

NETWORK 1 SECURITY SOLUTIONS INC
Form 10-Q
May 14, 2010

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 March 31, 2010

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 1-14896

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 1018, New York, New York 10022
(Address of principal executive offices)

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 May 12, 2010 was 24,135,557.

NETWORK-1 SECURITY SOLUTIONS, INC.

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Item 1. Financial Statements

NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED BALANCE SHEETS
UNAUDITED

	MARCH 31, 2010	DECEMBER 31, 2009
	(UNAUDITED)	
Assets:		
Current assets:		
Cash and cash equivalents	\$ 2,269,000	\$ 3,022,000
Royalty and Interest Receivable	108,000	120,000
Other current assets	65,000	70,000
Total current assets	2,442,000	3,212,000
Security Deposits	6,000	6,000
Patents	90,000	92,000
	\$ 2,538,000	\$ 3,310,000
Liabilities:		
Current liabilities:		
Accounts payable	\$ 323,000	\$ 324,000
Accrued expenses and other current liabilities	101,000	261,000
Total current liabilities	424,000	585,000
Commitments and contingencies		
Stockholders' Equity		
Common stock - \$0.01 par value ; authorized 50,000,000 shares; 24,135,557 shares issued and outstanding at March 31, 2010 and December 31, 2009	241,000	241,000
Additional paid-in capital	56,004,000	55,957,000
Accumulated deficit	(54,131,000)	(53,473,000)
	2,114,000	2,725,000

\$ 2,538,000 \$ 3,310,000

See notes to condensed financial statements

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NETWORK-1 SECURITY SOLUTIONS, INC.
CONDENSED STATEMENTS OF OPERATIONS
UNAUDITED

	Three Months Ended March 31,	
	2010	2009
Royalty Revenue	\$118,000	\$27,000
Cost of Revenue	6,000	1,000
Gross Profit	112,000	26,000
Operating Expenses:		
General and administrative	723,000	\$436,000
Non-cash compensation	47,000	555,000
Total Operating Expenses	771,000	991,000
OPERATING LOSS	(658,000)	(965,000)
Other Income (Expenses):		
Interest income, net	—	1,000
Loss Before Income Taxes	(658,000)	(964,000)
INCOME TAXES	—	—
Net Loss	\$(658,000)	\$(964,000)
Net loss per share - Basic and Diluted	\$(0.03)	\$(0.04)
Weighted average number of common shares outstanding	24,135,557	24,135,557

See notes to condensed financial statements

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

	Three Months Ended March 31,	
	2010	2009
Cash flows from operating activities:		
Net loss	\$ (658,000)	\$ (964,000)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	2,000	2,000
Non Cash Compensation	47,000	555,000
Changes in:		
Royalty Receivable and other current assets	17,000	82,000
Accounts payable, accrued expenses and other current liabilities	(161,000)	(146,000)
Net cash used in operating activities	(753,000)	(471,000)
Cash and cash equivalents, beginning of period	3,022,000	4,484,000
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 2,269,000	\$ 4,013,000

SUPPLEMENTAL DISCLOSURE OF CASH FLOW
INFORMATION:

Cash paid during the periods for:

Interest	\$ —	\$ 1,000
Taxes	\$ 5,833	\$ 14,799

See notes to condensed financial statements

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

[1] BASIS OF PRESENTATION:

The accompanying condensed financial statements as of March 31, 2010 and for the three month periods ended March 31, 2010 and March 31, 2009, 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 March 31, 2010, and the results of its operations and its cash flows for the three month periods ended March 31, 2010 and March 31, 2009. 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, 2009 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 months ended March 31, 2010 are not necessarily indicative of the results of operations to be expected for the full year.

[2] BUSINESS:

(a) The principal business of the Company is the acquisition, development, licensing and protection of its intellectual property. The Company presently owns six patents covering various telecommunications and data networking technologies including, among others, patents covering the delivery of power over Ethernet cable for the purpose of remotely powering network devices, and the transmission of audio, video and data over computer and telephony networks. The Company’s strategy is to pursue licensing and strategic business alliances with companies in the industries that manufacture and sell products that make use of the technologies underlying its patents as well as with other users of the technology who benefit directly from the technology including corporate, educational and governmental entities. To date, the Company’s efforts with respect to its intellectual property have focused on licensing its patent (U.S. Patent No. 6,218,930) covering the control of power delivery over Ethernet cables (the “Remote Power Patent”). At least for the next twelve months, the Company does not currently anticipate licensing efforts for its other currently owned patents besides its Remote Power Patent. The Company may seek to acquire additional patents in the future. The Company continually reviews opportunities to acquire or license additional intellectual property for the purpose of pursuing licensing opportunities.

(b) As reflected in the accompanying financial statements, the Company has incurred substantial losses and has experienced net cash outflows from operations for the year ended December 31, 2009 and the three month period ended March 31, 2010. For the year ended December 31, 2009 and the three month period ended March 31, 2010, the Company had revenue of \$811,000 and \$118,000, respectively. The Company will continue to have

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

operating losses for the foreseeable future until it is successful in licensing its patented technologies. The Company has been dependent upon equity financing and royalty revenue from license of its Remote Power Patent to fund its operations. The Company had cash and cash equivalents of \$2,269,000 as of March 31, 2010. The Company believes its current cash position will more likely than not be sufficient to satisfy the Company's operations and capital requirements until at least June 30, 2011, although there can be no assurance that such funds will not be expended prior thereto.

[3] STOCK-BASED COMPENSATION:

During the three month period ended March 31, 2010 the Company recorded non-cash compensation expense of \$37,000 for the vested portion (62,500 shares) of options to purchase 750,000 shares issued to the Company's Chairman and Chief Executive Officer in June 2009 (See Note C). In addition, during the three month period ended March 31, 2010 and March 31, 2009 the Company recorded non-cash compensation expense of \$10,000 and \$14,000, respectively, for the vested portion of options granted to its Chief Financial Officer, directors and consultants prior to January 1, 2010.

On March 11, 2009, the Board of Directors of the Company approved adjustments to the exercise prices and terms of certain of its outstanding options and warrants as described below and as a result the Company recorded non-cash compensation expense of \$541,000 for the three month period ended March 31, 2010:

- (i) the exercise prices of certain outstanding compensatory options and warrants issued to officers, directors, consultants and others to purchase an aggregate of 5,029,945 shares of common stock were adjusted to an exercise price of \$0.68 per share (closing price of the Company's common stock on March 11, 2009) including options and warrants to purchase an aggregate of 4,031,195 shares held by the Company's Chairman and Chief Executive Officer, and an affiliated entity, options to purchase an aggregate of 150,000 shares held by the Company's Chief Financial Officer, and options and warrants to purchase an aggregate of 300,000 shares held by two directors of the Company;
- (ii) the exercise price of outstanding warrants to purchase an aggregate of 473,750 shares of common stock (including warrants to purchase 187,500 shares owned by a principal stockholder of the Company), issued as part of the Company's private placement completed in December 2004/January 2005, which exercise price was scheduled to increase to \$2.00 per share on March 31, 2009 (from \$1.75 per share) adjusted to an exercise price of \$1.75 for the remaining exercise period of such warrants (May 21, 2010), subject to the adjustment set forth in item (iv) below;
- (iii) the exercise price of warrants to purchase an aggregate of 1,666,667 shares of common stock, (including warrants to purchase an aggregate of 1,150,001 shares owned by three principal stockholders of the Company), at an exercise price of \$2.00 per share, which warrants were issued as part of the Company's private placement completed in April 2007, were adjusted to an exercise price

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

of \$1.75 per share for the remaining exercise period of such warrants (April 16, 2012), subject to the adjustments set forth in item (iv) below; and

(iv) in the event that any holders of the above referenced outstanding warrants, issued as part of the Company’s December 2004/January 2005 or the April 2007 private placements, exercise such warrants at anytime up to and including December 31, 2009, the exercise price of all such warrants shall adjust to \$1.25 per share. No such exercises of warrants took place.

On March 17, 2009, the Board of Directors of the Company extended the expiration dates until December 31, 2009 of outstanding warrants to purchase an aggregate of 395,000 shares of common stock, exercisable at \$1.45 per share, and outstanding warrants to purchase an aggregate of 197,500 shares of common stock, exercisable at \$2.00 per share, which expiration dates were scheduled to expire on March 17, 2009 and March 31, 2009, respectively.

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:

	THREE MONTHS ENDED MARCH 31,	
	2010	2009
Risk-free interest rates	—	0.44% - 1.87%
Expected option life in years	—	1-7 yrs
Expected stock price volatility	—	68.25%
Expected dividend yield	—	-0-

[4] REVENUE RECOGNITION:

The Company recognizes revenue received from the licensing of its intellectual property portfolio 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.

[5] LOSS PER SHARE:

Basic net loss per share is calculated by dividing the net 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 12,569,312 and 12,159,382 at March 31, 2010 and 2009, respectively, are anti-dilutive, and are not included in the calculation of diluted loss per share. Such potential common shares reflect outstanding options and warrants.

[6] CASH EQUIVALENTS:

The Company places cash investments in high quality financial institutions insured by the Federal Deposit Insurance Corporation (“FDIC”). At March 31, 2010, the Company maintained no cash balances in excess of FDIC limits.

Note B - COMMITMENTS AND CONTINGENCIES

Services Agreement:

On November 30, 2004, the Company entered into a master services agreement (the "Agreement") with ThinkFire Services USA, Ltd. ("ThinkFire") pursuant to which ThinkFire has been granted the exclusive worldwide rights (except for direct efforts by the Company and related companies) to negotiate license agreements for the Remote Power Patent with respect to certain potential licensees agreed to between the parties. Either the Company or ThinkFire can terminate the Agreement upon 60 days' notice for any reason or upon 30 days' notice in the event of a material breach. The Company has agreed to pay ThinkFire a fee ranging from 5% to 20% of the royalty payments received from license agreements consummated by ThinkFire on its behalf after the Company recovers its litigation related expenses.

Amended Patent Purchase Agreement:

On January 18, 2005, the Company and Merlot Communications, Inc. ("Merlot") amended the Patent Purchase Agreement originally entered into in November 2003 (the "Amendment") pursuant to which the Company paid additional purchase price of \$500,000 to Merlot in consideration for the restructuring of future contingent payments to Merlot from the licensing or sale of the Patents. The Amendment provides for future contingent payments by the Company to Merlot of \$1.0 million upon achievement of \$25 million of Net Royalties (as defined), an additional \$1.0 million upon achievement of \$50 million of Net Royalties and an additional \$500,000 upon achievement of \$62.5 million of Net Royalties from licensing or sale of the patents acquired from Merlot. Certain then principal stockholders of the Company and related parties were also principal stockholders and directors of Merlot at the time of the original agreement in November 2003 and the Amendment.

Legal Fees:

Dovel & Luner, LLP provides legal services to the Company with respect to the litigation commenced in February 2008 against several major data networking equipment manufacturers (See Note D[1]). The terms of the Company's agreement with Dovel & Luner, LLP provides for legal fees of a maximum aggregate cash payment of \$1.5 million plus a contingency fee of up to 24% depending upon when an outcome is achieved.

With respect to the Company's litigation against D-Link, which was settled in May 2007 (See Note D[2]), 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, the Company will 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 after the Company recovers its expenses related to the litigation.

Note C - Employment Arrangements and OTHER AGREEMENTS

On June 8, 2009, the Company entered into an Employment Agreement (the "Agreement") with Corey M. Horowitz pursuant to which he continues to serve as the Company's Chairman and Chief Executive Officer for a three year term 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. Mr. Horowitz also receives a cash bonus in an amount no less than \$150,000 on an annual basis for the three year term of the Agreement. In connection with the Agreement, Mr. Horowitz was issued a ten (10) year option to purchase 750,000 shares of common stock at an exercise price of \$0.83 per share, which vests in equal quarterly amounts of 62,500 shares beginning June 30, 2009 through March 31, 2012, subject to acceleration upon a change of control. Mr. Horowitz shall forfeit the balance of unvested shares if his employment has been terminated "For Cause" (as defined) by the Company or without Good Reason (as defined) by Mr. Horowitz. In addition to the aforementioned option grant, the Company extended for an additional five (5) years the expiration dates of all options (an aggregate of 417,500 shares) expiring in the calendar year 2009 owned by Mr. Horowitz.

Under the terms of the Agreement, Mr. Horowitz also receives additional bonus compensation in an amount equal to 5% of the Company's royalties or other payments (exclusive of proceeds from the sale of the Company's patents which is covered below) with respect to the Company's remote power patent (U.S. Patent No. 6,218,930), (the "Remote Power Patent") and 12.5% of the Company's royalties and other payments with respect to the Company's other patents besides the Remote Power Patent (the "Additional Patents") (all before deduction of payments to third parties including, but not limited to, legal fees and expenses and third party license fees) actually received from licensing its patented technologies (including patents owned as of the date of the Agreement and acquired or licensed on an exclusive basis during the period in which Mr. Horowitz continues to serve as an executive officer of the Company) (the "Royalty Bonus Compensation"). In addition, during the term of his employment, Mr. Horowitz is also entitled to additional bonus compensation equal to (i) 5% of the gross proceeds from the sale of the Company's Remote Power Patent and 12.5% of the gross proceeds from the sale of the Additional Patents, and (ii) 5% of the gross proceeds from the merger of the Company with or into another entity. The Royalty Bonus Compensation shall continue to be paid to Mr. Horowitz for the life of each of the Company's patents with respect to licenses entered into with third parties during Mr. Horowitz's term of employment or at anytime thereafter, whether Mr. Horowitz is employed by us or not; provided, that, Mr. Horowitz's employment has not been terminated by the Company "For Cause" (as defined) or terminated by Mr. Horowitz without "Good Reason" (as defined). In the event that Mr. Horowitz's employment is terminated by the Company "Other Than For Cause" (as defined) or by Mr. Horowitz for "Good Reason" (as defined), Mr. Horowitz shall also be entitled to (i) a lump sum severance payment of 12 months base salary, (ii) the minimum annual bonus of \$150,000 and (iii) accelerated vesting of all unvested options and warrants. In connection with the Agreement, Mr. Horowitz has 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 Mr. Horowitz.

Note C - Employment ARRANGEMENTS AND OTHER AGREEMENTS

On December 18, 2008, the Company entered into an agreement with David C. Kahn pursuant to which he continues to serve as the Company's Chief Financial Officer through December 31, 2010. In consideration for his services, Mr. Kahn was compensated at the rate of \$7,292 per month for the year ended December 31, 2009 and is compensated at the rate of \$7,657 per month for the year ended December 31, 2010. In connection with the agreement, Mr. Kahn was also issued a five (5) year option to purchase 100,000 shares of the Company's common stock at an exercise price of \$0.54 per share. The option vested 40,000 shares on the date of grant and the balance of the shares (60,000) will vest on a quarterly basis in equal amounts of 7,500 shares beginning March 31, 2009 through December 31, 2010. Upon a "Change in Control" (as defined) all of the unvested shares underlying the option shall become 100% vested and immediately exercisable. The agreement further provides that the Company may terminate the agreement at any time for any reason. In the event Mr. Kahn's services are terminated without "Good Cause" (as defined), he will be entitled to accelerated vesting of all unvested shares underlying the option and the lesser of (i) six months base monthly compensation or (ii) the remaining balance of the monthly compensation payable through December 31, 2010.

NOTE D - LITIGATION

[1] In February 2008, the Company commenced litigation against several major data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of the Company's Remote Power Patent. The complaint named as defendants Cisco Systems, Inc., Cisco Linksys, LLC, Enterasys Networks, Inc., 3COM Corporation, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Netgear, Inc. and Adtran, Inc. The Company seeks injunctive relief and monetary damages, for infringement based upon reasonable royalties as well as treble damages for the defendants' continued willful infringement of the Remote Power Patent. The Defendants, in their answers to the complaint, asserted that they do not infringe any valid claim of the Remote Power Patent, and further asserted that, based on several different theories, the patent claims are invalid or unenforceable. In addition to these defenses, the defendants also asserted counterclaims for, among other things, non-infringement, invalidity, and unenforceability of the Remote Power Patent. A Markman hearing, a hearing on claim construction of our Remote Power Patent, was held in December 2009 and a trial date has been set for July 2010. On February 16, 2010, the United States District Court for the Eastern District of Texas, Tyler Division, issued its Markman Order in which the Court adopted a number of constructions proposed by the Company, while also adopting constructions proposed by defendants as well as effectively invalidating two of the Company's claims at issue. A Markman Order that does not entirely adopt either the plaintiff's or defendants' position is common in patent litigation. In the event that the Court determines that the Remote Power Patent is not valid or enforceable, and/or that the defendants do not infringe, any such determination would have a material adverse effect on the Company.

On May 29, 2009 the Company announced that the Company had agreed to settle the above referenced litigation with respect to Netgear, Inc. ("Netgear"). As part of the settlement and under its Special Licensing Program, Netgear entered into a license agreement with the Company for the Remote Power Patent and the Company agreed that all claims and counterclaims involving Netgear in the litigation would be dismissed with prejudice. Under the terms of the license, Netgear licenses the Remote Power Patent from the Company for its

NOTE D - LITIGATION (continued)

full term (which expires in March 2020), and pays quarterly royalties (beginning as of April 1, 2009) based on its sales of Power over Ethernet products, including those Power over Ethernet products which comply with the Institute of Electrical and Electronic Engineers 802.3af and 802.3at Standards. Licensed products include Netgear's Power over Ethernet enabled switches and wireless access points. The royalty rates included in the license are 1.7% of the sales price of Power Sourcing Equipment, which includes Ethernet switches, and 2% of the sales price of Powered Devices, which includes wireless access points. The royalty rates are subject to adjustment, under certain circumstances, if the Company grants a license to other licensees with lower royalty rates and Netgear is able to and agrees to assume all material terms and conditions of such other license. In addition, Netgear made a payment of \$350,000 to the Company with respect to the settlement.

[2] In August 2005, the Company commenced patent litigation against D-Link Corporation and D-Link Systems, Incorporated (collectively "D-Link") in the United States District Court for the Eastern District of Texas, Tyler division, for infringement of its Remote Power Patent. The Company's complaint sought, among other things, a judgment that the Remote Power Patent is enforceable and has been infringed by the defendants. The Company also sought a permanent injunction restraining the defendants from continued infringement, or active inducement of infringement by others, of its Remote Power Patent.

In August 2007, the Company finalized the settlement of its patent infringement litigation against D-Link. Under the terms of the settlement, D-Link entered into a license agreement for the Company's Remote Power Patent the terms of which include monthly royalty payments of 3.25% (subject to adjustment as noted below) of the net sales of D-Link Power over Ethernet products, including those products which comply with the IEEE 802.3af and 802.3at Standards, for the full term of the Company's Remote Power Patent, which expires in March 2020. In addition, D-Link paid the Company \$100,000 upon signing of the Settlement Agreement. The royalty rate is subject to adjustment to a rate consistent with other similarly situated licensees of the Company's Remote Power Patent based on units of shipments of licensed products. In June 2009, based upon several licenses issued to third parties under the Company's Special Licensing Program, the Company agreed with D-Link to adjust the royalty rate to 1.7% of the sales price for Power Servicing Equipment (which includes Ethernet switches) and 2.0% of the sales price for Powered Devices (which includes wireless access points).

[3] On November 16, 2005, the Company entered into a Settlement Agreement with PowerDsine, Inc. and PowerDsine Ltd. (collectively, "PowerDsine") which dismissed, with prejudice, patent litigation brought by PowerDsine against the Company in March 2004 in the United States District Court for the Southern District of New York that sought a declaratory judgment that the Company's Remote Power Patent was invalid and not infringed by PowerDsine and/or its customers. Under the terms of the Settlement Agreement, the Company agreed that, under certain circumstances, it would not initiate litigation against PowerDsine for its sale of Power over Ethernet (PoE) integrated circuits. In addition, the Company agreed that it would not seek damages for infringement from customers that incorporate PowerDsine integrated circuit products in PoE capable Ethernet switches manufactured on or before April 30, 2006. PowerDsine has agreed that it will not initiate, assist or cooperate in any legal action relating to the Remote Power Patent. In June 2008 the Company entered into a new agreement with Microsemi Corp-Analog Mixed Signal Group

NOTE D - LITIGATION (continued)

Ltd (“Microsemi Analog”), previously PowerDsine Ltd, a subsidiary of Microsemi Corporation (“Microsemi”), a leading manufacturer of high performance analog mixed-signal integrated circuits and high reliability semiconductors, which, among other things, amended the prior Settlement Agreement entered into between the parties in November 2005. As part of the Company’s Special Licensing Program and its agreement with Microsemi Analog entered into in June 2008, Microsemi entered into a license agreement, dated August 13, 2008, with the Company with respect to its Remote Power Patent. The license agreement provides that Microsemi is obligated to pay the Company quarterly royalty payments of 2% of the sales price for certain of Microsemi’s Midspan PoE products for the full term of the Remote Power Patent (March 2020).

NOTE E –SUBSEQUENT EVENTS:

On April 16, 2010, the Company’s Board of Directors extended for three years the expiration dates of certain outstanding options to purchase an aggregate of 955,000 shares of common stock, exercisable at \$0.68 per share, which were to expire in 2010. Of these options, 750,000 are owned by CMH Capital Management Corp., an entity in which the Company’s Chairman and Chief Executive Office is the sole officer, director and shareholder, 5,000 are owned by the Company’s Chairman and Chief Executive Officer and 75,000 are owned by the Company’s Chief Financial Officer. The Company incurred non-cash compensation charges of \$153,000 with respect to the aforementioned option extensions. Also on April 16, 2010, the Company issued to two consultants aggregate options to purchase 200,000 shares of its common stock, at an exercise price of \$0.90 per share. The non-cash compensation charges incurred with respect to such option grants was \$73,000.

ITEM 2: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

THIS QUARTERLY REPORT ON FORM 10-Q CONTAINS FORWARD-LOOKING STATEMENTS WHICH ARE STATEMENTS THAT INCLUDE INFORMATION BASED UPON BELIEF OF OUR MANAGEMENT, AS WELL AS ASSUMPTIONS MADE BY AND INFORMATION AVAILABLE TO MANAGEMENT. STATEMENTS CONTAINING TERMS SUCH AS "BELIEVES", "EXPECTS", "ANTICIPATES", "INTENDS" OR SIMILAR WORDS ARE INTENDED TO IDENTIFY FORWARD LOOKING STATEMENTS. ACTUAL RESULTS, EVENTS AND CIRCUMSTANCES (INCLUDING FUTURE PERFORMANCE, RESULTS AND TRENDS) COULD DIFFER MATERIALLY FROM THOSE SET FORTH IN SUCH STATEMENTS DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING, BUT NOT LIMITED TO, THOSE DISCUSSED BEGINNING ON PAGES 9-14 OF OUR ANNUAL REPORT ON FORM 10-K FOR THE YEAR 2009.

OVERVIEW

Our principal business is the acquisition, development, licensing and protection of our intellectual property. We presently own six patents covering various telecommunications and data networking technologies including, among others, patents covering the delivery of power over Ethernet for the purpose of remotely powering network devices, and the transmission of audio, video and data over computer and telephony networks. Our strategy is to pursue licensing and strategic business alliances with companies in the industries that manufacture and sell products that make use of the technologies underlying our patents as well as with other users of the technology who benefit directly from the technology including corporate, educational and governmental entities.

To date, our efforts with respect to our intellectual property have 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"). As of March 31, 2010, we had entered into six license agreements with respect to our Remote Power Patent which, among others, included license agreements with D-Link, Microsemi Corporation and Netgear, Inc. (See Note D to our financial statements included as part of our Quarterly Report). During the next 12 months we do not presently anticipate licensing efforts for our other currently owned patents besides our Remote Power Patent. We may seek to acquire additional patents in the future.

To date we have incurred significant losses and at March 31, 2010 had an accumulated deficit of \$(54,131,000). For the year ended December 31, 2009 and for the three months ended March 31, 2010, we incurred net losses of \$(2,578,000) and \$(658,000), respectively. We anticipate that we will continue to incur losses until we enter into additional license agreements with respect to our patented technologies. We achieved revenue of \$811,000 from our technology licensing business for the year ended December 31, 2009 and \$118,000 for the three months ended March 31, 2010 with respect to royalties pertaining to our Remote Power Patent. Our inability to consummate additional material license agreements and achieve revenue from our patented technologies would have a material adverse effect on our operations and our ability to continue business.

Our success and ability to generate revenue is largely dependent on our ability to consummate licensing arrangements with third parties. In November 2004, we entered into an agreement with ThinkFire Services USA, Ltd. ("ThinkFire") pursuant to which ThinkFire

has been granted the exclusive worldwide rights to negotiate license agreements for our Remote Power Patent with certain agreed-upon potential licensees. We have agreed to pay ThinkFire a fee of up to 20% of the royalty payments received from license agreements consummated by ThinkFire on our behalf after we recover our expenses.

In August 2007 we finalized the settlement of our patent litigation against D-Link in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent (U.S. Patent No. 6,218,930). Under the terms of the settlement, D-Link licenses our the Remote Power Patent the terms of which include monthly royalty payments of 3.25% (as adjusted as noted below) of the net sales of D-Link branded Power over Ethernet products, including those products which comply with the IEEE 802.3af and 802.3at Standards, for the full life of our Remote Power Patent, which expires in March 2020. In addition, D-Link paid us \$100,000 upon signing the settlement agreement. The royalty rate is subject to adjustment beginning to a rate consistent with other similarly situated licensees of our Remote Power Patent based on units of shipments of licensed products. In June 2009, based upon several licenses issued to third parties under the Company's Special Licensing Program, the Company agreed with D-Link to adjust the royalty rate to 1.7% of the sales price for Power Servicing Equipment (which includes Ethernet switches) and 2.0% of the sales price for Powered Devices (which includes wireless access points).

In February 2008, we commenced litigation against eight major data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent. The complaint named as defendants Cisco Systems, Inc., Cisco Linksys, LLC, Enterasys Networks, Inc., 3COM Corporation, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Netgear, Inc. and Adtran, Inc. We seek injunctive relief and monetary damages for infringement based upon reasonable royalties as well as treble damages for the defendants' continued willful infringement of our Remote Power Patent. The defendants answered the complaint and asserted that they do not infringe any valid claim of our Remote Power Patent, and further asserted that, based on several different theories, the patent claims are invalid or unenforceable. In addition to these defenses, the defendants also asserted counterclaims for, among other things, non-infringement, invalidity, and unenforceability of our Remote Power Patent. A Markman hearing, a hearing on claim construction of our Remote Power Patent, was held in December, 2009. On February 16, 2010, the United States District Court for the Eastern District of Texas, Tyler Division, issued its Markman Order in which the Court adopted a number of constructions proposed by us, while also adopting constructions proposed by defendants as well as effectively invalidating two of our claims at issue. A Markman Order that does not entirely adopt either the plaintiff's or defendants' position is common in patent litigation. A trial date has been set for July, 2010. In the event that the Court determines that our Remote Power Patent is not valid or enforceable, and/or that the defendants do not infringe, any such determination would have a material adverse effect on us.

On May 29, 2009 we announced that we had agreed to settle the above referenced litigation with respect to Netgear, Inc. ("Netgear"). As part of the settlement and under our Special Licensing Program, Netgear entered into a license agreement with us for our Remote Power Patent. Under the terms of the license, Netgear licenses the Remote Power Patent from us for its full term (which expires in March 2020), and pays quarterly royalties (which began as of April 1, 2009) based on its sales of Power over Ethernet products, including

those Power over Ethernet products which comply with the Institute of Electrical and Electronic Engineers 802.3af and 802.3at Standards. Licensed products include Netgear's Power over Ethernet enabled switches and wireless access points. The royalty rates included in the license are 1.7% of the sales price of Power Sourcing Equipment, which includes Ethernet switches, and 2% of the sales price of Powered Devices, which includes wireless access points. The royalty rates are subject to adjustment, under certain circumstances, if we grant a license to other licensees with lower royalty rates and Netgear is able to and agrees to assume all material terms and conditions of the other license. In addition, Netgear made a payment to us of \$350,000 with respect to the settlement.

In August 2007 we finalized the settlement of our patent litigation against D-Link in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent (U.S. Patent No. 6,218,930). Under the terms of the settlement, D-Link licenses our Remote Power Patent the terms of which include monthly royalty payments of 3.25% (as adjusted as noted below) of the net sales of D-Link branded Power over Ethernet products, including those products which comply with the IEEE 802.3af and 802.3at Standards, for the full life of our Remote Power Patent, which expires in March 2020. In addition, D-Link paid us \$100,000 upon signing the settlement agreement. The royalty rate is subject to adjustment to a rate consistent with other similarly situated licensees of our Remote Power Patent based on units of shipments of licensed products. In June 2009, based upon several licenses issued to third parties under our Special Licensing Program, we agreed with D-Link to adjust the royalty rate to 1.7% of the sales price for Power Servicing Equipment (which includes Ethernet switches) and 2.0% of the sales price for Powered Devices (which includes wireless access points).

As part of our Special Licensing Program and our agreement with Microsemi Corp-Analog Mixed Signal Group Ltd. ("Microsemi-Analog") entered into in June 2009, Microsemi Corporation ("Microsemi"), the parent company of Microsemi-Analog, entered into a license agreement, dated August 13, 2009, with us with respect to the Remote Power Patent. The license agreement provides that Microsemi is obligated to pay us quarterly royalty payments of 2% of the sales price for certain of Microsemi's Midspan PoE products for the full term of the Remote Power Patent (through March 2020).

Notwithstanding our license agreements with Netgear, D-Link and Microsemi described above, there is no assurance that we will achieve significant royalty revenue from such licenses, that we will be able to achieve additional material license agreements with third parties relating to our Remote Power Patent or our other patents, or that such license arrangements will result in material revenue to us.

RESULTS OF OPERATIONS

Three Months Ended March 31, 2010 Compared To Three Months Ended March 31, 2009

We had revenues of \$118,000 and \$27,000 for the three months ended March 31, 2010 and March 31, 2009, respectively, which were related to the receipt of royalties pursuant to our license agreements with D-Link, Microsemi and others. The revenue increase of \$81,000 for the three months ended March 31, 2010 as compared to the three months ended March 31, 2009 was due to additional license agreements.

We had a cost of revenue of \$6,000 and \$1,000 for the three months ended March 31, 2010 and March 31, 2009, respectively, which was related to the payment of bonus compensation based upon royalties pursuant to our employment agreement with our Chief Executive Officer. The gross profit for the three months ended March 31, 2010 was \$112,000 as compared to \$26,000 for the three months ended March 31, 2009.

General and administrative expenses include overhead expenses, and finance, accounting, legal and other professional services incurred by us. General and administrative expenses increased by \$287,000, from \$436,000 for the three months ended March 31, 2009 to \$724,000 for the three months ended March 31, 2010, due primarily to increased fees and expenses with respect to litigation involving our Remote Power Patent.

We incurred an operating loss of (\$658,000) for the three months ended March 31, 2010 compared with an operating loss of (\$965,000) for the three months ended March 31, 2009. Included in the operating loss for the three months ended March 31, 2010 was \$47,000 in charges relating to non-cash compensation expenses due primarily to the adjustment of the exercise prices of certain outstanding options and warrants (See Note A[3] to our financial statements included herein) as compared to \$555,000 for such non-cash expenses for the three months ended March 31, 2009.

No provision for or benefit from federal, state or foreign income taxes was recorded for three months ended March 31, 2010 and March 31, 2009 because we incurred net operating losses and fully reserved our deferred tax assets as their future realization could not be determined.

As a result of the foregoing, we incurred a net loss of \$(658,000) for the three months ended March 31, 2010 compared with a net loss of \$(964,000) for the three months ended March 31, 2009.

LIQUIDITY AND CAPITAL RESOURCES

We have financed our operations primarily from the sale of equity securities and royalty revenue from licensing our Remote Power Patent. We anticipate, based on currently proposed plans and assumptions, relating to our operations, that our cash and cash equivalents of approximately \$2,269,000 as of March 31, 2010 will more likely than not be sufficient to satisfy our operations and capital requirements until at least June 30, 2011. There can be no assurance, however, that such funds will not be expended prior thereto. In the event our plans change, or our assumptions change, or prove to be inaccurate (due to unanticipated expenses, difficulties, delays or otherwise), we may have insufficient funds to support our operations prior to June 30, 2011. Our inability to consummate licensing arrangements with respect to our Remote Power Patent and generate revenues therefrom on a timely basis or obtain additional financing when needed would have a material adverse effect on our company, requiring us to curtail or cease operations. In addition, any equity financing may involve substantial dilution to our current stockholders.

OFF-BALANCE SHEET ARRANGEMENTS

We do not have any off-balance sheet arrangements.

CONTRACTUAL OBLIGATIONS

We do not have any long-term debt, capital lease obligations, operating lease obligations, purchase obligations or other long-term liabilities.

Critical Accounting Policies:

Patents:

We own a patent portfolio that relates to various telecommunications and data networking technologies. We capitalize the costs associated with acquisition, registration and maintenance of the patents and amortizes these assets over their remaining useful lives on a straight-line basis. Any further payments made to maintain or develop the patents would be capitalized and amortized over the balance of the useful life for the patents.

Impairment of long-lived assets:

We record impairment losses on long-lived assets used in operations or expected to be disposed of when indicators of impairment exist and the cash flows expected to be derived from those assets are less than carrying amounts of those assets.

Use of estimates:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Not Applicable

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures.

Our Chief Executive Officer and Chief Financial Officer have reviewed our disclosure controls and procedures of the Company as of the end of the period covered by this Quarterly Report on Form 10-Q. Based upon this review, these officers concluded that, as of the end of the period covered by this Quarterly Report on Form 10-Q, our disclosure controls and procedures are effective to ensure that information required to be disclosed by us in the reports we file or submit under Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in applicable rules and forms and is accumulated and communicated to management, including our Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

(b) Changes in Internal Controls

There was no change in our internal control over financial reporting that occurred during the fiscal quarter ended March 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1: LEGAL PROCEEDINGS

Pending Litigation Against Major Data Networking Equipment Manufacturers

In February 2008, we commenced litigation against eight major data networking equipment manufacturers in the United States District Court for the Eastern District of Texas, Tyler Division, for infringement of our Remote Power Patent. Our complaint named as defendants Cisco Systems, Inc., Cisco Linksys, LLC, Enterasys Networks, Inc., 3COM Corporation, Inc., Extreme Networks, Inc., Foundry Networks, Inc., Netgear, Inc. and Adtran, Inc. We seek injunctive relief and monetary damages for infringement based upon reasonable royalties as well as treble damages for the defendants' continued willful infringement of our Remote Power Patent. The defendants, in their answers to our complaint, have asserted that they do not infringe any valid claim of our Remote Power Patent, and further asserted that, based on several different theories, the patent claims are invalid or unenforceable. In addition to these defenses, the defendants also asserted counterclaims for, among other things, non-infringement, invalidity, and unenforceability of our Remote Power Patent. A Markman hearing, a hearing on claim construction of our Remote Power Patent, was held in December 2009 and a trial date has been set for July, 2010. On February 16, 2010, the United States District Court for the Eastern District of Texas, Tyler Division, issued its Markman Order in which the Court adopted a number of constructions proposed by us, while also adopting constructions proposed by defendants as well as effectively invalidating two of our claims at issue. A Markman Order that does not entirely adopt either the plaintiff's or defendants' position is common in patent litigation. In the event that the Court determines that our Remote Power Patent is not valid or enforceable, and/or that the defendants do not infringe, any such determination would have a material adverse effect on our company.

On May 29, 2009 we announced that we had agreed to settle the above referenced litigation with respect to Netgear, Inc. ("Netgear"). As part of the settlement and under its Special Licensing Program, Netgear entered into a license agreement with us for the Remote Power Patent and we agreed that all claims and counterclaims involving Netgear in the litigation would be dismissed with prejudice. Under the terms of the license, Netgear licenses our Remote Power Patent from us for its full term (which expires in March 2020), and pays quarterly royalties (beginning as of April 1, 2009) based on its sales of Power over Ethernet products, including those Power over Ethernet products which comply with the Institute of Electrical and Electronic Engineers 802.3af and 802.3at Standards. Licensed products include Netgear's Power over Ethernet enabled switches and wireless access points. The royalty rates included in the license are 1.7% of the sales price of Power Sourcing Equipment, which includes Ethernet switches, and 2% of the sales price of Powered Devices, which includes wireless access points. The royalty rates are subject to adjustment, under certain circumstances, if we grant a license to other licensees with lower royalty rates and Netgear is able to and agrees to assume all material terms and conditions of such other license. In addition, Netgear made a payment of \$350,000 to us with respect to the settlement.

D-Link Settlement

In August 2005, we commenced patent litigation against D-Link Corporation and D-Link Systems, Incorporated (collectively “D-Link”) in the United States District Court for the Eastern District of Texas, Tyler division, for infringement of its Remote Power Patent. Our complaint sought, among other things, a judgment that the Remote Power Patent is enforceable and has been infringed by the defendants. We also sought a permanent injunction restraining the defendants from continued infringement, or active inducement of infringement by others, of its Remote Power Patent.

In August 2007, we finalized the settlement of its patent infringement litigation against D-Link. Under the terms of the settlement, D-Link entered into a license agreement for our Remote Power Patent the terms of which include monthly royalty payments of 3.25% (subject to adjustment as noted below) of the net sales of D-Link Power over Ethernet products, including those products which comply with the IEEE 802.3af and 802.3at Standards, for the full term of the Remote Power Patent, which expires in March 2020. In addition, D-Link paid us \$100,000 upon signing of the Settlement Agreement. The royalty rate is subject to adjustment to a rate consistent with other similarly situated licensees of our Remote Power Patent based on units of shipments of licensed products. In June 2009, based upon several licenses issued to third parties under our Special Licensing Program, we agreed with D-Link to adjust the royalty rate to 1.7% of the sales price for Power Servicing Equipment (which includes Ethernet switches) and 2.0% of the sales price for Powered Devices (which includes wireless access points).

Microsemi (PowerDsine) Settlement

On November 16, 2005, we entered into a Settlement Agreement with PowerDsine, Inc. and PowerDsine Ltd. (collectively, “PowerDsine”) which dismissed, with prejudice, patent litigation brought by PowerDsine against us in March 2004 in the United States District Court for the Southern District of New York that sought a declaratory judgment that our Remote Power Patent was invalid and not infringed by PowerDsine and/or its customers. Under the terms of the Settlement Agreement, we agreed that, under certain circumstances, it would not initiate litigation against PowerDsine for its sale of Power over Ethernet (PoE) integrated circuits. In addition, we agreed that it would not seek damages for infringement from customers that incorporate PowerDsine integrated circuit products in PoE capable Ethernet switches manufactured on or before April 30, 2006. PowerDsine has agreed that it will not initiate, assist or cooperate in any legal action relating to the Remote Power Patent. In June 2008 we entered into a new agreement with Microsemi Corp-Analog Mixed Signal Group Ltd (“Microsemi Analog”), previously PowerDsine Ltd, a subsidiary of Microsemi Corporation (“Microsemi”), a leading manufacturer of high performance analog mixed-signal integrated circuits and high reliability semiconductors, which, among other things, amended the prior Settlement Agreement entered into between the parties in November 2005. As part of our Special Licensing Program and our agreement with Microsemi Analog entered into in June 2008, Microsemi entered into a license agreement, dated August 13, 2008, with us with respect to its Remote Power Patent. The license agreement provides that Microsemi is obligated to pay us quarterly royalty payments of 2% of the sales price for certain of Microsemi’s Midspan PoE products for the full term of our Remote Power Patent (March 2020).

ITEM 1A. Risk Factors.

Our operations and financial results are subject to various risks and uncertainties that could adversely affect our business, financial condition, results of operations and trading price of our common stock.

Our Annual Report on Form 10-K for the year ended December 31, 2009 includes a detailed discussion of our risk factors and should be carefully considered by investors.

ITEM 2. Unregistered Sales of Equity Securities and Use of Proceeds.

None.

ITEM 3. Defaults Upon Senior Securities.

None.

ITEM 5. Other Information.

None.

ITEM 6. Exhibits

(a) Exhibits

31.1 Controls and Procedure Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Controls and Procedure Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

NETWORK-1 SECURITY SOLUTIONS, INC.

By: /s/ Corey M. Horowitz
Corey M. Horowitz
Chairman and Chief Executive
Officer

By: /s/ David C. Kahn
David C. Kahn
Chief Financial Officer

Date: May 14, 2010

