the Lease term or any renewal or extension thereof, or for any ten (10) months during the Lease term or any renewal or extension thereof, whether or not said defaults are cured by Tenant; or

(b) Tenant shall have received two (2) or more notices of default under Paragraph 26(c) within any one calendar year with respect to any other covenant of this Lease, whether or not such default(s) is/are cured; or

(c) Tenant shall have committed or suffered to exist any other event of default described under Paragraph 26 above, whether or not such default is cured by Tenant.

29. **WAIVER OF DEFAULT OR REMEDY:** Failure of Landlord to declare a default immediately upon its occurrence, or delay in taking any action in connection with an event of default, shall not be a waiver of the default. Landlord shall have the right to declare the default at any time and take such action as its lawful or authorized under this Lease. Pursuit of any one or more of the remedies set forth in Paragraphs 27 or 28 above shall not preclude pursuit of any one or more of the other remedies provided therein or elsewhere in this Lease or as provided by law, nor shall pursuit of any remedy be a forfeiture or waiver of any Rent or damages accruing to Landlord by reason of the violation of any of the terms of this Lease. Failure by Landlord to enforce one or more of its remedies upon an event of default shall not be construed as a waiver of the default or of any other violation or breach of any of the terms contained in this Lease.

30. **CHOICE OF LAW; VENUE; ATTORNEY'S FEES:** It is specifically stipulated that this Lease shall be interpreted and construed according to the laws of the State in which the Leased Premises are located, and any suit brought on this Lease shall be maintained in the county in which the Leased Premises are located. Further, the prevailing party in any such litigation between the parties shall be entitled to recover, as a part of its judgment, reasonable attorney's fees and costs and expenses incurred therein.

31. **HOLDING OVER:** Tenant will, at the termination of this Lease by lapse of time or otherwise, surrender immediate possession to Landlord. If Landlord agrees in writing that Tenant may hold over after the expiration or termination of this Lease and if the parties do not otherwise agree, the hold over tenancy shall be subject to termination by Landlord at any time upon not less than five (5) days advance written notice, or by Tenant at any time upon not less than thirty (30) days advance written notice. Further, all of the terms and provisions of this Lease shall be applicable during the hold over period, except that Tenant shall pay Landlord from time to time upon demand, as Base Rent for the period of any hold over, an amount equal to 125% of the Base Rent in effect on the date of termination, computed on a daily basis for each day of the hold over period, plus all additional Rent and other sums due hereunder. If Tenant shall fail immediately to surrender possession of the Leased Premises to Landlord upon termination of this Lease, by lapse of time or otherwise, and Landlord has not agreed to such continued possession, as above provided, then, until Landlord can dispossess Tenant under the terms hereof or otherwise, Tenant shall pay Landlord from time to time upon demand, as Base Rent for the period of any such hold over, an amount equal to twice the Base Rent in effect on the date of termination, computed on a daily basis for each day of the hold over period, plus all additional Rent and other sums due hereunder. No holding over by Tenant, whether with or without consent of Landlord, shall operate to extend this Lease except as otherwise expressly agreed by the parties. The preceding provisions of this Paragraph shall not be construed as Landlord's consent for Tenant to hold over.

32. **RIGHTS OF MORTGAGEE:** Tenant accepts this Lease subject and subordinate to any recorded mortgage, deed of trust or other lien (a "Mortgage") presently existing or hereafter to exist with respect to the Leased Premises. Further, but without limiting the

preceding sentence, Landlord is hereby irrevocably vested with full power and authority to subordinate and/or to evidence such subordination of Tenant's interest under this Lease to any Mortgage hereafter placed on the Leased Premises, and Tenant agrees upon demand to execute such additional instruments subordinating this Lease, and further defining the terms of such subordination, as well as the attornment discussed below, as Landlord or the holder of any such Mortgage, may require. Tenant agrees to provide to the holder of any such Mortgage, whose name and address have been provided to Tenant (a "Mortgagee"), a copy of each notice to Landlord which alleges any act, omission, or condition that might constitute a default by Landlord hereunder and Mortgagee, in its sole discretion, shall have all rights of Landlord hereunder to cure any such default. If the interests of Landlord under this Lease shall be transferred by reason of foreclosure or other proceedings for enforcement of any Mortgage on the Leased Premises, at the election of the transferee (sometimes called the "Purchaser") Tenant shall be bound to the Purchaser under the terms and conditions of this Lease for the balance of the remaining Lease term, including any extensions or renewals, with the same force and effect as if the Purchaser were Landlord under this Lease; provided, however, that such Purchaser shall not be liable or bound to Tenant (i) for any act or omission of any prior landlord, (ii) for any offsets or defenses which Tenant might have against any prior landlord, (iii) for or by any Rent which Tenant might have paid for more than the current month, (iv) by any amendment modification of, or consensual termination agreement with respect to, the Lease made without the Mortgagee's consent, (v) for any Security Deposit given by Tenant to a prior landlord unless such deposit is actually received by such Purchaser, (vi) for any repairs or replacements required by this Lease arising prior to the date Purchaser takes possession of the Leased Premises, or (vii) for any moving, relocation or refurbishment allowance or any construction of or payment or allowance for tenant improvements to the Leased Premises or any part thereof for the benefit of Tenant except as set forth in this Lease. Tenant further agrees at the election of the Purchaser to attorn to the Purchaser, including the Mortgagee if it be the Purchaser, as its Landlord. Such attornment shall be effective without the execution of any further instruments upon the Purchaser's succeeding to the interest of Landlord under this Lease. The respective rights and obligations of Tenant and the Purchaser upon the attornment, to the extent of the then remaining balance of the term of this Lease and any extensions and renewals, shall be and are the same as those set forth in this Lease, but Tenant agrees upon demand to execute such additional instruments defining the terms of such attornment as Landlord or the Purchaser may require. Each such Mortgagee and each such Purchaser shall be a third-party beneficiary of the provisions of this Paragraph.

33. **ESTOPPEL CERTIFICATES:** Tenant agrees to furnish on the Commencement Date of this Lease and from time to time within ten (10) days of request by Landlord or Landlord's mortgagee, a statement certifying that the Tenant is in possession of the Leased Premises; the Leased Premises are acceptable; this Lease is in full force and effect; this Lease is unmodified; Tenant claims no present charge, lien, or claim of offset against Rent; the Rent is paid for the current month but is not paid and will not be paid for more than one month in advance (except estimated additional Rent under Paragraph 6); there is no existing default under this Lease; and such other matters as may be reasonably required by Landlord or Landlord's mortgagee.

34. **SUCCESSORS:** This Lease shall be binding upon and inure to the benefit of Landlord and Tenant and their respective heirs, personal representatives, successors and assigns. It is hereby covenanted and agreed that should Landlord's interest in the Leased Premises cease to exist for any reason during the term of the Lease, then notwithstanding the happening of such even at the election of Landlord's successor herein, this Lease shall nevertheless remain unimpaired and in full force and effect and Tenant hereunder agrees to attorn to the then owner of the Leased Premises.

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35. **REAL ESTATE COMMISSION:** Tenant represents and warrants that is has dealt with no other broker, agent, or other person other than Jackson & Cooksey in connection with this transaction, and that no other broker, agent, or other person brought about this transaction. Landlord and Tenant each agree to indemnify and hold the other harmless from and against any claims by any broker, agent, or other person claiming a commission or other form of compensation by virtue of having dealt with Tenant or Landlord respectively with regard to this transaction. The provisions of this Paragraph shall survive the termination of this Lease.

36. **DEFAULT BY LANDLORD:** Landlord shall not be in default, and Tenant shall have no right to any remedy at law or in equity, unless the act, omission, or condition allegedly giving rise to such default shall have continued uncured or unabated for a period of thirty (30) days following written notice to Landlord (with a copy to any Mortgagee as provided in Paragraph 32 above) or, if such cure or abatement cannot be accomplished within said 30-day period, then, so long as Landlord or Mortgagee has commenced such cure or abatement

within such 30-day period and diligently pursues same, such period shall be extended a reasonable time to allow completion of the cure or abatement.

37. **MECHANIC'S LIENS:** Tenant shall have no authority, express or implied, to create or place any lien or encumbrance of any kind or nature whatsoever upon, or in any manner to bind, the interest of Landlord in the Leased Premises or the Project or to charge the Rent payable hereunder for any claim in favor of any person dealing with Tenant, including those who may furnish materials or perform labor for any construction or repairs. Each such claim shall affect, and each such lien shall attach to, if at all, only the leasehold interest granted to Tenant by this Lease. Tenant covenants and agrees that it will pay or cause to be paid all sums legally due and payable by it on account of any labor performed or materials furnished in connection with any work performed on the Leased premises on which any lien is or can be validly and legally asserted against its leasehold interest in the Leased Premises or the improvements thereon. Tenant further agrees to save and hold Landlord harmless from any and all loss, cost, or expense based on or arising out of claims or liens asserted by parties by virtue of their dealings with Tenant and encumbering the leasehold estate or the right, title and interest of the Landlord in the Leased Premises or the Project. Under no circumstances shall Tenant be or hold itself out to be the agent or representative of Landlord with respect to any Alterations of the Leased Premises whether or not consented to or approved by Landlord hereunder.

38. **HAZARDOUS WASTE:** The term "Hazardous Substances," as used in this Lease shall mean petroleum and petroleum products and by-products, crude oil, pollutants, contaminants, toxic or hazardous wastes, or any other substances, the use of which is regulated, restricted, prohibited or penalized, or the removal or disposal of which is required, by any "Environmental Laws," which term shall mean any and all federal, state or local law, ordinance or other statute of a governmental or quasi-governmental authority relating to the pollution or protection of the environment. Tenant hereby agrees that (i) no activity will be conducted on the Leased Premises that will produce any Hazardous Substances; (ii) the Leased Premises will not be used in any manner not in compliance with local and federal laws for the storage of any Hazardous Substances; (iii) no portion of the Leased Premises will be used as a landfill or a dump; (iv) Tenant will not install any underground tanks of any type; (v) Tenant will not allow any surface or subsurface conditions to exist or come into existence that constitute, or with the passage of time may constitute, a public or private nuisance, (vi) Tenant will not permit any Hazardous Substances to be brought onto the Leased Premises, and if so brought thereon, then the same shall be stored and used in compliance with all local and federal laws regarding same. Landlord or Landlord's representative shall have the right but not the obligation to enter the Leased Premises for the purpose of ensuring compliance with all Environmental Laws. If Tenant in any manner contaminates the Leased Premises, then Tenant shall promptly and diligently institute proper and thorough clean-up procedures at Tenant's sole cost. Landlord hereby agrees to defend, indemnify and hold Tenant, its employees, partners, agents, contractors, officers and directors and their heirs, successors, and assigns harmless from any and all costs (including costs of litigation), reasonable

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attorney's fees, expenses, liabilities, claims, damages or judgments arising or alleged to occur, and that result, or are alleged to result from the actual, or threatened discharge, dispersal, disposal, release or escape of Hazardous Substances or other wastes or pollutants (including, but not limited to asbestos, solid, liquid, gaseous or thermal irritants or contaminants, smoke, vapor, soot, fumes, acids, alkalis, chemicals, and water materials to be recycled, reconditioned or reclaimed), but only as the same are a direct result of any act or omission of Landlord or its agents, employees, contractors or subcontractors. Tenant hereby agrees to defend, indemnify and hold Landlord, its employees, agents, partners, contractors, officers and directors of their heirs, successors, and assigns harmless from any and all costs (including costs of litigation), reasonable attorneys' fees, expenses, liabilities, claims, damages or judgments arising or alleged to occur, and that result, or are alleged to result from the actual, or threatened discharge, dispersal, disposal, release or escape of Hazardous Substances or other wastes or pollutants (including, but not limited to asbestos, solid, liquid, gaseous or thermal irritants or contaminants, smoke, vapor, soot, fumes, acids, alkalis, chemicals, and water materials to be recycled, reconditioned or reclaimed), but only as the same are a direct result of any act or omission of Tenant or Tenant's Representatives. Landlord also agrees not to bring hazardous materials into the Leased Premises.

39. **ENTIRE AGREEMENT AND LIMITATION OF WARRANTIES:** It is expressly agreed by Tenant, as a material consideration for the execution of this Lease, that this Lease is the entire agreement of the parties and that there are and were no verbal representations, warranties, understandings, stipulations agreements, or promises pertaining to this Lease not incorporated in this Lease. Tenant expressly agrees that there are and shall be no implied warranties of merchantability, fitness, habitability, or of any other kind and that

Tenant's acceptance of the Leased Premises shall be "as is." It is likewise agreed that this Lease may not be altered, waived, amended, or extended except by an instrument in writing signed by both Landlord and Tenant. Not in limitation upon the foregoing, Landlord agrees that to the extent assignable, all warranties, if any shall exist, from contractors or suppliers with respect to the improvements to the Leased Premises hereunder are hereby partially assigned to Tenant to the extent necessary to avail Tenant of the benefits thereof with respect to its leasehold estate and property located at the Leased Premises.

40. **FINANCIAL STATEMENTS:** From time to time Landlord may need to obtain financing or renew financing on the Project, or perform calculations for various reasons regarding the value of the Project. Tenant hereby agrees to provide to Landlord financial statements on its business when requested, but not more than once annually, indicating the most current year end and quarterly financial status of the business. Landlord will not deliver such financial statement to any third party except in confidence and only as required by Landlord's lenders or in conjunction with appraisals of the Project.

41. **FORCE MAJEURE:**

(a) Landlord shall not be required to perform any covenant or obligation of this Lease or be liable in damages to Tenant for that time period during which the performance or non-performance of the covenant or obligation is delayed, caused by, or prevented by Tenant or Tenant's Representatives or by an act of God or force majeure.

(b) Except with respect to the payment of Rent or any other sum due hereunder, Tenant shall not be required to perform any covenant or obligation of this Lease or be liable in damages to Landlord for that time period during which the performance or non-performance of the covenant or obligation is delayed, caused by, or prevented by Landlord or Landlord's Representatives or by an act of God or force majeure.

(c) An "act of God" or "force majeure" is defined for purposes of this Lease as strikes, lockouts, sit-downs, material or labor restrictions by any governmental authority, riots, floods, washouts, explosions, earthquakes, fire storms, acts of the public enemy, wars, insurrections and

any other similar cause not reasonably within the control of Landlord and which by the exercise of due diligence Landlord is unable, wholly or in part, to prevent or overcome.

42. **MISCELLANEOUS:**

(a) Words of any gender used in this Lease shall be held and construed to include any other gender; and words in the singular number shall be held to include the plural, unless the context otherwise requires.

(b) Each party agrees to furnish to the other, promptly upon demand, a corporate resolution, proof of due authorization by partners, or other appropriate documentation evidencing the due authorization and power of such party to enter into this Lease and the empowerment and authority of the individual signing below to bind his or her principal.

(c) The captions inserted in this Lease are for convenience only and in no way define, limit, or otherwise describe the scope or intent of this Lease or any provision hereof, or in any way affect the interpretation of this Lease.

(d) If any clause or provision of this Lease is illegal, invalid, or unenforceable under present or future laws effective during the term of this Lease, then and in that event, it is the intention of the parties hereto that the remainder of this Lease shall not be affected thereby; and it is also the intention of the parties to this Lease that in lieu of each clause or provision of this Lease that is illegal, invalid, or unenforceable there be added as a part of this Lease a clause as similar in terms to such illegal, invalid, or unenforceable clause or provision as may be possible and be legal, valid, and enforceable.

(e) Intentionally deleted.

(f) All references in this Lease to "the date hereof" or similar references shall be deemed to refer to the last date, in point of time, on which all parties hereto have executed this Lease.

(g) In the event that Tenant shall fail to perform any duty or obligation hereunder, whether maintenance, repair or replacement of the Leased Premises, maintenance of insurance, or otherwise, then Landlord may, but shall in no event be obligated to, without notice of any kind, take such actions as Landlord deems necessary or appropriate to remedy such Tenant failure, and any sums expended by Landlord together with fair and just compensation for the time and effort of Landlord in such efforts shall be deemed additional Rent hereunder due and payable by Tenant on demand.

(h) If Tenant shall fail to pay, when the same is due and payable, any Rent or any other sum due hereunder, such unpaid amount shall bear interest from the due date thereof to the date of remittance at the rate of the lesser of 12% per annum and the maximum rate allowed by law.

(i) Landlord does not in any way or for any purpose become a partner with Tenant in the conduct of its business or otherwise, nor a member of a joint venture with Tenant.

(j) Tenant shall not record this Lease without the prior written consent of Landlord. However, upon the request of either party hereto, the other party shall join in the execution of a memorandum or so-called "short form" of this Lease for the purposes of recordation.

(k) Time is of the essence in the performance of all the covenants, conditions, and agreements contained in this Lease.

(l) Any duty, obligation, or debt and any right or remedy arising hereunder and not otherwise consummated and/or extinguished by the express terms hereof at or as of the time of termination of this Lease, whether at the end of the term hereof or otherwise, shall survive such termination as continuing duties, obligations, and debts of the obligated party to the other or continuing rights and remedies of the benefitted party against the other.

(m) This Agreement may be executed in one or more counterparts, each of which counterpart shall for all purposes be deemed to be an original; but all such counterparts together shall constitute but one instrument.

(n) Attached hereto, marked Exhibit "A" through Exhibit "F", are certain exhibits to this Lease all of which are hereby incorporated herein by reference

(o) Landlord agrees to allow Tenant at Tenant's sole cost and expense to install a basketball goal on the Leased Premises as long as such installation does not materially interfere with or reduce the available parking for the Project. Tenant agrees to restore the Leased Premises to its original condition upon Lease termination or Tenant's vacating of the Leased Premises.

**43. NOTICE:**

(a) All Rent and other payments required to be made by Tenant to Landlord shall be payable to Landlord at the address set forth below or any other address that Landlord may specify from time to time by written notice delivered to Tenant.

(b) All payments, if any, required to be made by Landlord to Tenant shall be payable to Tenant at the address set forth below or at any other address that Tenant may specify from time to time by written notice delivered to Landlord.

(c) Any notice or document required or permitted to be delivered by this Lease shall be deemed to be delivered (whether or not actually received) when deposited in the United States Mail, postage prepaid, certified mail return receipt requested, addressed to the parties at the respective addresses set forth below or such other address as hereinafter specified by notice given in accordance with this paragraph.

44. **LIMITATION ON TENANT'S DAMAGES:** Tenant agrees that any liability of Landlord under this Lease shall be limited solely to Landlord's interest in the Project, and no other assets of Landlord shall be subject to levy or execution.

Executed by Landlord and Tenant as of this \_\_\_\_\_ day of \_\_\_\_\_, 2000.

LANDLORD

TENANT

Jackson-Shaw Technology Center II Limited Partnership

TestChip Technologies, Inc.

4890 Alpha Road, Suite 100

Address: \_\_\_\_\_

Dallas, Texas 75244

Dallas, Texas \_\_\_\_\_

By: \_\_\_\_\_  
Stephen S. Kurth

By: \_\_\_\_\_

Its: First Vice President

\_\_\_\_\_  
(please print)

Its: \_\_\_\_\_

Leased Premises:

2600 Technology Drive, Suite 600

Dallas, Texas 75074

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## EXHIBIT B

### TENANT IMPROVEMENTS

Landlord will supply Tenant with a construction allowance of **\$457,550.00 (\$25.00 psf)** to be used for Tenant Improvements. Should the actual construction costs exceed this amount, Tenant shall pay such excess to Landlord prior to the commencement of the construction.

Landlord's architect will supply floor plans and construction drawings with MEP drawings to be provided by the subcontractors. The Tenant Improvements shall be constructed in accordance to plans and specifications approved by Landlord and Tenant. Landlord agrees to work diligently with Tenant to keep the improvement costs at the allocated allowance and Landlord at, no cost to Tenant or deduction from the Tenant Improvement allowance, shall obtain three (3) bids from qualified sub-contractors. The Landlord is responsible for the costs to construct the Building to its shell condition. The shell condition is defined as the slab, roof, exterior walls, overhead doors, storefronts and fire sprinkler system will be in place and water, gas, and electrical service will be nm to the Building.

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[JUPITER BUSINESS CENTER]

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## EXHIBIT "D"

### RULES AND REGULATIONS

The following Rules and Regulations are prescribed by Landlord in order to provide and maintain, to the best of Landlord's ability, orderly, clean and desirable premises, building and parking facilities for the Tenants therein and to regulate conduct in and use of the Lease Premises, the Building and parking facilities in such a manner as to minimize interference by others in the proper use of the Leased Premises by Tenant. All references to Tenant include not only the Tenant, but also Tenant's agents, employees, invitees, licensees, visitors, assignees, and/or sublessees:

1. Tenant shall not block or obstruct any of the entries, passages, or doors of Building or parking area, or place, empty, or throw rubbish, litter, trash, or material of any nature into such areas, or permit such areas to be used at any time except for ingress or egress of Tenants.
2. Landlord will not be responsible for lost or stolen personal property, equipment, money, or any article taken from the Leased Premises, Building, or parking facilities regardless of how or when loss occurs.
3. The plumbing facilities shall not be used for any other purpose than that of which they are constructed, and no foreign substance of any kind shall be placed therein, and the expense of any breakage, stoppage, or damage resulting from a violation of this provision shall be borne by Tenant.
4. Any additional keys or locks required by Tenant during the term of the Lease shall be the Tenant's responsibility.
5. The common parking facilities are available for use by any and all tenants. Landlord agrees to reserve four (4) parking spaces directly in front of the Leased Premises designated Visitor Parking and the cost of designating such parking to be the sole responsibility of Tenant. Landlord reserves the right to assign or allocate parking in the event of conflicts, abuse, or improper use. It is generally understood that any Tenant should utilize only those parking spaces immediately adjacent to that Tenant's Leased Premises.
6. Vehicles that are abandoned, disabled, have expired registration stickers, obstructing any means of ingress or egress to any leased premises, or in any way a general nuisance or hazard are subject to removal without notice by Landlord. All costs associated with such removal shall be at the Tenants's/vehicle owner's expense.

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## EXHIBIT "E"

### RENEWAL OPTION

Tenant is granted the option to extend the term of this Lease for 1 extended term of five(5) years, provided no event of default exists at the time of exercise of the option and no condition exists which with the giving of notice or the passage of time or both would constitute an event of default, and Tenant gives written notice of its exercise of the option at least one hundred twenty (120) days prior to the expiration of the original term. The extension terms(s) shall be upon the same terms and conditions as set forth herein, except Tenant shall have no further right of renewal after the 2nd extension term prescribed above, and the base Rental will be equal to the then prevailing rate for comparable space for a comparable term.



## EXHIBIT "F"

### EXPANSION RIGHT OF FIRST REFUSAL

During the term of this Lease, if no event of default exists beyond any applicable cure period, in the event that Landlord receives an offer to lease all or any portion of the Building of which space is contiguous to the Leased Premises outlined herein and which offer is not a renewal with an existing tenant in the Building and which offer Landlord is prepared to accept, Landlord shall give Tenant notice (the "Notice"), in accordance with Section 43(c) above, of such offer which Notice shall contain all of the pertinent terms of such offer. Tenant shall have a period of five (5) business days from the date the Notice is given to Tenant in which to commit irrevocably to lease all of the space covered by the Notice under all of the terms of the Notice, failing in any element of which election Tenant shall be deemed to have waived its rights under this Exhibit "F", time being especially of the essence herein. If Tenant so elects to exercise such option, Landlord and Tenant will immediately execute a lease amendment substantially in accordance with this Lease except that the terms of the Notice shall apply therein. If Tenant does not so elect, or is deemed not to have so elected, or if Tenant so elects but fails or refuses within five (5) days of receipt of the proposed lease to execute same, Landlord may proceed with the lease transaction described in the Notice. This Exhibit "F" shall remain in effect for subsequent leasing of space in the Building. If Tenant has an express option under this Lease to extend the term of this Lease, and if Tenant shall not timely so elect, then the provisions of this Exhibit "F" shall not apply subsequent to the expiration of said extension election option.

2.) If during the term of this Lease Agreement, Landlord leases to Tenant a space of a size larger than the present Lease Premises by an amount which is a minimum of 50% larger than the present Lease Premises in any development owned by Landlord or affiliate of Landlord, Tenants' then remaining obligations due under this Lease Agreement shall be terminated upon the commencement date of the new lease

#### QuickLinks

##### [EXHIBIT 10.21](#)

[COMMERCIAL LEASE AGREEMENT](#)

[EXHIBIT B TENANT IMPROVEMENTS](#)

[EXHIBIT "D" RULES AND REGULATIONS](#)

[EXHIBIT "E" RENEWAL OPTION](#)

[EXHIBIT "F" EXPANSION RIGHT OF FIRST REFUSAL](#)

### AMENDMENT TO LEASE AGREEMENT

This certain Lease Agreement dated June 1, 2000 between JACKSON-SHAW TECHNOLOGY CENTER, II, LTD., LANDLORD and TESTCHIP TECHNOLOGIES, Tenant, for approximately 18,302 square feet of office space located at 2600 Technology Drive, Plano, Texas, is hereby amended as follows:

**LANDLORD:** The landlord as described in section one (1) shall be modified and amended as follows:

- 1) Jackson Shaw/Jupiter 2 Limited Partnership

**LEASE PREMISES:** The leased premises as described in section three (3) shall be modified and amended as follows:

- 1) In consideration of the rents, terms and covenants of this Commercial Lease Agreement (this "Lease"), Landlord hereby leases to Tenant certain premises (the "Leased Premises") consisting of approximately 18,298 square feet within the 83,286 square foot building (the "Building") located at 2600 Technology Drive, Plano Texas, together with the non-exclusive right to use, in common with other tenants, the common areas of the Project, which are all areas neither exclusively leased to another tenant nor expressly reserved to or by Landlord. The land upon which the Building is located is described in the attached Exhibit A and, together with the Building, landscaping, parking and driveway areas, sidewalks, and other improvements thereon, shall be referred to in this Lease as the "Project").

**TERM:** The Term of the Lease Agreement as described in paragraph 4(a) shall be modified and amended as follows:

- 1) The term of this Lease shall be 66 months commencing on October 1, 2000, the "Commencement Date" and terminating on the last day of the 66th month following the Commence Date (the "Termination Date").
- 2) Sub-Section (b) and under Section four (4), "TERM" of the Lease Agreement shall be modified and amended as follows:
  - (b) Tenant acknowledges that it accepts the Leased Premises as suitable for Tenant's purposes subject only to Paragraph 4(c) below, if applicable. If this Lease is executed before the Leased Premises become available for occupancy, or if Landlord cannot acquire possession of the Leased Premises prior to the Commencement Date stated above, Tenant agrees to accept possession of the Leased Premises at such time as Landlord is able to tender the same.
- 3) Sub-Section (c) under Section four (4), "TERM" shall be modified and amended as follows:
  - (c) Landlord agrees to install at its cost and expense the improvements, if any, described in the plans and specifications described in Exhibit B. If such improvements are not completed and the Leased Premises are not ready for occupancy on the Commencement Date stated above, rent under this Lease shall nonetheless commence, and the Commencement Date of the Lease term shall be the date stated above. Landlord shall notify Tenant in writing as soon as such improvements are substantially completed and ready for occupancy. If Tenant believes that such improvements have not been substantially completed as aforesaid, Tenant shall notify Landlord in writing of its objections within three (3) days after receipt of the completion notice from Landlord. Landlord shall have a reasonable time after receipt of such notice (but in no event

more than 10 days) in which to commence such corrective action as may be necessary and shall notify tenant in writing as soon as it deems such corrective action has been completed so

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that the Leased Premises are completed and ready for occupancy. In the event of any dispute as to substantial completion or work performed or required to be performed by Landlord, the certificate of a registered architect shall be conclusive and binding on all parties.

- 4) Sub-Section (d) under Section four (4), "TERM shall be modified and amended as follows:
- (c) Tenant acknowledges that no representations or promises regarding construction, repairs alterations, remodeling, or improvements to the Leased Premises have been made by Landlord, its agents, employees, or other representatives, unless such are expressly set forth in this Lease or any Exhibit hereto Tenant is solely responsible for applying for and obtaining a Certificate of Occupancy for the Leased Premises and will satisfy itself as to the business park restrictions and all zoning and similar restrictions and regulations prior to commencement of any construction. Failure of Tenant to provide written notice of such objections prior to commencement of construction shall be deemed acceptance by Tenant. Tenant agrees that if its occupancy of the Leased Premises is delayed, this Lease including the payment of rent shall nonetheless continue in full force and effect. Tenant's taking possession of the Leased Premises shall conclusively establish that the improvements under the terms of this Lease have been completed in accordance with the plans and specifications therefor and that the Leased Premises are in good and satisfactory condition. In conjunction with, or at any time after, the Commencement Date, Tenant shall, upon demand, execute and deliver to Landlord an Estoppel letter (as defined in paragraph 33 herein) to acknowledge the Comencement Date.

**BASE RENT:** The base rent described in section five (5) of the lease agreement shall be modified and amended as follows:

- 1) Tenant agrees to pay to Landlord the following rental amounts (sometimes referred to in this Lease as the "Base Rent" or "Base Rental"): months 1 through 6, \$155,532.00 per year payable in monthly installments of \$12,961.00 each, Months 7-66, \$205,860.00 per year payable in monthly installments of \$17,155.00 each. Payment of rent is subject to proration for partial months and to adjustment for early or delayed occupancy under the terms hereof, and, if the area of the Leased Premises is, on the Commencement Date, different than the area stated in Paragraph 3 above, then Base Rent shall be adjusted to reflect the then applicable per square foot rate. On the commencement date of the Lease Agreement the first month's Base Rent shall be payable. All subsequent payments shall be made to Landlord monthly, in advance, without demand, deduction or offset, in lawful money of the United States of America at the address stated below. All installments of Base Rent shall be due and payable on or before the first (1st) day of each month during the Lease term.

**EXHIBIT "B" TENANT IMPROVEMENTS:** The tenant improvements as described in Exhibit "B" are hereby modified and amended as follows:

Landlord will supply Tenant with a construction allowance of \$457,450.00 (\$25.00 psf) to be used for Tenant Improvements. Should the actual construction costs exceed this amount, Tenant shall pay such excess to Landlord fifty percent (50%) prior to the commencement of the construction and fifty percent (50%) fifteen (15) days after the commencement of construction. Should there be any savings as a result of value engineering, such savings shall be directly passed back to Tenant and deducted from the excess amounts due from Tenant on the initial construction overages.

Landlord's architect will supply floor plans and construction drawings with MEP drawings to be provided by the subcontractors. The Tenant Improvements shall be constructed in accordance to plans and specifications approved by Landlord and Tenant.

The Landlord is responsible for the costs to construct the Building to its shell condition. The shell condition is defined as the slab, roof, exterior walls, overhead doors, storefronts and fire sprinkler system will be in place and water, gas, and electrical service will be run to the building.

All other terms, conditions, and provisions of the Lease Agreement shall remain unmodified.

AGREED AND ACCEPTED on this 7th day of August, 2000 by:

LANDLORD  
TECHNOLOGIES

TENANT: TESTCHIP

JACKSON-SHAW JUPITER 2 LIMITED  
PARTNERSHIP

/s/ \_\_\_\_\_

/s/ Brenda L. Stoner \_\_\_\_\_

By: Jackson-Shaw Company  
Its: General Partner

By: Brenda L. Stoner  
Vice President

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[EXHIBIT 10.22](#)  
[AMENDMENT TO LEASE AGREEMENT](#)

**MODIFICATION AND RATIFICATION OF LEASE**

This Modification and Ratification of Lease Agreement is made and entered into between *JACKSON-SHAW TECHNOLOGY II, LTD.* (Lessor or Landlord) and *TESTCHIP TECHNOLOGIES, INC.* (Lessee or Tenant) for and in consideration of One Dollar (\$1.00) and other good and valuable consideration, the receipt of which is hereby acknowledged.

**WITNESSETH:**

1. Lessor and Lessee hereby confirm and ratify, except as modified below, all of the terms, conditions and covenants in that certain written Lease Agreement dated August 7, 2000, between Lessor and Lessee, for the rental of the following described property:

Being a warehouse facility containing approximately 18,298 square feet out of a 83,286 square foot facility located at 2600 Technology Drive, Suite 700, Plano, Texas.

2. Lessor warrants that Lessee has accepted and is now in possession of the demised premises and that the Lease Agreement is valid and presently in full force and effect.

3. Lessor and Lessee agree that beginning October 1, 2001, the monthly rental payments set out in the Lease Agreement shall be changed from \$17,155.00 per month to \$8,578.00 per month in advance for the sixth month period October 1, 2001 through March 31, 2002. Beginning April 1, 2002 through September 30, 2003, the rental shall be \$20,014.00 per month in advance. Beginning October 1, 2002 through March 31, 2006 the rental shall be \$17,155.00 per month in advance.

SIGNED at Dallas, Texas, this 31 day of October, 2001.

LESSOR:

DAVID R. KENNINGTON  
d/b/a KENNINGTON PROPERTIES

By: /s/ \_\_\_\_\_

Title: Property Manager

LESSEE:

TESTCHIP TECHNOLOGIES, INC.

By: /s/ \_\_\_\_\_

Title: CFO

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[EXHIBIT 10.23](#)

[MODIFICATION AND RATIFICATION OF LEASE](#)

[WITNESSETH](#)

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**Exhibit 21.1**

**SUBSIDIARIES OF THE REGISTRANT**

<u>Subsidiary Name</u>	<u>Jurisdiction of Incorporation</u>
Heuristic Physics Laboratories, Inc.	California
FabCentric, Inc.	California
HPL International Ltd.	Cayman Island
HPLA Limited Liability Company	Armenia
HPL (S) Pte. Ltd	Singapore
HPL Japan KK	Japan
Tyecin-Innotech Corporation	Japan
HPL Technologies Private Limited	India
HPL Texas, Inc.	Delaware
TestChip Technologies, Inc.	Texas
Defect & Yield Management, Inc.	Delaware

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[Exhibit 21.1](#)

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**Exhibit 23.1**

**CONSENT OF INDEPENDENT ACCOUNTANTS**

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (No. 333-66962 and No. 333-87144) of HPL Technologies, Inc. of our report dated May 7, 2002 relating to the financial statements, which appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

San Jose, California

June 21, 2002

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[Exhibit 23.1](#)