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Scrambled Signal

Innovative Start-Up Flops, and a Lawsuit Against TCI Follows

Interactive Network Had Viewer-Friendly Gizmo But Never Got a Launch

A TV Frontier in Jeopardy

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SUNNYVALE, Calif. – John Malone always called it a "killer application" – interactive software that allows home viewers to play along with TV sports or game shows for prizes.

Three years ago, the powerful chief executive of cable giant Tele-Communications Inc. chanced upon the one such system he thought would take the TV world by storm: a sleek black, software-driven gadget developed by upstart Interactive Network Inc. Mr. Malone seemed convinced that its real-time capabilities would revolutionize the way people use their television sets, and be the first real hit in the hot, lucrative new niche known as interactive TV.

These days, however, it is Interactive that is using the word killer–as an accusation against TCI. Virtually bankrupt, with seemingly little way to raise new capital, Interactive is accusing TCI of using hardball tactics and questionable business practices to wreck Interactive and snatch its business patents.

David Lockton

"I feel like I've been robbed at gunpoint," says David Lockton, the intense, 58-year-old chairman and founder of Interactive. His case is laid out in a lawsuit filed in California state court charging TCI with, among other things, a breach of fiduciary duty, conflict of interest and "abuse of control."

So intensely personal has the dispute become that Mr. Lockton posed his 200 employees for a photo – all of them with raised fists, their middle-fingers extended. "I told them this one was for John Malone," he says.

TCI dismisses Interactive's complaint as the dying gasp of a Silicon Valley start-up that oversold its potential and ran into a lot of bad luck. Whatever the case, the clash makes one thing clear: In the race to roll out new technology in an evolving, multibillion-dollar industry, the ground is often shifting and slippery, and the pain often exceeds the gain.

Today, numerous cable giants around the country are halting interactive tests over delays, high costs and concerns about whether consumers really want it. Instead, many are focusing on using their wires to offer access to the Internet.

Others are still actively in the hunt in an industry that some say could be worth $14 billion in the next five years. One example: In a pilot project that should provide some indication of interactive TV's direction, Time Warner Inc., the nation's second-largest cable operator, wired the last of 4,000 interactive homes in Orlando, Fla., two months ago. Among the earliest practical applications will be video-on-demand, which allows viewers to choose from scores of movies at the flick of a remote-control unit.

John Malone

"There will be interactive TV of some sort," insists Gary Arlen, a Bethesda, Md., research consultant. "But it's going to have a long, long gestation period."

For Mr. Lockton, a Yale-educated entrepreneur who helped start 12 companies before Interactive, the outset of 1992 seemed auspicious. He initially called his idea for Interactive "TBO" – for "The Big One" – and boldly predicted as many as one million subscribers in the first year after launch. "It was frightening," he says of the company's market potential.

Indeed, the company's gizmo started a huge buzz among media companies, and some jumped in to give seed money or loans, including General Electric Co.'s NBC, Gannett Co., Motorola Inc., Sprint Corp., Cablevision Systems Corp. and A.C. Nielsen Co.

The main attraction: Using a black control unit with a keypad and display screen, viewers could play along with 50 different TV programs, including "Jeopardy" and "Wheel of Fortune," and Major League Baseball and National Football League games. They could even predict story lines in shows such as "Murder She Wrote."

Says Massachusetts Institute of Technology's Media Lab director Nicholas Negroponte, an early adviser to the company, "The fundamental idea was terrific."

Paul Kagan, owner of a leading cable-industry research firm in Carmel, Calif., became an investor after his first brush with Interactive's system. "It was very successful in my house," says Mr. Kagan, who adds: "Analysts who said the game doesn't work are wrong. It works."

It was Mr. Kagan who, in early 1993, got Mr. Malone interested in Interactive. In

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Start-Up Flops, Suit Against TCI Follows

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April of that year, Mr. Malone got his first peek at the system at TCI headquarters in Denver. There, with Mr. Kagan in attendance, Mr. Lockton and Robert Brown, a senior vice president, got the TCI chief to play a game of Interactive "Jeopardy." A smiling Mr. Malone was hooked.

At the time, hype over interactivity had reached a frenzy, and cable, telephone and computer industries all were tripping over themselves to stake their claims. So, in June, TCI began investing roughly $13 million for a 22% stake in the company, and Mr. Malone declared that the Interactive Network system would be "the industry standard for interactive television." TCI installed Gary Howard, a TCI vice president, on Interactive's board.

Eventually, TCI would sink $30 million in equity and loans into Interactive. Not only did Interactive seem to offer a prize system that made watching TV compelling, it had a bonus application: With antigambling laws being repealed in various states, Interactive's technology seemed a perfect way to break into the lucrative gaming and lottery business by allowing users to pick lottery numbers or bet on televised horse races.

Never mind that, like many start-ups, Interactive Network had lurched from one cash infusion to another, posting a loss of $24.8 million on revenue of $1.1 million in 1993. It had drawn enough viewers in test markets in San Francisco and Chicago to keep investments coming; in the Bay Area, Interactive claimed 3,000 customers paying an average $25 a month for its service. Its stock had soared from $8 to $15 a share in a year.

It wouldn't be long, however, before the honeymoon turned sour. For one thing, TCI insisted that it could more-efficiently market Interactive's system by installing Interactive's software on new high-capacity digital-cable boxes. Equipment makers promised to deliver these boxes by 1994, but the delivery date came and went – and the boxes never (and still haven't) arrived. Interactive, expecting a quick national launch, found itself cooling its heels and considering other options – all the while burning up precious capital.

Meanwhile, TCI, still convinced that Interactive had a critical lead over rivals, continued to increase its stake in the company. But to hedge its bets, TCI had also taken a stake in a rival interactive start-up known as Zing Systems. Interactive considered this a perplexing annoyance at first; later though, Zing itself would flame out, filing for bankruptcy in December. Interactive would judge it a disaster for its own fortunes when a divided TCI management seemed, at a critical juncture, to be throwing its weight and energy toward Zing.

Hold That Offering

All the more galling to Mr. Lockton was an episode in 1994. When TCI learned that Mr. Lockton was planning a $22 million public offering at a discount to offshore purchasers, Brendan Clouston, president of TCI's cable operations, called Mr. Lockton to Denver, where he persuaded him to halt the offering.

Mr. Lockton recalls that Mr. Clouston said, "If anyone is going to buy this company at a discount, it's going to be the guys who brought you to the dance." TCI told investment banker Lazard Freres to "stand by" at a meeting in April 1994 while TCI prepared a financing plan to roll out the service, according to the Interactive Network lawsuit. Both Mr. Clouston and Lazard Freres declined to comment on these events.

A new investor – Sony Corp. – also emerged when Mr. Lockton presented the company's financing needs and national rollout plans to lead investors TCI and NBC. Sony, which distributes popular game shows, had started Game Show Channel on cable and saw potential for Interactive's system. Under the plan, TCI proposed a $65 million public-rights offering, to be guaranteed by TCI and Sony; an additional $30 million in equity would be sold to TCI and Sony, with NBC as a junior partner, according to Mr. Lockton.

As it worked on a joint marketing plan with TCI, Interactive Network started adding employees, buying computers and equipping a new 80,000-square-foot production facility. Earlier, it had ordered 50,000 control units – backed by a letter of credit from TCI.

But at the last moment Sony, without explanation, pulled out. The move, Interactive's suit says, "left Interactive with no financing, and with $20 million in obligations incurred at the direction of TCI for the national launch." Sony declined to comment. But people close to Sony said the talks fell apart in August 1994 over terms that Sony thought favored TCI.

With Sony out, TCI began to play hardball, proposing a plan that would give it even greater control over Interactive. Atop its $20 million equity stake, TCI agreed to give Interactive an additional $10 million as a convertible secured loan. But, as a condition, Interactive would first have to obtain $15 million more from other TCI-approved investors, as well as $25 million in new equity – a total of $40 million, all within a scant two weeks.

TCI, the suit goes on, also demanded that the title to the patents, software and technology be deeded immediately to the secured creditors. Then, as the largest creditor, TCI designated an agent for the secured creditors – itself. Interactive could only regain full title to the patents and software by raising an additional $45 million, according to its lawsuit.

TCI says the terms, though tough, gave Interactive another shot at going big time while salvaging TCI's Interactive investment. But most on Interactive's board saw it differently. "We had no choice," says

Interactive board member Jerome S. Rubin, founder of Lexis and Nexis electronic-information systems. "It was take it or go under."

People at some of Interactive's other minority partners say they were privately aghast at TCI's moves, but were unable to stop them because TCI had other significant relationships with them. NBC badly needed TCI to carry its CNBC and America's Talking cable channels. Motorola was making new TV set-top boxes for the cable giant. Sprint was getting roughly $1.3 billion from TCI as part of a financing for a new wireless-telephone venture.

Most of Interactive's investors declined to comment. NBC, in a statement, said: "It is NBC's view that Interactive Network had a high degree of potential to be a leading interactive system. We were very disappointed that the company's plans did not come to fruition."

Rise Before the Fall

In August 1994, Interactive says it agreed to TCI's terms – and, surprisingly, raised $15 million from NBC, Motorola and Sprint, and more than $20 million in an offering of shares in Europe. Immediately, the company paid debts outstanding, and used the remainder as operating capital.

But Mr. Lockton says that TCI, as secured creditor, began quashing proposals to raise new revenue, such as a unit to license its technology for gambling. TCI says it had serious concerns about the viability of such proposals.

If this weren't trouble enough, Interactive also found itself in an internal TCI power struggle between high-ranking TCI executives, some of whom were sold on Interactive's technology and some of whom were touting TCI's other Interactive bet, Zing. At one point in 1994, Mr. Lockton, at a meeting in Denver, informed Mr. Clouston that he had sued Zing for patent infringement in federal court in San Diego. Mr. Clouston, who had been an Interactive ally, replied: "Good."

The management conflicts boiled to the surface on a trip in January 1995, when Interactive executives flew to Denver to present what they considered to be better than expected results of a TCI-approved marketing test of their system in Indianapolis. Mr. Clouston, Interactive's champion, wasn't at the meeting. Instead, Interactive executives say they found themselves facing hostile questions from Zing supporters who clearly were intent on disparaging the Interactive system.

"There was a lot of hostility," recalls Gordon Wade, an Interactive board member and president of a consulting concern. "It was apparent to me there were warring factions within TCI."

Says TCI's Gary Howard: "The management team at TCI is like any corporation–you can have healthy tension. Everybody is looking at the bottom line."

Though Zing would also fall by the wayside, Mr. Lockton says that meeting convinced him that he was being abandoned by TCI. In the following months, he tried unsuccessfully to lure other giants such as ITT Corp., News Corp. and Bell Atlantic Corp. as investors.

But by mid-1995, Interactive was broke again. Its once-promising San Francisco and Chicago pilots never attracted more than 5,500 subscribers and are now defunct. The company, since 1987, had raised and raced through $130 million without ever getting its national roll out.

Its stock, which had traded at an all-time high of $15 a share on the Nasdaq Stock Market, dropped to 25 cents, and the company was delisted last spring. One by one, for a variety of reasons, Motorola, Sprint and Gannett have resigned from Interactive's board.

For now, Interactive seems to have two options: file for protection under Chapter 11 bankruptcy laws, or be forced to do so by creditors. TCI, as its chief lender, stands to gain all its remaining assets – including the technology, software and patents.

Interactive now charges in its lawsuit that TCI's goal was simply to snatch Interactive's patents. It also asserts that Mr. Howard, TCI's designee to Interactive's board, had a clear conflict, divided between the interests of Interactive's shareholders and safeguarding TCI's Interactive investment.

TCI dismisses Mr. Lockton's assertions. "When the whole digital world got delayed, [Mr. Lockton's] ability to get his cost down was delayed, too," says TCI's Mr. Howard. "We're not used to writing off $30 million."

He adds: "No one around here wants to be part of a failed effort." In suing TCI, Mr. Lockton is "stretching to find a reason why his business failed," Mr. Howard says.

Mr. Lockton has moved his handful of remaining employees to a hangar-sized warehouse in Silicon Valley, where thousands of the Interactive black boxes are collecting dust. He makes calls from a car telephone – the office phone was cut off. Back at the entrance of the white, mirrored offices of Interactive Network, a sign says: "Game over."