

NETWORK 1 SECURITY SOLUTIONS INC
Form 10-Q
August 14, 2013

U.S. SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

For the quarterly period ended June 30, 2013

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 1-15288

NETWORK-1 SECURITY SOLUTIONS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware
(State or other jurisdiction of incorporation or organization)

11-3027591
(IRS Employer Identification No.)

445 Park Avenue, Suite 1020
New York, New York
(Address of principal executive offices)

10022
(zip code)

212-829-5770
(Registrant's Telephone Number)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§223.405) of this chapter) during the preceding 12 months (or such shorter period that the registrant was required to submit and post

such files). Yes No

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

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

The number of shares of Common Stock, \$.01 par value per share, outstanding as of August 12, 2013 was 26,047,683.

NETWORK-1 SECURITY SOLUTIONS, INC.

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PART 1. FINANCIAL INFORMATION

Item 1. Financial Statements

NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED BALANCE SHEETS

UNAUDITED

	JUNE 30, 2013 (UNAUDITED)	DECEMBER 31, 2012
CURRENT ASSETS:		
Cash and cash equivalents	\$ 18,103,000	\$ 21,983,000
Marketable securities	533,000	547,000
Royalty receivables	1,867,000	775,000
Other current assets	232,000	222,000
Total Current Assets	\$ 20,735,000	23,527,000
OTHER ASSETS:		
Deferred tax asset	\$ 5,878,000	6,194,000
Patent, net of accumulated amortization	5,675,000	65,000
Security deposits	19,000	19,000
Total Other Assets	11,572,000	6,278,000
TOTAL ASSETS	\$ 32,307,000	\$ 29,805,000
LIABILITIES:		
CURRENT LIABILITIES:		
Accounts payable	\$ 160,000	\$ 232,000
Accrued expenses	651,000	593,000
TOTAL LIABILITIES	811,000	825,000
COMMITMENTS AND CONTINGENCIES	—	—
STOCKHOLDERS' EQUITY		
Common stock - \$0.01 par value; authorized 50,000,000 shares; 25,597,183 and 25,392,269 shares issued and outstanding at June 30,2013 and December 31,2012, respectively	256,000	254,000
Additional paid-in capital	\$ 59,728,000	\$ 58,046,000
Accumulated deficit	(28,460,000)	(29,306,000)

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Other comprehensive income(loss)	(28,000)	(14,000)
TOTAL STOCKHOLDERS' EQUITY	31,496,000	28,980,000
TOTAL LIABILITIES AND STOCKHOLDERS EQUITY	\$ 32,307,000	\$ 29,805,000

See notes to condensed financial statements

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NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
UNAUDITED

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
ROYALTY REVENUE	\$1,907,000	\$1,966,000	\$5,971,000	\$6,391,000
COST OF REVENUE	547,000	562,000	1,772,000	1,948,000
GROSS PROFIT	1,360,000	1,404,000	4,199,000	4,443,000
OPERATING EXPENSES:				
General and Administrative	767,000	446,000	1,445,000	1,036,000
Non-Cash compensation	144,000	74,000	256,000	165,000
TOTAL OPERATING EXPENSES	911,000	520,000	1,701,000	1,201,000
OPERATING INCOME	449,000	884,000	2,498,000	3,242,000
OTHER INCOME (EXPENSES):				
Interest income, net	12,000	10,000	18,000	19,000
INCOME BEFORE INCOME TAXES	461,000	894,000	2,516,000	3,261,000
INCOME TAXES (BENEFIT)				
Current	(22,000)	9,000	26,000	33,000
Deferred	(299,000)	148,000	316,000	568,000
Total Income Taxes (Benefits)	(321,000)	157,000	342,000	601,000
NET INCOME	\$782,000	\$737,000	\$2,174,000	\$2,660,000
Net Income per share - Basic	\$0.03	\$ 0.03	\$0.09	\$ 0.10
- Diluted	\$0.03	\$ 0.02	\$0.08	\$ 0.09
Weighted average number of common shares outstanding:				
- Basic	25,181,736	26,192,920	25,098,074	25,595,913
- Diluted	27,087,061	28,819,929	27,396,414	28,729,256
NET INCOME	\$782,000	\$737,000	\$2,174,000	\$2,660,000
OTHER COMPREHENSIVE INCOME NET OF TAX:	(9,000)	3,000	(14,000)	2,000

Unrealized gain (loss) arising
during period

COMPREHENSIVE INCOME	\$773,000	\$740,000	\$2,160,000	\$2,662,000
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See notes to condensed financial statements

NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED STATEMENTS OF CASH FLOW

UNAUDITED

	Six Months Ended June 30,	
	2013	2012
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net Income	\$ 2,174,000	\$ 2,660,000
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation and amortization	249,000	5,000
Stock based compensation	256,000	165,000
Source (use) of cash from changes in operating assets and liabilities:		
Royalty receivables and other current assets	(1,051,000)	(1,162,000)
Accounts payable and accrued expenses	(5,000)	(1,012,000)
Income Taxes Payable	(62,000)	(67,000)
Deferred tax asset	316,000	568,000
NET CASH PROVIDED BY (USED IN) OPERATING ACTIVITIES	1,877,000	1,157,000
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of Patents	(4,420,000)	—
CASH FLOWS FROM FINANCING ACTIVITIES:		
Value of shares delivered to fund withholding taxes	(486,000)	(487,000)
Repurchase of treasury stock	(851,000)	(52,000)
NET CASH PROVIDED (USED IN) FINANCING ACTIVITIES	(1,337,000)	(539,000)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(3,880,000)	618,000
CASH AND CASH EQUIVALENTS, beginning of period	21,983,000	20,661,000
CASH AND CASH EQUIVALENTS, end of period	\$ 18,103,000	\$ 21,279,000
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the periods for:		
Interest	\$ —	\$ —
Taxes	\$ 93,000	\$ 127,000
NON-CASH INVESTING AND FINANCING ACTIVITIES:		
Value of shares and warrants issued to purchase patents	\$ 1,438,000	\$ —

See notes to condensed financial statements

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NOTE A – NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

[1] BASIS OF PRESENTATION:

The accompanying condensed financial statements as of June 30, 2013 and for the three and six month periods ended June 30, 2013 and June 30, 2012 are unaudited, but, in the opinion of the management of Network-1 Security Solutions, Inc. (the "Company"), contain all adjustments consisting only of normal recurring items which the Company considers necessary for the fair presentation of the Company's financial position as of June 30, 2013, and the results of its operations for the three and six month periods ended June 30, 2013 and June 30, 2012 and its cash flows for the six month periods then ended. The condensed financial statements included herein have been prepared in accordance with the accounting principles generally accepted in the United States of America for interim financial information and the instructions to Form 10-Q. Accordingly, certain information and footnote disclosures normally included in the financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to such rules and regulations, although management believes that the disclosures are adequate to make the information presented not misleading. These financial statements should be read in conjunction with the audited financial statements for the year ended December 31, 2012 included in the Company's Annual Report on Form 10-K filed with the Securities and Exchange Commission. The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the results of operations to be expected for the full year.

[2] BUSINESS:

Our principal business is the acquisition, development, licensing and protection of our intellectual property. We presently own nineteen (19) patents issued by the U.S. Patent and Trademark Office that relate to various technologies including patents covering (i) the delivery of power over Ethernet ("PoE") cables for the purpose of remotely powering network devices, such as wireless access ports, IP phones and network based cameras, over Ethernet networks; (ii) foundational technologies that enable unified search and indexing, displaying and archiving of documents in a computer system; (iii) enabling technology for identifying media content on the Internet, and taking further action to be performed based on such identification including, among others, the insertion of advertising and the facilitation of the purchase of goods and services; and (iv) systems and methods for the transmission of audio, video and data over computer and telephony networks. In addition, we continually review opportunities to acquire or license additional intellectual property. Our strategy is to pursue licensing and strategic alliances with companies in industries that manufacture and sell products that make use of the technologies underlying our intellectual property as well as with other users of the technologies who benefit directly from the technologies including corporate, educational and governmental entities. To date, our licensing efforts have largely focused on licensing our patent (U.S. Patent No. 6,218,930) covering the control of power delivery over Ethernet cables (the "Remote Power Patent"). At June 30, 2013, we had entered into a total of sixteen (16) license agreements with respect to our Remote Power Patent which, among others, include license agreements with Cisco Systems, Inc. and Cisco-Linksys, Microsemi Corporation, Extreme Networks, Inc., Motorola Solutions, Inc., Allied Telesis, Inc., NEC Corporation and several other major data networking equipment manufacturers. We have a pending patent infringement litigation against eleven (11) data network equipment manufacturers for infringement of our Remote Power Patent (See Note D[1] to our financial

NOTE A – NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

statements included in this quarterly report). As part of our patent acquisition strategy, in February 2013 we acquired four (4) patents and one (1) pending patent application and in May 2013 we acquired nine (9) patents and five (5) pending patent applications (See Note B[2] to our financial statement included in this quarterly report). In May 2013, the Company's newly formed subsidiary (Mirror Worlds Technologies, LLC) initiated patent litigation against Apple, Inc., Microsoft, Inc. and several other major vendors of operating system software and computer systems for infringement of one of the patents acquired in May 2013 (See Note D[2] hereof).

(b) As reflected in the accompanying financial statements, the Company had revenue of \$1,907,000 and \$1,966,000 for the three month period ended June 30, 2013 and June 30, 2012, respectively, and revenue of \$5,971,000 and \$6,391,000 for the six month period ended June 30, 2013 and June 30, 2012, respectively. The Company has been dependent upon royalty revenue from license of its Remote Power Patent to fund its operations. The Company had cash and cash equivalents of \$18,103,000 as of June 30, 2013.

[3] STOCK-BASED COMPENSATION:

On June 19, 2013, the Company issued to a director a 5-year option to purchase 300,000 shares of its common stock, at an exercise price of \$1.88 per share, for service as the sole member of the Company's Strategic Development Committee. The shares underlying such option vested 100,000 shares on the date of grant and will vest 100,000 shares on June 19, 2014 and 100,000 shares on June 19, 2015. The Company recorded \$75,000 in non-cash compensation in connection with the vested portion of the option for the six month period ended June 30, 2013.

On January 24, 2013, the Company issued stock options to each of its four (4) non-management directors to purchase 25,000 shares of common stock at an exercise price of \$1.19 per share. Such options vest over a one year period in equal quarterly amounts, subject to continued service on the Board. The Company recorded \$24,000 in non-cash compensation in connection with the vested portion of these options for the six month period ended June 30, 2013.

During the six month periods ended June 30, 2013 and 2012, the Company recorded non-cash compensation expense of \$54,000 and \$74,000 for the vested portion of options to purchase 500,000 and 750,000 shares issued to the Company's Chairman and Chief Executive Officer in November 2012 and June 2009, respectively. In addition, during the six month periods ended June 30, 2013 and June 30, 2012, the Company recorded non-cash compensation expense of \$101,000 and \$54,000, respectively, for the vested portion of options granted to its Chief Financial Officer, directors and consultants in prior years.

On April 11, 2012, the Company issued a 5-year option to purchase 125,000 shares of its common stock to one of its directors, at an exercise price of \$1.40 per share, in consideration of serving on a special committee of the Board of Directors, and such option was to vest over a one year period in equal quarterly amounts of 31,250 shares (the vesting was accelerated following the resignation of the director in December 2012). On April 12, 2012, the Company issued to its Chief Financial Officer, in consideration of extension of his consulting

NOTE A – NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

agreement with the Company (See Note C[4]), a 5-year option to purchase 75,000 shares of its common stock, at an exercise price of \$1.40 per share. Such option vests over a one year period in equal installments of 18,750 shares.

On January 27, 2012, the Company issued a 5-year option to purchase 50,000 shares of its common stock, at an exercise price of \$1.21 per share, to a director for joining the Board of Directors, which option vests in equal quarterly installments over a one year period. On January 31, 2012 and February 24, 2012, the Company issued 5-year options to purchase an aggregate of 25,000 shares to each of its three non-management directors, at exercise prices of \$1.21 and \$1.35 per share. These options vest over a one year period in equal quarterly installments.

During the three month period ended June 30, 2013, the Company's Chairman and Chief Executive Officer and an employee exercised options to purchase an aggregate of 1,125,000 and 52,500 shares, respectively, of the Company's common stock at an exercise price of \$0.68 per share. All such options were exercised on a cashless basis by delivery of an aggregate of 396,373 and 18,497 shares of common stock, respectively, and 241,540 and 10,201 shares of common stock were delivered with an aggregate value of \$466,617 and \$19,688 to fund payroll withholding taxes on exercise, resulting in aggregate net shares of 487,087 and 23,802 issued to the Chairman and Chief Executive Officer and the employee, respectively, with respect to such option exercises.

During the six month period ended June 30, 2012, the Company's Chairman and Chief Executive Officer and an affiliate exercised options and warrants to purchase an aggregate of 2,623,070 shares of the Company's common stock at an exercise price of \$0.68 per share. All such options were exercised on a cashless basis by delivery of 1,306,979 shares of common stock and 350,160 shares of common stock were delivered with an aggregate value of \$486,951 to fund payroll withholding taxes on exercise, resulting in aggregate net shares of 965,933 issued to the Chairman and Chief Executive Officer with respect to such option and warrant exercises.

The fair value of each option grant on the date of grant is estimated using the Black-Scholes option-pricing utilizing the following weighted average assumptions:

	SIX MONTHS ENDED JUNE 30,	
	2013	2012
Risk-free interest rates	0.78-1.24%	0.71-0.89%
Expected option life in years	5 years	5 years
Expected stock price volatility	43.54%-44.31%	45.86%
Expected dividend yield	-0-	- 0 -

NOTE A – NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

[4] REVENUE RECOGNITION:

The Company recognizes revenue received from the licensing of its intellectual property in accordance with Staff Accounting Bulletin No. 104, "Revenue Recognition" ("SAB No. 104") and related authoritative pronouncements. Revenue is recognized when (i) persuasive evidence of an arrangement exists, (ii) all obligations have been performed pursuant to the terms of the license agreement, (iii) amounts are fixed or determinable, and (iv) collectibility of amounts is reasonably assured. One licensee (Cisco Systems) constituted approximately 84% and 81% of the Company's revenue, respectively, for the six month periods ended June 30, 2013 and June 30, 2012.

[5] INCOME TAXES:

At June 30, 2013, the Company had net operating loss carryforwards (NOLs) totaling approximately \$23,954,000 expiring 2029, with a future tax benefit of approximately \$8,144,000. During the second quarter of 2011, as a result of the Company's financial results and projected future operating results, management determined that a portion of the NOL was more likely than not to be utilized resulting in the recording of a one-time, non-cash income tax benefit of \$7,000,000 (income) or \$0.29 per share (basic) for the three and six month periods ended June 30, 2011. At June 30, 2013 and December 31, 2012, \$5,878,000 and \$6,194,000, respectively, were recorded as a deferred tax asset on the Company's balance sheet. During the six month period ended June 30, 2013 as a result of income (before taxes) for the period of \$2,516,000, \$342,000 was recorded as income tax expense and the deferred tax asset was reduced by \$316,000 to \$5,878,000. To the extent that the Company earns income in the future, it will report income tax expense and such expense attributable to federal income taxes will reduce the recorded income tax benefit asset reflected on the balance sheet. Management will continue to evaluate the recoverability of the NOL and adjust the deferred tax asset appropriately. Utilization of NOL credit carryforwards can be subject to a substantial annual limitation due to ownership change limitations that could occur in the future, as required by Section 382 of the Internal Revenue Code of 1986, as amended, as well as similar state provisions.

NOTE A – NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

[6] EARNINGS (LOSS) PER SHARE:

Basic Earnings (loss) per share is calculated by dividing the net income (loss) by the weighted average number of outstanding common shares during the period. Diluted per share data includes the dilutive effects of options, warrants and convertible securities. Potential shares of 7,587,500 and 5,460,000 at June 30, 2013 and 2012, respectively, consisted of options and warrants. Computations of basic and diluted weighted average common shares outstanding are as follows:

	Six Months Ended June 30,		Three Months Ended June 30,	
	2013	2012	2013	2012
Weighted-average common shares outstanding – basic	25,098,074	25,595,913	25,181,736	26,192,920
Dilutive effect of options and warrants	2,298,340	3,133,343	1,905,325	2,627,009
Weighted-average common shares outstanding – diluted	27,396,414	28,729,256	27,087,061	28,819,929
Options and Warrants excluded from the computation of diluted income (loss) per share because the effect of inclusion would have been anti-dilutive	5,289,160	2,326,657	5,682,175	2,832,991

[7] CASH EQUIVALENTS:

The Company places cash investments in high quality financial institutions insured by the Federal Deposit Insurance Corporation ("FDIC"). At June 30, 2013, the Company maintained cash balance of \$17,583,000 in excess of FDIC limits.

The Company considers all highly liquid short-term investments purchased with an original maturity of three months or less to be cash equivalents.

Cash and cash equivalents as of June 30, 2013 and December 31, 2012 are composed of:

	June 30, 2013	December 31, 2012
Cash	\$ 1,456,000	\$ 1,346,000
Money market fund	16,647,000	20,637,000
Total	\$ 18,103,000	\$ 21,983,000

[8] MARKETABLE SECURITIES

Marketable securities are classified as available-for-sale and are recorded as fair market value. Unrealized gain and losses are reported as other comprehensive income. Realized gains and losses are included in income in the period they are realized. The Company's marketable securities consist of a corporate bond (face value \$500,000) with a 5% coupon and a maturity date of June 2015.

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Note B - COMMITMENTS AND CONTINGENCIES

[1] Legal Fees:

Dovel & Luner, LLP provides legal services to us with respect to our patent litigation commenced in May 2013 against Apple, Inc., Microsoft, Inc. and other major vendors of document system software and computer systems in the United States District Court of Texas, Tyler Division for infringement of U.S. Patent No. 6,006,227. The terms of our agreement with Dovel & Luner LLP provide for legal fees on a contingency basis ranging from 25% to 40% of the net recovery (after deduction of expenses) depending upon the stage of proceeding in which a result (settlement or judgment) is achieved, subject to certain agreed upon contingency fee caps depending upon the amount of the net recovery. The Company is responsible for a certain portion of the expenses incurred with respect to the litigation.

Dovel & Luner, LLP provides legal services to the Company with respect to the Company's pending patent litigation filed in September 2011 against eleven (11) data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler (See Note D[1]). The terms of the Company's agreement with Dovel & Luner LLP essentially provides for legal fees on a full contingency basis ranging from 12.5% to 35% (with certain exceptions) of the net recovery (after deduction for expenses) depending on the stage of the preceding in which a result (settlement or judgment) is achieved. For the six month period ended June 30, 2013 and June 30, 2012, the Company accrued aggregate legal fees with respect to the litigation of \$155,000 and \$268,000, respectively, to Dovel & Luner. The Company is responsible for a certain portion of the expenses incurred with respect to the litigation.

Dovel & Luner, LLP provided legal services to the Company with respect to the litigation settled in July 2010 against several major data networking equipment manufacturers (See Note D[2]). The terms of the Company's agreement with Dovel & Luner, LLP with respect to this litigation provided for legal fees of a maximum aggregate cash payment of \$1.5 million plus a contingency fee of 24% (based on the settlement being achieved at the trial stage). Because of the royalty payments payable quarterly by Cisco in accordance with the Company's settlement and license agreement with Cisco (See Note D[3]), the Company has an obligation to pay Dovel & Luner 24% of such royalties received. During the six months ended June 30, 2013 and 2012, the Company incurred aggregate legal fees to Dovel & Luner, LLP of approximately \$1,264,000 and \$1,296,000, respectively, with respect to the aforementioned litigation.

With respect to the Company's litigation against D-Link, which was settled in May 2007, the Company utilized the services of Blank Rome, LLP on a full contingency basis. In accordance with the Company's contingency fee agreement with Blank Rome LLP, once the Company recovers its expenses related to the litigation (which have not yet been recovered), the Company is obligated to pay legal fees to Blank Rome LLP equal to 25% of the royalty revenue received by the Company from its license agreement with D-Link. During the first quarter of 2013 the Company recovered its expenses related to the litigation and accrued legal fees to Blank Rome of \$6,000 for the six months ended June 30, 2013.

Note B - COMMITMENTS AND CONTINGENCIES (continued)

[2] Patent Acquisitions:

On February 28, 2013, the Company completed the acquisition of four (4) patents (as well as a pending patent application) from Dr. Ingemar Cox, a technology leader in digital watermarking content identification, digital rights management and related technologies, for a purchase price of \$1,000,000 in cash and 403,226 shares of the Company's common stock. In addition, the Company is obligated to pay Dr. Cox 12.5% of the net proceeds (after deduction of expenses) generated by the Company from licensing, sale or enforcement of the patents. Since the acquisition the Company has filed seven (7) additional related patent applications with the United States Patent and Trademark Office seeking patent protection based upon the original patent application filed in 2000.

On May 21, 2013, the Company's newly formed subsidiary, Mirror Worlds Technologies, LLC, acquired all of the patents previously owned by Mirror Worlds, LLC (which subsequently changed its name to Looking Glass LLC), consisting of nine (9) issued United States patents and five (5) pending applications covering foundational technologies that enable unified search and indexing, displaying and archiving of documents in a computer system. As consideration for the patent acquisition, the Company paid Looking Glass LLC \$3,000,000 in cash, and issued 5-year warrants to purchase an aggregate of 1,750,000 shares of our common stock (875,000 shares of common stock at an exercise price of \$1.40 per share and 875,000 shares of our common stock at an exercise price of \$2.10 per share). As part of the acquisition, the Company also entered into an agreement with Recognition Interface, LLC ("Recognition"), an entity that financed the commercialization of the patent portfolio prior to its sale to Mirror Worlds, LLC and also retained an interest in the licensing proceeds of the patent portfolio held by Mirror Worlds, LLC. Pursuant to the terms of the Company's agreement with Recognition, Recognition received (i) 5-year warrants to purchase 250,000 shares of the Company's common stock at \$1.40 per share, and (ii) 5-year warrants to purchase 250,000 shares of common stock at \$2.10 per share. Recognition also received from the Company an interest in the net proceeds realized from the monetization of the patent portfolio as follows: (i) 10% of the first \$125 million of net proceeds, (ii) 15% of the next \$125 million of net proceeds, (iii) and 20% of any portion of the net proceeds in excess of \$250 million. In addition, Abacus and Associates, Inc., an investment entity affiliated with Recognition, received a 60-day warrant to purchase 500,000 shares of the Company's common stock at \$2.05 per share. In accordance with the Company's agreement with Recognition, if Abacus exercises the 60-day warrant an additional warrant to purchase an aggregate of 250,000 shares of the Company will be issued to Recognition.

[3] Services Agreement:

Pursuant to an agreement, dated November 30, 2004, between the Company and ThinkFire Services USA, Ltd. ("ThinkFire"), the Company is obligated to pay ThinkFire fees from royalty payments received from certain licensees in consideration for services performed on behalf of the Company. During the six month periods ended June 30, 2013 and 2012, the Company accrued fees of approximately \$50,000 and \$47,000, respectively, with respect to its obligation to ThinkFire.

Note B - COMMITMENTS AND CONTINGENCIES (continued)

[4] Lease Agreement:

The Company currently leases office space in New York City at a cost of \$3,300 which lease expires on November 30, 2013.

On June 16, 2011, the Company entered into a four-year lease agreement commencing July 18, 2011 to rent office space, consisting of approximately 2,400 square feet, for offices in New Canaan, Connecticut. In accordance with the lease, the Company will pay a base rent of \$6,400 per month for the first two years, \$6,800 per month for the third year and \$7,000 per month for the fourth year. The base rent is subject to annual adjustments to reflect increases in real estate taxes and operating expenses. The Company also entered into a one year sublease (expiring July 2012) at a base rent of \$3,700 per month to sublet approximately 50% of the space to a third party.

Note C - EMPLOYMENT ARRANGEMENTS AND OTHER AGREEMENTS

[1] On November 1, 2012, the Company entered into a new employment agreement (the "Agreement") with its Chairman and Chief Executive Officer for a one year term (which shall automatically be extended for two successive one year periods unless terminated by the Company) at an annual base salary of \$415,000. The Agreement established an annual target bonus of \$150,000 for the Chairman and Chief Executive Officer based on performance criteria to be established on an annual basis by the Board of Directors (or compensation committee). For the year ended December 31, 2012, the Chairman and Chief Executive Officer received the target bonus of \$150,000. In connection with the Agreement, the Chairman and Chief Executive Officer was issued a ten year option to purchase 500,000 shares of the Company's common stock at an exercise price of \$1.19 per share, which vests in equal quarterly amounts of 41,667 shares beginning November 1, 2012 through August 31, 2015, subject to acceleration upon a change of control. The Chairman and Chief Executive Officer shall forfeit the balance of unvested shares if his employment has been terminated "For Cause" (as defined) by the Company or by him without "Good Reason" (as defined). Under the terms of the Agreement, the Chairman and Chief Executive Officer also receives incentive compensation in an amount equal to 5% of the Company's gross royalties or other payments or proceeds (without deduction of legal fees or any other expenses) with respect to its Remote Power Patent and a 10% net interest (gross royalties and other payments or proceeds after deduction of all legal fees and litigation expenses related to licensing, enforcement and sale activities, but in no event shall he receive less than 6.25% of the gross recovery) of the Company's royalties and other payments with respect to its other patents besides the Remote Power Patent (the "Additional Patents") (the "Incentive Compensation"). During the six months ended June 30, 2013 and June 30, 2012 the Chairman and Chief Executive Officer earned Incentive Compensation of \$299,000 and \$320,000, respectively. The Incentive Compensation shall continue to be paid to the Chairman and Chief Executive Officer for the life of each of the Company's patents with respect to licenses entered into with third parties during the term of his employment or at anytime thereafter, whether he is employed by the Company or not; provided, that, the Chairman and Chief Executive Officer's employment has not been terminated by the Company "For Cause" (as defined) or terminated by him without "Good Reason" (as defined). In the event of a merger or sale of substantially all of the assets of the Company, the Company has the option to extinguish the right of Chairman and Chief Executive Officer to receive future Incentive Compensation by payment to him of a lump sum payment, in an amount equal to the fair market value of such

Note C - EMPLOYMENT ARRANGEMENTS AND OTHER AGREEMENTS (continued)

future interest as determined by an independent third party expert if the parties do not reach agreement as to such value. In the event that the Chairman and Chief Executive Officer's employment is terminated by the Company "Other Than For Cause" (as defined) or by him for "Good Reason" (as defined), the Chairman and Chief Executive Officer shall also be entitled to (i) a lump sum severance payment of 12 months base salary, (ii) a pro-rated portion of the \$150,000 target bonus provided bonus criteria have been satisfied on a pro-rated basis through the calendar quarter in which the termination occurs and (iii) accelerated vesting of all unvested options and warrants.

In connection with the Agreement, the Chairman and Chief Executive Officer has also agreed not to compete with the Company as follows: (i) during the term of the Agreement and for a period of 12 months thereafter if his employment is terminated "Other Than For Cause" (as defined) provided he is paid his 12 month base salary severance amount and (ii) for a period of two years from the termination date, if terminated "For Cause" by the Company or "Without Good Reason" by the Chairman and Chief Executive Officer.

[2] On June 8, 2009, the Company entered into an Employment Agreement (the "Agreement") with the Chairman and Chief Executive Officer for a three year term (which expired in June 2012) at an annual base salary of \$375,000 (retroactive to April 1, 2009) for the first year and increasing 5% on each of April 1, 2010 and April 1, 2011. During the term of the Agreement, the Chairman and Chief Executive Officer received a cash bonus in an amount no less than \$150,000 on an annual basis. In connection with the Agreement, the Chairman and Chief Executive Officer was issued a ten year option to purchase 750,000 shares of common stock at an exercise price of \$0.83 per share, which vested in equal quarterly amounts of 62,500 shares beginning June 30, 2010 through March 31, 2012. In addition to the aforementioned option grant, the Company extended for an additional 5 years the expiration dates of all options (an aggregate of 417,500 shares) expiring in the calendar year 2009 owned by the Chairman and Chief Executive Officer. Under the terms of the Agreement, the Chairman and Chief Executive Officer also received additional bonus compensation in an amount equal to 5% of the Company's royalties or other payments with respect to the Company's Remote Power Patent (before deduction of payments to third parties including, but not limited to, legal fees and expenses and third party license fees).

[3] On February 3, 2011, the Company entered into an agreement with its Chief Financial Officer for his continued service through December 31, 2012. In consideration for his services, the Chief Financial Officer was compensated at the rate of \$9,000 per month for the year ending December 31, 2011 and was to be compensated at the rate of \$9,450 per month for the year ending December 31, 2012. In connection with the agreement, the Chief Financial Officer was also issued a five year option to purchase 100,000 shares of the Company's common stock at an exercise price of \$1.59 per share. The option vested 50,000 shares on the date of grant and the balance of the shares (50,000) vested on the one year anniversary date (February 3, 2012) from the date of grant.

[4] On April 12, 2012, the Company entered into an agreement, with its Chief Financial Officer which amended the agreement, dated February 3, 2011 (See Note C[3] above), pursuant to which he continued to serve the Company. The amendment (the "Amendment") provided as follows: (i) the term of service of the Chief Financial Officer shall be extended until December 31, 2013; (ii) monthly compensation shall be increased to \$11,000 per month; and (iii) the Chief Financial Officer was granted a five year option to purchase 75,000

Note C - EMPLOYMENT ARRANGEMENTS AND OTHER AGREEMENTS (continued)

shares of the Company's common stock at an exercise price of \$1.40 per share, which option vests over a one year period in equal quarterly amounts of 18,750 shares. Except as provided in the Amendment, all other terms of the Agreement, dated February 3, 2011, remain in full force and effect.

NOTE D - LITIGATION

[1] In September 2011, the Company initiated patent litigation against sixteen (16) data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of its Remote Power Patent. Named as defendants in the lawsuit, excluding related parties, were Alcatel-Lucent USA, Inc., Allied Telesis, Inc., Avaya Inc., AXIS Communications Inc., Dell, Inc., GarrettCom, Inc., Hewlett-Packard Company, Huawei Technologies USA, Juniper Networks, Inc., Motorola Solutions, Inc., NEC Corporation, Polycom Inc., Samsung Electronics Co., Ltd., ShoreTel, Inc., Sony Electronics, Inc., and Transition Networks, Inc. The Company seeks monetary damages based upon reasonable royalties. During the year ended December 31, 2012, the Company reached settlement agreements with defendants Motorola Solutions, Inc. ("Motorola"), Transition Networks, Inc. ("Transition Networks") and GarretCom, Inc. ("GarretCom"). In February 2013, the Company reached settlement agreements with Allied Telesis, Inc. ("Allied Telesis") and NEC Corporation ("NEC"). As part of the settlements, Motorola, Transition Networks, GarretCom, Allied Telesis and NEC each entered into a non-exclusive license agreement for the Company's Remote Power Patent pursuant to which each such defendant agreed to license the Remote Power Patent for its full term (which expires in March 2020) and pay a license initiation fee and quarterly or annual royalties based on their sales of PoE products. On January 25, 2013, certain defendants filed a motion to stay the litigation pending completion or termination of the Inter Partes review proceedings pending at the United States Patent and Trademark Office (see Note D(5) below). On March 5, 2013, the Court granted defendants' motion and stayed the litigation pending the disposition of the Inter Partes review proceedings.

[2] On May 23, 2013, the Company's newly formed subsidiary (Mirror Worlds Technologies, LLC) initiated patent litigation in the United States District Court for the Eastern District of Texas, Tyler Division, against Apple, Inc., Microsoft, Inc., Hewlett-Packard Company, Lenovo Group Ltd., Lenovo (United States), Inc., Dell, Inc., Best Buy Co., Inc., Samsung Electronics America, Inc. and Samsung Telecommunications America L.L.C., for infringement of the '227 Patent (one of the patents the Company acquired as part of the Mirror Worlds patent portfolio – See Note B[2] to our financial statements included in this quarterly report). The Company seeks, among other things, monetary damages based upon reasonable royalties. The lawsuit alleges that the Defendants have infringed and continue to infringe the claims of the '227 Patent by making, selling, offering to sell and using infringing products including Mac OS and Windows operating systems and personal computers and tablets that include versions of those operating systems, and by encouraging others to make, sell, and use these products.

[3] In July 2010, the Company settled its patent litigation pending in the United States District Court for the Eastern District of Texas, Tyler Division, against Adtran, Inc, Cisco Systems, Inc. and Cisco-Linksys, LLC, (collectively, "Cisco"), Enterasys Networks, Inc., Extreme Networks, Inc., Foundry Networks, Inc., and 3Com Corporation, Inc. As part of the settlement, Adtran, Cisco, Enterasys, Extreme Networks and Foundry Networks each entered

NOTE D - LITIGATION (continued)

into a settlement agreement with the Company and entered into non-exclusive licenses for our Remote Power Patent (the "Licensed Defendants"). Under the terms of the licenses, the Licensed Defendants paid the Company aggregate upfront payments of approximately \$32 million and also agreed to license the Remote Power Patent for its full term, which expires in March 2020. In accordance with the Settlement and License Agreement, dated May 25, 2011, which expanded upon the July 2010 agreement, Cisco is obliged to pay the Company royalties (which began in the first quarter of 2011) based on its sales of PoE products up to maximum royalty payments per year of \$8 million through 2015 and \$9 million per year thereafter for the remaining term of the patent. The royalty payments are subject to certain conditions including the continued validity of the Company's Remote Power Patent, and the actual royalty amounts received may be less than the caps stated above, as was the case in 2012 and 2011. Under the terms of the Agreement, if the Company grants other licenses with lower royalty rates to third parties (as defined in the Agreement), Cisco shall be entitled to the benefit of the lower royalty rates provided it agrees to the material terms of such other license. Under the terms of the Agreement, the Company has certain obligations to Cisco and if it materially breaches such terms, Cisco will be entitled to stop paying royalties to the Company. This would have a material adverse effect on the Company's business, financial condition and results of operations.

[4] On July 20, 2012, an unknown third party filed with the United States Patent and Trademark Office (USPTO) a request for an Ex Parte Reexamination, requesting that our Remote Power Patent be reexamined by the USPTO. The request for reexamination was stayed on December 21, 2012 pending the termination or completion of the Inter Partes Review proceedings described in Note D[4] below. The initial grant of the reexamination by USPTO is not unusual as the majority of such applications are initially granted by USPTO. While the Company believes that the reexamination proceeding will further validate and strengthen the Remote Power Patent, should the USPTO reach a final determination that the Remote Power Patent is invalid (unless overturned by the Board of Patent Appeals and Int